

THE PUBLIC ACCOUNTANTS EXAMINATIONS BOARD

A Committee of the Council of ICPAU

CPA(U) EXAMINATIONS

LEVEL FOUR

BUSINESS POLICY - PAPER 17

TUESDAY, 18 DECEMBER 2001

INSTRUCTIONS TO CANDIDATES

1. Time allowable: **3 hours**
2. Section **A** has **two** compulsory questions with question one carrying 50 marks and question two carrying 25 marks.
3. Section **B** has **two** questions and only **one** is to be attempted.
Each question carries 25 marks.
4. Please, read further instructions on the answer book.

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SECTION A

Question 1

Margarita Ltd is a manufacturer of television spare parts and other components. It was established in 1960 in Nairobi Kenya and by 1975 was exporting to all East African Community (EAC) countries.

It was a very profitable company until the late 1980s. Margarita Ltd. based its success from 1960 – 1987 on several factors: it possessed technological advantages in its manufacturing processes; it enjoyed quasi-monopoly status in many of its markets; it had an outstanding record of production innovation.

Since 1997 Margarita Ltd. performance has deteriorated, and it now faces some challenges. Manufacturing technology has been transformed by the invention of a new Swedish machine. This machine has been sold around the world and Margarita Ltd. now finds itself in competition with new manufacturers who are, like itself, using the Swedish machine. This has undermined Margarita Ltd's local monopoly. Although Margarita Ltd. continues its tradition of product innovation, this no longer seems to confer the advantage that it once had.

Margarita Ltd. engaged a firm of management consultants to help improve competitiveness. The consultants were chosen because of their experience in finance and manufacturing operations.

After investigation, the consultants concluded that Margarita Ltd. has the following weaknesses:

- a) A lack of production flexibility. Margarita Ltd is now using the Swedish machine, as are the rest of the world's manufacturers. Although, as the consultants pointed out, the machine has simplified manufacturing, its drawback is that production runs are very expensive and time-consuming to set-up. If Margarita Ltd. could obtain a technological advantage in this area, this would help to restore competitiveness.
- b) Insufficient quality in its manufacturing process. The Swedish machine has simplified manufacturing, and this has had the consequence that the general skill level required of the machine operators has also reduced. The consultants pointed out that rejection rates at final inspection had risen to 5% from less than 1%. A similar 'de-skilling' effect has been observed in the production planning and production control departments.

Two strategies which would alleviate the problems have been suggested by the consultants.

Problem

A lack of production flexibility

Strategy

Invest in a flexible manufacturing system

Insufficient quality in its manufacturing processes

Implement total quality control procedures

The consultants have made some preliminary investigations into the costs, cashflows and probabilities of occurrence attaching to each strategy, and also assessed the effect that each strategy would have upon competitiveness. Competitiveness, in this context, means market share, in all markets.

Strategy 1: Invest in a flexible manufacturing system

Cash outflow US\$ '000	Probability	Cash inflow US\$ '000	Probability
1,000 immediately	1	300 a year for eight years	0.5
500 for next two years	1	600 a year for eight years	0.3
No residual value	1	100 a year for eight years	0.2

In evaluating investment proposals with this degree of risk, the company regarded 18% as reflecting its opportunity cost of capital.

Effect on competitiveness of Strategy 1: increased by 10%

Strategy 2: Implement total quality control procedures

Cost US\$ '000	Probability	Pay-off US\$ '000	Probability	Effect on competitiveness
500 a year for three years	1	*	*	*

* No values were attached to these factors. However, the consultants considered that there would be significant benefits which would be difficult to quantify.

Notes

All the probabilities are the outcomes of joint estimates made by the consultants and Margarita Ltd. directors.

Financial data relating to Margarita Ltd.

Period	Turnover	Profit
1997	%	%
Kenya	35	30
Exports	65	70
2001		
Kenya	55	47
Exports	45	53

All figures below are at 2001 prices

	1997	1998	1999	2000	2001
	US\$	US\$	US\$	US\$	US\$
	'000	'000	'000	'000	'000
Turnover	25,160	23,163	18,743	16,311	15,200
Profit before tax	4,529	3,011	1,687	979	456
Tax	2,039	1,204	658	392	173
Dividends	1,750	1,126	726	528	255
Retentions	740	681	303	59	28

Financing. Margarita Ltd. was financed by equity throughout the period. It used bank facilities to cover short-term liquidity requirements, and also to finance some of its export sales. At year end 2001, it does not expect to have any medium-term or long-term debt in its balance sheet. Typically, in any year, the company paid only negligible amounts of interest.

There were 5,000,000 ordinary fully-paid Kshs. 90 (equal to US\$ 1) shares issued throughout the period 1998 – 2001.

The market price for the shares was as follows: -

1997	1998	1999	2000	2001
\$	\$	\$	\$	\$
7.50	5.40	2.10	0.96	0.42

Required:

- Prepare a report, for the board of directors of Margarita Ltd. The report should evaluate the two strategies. It should assess the ability of Margarita Ltd. to finance the strategies. You should also indicate any areas where further information would be helpful, and specify why this information would be helpful.
- Recommend which strategy the company should adopt and your reasons for so doing.

(50 marks)

Question 2

The management accountant of Stanley Ltd. has evaluated the activities of two of its important competitors. Within their industry the three firms share some 60% of the market supplying public authorities. It is suggested that the three firms' financial results can be represented as follows: -

	Variable costs/turnover	Operating profit/turnover	Operating profit/capital employed
Elgon Ltd	40%	10%	22½%
Stanley Ltd	30%	7½%	15%
Rwenzori Ltd	25%	15%	20%

Elgon Limited is thought to enjoy a 25% share of the market, Rwenzori Ltd some 20% and Stanley Ltd. 15%. It is also significant the Stanley Ltd.'s price/earnings ratio is reported as 10.4 whereas shares in Rwenzori Ltd. are fetching 17.3 times current earnings. This confirms the directors' belief that Stanley Ltd.'s attempts to improve market share by promotional advertising and exhibition activity have been less effective than had been hoped for.

Senior sales personnel have argued that buyers' search costs are such that once a satisfactory vendor rating has been arrived at, it is difficult to persuade authorities to change their suppliers. It has also become apparent that several customers are merely using Stanley Ltd's fine pricing to obtain additional discounts from their regular supplier. This has had the effect of reducing competitors' return on capital employed below what would otherwise be regarded as reasonable.

Alternative marketing strategies have been proposed – one is that Stanley Ltd. should increase its prices in line with competition so that at least 12½% is earned on turnover. If, as is believed, customers will not readily change their suppliers, it is assumed that improved returns will become available to Stanley Ltd. This would also bring Stanley Ltd's variable costs' ratio more into line with those of Rwenzori Ltd.

An alternative argument is that Stanley Ltd. is out-of-date in its production procedures and that the difficulties arise mainly because its capital equipment cannot be adapted to product development sufficiently quickly. Elgon Ltd may use less capital-intensive production methods but it compensates for this by being able to adapt more readily to changes required by its customers.

Required:

- a) Evaluate Stanley Ltd's existing and the two proposed marketing strategies in terms of the likely effects on the company's financial results.

(9 marks)

- b) Recommend whether an offer by Stanley Ltd. of three of its shares for every two held in Rwenzori Ltd would be in the interest of the present shareholders of Stanley Ltd.

(8 marks)

- c) Explain what further growth could be reasonably expected by Stanley Ltd.'s shareholders if the merger were to take place.

(8 marks)

(Total 25 marks)

SECTION B

Question 3

Many major organisations use formal strategies to identify development priorities for Information Systems (IS).

- a) Discuss the reason for this.
- b) What are the major stages in the development of an IS strategy?

(25 marks)

Question 4

Discuss the main issues which need to be addressed in developing a corporate strategy for **one** of the following:

- a) a bank;
- b) a building society;
- c) a college;
- d) a charitable organisation;
- e) a retail store;
- f) a city council (say Kampala City Council).

(25 marks)