Professional Level – Essentials Module

Business Analysis

Wednesday 10 June 2009

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

This paper is divided into two sections:

Section A – This ONE question is compulsory and MUST be attempted

Section B – TWO questions ONLY to be attempted

Do NOT open this paper until instructed by the supervisor.

During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.

This question paper must not be removed from the examination hall.

The Association of Chartered Certified Accountants

Paper P3

ACCA

Section A – This ONE question is compulsory and MUST be attempted

The following information should be used when answering question 1.

1 *greenTech* was established in 1990. The company began by specialising in the supply of low voltage, low emission, quiet, recyclable components to the electronic industry. Its components are used in the control systems of lifts, cars and kitchen appliances. Two medium-sized computer manufacturers use *greenTech* components in selected 'green' (that is, environmentally-friendly) models in their product range. Recent market research showed that 70% of the global electronics industry used *greenTech* components somewhere in its products.

In 1993 the company began a catalogue mail order service (now Internet-based) selling 'green' components to home users. Most of these customers were building their own computers and they required such components on either environmental grounds or because they wanted their computers to be extremely quiet and energy efficient. From 2005, *greenTech* also offered fully assembled computer systems that could be ordered and configured over the Internet. All *greenTech*'s components are purchased from specialist suppliers. The company has no manufacturing capability, but it does have extensive hardware testing facilities and it has built up significant technical know-how in supplying appropriate components. The management team that formed the company in 1990 still runs the company.

Finance and revenue

The company has traded profitably since its foundation and has grown steadily in size and revenues. In 2008, its revenues were $64 million, with a pre-tax profit of $10 million. The spread across the three revenue streams is shown in Figure 1:

All figures in $million	2008	2007	2006
Component sales to electronics industry	40	36	34
Component sales to home users	20	18	16
Fully assembled green computers	4	3	2
Total	64	57	52

Figure 1: Turnover by revenue stream 2006–2008

The company has gradually accumulated a sizeable cash surplus. The board cannot agree on how this cash should be used. One beneficiary has been the marketing budget (see Figure 2), but the overall spend on marketing still remains relatively modest and, by April 2008, the cash surplus stood at $17 million.

All figures in $	2008	2007	2006
Internet development & marketing	100,000	70,000	60,000
Display advertising (manufacturers)	50,000	40,000	30,000
Display advertising (domestic customers)	20,000	15,000	15,000
Exhibitions & conferences	30,000	20,000	15,000
Marketing literature	10,000	5,000	5,000
Total	210,000	150,000	125,000

Figure 2: Marketing budget 2006–2008

Company Doctor

In 2008 a television company wrote to *greenTech* to ask whether it would consider taking part in a television programme called 'Company Doctor'. In this programme three teams of consultants spend a week at a chosen company working on a solution to a problem identified by the company. At the end of the week all three teams present their proposal for dealing with the problem. A panel of experts, including representatives from the company, pick the winner and, in theory, implement the winning proposal. *greenTech* agreed to take part in the programme and selected their future strategic direction as the problem area to be analysed. Their cash surplus would then be used to fund the preferred option. The show was recorded in September 2008 to be transmitted later in the year. A brief summary of the conclusions of each team of consultants is given below.

– The accountants Lewis-Read suggested a strategic direction that planned to protect and build on *greenTech's* current strategic position. They believed that the company should invest in marketing the fully assembled 'green' computers to both commercial and home customers. They pointed out that the government had just agreed a preferential procurement policy for energy efficient computers with high recyclable content. 'This segment of the market is rapidly expanding and is completely under-exploited by *greenTech* at the moment', Lewis-Read concluded.

– The corporate recovery specialists, Fenix, put forward a strategic direction that essentially offered more services to *greenTech*'s current customers in the electronics industry. They suggested that the company should expand its product range as well as being able to manufacture components to respond to special requirements. They also believed that potential supply problems could be avoided and supply costs could be cut if *greenTech* acquired its own manufacturing capability. 'You need to secure the supply chain, to protect your future position.' They felt that the surplus cash in the company should be used to acquire companies that already had these manufacturing capabilities.

– The third team was led by Professor Ag Wan from MidShire University. Their main recommendation was that *greenTech* should not see itself as a supplier of components and computers but as a supplier of green technology. They suggested that the company should look at many other sectors (not just electronics) where quietness, low emissions and recyclable technology were important. 'The company needs to exploit its capabilities, not its products. It is looking too narrowly at the future. To compete in the future you need to develop your markets, not your products', concluded the professor.

Figure 3, which was shown on the television show, illustrates how each solution came from a different part of an amended Ansoff product/market matrix.

		Products	
		Existing	**New**
Markets	Existing	Protect/Build *Lewis-Read (option 1)*	Product development with new capabilities *Fenix (option 2)*
	New	Market Development with new uses and capabilities *Professor Ag Wan (option 3)*	No team chose this option Diversification

Figure 3: Adapted Ansoff matrix showing the position of the three solutions

In the television programme, the panel chose option 3 (as suggested by Professor Ag Wan's team) as being the most appropriate strategic direction and, much to everyone's surprise, the company began to pursue this direction with much vigour. Objectives and goals were established and a set of processes was designed to facilitate business-to-business transactions with potential new customers. These processes allow customers, by using computer-aided design software, to view the specification of products available, to assemble them and to integrate their own components into the design. This means that they are able to construct virtual prototypes of machines and equipment. This process design, delivered through a web service, is still under development.

Tackling operational problems

In parallel, *greenTech* has decided to make tactical changes to current processes where the company has received poor customer feedback. One of these is the ordering of fully assembled green computers. The current Internet-based process for ordering and configuring these computers is described below. A swim-lane diagram (flowchart) showing the process is also included as Figure 4.

On-line customers use the *greenTech* web site to enter the specific computer configuration they require. These details are fed through to the sales department at *greenTech* which then e-mails Xsys – *greenTech*'s Korean manufacturer – to ask for a delivery date for the requested computer. Xsys e-mails the date back to *greenTech* which then e-mails the customer with delivery and cost details. The customer then decides whether they wish to proceed with their order. Currently, 40% of enquiries proceed no further, which is of concern to *greenTech* as it means that time and effort have been wasted.

For those enquiries that do proceed, customers are invited to enter their payment details (credit card only). These details are sent directly to Equicheck – a specialist credit checking agency. About 20% of orders are rejected at this point because the potential customer has a poor credit rating. For orders that pass the credit check, a payment confirmation is raised by *greenTech* and sent to the customer and *greenTech* place a confirmed order with Xsys for the computer.

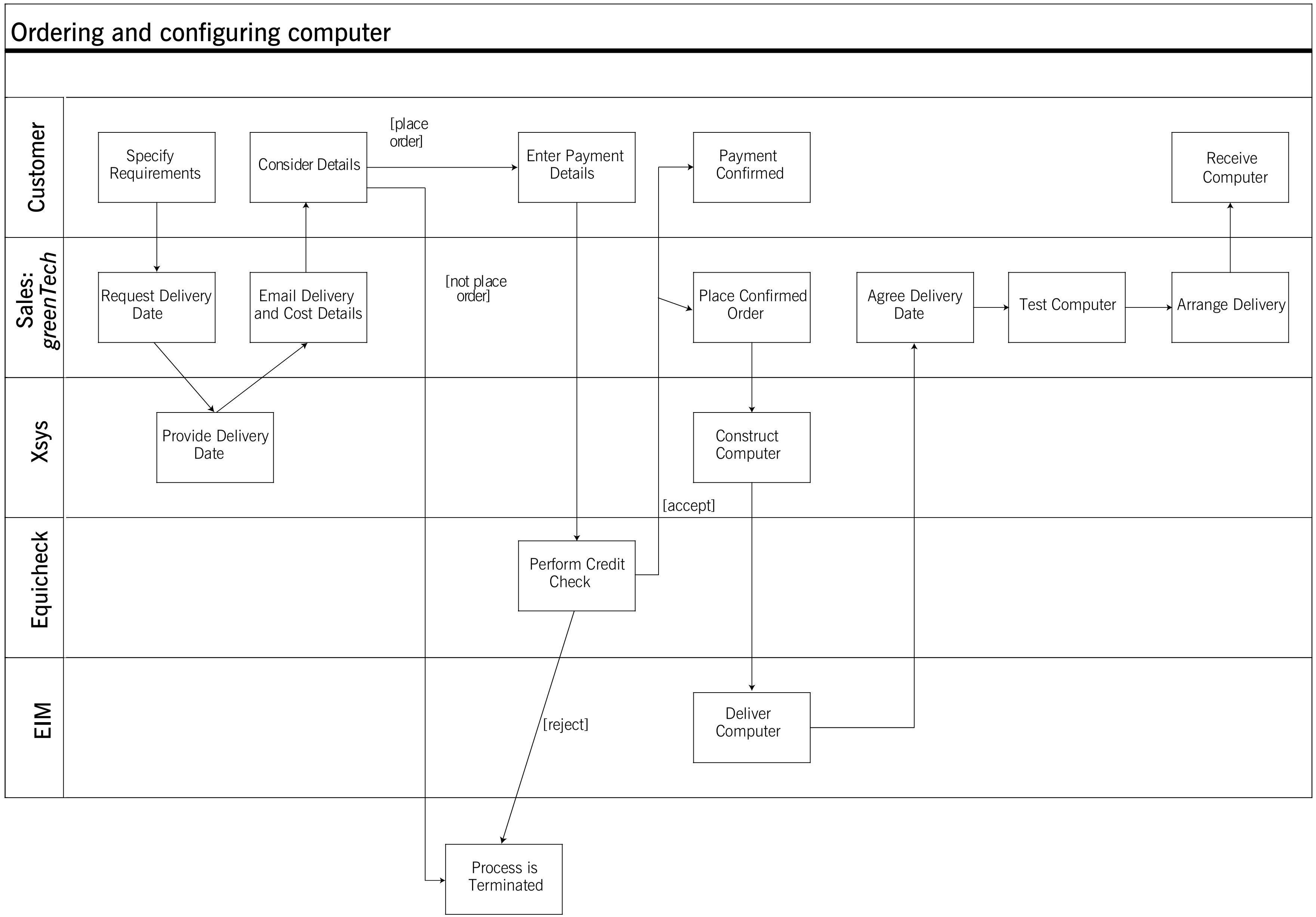

Figure 4: The process of ordering and configuring a computer

When Xsys has completed the construction of the computer it arranges for the international logistics company EIM to deliver the machine to *greenTech* for testing. After acceptance testing the machine, *greenTech* e-mails the customer, agrees a delivery date and arranges for delivery by courier.

Recent feedback from customers suggests that missing promised delivery dates is their biggest complaint. This is because the delivery date agreed early in the order process cannot necessarily be matched by Xsys when it actually receives the confirmed order. Figure 4 shows the process involved.

Required:

(a) Evaluate the current strategic position of *greenTech* using a SWOT analysis. (12 marks)

(b) The panel selected the proposal of Professor Ag Wan as the winning proposal.

Write a briefing paper evaluating the three proposals and justifying the selection of the proposal of Professor Ag Wan as the best strategic option for *greenTech* to pursue.

Note: requirement (b) includes 2 professional marks. (20 marks)

(c) (i) Identify deficiencies in the current Internet-based process for ordering and configuring fully assembled green computers. Recommend a new process, together with its implications, for remedying these deficiencies. (10 marks)

(ii) The board is determined to link strategy with current and future processes.

Analyse the relationship between process design and strategic planning using the context of *greenTech* to illustrate your analysis.

Note: requirement (c)(ii) includes 2 professional marks. (8 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 This scenario summarises the development of a company called Rock Bottom through three phases, from its founding in 1965 to 2008 when it ceased trading.

Phase 1 (1965–1988)

In 1965 customers usually purchased branded electrical goods, largely produced by well-established domestic companies, from general stores that stocked a wide range of household products. However, in that year, a recent university graduate, Rick Hein, established his first shop specialising solely in the sale of electrical goods. In contrast to the general stores, Rick Hein's shop predominantly sold imported Japanese products which were smaller, more reliable and more sophisticated than the products of domestic competitors. Rick Hein quickly established a chain of shops, staffed by young people who understood the capabilities of the products they were selling. He backed this up with national advertising in the press, an innovation at the time for such a specialist shop. He branded his shops as 'Rock Bottom', a name which specifically referred to his cheap prices, but also alluded to the growing importance of rock music and its influence on product sales. In 1969, 80% of sales were of music centres, turntables, amplifiers and speakers, bought by the newly affluent young. Rock Bottom began increasingly to specialise in selling audio equipment.

Hein also developed a high public profile. He dressed unconventionally and performed a number of outrageous stunts that publicised his company. He also encouraged the managers of his stores to be equally outrageous. He rewarded their individuality with high salaries, generous bonus schemes and autonomy. Many of the shops were extremely successful, making their managers (and some of their staff) relatively wealthy people.

However, by 1980 the profitability of the Rock Bottom shops began to decline significantly. Direct competitors using a similar approach had emerged, including specialist sections in the large general stores that had initially failed to react to the challenge of Rock Bottom. The buying public now expected its electrical products to be cheap and reliable. Hein himself became less flamboyant and toned down his appearance and actions to satisfy the banks who were becoming an increasingly important source of the finance required to expand and support his chain of shops.

Phase 2 (1989–2002)

In 1988 Hein considered changing the Rock Bottom shops into a franchise, inviting managers to buy their own shops (which at this time were still profitable) and pursuing expansion though opening new shops with franchisees from outside the company. However, instead, he floated the company on the country's stock exchange. He used some of the capital raised to expand the business. However, he also sold shares to help him throw the 'party of a lifetime' and to purchase expensive goods and gifts for his family. Hein became Chairman and Chief Executive Officer (CEO) of the newly quoted company, but over the next thirteen years his relationship with his board and shareholders became increasingly difficult. Gradually new financial controls and reporting systems were put in place. Most of the established managers left as controls became more centralised and formal. The company's performance was solid but unspectacular. Hein complained that 'business was not fun any more'. The company was legally required to publish directors' salaries in its annual report and the generous salary package enjoyed by the Chairman and CEO increasingly became an issue and it dominated the 2002 Annual General Meeting (AGM). Hein was embarrassed by its publication and the discussion it led to in the national media. He felt that it was an infringement of his privacy and civil liberties.

Phase 3 (2003–2008)

In 2003 Hein found the substantial private equity investment necessary to take Rock Bottom private again. He also used all of his personal fortune to help re-acquire the company from the shareholders. He celebrated 'freeing Rock Bottom from its shackles' by throwing a large celebration party. Celebrities were flown in from all over the world to attend. However, most of the new generation of store managers found Hein's style to be too loose and unfocused. He became rude and angry about their lack of entrepreneurial spirit. Furthermore, changes in products and how they were purchased meant that fewer people bought conventional audio products from specialist shops. The reliability of these products now meant that they were replaced relatively infrequently. Hein, belatedly, started to consider selling via an Internet site. Turnover and profitability plummeted. In 2007 Hein again considered franchising the company, but he realised that this was unlikely to be successful. In early 2008 the company ceased trading and Hein himself, now increasingly vilified and attacked by the press, filed for personal bankruptcy.

Required:

(a) **Analyse the reasons for Rock Bottom's success or failure in each of the three phases identified in the scenario. Evaluate how Rick Hein's leadership style contributed to the success or failure of each phase.** (18 marks)

(b) Rick Hein considered franchising the Rock Bottom brand at two points in its history – 1988 and 2007.

Explain the key factors that would have made franchising Rock Bottom feasible in 1988, but would have made it 'unlikely to be successful' in 2007. (7 marks)

(25 marks)

3 OneEnergy plc supplies over half of the electricity and gas in the country. It is an expanding, aggressive company which has recently acquired two smaller, but significant, competitors.

Just over a year ago, OneEnergy purchased the RitePay payroll software package from RiteSoftware. The recently appointed Human Resources (HR) director of OneEnergy recommended the package because he had used it successfully at his previous employer – a major charity. His unreserved recommendation was welcomed by the board because the company was currently running three incompatible payroll systems. The purchase of the RitePay payroll system appeared to offer the opportunity to quickly consolidate the three separate payroll systems into one improved solution. The board decided to purchase the software without evaluating alternative solutions. It was felt that payroll rules and processes were relatively standard and so there was no need to look further than a package recommended by the HR director. The software was purchased and a project initiated for converting the data from the current systems and for training users in the features and functions of the new software.

However, it soon became apparent that there were problems with the suitability of the RitePay software package. Firstly, OneEnergy had a wide variety of reward and pay schemes to reflect previous employment in the acquired companies and to accommodate a wide range of different skills and grades. Not all of these variations could be handled by the package. Consequently, amendments had to be commissioned from the software house. This led to unplanned costs and also to delays in implementation. Secondly, it also became clear that the software was not as user-friendly as the previous systems. Users had problems understanding some of the terminology and structure of the software. 'It just does not work like we do', commented one frustrated user. Consequently users made more errors than expected and training costs exceeded their budget.

Three months ago, another set of amendments was requested from RiteSoftware to allow one of the acquired companies in OneEnergy to pay bonuses to lorry drivers in a certain way. Despite repeated requests, the amendments were not received. Two weeks ago, it was announced that RiteSoftware had filed for bankruptcy and all software support was suspended. Just before this was announced the HR director of OneEnergy left the company to take up a similar post in the public sector.

OneEnergy has engaged W&P consultants to advise them on the RitePay project. An interim report from W&P suggests that OneEnergy should abandon the RitePay package. 'It is clear to us that RitePay never had the functionality required to fulfil the variety of requirements inevitable in a company the size of OneEnergy.' They also commented that this could have been avoided if the project had followed the competitive procurement policy defined in company operating procedures.

W&P also reports that:

– The procurement department at OneEnergy had requested two years of accounts from RiteSoftware. These were provided (see Figure 1) but not interpreted or used in the selection process in any way. W&P concluded 'that there were clear signs that the company was in difficulty and this should have led to further investigation'.

– They discovered that the former HR director of OneEnergy was the brother of the managing director of RiteSoftware.

Figure 1: RiteSoftware Accounts

Extract from the statement of financial position	$000	
Assets		
Non-current assets	2008	2007
Property, plant and equipment	30	25
Goodwill	215	133
	245	158
Current assets		
Inventories	3	2
Trade receivables	205	185
	208	187
Total assets	453	345
Liabilities		
Current liabilities		
Trade payables	257	178
Current tax payable	1	2
Bank overdraft	10	25
	268	205
Non-current liabilities		
Long-term borrowings	80	35
Total liabilities	348	240
Equity		
Share capital	105	105
Total equity and liabilities	453	345
Extract from the statement of comprehensive income		
Revenue	2,650	2,350
Cost of sales	(2,600)	(2,300)
Gross profit	50	50
Other costs	(30)	(20)
Finance costs	(10)	(4)
Profit before tax	10	26
Income tax expense	(1)	(2)
Profit for the year	9	24
Extract from the annual report		
Number of staff	90	70

Required:

(a) W&P concluded in their report 'that there were clear signs that the company (RiteSoftware) was in difficulty and this should have led to further investigation'.

Assess, using the financial information available, the validity of W&P's conclusion. (13 marks)

(b) **Examine FOUR ways in which OneEnergy failed to follow a proper evaluation procedure in the selection of the RitePay software package. Include in your examination a discussion of the implication of each failing.** (12 marks)

(25 marks)

4 Elegant Hotels is a chain of twenty hotels across the country. Each hotel is wholly owned by the company. Four years ago the chain was bought by a group of investors who installed a new management team.

The new management team introduced a new reward scheme for the hotel managers in an attempt to motivate managers to improve the revenue and profitability of the chain. The salary package devised for each manager comprised:

– A relatively low fixed salary
– A bonus payment based on high room occupancy rate. The occupancy rate is the percentage of usable hotel beds filled every night. Managers who achieved more than 90% occupancy rate receive a significant bonus. This target is aimed at keeping the hotel full.
– A smaller bonus payment based on the net profit margin achieved by the hotel. This is aimed at improving the profitability of the hotel.

However, despite these incentives the overall performance of the company is still declining. Managers are generally achieving a high occupancy rate but are largely failing to deliver higher net margins. It is also clear that some managers have achieved a high occupancy rate by declaring that some bedrooms were unfit for use or were being used as seminar rooms.

Also, the pursuit of high occupancy and high net profit appears to be affecting the perceived image of the hotel chain. Once regarded as a mid-market hotel chain, the chain now seems to be perceived as a budget buy. A large percentage of bookings are received through the Internet broker lastsecondhotels.com and their view of the chain is given below, together with some visitor quotes from their web site.

Comments

'Great last minute bargain … very easy to get rooms at half the advertised rate'

'Full of school children on a trip … will not be using this chain again'

'No Internet connections in the rooms or public areas, very disappointing'

'The bath was cracked and the windows were dirty. Cheap, but badly in need of a clean'

'Receptionists were very off-hand and unable to help. Did not seem to know much about the area surrounding the hotel'

'The staff were surly and uncommunicative. Much worse than last time we visited it. It used to be such a lovely hotel'

'Cheap, but don't eat there. The price for breakfast was extortionate'

'Cheap and cheerful but don't pay the full rate! Always lots of cheap beds available'

'Food was expensive and dull. The serving staff were uncommunicative, the cutlery was dirty and damaged. Staff were more interested in talking to each other than to the customers'

'Restaurant food was very expensive and of poor quality. The two nights I stayed there I was the only customer in the restaurant'

Lastsecondhotels.com says: 'Value for money hotels with rooms always available. Perfect for those last minute breaks'

Required:

(a) **Analyse the unanticipated consequences of the management reward scheme at Elegant Hotels.** (15 marks)

(b) The DMAIC methodology of Six Sigma includes five steps: Define, Measure, Analyse, Improve and Control.

Evaluate the potential benefits of using the DMAIC methodology at Elegant Hotels. (10 marks)

(25 marks)

End of Question Paper