

Strategic Professional – Essentials

# Strategic Business Leader

Specimen 3 Examination

Valid from September 2018 Exam Session



**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**

# Strategic Business Leader

The Association of  
Chartered Certified  
Accountants

## Introduction

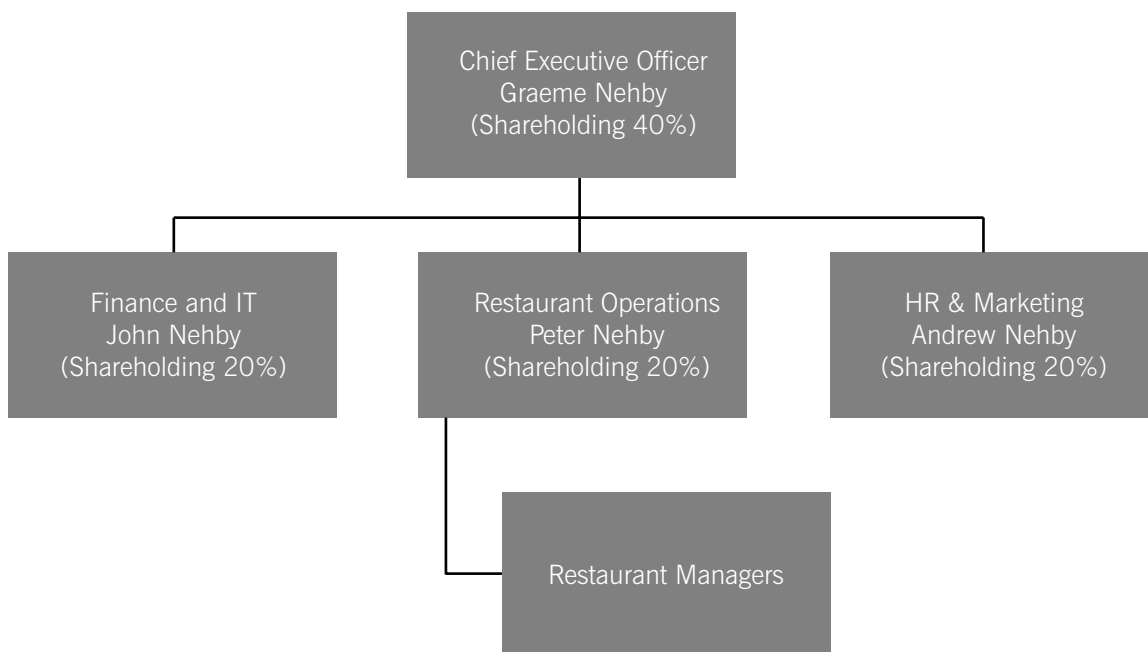
Nehby Company (Nehby) is a family business which owns and operates eight restaurants in Caputo, the capital city of the country of Ceeland. Caputo is located in the south of the country.

Nehby has been in business for the last 35 years. During that time the company has created some of Caputo's most iconic and best loved restaurants. The theme of their success is renovating and restoring historic buildings, transforming each one into a beautiful and original restaurant.

The original founder, Graeme Nehby, is also the chief executive officer (CEO) of the business. Graeme has a strong personality and his views have tended to dominate the direction of the business to date. Graeme's three sons have all joined the family business and together with Graeme form the board of Nehby.

Figure 1 below shows the current reporting structure and ownership of the business.

Figure 1



The Nehby board is considering the future strategic direction and investment plans for the business. The sons have suggested that Nehby should pursue a strategy of product diversification and enter the hotel industry. They have identified a new business opportunity, in the north of Ceeland, to renovate and restore a historic building, formerly a bank, and turn it into a hotel, which will be operated by Nehby. However, Graeme believes that the business should continue with its current business model of converting historic and iconic buildings in the capital city into restaurants and wants Nehby to open another new restaurant in Caputo.

Graeme and his three sons want to seek advice and guidance about the opportunities available to them. They have commissioned you, as an independent self-employed management consultant, to provide them with information and analysis to support their future expansion plans and advise them about their choice of strategic direction.

You have collected and analysed the following information, exhibits (1–6), to help with your task.

Exhibit 1: Article, on the success of Nehby's restaurants, published in the Caputo Post newspaper.

Exhibit 2: A transcript of the views of each member of the Nehby board on company performance to date and the future strategic direction of the business.

Exhibit 3: Information on the two investment plans, prepared by John Nehby.

Exhibit 4: Article on the hospitality industry in Ceeland.

Exhibit 5: Nehby Company financial and management accounting information – extracts for the year ended March 20X0.

Exhibit 6: A transcript of an interview shown on 'Talking Stock', a Ceeland television programme which looks at business topics.

The case requirements are included in the tasks shown below:

- 1 Nehby Company is now considering whether to continue with the current business model of renovating an historic building and transforming it into a restaurant in Caputo or to diversify the portfolio and enter the hotel industry by converting the former bank, situated in the north of Ceeland, into a hotel. The board of Nehby has requested an independent report on the two mutually exclusive investment options they are considering.

**Required:**

**Prepare a report which assesses and appraises the two options from a strategic perspective. The report should allow the board of Nehby to compare and contrast the two options.**

Note: A recommendation is not required. (20 marks)

Professional skills marks are available for demonstrating *evaluation* in assessing and appraising the information the board of Nehby will need to use to form the basis for their final decision. (4 marks)

**(24 marks)**

- 2 Graeme has been giving consideration to your assessment of the two available options for Nehby. He wants to understand more about how the new investment will affect the risk facing Nehby Company and the factors to consider when deciding on the financing decision for acquiring the hotel.

**Required:**

**Prepare briefing notes for the board of Nehby on the following:**

- (a) **An explanation of the appropriateness to Nehby Company of diversifying risk by going into the hotel business.** (6 marks)

Professional skills marks are available for demonstrating *scepticism* in questioning the appropriateness of diversification for Nehby. (2 marks)

- (b) **Consideration of the key factors which will influence the financing structure the board of Nehby Company might choose.** (8 marks)

Professional skills marks are available for demonstrating *commercial acumen* in using judgement and showing insight in clarifying the key factors and their implications for the board of Nehby. (2 marks)

**(18 marks)**

- 3 Following a board meeting which discussed your report on the two options, the board is in complete agreement that the hotel renovation and running a hotel is the strategic direction they have chosen to pursue. John recognises that renovating the former bank building and transforming it into a hotel will be a major project and adequate measures will need to be put in place to track how well the project is doing and to ensure overall objectives are achieved.

**Required:**

**Prepare a report for John which includes:**

- (a) **Recommendations, with justification, of the measures which will be important for tracking all major project variables to ensure satisfactory progress towards the achievement of the project goals and the successful opening of the hotel.** (8 marks)

Professional skills marks are available for demonstrating *commercial acumen* in demonstrating awareness of the suitable measures which will be important for the control of the hotel project. (2 marks)

John also recognises that as a result of choosing the hotel project and the size of the investment required, Nehby will need to secure equity funding from a venture capitalist. To secure the investment, the expectations of the venture capitalist will need to be taken into consideration, which will require changes to the governance and culture of the business.

**Required:**

**The report should also include the following:**

- (b) **An explanation of the implications, both for the board of Nehby and for how the business is managed, of the governance changes needed should a venture capitalist provide the equity funding needed for the hotel project.** (10 marks)

Professional skills marks are available for demonstrating *commercial acumen* in demonstrating awareness of the governance changes which will be required. (3 marks)

- (c) **An analysis of the current culture of Nehby and an assessment of how the culture may need to change to align with the strategic aims of a venture capitalist and external shareholders.** (12 marks)

Professional skills marks are available for demonstrating *analysis* in considering the implications of the changes needed in relation to the future culture of the business. (3 marks)

**(38 marks)**

- 4 The popular television programme 'Talking Stock' has just broadcast an episode which includes an interview with a venture capitalist. You have advised the board of Nehby to watch the episode with a view to understanding the need for improvements in the information currently presented in the management accounts and the additional information which will need to be provided in the future. You are then going to deliver a presentation to the board regarding their current management accounting information.

**Required:**

**Prepare a presentation with an appropriate number of slides and accompanying notes to support your findings covering the following items:**

- (a) **Identification of the weaknesses of the current management accounting information in supporting decision making for the restaurant business.** (6 marks)

- (b) **Recommendations for improvements to management accounting data which identifies key performance indicators (KPIs) which should be included in the monthly management accounts to support decision making for the hotel business.** (10 marks)

Professional skills marks are available for demonstrating *communication* in clarifying relevant information to the board of Nehby. (4 marks)

**(20 marks)**

## Another Prestigious Award for Nehby Company



### Elite restaurant business continues to move forward.

The most recent award, one in a long line of acknowledgements from the industry, is a special award for the significant contribution Nehby has made in shaping Caputo's dining scene for 35 years. It is the driving force behind some of Caputo's best-loved restaurants and the award is in recognition of their visionary approach and attention to detail which has never faltered in the 35 years the company has been in business.

The Company operates eight restaurants in Caputo. Its philosophy for success has been to masterfully renovate historic buildings transforming each one into an original restaurant. The eight restaurants are institutions where you are likely to see high profile film stars and famous sports personalities as well as government ministers. The clientele are demanding and refined and are the rich and influential of Ceeland society. Many of those who frequent the restaurants have been loyal to Nehby Company since the opening of its first restaurant.

The restaurants provide wonderful menus, serving only best quality food cooked to perfection. The Nehby Company's restaurants have always provided a perfect balance of service ambience and quality of food without an over-emphasis on one or the other.

This has been achieved by careful attention to detail and an absolute hands-on approach and a board member often being present in the restaurants. They also seem to have an intuitive sense of what restaurant-goers want from the experience and the ability to attract and command intense loyalty from senior staff in an industry known for high staff turnover. They have a talent for bringing together strong teams who run exceptionally busy outlets with complete regularity and precision.

There are relatively few people who can open a restaurant in Caputo with as much instant glamour as Nehby. The very best restaurants are like film sets in which diners play both cast and audience and no restaurateurs know this better than the Nehby executives.

Over the years they have collected plenty of awards, featuring in lists such as Top 50 restaurants in Caputo. Their many awards are deserved acknowledgment for their role at the forefront of Caputo's rise to becoming one of the culinary capitals of the world.

The industry rumours are that Nehby is looking to expand its portfolio and open its first hotel. This is the Company's opportunity to perform on a bigger stage than ever before. The board members just need to prepare for their audience at the hotel in the same way they have prepared in the restaurants. Long may their success continue!

## **Exhibit 2 – Transcript of the interviews which were held between you and each member of the Nehby board.**

You asked each member of the board to express their thoughts on company performance to date and the future strategic direction of the business. Below is the transcript of their views.

### **Graeme Nehby: CEO**

I am very clear about our future strategic direction; we should continue to build on our strengths and core competences by expanding our restaurant portfolio in Caputo. One of our clear aims is to maintain growth in our core markets by retaining the values associated with our current restaurants. If we continue to deliver excellent service and our unique and innovative fine dining atmosphere, we will continue to differentiate ourselves effectively from the competition and deliver more of the success we have achieved to date.

We have been successful in attracting and commanding intense loyalty from our restaurant staff. We know that the restaurant industry is renowned for long working hours, and often kitchen staff will work longer hours than they are actually paid for. Despite this, our staff turnover is relatively low, in an industry known for high staff turnover.

I know that to expand the business we will need a cash injection and if we undertake the hotel project it is likely to come from a venture capitalist. I fear that will mean substantial changes to the input the board will have in the future strategic direction. I understand that external investors can bring benefits and I know there are weaknesses that we need to address, not least our reactive planning approach which has meant that on occasions we have missed potential opportunities which we should have exploited.

Our reactive approach means we can change the strategy as we see fit. This approach is unlikely to be sustainable once the business has external ownership. We can currently take a longer term view and have the freedom to act in our own best interest which may involve taking decisions that are not wholly intended to maximise profit or wealth. I can see that my expensive company car will not be seen as essential by potential external investors. I believe the cars we drive are part of the status and reward for a 'job well done'.

### **John Nehby: Finance and IT**

Our current investment criteria are for projects to deliver a positive NPV at the cost of capital chosen and to achieve a payback within five years. Evaluation and authorisation are only the first steps of the investment process. It is important to report regularly on progress to enable effective monitoring and control of the investment project. The degree of commitment, enthusiasm and drive of the board in implementing a project is a major factor in determining our success to date and the success or failure of the option we choose for our next investment.

I am very excited about the extraordinary property that we have identified in the regeneration belt in the north of Ceeland. The building was formerly a bank and has a beautiful facade, a riverside location and a roof top terrace that has magnificent views over the largest city in the north of the country. The feel of the property is one that could be developed into a grand hotel once it has undergone a sympathetic renovation. I believe we should try and take any first mover advantage available to us.

We should also be taking advantage of the grants that are available for businesses choosing to invest in the north of Ceeland. The government has ring fenced more than \$3 billion of development activity which indicates an ambitious regeneration policy which we would be foolish not to be a part of.

A venture capitalist will be committed to our success in a way that the bank is not. A bank will get the same amount of interest on our loan regardless of how well we are doing. The current terms with our bank stipulate that our gearing does not reach 45% and that we remain solvent. A venture capitalist's return, on the other hand, grows in proportion to how successful we become. So, in signing away some measure of control in the form of shares, we also gain a powerful ally to help realise our plans. We do not have the appetite or capacity as a family to do this alone.

### **Peter Nehby: Restaurant operations**

My initial concern was not being able to finance the hotel without external investment and the potential dilution of my shareholding. However, after careful consideration of both the benefits and drawbacks, I am now excited about a new venture into hotels.

My main concern now is that the hotel sector is characterised by high operational gearing so that would be one aspect of the business I would want to monitor carefully, especially when economic conditions take a downturn. The strength of the hospitality industry is a measure of the wealth in people's pockets and so costs will need to be carefully monitored when there is uncertainty in the economic climate.

Our success is based on a strong set of values which we expect each member of staff to promote and live by. Our carefully crafted mission statement reflects those values *‘to deliver hospitality from the heart to create great places to eat which combine an intriguing atmosphere with excellent and interesting food where customer satisfaction is paramount and where people, staff and customers, feel they belong’*.

I know that my experience with the restaurants can be transferred to the hotel venture and that the mission statement can evolve to take account of the new addition to the portfolio. I am also looking forward to creating a restaurant space in the hotel that delivers a real sense of occasion.

**Andrew Nehby: HR and Marketing**

The market conditions are suggesting that maybe it is now time to diversify our portfolio. It will still be important that we continue with the values that have delivered our success to date and for us to stand out from the crowd. We will be transferring our values into the hotel sector of the industry.

The hotel's project plan is for 67 bedrooms, including 16 suites. Food will be a major part of the hotel with an 80-seat main restaurant in the centre of the hotel and a bar and lounge that will serve food throughout the day. We will take room service very seriously with a 24-hour operation with the same attention to detail as provided in the main restaurant. We intend to take the quality of service and choice experienced in the restaurant into the bedrooms and suites. We know that restaurants play a bigger role than ever in hotels, so we are still playing to our core strengths.

We have achieved significant recognition for our restaurants and I see no reason why that should not extend to the hotel sector. I have already made enquiries about becoming a member of the Worldwide Luxury Hotels Elite Group. This is an organisation representing the finest hotels in the world. Only the world's most distinguished properties are admitted into its membership. This would be a great marketing tool. If during the development we keep in mind the criteria needed to meet their standards, then I am reliably informed that we could be awarded this status within six months of opening.

### Exhibit 3 – Information for the two investment plans.

John Nehby has put together information on the two potential mutually exclusive investment options.

	Restaurant	Hotel
<b>Background on investment</b>	Expansion of our existing restaurant business. Opening a new restaurant in Caputo, taking our total restaurant portfolio to 9.	Open a hotel in the north of Ceeland which would qualify for a government grant towards renovation costs. This will add a new product to our overall portfolio.
<b>Initial investment outlay</b>	\$5m – The basis for determining the initial investment outlay is the actual cost incurred in the renovation of our latest restaurant added to our current portfolio, 15 months ago.	\$21m – The basis for determining the initial investment outlay is information sourced from industry experts who have recent involvement in hotel renovations projects.
<b>Proposed project commencement</b>	A building has been identified and has been held on reserve but if this falls through, then it may be hard to find another suitable property due to scarcity of buildings in Caputo which will meet the business requirements.	Former bank identified and has been held on reserve but if this falls through, there are other available properties which would meet the business requirements.
<b>Project duration</b>	3 months once final agreement negotiated and financing structure is agreed.	9 months once final agreement negotiated and financing structure is agreed.
<b>Cash flows (analysis below)</b>	The net cash flows are based on the figures achieved for the latest restaurant added to the current portfolio, 15 months ago.	The net cash flows do not include any of the government grants which may be obtained for the renovation work. The cash inflows are based on 65% occupancy in years 2, 3 and 4 rising to 85% in years 5, 6 and 7 and are calculated using average daily room rate per rented room for the industry as a whole.
<b>Discount factor</b>	8%	10% – Hotel investment is considered a higher risk.

Restaurant	Initial investment (\$m)	Net cash flows (\$m)	Discount factor 8%	Present value (\$m)
Year 0	(5)		1	(5)
Year 1		(0.5)	0.926	(0.463)
Year 2		0.5	0.857	0.4285
Year 3		1	0.794	0.794
Year 4		1.5	0.735	1.1025
Year 5		2	0.681	1.362
Year 6		2	0.630	1.26
Year 7		2	0.583	1.166
<b>NPV</b>				<b>0.65</b>

Hotel	Initial investment (\$m)	Net cash flows (\$m)	Discount factor 10%	Present value (\$m)
Year 0	(21)		1	(21)
Year 1		0	0.909	–
Year 2		4	0.826	3.304
Year 3		5	0.751	3.755
Year 4		6	0.683	4.098
Year 5		7.5	0.621	4.658
Year 6		7.5	0.564	4.230
Year 7		7.5	0.513	3.848
<b>NPV</b>				<b>2.893</b>

**Note:** The initial capital outlay for both options is to cover acquisition and renovation costs.

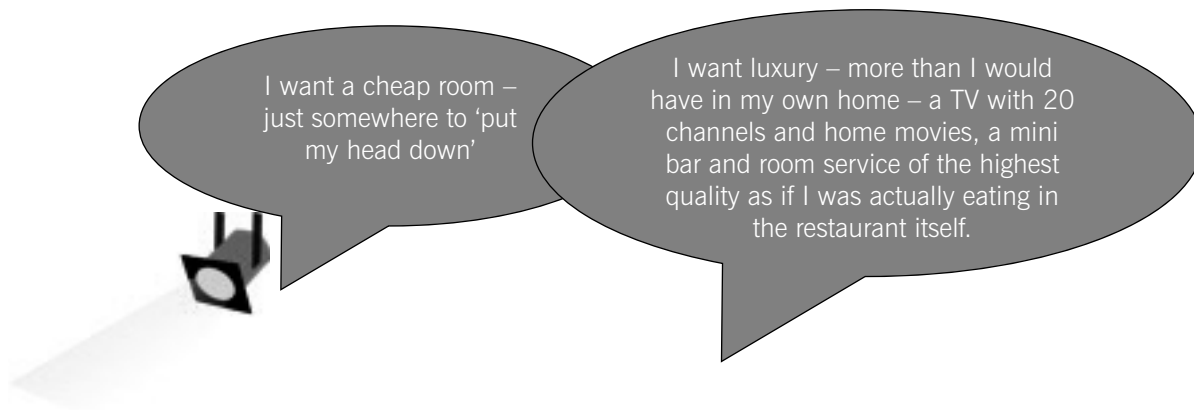


## Hospitality's importance as an industry sector

The hospitality industry makes a major contribution to the Ceeland economy and employs a large proportion of the population. In some parts of Ceeland the industry is the main source of income and employment. The industry is driven by and dependent on a strong economy. The strength of the hospitality industry is a measure of the wealth in people's pockets.

### Customers

Not everyone wants the same type of service or food. The industry has to identify customers' different needs and offer suitable services and food to match those needs.



### Spotlight on the future

Industry commentators expect another excellent year for the hospitality industry, anticipating rising hotel occupancy rates as well as an increasing number of restaurant meals served in all types of restaurants.

In the last 12 months revenue per available room (RevPAR), a performance metric used in the hotel industry, has increased from \$116.70 to \$118.40. The rate represents total room and related revenues divided by total available rooms. This is often used as a measure of performance yield for hotels. Over the same period average daily rate (ADR) achieved has remained consistent year on year. ADR is the average daily rate per rented room, or the mean price charged for all hotel rooms sold in a given period.

Restaurants play a bigger role than ever in hotels and the restaurant is unlikely to be sustained by the hotel guests alone. The demand for restaurant services has, in the past, been largely influenced by economic growth and the amount of available disposable income, so confidence should also be increased both by a fall in unemployment, 7.1% at the end of last year down by 0.7% on the previous year, and by a rate of GDP growth which was higher last year than at any time in the past seven years.

### Northern regeneration programme

Perhaps one of the most astonishing statistics regarding RevPAR is that the rate is likely to increase faster in the north of Ceeland where a regeneration programme is underway to support the successful bid for the north to host a major sporting event in two years' time. This can only be positive news as other countries who have hosted similar events have experienced millions of visitors each year for many years after the event. The Ceeland Government has unveiled wide-ranging plans to dramatically transform and regenerate the north of the country which has been given Ceeland Assisted Area Status allowing companies which facilitate economic growth in the area, to qualify for government grants.

The attraction of the capital as a destination for tourism remains high, but the outlook for the north also offers attractive opportunities. Overseas visitors to Ceeland will rise by 600,000 this year, the highest in the last five years. The good news is that the world has an ageing population with more disposable income and a desire to travel. Increased competition in the airline market has resulted in lower fares. Everything seems to be leading to increased travel, which is good news for the hospitality industry.

The 'feel good' factor in the capital is now extending to other major cities, particularly in the north of the country. We could have three times as many restaurants in the capital city, but there are not enough great sites available and there is fierce competition to acquire the best sites, so it makes sense for a business to consider investment in the north of Ceeland.

## **Trends set to continue**

### **Eco-friendly**

Responsible business practices are an important consideration for many consumers. Hotels and restaurants need to consider their wider contribution to society. Hotel guests are more conscious of environmental problems and have started to consider the environment in their accommodation choice. This is also becoming valid for luxury hotels. The development of eco-labels is thus helping customers in their choice. Without cutting back on clients' comfort, many efforts can be made by the hotel management through the application of best available practices and technological innovations.

### **Healthy options**

Healthy eating has become a mainstream dining trend in recent years with the arrival of the 'stealth health' trend where chefs replace salt, fat and sugar with healthy, bold flavours without promoting it to customers. Because customers now expect healthy options in all restaurants, chefs need to comply by offering them these options without sacrificing flavour.

### **Technology**

The industry is increasingly engaging with digitally active consumers who expect to be able to interact with brands on a personalised, multichannel basis and who are harnessing social media and mobile technology at an ever faster rate. Technology continues to have a multifaceted and substantial impact on the industry with rising mobile phone usage, social networks used to plan and share experiences and big data being used to improve business processes and intelligence to better deliver the customer promise.

### **Talent**

Talent is available in the country. Due to the economic stability we are currently enjoying in Ceeland, we are seeing much of the home grown talent staying rather than the exodus we have seen in previous years for employment outside the country and in more stable economies. There are still countries which tend to train and recruit the best in the industry and Ceeland needs to consider its training programmes so as not to fall behind the rest of the world.

The hospitality sector is diverse and rapidly changing and the challenges faced by hospitality businesses are wide ranging. These include the need to attract the best talent, a mission to harness technology and a constant drive to improve customer satisfaction and experience.

**Exhibit 5 – Extract from financial statements and period 12 monthly management accounts from the finance director – John Nehby**

**Statement of profit or loss for the year ended 31 March 20X0**

	\$
Sales	9,610,137
Cost of sales	(6,184,445)
Gross profit	<u>3,425,692</u>
Administration costs	(2,231,552)
Operating profit	<u>1,194,140</u>
Finance costs	(53,016)
Profit before tax	<u>1,141,124</u>
Tax	(598,426)
Net profit	<u>542,698</u>

**Statement of financial position as at 31 March 20X0**

	\$	\$
Non-current assets		1,623,650
Current assets		
Inventory	380,843	
Trade receivables	68,620	
Cash	<u>978,019</u>	
Total current assets		<u>1,427,482</u>
<b>Total assets</b>		<u>3,051,132</u>
<b>Equity and liabilities</b>		
Share capital	300,000	
Retained earnings	<u>933,758</u>	
Total equity:		1,233,758
<b>Non-current liabilities</b>		
Long-term loans	<u>1,065,010</u>	
Total non-current liabilities:		1,065,010
<b>Current liabilities</b>		
Bank loans and overdrafts	139,908	
Trade payables	287,371	
Tax payable	257,371	
Other payables	<u>67,714</u>	
Total current liabilities		<u>752,364</u>
Total liabilities		<u>1,817,374</u>
<b>Total equity and liabilities:</b>		<u>3,051,132</u>

## Management Accounts 20X0:

	Management Accounts Period 12 (March 20X0):					Cumulative – for the year (20X0):				
	Budget:		Actual:			Budget:		Actual:		
	\$	% of sales	\$	% of sales	Variance	\$	% of sales	\$	% of sales	Variance
Sales turnover	<u>1,000,000</u>	100	<u>995,000</u>	100	<u>(5,000)</u>	<u>10,000,000</u>	100	<u>9,610,137</u>	100	<u>(389,863)</u>
Food cost	325,000	32%	285,000	29%	40,000	3,000,000	30%	2,571,298	27%	428,702
Labour cost	350,000	35%	345,000	35%	5,000	3,600,000	36%	3,509,601	37%	90,399
Other cost	8,500	1%	14,100	1%	(5,600)	120,000	1%	103,546	1%	16,454
	<u>683,500</u>		<u>644,100</u>		<u>45,000</u>	<u>6,720,000</u>		<u>6,184,445</u>		<u>535,555</u>
Gross profit	316,500	32%	350,900	35%	34,400	3,280,000	33%	3,425,692	35%	145,692
Admin expenses	<u>170,000</u>	17%	<u>195,000</u>	20%	<u>(25,000)</u>	<u>2,000,000</u>	20%	<u>2,231,552</u>	23%	<u>(231,552)</u>
Operating profit	<u>146,500</u>	15%	<u>155,900</u>	16%	<u>(9,400)</u>	<u>1,280,000</u>	13%	<u>1,194,140</u>	12%	<u>(85,860)</u>
Food cost per head	\$16.30		\$15.90		\$0.40	\$16.30		\$14.35		\$1.95
Kitchen labour hours	25,000		27,000		(2,000)	300,000		301,500		(1,500)

### Notes to management accounts:

- Admin expenses include expenditure on accounting staff salaries, depreciation, rent and insurance on buildings.
- Food cost per head = Total food cost/number of customers.
- Kitchen labour hours includes all levels of staff working in the kitchen restaurants.

**Exhibit 6 – A transcript of an interview shown on ‘Talking Stock’, a Ceeland television programme which looks at business topics**

**Introduction by television (TV) presenter**

Venture capitalists have long played a vital role in helping entrepreneurs turn their vision into reality. They provide far more than just capital; they also provide the guidance, knowledge and experience needed to transform a company. Connect Risk Capital, a venture capitalist, was founded in 2001 investing in both start-ups and established hospitality businesses headquartered in Ceeland. We managed to get some time with one of the founders, Sam Redson (SR), and we are going to ask him a series of questions about the way venture capitalists operate in the hospitality industry.

**TV presenter: For how long do venture capitalists invest in a business?**

**Answer (SR):** We usually look to retain our investment for between three and seven years. The term of the investment is often linked to the growth profile of the business. Investments in more mature businesses where the business performance can be improved more quickly and easily are often sold sooner than investments in early-stage or technology companies, where it takes time to develop the business model. We expect robust risk management and control, because investment decisions will need to align with our appetite and we expect fast resolution of any risk issues so that return on investment can be maximised.

**TV presenter: Can you explain to us what is involved in the investment process?**

**Answer (SR):** The key stage in the investment process is the initial evaluation of a business plan. It is important that realistic forecasts have been prepared. As an example: with a new hotel we would expect forecast occupancy rates to be cautious and not exceed 50% in the first two years. In considering the business plan the venture capitalist will consider several principal aspects: is the product or service commercially viable; is the business considering the external drivers of the future; does the company have potential for sustained growth; is the skill set in place or can it be recruited; does the possible reward justify the risk? Venture capitalists need to be comfortable with their involvement.

**TV presenter: What does a VC expect of the company management?**

**Answer (SR):** We expect total commitment to the strategic direction. This would include not leaking cash in unnecessary expenditure like expensive company cars and flamboyant offices when more cost effective options will still serve the same purpose. Excessive salaries not linked to performance would be unacceptable as we would expect rewards to be linked to the achievement of business growth that we would identify at the outset of any discussions on our involvement.

We encourage a formalised approach to planning with detailed control and feedback loops. We also like to know how each part of the business is performing and to consider each part of the business as a profit centre. Total figures for the business do not allow us to monitor any under-performing parts of the portfolio and identify where greater control might be needed to keep our investment on track. Good management accounts are essential for this purpose.

The business needs to implement a structure that supports profit centre reporting and encourages a focus on both business and customer needs. We accept that fast decisions might have to be made at the operational level to support customer satisfaction and business continuity, so some decentralised and autonomous decision making is encouraged. This has to be supported by centralised guidelines and controls from ourselves to protect our investment.

**TV presenter: Why is the role of the non-executive director (NED) important?**

**Answer (SR):** It is normal for venture capitalists to place a NED on the board of the investee company to represent their interests. This can either be one of its own fund managers or an individual who has sectoral, market or management expertise which will help delivery of the corporate plan.

We also like to have an input into any key management roles which might be needed for any new venture. Even with successful businesses it is sometimes right to bring in new blood.

**TV presenter: Is it important to be a responsible investor?**

**Answer (SR):** Many of our clients strongly support environmental and social initiatives across their portfolio of companies. Target companies are assessed against a broad range of criteria: environmental, social, governance and sustainability. Companies would also be monitored on compliance with the policies and standards set out at the time of the investment; typically quarterly reports on performance would be required by venture capitalists.

**TV presenter: What else would you expect to see in the quarterly report?**

**Answer (SR):** That would depend on the critical success factors (CSFs) for the business we are considering investing in and the sector in which it operates. As an example, a hotel has so much available data to collect and businesses need to be clever about collecting it. The business must understand what they are looking for and make sure it is actually measurable.

Certain core key performance indicators (KPIs) have been established over the years. However, in recent times, alongside the rise in big data and data analytics, there has been a shift towards more specific measures, focusing on not just revenue and profit per room, but return per square metre (or how a hotel can best use the space available).

**TV presenter: What is the typical return expected?**

**Answer (SR):** Typically investors can expect annualised returns of 20% or more on their investment

**End of Question Paper**

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# Answers

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**Note**

*It is not always possible to publish suggested answers which comprehensively cover all the valid points which candidates might make. Credit will be given to candidates for points not included in the suggested answers, but which, nevertheless, are relevant to the requirements.*

*In addition, in this integrated case study examination points made in one question may be re-introduced or fully developed in other question(s) as long as these are made in the specific context of the requirements of the part of the question being answered.*

*The suggested answers presented below may give much more detail than would be expected from most candidates under examination conditions; they may also have used a particular approach or model which should not be taken as the only approach or model which could have been used. Different approaches and structuring of the answers are expected and full credit will be given for relevant and appropriate solutions to the tasks given. The answers provided here are therefore intended to support revision and tuition for future examinations.*

*Finally, it should be noted that candidates will not get full professional skills marks in a task requirement if they have not presented their answers according to the format asked for. For example, if a task is to be completed using a report and evaluation skills are tested, even if the answer has met the specifically stated evaluation criteria, candidates will not be able to earn all the professional skills marks available if they have not used the report format.*

**1 Report**

To: Nehby board  
From: External consultant  
Date: Today

**Report on two investment options prepared internally by Nehby Company**

**Introduction**

This report provides an independent assessment to the board of Nehby of the two proposed strategies under consideration, so that the next stage in the company's strategic growth is given careful consideration. This report is based on appropriate information available and has been produced to enable the board to make a well informed decision on the appropriate direction for the future.

**Suitability**

Suitability is concerned with whether a proposed strategy addresses the circumstances in which Nehby as a company is operating, that is, its strategic position and should ask the question 'does the rationale of the strategy make sense?'

The option to introduce a new restaurant is a strategy focusing on the existing product (the restaurant) in the existing market (Caputo) which has been behind Nehby's success to date. It will allow Nehby to exploit its strengths and acknowledged competences, providing a strategic fit with the mission and aim of maintaining growth in the core market.

The option to run a hotel involves introducing a new product to a new market and is a diversification strategy. It will allow Nehby to take advantage of an opportunity, the availability of grants to support the hotel development in a new growth area in the north of Ceeland. The opportunity also addresses the weakness of currently operating in only the restaurant sector of the hospitality business. Although the diversification is still within the hospitality sector, it could potentially result in a small reduction in business risk. There is the added first mover benefit of controlling a resource, the location of the hotel, which is better than locations later entrants to the development area will be able to obtain.

An additional consideration with the diversification is that it is not totally unrelated. The hospitality industry report indicates that restaurants are playing a bigger role than ever in hotels and, given the excellent track record in creating restaurants which serve good food in a relaxed and welcoming environment, Nehby already has the expertise to successfully deliver a major part of the new venture. The ambience firmly embedded in the Nehby restaurants should also become part of the culture in the hotel.

Nehby has explicitly positioned itself as a focused differentiator in a competitive market place. Competition appears to be increasing due to buoyant economic conditions and would need to continue with a visionary approach and attention to detail to continue to bring success. Nehby's strength in creating great places to eat and the many accolades it has received have helped to build such an excellent reputation. This is supported by customer loyalty and there is no reason why these customers should not frequent any new restaurant or hotel added to the portfolio.

Both options can exploit the economic growth and the fall in unemployment rates in Ceeland. The increased disposable income available is increasing the amount of travelling and the number of meals served and contributing to rising hotel occupancy.

Both options will need to recognise external drivers influencing and impacting the way business operates. Social values are driving the need for healthier options in restaurants. Customers are expecting to be able to interact with a restaurant or hotel on a personal and multi-channel basis driving the need for technology to be an important part of both investment options.

Cost advantages should be delivered with both strategies as the additional business from either option would allow for economies of scale and potential increased operational efficiency.

Both strategies may be considered as potentially suitable.



## Acceptability

The acceptability of the strategy is concerned with expected outcomes in terms of return, risk and shareholder reaction. Returns are the benefits which Nehby would expect to gain from the strategy, both in financial and non-financial terms.

The restaurant option requires a smaller capital outlay. However, the cash position may not support either of the two options and additional funding will be required for whichever option is chosen. This means that the capital structure of the company will need to change either way and will depend on whether the additional financing is raised via debt or equity or a combination of both.

Both options will potentially increase the wealth of the company as both investments have a positive NPV. The restaurant generates a positive NPV of \$0.65 m and the hotel \$2.893 m over the seven-year analysis. The hotel is considered to be a higher risk option and so this has been taken into account by using a 2% higher discount factor.

The payback period has always been used as a screening method for projects at Nehby. As a method of appraising investments, it is particularly useful for analysing the liquidity of an investment, or how quickly the cash invested can be recovered. As the options being considered are mutually exclusive, it can be used to determine which projects should be put into operation first. Using this measurement, the hotel would be given priority, paying back in 4.80 years. The restaurant option is paying back in 5.25 years and would be outside the five-year criteria set.

Both proposals will require some sensitivity analysis on the numbers. A critical point in any NPV evaluation is where a change in variable turns a positive into a negative NPV. The focus of the sensitivity analysis question is often therefore on the extent to which a variable can change before the investment becomes unprofitable and unacceptable financially. The sensitivity to the cost of the investment in each option is as follows:

Restaurant =  $\$0.65/5 \times 100\% = 13\%$

Hotel =  $\$2.893/21 \times 100\% = 13.78\%$

This means that the cost of the restaurant investment could rise by 13% before the NPV becomes negative. The cost of the hotel investment could rise by 13.78% before the NPV becomes negative. Both investments display a very similar cost sensitivity in that the increase in the cost of both investments can rise by almost the same percentage before the decision to go ahead would change. A more detailed breakdown of the cash flows would be required in order to consider the sensitivity to changes in, for example, the number of restaurant diners or room occupancy rates.

Before a final decision is made, it is advisable that the following adjustments could potentially be incorporated into the cash flows to give a more informed basis for the final decision:

- Given the regeneration of North Ceeland, especially the future international sporting event, as well as the fact that any likely government grants are ignored, the predicted net cash flows for the hotel appear to be more prudent and realistic.
- The restaurant cash flows are based on the performance achieved when other new restaurants were added to the portfolio. There is likely to be a diminishing return on such an additional restaurant in the capital city, Caputo, which a recent independent report indicates is already a mature restaurant market. Also, the economic climate at the time of the introduction might affect the initial success which might make the numbers either pessimistic or optimistic.
- The hotel occupancy rate in year two is 65% and the venture capitalist suggests 50% maximum; the venture capitalist may be overly cautious but an adjustment might be prudent.
- The average daily rate per rented hotel room does not take into account expenditure on peripheral facilities such as the restaurant and is based on the average for the industry which will include those customers who just want 'somewhere to put down their head'.
- For the hotel investment to be acceptable, it would need to be performing above the industry average and this would be expected as it is to be a luxury brand.
- Risk and return are typically linked together. The risk appetite of the board will probably be the important factor in determining the final choice.

## Feasibility

Feasibility focuses on whether Nehby has the resources to pursue the strategic choices. Feasibility analysis is an evaluation of the internal capabilities of the company.

Finance is an important consideration for both options. Consideration will need to be given on how this should be raised which has been provided separately.

The restaurant option is building on the current skills and competences of Nehby where there are experienced and knowledgeable human resources and from whom a sense of loyalty has already been commanded.

The hotel option will require an additional skill set which might mean appointing staff from already successful establishments. Additional management skills to carry out the diversification strategy should be considered. The current stable economic environment means that people with skills are available in Ceeland and the nature of this global industry also makes the potential market for recruitment substantial. Talent which has brought together strong teams which run exceptionally busy restaurants should be transferable to the team required for the hotel.

Buildings for the restaurant and the hotel have been held on reserve. If it fails to secure contract completion on the restaurant, there may be a delay in commencement as the appropriate buildings in Caputo are limited. If contract completion on the hotel fails, there

are suitable alternatives available and although this has a longer lead time, it may actually be developed in less time than it would take to find a suitable restaurant in Caputo.

Raising finance is a key factor in the overall feasibility.

### Summary

Balancing the costs, risks and benefits of the two mutually exclusive investments, it seems clear from the available evidence that the hotel will be a significantly better investment for Nehby.

The major limitation in this appraisal is not comparing like with like. The risks associated with the new hotel in the north are much more difficult to quantify than further expansion of a tried and tested and profitable business model in Caputo. It will therefore be up to the board of Nehby to assess these on the basis of individual and collective ambitions and risk appetite.

**Tutorial note:** *Consideration of the key factors is covered in a later requirement so has not been considered here.*

## 2 Briefing notes with additional information, as requested

### (a) FAO: The Board of Nehby

#### Diversification strategy

Diversification is designed to even out bumps in the time profile of profits and cash flows. The ideal form of diversification is to engage in activities which behave in exactly opposite ways. When sales and profits are relatively low in one area, the adverse consequences can be offset by participation in a sector where sales and profits are relatively high.

Both strategies, restaurant or hotel options, are operating in the hospitality sector and although the hotel is development beyond the present product and market, it is still within the broad confines of the 'industry'. They are both driven by and dependent on a strong economy and will move in the same direction with fluctuations in the economy.

However, risk might be partially reduced by spreading the activities into operations in different areas of the hospitality industry such as restaurants and hotels. Poor performance in one area can potentially be offset by good performance in another area, so spreading risk is a strategy you can potentially use to reduce total risk for Nehby. However, in order to generate substantial reductions in unsystematic or specific risk, Nehby would have to move into markets outside the hospitality business.

Nehby might obtain benefits from geographical diversification with the development of the hotel, as you would be operating in a different region in Ceeland. John has identified that the restaurant business in the capital is becoming increasingly more competitive. Opening a hotel in the north of Ceeland may have a positive impact on revenues as the north is being identified as a high growth area. Total risk could be reduced as your portfolio becomes geographically spread.

### (b) Cash held

The first criteria would be to consider whether the cash can be raised from internal sources. On 31 March 20X0, cash at bank was \$978,019.

Potentially some of the available cash could be used to fund the initial capital outlay needed. Both options require more cash than this, so you will also need additional finance. Cash will also be needed to support the working capital arrangements of the existing business operations and to meet the interest payment on borrowings.

There are grants available for the hotel which, depending on how much might be available, might cover a substantial part of the renovation costs.

#### Cost of borrowing

Whilst debt is usually cheaper than equity finance, it will place additional obligations to pay out more cash in the form of interest regardless of profitability. Failure to pay this can result in action being taken to wind up the company. The current interest cover is 23 times indicating that the interest payment will not be particularly vulnerable to a drop in profits.

If the hotel is the chosen option, you need to give consideration to Nehby's ability to generate cash to cover additional interest payments on \$21m which based on the current ratio of interest to loans and overdraft of approximately 4.4% ( $53,016 / (1,065,010 + 139,908)$ ) is \$924,000. Under this option, the debt burden would increase substantially. In the first year of the hotel operation the new hotel is not generating any net cash inflows and if we assume the same financial performance as in the current year, the interest cover will drop from 23 times to 1.2 times which will substantially increase the default risk.

Gearing is the ratio of debt to equity. Using the formula  $\text{non-current liabilities} / (\text{ordinary shareholders funds} + \text{non-current liabilities})$ , gearing is  $\$1,065,010 / (\$1,233,758 + \$1,065,010) = 46.3\%$ . Without raising any new finance, at 31 March 20X0 gearing has marginally exceeded 45%, the acceptable level for the bank, so taking on more debt is not looking feasible and on the contrary Nehby will urgently need to re-balance its gearing to comply with the terms of the covenant.

#### Security

Many lenders will require assets to be pledged as security against loans. The statement of financial position shows the value of non-current assets as \$1,623,650. There is insufficient existing asset security, another indication that further borrowing may not be an option. You would also need to consider whether there are any further covenants written into the existing debt arrangements which would prevent any increase in debt finance.

The existing bank covenant may be renegotiated on better terms if further bank borrowing is taken out and secured on the non-current assets, including the new hotel.

#### **Risk**

Investment in the hotel would be a product diversification strategy but is within the hospitality industry so is not substantially spreading the business risk. The hotel is not an area of the hospitality sector you have operated in before, creating uncertainty about whether the skills and competences which have contributed to the growth of the business to date can be transferred into the new venture. The hotel sector is also characterised by high operational gearing. Labour is a significant fixed cost in the hospitality industry which is largely independent of demand and fluctuations in demand could lead to a greater variability in operating earnings. This combination of financial risk and operational risk may be too high for Nehby to accept on its own.

#### **Equity finance and control**

You have stated that you do not have the appetite or capacity to finance this alone. As a private limited company, the shares may not be offered to the general public so there is no ability to raise new equity finance through share markets. You may want to inject more capital yourselves and so retain control of the business but you have noted the investment is too big to do all on your own. Therefore there is a need to turn to a venture capitalist to obtain the equity finance required. This will alter your voting control in the business and you will be unable to make decisions without reference to the venture capitalist who will be investing in order to participate in your success. Venture capitalists are often looking to an eventual flotation of the company after the term of their agreed investment has expired. Additionally they typically look for an annual rate of return of 20% or more on their investment which has yet to be factored into the computations.

### **3 Report**

**To: John Nehby**

**From: External consultant**

**Date: Today**

**Subject: Project controls, governance changes and culture changes in relation to potential hotel project**

#### **Introduction**

This report provides information on project controls in order to track all major project variables and to report on the governance and cultural changes which are likely to be needed to secure investment from a venture capitalist. This report is based on appropriate information available and has been produced to enable Nehby board to prepare for the changes required.

#### **(a) Project controls**

##### **Expenditure and cost performance**

Expenditure starts with the establishment of budgets and as the project progresses, decisions regarding procurement, design and development will be assessed with respect to their impact on expenditures. A robust tender process is also essential to success.

At a very simple level, at one month of reporting on the hotel project 11% of the project activities might be complete and should have cost \$2.31m this would be the budgeted cost of work performed (BCWP). This would be compared to the actual cost of work performed (ACWP) and would show the cost variance after one month of the project.

BCWP/ACWP is referred to as the cost-performance index and is a measure of cost efficiency. Early in the project the index may be an unreliable guide to the costs of the rest of the project because it is based on insufficient data, but later in the project could be used to extrapolate 'the cost to complete'.

##### **Schedule and time performance**

Schedule performance refers to the timely completion of project deliverables as compared to a baseline plan. It is possible to calculate a schedule variance which would measure how much work has been achieved at a given date compared to what was scheduled.

The ability to accurately forecast helps meet the time-to-market window. Any delay in time will mean that the hotel opening will be delayed and the timescale for ROI will also be affected. If the project is slipping, it is important to know why it is slipping so that appropriate action can be taken to get the project back on track.

The schedule will identify all of the hotel's stages, phases and activities assigned to each project team member, mapping them to a timeline which measures key milestones (dates) which are used to keep track of work progress. The key milestones might include: structural completion, utilities installation, decoration and room fitting completion as examples. Avoiding schedule slippage is a key objective.

It might be useful to create a key performance indicator (KPI) for the project indicating the percentage of tasks completed. It will be important to enter the planned time for each project activity so that the KPI will not reflect the number of various-sized tasks, but the time spent. This will give more accurate reporting and enable understanding of how far the project has progressed.

### **Quality performance and review**

Cost of quality is the amount of money spent on the hotel project because the design and development was not carried out correctly in the first place. It will include labour, materials and other costs spent on design and development aspects of the hotel which do not meet the specifications or expectations and where further work has been required.

Quality is monitored by reviewing and testing what has been produced. For the hotel project, the review would take the form of a physical inspection and design review at the end of each stage of the renovation process. This would include physical inspections of electrical and installation work through to the interior design and furniture of the rooms themselves. The costs might include any rectification of poor quality work. The importance of the quality review is to agree which aspects of the design and renovation have been accepted as satisfactory and which problems have still to be resolved. The important action from this is that those responsible for solving the problems take action immediately.

### **Issue management performance**

Issue management performance refers to the identification and resolution of issues or expectations which are impacting the successful delivery of the project. Issues can be related to communications; there will be a large number of sub-contractors on the project site and it will be important that their activities are co-ordinated so that they are not standing idle waiting for a prior dependent activity to be completed before they can start on their activity.

Issues can be related to human resources. Any conflict between project team members could delay completion. The purpose of issue management is to ensure that all matters requiring resolution, decisions or direction are addressed as soon as possible to avoid negative consequences on project objectives and deliverables.

## **(b) Governance changes**

### **Leadership**

The introduction of external shareholders, in the form of venture capitalists, would make the board accountable to external owners, rather than each other, even if the outside owners hold a minority of shares as a higher share of voting rights may be negotiated as part of the deal. That could create a situation where the board has to defer a decision on a strategic matter until the venture capitalist has been informed and voiced their opinion. The need to seek consensus is a significant change and having been used to the 'family way' of managing the company, these changes are likely to be difficult to deal with.

### **Timeframe for decisions**

Presently the board can take a long-term view on resolution of issues but the venture capitalist will want faster resolution and a greater return on investment. The board has the freedom to act in their own best interest which may involve taking decisions which are not wholly intended to maximise profit or wealth. There is now a fiduciary duty to act in the best interest of the venture capitalist whose priority will be maximisation of shareholder wealth.

### **Objectives**

As control is in the hands of the family, as the only members of the board of directors, you can run the business in a way which suits your own private objectives which includes decisions on expanding the business and/or maximising your salaries. As soon as outside shareholders take a stake in the company, your interests will be constrained to some degree, even if you retain a controlling stake in the business.

### **Leadership style**

Nehby culture allows decisions to go unchallenged. Graeme, as CEO, is used to dominating decisions and it may have been difficult in the past to confront him about his style as such an approach may have negatively affected family relationships. External scrutiny of board performance was not present and Graeme was not subject to questioning from anybody outside the company who might have a different view on his management than the members of the board. There is going to be a significant change to the way decisions are made in the future.

### **Introduction of non-executive directors (NEDs)**

The primary fiduciary duty which NEDs owe is to the company's external shareholders. They must not allow themselves to be captured or unduly influenced by the vested interests of the executives. A single NED will be put on the board to provide the venture capitalist with a voice on the board and may veto any action which might alter the venture capitalist's financial position and expectations.

The venture capitalist may be looking for more formality in the board structure. The change to your governance model, made necessary by the introduction of the venture capitalist, has heightened the need for an effective board committee structure. A separate nomination committee could focus on recruiting more talent, giving the venture capitalist confidence that the profit performance required can be attained.

### **Remuneration**

Currently as the only members of the board you have the ability to reward yourselves effectively out of company funds and this will have to cease. Pay would be linked to the performance targets required by the venture capitalist and should encourage the delivery of the typical growth requirement expected of 8 times return on equity.

## **Risk management and internal controls**

Governance recommends that the board should maintain sound risk management and internal control. Venture capitalists will expect robust risk management and control, investment decisions will need to align with their appetite and they normally expect fast resolution of any risk issues so that return on investment can be maximised. Nehby board will need to consider embedding the venture capitalist's requirements into company procedures.

### **Aligned risk appetite**

Nehby's risk appetite will need to become aligned with that of the venture capitalist, they will want to match the risk profile of the business with their own risk appetite. A greater emphasis will be placed on the changed risks created by the new business model and emphasis will be on the importance of an effective risk management process.

### **More robust risk management**

The risk environment is often dynamic and changeable. A robust risk management process will ensure that significant risks are identified and managed. When such a process is in place, adjustments can be made in accordance with a changed risk assessment. Controls can be adjusted in response to changes which occur to ensure each risk is controlled by an effective strategy. Without an effective risk management process, this ability to respond to changed risks would not be possible and the venture capitalist investment could be at risk.

### **Relations with shareholders**

Investors will need to know how the risks are being controlled and mitigated. By studying risk information provided, they can decide if they believe each control to be adequate for the control of that risk. Risk is an important element in all business activities. At this time, strengthened internal controls are clearly important to reassure the venture capitalists that, despite the changes in business model, you have taken the required actions to manage the new model viably and sustainably, to ensure the success of the current business portfolio and the new addition to the portfolio.

## **(c) Cultural changes**

The culture of an organisation is intangible and difficult to describe and can be explored from a variety of perspectives and through a number of frameworks and models. A useful tool for analysing the culture of an organisation is the cultural web. It provides a means of looking at the cultural assumptions and practices to make sure that organisational elements are aligned with one another and with an organisation's strategy. Different perspectives suggested in the model have been used to establish specific implications of the desired overall strategic change required by the venture capitalists by comparing the current position and the desired future outcomes. An audit of how the workings of your business will need to change has been provided.

### **Stories**

Stories relate to events which people tell about the organisation; they often reflect a belief in the way things should or should not be done.

#### **Current**

The careful attention to detail, the winning of many awards and the acknowledgements received from the industry are stories which could be told. Being the driving force behind some of the capital's best loved restaurants, your role at the forefront of Caputo's rise in becoming one of the culinary capitals of the world are good examples of memorable events which have contributed to customer loyalty and high staff motivation.

#### **Future**

This needs to be extended to the hotel, with continued focus on customer service and staff motivation. Using good customer feedback for stories relating to outstanding customer service, and increased recognition needs to continue to be obtained. Gaining membership of the 'Luxury Hotels of the World' would be significant in the hotel industry.

### **Symbols**

Symbols are objects, acts or people which may convey some meaning above their functional purpose. They are often visual representations of the company.

#### **Current**

The buildings chosen for renovation and the creation of atmospheres like film sets in the restaurants, with the diners as cast and audience members, are clear symbols of the philosophy behind the business model. This has been an important contribution to the loyalty of customers and is an element of the culture which should remain when developing the hotel. It is this differentiation which has contributed to the success to date.

#### **Future**

The expensive company cars are a status symbol for the executives. It is likely that the venture capitalists will propose removal of expensive status symbols which I know will be an unpopular suggestion. Profit margins are an important consideration for the future and frivolous expenditure will not be allowed. Re-focusing on symbols which support the future of the hotel will be a priority and the membership of the Luxury Hotels of the World would be a symbol which will deliver positive consequences for the future.

### **Power structures**

Power structures relate to which person or group of people hold power.

**Current**

At present power is invested in the hands of the family, reflected by their dominance on the board of directors. Graeme appears to have dominated the decision making to date. The board has also taken a 'hands on' approach to business and to the management of day-to-day business operations.

**Future**

The company will now have external shareholders and representation of their interest on the board in the form of a non executive director(s) who will hold you, as executives, to account for any decisions. Venture capitalists will also like to see 'new blood' injected into companies and that might also impact the balance of power.

**Organisational structure**

Organisational structure will reflect the power structure in an organisation.

**Current**

Nehby is structured on a functional basis reflecting the power being held by each of the board members as functional directors. Functional structures are linked with empire building and are a reflection of the power demanded by the family members.

**Future**

The future might require a divisional product structure based around the individual restaurants and the hotel. This aids responsibility accounting for the venture capitalists as they can appraise the performance of each product in the portfolio separately.

**Control systems**

The control systems of the organisation include measurement and reward systems, being the formal and informal ways that staff are monitored, including reward systems and performance metrics. They reflect what is considered important to the organisation.

**Current**

The current monthly management accounts reflect the control measures which are considered to be most important for the restaurants. Remuneration and rewards are set by the board. There is no need for a formal system as you are 100% owners and can make the decisions to fit your needs.

**Future**

A more formal performance related reward system will need to be introduced to ensure that excessive salaries are not paid without reference to performance and without the approval of the venture capitalist. An important measure for the hotel business would be RevPAR and occupancy rates to ensure performance is in line with the targets set in the investment proposal.

**Routines and rituals**

Routines and rituals concern the 'way we do things around here' and are the daily behaviour and actions of people which signal acceptable behaviour. This determines what is expected to happen in given situations and what is valued by management.

**Current**

The staff loyalty and strong teams have created a motivated workforce which has been an important part of the business culture. Investment in the training of the talent required to run the restaurants has reinforced the perception of how things are to be done and ensured that the correct skills, competences and behaviours in service ambience and quality of food are displayed in all restaurants. The visionary approach and attention to detail is demonstrated and valued by Nehby and has been a substantial contribution to 'the way you do things around here'.

**Future**

Nehby should continue to value staff loyalty, a motivated workforce and service ambience and quality. The visionary approach and attention to detail needs to be extended to the renovation and running of the hotel. There will also be the need to change 'the way we do things around here'. This might incorporate the need to offer healthier options in the restaurants and the need for sustainable business practices throughout the business. The value of becoming an environmentally responsible hotel and limiting damage to the environment should become the routine in the hotel operations.

**Paradigm**

Paradigm is the set of assumptions and collective experience of the organisation and is the result of all the other aspects of the cultural web.

The mission statement will need to be changed to incorporate the hotel business and incorporate 'great places to stay'. There is a need for faster resolution of company issues and a focus on maximising profit and wealth so that within seven years the venture capitalist can realise their expected return on investment.

**Conclusion**

Laid out in this report project control, governance and cultural considerations which Nehby board will need to address to secure investment from a venture capitalist have been provided. Nehby board should develop a plan to communicate and implement the changes needed to internal and external stakeholders in order to enable a smooth transition for the change process and to avoid any negative impact on current operations.

#### 4 (a) Slide

##### **Weaknesses in current management accounting system**

- Operating profit
- Total admin expenses
- Food cost per head
- Kitchen labour hours

##### **Notes**

###### **Operating profit**

Overall business performance does not allow for each product in the portfolio to be evaluated. Performance for each restaurant should be detailed, making it possible to calculate each restaurant's operating profit as a self-contained unit. Each restaurant manager should be accountable for the performance of revenues and costs and the management accounts should allow them to comment on individual performance. The accounts should then compare each restaurant's relative efficiency and profit.

###### **Administration expenses**

Total overhead figures with no breakdown of individual spend does not allow for the identification of specific areas of under and over-performance. The accounts show an adverse variance for the year of \$231,552. The administrative expenses include a number of the business expenses and it is not possible to identify which area(s) are causing the overall adverse variance. More detailed analysis would highlight where immediate action is required. One area of the business might be heading down a financially dangerous path and should be investigated immediately. Small variances might be acceptable, so you might decide only to investigate variances above a certain amount.

###### **Food cost per head**

As an overall measure it has limitations. Food cost per head will only be relevant if menu and service is consistent. Each restaurant might have different pricing structures and it might be more relevant to consider different food cost percentages for different meals like lunch and dinner.

Management decisions on food will include pricing adjustments, portion control and purchasing efficiencies, looking at more specific measures will support better decision making and control. Management might need to consider at which point a favourable food cost variance might be impacting quality which is important to customer satisfaction.

###### **Kitchen labour hours**

The industry norm is to work longer hours than actually paid for, so the negative variance in labour hours would be no surprise. More labour hours have been worked but the overall expenditure is a favourable variance. This would suggest that the amount paid per additional hour is below the average standard hourly rate set or, as is the industry standard, the extra hours worked by staff are not actually paid.

Since the figure is a composite of monies paid to all employees in all job categories within the kitchen, it is impossible to tell which category caused the variance from the standard cost.

Labour costs are controlled by improving productivity and no one single measure should be used to evaluate this. The hours will need to be broken down by job category. The number of customers per labour hour should be measured so we know the amount of labour used to serve each customer.

#### (b)

##### **Recommendations for improvements**

- Variance reporting
- More balanced measures
- **Key performance indicators (KPIs)**
  - o Occupancy rates
  - o Average daily rate (ADR)
  - o Revenue per available room (RevPAR)
  - o Gross operating profit per square metre
  - o Customer satisfaction
  - o Carbon footprint

## Notes

### Variance reporting

The original budget should be flexed to reflect the actual level of activity and to ensure that variance calculations are not distorted by a different activity level to what was expected. Separating the variable and fixed elements of costs would also allow for better identification of which costs vary with activity.

### More balanced measures

More measures are needed for effective control. There are no customer satisfaction measures. If you are not undertaking customer surveys, then these should be considered. If already undertaken, they should be reported in management accounts.

Corporate social responsibility and carbon footprint are external drivers for responsible practices. Ethical consumerism is driving the need for responsible business practises. Measures reflecting the reduced levels of food waste and energy usage could be used to show that sustainability is important for the business.

Key performance indicators (KPIs) needed to support decision making for a hotel may include:

#### Occupancy rates: Paid rooms occupied/Rooms available

It is important to demonstrate the efficiency and operational performance of the planned hotel development. The existence of occupancy rates which are less than the hotel capacity means that there are lost selling opportunities and reduced hotel revenue. It is important that the occupancy rate is high enough to ensure the variable expenses are covered and there is a contribution to fixed costs.

#### ADR: Total room revenue/Paid rooms occupied

ADR measures the average price paid per available room. It is a measure of financial performance and profitability. Profitability is likely to be strongly correlated to room revenues and maximising these revenues is going to be a top priority. This is a rate which could be used for comparison against past performance and to the competition.

#### RevPAR: Total room and related revenues/total rooms available

This measure incorporates both room rates and occupancy. It provides a snapshot of how well the business is filling its rooms, as well as how much it is able to charge. Rising RevPAR is an indication that either occupancy is improving, or room rates are rising or a combination of the two. This is only measuring one revenue stream and will need to be considered.

#### Gross operating profit per square metre

RevPAR focuses on room revenue, but where there is more revenue coming from other areas, it would be beneficial to analyse that more widely. It will help with comparisons of hotels of different sizes and non-room revenue. It will indicate how well the hotel is using the space available to it to drive its economic performance. It can be used to measure the profitability of individual areas to ensure they are achieving the best value from the space they use. Is the Spa area or the bar area generating a better return and if logistics allow should there be a change in activities to make better use of the space?

#### Customer satisfaction

Non-financial measures are important for hotels and can help raise their profile, particularly in the age of social media. Customer satisfaction surveys and feedback forms can be used to monitor praise and repeat business, and also complaints in order to effect improvements. If feedback from surveys is acted upon, it will show to the customer that you value their business, attract loyalty from them and build profitability through repeat custom and referrals.

#### Carbon footprint

Reduction of the carbon footprint of the hotel is a key external driver of sustainability and socially responsible business practices. Customers and other stakeholders are increasingly asking for carbon footprint improvements. The development of eco-labels is helping customers make their choice and it will be important to provide evidence of proof of compliance. Hotels are big consumers of energy. A reduction in the kilograms of carbon used each guest night would be one example of a good measure in this age of increased ethical consumerism.

**Note:** Candidates were not asked to prepare a specific number of slides and will be marked for the appropriateness of the contents as well as the communication.



- 1 Up to 2 marks for each relevant point which assesses and appraises the two options available (up to a maximum of 20 marks).
- Restaurant is a product development strategy which exploits current strengths and provides a strategic fit with the mission of maintaining growth in core markets.
  - Hotel allows for exploitation of an opportunity:
    - the availability of grants, which can support the cost of the hotel development, and
    - the regeneration of the North where they can achieve first mover benefit of a location better than locations later entrants to the development area will be able to obtain
    - government support in promoting the area
  - An excellent reputation and visionary approach in creating great places to eat have created customer loyalty and should be a good reason for customers to support either of the options.
  - There will be a restaurant established within the hotel which is an opportunity to continue to exploit their excellent track record as well as diversify.
  - Both options can exploit economic growth and the increase in disposable income which should increase the number of meals served and the rise in hotel occupancy rates to support either of the two options.
  - Both options will potentially increase the wealth of the company
    - Restaurant positive NPV of \$0.65m
    - Hotel positive NPV of \$2.893m
  - Using payback, the screening method used previously for projects, the hotel would be given priority with a payback in 4.80 years. The restaurant has a payback of 5.25 years which is outside the criteria set.
  - Buildings are held on reserve, failure to complete on this restaurant could mean delays as buildings are limited.

Professional skills may be additionally rewarded as in the following rubric:

How well has the candidate demonstrated professional skills as follows:	Not at all	Not so well	Quite well	Very well
1 Evaluation skills in assessing and appraising the information the board of Nehby will need to use to form the basis for their final decision	<i>The candidate has failed to demonstrate any evaluation skills in assessing the information as a balanced set of criteria has not been used. (Although suitability/acceptability/feasibility does not have to be used, there has to be a balanced set of criteria in order to enable the board to make an overall decision)</i>	<i>The candidate has demonstrated some, but limited, evaluation skills in assessing the information across a balanced set of criteria. However, the candidate has not considered enough information to form the basis for a sound decision.</i>	<i>The candidate has presented a report and has demonstrated good evaluation skills in assessing the information across a balanced set of criteria considering most of the relevant information which forms the basis for a sound decision. However, some of the relevant points which need to be included to enable the board to make a decision from the report are missing.</i>	<i>The candidate has presented a report and has demonstrated excellent evaluation skills in assessing the information across a balanced set of criteria covering all of the relevant information to form the basis for a sound decision</i>
<b>Example</b>	<i>There is an option to introduce a new restaurant.</i>	<i>The option to introduce a new restaurant is a product development strategy and is the strategy which has been behind Nehby's success to date.</i>	<i>The option to introduce a new restaurant is a product development strategy and is the strategy which has been behind Nehby's success to date. It will allow Nehby to exploit its strengths and acknowledged competences.</i>	<i>The option to introduce a new restaurant is a product development strategy and is the strategy which has been behind Nehby's success to date. It will allow Nehby to exploit its strengths and acknowledged competences, providing a strategic fit with the mission and aim of maintaining growth in the core market.</i>
	<b>0</b>	<b>1</b>	<b>2</b>	<b>4</b>

- 2 (a)** Up to 2 marks for each relevant point which explains or considers the appropriateness to Nehby Company of diversifying risk by going into the hotel business (up to a maximum of 6 marks).
- Explanation of ideal form of diversification, i.e. to engage in activities which behave in exactly opposite ways, adverse consequences in one area can be offset by participation in a sector which is performing well.
  - Both the restaurant and the hotel are in the same sector and will move in the same direction with fluctuations in the economy.
  - Risk may be partially reduced by spreading the activities into different areas of the hospitality business, however, to generate substantial reductions in unsystematic or specific risk, Nehby would need to move into markets outside of the hospitality business.
  - The hotel is operating in a different part of Ceeland which is potentially a high growth area, with the restaurant business in the capital becoming increasingly more competitive, total risk may be spread as the portfolio becomes geographically spread.
- (b)** Up to 2 marks for discussion of each relevant factor which could influence the financing structure the board might choose (up to a maximum of 8 marks).
- Cash available from internal sources
  - Debt position
  - Asset security
  - Grants available
  - Risk appetite and capacity
  - Voting control

Professional skills may be additionally rewarded as in the following rubric:

How well has the candidate demonstrated professional skills as follows:	Not at all	Not so well	Quite well	Very well
2 (a) Scepticism skills in questioning the appropriateness of diversification for Nehby	<i>The candidate has failed to demonstrate any scepticism skills as there is no questioning of the appropriateness of the proposed strategy in delivering effective diversification for Nehby.</i>  <i>The candidate is only stating what the strategy is and is not questioning whether the proposed strategy represents effective risk reduction for Nehby.</i>	<i>The candidate has demonstrated some, but limited, scepticism skills in that they have made an attempt to question the appropriateness of the proposed strategy in delivering effective diversification for Nehby.</i>  <i>The depth of questioning is limited to the potential benefit of being in different sectors of the hospitality industry.</i>	<i>The candidate has demonstrated good scepticism skills and made a reasonable attempt to question the appropriateness of the proposed strategy in delivering effective diversification for Nehby.</i>  <i>The candidate also questions the geographical move.</i>	<i>The candidate has presented briefing notes which have demonstrated deep scepticism skills in strongly questioning the appropriateness of the proposed strategy in delivering effective diversification for Nehby.</i>  <i>The candidate also questions the overall appropriateness to Nehby.</i>
<b>Example</b>	<i>Identifies that the hotel is still within the confines of the 'industry' but does not consider impact on risk.</i>	<i>Risk might be partially reduced by spreading the activities into operations in different areas of the hospitality industry such as restaurants and hotels.</i>	<i>Benefit might come from geographical diversification with the north being identified as a high growth area.</i>	<i>To significantly reduce overall exposure would lead to the need to 'spread risk' and move into as many different market sectors as possible.</i>
	<b>0</b>	<b>0.5</b>	<b>1</b>	<b>2</b>

How well has the candidate demonstrated professional skills as follows:	Not at all	Not so well	Quite well	Very well
2 (b) <i>Commercial acumen</i> skills in using judgement and showing insight in clarifying the key factors and their implications for the board of Nehby	<i>The candidate demonstrated no commercial acumen skills in that they have failed to use judgement and insight in considering the key factors for Nehby.</i>	<i>The candidate demonstrated some, but limited, commercial acumen skills in that they have recognised some of the factors for Nehby.</i>	<i>The candidate demonstrated good commercial acumen skills in that they have recognised most of the factors for Nehby.</i>	<i>The candidate's briefing notes demonstrated excellent commercial acumen skills in that they have recognised all of the four factors for Nehby.</i>
<b>Example</b>	<i>If cash position is good, a loan might be possible. (Makes no reference to the cash position of Nehby.)</i>	<i>Loans will impact the debt to equity ratio which currently stands at 45%.</i>	<i>Loan borrowing will impact the debt to equity ratio which is marginally exceeding the 45% acceptable level for the bank and Nehby will need to negotiate if a new loan is to be obtained for the hotel project.</i>	<i>Loan borrowing will impact the debt to equity ratio which is marginally exceeding the 45% acceptable level for the bank and Nehby will need to negotiate if a new loan is to be obtained for the hotel project and the answer is in the required briefing note format.</i>
	<b>0</b>	<b>0.5</b>	<b>1</b>	<b>2</b>

- 3 (a)** 2–3 marks for each project control measure recommended and clearly justified (up to a maximum of 8 marks).
- Expenditure and cost performance
  - Schedule and time performance – milestones for the hotel project
  - Quality performance and review – physical inspection important for the hotel
  - Issue management performance – identification and resolution of issues to avoid negative consequences
- (b)** Up to 2 marks for each relevant point explaining the implications of the key governance changes needed (up to a maximum of 10 marks).
- Leadership – board is now accountable to external shareholders – need to seek consensus for any significant change
  - Timeframe for decisions – venture capitalist likely to want faster resolution of issues – now a fiduciary duty to act in the best interest of the venture capitalist and not their own interest
  - Objectives – no longer able to run the business in a way which suits own private objectives
  - Leadership style – Graham, as CEO, has dominated decision making – now subject to external scrutiny – external shareholders may have a different view – significant change to the way decisions are made in the future
  - NEDs – to provide venture capitalist with a voice on the board – effective board committee structure may be required
  - Remuneration – currently able to set own remuneration – venture capitalist likely to want pay to be linked to performance
  - Risk management and internal controls – robust controls needed and investment decisions will need to be aligned with the appetite of the venture capitalist
  - Relations with shareholders – venture capitalist will want to know how things are being managed to ensure success of their investment
- (c)** Up to 2 marks for each relevant point, 1 mark for analysis of current culture and 1 mark for implication on future culture (up to a maximum of 12 marks).
- Stories
  - Symbols
  - Power structures
  - Organizational structure
  - Control systems
  - Routines and rituals
  - Paradigm

Professional skills may be additionally rewarded as in the following rubric:

How well has the candidate demonstrated professional skills as follows:	Not at all	Not so well	Quite well	Very well
3 (a) Commercial acumen skills in demonstrating awareness of the suitable measures which will be important for the control of the hotel project	<i>The candidate demonstrated no commercial acumen skills in that they have failed to demonstrate awareness of suitable measures.</i>	<i>The candidate demonstrated some, but limited, commercial acumen skills in recognising the correct range of measures but shows a weak understanding of their importance.</i>	<i>The candidate has presented a report and has demonstrated good commercial acumen skills in recognising the correct range of measures and shows an understanding of the importance of at least one of the measures.</i>	<i>The candidate has presented a report and has demonstrated excellent commercial acumen skills in recognising the correct range of measures and shows an understanding of the importance of all of the measures.</i>
	0	0.5	1	2

How well has the candidate demonstrated professional skills as follows:	Not at all	Not so well	Quite well	Very well
3 (b) <i>Commercial acumen skills in demonstrating awareness of the governance changes which will be required</i>	<i>The candidate demonstrated no commercial acumen skills in that they have failed to demonstrate awareness of the implications for Nehby and how the business is managed.</i>	<i>The candidate demonstrated some, but limited, commercial acumen skills in recognising the implications for Nehby and how the business is managed.</i>	<i>The candidate demonstrated good commercial acumen skills in recognising the implications for Nehby and how the business is managed.</i>	<i>The candidate demonstrated excellent commercial acumen skills in recognising the implications for Nehby and how the business is managed in all of the points made in their answer.</i>
<b>Example</b>	<i>Nehby would now have to deal with the introduction of external shareholders, in the form of venture capitalists.</i>	<i>The introduction of external shareholders, in the form of venture capitalists, would make the board accountable to external owners.  (The candidate has started to explore the implication in recognising more accountability.)</i>	<i>The introduction of external shareholders, in the form of venture capitalists, would make the board accountable to external owners.  That could create a situation where the board has to defer a decision on a strategic matter until the venture capitalist has been informed and voiced their opinion. The need to seek consensus is a significant change and having been used to the 'family way' of managing the company, these changes are likely to be difficult to deal with.  (The candidate has, in the majority of points, explored in detail the implication for Nehby.)</i>	<i>The introduction of external stakeholders will require a more formal governance and reporting structure as the agency relationship (existing in a family owned business) will substantially change as will the agency gap, where the directors will have greater accountability to the wider connected stakeholder group.</i>
	<b>0</b>	<b>1</b>	<b>2</b>	<b>3</b>

How well has the candidate demonstrated professional skills as follows:	Not at all	Not so well	Quite well	Very well
3 (c) <i>Analysis skills in considering the implications of the changes needed in relation to the future culture of the business</i>	<i>The candidate demonstrated no analysis skills in explaining the implication of the changes needed to the future culture of the business.</i>	<i>The candidate demonstrated limited analysis skills in that they have demonstrated some understanding of the implication of the changes needed to the future culture of the business.</i>	<i>The candidate demonstrated good analysis skills in that they have demonstrated considerable understanding, in the majority of points made, of the implication of the changes needed to the future culture of the business</i>	<i>The candidate demonstrated excellent analysis skills in that they have demonstrated considerable understanding, in all of points made, of the implication of the changes needed to the future culture of the business.</i>
<b>Example</b>	<i>The control systems of the organisation include measurement and reward systems.</i>	<i>A more formal performance related reward system will need to be introduced.</i>	<i>A more formal performance related reward system will need to be introduced to ensure that excessive salaries are not paid without reference to performance and without the approval of the venture capitalist.</i>	<i>A more formal performance related reward system will need to be introduced to ensure that excessive salaries are not paid without reference to performance and without the approval of the venture capitalist. An important measure for the hotel would be RevPAR and occupancy rates to ensure performance is in line with targets set in the investment proposal.</i>
	0	1	2	3

- 4 (a)** Up to 2 marks for each weakness included on the slide and discussed in the supporting notes (up to a maximum of 6 marks).
- Individual performance of restaurants is not detailed in the report
- Administration expenses
- Does not allow for identification of specific areas of under and over-performance
- Food cost per head
- Only relevant if menu and service is consistent
- Kitchen labour hours
- Hours are not broken down into job categories
- (b)** Up to 2 marks for each relevant recommendation of improvements to the management accounting information and demonstration of KPIs on the slides and discussed in supporting notes (up to a maximum of 10 marks).
- Recommendation for improvements
- Variance reporting
  - More balanced measures
- KPIs
- Occupancy rates – efficiency and operational performance
  - Average daily rate (ADR) – financial performance and profitability
  - Revenue per available room (RevPAR) – how well the business is filling its rooms
  - Gross operating profit per square metre – to consider revenue from other areas
  - Customer satisfaction – show the customer you value their opinion and to action any improvements

Professional skills may be additionally rewarded as in the following rubric:

How well has the candidate demonstrated professional skills as follows:	Not at all	Not so well	Quite well	Very well
4 (b) Communication skills in clarifying relevant information to the board of Nehby	<i>The candidate has demonstrated poor communication skills. They have failed to present clear and convincing arguments for why the information is relevant to the board of Nehby.</i>	<i>The candidate has demonstrated some, but limited, communication skills in presenting some clear and convincing arguments for why the information is relevant to the board of Nehby.</i>	<i>The candidate has presented slides with clear notes and has demonstrated good communication skills in presenting clear and convincing arguments for most of the information presented.</i>	<i>The candidate has presented slides with clear notes and has demonstrated excellent communication skills in presenting convincing arguments for all of the information presented.</i>
<b>Example</b>	<i>Nehby must concentrate only on financial data as non-financial information is unreliable and difficult to measure.</i>	<i>Nehby needs to have KPIs across a range of performance areas and needs to understand what its customers think of the service they are getting and what more they need.</i>	<i>Non-financial KPIs are also important. For example, social media can help a business grow and potentially social media could be used to damage its reputation where services fail. Feedback from customers is useful to help improve the customer experience.</i>	<i>Non-financial measures are important for hotels and can help raise their profile, particularly in the age of social media. Customer satisfaction surveys and feedback forms can be used to monitor praise and repeat business, and also complaints in order to effect improvements. If feedback from surveys is acted upon, it will show to the customer that you value their business, attract loyalty from them and build profitability through repeat custom and referrals.</i>
	<b>0</b>	<b>1</b>	<b>2</b>	<b>4</b>