PROFESSIONAL LEVEL EXAMINATION

TUESDAY 7 JUNE 2016

(2½ hours)

BUSINESS STRATEGY

This paper consists of **THREE** questions (100 marks)

1. Ensure your candidate details are on the front of your answer booklet. You will be given time to sign, date and print your name on the answer booklet, and to enter your candidate number on this question paper. You may not write anything else until the exam starts.

2. Answer each question in black ballpoint pen only.

3. Answers to each question must begin on a new page and must be clearly numbered. Use both sides of the paper in your answer booklet.

4. The examiner will take account of the way in which answers are presented.

5. When the examination is declared closed, you must stop writing immediately. If you continue to write (even completing your candidate details on a continuation booklet), it will be classed as misconduct.

IMPORTANT

Question papers contain confidential information and must NOT be removed from the examination hall.

DO NOT TURN OVER UNTIL YOU ARE INSTRUCTED TO BEGIN WORK

You MUST enter your candidate number in this box.

1. The Healthy Vegetarian plc (THV) is a listed company which operates 200 shops throughout the UK. THV shops sell ready-to-eat food, plus hot and cold drinks. All products are suitable for people who eat no meat or fish products (vegetarians). THV does not prepare food on the premises, although some snacks can be heated in the shop, on request, at the time of purchase.

Company background

Company history and development

THV has expanded organically by reinvesting operating cash flows to finance the opening of new shops. The board is not willing to borrow or raise new equity capital at this time.

Food products and operations

THV carries a range of 40 types of food and drink products. All products are purchased centrally by head office from four suppliers. Products are delivered by suppliers directly to each shop. All shops are charged the same price for each product, which is agreed by head office with suppliers.

One week in advance, the shop manager informs head office of the quantities of food and drink required for each day. Drinks can be displayed on shelves for a long time from the delivery date, but most foods can be displayed for only one or two days before being discarded, in line with hygiene regulations. Excessive delivery quantities therefore reduce the operating profit of the shop.

Each shop has one manager who decides on the number of staff to employ, but wage rates are set centrally at head office.

Head office determines capital expenditure. Depreciation on each shop's non-current assets is charged in arriving at the shop's operating profit, but no central head office costs are allocated to shops.

Markets

The target market for THV is customers who are healthy eaters. The company markets itself as selling healthy, vegetarian products, as reflected in the company's name.

Selling prices are determined by head office so, for each product, all shops charge the same price to customers.

Budgeting, performance assessment and closure review procedures

An annual budget is set for each shop at the start of each year, and the performance of each shop is assessed annually using key performance indicators (KPIs) and internal benchmarks (**Exhibit 1**). The worst performing shops are placed under 'closure review procedures' following assessment, and are then given three months to demonstrate substantial improvement, or be closed.

June board meeting

Closure review procedures

At the June 2016 board meeting, the performance director, Tina Thomson, expressed concern about the company's closure review procedures. "There is increasing stress amongst staff about these procedures. Staff do not understand how they operate and fear the possible loss of their jobs at short notice.

"We need to develop and communicate more objective criteria for placing shops under closure review procedures. To help determine which criteria are appropriate, I have provided illustrative data for two poorly performing shops, in Leeds and Hull, which have recently been placed under closure review procedures. I have also provided relevant internal benchmarks from THV shops across the performance range (**Exhibit 2**)."

Procurement processes

The head of management information systems, Paul Potter, suggested a change in procurement processes. "Currently each shop manager has responsibility for determining the quantities of food and drinks ordered each day. I believe that we could use information technology to have automated reordering centrally. The IT system would use data on the amount and timing of historic sales for each shop to predict future sales as the basis for ordering from suppliers. Shop managers would therefore no longer be responsible for ordering.

"I have consulted one group of managers about this, who suggested an alternative approach. Their suggestion was to allow shop managers to use their discretion to purchase up to (say) 20% of their shop's products, by value, directly from local suppliers, rather than ordering through head office. These managers argued that this would better enable them to satisfy local tastes using their local knowledge. The remaining 80% of products would continue to be ordered by shop managers through head office."

Ethical concerns

In a private conversation, Andrew Aimes, a non-executive director of THV, raised a concern with the marketing director, Diana Dunn.

Andrew said: "A major element of THV's marketing is that our products are not only vegetarian, but also are healthy because they are vegetarian. However, there is high sugar content in many of our products, and it is well-established that eating too much sugar can badly affect people's health."

Diana responded: "Look, Andrew, the sugar content in grams is marked on all our products in a small, detailed table of the ingredients. If people don't want to read it, or don't understand what number of grams is high or low for sugar content, then that is their problem."

Requirements

1.1 In respect of assessing shop performance:

(a) Evaluate and explain the performance of the shops in Leeds and Hull (Exhibit 2). So far as the information permits, give a reasoned opinion as to whether each shop should be closed. State key additional information that you would require to make a more complete assessment of the performance of the two shops; and **(10 marks)**

(b) Critically appraise the effectiveness of THV's KPIs (Exhibit 1) in identifying under-performing shops. Suggest and justify further relevant KPIs that would improve the process for implementing closure review procedures. **(8 marks)**

1.2 Explain how THV can make better use of budgeting (Exhibit 1). **(7 marks)**

1.3 In respect of procurement processes, explain the merits and problems of:

- permitting shop managers to purchase some of their products from local suppliers, rather than ordering only through head office; and
- using IT systems to automate ordering for all products centrally for each shop.

Assume these two proposals are mutually exclusive. **(11 marks)**

1.4 Explain the ethical issues for Andrew and THV arising from the matters discussed by Andrew and Diana. Set out any actions that Andrew should now take. **(8 marks)**

Total: 44 marks

Exhibit 1 – Performance assessment and budgeting

<u>Performance assessment and closure review procedures</u>

THV's accounting year end is 31 May. The annual performance of every shop is assessed in June each year. The performance of each shop is measured and the shops are ranked in order (from best to worst) for each of the following three KPIs:

- Revenue
- Operating profit
- Return on capital employed (ROCE) - calculated using the depreciated historic cost of the shop's non-current assets.

Staff in the best performing 50 shops are paid a bonus.

At the discretion of the board, shops which are placed bottom in the ranking for at least one KPI may be placed under closure review procedures. During these procedures, the shop manager must implement a three-month recovery plan, and the shop's monthly performance is measured against this plan. Unless the shop shows substantial improvement over the period of the recovery plan it is likely to be closed.

The closure review procedures were introduced to give an incentive to shop managers and other staff to perform well, as all the staff working in shops that are closed are normally made redundant.

The final decision to close a shop is made at the discretion of the board after considering all relevant factors.

Budgeting

Annual budgets are set for each shop, and the actual performance of each shop is compared to its budget annually. This is an additional, and separate, process to the annual closure review process.

Budgets are used for planning purposes, and also to motivate all shop managers, whether they are performing well or badly. The budgets are set by negotiation with each shop manager. However, head office does not accept shop budgets which have a lower revenue or operating profit than was actually achieved for the previous year. If a shop budget is consistently not achieved, the shop manager may be dismissed, although the shop would not be closed on this basis alone.

Exhibit 2 – Performance data and related internal benchmarks

Year ended 31 May 2016

	Shops under closure review procedures		**Benchmarks**		
	Leeds shop	**Hull shop**	**Average for all shops**	**Average for 50 worst performing shops**	**Average for 50 best performing shops**
Revenue	£425,000	£325,000	£480,000	£390,000	£580,000
Operating profit	£17,000	£11,000	£30,000	£20,000	£45,000
ROCE	3.1%	3.7%	9.7%	6.8%	10.0%
Date opened	2005	2014	2011	2013	2003
Floor space (square metres)	130	80	80	80	120
Non-current assets*	£550,000	£300,000	£310,000	£295,000	£450,000
Number of employees	11	7	7	7	10

* Non-current assets are property, plant and equipment valued at depreciated historic cost. At 31 May 2016 there were no leasehold properties.

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2. Elver Bloom Recruiting plc (EBR) is a medium-sized employment recruitment agency. It recruits staff, on behalf of its clients, to work on permanent employment contracts in the finance industry.

The employment recruitment industry

Recruitment agencies attract, identify and select suitable candidates as employees for their clients. Staff recruited may be for permanent or temporary contracts.

Recruitment agencies may also offer other services, such as training, project management (eg redundancy schemes and large-scale recruitment initiatives), advice (eg on employment law) and staff appraisal. Frequently, these services are provided to existing regular clients.

Advertising available jobs in the most efficient manner, and identifying potential employees, are key processes for any recruitment agency. Increased use of the internet and social media in recent years has facilitated these processes for all companies in the industry.

Key constraints on recruitment agencies are legal issues regarding both who can be recruited and the process by which employees can be recruited.

Smaller agencies tend to specialise in: a particular industry (eg finance, IT, hospitality, education, construction); a category of employee (eg new graduates, seasonal workers); or a geographical region (eg major cities or a single country). Larger recruitment agencies operate across a broad spectrum of services and sectors.

The majority of the revenue of recruitment agencies comes from charging fees to clients for achieving successful recruitment. The fee for recruiting a permanent employee is normally based on a percentage of the employee's first year salary. This can range from 10% (for large-volume, regular clients) to 30% (for a one-off assignment).

If the recruited employee does not stay in employment for more than three months, the agency pays a rebate to the employer, which is typically between 50% and 100% of the fee.

The market for recruitment agency services was weak during the recession from 2008 to 2012. However, more recently, revenue in the industry increased by 10% in 2014 and by 9% in 2015. Profitability growth has been highest in the recruitment of permanent employees, with average increases in profit in the sector of 18% in 2014 and 16% in 2015. Many new entrants to the recruitment agency industry are being attracted by increasing profits.

EBR – company background

EBR was formed in 2007 by Amy Cheng and Mark Prost, who had worked together in the human resources department of an investment bank. They set up an office in the financial district of London in 2008 and now have 35 staff. EBR has established a base of regular clients, but it also carries out one-off assignments. The industry is competitive and new clients and assignments are gained through tenders. Each year, existing regular clients put pressure on EBR to reduce fees.

EBR specialises in permanent appointments in the finance industry (eg banking, investment management, financial services and accounting). It seeks to attract candidates with a minimum of five years' relevant work experience. The average first-year salary of EBR's recruits is £80,000.

A further specialism is that EBR attempts to recruit candidates both in the UK and internationally, mainly for clients based in London.

Mark summarised this policy: “We use social media, the internet and industry electronic journals to recruit the best financial candidates in the world and bring them to London, which is one of the largest global financial centres. These international candidates bring language skills and knowledge of international financial markets. We recruit in three regions: Europe, North America and East Asia.”

Fees – a new approach

During the recession, market conditions for EBR were difficult, as they were for all companies in the industry. Then, as the UK economy began to emerge from the recession, EBR continued to find it difficult to win new tenders, retain existing clients and increase revenue.

The EBR board therefore decided to reduce all its fees by 10% for each employee recruited from 1 April 2015. This reduction was aimed at winning tenders and retaining clients, and thereby gaining a greater volume of business.

A board meeting in May 2016 reviewed the success of the fee reduction policy.

Mark Prost opened: “The policy to reduce fees has been a disaster. I have produced some financial information and operating data (**Exhibit**) which shows that, while revenue has increased, operating profit has fallen. I think we should revert to our previous fee levels.”

The marketing director, Nick Drapp, disagreed: “I think the policy has been a success. We have won more tenders in the year ended 31 March 2016 than in the previous few years, and we have retained nearly all our regular clients. This gives the agency a better basis to market itself to existing and new clients and therefore to build for the future.”

Amy Cheng had a different view: “I think we need to move upmarket and increase fees by 20% from their current, reduced, level. Clearly, we must offer something in return to clients, so I think we should go beyond the industry norm for offering rebates. I suggest we offer a 100% rebate to clients if our recruits leave their employment within six months of joining, and a 75% rebate if recruits leave between six months and 12 months of joining. We will then be giving a really clear signal that we have confidence in the quality and suitability of the candidates we have recruited.”

Requirements

2.1 Using the PESTEL framework, explain how the following factors affect the employment recruitment agency industry:

- Economic
- Technological
- Legal

You are **not** required to discuss the other PESTEL factors. **(10 marks)**

2.2 Use the available data (Exhibit) and other information to evaluate the decision to reduce fees by 10% from 1 April 2015. In a report to the board advise, with reasons, whether this price reduction should now be retained or reversed. Ignore Amy's proposal. **(16 marks)**

2.3 Explain the factors that should be considered in deciding whether to implement Amy's proposal. Provide a reasoned recommendation. **(9 marks)**

Total: 35 marks

Exhibit – Financial information and operating data

Financial information - years ended 31 March

	2016 £'000	**2015 £'000**
Recruitment		
Revenue: fees	12,480	11,900
Less:		
Rebates	(1,498)	(1,200)
Variable costs (eg advertising)	(2,496)	(2,142)
Fixed costs	(3,300)	(3,300)
Operating profit from recruitment	5,186	5,258
Operating profit from other services	610	560
Total operating profit	5,796	5,818

Operating data - years ended 31 March

	2016	**2015**
Number of permanent appointments	780	700
Number of active clients	168	142

Working assumption: if the change in pricing policy on 1 April 2015 had not taken place, the financial information and operating data for the year ended 31 March 2016 would have been the same as that for the year ended 31 March 2015.

3. TechScan Ltd (TechScan) develops and manufactures complex electronic scanners, which are used by hospitals in the UK. The company has a large research and development (R&D) department.

The basic TechScan technology is common to all its products and is protected by patents. However, the patent protection ends in 2017 and, unless new technology can be found, there will be a significant fall in profitability.

The TechScan board has identified two options:

- **Option 1** – TechScan's R&D department develops and patents new advanced scanner technology.

- **Option 2** – TechScan obtains a licence for the right to use new scanning technology which has already been successfully developed in the US by Ursa Inc, a rival company.

While the technologies under each option would be different, if TechScan's R&D is successful, the two different technologies are expected to be equally effective. It is therefore estimated that, using either technology, sales of scanners would be the same in quality, volume and price terms. The useful life of either technology would be five years, before being replaced by newer developments. Both technologies could be available to TechScan in 2017 and 1,000 scanners could be manufactured and sold over the following five-year period, under either option.

Option 1 – R&D project

TechScan's R&D department has been working on an R&D project to develop new advanced scanner technology for six years. It has incurred substantial expenditure over that period and, while some progress has been made, there remain significant uncertainties with the project. An immediate additional investment of £45 million is required to finance the final phase of the R&D project but, even with this investment, there is only a 60% probability of its success. If the project fails, no benefit would arise. However, the licence from Ursa Inc could still then be purchased (as per Option 2).

If the R&D project succeeds, the present value of all future costs to manufacture 1,000 scanners would be £20 million (in addition to the £45 million R&D investment). All costs would be incurred in £ sterling.

Option 2 – Purchase a licence

TechScan could abandon the R&D project immediately and purchase a licence from Ursa Inc. This would give TechScan the sole rights to include Ursa technology in all its scanners sold in the UK over the next five years. The present value of all future costs to develop and manufacture 1,000 scanners using Ursa technology would be £100 million, including the licence fees. All costs would be incurred in £ sterling.

Sales

The total sales volume over the five years of manufacture would be 1,000 scanners under either option. Over this period, the selling price would be subject to the same uncertainties for either option. There is a 70% probability of high prices, in which case the present value of revenues would be £160 million for either option. There is a 30% probability of low prices, in which case the present value of revenues would be £110 million for either option.

Requirements

3.1 If the board were to choose Option 2, discuss the likely impact of this decision on the R&D department and on TechScan's future R&D strategy. **(6 marks)**

3.2 (a) Calculate the expected net present values of the two options.

(b) Using the calculations in 3.2(a), and taking account of other relevant factors, advise and explain which of the two options should be selected. **(15 marks)**

Total: 21 marks