T4- Part B – Case Study

N Multi-channel retailer case - November 2013

REPORT

To: Finance Director of N
From: Management Accountant
Date: 21 November 2013

Review of issues facing N Multi-channel retailer

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Note:
This report is far more comprehensive than would be expected from a candidate in exam conditions. It is more detailed for teaching purposes.
1.0 Introduction

N is a profitable company but is facing fierce competition in a tough economic environment.

As the PESTEL analysis Appendix 1 indicates, the political and economic situation in Europe is a major threat to the future profitability and growth of retailers like N because the economic recession is reducing the amount of consumers’ discretionary income.

The Five Forces analysis Appendix 2 suggests that while the threat from suppliers, buyers and substitutes is low and that from new entrant’s only moderate, competitive rivalry is fierce as the battle for market share becomes ever more intense amongst the big players in the industry.

The SWOT analysis Appendix 3 indicates that while N enjoys a strong brand and opportunities for further growth in emerging markets and potential gains from the development of its, 'click and collect' business, it suffers from a number of potential threats and current weaknesses. If successful this would be an example of Ansoff’s, existing products, new channel, and Porter’s differentiation of service offering.

The economic and competitive threats have been noted above but threats also arise from operational weaknesses within N itself. These include weaknesses in merchandising which have led N to consider moving to the sale of ‘own label' white goods. Problems with outdated technology and systems have led to serious issues about whether technology and systems should be in-sourced or outsourced. The inadequate costing system in particular requires attention as it is has led to poor management decision-making.

Given the increasing uncertainty in the economic environment and the range of operational problems within N the need for a more focused risk analysis as proposed by Ms. Bilder is an essential requirement.

In many ways N does not appear to have moved forwards. Retail organisations operate in a fiercely competitive market place, and must continually innovate, otherwise they will end up like Lewis’s a large well known chain of UK department stores which had successfully traded for nearly 140 years but then went into administration in 1991.

The key issues are prioritised in section 3 of this report, and discussed and evaluated in section 4. Section 6 then summarises the main findings and makes recommendations.

2.0 Terms of reference

I am the Management Accountant appointed to write a report to the Finance Director which prioritises analyses and evaluates the issues facing N and makes appropriate recommendations.

I have also been asked to prepare an e-mail for the FD outlining the essential features of an effective costing system with recommendations regarding the current system operating in N.

3.0 Prioritisation of the issues facing N

The priority listing has been arrived at following an evaluation of the essential timing of each issue and in terms of an issue’s ultimate importance to the organisation.

3.1 Top Priority – Risk analysis

A thorough risk analysis process should be undertaken to ensure consideration is given to threats from the business environment and for possible events as yet unseen, which could adversely affect N’s strategies and its operational performance.
3.2 Second priority – Business process outsourcing

Systems which enable the business to configure for effective multi-channel operation, and potentially save costs must be a part of the medium/long term plan. This gives rise in particular to the question of whether N should in-source or outsource its distribution services.

3.3 Third priority – Store performance

It is essential to ensure costing is accurate, and reflects the true nature of performance, potentially profit damaging decisions are about to be made.

3.4 Fourth priority – Own Brand sales

From a financial point of view the costs/advantages of each supplier’s offer is similar, and so not particularly relevant to the decision. There are other considerations, but purchasing staff must take these into account when arriving at a choice of supplier.

3.5 Ethical issues

The ethical issues of faulty products and staff incentives need to be attended to directly but these can be managed alongside the other issues.

4.0 Discussion of the issues facing N

Overview

Consideration needs to be given to the risks associated with the various functions of the business and procedures considered to deal with these. A constant review of margins and potential profit improvement strategies is required.

In order to remain competitive N will need to undertake a thorough review of its operational reporting systems to ensure that store reports accurately reflect the true performance of the company.

A review of its information processing procedures is required to ensure that the correct and most cost efficient systems considering the current trading position and future plans are considered and implemented.

4.1 Risk analysis

The importance of being risk aware is illustrated by the response of the management team, which when asked, thought that the forecast may only be 80% achievable. If this were the case this would reduce the operating profit by more than Z$ 32.0 million in each year of the forecast period and would clearly be unacceptable (Appendix 4)

The effect on share price and investor confidence will be a major concern.

An initial thorough risk review should be undertaken; there may be important factors that require consideration in both short and longer term strategic plans. Once the initial process has been completed, the review can become more focused and graded according to the threat to future performance.

Useful techniques in this process will include SWOT with a detailed review of weaknesses and threats, PEST, reviewing all relevant aspects of the external environment and use of Porter’s Five Forces model which identifies risks associated with the competitive environment.
The lack of effective risk analysis has been illustrated by recent UK company failures such as Woolworths, HMV and Jessops, which all failed to appreciate the risks of ignoring on-line trading, and Morrisons supermarket whose recent sales decline has been attributed to its late appreciation of the importance of this rapidly developing sales channel.

The following risk profile seeks to identify the major risks facing N. In general the following options are open to N in the management of risk.

N can seek to transfer risks (through a third party contract); it can finance the risks by taking out insurance; it can seek to avoid the risk by aborting its plans and/or leaving the risk with the customer or supplier; it can take an alternative course of action with a lower risk exposure and/or invest in additional capital equipment or security devices to reduce risk or recognise that some risks are a normal part of doing business and monitor the risks to make sure that the potential impact or likelihood of risk has not increased.

Risk Profile for Company N

Note: The identification of the major risks facing N together with the likely impact of each risk is discussed below.

The mitigation of each risk is covered in section 6 (recommendations) pages 9-10

Risk and Impact

<table>
<thead>
<tr>
<th>Strategic Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic down-turn in Country Z and EU more generally with associated reduction in consumer spending. This is likely to reduce the sale of discretionary items.</td>
</tr>
<tr>
<td>Associated with the above the possibility of euro zone collapse due to enforced austerity programmes and political friction between European states.</td>
</tr>
<tr>
<td>Supplier cost price increases due to rising cost of energy which puts pressure on N's margins.</td>
</tr>
<tr>
<td>Intense pressure from competitors in home market with strong downward pressure on N's pricing strategy, margins and profitability.</td>
</tr>
<tr>
<td>Possibility that inbound logistical improvements and associated integration of N's multi-channels will take longer than planned and that this will result in lack of competitiveness resulting in the loss of market share (See Operational risks).</td>
</tr>
<tr>
<td>Political coup in one or another country where we have significant Foreign Direct Investment (FDI).</td>
</tr>
<tr>
<td>Sales in Europe and North America threatened by economic conditions.</td>
</tr>
<tr>
<td>Sudden currency fluctuations.</td>
</tr>
</tbody>
</table>
**Financial Risks**

The impact of competitive and cost pressures is having a telling effect on N's ability to maintain profit levels.

The need to continue dividend payments and to renegotiate the bank finance agreement to cover the original buy-out costs is creating added pressures on cash flow.

**Operational Risks**

| Slow moving sales of some items particularly women's clothing. |
| Late completion of multi-channel integration in light of shift in retailing to online channels. |
| Too few out of town stores and limited availability of click and collect facility, dependent on funding decisions. |
| Back office logistical problems and continuing danger of stock outs (see strategic risks). |
| Entry into emerging markets involves degree of uncertainty. (See strategic risks). |
| Inconsistent procurement policy. |

4.2 Business process outsourcing

The need for efficient logistical management and effective systems is illustrated by the problems with the extended delivery lead times. These have caused considerable cost and operational problems for N.

Potential efficiency savings and the development of multi-channel systems need to be balanced against in-house/outsourcing costs and risks. Given the current problems with the third party distribution supplier it is useful to consider why N outsourced its distribution service in the first place. This can be answered by looking at the advantages which are generally put forward as warranting the use of specialist distribution suppliers. These include:

- **Speed and Expertise:** Tasks can be completed faster and with better quality output
- **Concentrating on core process rather than the supporting ones:** Outsourcing the supporting processes gives the organisation more time to strengthen their core business process.
- **Risk-sharing** is one of the most important factors which influence an organisation in the outsourcing decision
- **Reduced Operational and Recruitment costs.**

But as will be evident in N's case these advantages have proved illusory. Not one of the advantages cited above for business process outsourcing has been demonstrated; in fact the reverse has occurred. Tasks have been completed so slowly that some products have reached the stores late and losses have occurred because clothing items have not been delivered on time. Furthermore, instead of being able to concentrate on core processes, the CEO has been distracted from core issues by having to spend time trouble-shooting the problems caused by N's chosen third party distribution centre supplier. Also, rather than sharing risks N seems to have suffered mightily from having risked
the use of a so-called expert supplier of distribution services and to have increased rather than decreased its operational costs.

The Williamson & Coase Hierarchy/Market model is relevant here. This aims to assess the relative merits of keeping processes and operations ‘in house’ rather than buying-in services. Mothercare is a UK example of an organisation which has recent experience of logistics problems resulting from outsourcing.

What seems very evident in this case is that BPO has been an unmitigated disaster for N. It may be of course that for the third party supplier this is a one-off failure and it was let down by its manager in the distribution centre. That said, this raises questions about the third party’s monitoring and control procedures. It is vital in situations that require just-in-time delivery that products are delivered in time every time and systems should be in place to see that this takes place.

This failure by the third party supplier points up the need for very careful vetting and selection of third party suppliers and raises questions about N’s processes for the selection for third party suppliers. It also raises questions about contractual arrangements between N and the third party supplier. No information is given in the case about what compensation arrangements are in place for the kind of losses N suffered, not only for its immediate loss of earnings but also to potential future losses due to reputational damage.

Should N contemplate outsourcing its distribution centre services in future therefore it must ensure that it has adequate processes in place to identify and recruit competent suppliers. In order to obtain the services of a third party with an outstanding track record it may need to offer an attractive contract but the cost of this may well be worthwhile given the potential damage that can occur as evidenced in this particular case.

Turning now to the advantages of In-house provision of distribution services as compared with business process outsourcing, the following are frequently cited:

- It obviates the risk of exposing confidential company information to a third-party.
- It overcomes potential problems of control that can arise when outsourcing.
- It avoids the transaction costs of outsourcing such as those to do with finding a suitable partner, drawing up a watertight agreement and the legal and other problems involved in enforcing the contract if things go wrong.
- It helps focus on N’s particular needs. An outsourced supplier will often be catering for the needs of many organisations. In such situations the provider may not have a sharp enough focus on N’s needs.

These advantages of an in-house distribution system over an outsourced system all appear very plausible but they assume that organisations, in this case N, already possess or can acquire at reasonable cost the necessary expertise to design, set up and operate a state of the art distribution system that can match that provided by one of the big specialist providers. This is not possible to decide without more information and a means must be established to collect the relevant information so that a realistic comparison between use of an outsourced and an in-house system can be established.

As a means to decide on whether or not to set-up and to operate its own distribution system, a thorough cost benefit analysis of the two alternatives; in-house or outsourced needs to be undertaken.

4.3 Store performance

The existing costing system needs a complete review, the current reports and reasons for the apparent product losses are illustrated in Appendix 4. The reports produced using the current absorption costing system are giving a misleading view of product profitability and will potentially lead to erroneous detrimental management decisions.

In this case a reduction of volumes by 50% has led to the same total overhead being absorbed and so resulting in an apparent loss of $48.25 per unit, when actually these products are generating a
positive contribution of Z$ 75.0 per unit. If the decision is taken to withdraw them this would have a detrimental effect on operating profit.

If the decision is taken to withdraw these items, at the reduced volume levels N will lose 3500 x Z$ 75.0 = Z$ 262,500 of contribution in the affected stores which would lead to the same overall reduction in N’s operating profits.

Absorbing costs by volume of throughput can lead to such problems, particularly if volumes of throughput are falling, and there are fewer products to absorb the allocated costs. This rigid system can lead to misleading information being produced. In this case if only one item is sold it will end up absorbing the whole overhead of Z$ 431,382.

Other costing systems such as simple marginal costing or activity based costing should be given consideration. A marginal costing system will indicate contributions, sales price less direct cost of goods, and give an indication of profitability related to selling prices, irrespective of the other overhead costs of running the Company, which would occur whether these goods are sold or not. Such a system should be relatively straightforward to implement as the information is readily available.

An activity based system would involve more analysis but would indicate the relative costs of activities in the Company, and is useful in making long term strategic decisions. It would also be sensible to express the margin earned in total to the area occupied in earning it, given that selling space is the store limiting factor.

The costing systems being used by the Company have developed and been used for many years and become embedded as part of the organisational culture. It is now appropriate to change these to more appropriate systems. Lewin’s change model may be useful in achieving this; unfreezing current practice, changing and updating the systems and then refreezing the updated systems.

Overall it is essential that the organisation has reliable and accurate key performance indicators, on which sound management decisions can be based.

4.4 Own Brand Sales

Ansoff’s theory is relevant to this discussion, this being an example of these developments of an existing product in an existing market. It is important that these developments do not take place in isolation and that the other aspects of the theory are not ignored, existing products new markets, new products existing markets and new products new markets.

The financial outcomes from the 2 suppliers are broadly equal; (Appendix 4). Other considerations such as levels of stock, quality, and reliability will need to be considered by the purchasing team, but the potential to improve margins overall should be continually reviewed.

An agreement with firm A offers a better financial outcome with a saving of Z$ 120,000 over firm B and in addition there is no need to hold as much stock, which would need to be stored for longer and may be subject to damage as a result.

However if warranty claims are reduced and as a result of their offer firm B is able to produce higher quality products, reducing these to less than Z$ 3.0 million, a supply contract with firm B will be beneficial. This could possibly apply to firm A, if they are able to reduce warranty claims with improved quality.

This can only be proven with experience, so although initially the contract may be awarded to A, based on historical warranty claim experience, product trials and discussions with firm B should be continued.

Porter’s Five Forces model may be a useful analysis when analysing supplier power relative to N’s current market position. It is new to negotiations with this market segment, and care will be needed to ensure that supply agreements are in the long term interests of N.
4.5 Other Business Issues

Apart from the above four main business issues, N is also facing two other specific issues that have both a business as well as an ethical aspect to them. The ethical aspects are discussed separately in section 5 below.

4.5.1 Faulty products
The recommendations on this issue are included in the ethics section in 5.

4.5.2 Staff incentives
The recommendations on this issue are included in the ethics section in 5

5.0 Ethical issues and recommendations on ethical issues

5.1 Faulty products

There is a commercial and ethical issue to be considered. Although N has not manufactured these fridges they carry its brand and as far as the customer is concerned they have been supplied by N. The reputation of N is under threat which may cause loss of future sales, this is a business issue. A further concern is the ethical aspect. N is responsible for supplying faulty goods, which in any event were not intended for resale and are causing physical harm to customers.

5.1.1 Recommendations

Whilst the manufacturer must be held accountable for producing fridges that are not fit for sale, in this case they were not intended for resale and N must be responsible. Investigations need to take place to find out how this situation has arisen. If they have been sold knowingly disciplinary action will be required. A more stringent registration process, where the product guarantee is registered to the customer is required; this should have alerted staff to the fact that these items were not intended for sale.

N should replace these items as soon as possible, at no cost to the customers.

If this is a result of poor administration, procedures need to be reviewed to ensure that this cannot happen again and that staff are trained appropriately.

5.2 Staff incentives

A conflict of interest has arisen here between the store staff that wish to be seen to be acting in the best interests of N by promoting the store card, and the self-interest of staff members to benefit from the commission earned from promoting the store cards.

This has led to customers being induced to take on debts that they are unable to repay; the staff will be seen to be benefitting at the expense of the customers, which is not only unethical but also commercially risky.

5.2.1 Recommendations

N needs to ensure that it approaches the provision of store cards to customers in a responsible manner.

Procedures should be introduced with authorisation limits to be signed off by senior sales staff. This will require improved procedures for vetting and staff training to ensure that these procedures are adhered to.

Staff incentives should be reviewed to ensure that they are rewarding staff for sales related improvements rather than encouraging customers to become excessively indebted.
6.0 Recommendations

6.1 Risk analysis

6.1.1 Recommendation

Detailed risks register to be compiled, analysing potential risks in the strategic, financial and operational areas of the business, and ways of mitigating these risks. This should be updated and reviewed at each Board meeting, with significant changes identified. Appropriate actions necessary to deal with these must be approved at the meeting.

6.1.2 Justification

Failure to take full account of, strategic, financial and operational risks leaves N open to financial losses and even the collapse of the Company.

Lack of awareness of potential risks in all functional areas of the business may result in forecasts not being achieved, and a lack of understanding of potential variances.

6.1.3 Actions to be taken, specific to each risk category

The strategic, financial and operational risks need to be evaluated, and all functions of the business must co-operate in producing a risk register and mitigating actions required. This process needs to be co-ordinated by the finance function.

Mitigation of Risk

Note: For reference the identification of the risks and their impact is repeated in the left hand column and the recommendations for mitigation in the right hand column.

<table>
<thead>
<tr>
<th>Strategic Risk</th>
<th>Mitigation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic down-turn in Country Z and EU more generally with associated reduction in consumer spending. This likely to reduce sale of discretionary items.</td>
<td>Proposed increase in own label products leading to price advantage. Increased effort on international sales in Middle East and Asia and enhanced online sales effort in international markets.</td>
</tr>
<tr>
<td>Associated with the above the possibility of euro zone collapse due to enforced austerity programmes and political friction between European states.</td>
<td>Difficult to prepare for but continued development of N's business in international markets is one hedge.</td>
</tr>
<tr>
<td>Supplier cost price increases due to rising cost of energy which puts pressure on N's margins.</td>
<td>Move to multiple sources where supply is not a problem but alongside this continue to foster close relationships with our key suppliers and negotiate deals beneficial to long term interests of both parties.</td>
</tr>
<tr>
<td>Intense pressure from competitors in home market with strong downward pressure on N's pricing strategy, margins and profitability.</td>
<td>Seek to increase differentiation of N's products through more effective merchandising. More attention to product mix and ensuring size availability for customers irrespective of size.</td>
</tr>
<tr>
<td>Possibility that Inbound logistical improvements and associated integration of N's multi-channels will take longer than planned and that this will result in lack of competitiveness resulting in the loss of market share (See Operational risks).</td>
<td>Increased investment in project management to seek to ensure that these projects are completed on time and to the best industry standards.</td>
</tr>
<tr>
<td>Political coup in one or another country where we have significant Foreign Direct Investment (FDI).</td>
<td>Careful appraisal of any new FDI investment and re-appraisal of existing FDI.</td>
</tr>
</tbody>
</table>
### Sales and North America

- Sales in Europe and North America threatened by economic conditions.
- Sudden currency fluctuations.

### Financial Risks

<table>
<thead>
<tr>
<th>Risk Description</th>
<th>Mitigation Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased investment in emerging markets to be considered.</td>
<td>Financial position of N adds urgency to risk mitigation at all levels, external, strategic, international and operational.</td>
</tr>
<tr>
<td>Use of hedging strategy.</td>
<td>Maintain dividends and renegotiate bank finance agreement.</td>
</tr>
</tbody>
</table>

### Operational Risks

<table>
<thead>
<tr>
<th>Risk Description</th>
<th>Mitigation Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Slow moving sales of some items particularly women's clothing.</td>
<td>Liaison with new Merchandising Director and review of promotional budget.</td>
</tr>
<tr>
<td>Late completion of multi-channel integration in light of shift in retailing to online channels.</td>
<td>Additional resources to ensure quick solution.</td>
</tr>
<tr>
<td>Too few out of town stores and limited availability of click and collect facility, dependent on funding decisions.</td>
<td>Additional resources to be made available to provide click and collect facilities, as this now has increased importance.</td>
</tr>
<tr>
<td>Back office logistical problems and continuing danger of stock outs (see strategic risks).</td>
<td>Improve monitoring and control. Consider move to in-house management of distribution centres.</td>
</tr>
<tr>
<td>Entry into emerging markets involves degree of uncertainty.</td>
<td>More intensive efforts in assessment of business environment and retail markets in targeted countries.</td>
</tr>
<tr>
<td>Inconsistent procurement policy.</td>
<td>Review to establish most effective policy in light of changing circumstances.</td>
</tr>
</tbody>
</table>

### 6.2 Business process outsourcing

#### 6.2.1 Recommendation

To undertake an urgent review of the Company processes used in the selection of outsourced service suppliers, especially in respect of the management of distribution centres. An immediate decision is required to improve the distribution situation; this is seriously affecting the business.

A monitoring and control system to be established to ensure the new, and any future, outsourcing agreements are providing the service required. This is particularly relevant to the new third party management with the existing agreement.

To review the third party company’s capability in respect of its ability to set up, run and maintain N’s distribution services in a cost effective manner. In this respect Johnson Scholes and Whittington’s model may be appropriate in ascertaining whether potential suppliers of outsourced services or the
retention of some of these ‘in house’ will produce the best outcome fulfilling N’s requirements. Will different proposals be suitable, acceptable and feasible for all parties?

In conjunction with the above to evaluate by a thorough cost/benefit analysis the most cost effective method of providing N’s distribution service.

6.2.2 Justification
The current systems and arrangements are not conducive to efficient and cost effective management of the business. Urgent review and action is required

6.2.3 Actions to be taken
The improvements in service by the third party provider must be closely monitored. Any delivery problems and stock shortages must be quickly identified. Service level agreements to be reviewed and updated as appropriate.

The remaining term of the 3 year contract must be closely scrutinised.

In the medium term all functions of N to participate in a business review to report and recommend accordingly in line with the recommendations in 6.2.1 above.

6.3 Store performance

6.3.1 Recommendation
The stores being discouraged from selling because of apparent losses on white goods should be advised to continue with the promotion.

A complete review of costing and reporting should be undertaken.

A marginal costing system is introduced.

Decisions on product sales profile will need to be revisited; profitable products may have been incorrectly withdrawn from sale in some stores.

The store performance report will need redesign to accommodate these changes.

6.3.2 Justification
The existing system is producing reports containing misleading information leading to incorrect management decisions in terms of product profitability.

This is highlighted by the potential loss of contribution if the product range is withdrawn. As discussed in 4.3 above.

6.3.3 Actions to be taken
A simplified costing system to be introduced attributing direct costs to products and ranking contribution by product and by store.

Store overheads to be reported and managed by the store manager, with appropriate budgets set with actual comparisons and explanations for variances required.

This new costing system must be implemented as soon as possible, in order to avoid incorrect decisions being taken and staff becoming de-motivated.

The store performance report must be redesigned to accommodate the new system.
Review conducted of previous product sales decisions, policy to be amended as necessary.
Store managers and staff to be appraised of revisions, and importance of information produced.

6.4 Own Brand Sales

6.4.1 Recommendation
Own brand to be pursued; care must be taken that goods supplied are of sufficient quality and fit for purpose.
Initially this to be with firm A. This offers a marginally better financial outcome.
Quality and supply effectiveness regularly reviewed.
Customer survey to be carried out to ascertain reaction to ‘own brand’

6.4.2 Justification
It will be possible to gain significant margin improvements.
An own brand label in white goods will increase customer awareness of N’s brand (Ansoff). This may be useful in further product development.

6.4.3 Actions to be taken
Initial agreement for supply from firm A
Procurement will need to review this decision on a regular basis, based on cost, quality, delivery, reliability and potential for further negotiations.
Ensure that deliveries are on time, as ordered at cost agreed.
Contracts to be signed and supply arrangements agreed.
Carry out customer survey and take appropriate action based on the results.

7. Conclusions
The company is moving into a different trading environment where traditional trading methods which have given it an advantage in the past are rapidly diminishing. In order to cope with this it is essential that N is aware of the risks that surround it, has information and operating systems that will enable it to trade effectively and that its reporting systems are providing information which accurately reflects the detailed trading operation of the company.
Appendix: 1  PESTEL Analysis: Department Stores in Country Z

Political
On-going uncertainty about the future operation of the EU
Impact of government austerity measures to counteract debt position of several EC countries including that of Country Z involve threats to all retail businesses

Economic
Euro-zone crisis manifested in low or zero growth, unemployment, wages freezes, welfare spending cuts all impacting on consumption demand for goods and pose a threat. Continued growth in emerging markets offers potential opportunities for expansion abroad.

Social/cultural
Relatively affluent ageing population with different lifestyles than younger generation so changing patterns of consumption pose both opportunities and threats depending on retail strategies adopted by stores.

Technological
Developments in Information Communication Technology (ICT) enabling improved logistics of distribution, data collection on customer spending patterns, speed in allocation of price information to all items etc. pose both opportunities and threats depending on speed of take up by stores.

Environmental
Concern with sustainability and preservation of the environment involves added costs but also opportunities.

Legal
Restrictions on mergers and acquisitions limit growth possibilities in domestic market but act as driving force to seek markets abroad.
Appendix: 2  Five Forces Analysis of Retail Department Stores

New Entrants

Significant capital requirements so low threat.
Brand image significant in the department store sector.
Scale economies in purchasing, distribution & advertising advantage large firms.

Suppliers

Supplier power is limited because of size and power of retailers.
Retailers buy from a large number of suppliers so not dependent.
Modern transportation allows retailers to source from areas of low cost labour.

Competitive Rivalry

Fierce due to competition from supermarkets, hypermarkets, speciality stores and large online retailers.
Consolidation in the retailing industry generally resulting in closure of smaller stores and competition increasing between larger retailers.

Buyers

Large scale department stores have potentially many buyers so individual buyer relatively weak
Many alternatives to buy from and low switching costs so strengthens hand of consumer.

Substitutes

A substitute for shopping in a department store may be shopping in other retailers with a different format, be these speciality stores, supermarkets or Web-only retailers.
Appendix: 3  SWOT analysis of N Company

Strengths
National coverage and with a presence in growing economies such as Asia and the Middle East.
In depth experience in the retail sector with a strong brand.
Store modernisation places N amongst the leaders in store design.
Excellent customer service remains one of the cornerstones of competitive advantage.

Weaknesses
Business process outsourcing.
Store performance report/ cost reporting.
Lack of integration of N’s multi-channels.
Recent weakness in merchandising though past record generally good (raises question of whether to increase sale of own-label white goods.)
Inbound logistics due to use of outdated technology and systems (leading to issue of inadequate costing systems and issue of outsourcing versus In-house provision.)
Inadequate use of risk analysis and preparation of plans for mitigation.

Opportunities
Growth opportunities in overseas markets.
Demand for own brand products might rise due to current recession, if prices are reduced.
Trend towards more demand for non-food goods on a ‘click and collect basis.

Threats
Lack of risk analysis and consequent effect on results
Economic recession and continuing euro zone crises with associated unemployment, wage freezes and cuts in welfare budgets is affecting demand.
Price increases in motor fuel, home fuel bills and higher food prices through bad harvests contributing to lower demand.
Fierce competition from supermarkets now stocking non-food products, speciality stores and big store international online discounters.
(All above lead to need for risk analysis.)
Potential warranty claims from own branded goods.
Reputational effect of faulty goods.
## Appendix: 4
### Supporting calculations

#### Risk analysis

<table>
<thead>
<tr>
<th></th>
<th>Z$ million</th>
<th>Z$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year ending 31 March</td>
<td>2015</td>
<td>2016</td>
</tr>
<tr>
<td>Forecast operating profit</td>
<td>162.5</td>
<td>160.6</td>
</tr>
<tr>
<td>80% achieved</td>
<td>130.0</td>
<td>128.5</td>
</tr>
<tr>
<td>Potential shortfall</td>
<td>32.5</td>
<td>32.1</td>
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</table>

#### Store performance

Overheads to be absorbed

<table>
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<th></th>
<th>Z$ million</th>
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<tr>
<td>Distribution costs</td>
<td>64.9</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>40.6</td>
</tr>
<tr>
<td>Depreciation</td>
<td>88.0</td>
</tr>
<tr>
<td>Sales expenses</td>
<td>150.0</td>
</tr>
<tr>
<td>Total</td>
<td>343.5</td>
</tr>
</tbody>
</table>

Floor area 1,114,800 sq. m.

Absorption rate Z$ per sq. m. = 308.13

Per typical store

Absorption for white goods sales area 1400sq. m. x 308.13 = Z$ 431,382 per annum

- At 7000 anticipated sales volume per store
  - Absorbed cost per unit 431,382/7000 = 61.62
  - Gross margin per unit 300 x 25% = 75.00
  - Net profit per unit = 13.38

- At 3500 anticipated sales volume
  - Absorbed cost per unit 431,382/3500 = 123.25
  - Margin = 75.00
  - Net loss = (48.25)
**Own brand**

<table>
<thead>
<tr>
<th>Description</th>
<th>Z$ million</th>
<th>Z$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home sales for 2013/2014</td>
<td>2080.6 x 20.5% = 426.5</td>
<td></td>
</tr>
<tr>
<td>50% own brand =</td>
<td>213.2</td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td>138.6</td>
<td></td>
</tr>
<tr>
<td>Margin @ 35%</td>
<td>74.6</td>
<td></td>
</tr>
<tr>
<td>Average cost of sales per month (inventory value)</td>
<td>11.6</td>
<td></td>
</tr>
</tbody>
</table>

**Relative costs/ benefits**

<table>
<thead>
<tr>
<th>Description</th>
<th>Firm A</th>
<th>Firm B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Extra stock holding Z$ 11.6@ 3% interest cost</td>
<td>0.35</td>
<td>0.70</td>
</tr>
<tr>
<td>Prompt pay discount</td>
<td>(2.77)</td>
<td></td>
</tr>
<tr>
<td>Cost of warranty claims provision</td>
<td>4.26</td>
<td>4.26</td>
</tr>
<tr>
<td>Firm B agreement</td>
<td></td>
<td>(3.00)</td>
</tr>
<tr>
<td>Total cost</td>
<td>1.84</td>
<td>1.96</td>
</tr>
<tr>
<td>Cost saving</td>
<td>0.12</td>
<td></td>
</tr>
</tbody>
</table>

Firm A is marginally better with a saving of Z$ 120,000, but other factors such as stock holdings, quality and long term ability to supply sufficient volumes will need consideration on an ongoing basis.
Appendix 5 Question 1 part (b): e-mail

To: Store Managers
From: The Management Accountant
Date: 21 November 2013
Re: The purpose of an effective costing system and its benefits

Dear Colleagues,

The Finance Director has asked me to prepare an e-mail to store managers outlining the purpose and benefits of an effective costing system and how an effective costing system can assist in the performance of their roles.

Accordingly please find below the key features:

Generally, we are trying to manage a system which will enable more reliable costs of our goods to be calculated, in order to avoid selling our goods for less than they cost and thereby making a loss.

We also need costing information to calculate our profit accurately for reporting and calculating your bonuses.

Input into the system needs to be as accurate as possible.

With this in mind please ensure that the base information and records required for the system to operate are accurate. It helps us to have confidence in the reports produced.

More specifically, we are aware that the way in which some of the costs are currently allocated is causing some problems.

In order to improve this we are undertaking a review of the current costing system, in which some overhead costs are allocated to products on the basis of the floor area they occupy in store.

This system of costing can be very subjective; the allocation of costs to charge to goods is not always accurate and can be subjective. They may have different sales values but all absorb the same amount of overhead cost. Some white goods are showing a loss of Z$48.25 per unit, when they are actually positively contributing Z$75.00 per unit.

In order to improve the system we are planning to introduce a marginal costing system which only allocates our supplier costs to the goods, and after allowing for direct staff costs arrive at an accurate cost for a ‘product’ group.

We will be able to calculate the margin on the products sold in the store and adjust our sales prices accordingly.

The SPR will be revised soon into a new format to reflect this and information briefings will be arranged.

We hope that you appreciate our attempts to make the system more accurate, the benefits should give you a much more reliable indication of cost per product and help you to decide on the product profile for your stores.

Management Accountant

......... End of the answer  ......

November 2013