MAY 2020 PROFESSIONAL EXAMINATIONS
STRATEGIC CASE STUDY (PAPER 3.4)
CHIEF EXAMINER'S REPORT, QUESTIONS AND MARKING SCHEME

GENERAL COMMENTS AND STANDARD OF THE PAPER

The standard of the paper was good and the questions were clear. The coverage was broad. The paper was a slight improvement over the maiden paper which was done in November 2019. Marks allocation followed the weightings in the syllabus and was fairly allocated to each sub-question.

PERFORMANCE OF CANDIDATES

The overall performance was average. Most candidates did well in Section A of the paper which was based on the pre-seen portion of the case study. Most of the candidates performed poorly in Section B which contributed to the overall low percentage pass rate in the paper.

NOTABLE STRENGTHS & WEAKNESSES OF CANDIDATES

Strengths

The candidates did well in the SWOT analysis and the financial appraisal. Most of the candidates answered questions on this paper.

Weaknesses

The candidates had a problem answering questions in Section B indicating their deficiencies in dealing with questions based on the additional information provided in the case. A few of the candidates appeared not to have prepared well for the paper. Some of the candidates have problems with questions relating to preparation of financial proposals and estimates of financial outcomes.

QUESTION

The beginning of Customer Focused Ltd

Customer Focused Ltd was registered to begin trading on 1 January 2017. It opened a retail food store near one of the key malls in Accra with the promise to customers to provide: 'Low prices, great value, and high quality - every day'. The founding investors were three Ghanaians Kpakpo Armah, Akwasi Boateng and Mary Acquah. The business owners are actively involved in the management of the store. The initial equity capital of the business was provided by them. Additional debt capital was also raised at the same time.

A retail unit was rented near one of Accra's leading malls for an initial period of five years and provided sufficient retail space to offer a range of food products. Initially, the focus was mainly on selling packaged and processed food so that customers could buy food that was convenient to cook at a time when it suited the busy Ghanaian office worker.

The business owners had all previously worked for the food retail stores in managerial roles and knew much about food retailing. However they had never consider what it meant to run a business in terms of attracting customers and dealing with the new commercial environment they faced. Even though competition was tough, the business owners realised that store location was paramount to the business' success and in this, they had proved to be correct.

Owners

Kpakpo Armah: Age 43. Has 20 years of experience in the retail food sector, working across all functions, beginning in a large store on the outskirts of Accra.

Akwasi Boateng: Age 37. Worked first in education but later changed to a business career originally in banking operations and later in food retail in Kumasi before being invited by Kpakpo Armah to work with him in Customer Focused Ltd.

Mary Acquah: Age 25. She graduated with a degree in business and this is her second job in food retailing. She is keen and committed to developing the marketing function of Customer Focused Ltd and provides better customer relations to help grow the business.

Customer Focused Ltd has traded successfully and profitably since its launch although there are challenges ahead.

Food retail market in Ghana

The food retail market has three subsectors and the market share of total retail sales in Ghana for each subsector is estimated as follows:

Supermarkets	5%
Convenience stores	40%
Traditional markets	55%

There is tension in Ghana and many African countries between the growth of supermarkets/convenience stores and traditional markets. When incomes rise, consumers look for convenience in their food purchases, and they are able to pay more for food that is sold in expensive retail outlets that are close to other traditional retail outlets. This means that some traditional markets are losing customers.

The competition between supermarkets/convenience stores and traditional markets often breaks down into income levels and purchasing power when a noticeable division in consumers arises. The competitive struggle has often been characterised along the lines of price, quality, and convenience.

Supermarket retailers, whilst facing higher rents, due to location, higher standards of fitting-out and presentation, are able to buy in bulk and also engage in loss leader selling and other marketing activities which are attractive to the modern consumer. Traditional markets rely on social networks and long relationships with customers to underpin their continued existence. However, an important question arises: how far does loyalty to traditional methods to sell product stretch in the face of price competition, wider product choice of high quality, and convenience in terms of hours of trading and location? Traditional markets are under pressure to sell more and have been responding by an increasing focus on fresh produce. They also ensure that their remaining customers get the choice they need rather than perhaps offering products they cannot afford.

Traditional markets have a long history in Ghana. They appear in most towns, some are open every day and offer mostly local produce. They cannot offer cold storage facilities and, so, market traders must have a very keen knowledge of their customers in order to develop a sense of what to stock and sell. For consumers, the social network that a market provides will be important as will be the low prices and local convenience. Indeed, the traditional markets may be the only source of fresh produce that is available. However, the rapid urbanisation of Ghana and growth in income is presenting a challenge to traditional markets that, conversely, supports the development of food retailers that are concentrated in the major population centres, particularly in the south of Ghana. Increases in household income growth have been associated with a reduction in spending on staple products.

Wider economic and social forces are at play in Ghana. Two are worth mentioning. Diet changes are arising from the effect of greater disposable income thus encouraging food retailers to venture into a healthier range of products, at higher prices. Health awareness concerning diets is also having an impact on what is demanded by consumers, particularly as a response to the widespread obesity crisis. The second force concerns the shift in demand towards processed foods. A processed food is any food that has had an element of treatment: for example, part-cooked, added ingredients, and even packaging. A key element of processing is designed to support food safety and the lengthening of shelf-life so that food remains edible for a longer period. However, increased consumption of processed food, throughout the world, has been associated with weight gain and has been linked to the obesity crisis.

Convenience in shopping becomes a priority in the large population centres. For example, traffic congestion can dictate that shopping frequency should fall and hence a location that offers a wide range of produce can be attractive to individuals who are substantially time-constrained. Additionally, increased urbanisation and the centralisation of business activity has led to greater employment opportunities for women who have typically been responsible for food purchases. Add child responsibilities and it becomes clear that shortage of time becomes an important factor in choosing where to shop.

Technology developments have been an important driver in retail food growth and have often under-pinned competitive advantage of one retailer over another. It has also addressed some of the issues surrounding the pressure of time that consumers face and the demand for convenience. For stores, technology provides information and can create loyalty in a market-place where competition cannot always be judged on price attractiveness alone. For consumers, the development of online ordering and even delivery has the potential to change the face of food retailing.

New methods of food retailing have developed rapidly for modern stores, particularly in the use of technology. E-commerce, digital marketing, and technology-based management of the business have become common in many stores especially the food retail sector where rapid change takes place. Moreover, increased competition means that customer loyalty cannot be taken for granted.

Loyalty schemes operated by food retailers have now become part of the landscape of shopping. There are two parts to loyalty schemes. For the consumer, loyalty schemes allow for discounted purchases either immediately or in the future. They enable direct marketing such that discounting offers are targeted to consumers according to their purchasing activity. For the business, gathering information on purchasing activity allows it to see patterns in purchasing at the store, by time, by product, and by consumer. All of this is vital in maintaining knowledge about what products should be offered and when. It facilitates flexible business operations such as inventory management and it reinforces budgeting practices if retailers can discover regularity patterns in purchasing. Loyalty schemes are offered by many retailers in Ghana and, to be without one, might place a particular store at a significant competitive disadvantage. That is, loyalty cards are likely to be essential to sustain a business as they have become embedded in retail operations in much the same way that effective inventory management is a key requirement.

Customer Focused Ltd Performance and Position

The development of supermarkets in Ghana over 30 years ago coincided with the growth of incomes and the increase in purchasing power. International food retail chains launched branches in Ghana (such as Shoprite which is South African owned) alongside the rapid development of home-grown stores and chains such as MaxMart. The building of new shopping malls across Accra and elsewhere altered the pattern of shopping and changed expectations about what was demanded from store retailers in terms of the range of products offered and the convenience of the shopping experience. For example, one key aspect of Koala's positioning is to make available a diversity of products. There are other examples concerning differing commercial approaches to food retail such as a substantial online presence (for example, Melcom) to the very larger hypermarket run by Palace Hypermarket.

In this context Customer Focused Ltd began trading on 1 January 2017. Initial capital was created with 100,000 ordinary shares and the Share Capital amounted to GH¢300,000. The shares were owned in the proportions: Kpakpo Armah: 70%, Akwasi Boateng: 20%, Mary Acquah: 10%. Debt capital was also introduced. Customer Focused Ltd raised loan finance of GH¢100,000 which was repayable in full after five years unless renewed, subject to negotiation. The loan carried a variable interest charge which was reviewed on the anniversary of taking out the loan. The loan carried a range of covenants associated with it and these are detailed below in the summary loan documentation.

Customer Focused Ltd leased premises in Accra. The lease agreement required the company to pay a rental at the start of each year and the high expense of the agreement reflected the store's proximity to one of Accra's leading malls. The lease agreement was to run for five years, with the possibility of renewal.

The leased unit size was sufficient for Customer Focused Ltd to offer a range of goods to attract high spending customers who prioritised convenience over price. All the initial funding was spent on creating product lines in sufficient quantity to attract these customers. Additionally, the store unit required substantial amounts to be spent on re-fitting and purchasing of refrigeration units and cash desks that were capable of maintaining inventory records and of using loyalty cards.

The owners forecast profitability from the onset and had, initially, carried out an investment appraisal that indicated that the store would make money over a five year period. There was an expectation that the business would continue after the five year period but only after a substantial appraisal was undertaken shortly before that time about whether the business was likely to be viable in the longer term. Discussions had taken place, at the beginning, concerning how the owners would exit the business should they wish to dispose of their investments in five years. The owners agreed that they would not take any dividends out of the business.

Summary loan documentation: Agreement between Customer Focused Ltd and Accra Business Bank (ABB)

Loan amount	GH¢100,000
Interest rate	Standard variable rate of ABB
Repayable in full	31 December 2021
Security	Fixed charge on personal property of signatories

Conditions: Customer Focused Ltd agrees to meet the following as a condition of the loan

1) Repayment interest rate, repayment schedules and final date of repayment can be altered by ABB if covenants are not met.
2) Customer Focused Ltd agrees to maintain the following covenants:

- To maintain monthly cash balances sufficient to pay the following month's interest payment
- To maintain net working capital always at a positive amount, defined as Inventories plus Receivables less Payables
- To maintain gearing at no higher than 50%. Gearing is defined as (debt/(debt plus equity plus retained earnings)).

Customer Focused Ltd Summary Management Accounts

	For periods ended 31 December		
	2019	**2018**	**2017**
	GH¢000	**GH¢000**	**GH¢000**
Sales	10,570.4	10,488.3	10,551.6
Cost of sales	(7,716.4)	(7,341.8)	(7,069.6)
Operating profit	**2,854.0**	**3,146.5**	**3,482.0**
Finance and administration costs	(2,334.7)	(2,462.0)	(2,585.7)
Profit before tax	**519.3**	**684.5**	**896.3**
Tax	(129.8)	(171.1)	(224.1)
Profit after tax	**389.5**	**513.4**	**672.2**

	At each of 31 December		
	2019	**2018**	**2017**
	GH¢000	**GH¢000**	**GH¢000**
Non-current assets			
Property, plant and equipment	614.9	922.4	1,229.9
Current assets			
Inventory	951.3	704.0	484.2
Receivables	104.3	120.7	65.0
Cash	1,563.1	1,417.2	980.3
	2,618.7	**2,241.9**	**1,529.5**
Current liabilities			
Payables	(591.9)	(603.4)	(426.1)
Loans	(333.3)	(333.3)	(333.3)
	(925.2)	**(936.7)**	**(759.4)**
Non-current liabilities			
Loans	(433.3)	(742.0)	(1,027.8)
	1,875.1	**1,485.6**	**972.2**
Equity			
Retained earnings	1,575.1	1,185.6	672.2
Share Capital	300.0	300.0	300.0
	1,875.1	**1,485.6**	**972.2**

Notes

1) The accounts are summarised and extracted. They are used for management review purposes. Statutory accounts, which are fully compliant with reporting standards, are produced separately.
2) Within the management accounts, the company had capitalised the lease on the property to record more accurately the asset base that the company was using.
3) Accruals and prepayments are negligible and are combined into payables and receivables, respectively.
4) The business owners took only a minimal salary from the business.

Business Objective, Business Model and Product Profile

The objective of the business is to ensure sustainability by meeting customer demand in a profitable manner.

The business model is the means by which the objective is achieved. The following description of the key aspects of Customer Focused Ltd's business model is provided by Kpakpo Armah. Customer Focused Ltd aims to:

- maintain reliable supply arrangements and good distribution to the store,
- keep adequate inventory for all product lines and sufficient storage capability, including cold storage,
- provide a small choice of perishable goods. Customer Focused Ltd concentrates on the sale of processed and dry foods that are not perishable. It stocks a small range of perishable goods that are focussed on daily needs and are therefore frequently bought,
- ensure that shelving, including refrigerated units, and presentation are good enough to deliver customer needs,
- put in place adequate staffing to monitor supplies inwards and keep the presentation of inventory at appropriate levels,
- maintain high quality staff at customer check outs (there are no self check-out registers)
- provide convenience in terms of opening hours to accommodate passers-by who can arrive at all times. The store is open from 6am to 11pm,
- gather marketing and other information collection to support business objectives. This is needed to provide information and intelligence on customers. Traditional markets gather such information based on personal relationships,
- establish and maintain a bulk-order business line. Whilst Customer Focused Ltd mostly relies on individual customers for its sales, it has a smaller additional income stream acting as a supplier for a range of events, and to other businesses for bulk orders. This is not likely to be a growth business for Customer Focused Ltd, and
- ensure adequate financing for both investment and operations. Financing is needed but such needs are supported by the business which is planned to have a strong cash flow.

The main product areas on offer at the store are as follows:

- Food and provisions: packaged or tinned goods (milk, some meats and fish, cheese, cookies, coffee, tea, sugar, salt, biscuits)
- Grains, rice and various pastas
- Breakfast cereals
- Fresh produce: milk, a small selection of vegetables and eggs
- Ready-made meals
- Soft drinks and juices
- Sweets and chocolates

The business owners plan not take any dividends from the business and hope to either sell the business after five years or continue the business and sell at a subsequent date.

Problems, Plans and Proposals

Customer Focused Ltd was approaching its fifth anniversary and the business owners had begun discussions concerning the next steps. There were a number of areas that were discussed. The business owners recognised that there were some unresolved problems with the business that required attention. They also recognised that their planning processes were inadequate and that this had led to some underperformance of the business, but they were unsure how to respond. At some point soon the business owners agreed that a decision should be made, and a firm proposal adopted either to exit the business completely or to alter its operations or direction in some manner.

Problems

A number of problem areas had emerged which the business owners recognised would need to be addressed if they were to restore the profitability of the business to the levels they expected.

Risk management

The business owners had never introduced a risk management policy, largely because they had never identified the risks to the company. They were now concerned that this should be addressed, largely as a response to the declining profitability of the business and the business owners were concerned that they could see the value of their investments declining.

The risk areas they were most concerned with were:

- Competition: the market is highly competitive and new entrants are frequently emerging. There is a particularly challenging risk arising in the possibility of discount retailers entering the market aggressively.
- Changing preferences of customers: retailers are constantly challenged to anticipate what new trends will arise. Marketing is a vital activity in this respect since it is essential that the company knows its customers and what their changing preferences might be.
- New product lines: the capacity to respond to changing preferences by the development or offering of new products is important and so is the capacity of the business to be able to respond. Capacity constraints may be physical, financial or may arise from operational restrictions.
- Uncertainty: uncertainty is not the same as risk. With risk, key parameters of the problem are understood. With uncertainty, even these key parameters are not known. For example, uncertainty may arise because of product developments – currently unknown by Customer Focused Ltd - that are taking place by competitors which can affect how customers shop.
- Supply arrangements: it is vital that store shelves are stocked to meet customer demand. Any reduction in supplies is a risk along with the potential for price increases on those supplies.
- Customer switching: unless the business builds loyalty, the company is always at risk from customers who will shop where prices are lowest.

Marketing and Digitisation

The business owners were aware that they did not have enough information about their customer base to develop effective marketing campaigns. They had fallen behind their competitors in developing data capture systems that would allow them to collect and utilise information on customer spending habits. The feeling amongst the business owners was that they lacked the expertise to develop this and that funding restrictions meant that no new major initiatives were likely to take place in the short term.

Customer demographics
The business owners were unsure if they had correctly anticipated the changing profile of customers, and this is related to the fact the Customer Focused Ltd does not gather information on its customers. Younger customers have noticeably been shopping at the store, particularly during early evening, and many of them have asked for products that have been unavailable, either because they are not stocked by Customer Focused Ltd or because they product line had been sold. A number of areas had opened up as further possibilities for Customer Focused Ltd to sell, including cosmetics, toiletries, and other personal hygiene products, but these had never been a priority for what started out as a food retailing store.

If footfall was important to the business, and it unquestionably was, then Customer Focused Ltd was not servicing the needs of many of its potential customers.

Best sellers and inventory
One of the best sellers in-store were ready-made meals. However, these had limited shelf-life and, at the end of the day, the store had always sold-out. The business owners were not sure how long some of the other, non-perishable, lines had been on the shelves and it was not immediately clear to them which products were selling well and which products did not sell. Inventories were managed by staff but inventory information was neither gathered nor studied.

Plans
It was recognised by the business owners that a five year appraisal was due but that they should bring-forward some efforts immediately since a number of the problems facing Customer Focused Ltd required immediate attention.
The following notes represented the discussion that took place at a meeting held on 30 April 2020:
Kpakpo Armah: 'I am concerned about the continued decline in our profitability even though our sales for the last 3 years have looked good. I think we should prepare forecast accounts to the end of the year to see what our position is.'
Akwasi Boateng: 'I think we all know what the position is, but it will be useful to get the facts and forecasts. We would need to think about an appraisal of the accounts to try and understand the key areas which might need our attention.'
Kpakpo Armah: I'll arrange to get the forecast accounts prepared but we should be ready to begin making some tough decisions, along the lines that we have already made. In addition, it is about time we started considering alternative courses of action for the company. If we wait for the five year anniversary then it may be too late to take any effective action.'
Mary Acquah: I've already sketched out some ideas (contained below in 'Proposals'). They are undeveloped and we would need to work through the implications and to develop detailed plans if they were to be implemented. I fully appreciate that financing will be an issue and the prospects of our continuing in business may not be very good if we cannot arrange adequate financing for the period after the five year anniversary.'
Akwasi Boateng: That much is pretty obvious, but which of your plans is likely to be successful? Do we perhaps need another investing partner? I'm not sure that I am clear about where we go from here….'

The meeting adjourned with nothing more being said.

Proposals

The proposals tabled by Mary Acquah consisted only of a number of headline items as follows:

- Company should launch a loyalty card and develop a marketing programme
- Reduce costs: look for more secure supply arrangements at a reduced price
- Seek a further equity partner, already running a business, to make an alliance and to secure funding
- Seek an additional major investment and possibly relocate to a cheaper premise and launch either
    - a companion store in another location, or
    - increase the product range
- Exit the business with an attempted sale as a going concern.

SECTION A

Customer Focused Ltd has updated its management accounts (**Exhibit 1**) to produce a forecast for the year 2020 and these have indicated some significant problems. The business owners are unsure what to do next.

Required:

You are acting as an advisor to the company and they ask you to:

1) Prepare a SWOT analysis of Customer Focused Ltd.
You should list the strengths, weaknesses, opportunities and threats in the SWOT analysis of Customer Focused Ltd. You should then select from your list the key strengths, weaknesses, opportunities and threats and explain why they are important. **(20 marks)**

2) Prepare a financial appraisal of Customer Focused Ltd to identify the problems faced by the company by calculating and commenting on key ratios that you consider important for the company.
You should specifically include in your appraisal an analysis of sales growth, operating margins, working capital (in terms of inventory, receivables and payable days), and changes in cash balances over the years that the company has been operating. **(21 marks)**

3) Based on your work in 1) and 2), identify and explain three key factors which must be addressed for Customer Focused Ltd to be sustainable over the short term. **(9 marks)**

(Total: 50 marks)

SECTION B

Customer Focused Ltd has received a proposal from a potential supplier, Look and Like Ltd, to provide fresh produce (**Exhibit 2a**) and is considering whether to accept. Kpakpo Armah has written a note (**Exhibit 2b**) about Look and Like Ltd.

Required:

Using the information available, including information you feel relevant from your answer to Section A:

4) Evaluate the proposal in terms of the potential impact on the financial performance for Customer Focused Ltd.
You should prepare an estimate of the incremental financial outcome of accepting the contract for the minimum order level by calculating a profit or loss after tax for the period up to 31 December 2020. Calculate and comment on the impact of contract acceptance on sales, operating profit, and profit after tax for the forecast figures for 2020 for Customer Focused Ltd. Include any further observations that you feel relevant. **(18 marks)**

5) Identify and explain the specific risks faced by Customer Focused Ltd in the proposed contract. **(12 marks)**

6) Describe an appropriate foreign currency risk management hedging method for the risk the company might face in the future as described in Exhibit 2b. **(6 marks)**

7) Explain any ethical issues for Customer Focused Ltd in accepting the proposed contract. Use an ethical decision model to support your explanation. **(8 marks)**

8) Provide a recommendation, with reasons, as to whether the proposed contract should be accepted. **(6 marks)**

(Total: 50 marks)

EXHIBIT 1

Forecast Management Accounts for 2020 and results for the previous 3 years

	For years ended 31 December			
	2020	**2019**	**2018**	**2017**
	GH¢000	**GH¢000**	**GH¢000**	**GH¢000**
Sales	10,041.9	10,570.4	10,488.3	10,551.6
Cost of sales	(7,531.4)	(7,716.4)	(7,341.8)	(7,069.6)
Operating profit	**2,510.5**	**2,854.0**	**3,146.5**	**3,482.0**
Finance and administration costs	(2,310.0)	(2,334.7)	(2,462.0)	(2,585.7)
Profit before tax	**200.5**	**519.3**	**684.5**	**896.3**
Tax	(50.1)	(129.8)	(171.1)	(224.1)
Profit after tax	**150.4**	**389.5**	**513.4**	**672.2**

	At each of 31 December			
	2020	**2019**	**2018**	**2017**
	GH¢000	**GH¢000**	**GH¢000**	**GH¢000**
Non-current assets				
Property, plant and equipment	307.4	614.9	922.4	1,229.9
Current assets				
Inventory	928.5	951.3	704.0	484.2
Receivables	77.0	104.3	120.7	65.0
Cash	1,723.7	1,563.1	1,417.2	980.3
	2,729.2	**2,618.7**	**2,241.9**	**1,529.5**
Current liabilities				
Payables	(577.8)	(591.9)	(603.4)	(426.1)
Loans	(333.3)	(333.3)	(333.3)	(333.3)
	(911.1)	**(925.2)**	**(936.7)**	**(759.4)**
Non current liabilities				
Loans	(100.0)	(433.3)	(742.0)	(1,027.8)
	2025.5	**1875.1**	**1485.6**	**972.2**
Equity				
Retained earnings	1,725.5	1,575.1	1,185.6	672.2
Share Capital	300.0	300.0	300.0	300.0
	2,025.5	**1,875.1**	**1,485.6**	**972.2**

EXHIBIT 2a

Contract proposal for the supply of fresh produce from Look and Like Ltd

Following initial discussions between Customer Focused Ltd and Look and Like Ltd we are pleased to outline a summary contract proposal for the supply of fresh fruit, vegetables and salads. We can move forward to discuss the detail once we have confirmation that the summary is acceptable. The directors of Look and Like Ltd would be proud to serve and support Customer Focused Ltd and to ensure you of our full commitment to providing an excellent service.

Look and Like Ltd proposes:

1) To supply a range of seasonal fresh produce
2) Orders to be placed weekly and deliveries to take place Monday and Friday only
3) Prices to be determined by market conditions but subject to restrictions on price changes to be charged to Customer Focused Ltd (such limitations to be agreed but are likely to be in the range of 90%-120% of weekly average market prices)
4) There is a minimum supply order each month to the value of GH¢112,300 to ensure the maintenance of supply arrangements
5) Payment terms are 30 days, strictly
6) Non or late payment penalties are to be charged monthly at the rate of 18% of outstanding monies
7) Delivery to Customer Focused Ltd's premises in a mix of re-usable and non-reusable containers
8) Quality grading standards are to be determined and agreed, and any produce not meeting standards are subject to return to Look and Like Ltd
9) Any product returns must be notified to Look and Like Ltd on the day following delivery
10) Customer Focused Ltd is responsible for meeting regulatory labelling requirements for fresh produce (eg sell-by dates). Look and Like Ltd will supply relevant information for labelling purposes (eg delivery date, product description and type, product grading and so on)
11) Look and Like Ltd does not offer any indemnities to Customer Focused Ltd as a result of any legal action taken by Customer Focused Ltd's customers arising from the purchase of produce supplied by Look and Like Ltd
12) The agreement to start on 1 July 2020 and end on 30 June 2023.

EXHIBIT 2b

Note from Kpakpo Armah regarding Look and Like Ltd

To: The Directors of Customer Focused Ltd

From: Kpakpo Armah

I have known about Look and Like Ltd for some time through meeting some of the directors at my sports club. During informal chats with them over the years, they have always struck me as being very aggressive in attracting new business and their business has grown rapidly as a consequence.

I am concerned, however, about some of their employment practices. I have heard from other friends that they pay very low wages to their staff. Importantly, as Look and Like Ltd acts as a food wholesaler, I have heard some disquieting news about their business relationships with farmers.

I have heard that they charge farmers a fixed fee annually to be on the preferred Look and Like Ltd supplier/farmer list. I have not heard of this before and I personally find it unacceptable.

My research into perishable produce – even for well-managed businesses - indicates that there is likely, on average, to be about 20% of wastage due to damage and inventory past its sell-by date. My contacts in the industry suggest that mark-ups, as a consequence, are of the order of 40-60%. I think we can expect to sell all of the minimum order at a mark-up of 40% to be competitive. I believe that there is a risk that our wastage might be higher if our inventory management (refrigeration, shelf replenishment, careful handling, and so on) is not of the highest standard. I would expect there to be additional overheads amounting to GH¢50,000 a year in the first year.

I understand, also, that Look and Like Ltd has plans to import some fruit and vegetables that would be subject to foreign exchange currency risk that we might have to face. Whilst it is not part of our current contract, we might want to consider selling these products as they may add significantly to the attractiveness of our product offering. I am concerned, however, that Look and Like Ltd will want to ensure that Customer Focused Ltd bears the foreign exchange risk. I have been told that we could hedge such risk but I don't know how this might be done and I definitely do not want to add any further to the costs of our operations.

SOLUTION TO QUESTIONS

SECTION A

QUESTION ONE

SWOT ANALYSIS

Strengths

- The company's location is a significant advantage
- Being next to a mall results in high footfall
- Company has traded profitably
- Opening hours offer convenience
- Bulk ordering enables competitive prices to be offered
- Good liquidity position
- Relevant experience of the founders
- Significant reduction in agency problem and its associated costs
- Use of debt capital resulting in tax savings

Weaknesses

- Lack of strategic experience of the management team
- Available funds to invest are limited
- No significant technology presence OR Lack of expertise to develop technology
- Declining profitability
- Lease on the premise is about to expire
- Lack of risk management policy
- Lack of marketing information
- Poor inventory management and lack of knowledge of which products sold well and those that did not

Opportunities

- Technology developments in operations management can assist the business
- Technology developments in loyalty cards can increase marketing opportunities
- New product ranges with higher margins could be sold
- Dietary changes create opportunities to sell healthier products
- Higher disposable incomes enable higher-priced/higher margin products to be sold
- Shift in demand for processed food with longer shelf life and easier inventory management
- Increased demand for convenience
- Development of online ordering (order and collect, home delivery)

Threats

- The competition level is high
- Price competition may reduce profitability
- New businesses can enter the market relatively easily
- Customer loyalty may be low as customers are easily able to switch
- Obesity crisis/Lifestyle changes may shift demand for goods
- The lease on the premises is due to expire and the business may face substantial increased costs.

- Change in customer demographics opening opportunities to sell high margin items like cosmetics

(1 mark for each point, max 3 marks for each quadrant = 12 marks)

Key areas:

Key strengths

- The business' location is a key strength but this is presumably costly in terms of the lease agreement.
- The company has traded profitably and, hence, knows how to run a convenience store profitably.
- The company has substantial liquidity and this provides flexibility in making decisions.

Key weaknesses

- Lack of technology development is hindering the marketing and development of the business
- Whilst the business has substantial liquidity there will be demands on those funds in terms of investments required and renewing the lease
- Management weaknesses in terms of strategy development and inventory management may prove costly in terms of the potential mistakes that could be made when important decisions are imminently required

Key opportunities

- Technology developments in marketing and inventory management will support better marketing and operations
- Product offering, particularly with respect to higher margin products, such as healthy ranges of foods can be expanded thus securing business sustainability

Key threats

- Declining profitability could have resulted from competition and/or lack of product development
- Customer loyalty is low and emphasises the need for better market intelligence
- The expiry of the lease will be a key issue possibly affecting location and sustainability.

Overall, the business has started well and was profitable but declining profitability has presented challenges to the owners about what they should do to address the sustainability of the business.

(1 mark for each explained point from each of the four quadrants)
(Max 2 marks for each quadrant = 8 marks)

EXAMINER'S COMMENT

This question required the candidates to prepare a SWOT analysis of the company, Customer Focused Ltd, which was the subject of the case. They were also required to explain the importance of SWOT analysis. Most of the candidates did well in this question.

QUESTION TWO

FINANCIAL APPRAISAL

	2020	**2019**	**2018**	**2017**
Sales growth	-5.0%	+0.8%	-0.6%	
Operating margin	25%	27%	30%	33%
Inventory days	45.0 or 46*	45.0 or 39*	35.0 or 39*	25.0
Receivables days	3	4	4	2
Payables days	28.0	28.0	30.0 or 26*	22.0
Cash balance growth	10%	10%	44%	
Gearing covenant	18%	29%	42%	58%
Working capital covenant	427.7	463.7	221.3	123.1
For information:				
Operating margin	% Operating profit / Sales			
Inventory days	Inventory / (Cost of sales / 365 or 366) or Inventory / (Purchases / 365 or 366)			
Receivables days	Receivables / (Sales / 365 or 366)			
Payables days	Payables / (Cost of sales / 365 or 366) or Payables / (Purchases / 365 or 366)			

Note:* represent answers using average figures

(24 correct figures at 0.5 marks each = 12 marks)

Comments

Data and information

- The company has been operating profitably
- Sales have been flat in the first 3 years with a 5% forecast decline in 2020
- Operating margins have declined
- The business has built-up a significant cash balance
- The growth in cash balances has flattened
- Inventory days have been rising

- Receivables appear high but receivables balances are a small part of the balance sheet
- Payables are static
- Loans are declining but this looks to be due to a scheduled repayment
- PPE assets are declining but this looks to be due to depreciation only
- There is no information about
    - ✓ Additional loans taking place
    - ✓ Further asset investment taking place
    - ✓ Product mix performance: some products may be growing and profitable, for example and others might be declining
- The gearing covenant has been breached in 2017 (should have been no more than 50%). This had presumably been discussed with the bank since the following figures meet the covenant.
- The working capital loan covenant has been met in all years.

(0.5 marks each for max 8 points = 4 marks)

Appraisal

- Generally, the financial statements are highly summarised and analysis will be limited by the amount of detail available.
- We do not have information regarding the forecast decline in sales for 2020. Presumably the forecast has been based on real figures for the first few months and that these have been rolled-forward to the end of the year. It will be important in understanding the prospects for the company that this information is provided. Whatever the cause, the forecast drop is:
    - ✓ a significant reduction that has follow-through impact on profitability with finance and administration costs remaining largely fixed, and
    - ✓ possibly a prelude to a further fall, perhaps significant, in 2021 with implications arising for going concern and business value.
- Inventory days have been rising suggesting that stock is not moving as quickly as before. Inventory days are calculated at 45 on a falling cost of sales requirement suggesting that inventory management is not being carefully monitored.
- The owners will be considering the next steps for the business in the forthcoming fifth anniversary review. If a business sale is being considered then the decline in profitability will almost certainly reduce business value and may reduce their options.
- The loss of profitability only reflects underlying causes and these will need investigating. For financial reporting purposes, there is a possibility of asset impairment arising which will impact profitability and business value further.
- The cash balance is healthy but available cash will be needed in the short term to:

    - ✓ renew the lease which expires on the fifth anniversary of the business, and
    - ✓ invest further in assets if new plans are considered to expand or otherwise alter the business
- The lease on the premises is due to expire. This gives rise to two significant risks:
    - ✓ the possibility of an increase in the lease rental, and
    - ✓ the possibility that a lease renewal might not take place and that relocation becomes necessary.
- If business relocation becomes necessary then this might have a big impact on the business given that its success is largely dependent on location.
- The problems posed in the financial appraisal reflect some of the weaknesses identified in the SWOT appraisal, particularly
    - ✓ availability of funds to invest which might be impacting on performance, particularly around technology
    - ✓ no clear risk management policy so that the period by period decline is continuing
    - ✓ poor or possibly inadequate marketing
    - ✓ over-reliance on footfall and location
    - ✓ poor inventory management
- The macro-environment effects identified in the SWOT analysis may also be having an impact, particularly
    - ✓ The company is missing out on key opportunities relating to
        - ▪ technology and related marketing such as loyalty cards, giving rise to, for example. …
        - ▪ new product ranges with higher margins
        - ▪ not investigating why sales have fallen. Has it been due to dietary changes missed or a changing demographic?
    - ✓ The risks materialising in relation to the threats, such as
        - ▪ has there been increase competition, in price or new businesses?
        - ▪ have customers left? How many? What profile?

(1 mark each for max 5 points = 5 marks)

EXAMINER'S COMMENT

This question involved the preparation of financial appraisal using sales growth, operating margin, working capital and changes in cash balances. Most of the candidates were able to calculate the relevant ratios as well as provide comments on them.

QUESTION THREE

COMPANY VIABILITY – THREE KEY FACTORS

- ***Declining sales and profitability***: if this continues at the rate identified in b) then business value is in danger of becoming negligible and the room for manoeuvre by the partners in their 5 year review becomes very limited. They may not be able to sell the business.
- ***Further investment***: There appears to have been no investment in PPE in the period since launch. Whilst the company has a large cash balance, there will be funding requirement for further investment in possibly one or both of the following areas:
  - ✓ store update and technology implementation
  - ✓ possible relocation and associated costs
- ***Lease renewal:*** The store is at risk of not being able to complete a lease renewal, which is due. This is always a possibility when leases expire. If relocation becomes a likelihood then the business loses one of its biggest drivers of profit.

Other issues might include:

- Lack of ***experience/expertise*** in marketing and strategy. The current management are over-reliant on location as the key business driver and perhaps lack focus on the opportunities and threats that the business faces
- ***Staffing and the monitoring* of business operations**. There appears to be insufficient management oversight of inventories.
- Lack of assessments of ***new products and monitoring of sales*** and stocking by product line. There appears to be insufficient use of managerial information that are key to retail food store operations.
- Proper collection and management of customers' data.

(Any three points well explained @ 3 marks each = 9 marks)

(Total: 50 marks)

EXAMINER'S COMMENT

This was a follow up question from questions 1 and 2. The candidates were required to identify and explain 3 key factors which Customer Focused Ltd. should address in order to be sustainable over the short term. The performance was not very good. Most of the candidates could not identify the factors.

SECTION B

QUESTION FOUR

PROPOSAL EVALUATION

	GH¢'000s	
Sales	754.6	Sales are after wastage at a mark-up on cost of sales
Cost of sales	(539.0)	6 months minimum orders but only 80% sold
Wastage	(134.8)	Lost purchases: wastage at 20% of purchases
Operating profit	**80.8**	
Additional overheads	(25.0)	
Profit before tax	**55.8**	
Tax	(14.0)	
Profit after tax	**41.8**	For 6 months
	83.6	For 1 year

Sales increase	7.51%	(754.6 / 10041.9) x 100
Operating profit increase	3.22%	(80.8 / 2510,5) x 100
Profit after tax	27.79%	(41.8 / 150.4) x 100

Sales = 2 marks; COS = 2 marks; Wastage = 2 marks; Additional overheads = 1 mark; Profit before tax = 1 mark; Profit after tax = 1 mark; Sales increase = 1 mark; Operating profit increase = 1 mark; Profit after tax = 1 mark
(12 marks)

Comment

- The overall impact on sales, operating profit, and profit after tax are 7.5%, 3.2%, and 27.8%, respectively.
- There is only a relatively small increase in profit after tax of GH¢41,900.
- The purchases of GH¢673,800 for 6 months does not represent the full commitment since the minimum contract term is 3 years.
- Thus, the overall return appears low for the risk (see next) and the additional work and responsibility required.
- Whilst the mark-up is high, so is wastage. If the wastage estimates are higher then, profitability might easily be eliminated. Wastage has to rise to only 26% for profit to be eliminated.
- *Kpakpo Armah* has said that wastage of 20% is to be expected for 'well-run businesses'. *Customer Focused Ltd* would not be characterised in this manner because it is known that it has inventory management problems.

- In relation to the SWOT analysis, the proposed contract
    - ✓ Might expose to a greater degree the already-identified weakness in inventory management
    - ✓ Addresses an opportunity in terms of product development that has been needed
    - ✓ Might address some of the threats in creating better customer loyalty and addressing profit decline

(Any **six points @ 1 mark each = 6 marks)**

Workings

1. Cost of sales (GH¢112, 300 x 6 x 0.8) = GH¢539, 000
2. Sales (mark up of 40%) = GH¢539, 000 x 1.4 = GH¢754, 600
3. Wastage (GH¢112, 300 x 6) x 0.2 = GH¢134, 000

EXAMINER'S COMMENT

This question involved evaluation of a proposal in terms of the potential impact on financial performance of the company. This question was poorly answered reflecting the weak analytical skills of the candidates.

QUESTION FIVE

RISKS

- The expansion of fresh produce is a significant enhancement of the product lines in *Customer Focused Ltd* and there will be new management problems arising in terms of:
    - ✓ inventory management requiring a much more active and vigilant approach. Twice weekly orders will now be placed. Also, the returns policy may require substantial management intervention and worker-activity given that returns have to be notified to the supplier quickly.
    - ✓ shelving and sales expertise in dealing with fresh produce. This will require higher activity levels for management and workers.
    - ✓ regulatory responsibilities will be introduced in terms of maintaining the freshness and quality of the produce on sale. This might require more or better refrigeration units and greater responsibilities in accurate labelling.
- The mark-up is high and the wastage rates are substantial, but at typical levels. If these estimates are over-estimates then the contract could easily turn loss-making.
- There will need to be promotional activities and extra spending will be required that is not incorporated in the detail above to establish awareness of the newly expanded product line.
- There is no information on the likely demand for fresh produce and it would be wise to undertake or have an informed view of the possible sales that could arise.

- The prices for the fresh produce are indicative only and subject to a range of 90%-120% of that quoted. The risk for *Customer Focused Ltd* is substantially on the downside as there is more likelihood of a price increase than a price decrease.
- There is no guarantee that *Customer Focused Ltd* will be able to pass-on price increases and hence this range represents a substantial risk.
- There may need to be promotions and discounts offered to establish the products and this may reduce profit after tax.
- The risks relating to the new launch might be mitigated by cross-sales to other products and also introduce new customers to the store.
- The financial impact indicates only a marginal impact on sales and profit but the additional management and operational activity to implement the new contract may be substantial. There may be hidden risks that are not financial, in this respect, because of the increased demands, operationally.
- The commitment to a 3 year-long contract might result in a substantial detrimental impact on the business should some of the risks materialise. A commitment of this length increases the probability of risks crystallising. An evaluation should take place on the exit routes from the contract, possibly by requesting legal advice.
- The payment terms of 30 days are short, but viable for the business; the non-payment penalties are substantial at 18%. This would mean that cash flow management would have to be good for the business to avoid this. The indication is that the business does generate strong cash flow and has substantial cash reserves.
- The risks adopted by *Customer Focused Ltd* in terms of product liability cannot be passed-on to *Look and Like Ltd*. The company should evaluate the possible impact of this.

  Overall: the impact of these risks will have to be assessed in terms of the risk appetite of the business and what possible mitigations might be put in place.

Note: Some candidates may identify the general risks such as legal risks, business risks, market risks, reputational risks, foreign exchange risks, etc. Candidates' answers along these lines, which are well explained, should attract the full marks.

(Any six points well explained at 2 marks each = 12 marks)

EXAMINER'S COMMENT

This question required the candidates to identify and explain the specific risks faced by Customer Focused Ltd. It was a popular question for most of the candidates. A few of them also performed poorly.

QUESTION SIX

FOREIGN CURRENCY RISK: HEDGING

Kpakpo Armah is describing a transactions foreign currency transaction risk. In this case, such risks arise when the agreed price for a supply is fixed before the settlement of the invoice. During this period, the supply which is quoted in a foreign currency, may have increased in price in terms of the domestic currency.

There are a range of hedging methods available. Expensive contracts are ruled-out by *Kpakpo Armah:* this would preclude options and futures which would not appear appropriate for the level of hedging likely to take place. Also not appropriate are money market operations since such an approach would appear to be too complex for the business. Non-contract methods, such as netting and matching receipts and payments are inappropriate unless there are offsetting currency flows which is not the case. The most likely method would be to take out a forward contract which would be flexible in terms of the amount that could be arranged.

A forward exchange contract is a contract entered into 'now' for settlement at an agreed future date (or at any time between two agreed future dates).

Note: Candidates who identify swap contract as a strategy for dealing with foreign currency transaction risk should be awarded a full mark if it is well explained.

1 mark for transaction risk
3 marks for reasoned discussion
2 marks for correct choice
(6 marks)

EXAMINER'S COMMENT

In this question, the candidates were asked to explain foreign currency risk management hedging method. Most of the candidates did well in this question.

QUESTION SEVEN

ETHICAL ISSUES

Introduction

- There is no indication that any law is being breached by *Look and Like Ltd* and hence the problems raised by *Kpakpo Armah* appear to be ethical issues.
- *Customer Focused Ltd* does not have an ethical policy and so there are no company ethical standards to apply.
- The problem therefore to be considered, principally, is in terms of business ethics and the issue concerns the ethics of making a decision to accept the contract.
- The are two models: Tucker's and the American Accounting Association.

Tucker's model

1. It seems appropriate to apply Tucker's model that supports business decisions being made in an ethical manner.
2. In Tucker's model, answering 'yes' to the following questions would indicate that an ethical decision has been made:
   a. Is it profitable?
   b. Is it legal?
   c. Is it fair?
   d. Is it right?
   e. Is it sustainable or environmentally sound?
3. The answer to a). The proposed contract is profitable for *Customer Focused Ltd.*
4. The answer to b)
   - ✓ Paying low wages to staff: this might breach minimum wages requirements in Ghana. *Customer Focused Ltd* may want to query *Look and Like Ltd* on this.
   - ✓ Requiring farms to pay a fixed fee. This is normal practice in some countries and amounts to a commercial decision.
5. The answer to c)
   - ✓ Paying low wages to staff: if wages are above minimum wage then it might not be reasonable to question fairness since this, presumably, has already been considered in relation to the setting of the minimum wage. However, the question might be raised as to whether it is fair to the workers in relation to the work they are asked to do. It does not look as if *Customer Focused Ltd* could reasonably expect to be a judge on this since it appears to stretch ethical responsibility too far.
   - ✓ Requiring farms to pay a fixed fee. This is normal practice in some countries and amounts to a commercial decision. Farmers do not have to accept this practice.
6. The answer to d)
   - ✓ Paying low wages to staff: *Look and Like Ltd* are obeying the law if they are paying the minimum wage or above and hence are doing the right thing.
   - ✓ Requiring farms to pay a fixed fee. Farmers might not have much of a choice in finding another customer but they always can make a commercial decision to stop supply. This may be a tough decision since it will involve other work in terms of finding new business. Is charging a fee right? It does not appear wrong ethically.
7. The answer to e). The sustainability and environmental soundness of *Look and Like Ltd* might be questionable but it is one that *Customer Focused Ltd* will have to query if the owners of the business consider the issues to be important in terms of the company's own values. Perhaps a first step, might be for *Customer Focused Ltd* to establish a sustainability and environmental policy before judging others.

American Accounting Association model

The American Accounting Association (AAA) model offers a different approach to addressing the ethical problem facing *Customer Focused Ltd*. The following questions (on the left of the table are raised in the AAA model and the answers – as they relate to *Customer Focused Ltd* - are inserted in the right hand side).

1. What are the facts?	The facts are outlined in the question but essentially involve low pay and questionable business practices (charging suppliers a fee). These 'facts' are based on hearsay and *Customer Focused Ltd* has not confirmed the issues.
2. What are the ethical issues	The ethical issues surround the 'fairness' of paying low but legal wages and the issue of whether it is ethical to charge a fee to suppliers which might appear to be exploitative.
3. What moral principles, values or 'norms' are relevant to the decision?	The issue is whether *Customer Focused Ltd* objects to the ethical issues but *Customer Focused Ltd* has no declared values or ethical position. It is arguably normal to pay low but legal wages in Ghana and it is difficult to assess whether it is normal to charge a fee.
4. What are alternative courses of action for the decision maker?	The alternatives appear to be: • Reject the proposal on ethical grounds • Explore further to confirm the facts and then reconsider.
5. Which course of action (or courses of action) seems best, because it is consistent with the moral principles and values identified in Step 3	*Customer Focused Ltd* needs to do two things: 1. Specify its ethical position with respect to the two issues 2. Contact *Look and Like Ltd* to confirm the facts. If the facts are confirmed: 3. *Customer Focused Ltd* should decide if either or both issues are ethically unacceptable. 4. *Customer Focused Ltd* should reject or accept the contract, accordingly.
6. What are the consequences of each possible course of action?	1. Rejecting a potentially profitable contract 2. Possibly annoying *Look and Like Ltd* by asking questions that do not directly concern *Customer Focused Ltd.*

7. What is the decision?	The course of actions seem to indicate that the proposal should be rejected on profitability and risk grounds and that the ethical doubts that *Customer Focused Ltd* has only confirm this decision rather than reverse it.

2 marks for the introduction which outlines key points.
6 marks for applying the context to either Tucker's model or the AAA model
(8 marks)

EXAMINER'S COMMENT

In this question, the candidates were required to explain the use of an ethical decision model to accept a proposal or not. Most of the candidates were not familiar with ethical decision models. They therefore performed poorly.

QUESTION EIGHT

RECOMMENDATION

It is recommended that the contract is rejected on the following grounds

- The financial impact does not justify the commitment to a three year contract
- The risks are substantial and the contract could feasibly become loss making
- The ethical practices of *Look and Like Ltd* are questionable but not, on the face of it, unacceptable. *Customer Focused Ltd* may well need to gather further information before reaching a conclusion if the ethical practices are unacceptable. In relation to the other factors (1. and 2.), this may not be a worthwhile activity.

(2 marks for each point = 6marks)

(Total: 50 marks)

EXAMINER'S COMMENT

This was the concluding question in the paper. The candidates were required to provide some recommendations based on the case. Most of the questions in this section (SECTION B) were poorly answered. Recommendations from candidates were abysmal.

CONCLUSION

The future candidates for this paper should prepare well for the examinations. They should study the manual published by the Institute.