APPROVED TEACHING RESOURCES ACCA

Mock One

Business Analysis

P3BA-MK1-Z17-A

Answers & Marking Scheme

Paper P3

BECKER PROFESSIONAL EDUCATION®

Tutorial note: *The answers that follow are fuller and more comprehensive than would have been expected from a well-prepared candidate. They have been written in this way to aid study and revision for candidates.*

1 DPP

(a) Assessment of advantages and disadvantages of acquiring Papier Presse

Acquiring PP may be a way of achieving growth in revenues and profits in an industry that has reached maturity, where organic growth appears elusive. The paper industry for which DPP manufactures textiles is in decline, due to the emergence of substitutes such as the TV and internet. PP has a high market share in Awayland, so offers DPP the opportunity to expand into this country quickly.

The acquisition may lead to synergies. Synergy is the concept whereby two entities combined produce more value than two separate entities. This may arise due to cost savings, increased market share or other synergistic benefits.

An obvious source of synergy is that some activities such as marketing and management are likely to be duplicated, and some cost savings will be available from rationalising these. It will be only be necessary to have one marketing and sales department for the two entities after acquisition, and the current management of PP would probably not be required.

Another source of synergy would be the sharing of capabilities. PP has very good customer service capabilities, for example, and DPP could benefit from adopting these throughout the group. It seems that DPP excels in product innovation, and so acquisition would allow the customers of PP to benefit from these.

The combined entity would have more bargaining power with than two separate companies. PP also has 25% market share in other European countries, which along with DPP's own share of 15% would lead to a combined market share of 40%. This is likely to give the company greater bargaining power with both customers and suppliers.

From a financial perspective, PP's performance should be analysed. A comparison of DPP and PP shows the following:

	DPP	*PP*
Gross profit margin	38%	25%
Operating profit margin	11%	12%
Return on capital employed (ROCE)	36%	46%
Revenue per employee	$156,400	$120,000

Gross profit margins are only 25% at PP compared to 38% at DPP, so it seems there are opportunities for cost savings to be found. This may relate to the higher staff levels at PP – revenue per employee at DPP is 30% higher than at PP, so there may be some opportunities for cost savings to be made there, although the factories are heavily unionised, so reducing headcount may lead to industrial action.

The operating margin and ROCE of PP are higher than DPP. DPP depreciation accounts for 5% of revenue at DPP but at PP this is only 1%. This may reflect under investment in machinery at PP, which would also explain the higher ROCE. If acquisition does take place therefore it may be necessary to modernise plant and machinery.

A big question relating to the acquisition is the price to be paid. PP's revenues are 46% of those of DPP, so it the acquisition will represent a significant investment. DPP may have to pay a premium over the fair value of PP in order to persuade the owners to sell. There is considerable evidence that the biggest winners in acquisitions are the shareholder of the firm being acquired, who enjoy the benefits of the premium; the shareholders of the acquiring company have to wait before the enhanced cash flows and profits of the combined entity justify the price paid.

Following the acquisition it will be necessary for two organisations with different cultures to come together. PP has three very heavily unionised manufacturing plants. PP is also an owner managed business in contrast to DPP. Since DPP is the acquirer, it is likely that the staff of PP would be expected to fit into the existing culture of DPP. If PP staff do not like that culture, this may lead to conflicts or a high number of resignations, which may damage the business due to the loss of know-how and customer contacts.

The sales, service and distribution systems of the two companies are currently separate, so would have to be unified at some point, particularly since the two companies share some customers. This is likely to be a large project.

PP has very little in the way of sales outside of Europe, so DPP is unlikely to gain in terms of additional global reach.

Overall it does appear that the additional bargaining power that an acquisition brings and the potential synergies of the acquisition outweigh the potential pitfalls of acquisitions, so it would appear to be a suitable strategy.

WORKINGS

Financial ratios	*DPP*	*PP*
1. Gross profit margin		
$= \dfrac{\text{Gross profit}}{\text{Revenue}}$	$\dfrac{73.3}{195.5} = 37\%$	$\dfrac{22.5}{90} = 25\%$
2. Operating profit margin		
$= \dfrac{\text{Operating profit}}{\text{Revenue}}$	$\dfrac{21.9}{195.5} = 11\%$	$\dfrac{10.6}{90} = 12\%$
3. ROCE		
$= \dfrac{\text{Debt}}{\text{Equity} + \text{debt}}$	$\dfrac{100}{100+175} = 36\%$	$\dfrac{68}{68+80} = 46\%$
4. Revenue per employee		
$= \dfrac{\text{Revenue}}{\text{Employees}}$	$\dfrac{\$195.5\text{m}}{1{,}250} = \$156{,}400$	$\dfrac{\$90\text{m}}{750} = \$120{,}000$

Tutorial note: *Although no particular model is used in the model solution above, an alternative approach could have used the "suitability, acceptability and feasibility tests" to provide a structure to the answer.*

(b) Advantages and disadvantages of greenfield option

From the information given in the scenario, DPP will face significant problems if it chooses to develop a greenfield site. The bureaucratic planning procedures adopted by the host government can add considerable time to get an efficient plant up and running. In some ways, such governments are in a dilemma, anxious to secure foreign direct investment, but at the same time protect inefficient domestic manufacturers. Certainly, DPP in its own risk assessment would need to take political risk into account. In assessing the risks of a Greenfield site, Ken could use Porter's "diamond" to good effect. Factor conditions might be seen as quite favourable, with an educated, trained, albeit low productivity, labour force. However, the lack of demanding tough global customers, a weak and inefficient domestic industry to supply the new venture and competitors who have been highly protected mean that DPP will have to battle to create a supportive and sustaining environment.

Financial exposure may be increased through currency risk. Clearly, the fresh start will allow integrated information systems to be developed and the latest technology to be used. However, the new capacity will have a significant impact on DPP's existing plants. The extent to which expatriate management is used is clearly an issue. The host government is likely to require some commitment to the training of local management and the degree of autonomy given to the new plant may well be an issue.

Cultural issues and sensitivities will be significant – often shop floor workers and managers will be used to high levels of absenteeism being tolerated in government owned and controlled firms. Also the issue of involvement and participation could be an issue – there may be a marked reluctance on the shop floor to contribute ideas towards raising productivity and quality. DPP is part of a group that has experience of operating abroad and there is a real need to access information on key problems in greenfield operations.

In many ways the move to a greenfield site links the macro environmental analysis generated by a PESTEL analysis to five forces industry analysis with its focus on customers, competitors and suppliers. Certainly, creating an integrated value chain with DPP's existing business will be a real challenge to the management. It also adds capacity to a Regional industry where there is already a problem. Choosing between the two options to achieve the strategic goal of a lower cost base can be done using the tests of suitability, acceptability and feasibility. The decision will not be an easy one.

(c) Strategic drift

Strategic drift is where changes the strategy of an organisation is no longer aligned with the external environment. It occurs where the external environment changes significantly, while strategy is typically developed incrementally. If strategic drift continues unchecked, it may ultimately lead to corporate failure (bankruptcy) of the organisation.

DPP provides textile fabrics for the paper industry. The paper industry itself provides paper mainly to book publishers and newspapers. Due to developments in technology, such as the development of e-books and the competition from the internet and TV, the paper industry itself appears to be in decline. There is little indication from the scenario that DPP has made any changes to its strategic direction other than attempting to increase capacity through acquisition or investment in greenfield sites described in (parts (a) and (b)).

If strategic drift can be identified at an early stage, actions can be taken to bring the strategy of an organisation back in line with the environment. It seems that in the case of DPP the strategic drift is in an early stage, since the company still appears to be making reasonably good return on revenue and capital employed (see part (a)), although without comparative figures for earlier financial periods it cannot be seen whether these are declining.

Using the Ansoff matrix as a tool to help come up with new ideas may be a useful exercise. The Ansoff Matrix suggests that growth can come from two dimensions – the first is to develop new markets for existing products, the second dimension is to develop new products.

Taking the first dimension, the development of new markets for DPP could be taken to either mean new geographic markets, or new market segments. If DPP aimed for a strategy of selling its existing products in new geographic markets, the company would probably only be buying time, as the whole market for paper and related products appears to have reached maturity and may soon decline, so this may not be a good option. In a specialised industry such as paper manufacturing, there are unlikely to be too many market additional market segments of any size to offer feasible alternatives.

This suggests that product development may be the more obvious method of finding new areas of growth. Clearly developing related products would be less risky than developing entirely new products, as this would build on the existing capabilities of DPP. Since DPP is making textiles for paper machinery, the company clearly has capabilities in the textile industry and could consider other customers of textiles. An obvious market would be the clothing industry, but there may be other types of machinery that require the use of textiles.

My suggestion therefore would be to explore opportunities to change the products and provide textiles to industries where demand is still buoyant.

Tutorial note: *This solution used Ansoff as a tool. There was no requirement to use Ansoff or any model – credit is given for any sensible comments relating to alternative strategies that DPP could pursue.*

2 GOOD SPORTS

(a) Advantages and disadvantages of e-business

To: **Good Sports**
From: **XYZ**
Date: **15th Dec 20XX**

E – Business strategy

Clearly, the markets that Good Sports operates in are being affected by the development of e-business and its experiences to date are mixed to say the least.

In many ways the advantages and disadvantages of e-business are best related to the benefit the customer gets from the activity. Technology can help Good Sports to identify, anticipate and satisfy customers' needs and wants.

Advantages

- Through integrating and accelerating business processes e-business technologies enable response and delivery times to be sped up.
- There are new business opportunities for information-based products and services.
- Websites can be linked with customer databases and provide much greater insights into customer buying behaviour and needs.
- There is far greater ability for interaction with the customer, which enables customisation and a dialogue to be developed.
- Customers may themselves form online communities able to contact one another.

Disadvantages

Despite the many advantages for companies adopting this new way of doing business, there are barriers to making use of it.

Customer service: The key to Good Sports survival is customer service – in strategic terms they are very much niche marketers supplying specialist service and advice to a small section of the local market. The nature of the business means that face-to-face contact is crucial in moving customers from awareness to action (AIDA – awareness, interest, desire and action).

High investment costs and the availability of the technical infrastructure

Technical and integration problems: Systems are not compatible around the world. Integrating them after an acquisition or merger can be very difficult. Often integration has to be completed before companies then can begin to put in e-commerce solutions among all the parties.

Culture and resistance to change: The fax was a wonderful device years ago, only to be replaced by newer technology. But it still works and people tend to prefer familiar technology to new devices said to improve efficiency. They are afraid of new technology and fear to be made redundant.

Lack of education and training: New processes and procedures mean employees must learn to use the new systems as well as change their behaviour from the "we've always done it this way" attitude. The money that must be spent to accomplish this change can be more than the total cost of the hardware and software needed to implement e-commerce. Some people who have gone through this process say the costs can be as much as five times more.

Processes most likely effected

Electronic business methods enable companies to link their internal and external data processing systems more efficiently and flexibly, to work more closely with suppliers and partners, and to better satisfy the needs and expectations of their customers.

Software solutions allow the integration of intra and inter firm business processes. E-business can be conducted using the Web, the Internet, intranets, extranets, or some combination of these.

It involves business processes spanning the entire value chain:

- electronic purchasing and supply chain management;
- processing orders electronically;
- handling customer service;
- cooperating with business partners.

(b) E-business support for niche strategy

Good Sports has pursued a conscious niche or focus differentiation strategy, seeking to serve a local market in a way that isolates it from the competition of the large national sports good retailers competing on the basis of supplying famous brands at highly competitive prices. Does it make strategic sense for Good Sports to make the heavy investment necessary to supply goods online? Will this enhance its ability to supply their chosen market?

- In terms of price, e-business is bringing much greater price transparency – the problem for companies like Good Sports is that customers may use their expertise to research into a particular type and brand of sports equipment and then simply search the Internet for the cheapest supply. The Internet has tended to weaken industry profitability and made it more difficult to hold onto operational advantages. Choosing which customers you serve and how are even more critical decisions.

- However the personal advice and performance side of the business could be linked to new ways of promoting the product and communicating with the customer (e.g. CRM). The development of customer communities referred to above could be a real way of increasing customer loyalty. The partners are anxious to avoid head-on competition with the national retailers.

- One way of increasing the size and strength of the niche they occupy is to use the Internet as a means of targeting their particular customers and providing insights into the use and performance of certain types of equipment by local clubs and users.

- There is considerable scope for innovation that enhances the service offered to their customers. As always there is a need to balance the costs and benefits of time spent. The Internet can provide a relatively cost effective way of providing greater service to their customers.

There is little in the scenario to suggest they have reached saturation point in their chosen niche market. Overall there is a need for Good Sports to decide what and where its market is and how this can be improved by the use of e-business.

3 HCC

Tutorial note: *Porter's analysis of competitive forces provides a framework for part (a); part (b) can be broken down along traditional SWOT lines.*

(a) Five forces model

Michael Porter analyses the competitive forces facing businesses under five headings, and these are used as the framework for discussing the position of HCC below.

Rivalry among competitors

The company faces strong competition for haulage work and haulage contractors operate on a low-margin basis. This latter factor makes successful competition more difficult, since the possibility of competing on the basis of price is limited. The fact that smaller companies often subcontract from large-scale hauliers makes it that much more difficult for HCC to obtain profitable jobs.

Threats from potential entrants

Matt set up HCC by simply taking out a loan and buying himself a heavy goods vehicle. This illustrates that barriers to entry in this industry are not difficult to surmount and the threat from potential entrants is therefore high. Once into the market new entrants face little difficulty in acquiring a customer base because they are able to take on subcontract work from larger firms.

Bargaining power of customers

In general the position of customers in the industry is a strong one. The large number of firms operating haulage services provides potential customers with a good level of choice, and competition makes it difficult for the hauliers to increase their margins.

In the case of HCC in particular the position is critical. The company is heavily dependent on a single company, which is undesirable at the best of times. At present, it is even more dangerous than usual because Capok has sought other suppliers and significantly reduced the volume of business sent to HCC one third.

Bargaining power of suppliers

For the supplies necessary to run the business – vehicles, equipment, labour, etc. – there appears to be no particular problem for HCC. The one other vital resource – finance – is more problematical. As things stand the bank is happy to extend additional loan facilities, but this situation may be precarious. Only a short time ago the company was close to liquidation in the opinion of the bank and any further doubts on this score would endanger future financing.

Threats from substitutes

The business of HCC is to offer transportation in a particular mode (road haulage). There are alternative modes of transportation such as rail freight or airfreight, as well as heavy competition within the road haulage sector.

(b) Position appraisal

In preparing a position appraisal it is usual to distinguish between internal factors (namely strengths and weaknesses of the organisation) and external factors (namely opportunities it can exploit and threats it faces).

Internal factors – strengths

The main strengths of the business are as follows.

- The personal abilities of Matt. These have been demonstrated in his single-handed founding and management of the business over the past 12 years.
- The customer base and goodwill built up over the same period. Although there appears to be scope for new firms to enter the market fairly easily, these will not bring the same advantages with them. However, there is some danger that this strength is declining because of the loss of business from Capok.
- Strong financial discipline introduced since the appointment of Julia.
- The fact that Matt lives on site means that he can offer a 24-hour service to customers, giving his company a competitive advantage over other firms. However, once again this strength may be diminishing with the move to a new site.
- Diversification of the business (fork-lift training) has reduced the threats faced by HCC by providing alternative sources of income.

Internal factors – weaknesses

- Over-dependence on a single customer, Matt has been depending on Capok for 70% of his business, and Capok has now started to look to other suppliers.

- Lack of liquidity. The company has fairly heavy debt, increased recently to finance development of the new land. The bank manager is apparently content with progress at the moment, but that could change, especially if Julia were to leave. The situation may also become worse if further finance is needed for the replacement of vehicles – six tractor units have been replaced recently because of wear and tear, and presumably others are in a similar state.

External factors – opportunities

- The company seeks to exploit the new premises and tractor units that have been invested in recently.

- The company has the chance to grow a new side of the business, the training courses.

- Although some sales to Capok have been lost, there is the opportunity to win this back by re-establishing close links.

External factors – threats

- The main threat consists of the large number of competitors apparently prepared to trade on low margins. That presents the possibility of a damaging price war.

- Another threat arises from the reaction of local residents objecting to the disturbance caused by Matt's business. This could lead to restrictions on the activities that are permitted.

4 JAY-C

(a) Managing cultural and ethical problems

Cultural problems

There is a tendency in many companies that have easy, early success for management to become over confident of its capability and believe its own propaganda (the "Icarus Paradox"). Under these circumstances, a company fails to appreciate the dangers of future risks, resulting in missed opportunities and occasionally corporate failure as the company expands or diversifies believing it can do nothing wrong.

The arrogance of the board chairman towards the shareholders and the self-perception of the Board itself indicate that there is an element of this paradox present in Jay-C.

An area of potential cultural mismatch, could well arise with the new finance director whose US background may cause friction in the execution of board decisions as well as his understanding of how the UK and international business is run. The board itself is highly skewed towards the executive board members. Fitting in to this highly polarised board could be a difficult task for the new finance director, especially if he is unwilling to support the new expansion plans.

On a professional plain, the new finance director may also find it somewhat problematic adjusting the principles-based guidance of IFRS as opposed to the more strict rules of US GAAP when it comes down to the structuring and management of the company's present and future finances.

Ethical problems

Within Jay-C there seems to be a lack of ethical values at many levels. Much of this appears to stem from the attitude of the CEO who exhibits a personal rather than a business bias toward the execution of strategy and policy in various areas. His attitude to shareholders' concerns and their recommendations implies an unwillingness to put the shareholders' value at the top of the agenda.

The board's attitude to risk and almost cavalier position on the expansion programme are also a concern and raises the question if decisions are being made in the long-term interests of the shareholders.

The readiness of the new finance director to consider offshore accounts and hedge funds, so early and with relatively little experience, implies that he is equally willing to take serious risks with shareholders' money.

The composition of the board is also a concern on the grounds of balance. The merging of the CEO and chairman as well as the low proportion of non-executives directors (NEDs) all add to a sense of disquiet over the decision-making process of the Jay-C board. Objectivity maybe poor.

How problems could be managed

Many recent codes on corporate governance such as the UK corporate governance code encourage greater dialogue with shareholders to ensure the objectives of the shareholders are understood.

The board including its supporting audit and remuneration committees are clearly open to abuse, by the power of the CEO and likely compliance of the board members. The UK corporate governance makes several proposals to stop exactly this situation arising. The role of chairman and chief executive should be split. Non-executive directors should be appointed who are independent of the board. One of the roles of non-executives is to ensure that financial risk controls are in place and are operating correctly.

Clearly in the case of Jay-C this system and structure is not as it should be. The board as a whole is over confident, almost arrogant in its dealing with stakeholders, and focused on an agenda that is not in the interests of the company's stakeholders.

In addition to these, the use of rotated independent auditors, more accountability on behalf of the directors for annual reports to shareholders, as well as higher levels of internal financial control are being vigorously pursued by the EU and SEC. Resistance on the grounds of over prescription is evident, but movement on changing these issues in clearly gaining momentum. Many companies are forming governance committees for ensure that compliance with new governance rulings and guidance is actioned.

Jay-C would clearly have problems in defending some of its actions on ethical and governance grounds.

(b) Nomination committee and selection

In the EU, the increased use of nomination committees is being encouraged. These committees of independent directors ensure that the nomination and selection of directors reflects best practise and the best interests of the company's stakeholders. The EU is likely to strongly support the increased influence of shareholder in the nomination and selection of board members and their remuneration, possibly by being represented at these committees.

In the US, the Securities and Exchange Commission has adopted rules requiring companies to provide more information about nominating committees and how they select directors. The agency also wants firms to establish procedures to enhance shareholder communications with their firms.

Throughout the process checks and monitoring against compliance with legal requirements (disabled persons, equal opportunities, sex and race discrimination, rehabilitation of offenders) would need to be ensured.

The impact of such appointments is crucial to shareholder value. Leadership and governance of a company have been shown in the past 20 years to key to corporate success and failure. Enron, Qwest, WorldCom and Parmalat all demonstrate what happens when the wrong people are in charge.

Marking Scheme

1 DPP

(a)	Up to 2 marks for each advantage and disadvantage discussed		Max 16	
	½ mark for each relevant ratio calculated for both companies		Max 4	
			——	max 18
	1 mark each structure and clarity of analysis	professional marks		2
(b)	Advantages and disadvantages of greenfield option up to 2 per point			
	Up to 2 marks per point for comparison with acquisition			
				max 14
(c)	Up to 2 marks for explanation of Strategic drift		2	
	Up to 4 marks for discussion of whether DPP suffers from drift		**4**	
	Up to 2 marks per point for discussion of alternative strategies		8	
				max 14
	1 mark each structure and fluency of report	professional marks		2
				50

Note: *in deciding whether a point deserves 1 or 2 points, give 1 mark for making a valid point, and a second mark if that point is clearly explained. In paragraph 1 of the model answer for example, there would be one mark for stating that the acquisition would lead to growth in sales, and a second for discussing the fact that the market is mature, so it is difficult to achieve organic growth.*

2 GOOD SPORTS

(a) **Advantages** of Good Sports developing an e-business strategy, up to 8 marks
– Improved processes allowing better customer service
– Opportunity to develop information based new products and services
– Greater insight into customer behaviour
– Greater interaction and customisation
– Customers creating own communities
Disadvantages of developing an e-based strategy, up to 8 marks
– Costs exceed benefits
– Inappropriate to nature of service provided
– Lack of in-house skills and competences
– External Internet "experts" use inappropriate language and systems — max 15

(b) E-strategy supporting Good Sports' niche strategy, up to 3 per point
– Better levels of service possible
– New niches developed
– Better understanding of customer needs
– Focused promotion and communication — max 10

25

3	**HCC**	
(a)	Five forces model – Up to 2 marks each force	10
(b)	Position appraisal – Up to 2 marks each strength/weakness/opportunity/threat 1 mark for balance of appraisal	15
		25
4	**JAY-C**	
(a)	Up to 2 marks each cultural/ethical problem up to 9 Up to 1 mark each point contributing to explanation of solution up to max 9	max 15
(b)	Up to 2 marks each valid point	max 10
		25

Q	Part	Topic	Study Text ref	RQB coverage	Commentary
Section A (Compulsory) – 50 marks					
1	(a)	Acquisitions	8	Q 18EMS	This part required students to assess the advantages and disadvantages of DPP acquiring PP. Weaker candidates simply recited rote learned advantages and disadvantages of growth by acquisition without referring to the scenario at all. Another weakness was ignoring the financial information provided – if financial information is provided in questions, students are expected to use it in their answers. Good answers applied knowledge to the facts in the scenario.
	(b)	International diversification	7	Q16 Excalibur part (b)	This part required candidates to assess the advantages and disadvantages of DPP investing in a greenfield site rather than acquiring an existing company. Performance in this part question was reasonable with the majority of candidates managing to identify sufficient advantages and disadvantages to achieve a comfortable pass.
	(c)	Strategic drift	1	M/J16 Q4 Westoria part (a)	This part required students to assess whether DPP was facing strategic drift, and to suggest new strategies. Any reasonable suggestions would have gained credit. Weaker candidates made suggestions without justifying them, while stronger candidates provided justification for suggestions based on information in the scenario.

Q	Part	Topic	Study Text ref	RQB coverage	Commentary
Section B (2 from 3) – 50 marks					
2	(a) and (b)	E-business	12	Q27 The Managem ent Press	Part (a) of this question asked for a report on the advantages and disadvantages of developing an e-business strategy. Good answers provided advantages and disadvantages based on information in the scenario, while weaker answers gave advantages and disadvantages of e-business in general. Part (b) asked candidates to assess the extent to which an e-business strategy could help support a niche strategy. Students generally performed poorly on this part, providing answers that discussed the advantages of a niche strategy rather than how an e-business strategy could support it.
3	(a)	Competitive forces (Porter)	2	Q11 Autofone part (a)	This part required an analysis of the competitive forces within the haulage industry based on information provided in the question. This part was well performed by many students, who clearly have good knowledge of this area.
	(b)	Position (SWOT) analysis	1	Q12 Moor Farm part (a)	This required a position analysis. SWOT analysis was a useful tool, although it was not mandatory to use this. Candidates generally performed well on this part question. Some candidates who used SWOT analysis confused weaknesses and threats in some places – a threat is generally external, while a weakness is internal.
4		Organisational influences	5	Q14 i-compute part (a)	Part (a) required students to explain the cultural and ethical problems faced by a company with a poor corporate governance culture. Most students could identify the problems, but stronger answers went on to explain how each problem might impact on the strategic position of the organisation. Part (b) focussed on the role of nomination committees in corporate governance and was well answered by most.