CIMA
Chartered Institute of Management Accountants

Exam focus – the pre-seen case study for the November 2012 & March 2013 Strategic level exams

BPP subject specialists David Culley, Doug Haste and Steve Whittenbury analyse the pre-seen case study for the November 2012 & March 2013 Strategic level exams from the viewpoint of each of the three papers (E3, F3, P3).

This article begins with a brief reminder of the purpose of the pre-seen case study before going on to analyse the key issues in the latest pre-seen from the perspective of each Strategic level paper.

Purpose of the pre-seen

It is important to remember that CIMA does not expect students to spend significant amounts of time researching the industry described in the pre-seen. This can wait until you get to T4 - TOPCIMA.

By giving you a pre-seen case study, CIMA aims to ensure that no candidate is put at an advantage or disadvantage by their level of familiarity with the industry involved. All candidates now have time to ensure that they have a basic understanding of the main issues involved in the case study before walking into the exam.

The latest pre-seen

In the latest pre-seen we are provided with details of V - a travel company based in SK, a European country outside the Eurozone. With only 50 branches, V does not sound like a large company but, in the absence of further information about SK and its currency, it is difficult to be sure of this. Similar companies to V in the UK, in terms of their size, include Bath Travel and Barrhead Travel; further details of these companies and this sector can be obtained from websites such as *travelweekly.co.uk* but do bear in mind the comments above about the dangers of 'over-researching' this sector.

V is an unlisted company owned by its directors that offers 3 types of holidays – Package, Adventure and Prestige Travel. The Chairman (and Chief Executive) currently owns 52% of the shares and has announced his intention to retire by 30 June 2013.

The travel industry is in the process of significant transition at present, and it would be worth doing some general reading to familiarise yourself with some of the main issues. For example, *travelweekly.co.uk* has published a survey of the travel industry which is available online *http://www.travelweekly.com/Travel-News/Travel-Agent-Issues/2011-Travel-Industry-Survey/* . Successful independent travel agents have had to adapt to the challenge of the internet and the faltering global economy, and we should expect V to have to face these challenges in the forthcoming set of your strategic level exams.

The full text of the pre-seen can be found at www.cimaglobal.com/strategicpreseen. You will need to read this in full before reading the remainder of this article.

Understanding the main issues from an E3 Performance Strategy Exam perspective

A basic rule of detective fiction is that omissions often reveal as much as the evidence itself. Here, V is the first Strategic pre-seen since May 2010 which doesn't contain a list of strategic objectives.

Whether strategic objectives will be given in the un-seen, or whether students will need to produce them (possibly with reference to a mission statement), these objectives will need to form the basis for any decision-making. The Balanced Scorecard would be a useful tool to ensure that the objectives cover an appropriate range of commercial areas before they are broken down into Critical Success Factors and Key Performance Indicators (NB Q3 from May 2010 differentiates between the two).

V only started to engage in long-term planning five years ago, when it launched its online service. The absence of strategic objectives combined with a shortage of data about the performance of three diverse products raises a number of fundamental questions about the strategic direction V should take.

The first question is whether V has a clear approach to strategic planning. Without one, the board may need advice on an appropriate model to adopt. The Rational Planning Model is the most obvious, but an emergent approach might also be justifiable depending on the circumstances.

When it comes to corporate appraisal, the board of V in general and the Executive Chairman in particular see V's strength as being "the friendly and direct personal service" but there is no evidence presented to support this view. It is possible that a more detailed analysis, possibly using Porter's Value Chain, might reveal a different picture.

V's existing products are crying out for analysis. As well as any variances in profitability, which the Finance Director has already hinted at, models like the BCG Matrix and Product Life Cycle could be used to identify gaps in the product portfolio.

In order to fill any potential gaps and meet the Chief Executive's plan "to expand and diversify", the following tools could be used to develop strategic options:

- Porter's Generic Strategies – the existing portfolio contains both a cost-leader and a differentiator. It would be worth considering the extent to which the market can be segmented in order to accommodate both strategies.
- Ansoff's Growth Vector Matrix -
    - Product development – cruise ships, health tourism (see Best Exotic Marigold Hotel!), event tourism (rugby/football/cricket matches), own-brand holidays (either independently or as a joint venture)
    - Market development – expansion of branches (e.g. overseas) or online services.
- Lynch's Expansion Matrix – Barrhead offered franchises in December 2009 and, in August 2012, announced plans to place stores in supermarkets. With SK$123M of non-current assets, V seems to own its own stores, so the possibility of selling some (or all?) of them to finance expansion of some sort could be an option.

Chartered Institute of Management Accountants

Whatever the choice of new or existing products, there are repeated references to the technology employed by V. The IT / IS systems received a major upgrade five years ago and so are coming to the end of their useful lives. The Operations Director has explicitly highlighted customer relationship marketing, which could link closely to Web 2.0 and other contemporary social media. At the same time, the lack of internal information suggests that V may need to develop internal systems – if it doesn't already have it, a Management Information System (MIS) or Enterprise Resource Planning (ERP) software would be vital to inform decision-making.

A final stakeholder to consider is V's workforce. They seem content in their work ("turnover of staff is relatively low") but this cannot be taken for granted, particularly if major change is expected. Obvious potential for conflict could revolve around changes to the bonus structure and possible redundancies if some shops are shown to be running at a loss. Issues like this will need to be carefully managed, bearing in mind that "friendly, direct, personal service" is what V sees itself as excelling in.

Understanding the main issues from an F3 Financial Strategy Exam perspective

From appendix 1 of the pre-seen, V would appear to be a successful travel business:

	2012	Workings
ROCE *net operating profit* *(equity +long-term borrowings)*	28%	SK$35m / (SK$75m + SK$50m)
Gearing (using book values) *long-term debt* *(long term debt + equity)*	40%	SK$50m / (SK$50m + SK$75m)
Operating profit margin *Operating profit / sales*	14%	SK$35m / SK$ 250m

However, we are also told that V has two key objectives, the first of which is to grow earnings (remember this is profits *after* interest and tax) by, on average, 5% per year. Despite the reasonably healthy financial ratios shown above, it is possible that V is not generating 5% earnings growth – this is indicated by the statement in the second paragraph of the pre-seen case study that "V achieved steady growth until 6 years ago".

The other key objective is to pay out 80% of profits as dividends. It is not clear from the information provided whether this is being achieved. Dividends payable would be shown within the trade and other payables value of SK$35m but we are not given the breakdown of this value – so while it is *possible* that 80% of profit (0.8 x SK$24m = SK$19.2m) is being paid as a dividend we cannot be certain of this.

So, it is possible that V is not achieving either of its key objectives but we do not know for certain and this is an area that may be developed further on the day of the F3 exam.

From the general narrative in the pre-seen it is also notable that:

- V is an unlisted company so you may be asked to calculate its cost of equity on the day of the exam by taking the beta factor of a quoted company (which would be given) and adjusting for differences in gearing
- 75% of shareholders (using UK law as an example) need to approve a special resolution that would be required if this company is to seek a stock market listing, so this would require the agreement of the executive chairman and 2 other director shareholders.
- SK$15m of long-term borrowings are due to be repaid on 30 June 2014
- Debt covenants oblige V to keep its gearing below 50%.

From the above we can see that there are a number of potential issues that could be developed in the pre-seen. These include:

- **Investment appraisal**, this could include analysis of:
  - a new initiative such as a move into the market for cruise holidays, or a further expansion of its branch network; page 4 of the pre-seen case study refers to V intending to "expand and diversify its product range"
  - investment in updating V's IS systems.
- **Financing issues**, this could potentially cover:
  - obtaining suitable finance to support its expansion, recognising the impact of the 50% gearing debt covenant
  - the suitability of its existing dividend policy in light of this.
- **Valuation of V:**
  - either as part of a question on a proposed stock market listing, or
  - an evaluation of a takeover bid for V, or even
  - the Chairman's 52% holding may need to be valued because he wants to dispose of part or all of it on retirement.
- **Other valuation issues:**
  - V could be considering the acquisition of a rival firm, or
  - the acquisition of a small chartered airline.
- **Impact** of any of the above **on V's key financial objectives:**
  - 5% per year earnings growth
  - 80% dividend payout
  - this could also be tested by a question requiring a forecast of financial statements or an analysis of historic performance.

Understanding the main issues from a P3 Performance Strategy Exam perspective

V finds itself very much at a **crossroads** – the Executive Chairman has given the last 40 years of his life establishing the company and now seems keen on drawing down on this investment by selling some of his equity stake in the company, allowing a **change in direction** that other members of the Board seem very keen to pursue. What does this mean for P3 then?

- There are areas where V could **expand its product portfolio** – cruises are one example – plus, given the concerns about profitability raised by the Finance Director, there could also be certain products which V may choose to discontinue if it had better visibility of them, so some **assessment of products using performance measurement**

techniques would fit in well here, as well as considering the risks and controls associated with any such expansion

- Any changes to products would raise the issue of **fitness for purpose of the existing IT infrastructure,** plus the availability of **sufficient appropriate information for decision-making**, so either an assessment of existing facilities or the recommendation of any replacement becomes a possibility
- It is likely that the departure of the Executive Chairman and any changes to infrastructure would lead to some form of **investment in V by third parties** (or by other directors perhaps?) so the existing **governance structures** would probably need to be revisited. This is likely to be necessary whether this took the form of equity or debt, but the latter may also have **gearing implications** that would impact on V's existing debt covenant
- Such investment may not be limited to non-controlling interests as V may find itself the target of a **takeover bid**, although the opposite may fit better into the P3 exam where conflicting strategies and resources may need to be assessed in advance of any bid made by V
- Similarly V may decide to **change its routes to market** by association with other travel providers or affiliation with players such as www.tripadvisor.com or www.expedia.com
- As with previous pre-seen case studies, there are a number of **discreet developments** that may be expanded upon and from a P3 perspective certain **risks and controls** could be considered, such as:
    - **Foreign exchange exposure** for V when booking flights and hotels in overseas destinations, plus the risk attached to loading pre-paid cards with local currency
    - **Economic risk** from the ongoing use of overseas destinations
    - **Commodity risk** and adverse customer reaction from **rising fuel prices**
    - **Customer safety**, especially the risk of stomach complaints at resorts in warm climates
    - **The branch network**, including **establishment costs** (especially when competing against many retailers found only online)
    - **Insurance products**, misleading **holiday literature** and **staff incentives**, all of which may create dysfunctional behaviour in V's staff
    - The company has to find SK$15m in two years' time, plus its cash balance is half that of the receipts held in advance, so **cash-flow problems** may become more acute
    - Local (such as **holiday representatives' expenses**) and corporate (consistent **discounts granted by branches**) cost pressures may need to be reviewed by **Internal Audit** (if there is one…)
    - The **small finance department** and **part-qualified management accountant** may find themselves thrust into the spotlight if some **irregularity** is introduced (for example, is the company's ongoing financial success somehow down to some form of fraudulent financial accounting?) which may lead onto some form of **ethical dilemma.**
- Finally, unseen questions could still bring in topics **not raised in the pre-seen at all:**
    - V holidaymakers could be placed at risk of **adverse weather conditions, terrorism,** or **political disruption**;
    - There may be **travel industry reforms** which affect V; or
    - There may even be **deteriorating customer demand** which may have an impact on V's profits.

You should therefore be prepared for anything!

One theme that does run through this pre-seen is the nature of V as a service-oriented business that relies on its people to maintain its solid **reputation** – however, the inevitable changes that V will have to undergo to maintain its good financial position and performance may lead you to question whether it can change and still leave its reputation intact, so this is likely to be a major theme that the P3 exam will expand on in the unseen questions.

Conclusion

To conclude, while consideration of the pre-seen is an important activity, students must remember that it forms just one dimension of exam preparation and should not be over-emphasised at the cost of question practice and other exam preparation.

Good luck in your exams!

David Culley, Doug Haste and Steve Whittenbury are BPP subject specialists.