MANAGEMENT CASE STUDY NOVEMBER 2018 EXAM ANSWERS

Variant 4

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Section 1

Generic strategies

There are three key generic strategies which a company can adopt to obtain competitive advantage. Other models, suggest similar, but the number of different strategies may vary. The three main strategies are cost leadership, differentiation and focus, although others may be considered, such as hybrid strategies. Briefly, these would require a company to behave as follows:

Cost Leadership – aim to become the lowest cost provider in the industry, such that low prices may be charged, whilst still achieving good profit margins.

Differentiation – Offer products which have a feature desired by customers, but not offered by other competitors. This allows a high price to be charged.

Focus – Aim to capture a small part of the market by meeting their needs exactly.

Grapple would be considered to be a differentiator, as the taste is seen as something very important and has not been matched by our competitors, according to our strategy statement. Our brand is also a differentiating factor, although it could be argued that this is as a result of the taste.

Generic strategies are important as Porter argued that if you get 'stuck in the middle' I.e. try to follow both cost leadership and differentiation, then you are less likely to be successful. Whilst others argue that you can follow different strategies for different products (indeed, supermarkets have quality and basic ranges). However, it can affect the brand if you are known for one generic strategy and try to adopt another.

Given that our brand is important to us, our product launch must take these factors into consideration, in order to ensure the generic strategy fits with our current approach:

- Who do we want to launch to? (focussed on a specific market or wider population)
- Do we want to reduce costs (and charge low prices) or emphasise the differentiating features? The latter would be in line with our mission of producing "a unique soft drink experience".

Target costing

Target costing is considered to be a pull-system, unlike the typical push-system of setting a price based on the costs.

It takes external forces as the driving factor, setting a price which is appropriate for the current competitive environment. This could take into account competitor products, Grapple’s own differentiation strategy and market research on customer viewpoints. Once the price has been decided, a margin is deducted to derive the target cost for the product. As Grapple’s current gross profit margin is around 31%, it may choose to deduct a margin similar to this.

After doing this, Grapple would be left with a target cost and it would usually be the responsibility of the product design or research and development team to design the product and the production processes to meet these costs. Grappe does not have a dedicated product design team, so this would presumably be the responsibility of the production team alongside procurement.

It is worth pointing out that the target cost should be agreed and accepted by those responsible for achieving it, in order to ensure ownership for the achievement of the target. For example, if the marketing team set a price which leads to an unrealistic target cost, it is unlikely to prove to be a successful endeavour.

It is unclear whether the product has already been developed and the launch is imminent. If this is the case, it may now be too late to successfully implement target costing, as it should be a pro-active system, put in place before the design is finalised. This is because it is difficult to change costs already incorporated into the designed product.

If it is still in the very early stages, then costs can be influenced across all development activities, such as ingredients, bottling, and the actual production processes. If using existing production lines, it may be difficult to influence the latter to any great extent.

Overall, target costing should lead to cost reductions rather than focussing simply on cost-control.

Business Risks associated with product development

Business risks can be considered to cover a number of different categories. The key ones associated with product launch may be considered to be as follows:

Strategic risk - This is the risk that a new strategy, in this case a new product, will fail. However, if managed correctly, it should not affect our overall strategy, which should remain positive, as it currently is. This is exemplified by our exceptional growth rates due to our existing products.

Product risk - This includes both the risk of the failure of the new product itself, which would be costly to us e.g. as a result of development, production and marketing costs, which may not be recovered. There is also the risk to our existing products I.e. if Grapple Sport is bought by customers as a replacement to existing drinks. This seems unlikely, as it will be designed to meet a very different purpose.

Reputational risk – As mentioned previously, there is a risk that our brand image, and reputation, may be affected if we choose the wrong strategy for our product launch. Given our awareness of this, we should ensure that we manage the launch so as to avoid this, but we should consider all eventualities, such as potential health issues associated with drinks or if it contains too much sugar for a sports drink for example, given the recent focus on this.

Operational risk - There is the risk that the processes we implement to produce this new product may fail. We will need to ensure that this is well-planned. Taking into consideration that we already produce a variety of drinks, it is unlikely that we will fail in this area unless we use entirely new methods and equipment.

SECTION 2

Sales to Jacks

IAS 24 Related parties, states that a related party is 'a person or entity that is related to the entity that is preparing its financial statements'. Related parties include close family members of key management personnel. Jack Grapple is Roger Grapple's son (a child of the key management personnel and majority shareholder). Roger is a related party to both Grapple and Jack. Jack controls his company so both Grapple and Jacks are related parties.

The sales made to Jacks are related party transactions regardless of whether the full price or a discounted price is charged by Grapple.

In the financial statements of Grapple the following will need to be disclosed:

- The nature of the related party relationship between Grapple and Jacks: the fact that Roger is key management personnel of Grapple and Jack's father. The name of the related party need not be stated.
- The nature and amount of the transaction: sales value of Grapple Sport.
- If the goods were sold on credit to Jacks, any receivable balances outstanding at the year end, and any irrecoverable debts.

Pricing

If we ignore the mathematical approach to pricing, as you suggest, there are two alternative ways of considering how to price Grapple Sport. Strategies may have a differentiation focus or cost focus.

Cost plus % margin

This method of pricing Grapple Sport would involve calculating the production cost and adding, say, 20% of that cost to arrive at the suggested selling price. As you have suggested total absorption costing this will include the unit cost of raw materials, direct labour and variable overheads and a proportion of the fixed costs. This method is easy to calculate for us as we will have the costing information to hand from internal reports. It will also ensure that every unit sold at that price makes Grapple a profit.

However, it has its drawbacks. If the % added is too high, it may make the product much more expensive than those of our competitors. Our customers may not buy our product at that price, so we will not make sufficient profits to cover the costs of production. This could lead to substantial losses for Grapple.

A new product will involve research and development expenditure as well as advertising and marketing costs on the initial launch. We would need to make sure these are covered but if we charged them in the first year it would make the price even higher.

I do not think this would be a suitable method.

Discount pricing

This method would price Grapple Sport much lower than our competitors' sports drinks. Grapple would hope to gain market share and sell in such volume that the total contribution would cover the fixed costs and we would make substantial profits. We would need to make sure that we have demand to sell large volumes. We know that the quality is high but some customers may believe that our prices are lower because the product is inferior to that of our competitors and this may have an effect on our brand value. This may be suitable if the barriers to entry are low, but a large investment is needed in the equipment and research, so I do not think this is suitable.

Penetration Pricing

This method of pricing involves setting a low price on the launch of Grapple Sport and then increasing the price as our customers become more loyal to the product. This is suitable where there are other competitors in the market with products similar to ours and we want to gain market share. We need to make sure that the price is not so low that it is difficult to bring it up to a market price at a later date.

I think this is a suitable method as we have some competition.

Skimming

This method would maximise revenue as it involves setting a high price initially and then lowering it later as other competitors move into the market. It would be the best one in terms of making a return on Grapple Sport. However, the price of this product is unlikely to be inelastic and we may not appeal to a sufficiently large number of customers who are willing to pay this price. The product would need to be unique and highly desirable. We have too many other competitors for this to be the case.

I would not recommend skimming as a suitable pricing strategy.

In conclusion, I would recommend penetration pricing.

SECTION 3

Commentary on the financial performance from the analysis provided by David Guy

It is worth noting that Grapple Sport was launched six months ago and therefore the financial statements for the year ended 30 June 2019 do not include a full year's results. It is hoped that next year, once the product is more established and with more market penetration the results will be better still.

Revenue

The revenue has not grown as much as it did over the previous year. The revenue increases will be due to higher prices, higher volumes or both. We know that the prices of each product have increased this year. Grapple seems to have gained market share in previous years on the strength of the brand and this may have continued this year. However, the more recent concern with the sugar content of soft drinks will be leading to a reduction in demand for these products in the market. Grapple Sport's sales will have created an increase and has gone some way to continuing a growth trend. With a full year's trading next year Grapple may see the revenue grow further, if the negative television series on sugar does not have a long-term effect on the market.

Gross profit margin

The margin has improved over the last three years. This is likely to be due to the change in sales mix between the products. Grapple Sport's sales this year may have a higher margin than the other products and with this being introduced this year it will have improved the margin overall. The increase may also be due to the fact that Grapple is increasing production volumes and are in a position to negotiate better prices with their suppliers for buying inventory in larger quantities.

Operating profit margin

The operating profit margin improved between 2017 and 2018 and then declined in 2019. If the gross profit margin increased this would lead to an increase in the operating margin unless there are higher running costs. When a new product is launched there are often advertising and marketing costs incurred to make sure that the product is known to the market. In addition, any costs incurred in the development of the product that may have been accounted for as an intangible in the past may now be amortised and this may have been accounted for in the operating expenses. Both of these may lead to a reduction in the operating profit margin. It may also be the case that Grapple Sport incurs higher distribution costs as its customers are more geographically spread, and this would lead to a reduction in the margin also.

Once Grapple Sport is established in the market, the costs will reduce and the margins should improve.

Return on capital employed (ROCE)

As ROCE is calculated by dividing the operating profit by the capital employed, any reasons for the reductions in the operating profit margin would partly explain the reductions in the return on capital employed. In addition, the fact that new plant and machinery would have been acquired for the production of Grapple Sport would further explain the decline in this ratio.

Total non-current asset turnover

The total non-current asset turnover ratio has improved up to 2018 and this year has reduced. This is despite the continued growth in the revenue over the last year. The reason for the decline will be because new production plant will have been required for the production of Grapple Sport and there will have been development costs capitalised leading up to the launch of the product. These tangibles and intangibles will start to be amortised and this will bring down the level of the total non-current assets in the next year so if the revenue increases with a successful full year's trading the ratio should improve in the future.

Other issues and further information

The financial statements have yet to be audited. Alice believes that they have been prepared correctly but figures may need to be amended after the audit if the auditors discover any errors or misstatement.

Grapple Sport was introduced to the product range six months ago. The financial statements include a full year's results for the existing products and only six months for the new one. It would be beneficial to have some segmental analysis that gives a breakdown of the profitability for each product specifically.

The breakdown of sales and costs by product would give more useful analysis.

Competitor analysis

It is insufficient to analyse our competitors on revenue and profitability alone. These data items need turning into more useful information. Revenue should be considered against the total market to determine market share, whilst reasons contributing towards the profitability need to be gathered if at all available. Additionally, changes over time should also be assessed. We know that we cannot hope to compete on size with our major competitors Party Pops and Carnival, which makes the revenue figure somewhat irrelevant at this time, but the growth in revenue would be important so we could see if we were keeping pace. Furthermore, these figures are for the total product ranges, not just for their sports drinks.

Further useful information would include:

Strategy. Much of this information may be available externally. For example, we should be able to assess which of our competitors has similar sports drinks by simply examining the products offered across a variety of outlets or by looking at industry publications. We could then assess the product ranges and compare such factors as prices and outlets available to determine their pricing and distribution strategies. This would allow us to determine who we believe their target markets to be and who we consider to be our main competitors on this particular product, price and distribution. These main competitors will not necessarily be the same as our main competitors for our other product lines.

Goals and objectives. This can be difficult to ascertain but could be established by closely following the activities of our closest competitors, once we have determined who they are. This could include taking note of any new distribution channels, or new product launches. New launches usually involve high profile advertising campaigns so we could keep track of these. We could ask our retail customers what new sports drink suppliers they are approached by.

Products. Much of this may be covered by the information gathering above, but it is important to know the full range of sports drink products and the form they take. For example, are some provided in a powdered form, which is mixed with water? We could use market research to determine what customers of this market like, or don't like, and why they may choose a competitor's product over ours.

With the increasing use of Big Data, we could easily gather information from other global markets to determine the nature of competition in those areas, including how the market has developed over time.

SECTION 4

Bonuses and performance measurement

It does appear that the Northern Sales Manager has been disadvantaged by a combination of the current bonus scheme and the special deal with Jacks. His bonus includes nothing for the new Grapple Sport, as a result of the low margin on this deal. As Grapple Sport was heavily weighted in the bonus scheme, this has seen his bonus fall well below the other sales managers.

His other bonuses suggest that he is a high performing sales manager. His repeat business is greater than for the other regions and he still achieved a new business bonus of a third of that for the Central Region, despite the 1:4 weighting of this when compared to Grapple Sport bonuses.

However, without seeing the figures split out, it is impossible to determine the exact amount which was due to the special deal. It could be that he had made some other low margin deals himself.

The main consideration arising from this, however, is that of controllable versus uncontrollable elements when considering performance appraisal. A fair performance measurement system should measure those elements in the control of the employee being assessed. There are a number of areas where a lack of controllability is apparent.

All of the sales managers have their bonuses calculated using a combination of revenue and operating profit margin. Whilst the revenue would usually be controllable, the sales managers would be unable to control many of the factors affecting the operating profit. It may be more appropriate to use gross profit margin, as this ensures the sales managers to consider this when making pricing deals with customers. If, however, the sales managers have no control over the selling price, then they also have no control over the gross profit. In this case, volume sales or total revenue may be the most appropriate bases, as these would be controllable.

The Northern Sales Manager particularly has no control over the operating profit margin, as 80% of new sales of Grapple Sport are through a deal not organised by himself. Therefore, he should not be punished through his bonus when this does not meet the required margin.

It could be argued that the Northern Sales Manager is not controlling the revenue for this deal either, and so should not benefit from it. This is a reasonable suggestion, but only if there is no requirement for him to deal with the client. If there is, then he deserves an appropriate reward for doing so. It may be that the client would only buy half of the volume without this sales manager's efforts.

Thus, I would suggest a review of the bonus procedure to include controllable elements only, and to be fully published in advance such that sales managers are aware of the terms.

Conflict resolution

Two types of conflict are evident here; vertical conflict between the Northern Sales Manager and Li Ying and horizontal conflict between him and the other sales managers.

To deal with the horizontal conflict first; this is not always a bad thing if it can become constructive conflict. We know that our sales managers are very competitive with each other and this can be constructive, encouraging them all to improve and perform well against their colleagues. However, it appears the competition may have gone a step too far, in this case, and is in danger of becoming destructive. The other two sales managers may be alienating the Northern Sales Manager. This, combined with the bonus problem, may demotivate him and cause his departure, which we would not want to happen.

I would suggest that conflict resolution or conflict reduction may be appropriate here. A social event may help break the bad atmosphere and allow them to go back to 'business as normal'.

Alternatively, we could encourage the three sales managers to collaborate in order to suggest a new basis for the bonus scheme. This would be seeking a win-win solution and encourage cohesiveness as a group.

Of course, it is possible that they wouldn't all agree, and the conflict couldn't be resolved completely. In this case, conflict reduction would be appropriate. This would involve building on areas of agreement in order to break down barriers and change attitudes about the other parties involved. It may be that there is some jealousy involved if the Northern Sales Manager usually gets better bonuses. If he could explain to the others how he achieves high sales bonuses, they could all share their best practices and all could benefit from this, as well as the company.

The vertical conflict may need more gentle handling. Li Ying is the line manager and may consider this insubordinate behaviour towards her. If they are to maintain a professional relationship, it must be resolved quickly.

Simple communication could be the key here. It was not Li Ying's decision to take on the special deal, but that of the entire Board. This could be explained, but I feel it is unlikely to do much to appease things, it might just spread the conflict wider.

It may be that Li Ying chooses to avoid the conflict; that is, either pretend it is not present, and carry on as normal, or discipline the sales manager for unprofessional behaviour. The latter is likely to exacerbate the situation. It is possible that ignoring it could work; sometimes initial conflict is in the heat of the moment and dies down after a while.

Given my earlier suggestion that the bonus scheme should be adapted to eradicate the result of this uncontrollable special deal, it could be that Li Ying, as the bearer of this news, may find the conflict automatically resolves itself. This might be considered to be an accommodating approach to conflict resolution, and seems appropriate in this case. However, there may be an issue in the future if the sales manager feels he can force his manager into accommodating his employment terms and conditions.

Alternatively, as with my suggestion for the sales managers working together to propose a new bonus scheme, Li Ying could also be involved in this, and be seen as a collaborator. She could lead the negotiation in which all parties should benefit, to remove any conflict.