

CA



THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

14304 – Strategic Management Process

CA Professional (Strategic Level I) Examination
DECEMBER 2013

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

Answer No. 01

- (a) SERS will impact the SHW of the main company, to the extent it can create/destroy value in terms of contributing to the capital of the centre.

First we will have to consider the extent to which SERS creates value: i.e. profit in relation to capital deployed. We may use the concept of EVA as a tool to measure the real profitability.

$EVA = \text{Net operating profit after tax} - \text{A capital charge}$

Where, capital charge = Invested capital * WACC, Invested capital = FA + CA - CL

(In 2007 SERS started with 40 cars and we find in 2013 the number works out to 40 cars as well. If we assume an inflation rate YOY of 10 %, we will have the 40 cars at WDV amounting to nearly Rs. 82m - given in the question as well.)

If we assume a WACC of 20% for this venture (considering the type of risk) the capital charge will be Rs. 82m * 20% = Rs. 16m

Taking into account of the profitability of SERS for the y/e 31/3/2013 we will have an EVA as follows:

Net profit as given = Rs. 5.7m

However, any realistic assumptions/adjustments necessary to make the accounts reflect the true position of relevant incremental profitability of the project must be considered.

We have not charged any 'incremental' indirect overheads such as staff costs, office expenses such as stationery, electricity and security (a necessary expense in running a Rent-A-Car operation to track the movement of vehicles). If we assume these cost to be Rs. 150,000 per month, the total cost per year would approximately be Rs. 2m (i.e. Rs. 1.8m rounded up).

Therefore the adjusted incremental NP is Rs. 5.7m - Rs. 2m = Rs. 3.7m

$EVA = \text{Adjusted incremental NP} - \text{capital charge}$
 $= \text{Rs. 3.7m} - \text{Rs. 16m}$
 $= - \text{Rs.12.3m}$

Hence SERS, from a financial perspective, seems to be destroying SHW of Excellent Automobiles.

Note: the following will not form part of the answer

Ascertaining the WDV of the vehicle fleet on 31/3/13

Date Of Pur.	Pur. Price Rs. million (m)	Accum Dep'n WDV Rs. million (m)	Rs. million (m)
1.4.10	$2m*(1.1*1.1*1.1) = 2.7$	$2.7*75\%$	$0.7*10 = 7$
1.4.11	$2m*(1.1*1.1*1.1*1.1) = 2.9$	$3*50\%$	$1.5*10 = 15$
1.4.12	$2m*(1.1*1.1*1.1*1.1*1.1) = 3.2$	$3.2*25\%$	$2.4*10 = 24$
1.4.13	$2m*(1.1*1.1*1.1*1.1*1.1*1.1) = 3.6$	-	$3.6 * 10 = 36$
			82

(b) Financial drives

Major financial drivers are profitability (true profitability measured by EVA), growth, free cash flow and leverage.

(i) Profitability:

Profitability is driven by profit margin and asset turnover.

Profitability was analyzed in (a) above (some expenses were understated).

Vehicle utilization is a major driver of asset turnover and it may be analyzed and estimated as follows:

2011 vehicle utilization

Expected average monthly car rental – Rs. 115,000 (net of VAT)

Number of vehicles – 40

Therefore at full utilization of the fleet, Revenue = Rs. 115,000 * 12 * 40 = Rs. 55m

However, actual turnover recorded is Rs. 33m

Hence, vehicle utilization in 2011 is only 60% (Rs. 33m ÷ Rs.55m)

2013 (current) vehicle utilisation

Expected average monthly car rental – Rs. 139,000 (Rs.115,000 * 1.1 * 1.1)

[Hiring rates will increase by the rate of inflation]

Number of vehicles – 40

Therefore at full utilization of the fleet, Revenue = Rs. 139,000 * 12 * 40
= Rs. 67m

However, actual turnover recorded is Rs.40m

Hence, vehicle utilization in 2013 is also only 60% (Rs.40m ÷ Rs.67m)

Therefore one of the main drivers of the problems of SERS is the low vehicle utilization percentage.

One needs to construct a small table to arrive at the number of cars in 2013 as 40.

Year	Balance b/f	Additions	Disposals	Bal c/f
1.1.07	10 + 15(1 yr) + 15(2yr)**	-	40	40
1.1.08		40	10	50
1.1.09		50	10	(15)
1.1.10		45	10	(15)
1.1.11		40	10	(10)
1.1.12		40	10	(10)
1.1.13		40	10	(10)

** 10 brand new cars

Assumed the balance cars were equally split between 1- year old and 2-year old cars

(ii) Growth (Revenue):

When discounted for inflation, there is no real revenue growth. Furthermore, the number of vehicles remains as 40.

Non-Financial drivers

Market/Customer related drivers - Selection of market segments, segment satisfaction driven by product quality and service quality.

Product and service quality: product quality seems to be acceptable given the quality and condition of the cars. However, service quality seems to be unsatisfactory according to the consultant's observations.

Internal process driver: Not satisfactory, need to be improved.

Staff competencies and learning: Not satisfactory, need to be improved.

(c) According to Tracey and Wiersema, the competitive advantage of a firm is a function of the firm's ability to deliver one of the three value disciplines, namely: Customer intimacy, Operational excellence and Product leadership.

As the Chairman mentions, SERS seems to opt for customer intimacy; customer intimate companies exactly deliver what customers need and provide a total solution at a reasonable price. They also cultivate relationships, have intimate knowledge of the customer and provide best solutions for them.

Hence as mentioned in the opening remarks by Patrick Gallage, SERS seems to be opting for customer intimacy.

However SERS has only partially adopted this strategy. Being customer centric in words only is not sufficient. For example SERS feels they can charge premium prices but only providing sound vehicles and building relationships is not sufficient.

Further, it must be borne in mind that choosing one value discipline does not mean you abandon the other two. These too will have to be maintained at acceptable levels, which does not seem to be the case with SERS. SERS for example does not seem to have paid much attention to operational effectiveness.

- (d) Advantages:
- addresses an emerging need
 - could be strategically relevant
 - will be able to charge higher rentals
 - less risky option

Disadvantages: when you specifically allocate cars in this manner, utilization will be less as there will be more idle time.

- (e) 'Leading' indicators are those that will indicate the impact on results before the event really occurs:
- effective segmentation
 - vehicle utilization efficiency
 - service quality such as waiting time for finalizing a hire, simplified documentation
 - knowledge of staff in assisting a potential hirer in making a choice
 - ability to screen a client in avoiding fraudulent customers
 - efficient processes such as order fulfillment

(f)

Risks		Tactics
1.	Cars being stolen	<ul style="list-style-type: none"> - Explore possibilities of finding insurance companies and negotiate to insure cars. - Use latest technology, e.g. GPS technology to track the cars.
2.	Poor quality services being complained of	<ul style="list-style-type: none"> - Employ separate staff after proper training on providing quality service is given.
3.	Credit risk	<ul style="list-style-type: none"> - Obtain rent in advance.

Answer No. 02

- (a) (i) An organizational structure is an arrangement of tasks and people, aimed at facilitating the achievement of organizational goals. A structure is not an end in itself. A structure is good only to the extent that it helps the organization to implement its strategy and accomplish its goals. The structure should be changed if it impedes the achievement of goals.

If strategy were to follow structure that is already in place, it would only limit the scope for action and it would result in inefficiency. Thus, 'structure should follow strategy'.

- E.g.
1. In any business, some activities in the value chain are more critical to strategic success and competitive advantage than others. For example, hotels have to be good at fast check in/checkout, housekeeping and facilities maintenance, food service, and the creation of a pleasant ambience.
 2. For a manufacturer of technical equipment, the critical activities can be R & D, product innovation, getting products to the market quickly, effective marketing and after-sales service. Accordingly the organization structure must be built around the efficient performance of these activities.
 3. In a multi-business organization, different businesses are generally organized into strategic business units (SBU's) for purposes of effective management. Such divisions are normally created along distinct product-market domains.

- (ii) A company that is following a low cost strategy would have to possess strong process engineering skills to ensure that costs are reduced at every link in the value chain. It will be a functional organizational structure where people performing similar tasks are grouped together. There is a clear demarcation of authority and responsibility. Since there are many different functional hierarchies (in production, finance, and so on), there is more control in this structure. Incentives will be based on meeting strict quantitative targets. Organizational culture would have its emphasis on tight controls and budgets.

A company that is pursuing success through a differentiation strategy needs to possess strong product engineering skills to add features to the total product offering. Creative flair, research capability and marketing skills are important for success. Hence, it will be a decentralized structure where decision making is pushed down to the lowest level capable of making timely, informed and competent decisions. It is a less formal approach which recognizes that creativity and innovation could reside anywhere in the organization. Thus, there would be a flat structure with cross-functional teams and project teams. A matrix structure, for example, has the advantage of cross-functional integration, which improves the organization's speed and flexibility in responding and dealing with change.

Reduced importance of hierarchy is replaced by the development of shared beliefs and values. In other words, corporate culture becomes very powerful. Controls would be through values and norms which promote creativity and innovation. Control is cultural rather than bureaucratic.

Summarized answer

	Cost leadership	Differentiation
Organizational structure	Functional	Decentralized, flat, matrix (cross functional)
Control	Tight – process engineering skills	Flexible – product engineering skills
Culture	Bureaucratic	Informal

- (b) (i) Critical success factors (CSI) are those product features that are particularly valued by customers, and therefore where the organization must excel at to outperform competition.
- KPI's are measures that quantify management objectives and enable the measurement of strategic performance.
- (ii) KPIs enable a company to focus on:
- Aspects of organizational performance that are most critical for the current success.
 - Measures that are critical for the future success of the organization
- (iii) - Manufacturing: Product rejection rate; Productivity level of production division employees; Capacity utilisation rate of machines; Machine breakdowns; Machine change-over times.
- Marketing: Customer attrition rates; New customers acquired; Frequency of customer complaints; Sales per employee; Market share.
- HR: Recruitment cost per employee: Average time to recruit (per position) Employee turnover ratios; Number of training programmes conducted. Number of training hours per employee.
- (iv) (1) Supply time when marketing “bearings” as machines will lie idle without bearings and hence this is a CSF in the industry of marketing bearings.
- Grocery store: customer service, quality/fresh products, clean environment
- Restaurant: good location, service of waiters, quality of food

Answer No. 03

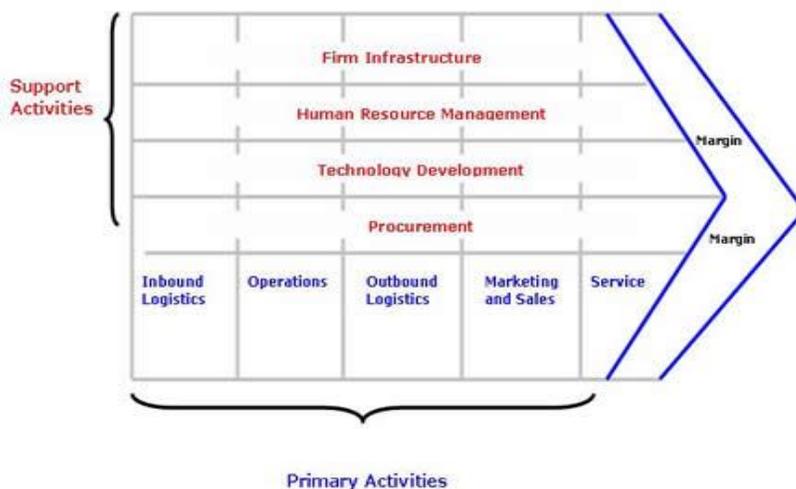
- (a) (i) Competitive advantage is anything which gives one organization an edge over its rivals. Porter argues that a firm should adopt a competitive strategy which is intended to achieve some form of advantage for the firm.

A competence is something an organization is good at doing. A core competence is a more valuable resource strength than other competencies because it is a proficiently performed internal activity that is central to a company's strategy and competitiveness. Core competencies are the linked set of skills, activities and resources that together deliver customer value. It is usually the product of accumulated learning and experience in performing specific activities e.g. skills in manufacturing a high quality product.

A distinctive competence is something that a firm does exceptionally well in comparison to its competitors. A core competence becomes a basis for sustainable competitive advantage only when it is a distinctive competence. A distinctive competence is a competitively potent resource strength for three reasons (a) it gives a company a competitively valuable capability that is unmatched by rivals (b) it has the potential for being the cornerstone of the company's strategy and (c) it can produce a competitive edge in the market place since it represents a level of proficiency that is superior to rivals. It is achieved through the coordination of activities across several functional departments/divisions and cannot be easily imitated by rivals because the advantage does not reside in one division but is spread throughout the organization. It is always easier for a company to a build competitive advantage when it has a distinctive competence in performing an activity important to market success, e.g. Toyota's short design-to-market cycles.

(ii) Students are free to offer an example say from the manufacturing sector or the service sector.

(b) **Porter's Value Chain Diagram**



Supporting Activities

1. Firm infrastructure- A suitably designed building, with required furniture, fixtures & fittings, kitchen appliances & utensils, cutlery & crockery, curtains, table cloth & serviettes, parking facilities, motor cycles for home deliveries.

2. Technology- A system to accept orders on- line, system to make payment by credit card.
3. HR- Adequate number of employees in different categories; training of chef and his staff training of waiters and others on customer service; delivery staff with a good knowledge of the local road network.
4. Procurement- Obtaining quality supplies and other inputs; develop a network of reliable suppliers who will deliver supplies on time and at the best possible price.

Primary Activities

5. Inbound logistics - Receiving, handling, and storing of inputs such as rice, vegetables, fish & meat, fruits, condiments & beverages.
6. Operations- Converting inputs to finished product (this has to be done hygienically), presence of an adequate number of well-trained waiters and waitresses to serve guests.
7. Outbound logistics- Packaging for take-away, boxes for home delivery.
8. Marketing & sales - Advertising on media promotions via leaflets and placards (e.g. Today's Special), sales promotions.
9. After-sales- A system to receive and then deal with customer complaints, customer satisfactory surveys.

Answer No. 04

- (a)
 - What are our products: 'automotive' leadership indicates the industry
 - Who are our customers/markets: 'global enterprise' suggests that its customer base is global
 - Technology: 'accelerate development of new products', 'changing models' and 'lean global enterprise'
 - Concern for growth & profitability: 'operate profitably', 'improve our balance sheet'
 - Philosophy (values): 'work together as one team', 'employee satisfaction'
 - Concern for public image: 'Work towards customer, supplier and community satisfaction'
- (b)
 - Being in the automobile industry, the mission statement could have mentioned the company's concern for the environment.
 - Being a large employer, the company's commitment to provide growth and advancement for employees could have been emphasized.

Answer No. 05

- (i) The three bottom lines are (a) social justice bottom line (b) environmental bottom line and (c) economic bottom line. These are commonly called the three P's: People, Planet and Profits.

The Social Justice bottom line refers to fair and beneficial business practices toward labour such as the payment of fair wages, employee health and safety, and employee engagement. It also includes the community.

The Environmental bottom line refers to careful management of energy, reducing manufacturing waste, recycling of materials, careful disposal of waste without endangering public health.

The Economic bottom line includes not only business profits but an assessment of the impact of an organization's activity on its economic environment.

- (ii) The advantages are:
- Access to untapped markets e.g. eco tourism
 - Enhances image of the company and contributes to business sustainability
 - Helps to attract and retain high caliber employees
 - Improves access to investors
 - Identifies potential cost savings
 - Increases scope for innovation

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