

Strategic Professional – Essentials

Strategic Business Leader (SBL)

March/June 2019 – Sample Questions



SBL

Time allowed:

4 hours including reading, planning and reflective time.

This question paper is an integrated case study with one section containing a total of 100 marks and ALL tasks must be completed.

All tasks contain Professional Skills marks which are included in the marks shown above.

Do NOT open this question paper until instructed by the supervisor.

You must NOT write in your answer booklet until instructed by the supervisor.

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

Think Ahead

ACCA

The Association of
Chartered Certified
Accountants

Background information

SmartWear is a long established clothing retailer in Noria, a highly-developed northern European country, which is currently in the middle of a deep economic recession. The country is also experiencing political uncertainty because of its coalition government, who many influential commentators believe will not last for its full term of office. These two factors have contributed to record high levels of unemployment, low business confidence and a steady decline in the standard of living of the general population. The company also operates in two other countries on the European continent, Southland and Centrum.

SmartWear has enjoyed long-term business success mainly due to the fact that it has carefully positioned itself towards the lower end of the clothing retail sector. It sources its products directly from suppliers in low-cost economies, and it has been able to target a mass market with consistently low prices. This has meant that during the recent economic downturn in Noria it has been able to profit from the growing number of price-sensitive consumers, who have switched from the more high-end of the clothing retail market to budget retailers like *SmartWear* – who are the market leader in this high volume market.

SmartWear's long term strategy has always been based on a low cost – low price business model, which is described through its mission statement and strategic goals. However, following a prolonged period of expansion and growth, including successfully penetrating several other European markets, the company is for the first time experiencing a marked downturn in both its operational and financial performance. This appears to be in part due to economic pressure and the growing intensity of competition in all of its markets, both at home and abroad.

At a recent board meeting to discuss the latest set of disappointing financial results, it was proposed that an external consultant be appointed to investigate the deteriorating performance of *SmartWear* and propose the best way forward for the company.

You are the external consultant engaged by *SmartWear*, and you have gathered the following information to help you with your assignment:

Exhibit 1: Briefing notes prepared by the business development department for the consultant.

Exhibit 2: Transcript of a recent *SmartWear* Board meeting discussion.

Exhibit 3: An article from the Noria Herald dated 21 February 20X9.

Exhibit 4: Comparative macroeconomic data for Noria, Southland and Centrum.

Exhibit 5: Executive Summary of the *SmartWear* Internal Audit Report on Supply Chain Management.

Exhibit 6: Customer Database Management System (CDMS) Financial Investment Appraisal.

The case requirements are included in the tasks below:

- 1 It is apparent that the downturn in *SmartWear*'s performance can be in part attributed to external factors beyond the company's direct control. A recent national newspaper article further confirms that the economic situation in Noria has made trading conditions tough for business. Therefore, a good understanding of those external environmental factors negatively affecting the *SmartWear* business model is essential so that action can be taken to remedy the current situation and improve the future prospects for the company and its investors.

The board of *SmartWear* wants to fully understand how the general environment is impacting on the company, as this will directly influence its ability to enable the business to succeed and prosper. The board has asked you to brief the board on this issue for their next board meeting.

Required:

Prepare a briefing paper to be presented at the next board meeting, which:

- (a) **Analyses the environment in which *SmartWear* operates and consider how this might impact its business model, mission and strategic goals.** (10 marks)
- (b) **Assesses the major risks presented by *SmartWear*'s current business model, and suggests appropriate mitigating actions to manage these risks.** (10 marks)

Professional skills marks are available for *evaluation* skills by assessing the identified risks at *SmartWear* objectively. (4 marks)

(24 marks)

- 2 The board is becoming aware that Noria may not be the suitable country that it was 15 years ago for a business like *SmartWear* to operate successfully in. The financial performance of *SmartWear* in Southland is significantly better than that being achieved in the more established homeland of Noria, or in its other European markets like Centrum, so the board has asked you to help them understand why this is the case.

To help with this task, you have gathered summarised information on the country of Southland, where *SmartWear* opened its first retail outlet six years ago, together with comparative data for Noria and the neighbouring country of Centrum. The company now has over 30 retail outlets in all major towns and cities across the country of Southland, where the economy is booming, and Southland generates the most of *SmartWear*'s revenue as a national market after Noria.

Required:

Prepare a report for the board, in which you:

- (a) **Analyse the company's strategic position in the Southland market to determine why *SmartWear* appears to be performing so well in this particular country compared to Noria.** (8 marks)

Professional skills marks are available for demonstrating *analysis* skills in determining *SmartWear*'s strategic position in the Southland market. (2 marks)

The board agreed that a radical response to the current situation was required to reassure investors and the stock market by showing them that the *SmartWear* board remained in control of the business, and was willing to take essential action when necessary. The board decided that the company needed to rationalise its operations by closing the 20 worst performing retail outlets in Noria, and withdrawing entirely from the neighbouring country of Centrum, where *SmartWear*'s 15 retail outlets were all suffering heavy losses and showing absolutely no sign of recovery.

- (b) **Evaluate the strategic and ethical implications to *SmartWear* of the planned shop closures in Noria and the withdrawal from Centrum.** (12 marks)

Professional skills marks are available for applying *scepticism* skills to the underlying issues and problems which may arise from this strategic decision. (2 marks)

(24 marks)

- 3 The executive summary of an internal audit report on *SmartWear*'s supply chain management has been given to you by the chair of the audit committee. The report identified a number of significant issues in areas such as an appraisal of existing suppliers' performance and internal reporting provisions.

On behalf of the board of directors, the chair of the audit committee has asked you to provide the buying and merchandising director with an objective appraisal of the supply chain management arrangements at *SmartWear* to effectively address the various issues raised in the report.

Required:

Draft a memo to the buying and merchandising director, which evaluates the effectiveness of internal control systems at the company, particularly on the procurement side, and recommends control improvements to rectify the identified areas of concern. (12 marks)

Professional skills marks are available for *commercial acumen* skills when recommending solutions to those issues highlighted in the internal audit report. (4 marks)

(16 marks)

- 4 Recently commissioned market research has concluded that *SmartWear* appears to have no clear understanding of the profile of its customer mix, and as a result operates quite unsophisticated and ineffective marketing campaigns. Recent financial results indicate that *SmartWear* is finding it hard to both retain and get repeat business from existing customers, and the company is clearly losing market share to both established competition and newer e-retailers.

The sales and marketing director has been considering the development and implementation of a sophisticated customer database management system (CDMS), incorporating a customer loyalty scheme, to replace the existing very basic customer database. The marketing department has undertaken a financial appraisal of this proposal to supplement the market research findings, and this indicates that it is financially viable in net present value (NPV) terms. You have advised the sales and marketing Director that for the board to agree to the proposal, a clearly stated business case and more reliable evaluation of the financial viability of the project will be needed. She agreed and asked you to help her in this regard.

Required:

Write a report on behalf of the sales and marketing director, for presentation to the board which achieves both of the following:

- (a) **Describes the benefits of introducing a customer database management system, including the loyalty scheme, for *SmartWear*.** (6 marks)

Professional skills marks are available for *commercial acumen* skills by demonstrating awareness of business and wider external factors impacting on the decision to implement the CDMS. (2 marks)

- (b) **Evaluates the marketing department's NPV analysis that supports the CDMS investment, questioning any underlying assumptions made.** (10 marks)

Professional skills marks are available for displaying *scepticism* about the cash flow forecast used to support the proposal. (2 marks)

(20 marks)

- 5 Severe criticism was forwarded to the chairman of *SmartWear* from an influential institutional shareholder about what it perceived as the short-sighted and narrow focus of the board on the low cost – low price business model. However, the board considers this criticism to be unjustified, since its focus has always been on the wider and longer-term strategic interests of *SmartWear* that has enabled it to achieve sustainable business growth.

The board believes the most probable reason for the criticism is a lack of understanding by certain investors of the *SmartWear* business rationale and the company's integrated thinking. To further improve the effectiveness of communication with investors, and the wider stakeholder community, the board of *SmartWear* decided to adopt its own version of the integrated reporting <IR> framework. The board unanimously agreed that the best results would be achieved when the company takes a more holistic view of its operations and performance, and so you are tasked to brief the board on how to make this message clearer to investors.

You have been asked by the CFO to help him make the case and persuade the board and his own finance team that integrated thinking and the Integrated Reporting <IR> framework should be adopted at *SmartWear*.

Required:

- (a) **Prepare one slide [with appropriate notes] for a brief presentation to be given by the CFO at the next board meeting which describes the benefits of integrated thinking within *SmartWear* to all stakeholders.** (6 marks)
- (b) **Prepare a briefing paper for the CFO to allow him to address the wider finance team to explain how corporate reporting using the <IR> framework provides more relevant information for *SmartWear*'s shareholders about the creation of sustainable long-term value.** (6 marks)

Professional skills marks are available for demonstrating appropriate *communication* skills to the different audiences. (4 marks)

(16 marks)

Exhibit 1: Briefing notes prepared by the business development department for the consultant

SmartWear Mission Statement: *Our mission is to make the widest range of good quality fashion, which is responsibly sourced, available to everyone at affordable prices.*

To achieve the mission, the Board has agreed the following strategic goals:

1. Continued investment in all of our core markets that continue to offer significant growth opportunities to satisfy the needs and demands for low cost products and services of all our customers.
2. Develop strong, long-term relationships with our key suppliers based on mutual respect and serving each other's interests.
3. Function with the highest ethical standards of social responsibility, expecting the same from all business partners.
4. Maintain a successful and viable company that delivers healthy financial returns to our investors.
5. Be a responsible custodian and user of natural resources which are managed in a sustainable way.

Governance arrangements

SmartWear has a balanced board of directors, most of whom have been with the company for more than a decade and whose responsibilities cover all of its core business functions. The five Non-Executive Directors [NEDs] ensure that the board and the company remain fully compliant with the Noria Code of Corporate Governance; a listing requirement for all companies on the Noria Stock Exchange.

The NEDs, being part of the unitary board, discharge their duties and responsibilities through a number of sub-committees [e.g. the audit committee] with expressed authority to challenge and scrutinise the executive members of the board.

Business development

Since it was listed on the Noria Stock Exchange five years ago, *SmartWear* has enjoyed meteoric success. At that time, it had only 40 retail outlets in Noria, but since then through careful and planned investment, the company has achieved sustained growth and become a substantial multi-national business with over 100 outlets in Noria and a similar total number of stores in several other European countries.

Industry analysts have remarked that *SmartWear* has never exploited e-commerce opportunities, when there have been several new entrants into the market in the past few years who only sell online. The convenience and quality of service that these e-retailers provide has proven to be very appealing to many of *SmartWear's* traditional customers, who have shifted their shopping patterns and loyalty. The absence of detailed customer data has prevented *SmartWear* from mitigating the risks presented to its market share from e-commerce.

Exhibit 2: Transcript of a recent *SmartWear* board meeting discussion which took place before the external consultant was appointed

Chairman	<p>The next item on the agenda is a review of our recent financial performance, which I know is of real concern to us all, particularly with the poor economic conditions we currently face in Noria, and the weak performance of our operations in Centrum.</p> <p>This is despite a somewhat optimistic recent newspaper article report suggesting that things in Noria may improve next year. So, I have asked the Finance Director to present us the facts so that we can decide on the best way to move the business going forward.</p>
Finance director	<p>Thank you, Mr Chairman. It is true that our current financial statements do not present the company in a particularly strong position. However it is not all bad news. The profit levels have fallen primarily because our sales revenue has dropped significantly over the last year. However, we have managed to maintain tight cost control over our suppliers so our gross profit margins are still holding well. Unfortunately, we are victims of our success in recent years, which means that we now have significant infrastructure costs and overheads to carry because we are much larger business than we were previously.</p>
NED, stood and got the attention of the finance director	<p>I'm sorry to interrupt you, but I have something important to add at this point as it may alter what you say next. One of our larger institutional investors contacted me, because we have other mutual business interests, stating in very clear terms that they were dissatisfied with the level of returns they are currently getting on their investment in <i>SmartWear</i>. They have seen a significant fall in share price value and are concerned about whether there would be any proposed annual dividend. I would just like to provide them with assurances that these rumours are wrong, and that they can expect our share price to rise again in the near future.</p>
Finance director	<p>Thank you for bringing this matter to our attention, as I too have had difficult conversations with a number of investors over the past few weeks. I suspect that it might be from some of my discussions that they are worried about a suspension of the dividend. However, I'm afraid it is true, and it was going to be one of the proposals I was to table later at this board meeting. With the current state of company finances it would be negligent of me as finance director to recommend a dividend this year and deplete our cash reserves further.</p> <p>Also, in accordance with Noria Stock Exchange listing rules, the company has to issue a profit warning when forecast earnings levels fall significantly below analysts' expectations, which I regret they now do. This is likely to result in a further downward adjustment in our share price, at least in the short term.</p>
NED interrupted again	<p>This institutional investor further suggested to me that the strategic direction of the company is completely wrong, and that <i>SmartWear</i> has become out of touch with its core customers. He suggested that this is the main reason why the company has been losing sales to competition, and unless the board make radical changes the situation may get far worse.</p> <p>I'm afraid that simply informing our investors that things are as bad as they thought will not reassure them about the board's ability to turn around the business. The absence of detailed and accurate information about customers, and the lack of technology to systematically capture and analyse such information, is putting <i>SmartWear</i> at a competitive disadvantage.</p> <p>Therefore, I propose that we engage the services of an external consultant to investigate what is currently wrong with <i>SmartWear</i>, and to report back with proposals on how the business can return to success. A fresh pair of eyes is always useful when a critical and objective appraisal of a difficult situation – like this – is required.</p>

Noria Herald

More doom and gloom on the horizon

Having already suffered more than three years of economic misery there is still no end in sight for the poor people of Noria. A recent report issued by the Finance Ministry has forecast negative economic growth, which in reality means further decline for Noria during the whole of this year and possibly beyond. Price inflation has been running at nearly 7% for over a year, which is high for the Noria economy, but with a stagnating economy the central bank will be reluctant to raise interest rates. So, with more than 8% of the adult population currently unemployed and an austerity programme imposed by government because of reduced taxation revenue – the prospects in Noria still look pretty bad!

The big question must be – are there any signs of economic recovery, which a reporter from the Noria Herald asked the Finance Minister at a press briefing yesterday. To which his reply was: ‘So, if we are able to successfully survive the 20X9 period without any more important businesses going into liquidation or further heavy job losses, then it seems that an economic recovery may start as early as next year ... that is our expectation, but we have to wait and see.’

Exhibit 4: Comparative macroeconomic data

	Noria	Southland	Centrum
Population	<ul style="list-style-type: none"> • 10,400,000 • Working age population 6,550,000 • Growth rate +0.2% per annum • 38% under 30 years 	<ul style="list-style-type: none"> • 5,780,000 • Working age population 3,450,000 • Growth rate +0.8% per annum • 43% under 30 years 	<ul style="list-style-type: none"> • 3,250,000 • Working age population 1,860,000 • Growth rate +1.4% per annum • 52% under 30 years
Unemployment rate	<ul style="list-style-type: none"> • 8.8% current year • 9.1% last year 	<ul style="list-style-type: none"> • 6.2% current year • 5% last year 	<ul style="list-style-type: none"> • 12.0% current year • 10.5% last year
Average annual earnings	\$48,500	\$51,700	\$38,500
Central bank interest rate	<ul style="list-style-type: none"> • 1.50% • Unchanged over 18 months 	<ul style="list-style-type: none"> • 2.50% • Increased by 1.0% over 18 months 	<ul style="list-style-type: none"> • 6.00% • Increased by 2.5% over 12 months
Inflation rate	2.2% [stable]	1.4% [stable]	3.8% [rising]
Consumer debt as a percentage of Gross Domestic Product	<ul style="list-style-type: none"> • 88% [and falling very slowly] 	<ul style="list-style-type: none"> • 67.5% [and falling slowly] 	<ul style="list-style-type: none"> • 115% [and rising]
Political and economic system	<ul style="list-style-type: none"> • Democratically elected coalition government • Free market economy • Developed capital markets 	<ul style="list-style-type: none"> • Democratically elected government • Free market economy • Developed capital markets 	<ul style="list-style-type: none"> • Democratically elected government • Emerging economy • Developed capital markets
Dominant business sectors	<ul style="list-style-type: none"> • Financial services • Retail • Defence technology • Tourism 	<ul style="list-style-type: none"> • Financial services • Retail • Shipping and transportation • Technology development 	<ul style="list-style-type: none"> • Agriculture • Steel production • Mining • Tourism

Exhibit 5: Executive summary of the *SmartWear* internal audit report on supply chain management

Introduction

This report analyses the effectiveness of the supply arrangements between *SmartWear* and its core suppliers, all of whom are based in countries in south east Asia. The report itself was requested by the audit committee when information about alleged poor working practices among some suppliers was brought to its attention. However, the scope of this internal audit extended beyond this narrow social responsibility issue into broader operational and financial management aspects of the *SmartWear* supply chain.

Supply chain management is particularly important to *SmartWear* because as a retailer a very significant proportion of direct costs relate to inventory purchases, which in turn directly impacts on corporate profitability and investor returns.

1. Appraisal of existing suppliers' performance

Most suppliers have been working with *SmartWear* for more than five years, and there have been no reported instances when purchase orders have not been completed on time or in full. This has led to a rather complacent attitude from the buying department who do not see the point in 'fixing something that isn't broken'. As a result, if no quality problems arise the buyers rarely contact the suppliers, which led to a culture of carelessness. Supply contracts are awarded for a period of between three and five years, with prices charged indexed to inflation. This means that prices rise annually by only a few percentage points, which is then built into the *SmartWear* budgeting process. No effort is made by the buying department during a contract period to compare what prices the company is paying to its suppliers compared with the industry average or competition.

The allegations that have been made about poor working conditions in some supplier factories have gone unchallenged, and even possibly unnoticed by the buying team. If the suppliers had been more effectively monitored, then the buying department would have identified a clear contravention of the general terms and conditions contained within all *SmartWear* supply contracts. These standard terms are a reflection of *SmartWear*'s own corporate social responsibility commitments. However, as the buying department operates as a cost centre, the buyers' primary motivation is always to keep costs down rather than monitor the ethical practices of the suppliers.

2. Reporting weaknesses

There is an expectation that any serious breach of supplier performance or unacceptable behaviour would be reported to senior management, so that an appropriate and measured response could be made. However, the word serious is rather subjective and it is entirely up to the buying department whether or not to escalate any matter. Consequently, if a serious issue is not raised then the buying and merchandising director would not be aware of any problem, and so he would not bring it to the attention the board. The absence of formalised regular reporting means that supply chain issues are only ever considered by the board of *SmartWear* when an exceptional event occurs, and this has not been the case over the past two years. Therefore, the board has been working on the assumption that supply chain management in the company is operating efficiently and effectively, when this audit has shown this not be the case. This represents a serious internal control weakness which needs to be rectified.

Exhibit 6: Customer database management system [CDMS] financial investment appraisal

(All figures \$ millions)	Note	Time periods					
		0	1	2	3	4	5
Investment in CDMS technology	1	(38·0)					
Operating costs			(2·0)	(2·0)	(2·0)	(2·0)	(2·0)
Additional contribution	2		22·0	22·0	22·0	22·0	22·0
Interest payable on loan	3		(3·0)	(3·0)	(3·0)	(3·0)	(3·0)
Net cash flow		(38·0)	17·0	17·0	17·0	17·0	17·0
Corporation Tax at 30%			(5·1)	(5·1)	(5·1)	(5·1)	(5·1)
Post tax net cash flow		(38·0)	11·9	11·9	11·9	11·9	11·9
Discount factor at 10%	4	1·000	0·909	0·826	0·751	0·683	0·621
Present value of net cash flows		(38·0)	10·8	9·8	8·9	8·1	7·4
Net Present Value		<u>7·0</u>					

Notes

- Total investment comprises: – Initial capital outlay.
– Sales tax on the purchase price recoverable through the Noria tax authorities.
– Installation and system testing costs.
– Staff training on the CDMS.
– Five-year maintenance and support contract with the supplier.
- It is estimated that the CDMS will directly generate additional contribution from new and retained customers.
- A new \$38 million loan will be taken out to finance the project, with interest payable at 8% per annum.
- The *SmartWear* weighted average cost of capital of 10% is used as the project discount factor.

End of Question Paper