Appendix C - HW Inc. case study – Draft ideas and solutions for activities

Contents

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A note on the suggested solutions

There is often not just one correct answer to many of the activities related to HW Inc. Strategy can be entirely subjective, and therefore what follows as suggested solutions are just that. They are suggestions. The purpose and key to these activities are to apply your knowledge and judgment to the questions using the evidence placed before you and to justify your viewpoint. Your view and opinion are probably just as valid as anyone else's, so long as you can explain it.

Chapter 1, Activity 1 – HW Inc. Approach to strategy

Rational approach

There are several areas in the case study information that supports a rational approach to strategy. In section A.1, it notes that HW Inc. grew by diversification and that the overall structure is such that the strategy and operations can be controlled by the C-suite senior management team, who view it as a form of parental control.

In section A.5, examples of a rational approach that could be used to support the argument include the acquisition of the European logistics company so that HW Inc. may more directly control online deliveries to customers; the cost reduction exercise; the references to supply chain management; moving manufacturing to emerging economies for strategic reasons; the reference to a "future potential review"; actively seeking areas for international business expansion; and discussing options such as creating a bank. These examples would support a rational, planned approach to strategy.

The rationalization of stores in section A.6 supports this viewpoint. Section A.7 also refers to working closely with suppliers on sustainability, the hub and spoke logistics which has good strategic reasons for its adoption, and the control exercised over the concessions. All of these decisions support a rational approach.

Emergent strategies

There are, however, two significant events that suggest emergent strategies. The introduction of the sports equipment and apparel and the instigation of the interior design business could be described as emergent strategies. Both began by one manager trying out the idea, we can assume without full head office knowledge until after the event. The scenario suggests that these ideas were picked up later by the C-suite senior management team and the initiatives 'crafted' into the overall strategy for HW Inc.

Outside-in or inside-out

Deciding whether the approach is outside-in or inside-out is hugely subjective, especially as we have little information about the thought process behind the strategies adopted by HW Inc. One argument might be that the strategy appears to be an outside-in approach. There are numerous references to customers and the customer experience, which implies that rather than working on core competencies as a competitive advantage, HW Inc.'s strategy has customer needs and experience as the primary focus. The activities adopted are done for the benefit of the customer need, potentially indicating an outside-in approach.

The vision and mission are customer-focused; even the cost reduction exercise was undertaken without compromising quality and customer service. In section A.7, it specifically mentioned that the hub and spoke, and inventory management has an impact on customer satisfaction ratings. Also, the store layout is designed with customer experience in mind. The whole focus of HW Inc.'s strategy appears to be looking externally at the customer and the market and developing the core competencies to satisfy the customer, rather than developing core competencies which it then hopes will give it a competitive advantage. The emergent strategies also appear to have been a response to an external stimulus rather than internal competencies, which strengthens the case for the outside-in approach.

There is, however, an alternative view in that the expertise in inventory management, supply chain management, logistics, store layout, and the design of sustainable products are competencies that HW Inc. has perfected. By concentrating on these core competencies, it has turned some into distinctive competencies to give it a competitive advantage. These aspects might be said to be taking an inside-out approach.

In practice, there are likely to be elements of both outside-in and inside-out, as there are examples of emergent strategies within the overall rational, planned approach to strategy development. A good management team will be alive to the possibility of opportunities arising from outside and inside the organization.

The key is to have the courage of your conviction to argue your viewpoint.

Chapter 2, Activity 2 – HW Inc. Vision and mission

Evaluate the vision and mission statement.

Campbell, Devine, and Young (1990) suggested that a good mission statement should include elements of purpose, strategy, behavior standards, and values. Lynch (2003) suggesting that a good mission statement is one that:

- Communicates the nature of the business
- Considers the customer
- Sets out the values and beliefs
- Encompasses a sustainable competitive advantage
- Is flexible to allow for changes in the environment
- Is realistic and attainable

The mission of HW Inc. clearly communicates what the organization does in terms of offering a range of quality products that can be used in creating the perfect home. The vision tends to use phrases that are subjective such as “make life easier,” “realize their dreams,” and “make the world a happier place.” These are more visionary and more difficult to quantify in terms of objectives.

Elements of the mission statement, however, in referring to “affordable and competitive prices, backed up with exceptional customer service,” lend themselves well to the setting of strategic objectives.

The mission includes elements of strategy. It could be argued that the mission sets out how HW Inc. intends to compete, its target markets, and the use of resources to achieve its strategy. It is perhaps more difficult to determine from the statement whether the reference to “affordable prices” is a cost-led strategy or the “exceptional service” is a differentiated strategy. We would need more information about the competitors to understand precisely where in the market for homeware HW Inc. intends to position itself. Quality products can refer to more expensive products targeted at the discerning customer, as opposed to low-cost products aimed at a high-volume market. The statement does appear to consider the customer, but precisely what demographic is targeted is less clear.

The statements concerning the use of “sustainable materials wherever possible, engage in staff development activities to help all of our staff become ambassadors for clean and healthy living, encourage and facilitate our staff to become involved in the local community activities, while providing a reasonable return for our investors” all relate to behavior standards, as do many of the core value statements, which also set out the values and beliefs of HW Inc.

We can see how the company intends to compete, but as to whether this is sustainable depends on how well the company is managed. This point links to being flexible for change.

HW Inc. includes within the values: “We take sustainability seriously and always try our best to act responsibly towards our future environment. We value our employees and seek ways to help all to develop as individuals. The wellbeing of our customers and their families is at the forefront of our development.” These statements could infer that they are willing to change in response to a changing environment, but the aspects of the development of employees and wellbeing are entirely subjective. We would need to see how these are interpreted in the strategic objectives to judge how flexible the organization could be.

It is interesting that investors are considered as it could be argued that if investors are not happy, the organization would not be in business long enough to be sustainable and engage with local communities in the future.

Implications for management information

The implications for the management information are that the traditional/conventional accounting techniques such as budgeting, cost control, and so on would be useful. But the reference to competitive prices and sustainable materials indicates the requirements for external information. There would also need to be qualitative objectives such as customer satisfaction and employee morale to understand the achievement of exceptional customer services and employee development.

Without noting specific techniques, we could assume that HW Inc. would benefit from a more strategic approach to management accounting with the inclusion of quantitative and qualitative, internal and external, and historical and future-oriented information. We could also say that all of Simon's levers for control would be relevant to some extent within HW Inc.'s management control system. The inclusion of diagnostic and interactive controls would almost certainly be useful within the management accounting system.

Chapter 3, Activity 3 – HW Inc. Environmental analysis

(a) HW Inc. environmental analysis

The environmental analysis for HW Inc. will be undertaken using two analytical frameworks - PESTEL and Porter's Five Forces. The PESTEL framework (political, economic, sociocultural, technological, environmental (sustainability), and legal factors) is a useful tool for analyzing the general (macro) business environment and its potential impact on HW Inc., whereas Porter's Five Forces is a helpful framework for analyzing the forces that influence the profitability and attractiveness of the industry sector in which HW operates.

Political

HW Inc. is a global company in that the company operates across six continents. This global aspect exposes the company to issues of political stability in different parts of the world and the policies of different political regimes. For example, some countries may adopt a protectionist approach to foreign companies doing business in their country, which could make it more difficult for HW Inc. to trade on a competitive basis and to expand its overseas business.

The issue of BREXIT and the future of European trading regulations is creating uncertainty and making it difficult for companies to plan, not least, the impact that the issue has had on the U.K. currency (pound sterling). Until there is more certainty about how BREXIT will be achieved, it is difficult for HW Inc.'s board of directors to plan effectively for the impact that it will have on the company.

Also, the economic risk associated with trading in different economies cannot be overlooked, as not all economies behave in the same way. In fact, not all economies were affected to the same degree by the financial crisis, and indeed, the emerging economies behave differently to the more developed economies. The senior management team of HW Inc., therefore, need to develop regional strategies that fit within the overall strategy of HW Inc. In some respects being diversified geographically helps to mitigate the economic risk, as when some parts of the world are not growing, other trading groups may be doing quite well, for example, the recently named TICKs and MINT countries (Taiwan, India, China, Korea and Mexico, Indonesia, Nigeria, Turkey).

Economic

The economic cycle can be at different stages in different countries, which, for a company operating in six continents, can be a positive or a negative aspect depending on how well the senior management team manages the situation. HW Inc. should be able to cope with this situation as it has established subsidiary companies that have a more “local” responsibility. Therefore, it should be possible to develop regional strategies that fit within the overall corporate strategy.

Foreign exchange issues will also influence trade within a global company, particularly where products are sourced from global suppliers and suppliers operating locally in different parts of the world. There is an overlap with the political issues as government policies will affect the local economies and trading conditions in local markets. Therefore, the senior management team needs to be able to build in some flexibility to their strategic planning to cope with any differences in political or economic impacts.

Sociocultural

The fact that HW Inc. trades in six continents also opens significant cultural aspects, such as the product ranges and working practices, which need to be culturally acceptable and adapted to the local consumers and employees. HW Inc. will not be able to assume a standard product mix across the whole global company but must tailor it to local preferences taking into account the demographics and culture of each country.

Trends in shopping, such as online shopping, maybe more developed in some countries than others, and therefore, not only the product ranges but also the mode of operation will need to be adapted. HW Inc.’s senior management team will also need to be aware of the changes within the local demographics and shopping trends to ensure that it’s offering remains current and up to date. This has implications for marketing research and highlights the importance of taking account of consumer feedback in its local markets.

Technology

Technology affects HW Inc. in several ways. The product ranges include electrical goods which are continually being developed by the manufacturers and it is essential that HW Inc. is aware of the current trends, and that it is offering an up to date product range. This has implications for supplier relations and inventory management in that while it is crucial to provide the latest models, HW Inc. does not want to hold an excessive inventory of items that are changing at a rapid pace.

The technology used in the marketing and sales channels also needs to be up to date and take account of trends in the sector, for example, the use of social media advertising, and online and mobile shopping. This requires HW Inc. to continually monitor trends in the use of technology by its customer base and to invest in new technology to support and promote those trends that are favored by its customers. The development of technology and its increased availability of information flows to, and from, the customer opens the possibility of using data mining techniques to discover trends and previously unknown relationships. This ability comes with the added responsibility of protecting its customers from cyber-crime. Therefore HW Inc. needs to invest in the security systems that safeguard both its own and customers' data.

Environmental

It is logical to include sustainability within the environmental heading as this is a topic that is very current and has implications for manufacturing, product development, retailing and general operations of companies. As HW Inc. trades in six continents, it is vital that they operate a robust ethical code and adopt a corporate code of practice that provides a framework for all decisions, wherever they are taken within the world. Used positively, this can support the corporate brand values and ethical standards stated on the corporate website.

Sustainability issues impact on supplier relationships and HW Inc. have in place policies relating to quality and the operating standards of its suppliers. The company has also adopted a strong ethical stance, which is essential to maintain and promote as part of its corporate image as a responsible company. There has recently been an increase in media attention on corporate behavior, partly due to the number of scandals that have received significant publicity, and the senior management team must be aware of the growing significance placed on this by the general public.

The impact of the covid-19 pandemic does not easily fit under any specific heading but can be logically related to environmental issues. The senior management team needs to be aware of the political approach to the pandemic in each country in which it operates and ensure that it operates within the rules established. The pandemic is likely to have a significant impact on the operations of HW Inc. Therefore, there needs to be a local response but also a corporate plan to recover post-pandemic. This will mean a full strategic review of the organization and its scale of operations.

Legal

The senior management team needs to be aware of the legal issues surrounding consumer trading in all the continents in which it operates. The subsidiary companies will be vital in ensuring that they are trading within the law on all continents. Copyright and patent law are also significant for its product and brand protection, and issues such as the copying of designs and technology that are prevalent in some countries need to be monitored to ensure that the HW brand is not devalued.

As HW Inc. operates a credit card, legislation relating to consumer credit needs to be monitored, as does labor laws, planning regulation for new stores, and health and safety. Some of these elements can be quite complex when operating in many different countries. Therefore HW

Inc. would be advised to have a separate legal department if it does not already have one, which can monitor and advise on legal issues affecting the company.

Porter's Five Forces

The threat of new entrants, buyer and supplier power, availability of substitute products, and competitive rivalries are discussed below.

The threat of new entrants

HW Inc. operates in a highly competitive industry which is dominated by large companies who are capable of exercising buyer power and enjoy significant economies of scale. Their presence would tend to reduce the potential for new entrants. The marketplace, however, is quite diverse in that there are many independent companies and specialist shops that operate in part of the market, that is, companies selling reduced product ranges and on a more local geographic basis. This indicates that, although the number of independent retailers has been decreasing in recent years, there is still plenty of scope for new entrants on a smaller scale, or medium-sized companies to scale-up and compete.

HW Inc. cannot be complacent about the threat of new entrants, even though the threat may be quite low and difficult for companies to compete on a similar scale as HW Inc. and its current direct competitors. In fact, the danger is more likely to come from existing competitors increasing their global reach by expanding into markets where HW Inc. already has a presence.

The pressure from concessions companies could also be a way for new entrants to gain access to the market or at least more control over the sale of their products, which could have an impact on the profitability of concessions for the large retailers such as HW Inc.

Supplier power

When retailers are so large, it is often the case that the power is in the hands of the larger retailers. This can be due to the economies of scale, giving them buyer power, and the strategic importance they present as a customer of smaller suppliers. In most cases, this is probably true; however, exclusive brands may have considerable power in negotiations if the retailer is keen to stock their products to offer the leading brands to the public. The balance of power in negotiations often comes down to the power of the brand.

Suppliers are keen to make their products available on a global basis, and therefore would benefit from the global company stocking their products. The retailer is eager to be seen to offer the leading brands. HW Inc. has adopted a policy of working closely with suppliers for mutual benefit and, therefore, should be able to mitigate any supplier power that exists, meaning that it is probably quite low.

Buyer power

In retailing, it is difficult to say that the buyer has much power on their own. The very fact that there is a considerable degree of choice to the consumer means that competition for their custom is extremely high amongst the retailers. Therefore, it is the degree of competition created by consumer choice, and low switching costs of the consumer, that keeps the downward pressure on the prices rather than any significant buyer power.

Substitute products and services to the output of the industry

The fact that HW Inc. and many of its competitors offer convenience as one of its key selling points tends to mitigate any substitutes that might be available. There are indeed many different products that a customer can buy, but this is more to do with competitive rivalry, that is, buying a competitor product rather than an HW Inc. product. The threat from substitute products is quite low in the case of HW Inc.

Competitive rivalry

It is possible to conclude that the key driving force that affects the profitability of the industry is probably competitive rivalry. As explained earlier, the main threat of new entrants is possibly from existing local competitors becoming more global. Buyers have low switching costs and a large variety of choice of retailer, which impacts on the degree of competitor rivalry. There are few substitutes, which again increases competitive rivalry as companies compete for the consumers' attention, and suppliers have little power over the larger retailers. Therefore, the biggest threat is the competition for customers and the factors affecting the industry from the PESTEL analysis, which will affect the whole sector, albeit some companies more than others.

(b) The major challenges

[The ideas here do not represent the only correct answer, as this is subjective, and based on your cultural background, education, and experiences, you may have different views. This is something that the senior management team would discuss to arrive at a consensus on which to base their future strategy.]

The major challenges being faced by HW Inc. from the environment include:

The degree of competition in the homeware market from major competitors as the upward pressure on costs and the downward pressure on prices means that margins are becoming smaller.

The increase in the globalization of brands and major competitors is also of concern as this affects all the markets in which HW Inc. operates.

The issue of political and economic stability over the next few years, particularly in the light of BREXIT and the effect of changes in political regimes in many countries, will need to be monitored carefully. This changing situation creates uncertainty, and the senior management team will need to keep up to date on what is happening in the global economy to respond.

Technology is changing the way consumers shop, and the trend towards online and mobile shopping is something that HW Inc. will need to ensure that they are aware of to retain customers, but also to take advantage of new ways to attract customers.

Environmental and sustainability issues, including fair trade and ethical trade, could be seen as significant for retailing. Not only are consumers becoming more concerned, but governments are also beginning to legislate to force companies to operate on a more sustainable and socially responsible basis. This potential change of views could have implications for methods of operation, design of products, and supply chain issues, all of which could impact on costs.

Of more immediate concern will be the covid-19 pandemic and the impact on the organization and the need to develop a recovery strategy.

(c) How can the accountant contribute to the process of environmental analysis?

The following points could be made concerning part (c).

Points may include but are not restricted to:

- Assisting in the collection and provision of information on external factors, for example, industry statistics, interest rates, and economic data.
- Evaluating the financial impact of environmental influences on HW Inc., for example, increased emphasis on sustainable products, BREXIT as more information becomes available, or shift from in-store to online shopping.
- Linked to the above, assisting in assessing HW Inc.'s ability to deal with changes in the environment to ascertain whether changes are opportunities or threats.
- Competitor analysis, for example, assessment of key competitor financial performance for comparison to HW Inc.
- Assisting in the development of scenario analysis to evaluate the impact of strategic options and the potential impact on the business environment, for example, expanding operations in emerging economies, rationalizing the high street presence, and placing more focus on online shopping.

Chapter 4, Activity 4 – HW Inc. Portfolio analysis

Part (a)

Critically evaluate the usefulness of using portfolio analysis, such as the Boston Consulting Group (BCG) matrix, in developing strategies to manage diverse organizations such as HW Inc.

Answers may include but are not restricted to the following points.

Potential answers could explain the axes of relative market share and market sector growth, commenting on how easy or difficult it is to assess both aspects.

Market share requires external info on both markets and competitors.

Growth requires an assessment of growth rates, which may not be easy to ascertain from available information.

At best, the construction of the matrix is based on estimates of the business units' position, so it is not a precise tool but acts as a guide to management decision making.

Answers should mention that the BCG can be used at a corporate level where business units are mapped on the matrix, or at a product level where product groups are mapped. In fact, for HW Inc., the model could be used at a store level, mapping market growth in the local area, at a country level. For example, the U.S., or at a global level, where countries become the business units being mapped, and the growth rate per country becomes relevant. It is, therefore, quite a powerful tool in assessing the potential strategies that could be employed within the business.

The answer should also include mention of uses and advantages:

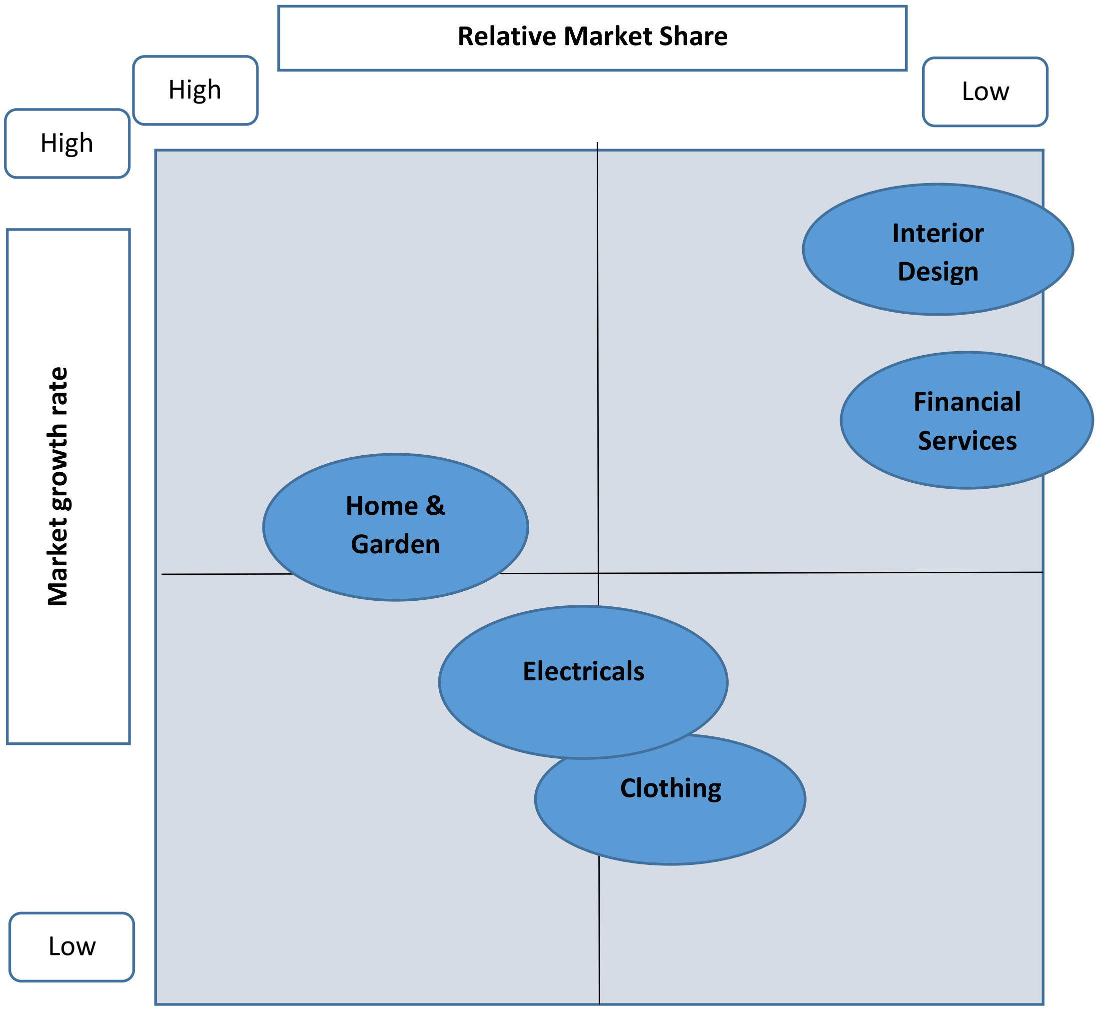
- Internal balance – a mix of new products to replace old ones
- Assess trends over time – is the strategy working?
- Evaluate threats from the competition – analysis competitor portfolio
- Ascertain the level of business risk and scenario analysis – assessing different strategies

Criticisms

- Too simplistic – only uses two dimensions
- Neglects synergies between business units/products
- It depends on how you define the market
- Focus is on cash – not profitability!
- The underlying assumption that high share is good – can be dangerous if not understood.
- High market share does not necessarily lead to profitability
- Market share is not the only indicator of success
- Sometimes dogs can generate high levels of cash
- A business with a low market share can be profitable too
- May miss small competitors that have high rates of growth
- Requires high volumes of information for an extensive portfolio of products plus problems of obtaining data

Part (b)

Note that the discussion and viewpoint expressed as to strategies that could be adopted is not the only answer to this part. Make sure that you justify your viewpoint.



The Interior Design and Financial Services have relatively low market shares but are in market sectors that have a high growth rate. This puts them in the question mark category. The BCG matrix would indicate that these require investment to enable them to grow. However, although HW Inc. has plans for the development of these product groups, they primarily support products to the main business, and so turning them into Stars may not be the objective, that is, does HW Inc. really want to compete with major financial services firms. This would require high levels of investment in what is an extremely competitive market. Plus, the potential for increased government regulations may make it a more specialized market that limits future growth rates.

Similarly, the Interior Design services might be very good operating as a niche area within which HW Inc. has a presence, rather than trying to compete with specialist firms. HW Interior Design does have an advantage in that it is backed by the HW Inc. product range and manufacturing unit, and the senior management team could focus on growing this part of the business, mainly as it appears to be quite profitable. However, the high growth is due to a market trend, and it might be worth undertaking some research to determine if this is likely to continue in the future, or if it is just a short-term trend. The planned move towards targeting corporate clients might be a good move as it takes the business unit away from a reliance on growth that might only be due to a trend in the consumer market. It will require investment in expertise in the corporate and education sectors.

The home and garden business has a relatively high market share and is in a market with a relatively high level of growth, which puts it in the Star category. The BCG suggests this business unit would require investment to maintain its market share so that as growth slows, it becomes a cash cow. It is also supported by the HW Inc. product design and manufacturing units with the HW brands and, therefore, the senior management team needs to continue to invest in the manufacturing to support the HW product ranges. They also need to maintain supplier relationships as the supply of a variety of other brands is essential in this sector.

The electrical product group is competitive, and HW Inc. has a relatively high market share in a growing, but not a particularly fast-growing market sector. The difficulty in this sector is that some sub-product groups, such as audio-visual, are continually being developed, and keeping the product range up to date is significant for consumers. There is also a lot of competition from specialist electrical goods retailers in the high street. Ideally, HW Inc. needs to maintain its presence in this market and maintain its market share. Links with suppliers to ensure ranges are up to date and supported by good inventory management will be essential factors to focus on in this sector. Perhaps the use of concessions might be an option that HW Inc. could expand in this product group, if not already exploited, as it could help share the risk.

The clothing sector is relatively low growth and set to remain so in the future. Although HW Inc. has a relatively small market share, and the BCG matrix puts it in the dog category, there is nothing that suggests that HW Inc. should exit the product group completely. The clothing range could still be contributing to fixed costs and profit. HW Inc. could consider limiting the space given to the product group or try to exploit concessions more to reduce the risk and investment in inventory required, particularly with the seasonal nature and fashion-led influences of some of the products within this group.

Part (c)

Financial controls for question marks – the key is that HW Inc. is making investments in the product ranges in this sector and should, therefore, treat decisions as investment decisions.

- Net present value (discounted cash flow) project appraisal approach to investment
- Strategic milestone targets set
- Target costing/profitability of division and its products
- Control over marketing expenditure
- Competitor analysis important

Financial controls for stars and rising stars – the key here is to continue to invest in the product range to ensure that market share does not slip back below competitors, but also to keep a watchful eye on the actions of competitors.

- Net present value (discounted cash flow) for further investment
- Marketing controls, effect on market share analysis
- Competitor analysis

Financial controls for cash cows – here, HW Inc., needs to try and maximize cash flow and contribution per product and square foot. It is these products that provide the cash flow to invest in other products within the question mark and star sectors.

- Return on investment/residual income targets to ensure position maintained
- Customer account profitability – where possible, or customer segment profitability.
- Contribution per product maximized
- Cash generation targets

Financial controls for dogs – here, HW Inc., is trying to minimize the investment and reduce reliance on the products, perhaps while maintaining a market presence.

- Cost controls to minimize costs
- Free cash flows maximization

Chapter 4, Activity 5 – HW Inc. Customer profitability analysis

Part (a)
The profitability of each customer type is shown below:

	Customer type 1	Customer type 2	Customer type 3	Customer type 4	Customer type 5
	$	$	$	$	$
Initial sales	1,000	1,000	2,500	3,000	1,500
Less goods return at full sales value	0	(200)	(500)	(1,500)	(250)
Net sales	1,000	800	2,000	1,500	1,250
Less cost of goods at 75%	(750)	(600)	(1,500)	(1,125)	(937.5)
Gross profit on sales	**250**	**200**	**500**	**375**	**312.5**
Other customer-related costs					
Process mail orders (orders x cost per order)	0	30	20	0	0
Process phone orders (Average time spent x number of orders x hourly rate)	20	0	0	80	0
Process online orders (orders times cost per order)	0	0	0	0	1
Process returns (number of returned items x cost per item)	0	60	30	210	30
Standard delivery costs (number of orders x delivery cost)	10	60	40	120	20
Overnight deliveries (number of overnight deliveries x cost per request)	4	0	0	48	0
Total other costs	**34**	**150**	**90**	**458**	**51**
Customer profitability	**216**	**50**	**410**	**(83)**	**262**
Deduct customer maintenance (marketing) estimate per customer	50	50	50	50	50
Customer profitability less maintenance costs	166	0	360	(133)	212
Profit as % of net sales revenue - before marketing costs	21.6%	6.3%	20.5%	(5.5%)	20.9%
Profit as % of net sales revenue - after marketing costs	16.6%	0.0%	18.0%	(8.9%)	16.9%

Note: as the cost of customer maintenance (marketing) is the best estimate and it does not vary by customer, and therefore the relative profitability is not be affected by its inclusion, a subtotal has been taken before its addition. It is recommended that additional investigation into this cost is undertaken, such as identifying the cost of the catalog separately, and monitoring customer complaints by both customer type and type of complaint, so that a more accurate allocation can be achieved.

Part (b)

Customer types 1, 3, and 5 are the most profitable types. Type 1 due to the high-value order; type 3 due to the good gross profit earned with relatively lower other costs; type 5 as they use the ordering process with the most economical cost, that is, online orders, and accept the standard delivery terms, also their returned items are not excessive.

The type of customer that is the least profitable is type 4 as they return 50% of the orders and always request special delivery. Type 2 is a relatively high-volume low order value customer, so the 'free delivery' policy is reducing the profitability of this type of customer.

Part (c)

The costs of each activity could be reviewed to see if improvements can reduce them in working practices. Also, a review of policy towards customers may be useful, for example, the management of HW Inc. could consider the returns policy, as this appears to be encouraging customers such as type 4 to return goods even if this is only to ask customers to pay the return postage. However, care must be taken of the potential impact on other more profitable customers. The special deliveries could be charged to customers in their entirety, as well as increasing the charge to cover the administration fee. This may deter customers from requesting this service every time. Also, consideration of a minimum order value before delivery costs are free could also be considered. Reviewing what competitors charge should be considered to make sure that policy changes do not affect the competitive position.

It would also be worth encouraging customers to use online ordering wherever possible, as this is the lowest cost for HW Inc. However, the customer base and access to the internet must be considered. This should be a consideration as internet coverage improves in various countries.

As mentioned above, the costs of maintaining the customer could be analyzed in more detail – as well as the reasons for customer returns, as this could potentially be reduced by providing more information. For example, if the products are clothes, more detailed sizing information could be beneficial or improving the description of items in the catalog.

Chapter 4, Activity 6 – HW Inc. Value creation system

<table>
<tr><td colspan="5">The value chain for HW Inc. – Retail operations</td></tr>
<tr><td>Structure, strategy, management systems</td><td colspan="4">Team of technical specialist
Quality policy and procedures designed to support quality operations and control supplier quality standards.
Decentralized management but with oversight from parent company</td></tr>
<tr><td>Technology</td><td colspan="4">Inventory management system supports inputs and delivery to the customer
IT network aids the whole of the value system</td></tr>
<tr><td>HRD</td><td colspan="4">Staff training and development</td></tr>
<tr><td></td><td>Inputs</td><td>Operations</td><td>Delivery to customer</td><td>After-sales service</td></tr>
<tr><td>Primary activities</td><td>Flatpack of furniture

Close links with suppliers

JIT systems aids inventory management</td><td>Financial services could be part of the operations and are seen as part of the normal offering (may also have a marketing effect, i.e., attracts customers because of easy payment terms).
Concessions are part of the operations.
Store layout and design.
Links between stores and manufacturing merges operations and inbound logistics with manufacturing value creation system</td><td>Flatpack of furniture

Hub and spoke distribution system.</td><td>Assembly and installation if viewed as being an add-on to the basic sale.
Guarantee and maintenance contracts after-sale.
Financial services, if seen as an add-on</td></tr>
<tr><td>Marketing and sales</td><td colspan="4">Marketing channels and sales proposition.
Look and feel of stores and store layout has a marketing effect.
TV advertising, web, etc.
Link to manufacturing units for a specific order.</td></tr>
<tr><td colspan="5"></td></tr>
</table>

The value chain for HW Inc. – Factory unit				
Structure, strategy, and management systems	Team of technical specialist Quality policy and procedures designed to support quality operations and control supplier quality standards.			
Technology	Inventory management system supports inputs, operations, and delivery to customers. IT network aids the whole of the value chain			
HRD	Staff training and development			
	Inputs	Operations	Delivery to customer	After-sales service
Primary activities	Close links with suppliers JIT aids inventory management	Manufacture of furniture	Hub and spoke distribution system of retail stores Delivered direct to the customer for Interior Design customer orders	None
Marketing and sales	Interior design and retail outlets create demand Made to measure orders sent directly to the factory from the retail unit or Interior Design Customer tracking of order could be considered as marketing and sales activity			

Chapter 4, Activity 7 – HW Inc. Financial Ratio analysis

A suggested solution to financial analysis

The financial ratios are shown below.

Ratios

	Industry average	2020	2019	2018	2017	2016	2015	2014
Gross Profit percentage of revenue	30.5%	24.8%	25.5%	25.9%	31.1%	31.6%	32.0%	32.1%
Operating profit percentage of revenue	2.5%	-1.0%	1.2%	2.8%	2.0%	1.9%	2.1%	4.4%
Return on Net Assets (Profit for year/Net Assets)	3.5%	-1.1%	2.0%	3.4%	3.0%	2.4%	3.1%	7.0%
ROCE - Operating profit as percentage of Capital Employed (Operating profit/Long term borrowings plus Equity)	6.2%	-1.4%	1.7%	3.8%	3.6%	3.4%	4.0%	9.0%
Asset turnover (Sales revenue/Long term borrowings plus Equity)	2.5	1.4	1.4	1.4	1.9	1.8	1.9	2.1
Non-current asset turnover (Sales revenue/Non-current assets)	3.0	2.0	2.1	1.9	2.5	2.5	2.5	2.6
Gearing percentage (Long term borrowings / Equity + Long term borrowings)	40%	0.7%	0.7%	4.1%	6.2%	5.9%	6.3%	6.6%
Current Ratio (Current assets/Current liabilities)	2.0	1.9	2.1	1.9	1.9	1.9	2.0	1.7

Stock turnover (Inventory/cost of sales) *365 = number of days stock held	100	109.1	87.5	112.2	84.5	91.8	89.8	93.5
Receivable days (Trade receivables / revenue) *365 = average days to collect	75	76.5	71.6	68.2	45.9	42.5	38.9	38.1
Payable days (Trade Payables / Cost of sales) *365 = average days to pay suppliers	90	124.7	121.7	116.3	86.3	95.9	76.8	96.3

The underlying trend of HW Inc.'s financial performance over the last six to seven years is one of worsening performance. In nearly all instances, it is worse than the industry average. It would be interesting to see if the industry average has also deteriorated over the last six years or so, as in 2014, HW Inc. was performing better than the current industry average, but this is over six years ago.

The gross profit has reduced from 32.1% to 24.8% and is nearly 6% less than the industry average. This fall could be due to a reduction in sales prices due to the competition, or a rise in the costs of goods sold, or change in the mix of sales. There was evidence of increasing competition and upwards pressure on costs in the environmental analysis. Still, one would expect that this would also be reflected in the industry average if it were an industry-wide phenomenon. It appears that HW Inc. has suffered more than others.

One of the ratios that organizations attempt to keep constant, particularly in retailing, is the gross profit. Once a drop in gross margin occurs, the only way to keep the operating profit level healthy is to reduce operating costs. On the plus side, although the operating profit is less than the industry average and has diminished over the last seven years, the gap between the gross profit and operating profit, that is, the operating expenses have reduced. In 2014 the difference was 27.7 percentage points. In 2019 it was 24.3 percentage points and 25.8 in 2020. This indicates that at least the management team has managed to contain operating costs for several years. Still, the disappointing aspect is the current loss and project continued loss in 2021.

The comments of the Chief Executive are perhaps relevant here in that he has given reasons for the decline during the last two to three years as being due to the effect of inconsistent store operations across the group, issues with stock availability, an estate of physical stores that is still too large to support the level of sales currently being generated, the increasing trend towards online shopping, and product pricing on some ranges not being competitive in the current market place (see the financial performance section in the case study). Most of these reasons appear to indicate the big issue is with generating enough sales from the estate that HW Inc. is operating. This is supported by the asset turnover figure that indicates that HW Inc. is only generating $1.4 for every

$1 of capital it invests, and the non-current asset turnover which indicates that HW Inc. only generates $2.0 for every $1 of non-current assets. In contrast, the industry average is $2.5 and $3.0 respectively. This illustrates that HW Inc. is not generating enough revenue and could point to the product range and pricing strategy, as the CEO suggests. With the reduced operating profit percentage over the year and the loss in 2020, this indicates why the return on capital employed is lower, that is, operating profit multiplied by the asset turnover equals the ROCE. In HW's case for 2019: 1.2% x 1.4 = 1.68% (or rounded to 1.7%), and 2020: 1.0% loss x 1.4 asset turnover = a negative ROCE of 1.4%, and for the industry average: 2.5% x 2.5 = 6.2%. Therefore, HW Inc. needs to increase its operating profit and asset turnover.

The issues cited by the CEO could have been a problem over a more extended period than just the last two or three years to which the CEO is referring. The worrying aspect is that 2021 looks as if the trend has continued, possibly even before the covid-19 pandemic. The impact this will have on shareholders willing to make further investments cannot be underestimated. The problem does appear to be within the product area of the business.

The interesting aspect of the comparison is that HW Inc. has exceptionally low gearing. Given the low interest rates now, it would make sense for HW Inc. to consider financing any capital projects via loan capital. However, if interest rates rise, HW Inc. will need to make sure that the increased operating profits from new investments are capable of covering the interest payments, that is, they need to make sure that they can service the loan in the long term.

The current ratio is not much different from the industry and represents a reasonably healthy position. However, if product obsolescence is an issue, inventory management will require special attention. The new inventory management system has helped keep operating costs lower, and the average stock days are lower than the industry average, which is encouraging. But HW Inc. needs to make sure that the product ranges it stocks are moving. Therefore inventory turnover by product category and product line needs to be monitored to identify slow-moving product lines or where demand is low or at risk of obsolescence.

The receivable days are about the same as the industry average, but HW Inc.'s is increasing. This needs to be monitored carefully to make sure that it does not increase anymore. The payable days are also lengthening, and HW Inc. needs to be careful that this does not begin to damage its relationship with key suppliers.

The analysis above is based on HW Inc. as a whole. It is assumed that the industry average includes companies that also trade globally and is, therefore, a meaningful comparison. HW Inc. should analyze the business performance over the six continents and within each country. It could be that different parts of the world are performing differently, and this would have an impact on the future strategy. The analysis of product groups and business units (Interior Design, Manufacturing, and Financial services) should also be broken down by region.

If possible, a comparison with the significant competitors rather than the industry should be undertaken. While the industry average is useful, it might be more beneficial to make a more direct comparison with companies of a similar size and global operation to that of HW Inc.

Investigating the trends in online shopping versus in-store and trends in click and collect should also be investigated. This could include an investigation into the efficiency of the hub and spoke delivery system.

An area that is difficult to analyze from the information provided is the effectiveness and efficiency of the manufacturing operations. Presumably, this is lost within the product analysis, but it would be useful to investigate whether operating their manufacturing unit is still the best option. For example, what is seen to be the strategic advantage of manufacturing HW's own products? Is it possible to gain economies of scale to make it cost-effective? Is it control over production and quality, or a strategic understanding of the manufacturing processes to be able to negotiate with other manufacturers that provide the strategic benefit?

Chapter 5, Activity 8 – HW Inc. SWOT analysis

Part (a)

[The SWOT analysis is often done in bullet point format in the form of a cruciform chart. However, for the many examinations or coursework, tutors prefer it if you explain your points. As SWOT, like environmental analysis, can be subjective it is better if you explain why you feel that an issue presents a strength or weakness, etc.]

The SWOT analysis brings together internal analysis and external analysis. It provides an answer to the question, where are we now? or presents a view of the current strategic position of the company. It is sometimes referred to as a corporate appraisal.

Strengths

HW Inc. offers a wide range of products via a variety of marketing and sales channels under the brand values of convenience, quality, and price, which it uses as part of its market offering. This diversity of products and marketing channels can be a key strength to be used in its competitive strategy.

HW Inc. is geographically diversified, that is, operates in six continents, and therefore, has some resilience to local economic cycles, but would still be affected by a global recession.

Investment in inventory management systems is helping to reduce inventory levels, and the investment in technology could be seen as a strength in that it will help to retain HW Inc.'s competitive position and help to reduce costs, which, in turn, will help to restore margins.

HW Inc. has a diverse workforce and invests in training, which can be a strength and helps to reinforce its competitive strategy of convenience and quality.

The low gearing could be a strength in that HW Inc. would be able to raise finance for future strategic initiatives, even if via a loan rather than equity. To raise significant funding via equity would require the confidence of shareholders, so a thoroughly evaluated and convincing strategic plan would need to be put forward to stop the decline and stimulate growth.

Weaknesses

The fact that some stores are seen to need refurbishment could be a weakness. This could affect the brand image if the senior management team does not address the issue – it will require investment in the stores. Still, it could be done in conjunction with the rationalization of store space if stores in certain areas are unprofitable. This may, however, have an impact on the overall profitability of HW Inc.

Despite the new inventory management system HW Inc. has experienced occasional stock-outs on some products, which could damage customer goodwill if not addressed. Similarly, in overseas markets, if publicity of alleged corruption is reported and found to be accurate, this could also damage the brand image and require the senior management team to take demonstrative action to show that they take the issue seriously. Also, the publicity HW Inc. has received concerning the "non-promotion," or reliance on U.K. staff, to manage the stores could have a negative effect. The senior management team needs to monitor and be aware of media coverage that reflects on the company. Still, they must not let media coverage drive the strategy; that is, they must not react without giving the matter due consideration to making the right strategic decision.

The poor financial performance of 2020 and the reducing margins in the industry generally is also a weakness. The chief executive has identified the factors leading to this, which may indicate poor management decision making. This situation could affect shareholder relations and their confidence in the senior management team and make it more difficult to raise finance for future expansion or strategic initiatives that required funding. The fact that shareholders have expressed their concern should highlight the significance of addressing the issue sooner rather than later. The senior management team cannot hope that it is a short term issue that will auto-correct itself next year without some form of strategic action on their part. Of course, the impact of the covid-19 pandemic will need to be addressed as part of any strategic plan to address the poor performance of the last year.

Opportunities

Opportunities in the form of market development, product development, and diversification have already been put forward. These are typical areas for expansion, and the senior management team needs to use the SWOT analysis to make sure that future strategies are evaluated on whether they build on strengths, address weaknesses, avoid the threats, and are consistent with the overall strategic values of the company.

Threats

Possibly the most significant threat is the impact of covid-19. This has affected the whole industry globally and therefore affects all areas of HW Inc. and its competitors. The senior management team will need to develop a strategy quickly that responds to the crisis and also ensures the survival and future profitability of the organization.

The economic uncertainty created by issues such as BREXIT and political stability in some parts of the world also creates a threat. This uncertainty makes developing a strategy more problematic, especially when there is a high degree of risk about the future trading arrangements that could be available. The potential fallout in terms of trade wars could impact on global supply chains. HW Inc. should lobby governments to put forward their view of what should happen and to join other industry leaders in pressing for a resolution.

Also, the senior management team needs to monitor the degree of uncertainty around the financial stability of various countries as governments prop up financial markets as this could affect currency rates and the cost of imports and exports of goods sold by HW Inc.

Current low consumer confidence in western countries will affect the industry but is also having an impact on HW Inc.'s performance. The effect of covid-19 on customers' willingness to return to normal will need careful monitoring and measures taken to encourage shoppers to return in a safe environment.

The globalization of suppliers and rising labor costs and material costs generally will be a threat to the whole industry; therefore, the senior management team will need to address this issue so that it impacts on HW Inc. less than its competitors.

The increased competitive nature of the market is putting pressure on margins, and with low consumer confidence and upward pressure on costs, it is becoming more difficult to maintain margins.

Part (b)

Key strengths

- Global reach – as this provides some protection from economic cycles.
- Available finance – although recent financial performance has been quite weak (see weaknesses), HW Inc. does have the ability to raise funding to undertake strategic developments.

Key weaknesses

- Recent poor financial performance may put HW Inc. into financial difficulties. The senior management team could also come under pressure if shareholders decide that they no longer represent a good investment and the recognition that the leading cause of poor performance could be due to poor management decisions.

Key opportunities

- There are plenty of opportunities to expand the business both via product development, market development, and diversification – the senior management team will need to make sure that it does not try to be too ambitious.

Key threats

- The impact of covid-19 needs to be addressed as a matter of urgency.
- Increased competition in the marketplace, coupled with low consumer confidence.
- The uncertainty surrounding BREXIT in Europe and other political factors, such as the relationship between America and China, will make it challenging to plan global supply chains. Tariffs on goods could impact on costs.

Chapter 6, Activity 9 – HW Inc. Competitive strategies

Part (a)

Numerical analysis

Year	Total number of Kitchen Units sold	Sales Value of Kitchen Units	Interior Design Sales revenue generated from Kitchen design	Operating profit generated from Kitchen Units and Design together
		€m	€m	€m
2018	2,050	922,500	650,000	162,000
2019	2,700	1,080,000	600,000	144,000
2020	3,600	1,260,000	550,000	107,500

Note: Profit from Interior Design services usually is 15% of the sales value generated from Design.

Year	Total number of Kitchen Units sold	Sales Value of Kitchen Units	Interior Design Sales revenue generated from Kitchen design	Operating profit generated from Kitchen Units and Design together		Profit generated from Interior Design - 15% of sales value for Interior Design C x 15%	Profit from Sales of Kitchen Units D-E
	A	B	C	D		E	F
		€m	€m	€m		€m	€m
2018	2,050	922,500	650,000	162,000		97,500	64,500
2019	2,700	1,080,000	600,000	144,000		90,000	54,000
2020	3,600	1,260,000	550,000	107,500		82,500	25,000

		Average sales price of kitchen units B / A €	Average Profit of Kitchen Unit F / B €	Average Cost of Kitchen Unit (Average sales – average profit) €
2018		450	31.46	418.54
2019		400	20.00	380.00
2020		350	6.94	343.06

The numerical analysis indicates that the increase in the volume of kitchen units has potentially been achieved by reducing the price. This is probably a response to the competitive market in Italy. The analysis relies on the suggestion that a 15% profit is achieved on the Interior Design services. We would wish to check this fact. It does, however, indicate that as costs of kitchen units have not reduced at the same rate to match the reduction in price. The profit per unit has, therefore, also decreased. The conclusion is that a cost leadership strategy could not be sustained unless HW Italy can reduce the manufacturing costs of its own branded products and negotiated prices with other suppliers.

Part (b)

HW's overall strategy is one of convenience, quality, and price. However, sustaining a further reduction in price does not look viable, given the decreasing profit per unit. There is the added danger that reducing the price could undermine the 'quality' aspect of HW Inc.'s sales proposition.

The managing director of HW Italy commented that the Italian customer is looking for functionality with style. If the competitive market is moving more towards a focus on price, there may be an opportunity for HW to **differentiate** its product offered by emphasizing the quality aspect, or "functionality with style." This strategy may justify a slightly higher price in the marketplace and help to maintain the margin.

A differentiated strategy may entail some work on the design of the HW Italy range to ensure that the products meet the "functionality with style" aspect. It provides the opportunity to look at the manufacturing process to see if it is possible to reduce the costs and still meet customer expectations. A technique known as target costing could be used in which the end price, less a profit margin, is used to create the target cost to which designers can work.

The claim that the Interior Design services make 15% profit should be investigated, and some marketing research and analysis could be undertaken to test whether the sales of Interior Design services could be increased. Questions need to be asked, such as, what is the state of the current market and the current trends within this area of business? What is HW's current market share, and what is the probability that this can be increased? What might the reaction of competitors be? Does HW Italy currently have the capacity to take on additional Interior Design services, for example, will it require further recruitment and hence costs? What is the lead time for updating the product range?

Chapter 6, Activity 10 – HW Inc ABC picnic tables

Part (a)

Calculation of traditional method – single overhead absorption rate

Total overhead = $429,000

Number of products produced = 12,000 + 14,000 = 26,000

Overheads per product based on units produced.

$429,000/26,000 = $16.50 per product.

Total cost per product	Alpha	Beta
	$	$
Material (total/units produced)	20.00	25.00
Labor (total/units produced)	14.00	10.50
Overheads (as calculated)	16.50	16.50
Total cost per product	**50.50**	**52.00**
Mark-up 25%	12.63	13.00
Selling price	**63.13**	**65.00**

Calculate the activity cost driver rates

Total activity	Alpha	Beta	Total
Machine hours	2,100	2,400	4,500
Orders executed	150	110	260
Production runs	90	40	130
Number of shipments	50	15	65
Number of returns	90	40	130

Cost per activity driver			
	$		$
Production overheads	180,000	4,500	40.00
Material Handling	78,000	260	300.00
Quality inspection	130,000	130	1000.00
Delivery	26,000	65	400.00
Production returns	15,000	130	115.38
Total	429,000		

Calculate overhead rate (activity x cost driver rate)

Overheads per ABC	Alpha	Beta	
Production overheads	84,000	96,000	
Material Handling	45,000	33,000	
Quality inspection	90,000	40,000	
Delivery	20,000	6,000	
Production returns	10,385	4,615	
Total	249,385	179,615	429,000
Output in units	12,000	14,000	
Overhead cost per unit	20.78	12.83	

Calculate direct costs per unit, total cost and selling price

Direct costs	Alpha	Beta
Materials	240,000	350,000
Labor	168,000	147,000

Total cost per product	Alpha	Beta
	$	$
Material (total/units produced)	20.00	25.00
Labor (total/units produced)	14.00	10.50
Overheads (as calculated)	20.78	12.83
Total cost per product	**54.78**	**48.33**
Mark-up 25%	13.70	12.08
Selling price	**68.48**	**60.41**

Part (b)

The use of ABC aids management decision making on pricing and cost control because it provides a more informed method of allocating costs. It highlights the costs of various activities based on the current utilization of resources, and in some cases, can highlight where this cost is unusually high. This would prompt management to investigate further to see if the cost can be reduced.

It also provides a more informed basis on which to set prices when using a cost-plus method. The activity-based costs consider the level of activity used by each product and allocate costs accordingly. It provides a fairer allocation of costs to products. However, we should bear in mind that activity base costs calculated using historical data may not be relevant for the future. If, as they should be, costs are based on estimates of future activity, the cost may be incorrect if the estimates provided are highly inaccurate. However, with modern forecasting techniques, there is no reason why future estimates cannot be reasonably accurate. In the case of new products where estimates could be aspirational, that is, marketing hopes to sell a given number of products; sensitivity analysis should be undertaken to test the impact on costs and hence profitability. It should also be recognized that volumes can have a significant effect on whether the target costs of new products are achieved or not.

Under the old method of allocation that of merely allocating costs based on the number of units produced, Alpha has a selling price of $63.13, and Beta, $65.00. However, under ABC, this is switched so that Alpha is the most expensive at $68.48, and Beta is the lower-priced of the two products at $60.41. As ABC considers the activities involved, this is probably a more realistic pricing method.

Therefore, so long as management is aware of the potential issues when reviewing ABC costs, it can aid their decision making in identifying areas of improvement in the production process and also when making pricing decisions.

Chapter 6, Activity 11 – HW Inc. TDABC and call center

Part (a)

The main activity undertaken by the call center is measured in minutes. This is also a measure of its capacity, that is, the number of minutes available during which a service can be provided. Therefore, the time-driven activity of minutes is the best way to allocate the resources. It will also provide management with information on the utilization of the resources available.

Part (b)

	Product group X	Product group Y
Number of call minutes - information	50,000	12,000
Number of call minutes - complaints	18,000	1,800
Total minutes	68,000	13,800
Cost of resource used	£68,000	£13,800
Cost allocated under the old system	£20,000	£80,000

Under the new system, the cost is much higher for Product group X.

Part (c)

Under the old system, the only way to reduce the allocated costs is to sell fewer products to reduce the sales value, which is not in the best interests of HW Inc. However, under the new system, the emphasis would be to reduce the need for customers to make calls in the first place.

This strategy could go back to the design of the product, which may mean talking to manufacturers and suppliers, if not an HW Inc. manufactured product. The provision of information about the product could be made more explicit. It could include descriptions of products on the website or in-store. Training of sales staff in-store to answer questions of customers before and during the purchase decision. Training of call center staff to deal with calls more effectively or provision of frequently asked questions on the website within the 'contact us' section. It could include web discussion forums in which customers can post reviews or ask questions of other users.

All functions within the organization can contribute to reducing the need for customer calls—for example, designers, sales staff, installers, as well as marketers and production employees.

Part (d)

Call center staff may resist the implementation as it will enable managers to assess the effectiveness of the call center in terms of total capacity. If the call center activity is reduced, it may result in job losses. Also, we could assume that the manager of product group X will not be in favor of the change.

Part (e)
The use of a Time-Driven ABC system will enable managers to assess the utilization of the call center and the resources required to run it effectively. This information could be used in comparing the costs of outsourcing, that is, the charge from an outsourcing company which, more than likely, would charge based on usage, with the provision of its center. It also provides management with a cost of underutilized resources; that is, if not all of the hours available are used, there is a cost associated with this. If the cost per minute is adjusted, that is, increased, to ensure that all the costs are recovered, it increases the cost of provision to the product managers, and again raises questions as to whether the service could be provided more cost-effectively by outsourcing. It, therefore, ensures that the best way to provide the service is always kept under review. HW Inc. also needs to make sure that they consider service levels by an outsourcing company as it is HW's reputation that is the hands of the outsourcing company. Therefore, the decision is not purely a financial one.

The value creation system is also useful in the decision as HW can investigate the costs of the activities and decide strategically if the provision of a call center, which is probably part of the after-sales service activity, is a critical activity and how much this adds value to the customer. There could also be a marketing effect of providing the after-sales advice, which cannot be ignored, plus there may be implications for the support activities, for example, technology and HRM. For example, using technology to provide more information or alternative ways of answering questions, or training of staff may be part of the solution. Therefore, the value creation system allows HW Inc. to see the activity within the context of the whole business, and not just to view the call center in isolation.

Chapter 6, Activity 12 – HW Inc. Cost of quality

Note in the following ideas; quality has been taken to encompass the customer experience as well as the actual product being fit for purpose. It is quite a broad view of quality.
Answers can also be interpreted in more than one way as the scenario creates a subjective view of the process.
Many of the problems associated with quality can often be prevented with training. It is evident from the service sector example given.

Problems	Cost issue	Corrective action	Classification
Allowed to wander around without being asked if help needed. Could have walked out again.	Loss of contribution from a potential lost sale. Plus, adverse customer experience can be told to friends and family and other potential customers.	Training – sales staff training in when to intervene to ask if customers require assistance.	Prevention.
Non-committal attitude of sales assistant – not customer-focused.	Potential lost sale.	Training. Also recruitment of staff who have customer service focus.	Prevention.
Time taken to place the order.	Poor customer service leading to unlikely repeat sales. Loss of confidence of the customer in the procedure.	Improve the order taking process. It could also be a system-based issue, so the computer ordering system requir4eds a review for ease of use.	Prevention.
Lead time to order quite long.	Potential for customer dissatisfaction and loss of repeat business.	Working more closely with suppliers to improve customer service.	Prevention.
Time taken to set up and authorize credit card, although this is a critical process to get right, so possibly expected to take some time. It is good that the process was completed at the pay point, and the customer did not have to apply separately.	Number of staff involved in the process of taken and processing and order.	Systems review, plus a review of staff responsibilities and the ability to multitask.	Prevention.
Supplier of cloth.	Delay in the process causing loss of goodwill	Supplier lines should be checked	Internal failure.

	and potential future repeat purchases. Administrative costs in dealing with the query.	before the order taken to avoid disappointing customers later. It could be achieved by online link, or up to date info on stock being made available online.	
Failure of sales staff to realize the implications of the credit card being maxed out on first use and £3 insurance taking is over the limit.	Loss of goodwill. Administrative cost of dealing with query/complaint.	Training of staff.	Internal failure (could also be classed as an external failure as it happened after purchase). It highlights the impact of the external value chain.
Onus placed on the customer to arrange a date, not asking the customer when the delivery date would be convenient. What happens if the customer had been away and unable to respond in time?	Loss of goodwill.	Review system to ensure that customer interests considered upfront.	Prevention or internal failure. It depends on whether we consider this to be a system problem or just bad practice.
Wrong chairs delivered and delivery staff unaware of the product range.	Inconvenience to the customer, loss of goodwill. Cost of re-delivery and collection of incorrect chairs. Possible repercussions for its supplier. Supplier may well have to manufacture chairs if	The order needs to be checked before dispatch, plus incorrect info provided, train delivery staff on product range, or in customer handling skills.	Inspection and external failure as the error reached the customer.

	not held in stock – can it resell the wrong chairs.		
Incorrect info was given by the company and supplier.	Loss of goodwill.	Need more contact with the supplier to progress chase orders so that they can answer customer queries. Customers should not have to contact their supplier. They made the sale; it is their responsibility.	Internal failure and also an external failure as the customer knew about the mistake and was left to sort it out with the supplier.
Failure with supplier systems not being customer-focused. Poor telephone approach. Nonresponse to customer.	Time of telephone call – if no complaints received - no costs incurred in dealing with them. Costs of redelivery. Inconvenience of customer and loss of goodwill.	Control of suppliers needs improvement as it is affecting the goodwill of HW Inc.	Internal failure and external.
The delivery of the sofa is way outside six weeks expected.	Loss of goodwill.	Systems review, up to date info required so that more accurate promise can be made.	Internal failure and external.
Sofa damage and lack of trust shown to the customer.	Cost of repair. In this case, loss of sale and goodwill. The cost of collection of product and as made for the customer may not be resalable.	Careful onsite checking of goods delivered. Training of staff in dealing with angry customers – it would have been useful if the customer account had been flagged as a customer having complained as this	External failure.

		could have indicated the delicate nature of the call.	

The analysis brings out several points.

- Reliance on supply chain members to fulfill their part in the value system so that the customer is happy.
- Many factors affect customer goodwill, so main cost is the loss of potential sales.
- Marketing maxim that if we have a good experience, on average, we tell three people about it, if we have a bad experience, on average, we tell 11 people about it. However, tempered by a customer that has complained and had their complaint satisfactorily dealt with is happier than a customer who has not complained. [This is a marketing reason behind the no quibble refund policy of some high street retailers].

Chapter 7, Activity 13 – HW Inc. International expansion

Porter's diamond is useful when evaluating a country as it provides a framework for considering the various factors that give a nation a competitive advantage and can be used by companies operating in the industry using the country as a base.

For example, if HW wishes to operate in Bangladesh, they will need access to the basic factors as well as the advanced factors that Porter identified. HW will need to assess the availability of labor and capital, as well as the level of education, the technology available, and infrastructure.

The information provided so far indicates that the Bangladesh government has invested in education, and one could assume that the population and hence the workforce will be relatively well educated, even though 26% of the people are living below the poverty line. Unemployment is running at approximately 5% per annum, so HW will likely be able to recruit and train the labor required for the store. One aspect that HW will need to check is that the key industries appear to be textile and manufacturing, although there is a robust financial sector, little is known about the strength of the service sector and retailing. These are the skill sets required by HW to complement its operations, and more information would be needed on this aspect.

As there is a strong financial services sector, we could assume that any finance required could be raised locally. Also, the fact that there appears to be growth in online shopping, due to investment in technology development, is good news for HW, as it indicates that online retailing is developing. Therefore we could assume that the retail sector is reasonably well established. The good seaport access possibly means the right infrastructure elements exist to get goods into the country, and also potentially opens up other markets. Little is known, however, about how easy it would be to get products around the country, that is, the road and rail networks, which might be needed if further expansion was planned in later years.

In terms of related industries, Bangladesh has a strong manufacturing tradition in clothing and apparel, and this could be beneficial for HW should it wish to source products locally. However, quality of work would need to be investigated as the clothing appears to be sold to discount stores and, therefore, may not be of the required quality standard.

Demand conditions would appear to be good, but the high level of poverty might indicate that customers shop at the lower end of the price spectrum, particularly as it is suggested that the market is price sensitive. HW will need to assess the market for its style of products, as well as checking out the competition.

The structure of the retailing industry sector is not known at the moment and is an area that HW will need to check. However, the information that low-cost goods from India and China dominate the market and that it is price sensitive tends to indicate that it is a competitive market. HW would do well to check out the International Homeware Company to see what end of the market it targets, that is, low-cost or a higher quality product.

Overall, the factor conditions and related industries are favorable to HW's plans. However, the big issue is the market conditions and whether there is a demand for products such as HW's. It is worth investigating this in more detail before making a final decision.

Chapter 7, Activity 14 – HW Inc. Joint development

Part (a)

Opportunities and threats

There is an opportunity for HW China to expand its reach and appeal to consumers who cannot afford the latest high street fashions and furnishings. Therefore, an out-of-town store may be attractive to aspirational customers if HW China's products become more attainable. However, HW China needs to be careful of their strategy as the concept of the Shopping Villages appears to be based on a small outlet selling quality products, but at a lower price because they are end of the season or overstocked items. HW China needs to be careful that this concept will work on a large scale, or it risks undermining the high street shops. It could confuse the customer if the out-of-town store stocks exactly the same items, are the same price as the high street store, but is near the Shopping Village that already has shops under the name of the top quality brands. The fact that the top brands are threatening not to allow the sale of their brands in out-of-stores may undermine the whole concept.

The link with the food retailer, if of a similar strategy, that is, convenience, quality, and reasonably priced, could attract more customers to HW China if on the same site. Customers of the food retailer may enter the HW China store while they are on-site doing their regular food shop. This could increase footfall (number of customers entering the shop) for HW China.

The threat of competitor action will always be an issue, and it is unlikely that, if seen as being successful, HW China's competitors will not react, which could reduce the sales generated from the new store, and possibly other HW China stores.

The central government is concerned about the impact of out-of-town stores on the high street and city centers, so it may take action that is detrimental to out-of-town shopping, which could impact on the future profits of the stores. Similarly, the local opposition from the local community, and also the change of heart from the local transport providers, may make the venture unprofitable, and could potentially damage the image and reputation of HW China if the story is picked up by the national media.

Part (b)

Stakeholders

Shareholders potentially have power over the senior management team. Still, as this is a reasonably small decision in the overall context of HW Inc., it is unlikely that the shareholders will be that interested at the moment. They may be aware of the proposal via the communications with the Supervisory board on strategy. Still, the board will need to monitor the performance of the strategy, if implemented, and judge the reaction of the shareholders to future performance.

Employees and management of HW China, both potential employees of the new stores and existing employees of current stores, in Beijing are all stakeholders with interest in the project. The new store will presumably provide new employment opportunities, but the existing employees may be concerned about the impact on the stores. Employees would be extremely interested and could potentially disrupt the strategy, but this may be short term.

Customers could potentially be pleased with the decision as it makes the products more available, but if the out-of-town strategy is seen as a move down-market, it could damage the quality image and the brands that HW China sells. HW China needs to be careful about how this decision is communicated and the rationale for the new out-of-town strategy. The senior management team needs to consider whether this will be seen as a natural expansion of retailing, or whether out-of-town stores are seen as quality outlets. An issue to recognize is whether there is such a thing as a "high street" brand image and an "out-of-town" image in China, or do customers make no distinction.

Suppliers may well welcome the opportunity to sell more products via HW China and make their products more widely available. The views of luxury brand owners, however, appear to suggest that they feel it may be downgrading their image to a permanent discount store and resist their brands being sold by HW China in the out-of-town store. This stance could undermine the whole strategy.

The government, both central and local, have a degree of power to disrupt. Indeed, the provincial government can stop the planned development by not granting permission, and so would be in the key player category.

Other suppliers, such as the transport companies, could make it challenging to implement the strategy but may not be able to stop the development if permission is granted. If customers are local and others arrive via car, the store may still be successful without public transport. It largely depends on how critical the provision of public transport is to the planned development.

The local community is quite significant because if the development does not have their support, they could create on-going difficulties throughout the construction and bring unwanted negative media attention. Any adverse media coverage will also affect the local government, who may turn against HW China. Bad publicity will also influence future local governments and communities for any other planned sites in the future. Therefore, it could be seen as essential for HW China to involve the local community and come to a compromise so that they have their support.

Part (c)

The issue of whether to undertake projects on their own or as a joint venture with a partner is mostly down to control and risk. If HW China undertakes the development on its own, then it is in total control of the project but will be carrying all the risk. However, if undertaken as a joint venture, it will be sharing the risk but may have to make compromises for the partnership to work. The terms of the contract are critical to the success as any disagreement later could risk dissolving the partnership and leaving HW China in an awkward position.

The collaboration may attract more customers to the site and increase the footfall for HW China, that is, customers of the food retailer may enter the HW China store while they are on-site doing the regular food shopping. However, HW China needs to make sure that there is a match between strategies and the customer demographic targeted. While it is sometimes useful to attract a different demographic, it could, in this instance, undermine HW China's brand image if the food retailer targets a different demographic profile of the customer.

As they are on the same site as the food retailers, the sharing of services, facilities, and security arrangements could produce economics of scale and efficiencies. Still, an agreement needs to be made as to how this will work in practice.

Marketing strategies need to be similar, and the approach to promotions and pricing would need to be acceptable to both parties, as this could set up expectations in the minds of the customer if one retailer ran a different strategy to the other. Also, as staff are on the same site in proximity, staff policies will become known, and this could create difficulties if there are substantial differences in the way the companies treat their staff. Rumors and feelings of fairness can affect employee morale if not managed carefully.

Chapter 7, Activity 15 – HW Inc. Growth strategies

Part (a)

Business Environment

The business environment can be analyzed using the framework known as PESTEL. It provides a framework that enables a broad consideration of the factors in the general business environment that could influence the structure and nature of the industry in the future and hence affect XYZ Inc.'s ability to achieve its strategic objectives. The senior managers of XYZ Inc. need to assess whether there needs to be a strategic response to any factors arising from the analysis to ensure that the company meets its objectives.

Political and legal factors

As a primary service provider and public company, XYZ Inc. will have to deal with many stakeholders, including the government, as telecommunications and access to the internet may well form part of government policy. XYZ Inc. and its competitors may find themselves being influenced by the government's agenda in many different countries as governments attempt to improve the infrastructure and access to digital technology, particularly for educational purposes. Therefore, industry regulations and government policy will form a crucial part of future planning for XYZ Inc.

With a 55% market share in its domestic market, XYZ Inc. is the dominant player. The government will almost certainly wish to make sure that there is sufficient competition in the industry, which may mean that it restricts XYZ Inc.'s ability to grow in its domestic market. Ultimately this will mean that XYZ Inc. will need to seek growth from other areas of the business and in overseas markets.

Economic factors

XYZ Inc. is dominant in its domestic market, however, as most individuals in developed economies, and particularly in XYZ Inc.'s local market, already have a phone of some description, growth will need to come from the provision of services and increased usage.

XYZ Inc., however, may not be the market leader in other overseas markets, so significant growth can only come from these markets. XYZ Inc. has the opportunity in markets that are rapidly growing to increase revenues and market share. As many developing markets, especially the emerging economies, can "leapfrog" some of the older technology, there is the opportunity to install the newest and more efficient technology in these economies.

It would be useful for XYZ Inc. to expand its business geographically as it spreads the economic risk, that is, the economic cycle, and as there is a demand for global telecoms services, there is scope for strategic alliances and mergers in the industry.

Sociocultural factors

Mobile phones and landlines are now almost ubiquitous (everywhere) in the developed world. Therefore, XYZ Inc. will need to try to encourage greater usage by offering a wide range of services. The Internet is becoming a vital tool for business and leisure with the growth of home entertainment. Trends such as homeworking, home banking, and online shopping have increased the demands and usage of digital services. The use of social media is expanding, which also requires effective telecommunications services and national coverage of fast broadband speed. The covid-19 pandemic has increased the usage of telecommunications for work, educational, and leisure activities.

Technological factors

Technology changes very quickly and therefore requires continuous investment to stay at the forefront of technology developments.

The telecommunications industry has seen a convergence between telecommunications, computing, and broadcasting so that digital devices that were previously used predominantly for telecoms services are now being used to watch TV, social media, access news services, movies, and entertainment. More recently, the devices and Bluetooth technology are being used to target marketing messages and to make payments for goods and services.

As technology enables a sharing of platforms, there may be a reduction in the cost base of providing the infrastructure as new services are brought in that use the full capacity of the infrastructure. Therefore, XYZ Inc. should attempt to benefit from economies of scale. However, there is a danger that the infrastructure is not capable of handling the increased usage without further investment to upgrade and keep pace with the growth in demand.

Environmental factors

There is currently a concern over the volume of technology waste that is being created as users update their digital devices and need to dispose of their old ones. The cost of disposal is being placed on the industry members, and XYZ Inc. will, therefore, need to develop a strategy to deal with this responsibility.

The need to develop the infrastructure sustainably is also key to the environmental aspect of business as well as the choice of sites for digital cell stations and the need to put fiber optic cable underground wherever possible.

XYZ Inc. will need to make sure that it is aware of the environmental impact of its activities and develop a strategy to ensure that it can deal with its responsibilities for sustainability within the industry. Adopting a sustainability strategy is particularly crucial concerning international developments in emerging markets as the regulation may not be so strict in these markets, and XYZ Inc. would do well to adopt an integrity approach by applying the same standard worldwide.

Summary of critical environmental factors

The key drivers for change in the environment are the speed of technological change, which requires continued investment, the social trends and increased demand for digital services, and the deregulation of markets as governments seek to improve access to digital services within their countries. All these signs are positive in that there is scope for expansion in overseas markets if XYZ Inc. can exploit its technological advantage before competitors catch up.

Part (b)

Potential market developments

The potential market developments can be assessed using Ansoff's product market growth matrix, which provides a range of options that organizations can consider in the pursuit of growth.

The Ansoff matrix enables companies to consider product and market issues systematically, and given XYZ Inc.'s desire for growth and strategic position offers four realistic options for growth:

Market penetration

Domestic market: XYZ Inc. has 55% of the local market, and there is a regulator whose job it is to ensure that the market is a competitive one. The only hope for a penetration strategy is by an increase in the size of the market, but this does not seek likely. XYZ Inc. may not be able to increase prices due to the degree of competition and also the protection of consumers by the regulator.

Mobile and digital communications are expanding in overseas markets, particularly emerging economies, so this is the most viable option in terms of market penetration. XYZ Inc. may be better to **consolidate** its domestic market position and attempt to **penetrate** overseas markets.

[Note: withdrawal is not an option as XYZ Inc. does not have a market from which it would wish to withdraw].

Market development

Overseas markets. As a new entrant to emerging markets XYZ Inc. may be in a better position to pick up customers, especially if foreign governments are keen to promote competition in their markets. An overseas expansion could be achieved by XYZ Inc. seeking to enter the markets on their own, or via a joint venture, merger, or acquisition.

Product development

Technology development is a vital part of the telecoms industry, and XYZ Inc. could work to increase the speed of its broadband offering or to develop new products that will enhance access to the Internet. The development of telecoms products that can span the social media and TV content could be possible developments in the light of XYZ Inc.'s objective to become a global telecommunications provider.

XYZ Inc. should seek to exploit its knowledge and R & D. Examples of developments in the industry in recent years have been caller identification, call-waiting, and voice and video mail. XYZ Inc. may be able to offer business users a more extensive range of communications options, particularly as the personal user market is becoming saturated in the domestic market, as most people own a mobile phone.

Diversification

The Chairman intends to diversify. Given that new services will be marketed to the existing customer base, this is more characteristic of product development or related diversification.

Ansoff's matrix provides a framework for potential bases of development for growth. There may be synergies between options. For example, new developments that represent related diversification could be marketed through existing channels to existing customers as well, hence the link to product development.

Chapter 8, Activity 16 – HW Inc. Investment appraisal and stakeholders

Year	0	1	2	3	4	5
Description	€,000	€,000	€,000	€,000	€,000	€,000
Sales of Antwerp and Aarschot		10,000	10,000	10,000	10,000	10,000
Reduction of 5%		(500)	(500)	(500)	(500)	(500)
Sales of Turnhout and Hasselt		4,500	4,950	5,445	5,990	6,589
Total sales revenue		14,000	14,450	14,945	15,490	16,089
7% of sales revenue		**980**	**1,012**	**1,046**	**1,084**	**1,126**
Costs						
Land and buildings	(500)					
Forklift truck and stackers	(18)					
Lorries	(250)					
Annual running costs of the depot		(300)	(308)	(316)	(324)	(332)
Manager		(25)	(26)	(27)	(28)	(29)
Workers 20 x €15,000		(300)	(308)	(316)	(324)	(332)
Drivers 10 x €18,000		(180)	(185)	(190)	(195)	(200)
Net cash flow from 7% sales revenue less costs	(768)	175	185	197	213	233
Discount 3%	1.000	0.971	0.943	0.915	0.888	0.863
Discounted cash flow	(768)	170	174	180	189	201
Net present value						146

The approach taken is to calculate the revenue generated by the stores to be serviced by the new depot and then calculate 7% of this. This figure has subsequently been used as the positive cash flow in our NPV calculation. Deducting the costs from this and calculating the NPV of the net cash flows will provide either a positive or a negative NPV. If the NPV is positive, it indicates that costs do not exceed 7% of the revenue generated. If negative, then the costs exceed 7% of revenue, and the depot does not meet the investment criteria.

The Net Present Value is €146,000 and therefore would appear to satisfy the requirements that the costs be no higher than 7% of revenue served from the depot.

It would be beneficial to undertake some sensitivity analysis to test how sensitive the results are to changes in the estimates that have been made. For example, what happens if the estimates of revenue are lower or higher? Is there anything that can be done to lower the operating costs?

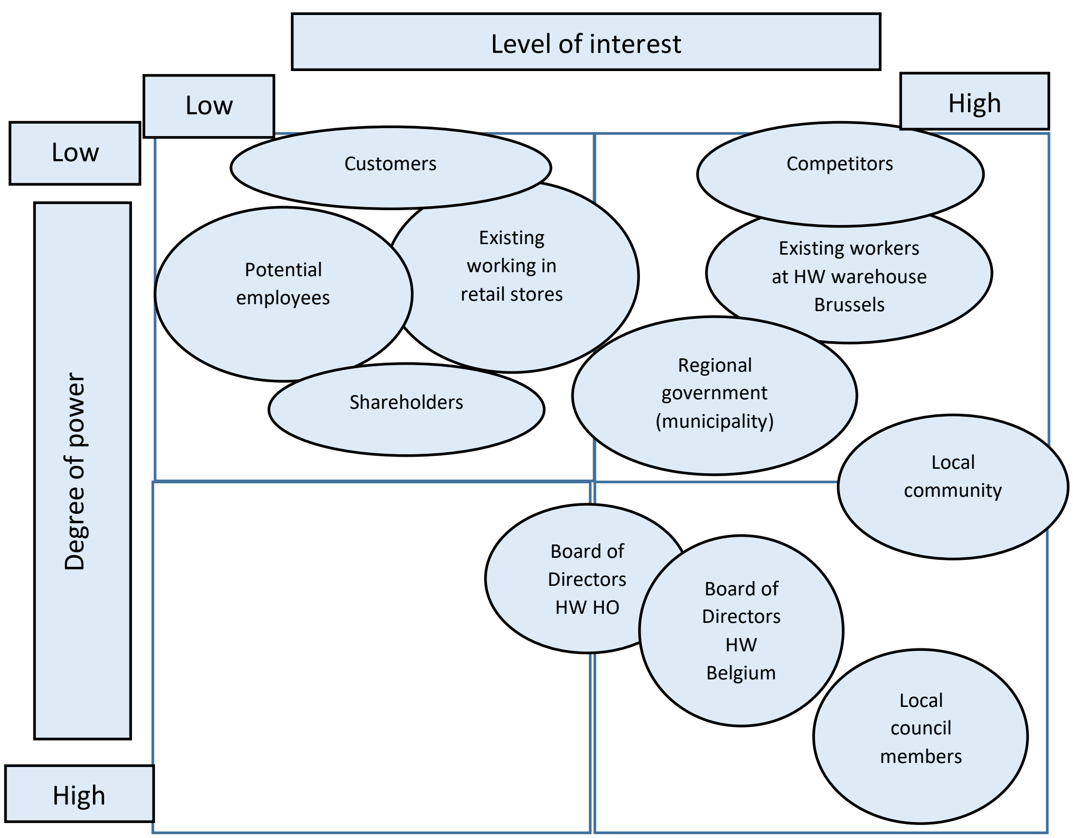
Do drivers' wages have to go up in line with inflation? Are 18 drivers and 20 workers needed from the first year if sales are expected to increase, or is the estimate when the depot is operating at full capacity?

Part (b)

Stakeholder analysis

Various stakeholder groups might have an impact on the decision to develop a depot at Herentals.

[Many possible stakeholders could be discussed. In strategic decisions a company may take into account a range of stakeholder views, even if they do not have a direct responsibility to the stakeholder group, however, the significance of the analysis is to identify the key stakeholders that the company needs to engage with to be able to implement their strategy. In some cases, the argument is subjective, and you may have a different viewpoint. This is true in real life where a consensus would be arrived at through discussion, and therefore being able to put your point of view across and argue your thinking is the key to questions such as this. Note how each stakeholder group identified below is discussed as to what their level of interest and power might be.]



HW Inc. Senior management team (C-suite)

Based on the structure of the company, it is possible that the C-suite members of HW Inc. would have the final say on whether the strategy was acceptable or not. Still, given their approach of allowing the local managers some autonomy, they may not have as much say as the local management team. They would have a relatively high degree of interest in how the managers at HW Belgium were managing the development of the location and have a high degree of power, being the main decision-making body. Still, they may not choose to exercise it, making it clear that the local managers at HW Belgium have the autonomy to make the decision.

The local management team at HW Belgium

It may be odd to include the local managers in the stakeholder analysis, as they are the body making the decision. It is the managers at HW Belgium who would be undertaking the stakeholder analysis; however, there could be differences of opinion between the members of the team, so it is worth including them in the analysis for completeness.

Existing workers at HW Belgium in the warehouse in Brussels

The workers would probably be very interested in the decision as it will have an impact on their work. Still, as HW Belgium employs them, they would probably have little power to stop the decision, unless they can act together to create collective power. It would be possible to split this stakeholder group into subgroups as the warehouse workers would probably not see much difference. However, the drivers are more against the decision, as they see a direct impact on their current work. However, based on Mintzberg's ideas of replacement and disruption, any power they hold would be short-term disruption, as in the long term, they could probably be replaced.

Local government (Council) in Herentals

The local government in Herentals is hugely interested as they see the potential for jobs but might also be cautious about supporting the proposal too eagerly, due to the local community concerns. It might be that some of the local council will have their re-election in mind and so be keen to keep the locals happy. One outcome might be that the proposal is granted but with restrictions placed on traffic flows. HW Inc. will need to assess whether any limits set on the operation of the site will impact on its efficiency. This puts the local council in a strong position of power over the viability of the site.

Regional government (municipality) in Belgium responsible for Herentals.

The Regional government appears to be supportive and is clearly interested, but as they support the proposal may not wish to exert too much power over the decision. It is not clear precisely how much power the municipality has over the local council. Still, it is suggested that they usually accept the local decisions – therefore, it could be argued that they have, or will exert, little power.

Local community close to the proposed site

The local community is concerned about increased traffic and any possible impact on their day to day lives. They have lobbied the local council, and with the forthcoming re-election of members, it puts it in an influential position - possibly more so that the regional government.

Employees in the existing retail stores in Aarschot and Antwerp who are serviced from the warehouse at Brussels

Depending on how involved they feel, it could be argued that so long as the retail store gets its products delivered as and when required, employees in the existing stores may not be too worried about where the products originate. In fact, it might even make their lives a bit easier if deliveries were made from a more local source, and we could assume that they would support the proposal if it improved efficiency; however, in reality, they probably have little influence over the final decision. Therefore, as we do not know much about how involved they are, we could treat them as low interest, low power.

Potential workers, for example, drivers and workers who could gain employment

There is very little that this group could do to influence the decision, and therefore they could be treated as low interest, low power.

Competitors

HW Belgium will need to bear in mind the potential reaction of competitors. They will be interested in what HW Belgium is planning (we could assume that they may spot the proposal lodged with the local council as this would be public knowledge). However, the competitors cannot directly influence HW Belgium in their decision, so they have little or no power.

Customers

Customers are probably not that interested in the decision and may not even be aware of the plans and certainly have no power. However, it could be argued that HW Belgium is considering customers as the rationale for the decision is to improve efficiency. Therefore, the customer experience is a factor that HW Belgium takes into account, but as a stakeholder group, they have very little influence.

Shareholders

When taken into account that HW Inc. is a large organization spanning six continents, the impact of a decision in Belgium is not likely to be of concern for the shareholders of the HW Inc. Shareholder influence is relative, and this could be viewed as a strategic decision for HW Belgium, but not that significant in terms of HW Inc.'s overall results. In fact, it is in line with the overall strategy of operating a hub and spoke logistics policy. If they are aware of the decision, shareholders may simply view this as just a case of implementing company policy.

Strategy to deal with stakeholder groups.

The key players are the stakeholder groups that HW Belgium needs to involve in the decision and convince them that it is a good idea. Key players include the local council members and the local community. It can have reputational impacts if bad publicity is generated, and the company must work with the local community, so it would be beneficial for HW Belgium to meet with local representatives to see if a compromise is possible. If the issue cannot be resolved, HW Belgium would be advised to look at alternative sites.

Those stakeholders falling within the high interest but low power category should be kept informed, and a communication strategy should be devised to ensure that they are fully informed of the implications of the decision.

There are no stakeholders placed within the low interest, high power category on the stakeholder map, but if there were any in this category, an intervention strategy of explaining the rationale behind the decision should be adopted. It could be argued that the main board of directors at HW Inc. are in this box and that the local management team has to put forward a business case for the new depot to gain the approval of the C-suite members. Still, it is not certain exactly how much autonomy the local managers are allowed.

Those stakeholders falling within the low interest and low power category should be monitored, but no specific strategy needs to be developed – they can receive minimal effort but cannot be ignored.

Chapter 8, Activity 17 – HW Inc. Investment appraisal

Investment appraisal

	1	2	3	4	5	6
	$	$	$	$	$	$
Capital items						
Fitting out of premises	(400)					
Investment in stock	(250)					
Tax deductible items						
Legal fees and agents' costs	(150)					
Annual rental of premises	(100)	(300)	(300)	(300)	(300)	(300)
Arrangement fee	(12)					
Commission fee	(1)	(3)	(3)	(3)	(3)	(3)
Recruitment and training	(50)					
Marketing costs	(200)					
Sales revenue		3,000	3,300	3,630	3,993	4,392
Cost of goods sold		(2,100)	(2,310)	(2,541)	(2,795)	(3,074)
Operating costs		(350)	(368)	(386)	(405)	(425)
Net cash flows	(1,163)	247	319	400	490	590
Tax paid		0	(21)	(160)	(196)	(236)
Net cash flows	(1,163)	247	298	240	294	354
Discount factor 6%	0.943	0.890	0.840	0.792	0.747	0.705
Discounted cash flow	(1,097)	220	250	190	220	250
Net present value						33
Tax deductible items in the first year		(513)				
Net operating cash for the year		247	319	400	490	590
Net operating cash for tax purposes		(266)	53	400	490	590

The project appears to breakeven over five years of operation. HW Inc. may wish to undertake some sensitivity analysis to see what the effect will be if estimates are incorrect. Strategically this may be a good investment, and as the cash flows are positive once trading begins, assuming that the management team is confident that the level of revenue can be achieved, it is worth proceeding.

Chapter 9, Activity 18 – HW Inc. Implementing strategic change, Beyond budgeting.

Briefing note: - Implementing beyond budget at HW Inc.

Beyond budgeting is a response to some of the criticisms of traditional budgeting.

Traditional budgeting is said to be time-consuming, resource-intensive, can restrict innovation, and is open to dysfunctional behavior.

Beyond budgeting is a system that attempts to provide flexibility to the planning process of target settings and performance management. Rather than setting a fixed budget target and reporting against the plan, beyond budgeting sets stretch targets that are aimed at continuous improvement. In other words, performance monitoring is looking at the improvement made over relative targets, in comparison to the performance of others, or previous years.

Performance can be measured against internal or external comparison, such as other business units or competitors and industry sector performance. It encourages competition, both between internal teams and external measures. It seeks to challenge employees to be better than an external target, or to make progress towards bettering the target.

The challenging work environment would not be attractive to everyone. Therefore the system attracts certain types of employees, those that are confident of their capabilities and relish in a challenge. It can be quite daunting if employees are concerned about the stretch targets and the competitive environment.

The decentralized structure of HW Inc. would lend itself to the implementation of beyond budgeting. One of the principles of beyond budgeting is to create autonomous profit centers so that employees feel they are running their own business. It could be done at the store level, country level, and continent level. The senior management team (C-suite) of HW Inc. would need to learn to monitor on an exception basis and to allow a high degree of autonomy of the business units. It means that they need to instill a strong sense of mission as the senior management team will lose an element of control. The C-suite would consign itself to looking at the big picture.

The reporting systems would need to be such that comparisons with other business units and external benchmarks can be reported. The performance management system would also need to be flexible so that reporting was always in line with the strategy.

The use of a balanced scorecard system might be helpful as the targets set can be designed to encourage improvement and initiatives allow for innovation.

Beyond budgeting is often associated with a rewards system that is ideally based on team or group performance. The use of group rewards can encourage ‘slackers,’ but it is suggested by proponents of beyond budgeting that group performance identifies slackers and that peer pressure avoids it becoming an issue. Rewards could be based on store performance.

As HW Inc. operates in six continents and various countries within those, it will be essential to consider any differences that might affect performance at any given time. For example, events may affect the performance of one country, such as a recession, or political situation, or even natural disasters, and therefore comparisons across countries and continents need to be done with care.

Training of the managers and employees would be required to implement beyond budgeting at HW Inc. so that they were able to operate within the new system. The collection of data for comparisons, both internally and externally, may require changes to the information systems currently employed.

It may be beneficial to implement it as a pilot in one country, but ideally, it would be a corporate-wide implementation. There may be teething problems as employees get used to the new system, and therefore, it would be advisable to ensure that the accounting team can provide extra support. As with any change, it will need a commitment from the top management team. The appointment of champions or change agents in each country would be a good way of providing support for the change in the system. It will essentially mean a shift in culture within the organization.

It should be noted that traditional methods of budgeting can be adopted that include stretch targets and that using a balanced scorecard approach complete with targets and initiatives, can help towards making improvements in performance. Techniques such as benchmarking can be used to identify enhancements and improvements to operations and hence performance, and competitor analysis can ensure that HW Inc. is always aware of the relative performance.

The chief benefit of beyond budgeting, however, is that it incorporates these elements in a continuous system that seeks continuous improvement towards challenging targets.

Chapter 10, Activity 19 – HW Inc. Balanced scorecard

Part (a)

The balanced scorecard is designed to enable management to translate the organization's vision and mission into a set of objectives and performance measures that will help them achieve the overall mission. It may be particularly useful for HW Inc. at this time as management will be able to take a fresh look at the business in developing a scorecard that will help turn the company around into a profitable business again.

The four perspectives represent the financial perspective, customer perspective, internal business perspective, and the learning and growth perspective. The idea is that management can develop a range of objectives and performance measures, which means they measure more than just financial performance. If management only uses financial ratios to monitor the business, it can encourage a short-term approach, but including internal and external, financial and non-financial, quantitative and qualitative, and leading as well as lagging performance indicators encourages a long-term approach. It can also enable the management to ensure that they are addressing the expectations of a range of different stakeholders, for example, shareholders, debt providers, customers, employees, suppliers, and so on.

Each perspective has four elements: the objective, the target, the measure, and the initiative. The initiative will enable the management of HW Inc. to review whether there is anything that they could do differently to improve the business rather than just rolling the objective and measures over from year to year. This could be a useful exercise for the management of HW Inc., given the need to improve performance. Benchmarking exercises can often be used to aid the development of initiatives to help achieve the objectives.

The linkage between the perspectives also enables management to gain an understanding over time of how performance measures link together, for example, improving productivity and quality controls via staff training initiatives will impact on customer satisfaction and hence improve profits. The linkages between measures are usually shown in a strategy map and are there to help management ensure that all measures aid the achievement of the overall vision and mission. It can also be used as a means of communicating the strategy to the employees of HW Inc.

HW Inc. would ideally have a series of balanced scorecards at different levels that would link together. For example, they could have one at the level of the business unit, that is, store, manufacturing unit, country, continent, and whole corporate entity. The scorecards can be tailored specifically to suit HW Inc. This enables levels of management to focus on their area of responsibility and means that the senior management does not have to monitor everything in detail, as aspects of the business are being dealt with at different levels. The concept of critical success factors can be used to ensure that management focuses on the key activities that ensure the survival of the business.

There are, however, some difficulties that can arise when implementing a balanced scorecard approach. For example, if there are too many measures, management can get confused about where to focus their attention. It is not always possible to establish clear links between measures as sometimes one measure may have multiple impacts. For example, developing new product lines as a learning and growth measure can impact on production aspects, customer satisfaction, and the finances of the company due to the resources required to develop new products. Therefore, the reason as to why performance targets have been achieved, or not, is not always evident, making it difficult for management to determine the correct course of action to correct any adverse variance. Some measures, such as customer satisfaction and employee morale, can be quite tricky to measure as they are both qualitative and subjective, and as mentioned earlier, can be influenced by a range of different elements.

There is always the behavioral displacement aspect of performance measurement that can impact on the implementation of a balanced scorecard. For those employees and managers not used to being monitored, it requires support and training while it is being implemented. Another danger can be that managers focus on trying to meet the targets they deem to be important and take short term decisions to meet a few targets, rather than taking a long-term view in running the business.

The balanced scorecard is also meant to be used as a developmental tool, that is, for measures to be changed and developed as the business grows. Unfortunately, many organizations have left the measures unchanged from year to year and not found the scorecard approach helpful.

Therefore, the management of HW Inc. needs to ensure that they develop measures to suit the business. For example, if they expand into new areas of business such as insurance in the Financial Services business unit, or corporate clients in the Interior Design business, there may be new aspects of the business that require careful monitoring.

The balanced scorecard could provide a useful tool for the management of HW Inc. to refocus its strategy and to communicate this to employees so that they all move in the same direction to help improve performance.

Part (b)

[*The trick with the performance measures is to keep it as simple as possible. The common mistake is to try and make it far too complicated. For example, if you wanted to try and increase the number of customers, the measure is simple to count the number of customers. If the number of customers is higher than last year, then it has increased. Often students try and make a link that is not necessary. For example, for an objective to increase the number of customers, a measure of the increase in sales might be suggested. However, this measures sales value and not the number of customers. An increase in sales value could be achieved by the same number of customers buying more, therefore the sales value increases, not the number of customers. So, think carefully about what it is you are measuring.*

Try and think of one objective and measure under each of the four perspectives for each business activity. Initiatives can be anything that might help meet the objective, so you can think creatively here. You do not need one per objective, as often initiatives might help a range of measures within a perspective. For example, introducing a customer loyalty scheme might help increase sales, as well as attracting new customers.]

The following are examples and do not constitute the only correct answer. Note how sometimes the objectives and initiatives are complementary across the different areas of the business and how they work together as they are part of the same overall business.

<table>
<tr><th>Objective</th><th>Measure</th><th>Initiative</th></tr>
<tr><td colspan="3">Retail Stores</td></tr>
<tr><td>Financial perspective
To increase sales per square foot</td><td>Difference in sales per square foot in the year compared to the previous year</td><td rowspan="2">Hire a specialist consulting firm to review store layout to facilitate the flow of customers and display of products to enhance sales volumes.</td></tr>
<tr><td>To increase average profit per retail outlet</td><td>Difference in average profit/(loss) of retail outlets in the year compared to the previous year</td></tr>
</table>

Customer perspective Increase the footfall and conversion rate for in-store purchases	Difference in footfall and conversion rate this year compared to the previous year	Hire a specialist to review advertising, particularly window displays to attract customers—link to store layout review above.
Increase repeat customers	Number of repeat uses of store card or credit card number this year compared to the previous year	Marketing of store card coupled with more targeted mail shot marketing, including tailored offers to existing customers where an address is known.
Increase customer satisfaction score	Customer satisfaction score based on a survey	Undertake customer surveys or install polling points at checkouts in stores.
Internal business perspective Reduce average inventory holding time.	Difference in inventory turnover this year compared to the previous year	Ensure all staff trained in the new inventory management system to enhance understanding of report outputs from the system and actions to take.
To increase the use of concessions in store	Number of concession operators this year compared to the previous year	Encourage concessions in-store by offering incentives to operators during the 1st year of operation.
Learning and Growth perspective To develop and launch five new product ranges in household furniture (to build on strong market position)	Number of new products launched in the year that achieved a breakeven sales volume	Conduct marketing research to identify customer preferences in household furniture.
To open stores in out-of-town shopping villages in three countries	Number of new stores in shopping villages opened during the year and in which countries	Undertake marketing research to identify suitable countries for shopping village outlets.
Objective	**Measure**	**Initiative**
Interior Design		

Financial To maintain profit margins from existing business	Gross margin this year compared to the previous year	
To increase sales revenue generated from the corporate sector	Sales from the corporate sector this year compared to the previous year	Target marketing campaign at corporate clients.
Customer To increase the number of corporate clients	Number of corporate clients this year compared to last year	
To increase customer satisfaction levels	Increased in customer satisfaction index over the previous year	Undertake customer survey.
Internal business To increase the number of orders satisfied using HW manufactured products	Number of orders where HW manufactured products are used compared to the previous year	Work with HW R & D to improve HW manufactured product range based on customer feedback and knowledge of other manufacturers' products.
Reduce lead time from order to installation of kitchen design (popular re-design)	Time from order to completed installation compared to the previous year	Undertake a benchmarking exercise, either internal between different countries, or find a suitable external partner willing to participate.
Learning and growth Recruit and train new interior designers with experience of the corporate sector	Number of new employees recruited	Establish a training program to familiarize staff with the requirements of corporate clients.
Gain at least one new client in the education sector as a starting point	Number of clients in the education sector	Target marketing to education sector institutions.
Objective	**Measure**	**Initiative**
Financial Services		
Financial		

Increase revenue generated from insurance products	Sales revenue generated from insurance products compared to the previous year	Target marketing to insurance products.
Reduce administration costs	Administration costs compared to the previous year (are they less and by how much)	Undertake benchmarking or review of administration processes.
Internal Business Reduce process times for opening credit card account or insurance policy approval	 Time taken to open a credit card account, approve insurance policy compared to the previous year	 Undertake benchmarking or review of administration processes or undertake additional training.
Reduce time to deal with insurance claims on HW purchased goods successfully	Time taken from notification of the claim to successful resolution compared to the previous year	Undertake a benchmarking exercise.
Customer Increase number of credit card customers	 Number of credit card customers compared to the previous year	 Marketing campaign, free transfer of balance, 0% interest rate offer, etc.
Increase the number of insurance customers	Number of insurance customers compared to the previous year	Marketing campaign.
Learning and growth Increase number of staff qualified in financial services with knowledge of the insurance market	 Number of staff recruited with relevant experience compared to the previous year	 Recruitment campaign.
Increase the number of insurance products offered to customers	Number of new insurance products within the product portfolio compared to the previous year	Engage with a consultant firm to research the most popular insurance products and develop competitive offerings to market.
Objective	**Measure**	**Initiative**
Product development and manufacturing		
Financial		

Reduce the cost of product development	Product development costs compared to the previous year	Work with the R & D team to undertake a benchmarking exercise to reduce product development time and hence costs.
Reduce the cost of materials	Cost of materials compared to previous years	Work closely with suppliers to reduce material content or costs.
Customer Maintain the sales revenue of HW manufactured products in HW stores	Revenue from HW manufactured products compared to the previous year	Work with HW retail stores to promote HW branded products.
Increase sales volumes of products to Interior Design customers	Number of products sold to Interior Design customers compared to the previous year	Work with the Interior Design team to promote HW products – maybe with financial incentives by working with HW Financial Services.
Internal business Reduce energy usage and wastage	Energy usage and wastage rates compared to previous years	Undertake energy audit and waste management study.
Reduce the length of the new product development cycle	Length of the new product development cycle compared to the previous year	Undertake a review of new PD cycle – perhaps with help from consultant firm.
Reduce the level of inventory and turnover	Inventory level and turnover compared to the previous year	Undertake a review of the inventory management system.
Learning and growth Develop new products with Interior Design suitable for corporate and education sector clients	Number of new products developed targeted at corporate and education sector clients	Work with Interior Design team and R & D to develop new products.
Identify sustainable material supplies suitable for furniture products.	Number of new supply sources of sustainable materials.	Research sustainable materials suppliers.

Chapter 10, Activity 20 – HW Inc. Critical success factors and performance management

Part (a)

Critical success factors include:

- Store location
- Relationship of footfall to passing trade and conversion from footfall to the point of purchase.
- Economies of scale and operation
- Good links with suppliers and inventory management
- Store layout and ambiance

Part (b)

Measures provided plus additional calculations

	HW Bournemouth	**HW Newcastle**	**Competitor Manchester**
Customer satisfaction score out of 10	7.8	6.7	8
Passing trade – average number of people entering the shopping center per day	10,000	15,000	20,000
Footfall – average number of people entering the store per day	1,500	2,000	4,000
Point of purchase – average number of purchases made in-store per day	400	450	1,000
Conversion rate – point of purchase as a percentage of footfall	26.70%	22.50%	25.00%
Annual sales from store £m	8.76	8	9.7
Annual cost of goods sold from store £m	6.12	5.92	6.79
Average value of click and collect sales per annum included in total sales £m	0.087	0.16	0.388
Closing inventory value at the end of last financial year £m	1.04	1.776	1.058
Number of employees in the store	292	316	275
Square foot of retail space in store	40,000	45,000	50,000
Average number of product ranges stocked in store	25,000	26,000	15,000
Annual cost of wages for store staff £m	4.38	4.538	3.947

Opening hours of store	9:00 - 17:00 Mon – Sat 10:00 – 16:00 Sun	9:00 – 17:30 Mon - Sun	8:30 – 18:00 Mon – Sun
Annual rental cost of property £m	10	9	10.5
Unemployment rate in the region	1.80%	8.10%	7.40%
Population growth in the region p.a.	1.60%	2%	3.20%
Percentage of population of working age in the town	62.6%	68.50%	66.0%
Average annual income of population in the region	£24,300	£20,862	£21,623
Average family household size	2.18	2.4	2.35
Extra calculations that can be made based on data provided			
Conversion rate – point of purchase as a percentage of footfall	26.7%	22.5%	25.0%
Footfall as a percentage of passing trade	15%	13%	20%
Average sale value per point of purchase £	60	49	27
Gross margin percentage of sales	30%	26%	30%
Percentage of sales as click and collect	1.0%	2.0%	4.0%
Inventory turnover based on the cost of sales	62	110	57
Average sales per employee £m	0.03	0.025	0.035
Average sales per square foot £	219	178	194
Average gross margin per square foot £	66	46	58
Average annual wage per staff member £	15,000	14,361	14,353

The comparisons between the Bournemouth store and the Newcastle store needs to be reviewed with the fact in mind that they are in different parts of the country with different economic indicators and potentially different demographics. While the comparison is useful in terms of operational indicators, as this could be used to help improve the operations of the northern store, the external influences on performance cannot be ignored. For example, the inventory turnover is much faster (that is, held for fewer days) in the Bournemouth store than Newcastle, but the product range could influence this, for example, the mix of clothing, home and garden, and electricals.

It is also interesting that the average sales per square foot and gross margin are higher in Bournemouth than Newcastle, which could be due to store layout. This might also impact on the conversion rate of footfall into purchases being higher. However, factors that might influence this are the average family size and average income levels, as well average age of the population, which could also influence the mix of products being purchased. Other factors to consider are that the Bournemouth store is 5,000 square feet smaller than Newcastle and stocks 1,000 fewer product ranges, which could impact on the differences in the recorded performance.

The opening hours are also slightly different. Employee numbers vary with the Bournemouth store paying slightly more on average, which may be due to local economic factors, but the sales per employee are higher, even though they are open for slightly fewer hours than Newcastle. Researching the product ranges and demographics of the customers could shed more light on this before any decisions are taken to change the operation of Newcastle. Also, the customer satisfaction levels appear to be lower in Newcastle, and further investigation as to what is causing this would be useful, for example, is it store layout, helpfulness of staff, opening hours, or other factors, that are causing the difference.

Newcastle is performing poorly compared to the major competitor. Even though they are both in the north, the economic conditions between Newcastle and Manchester still need to be considered. For example, the population growth rate is slightly higher in Manchester, as is the average income level. The Manchester competitor is open for longer, which may be an option that HW Newcastle could explore, but this will, of course, need to be resourced, which will increase wages. Therefore, the increased opening hours will need to generate enough sales to cover the cost of the additional wages, plus any additional costs.

The Manchester competitor also stocks far fewer product ranges and has a faster stock turnover. They also have more “click and collect” sales and have a higher conversion rate, both in terms of point of purchase to footfall and passing trade. Investigating the store layout and window displays to understand what is drawing in the customer into the store could be useful. One aspect that could impact this is the actual location of the competitor store in relation to other amenities and stores in the centers at Manchester, for example, being close to toilet facilities or entrance and exit to car parking, lifts, and so on, can often increase passing trade. This could be worth investigating for other centers where HW Inc. might operate. Developing a good relationship with Intu could be beneficial in the long run.

However, taking the point of purchase of sales per day and grossing this up to an annual figure we find that the average value of a sale in the competitor Manchester store is £27 compared to HW Newcastle of £49, and HW Bournemouth, £60, which raises the question as to the competitive strategy and target customer demographic of the competitor Manchester store, and hence whether it is a valid comparison. The store layout would be interesting to investigate in more detail as the store is more extensive than HW Newcastle and has fewer product ranges, so exploring how the sales space is used to generate sales could provide some useful information, even if a different demographic and competitive strategy is being followed.

The Newcastle store could investigate the customer satisfaction level as this might increase sales and conversion rates. Also, research could be undertaken to find out whether customers would prefer longer opening hours, bearing in mind the associated costs of opening for longer. Inventory stock management is an area where HW Inc. is supposed to have improved its management systems, but HW Newcastle is less efficient than the Bournemouth store and the competition in this respect. Also, store layout might be worth looking into to see if improvements could be made to engage the customer more and increase conversion rates.

Chapter 10, Activity 21 – HW Inc. evaluation of EVA^{TM}

Part (a)

Economic Value Added was developed by a firm of consultants *(Stern Stewart)* as a means of measuring company performance and linked to executive pay and rewards. The economic value is the net operating profit after tax from which a deduction is made for the use of capital in the form of a capital charge, based on the weighted average cost of capital, to arrive at the economic value. It is an absolute value, that is, a number rather than a percentage, and therefore if used as an investment appraisal method would encourage managers to undertake an investment if it increased the economic value added. In this way, it is said to be a good measure to use as it encourages managers to make decisions based on the interests of the shareholders and the company.

The firm of consultants recommended that adjustments should be made to the financial accounting profit to derive an adjusted net operating profit. The typical adjustments include adding back non-cash items and accounting adjustments, such as depreciation. This is to arrive at a figure that is closer to cash generated – hence its use as an investment appraisal technique. Other typical adjustments include research and development, marketing, and training. The underlying justification for adjusting these items is that they are an investment in generating future revenue streams rather than a charge against profits in the year in which they are incurred. An adjustment is made to treat them as investments and therefore added to the balance sheet to be written off over the period for which they are deemed to be generating revenue and, hopefully, profits. For example, a new product developed by HW Inc. may generate profits over three years, and therefore, the product development costs should also be written off over the same period.

As mentioned above a key benefit of EVA^{TM} is that the basic principle is similar to that of Residual Income and the NPV principle, in that it reduces the potential for dysfunctional behavior based on past results, for example, undertaking a project reducing the average ROI, whereas EVA^{TM} will encourage managers to undertake the project if it increases the absolute value of EVA^{TM}.

EVA^{TM} is said to have several uses that may be of interest to HW Inc. For example, it can be used to set organizational goals and, therefore, could feature as a performance measure and target on the balanced scorecard. It can also be used to determine bonuses at a divisional and whole organizational level and could be a way of motivating managers to increase economic value. It can also be used to value companies and determine equity investments, but these are of less use to HW Inc. now.

Other benefits are that it introduces an element of accountability to divisional managers for investment decisions that benefit the company in the long term. This may be useful to HW Inc. as it will encourage managers to think about the long-term issues rather than attempting a short-term fix. It also makes managers think along the lines of shareholders in terms of adding value to the business.

However, as with most techniques, there are some issues that HW Inc. needs to be aware of if thinking of using EVA™ as a performance measure. It is complex and can require the collection of data that is not usually collected within the accounting system. Managers who do not have a financial background can also find it challenging to understand. Therefore there will be a requirement for training and support at all levels in the organization.

As it is a single measure, it can be dangerous to focus on value-added, so it needs using as part of a balanced scorecard approach to performance management.

There is also a high degree of subjectivity in estimating the length of time that items such as research and development, marketing, and training continue to generate revenue streams and, therefore, the period over which they should be written off. In fact, the adjustments only make a difference to EVA™ in the long run in periods when research and development, marketing and training are increasing, or reducing, year on year. Otherwise, the net effect is simply to spread the costs over a more extended period, and it becomes an issue of accounting timing rather than a management issue. In which case, the tendency is for managers to ignore the measure.

However, a focus on value could be beneficial for HW Inc. now, given its recent poor performance and used in conjunction with other measures could help to revitalize the company over the next few years. Other techniques, such as the value chain analysis, could be used to help the management of HW Inc. identify where the real value could be added.

Part (b)

The method adopted is to add back the items for adjustment in full and then write off the appropriate value to the profit and loss account with the net amount of the adjustment shown in the balance sheet.

	2018		2019		2020	
	Products	Interior Design	Products	Interior Design	Products	Interior Design
	£m	£m	£m	£m	£m	£m
Profit before interest and taxation	188.4	332.5	278.0	274.4	(91.5)	317.6
Add back depreciation	160.3	57.3	144.2	51.5	91.0	32.5
Add back R & D 2018	247.9	144.6				
Write off 1/3 2018	(82.6)	(48.2)				
Write off 1/3 2019			(82.6)	(48.2)		
Write off balance 2020					(82.7)	(48.2)
Add back R & D 2019			147.2	85.9		
Write off 1/3 2019			(49.1)	(28.6)		
Write off 1/3 2020					(49.1)	(28.6)
Add back 2020					154.3	90.0
Write off 1/3 2020					(51.4)	(30.0)
Add back marketing 2018	322.8	271.8				
Write off 1/2 marketing 2018	(161.4)	(135.9)				
Write off 1/2 marketing 2018			(161.4)	(135.9)		
Add back marketing 2019			234.8	177.7		
Write off 1/2 marketing 2019			(117.4)	(88.9)		
Write off 1/2 marketing 2019					(117.4)	(88.8)
Add back marketing 2020					222.3	158.8
Write off 1/2 marketing 2020					(111.2)	(79.4)
Training - no adjustment required						
Net operating profit	675.4	622.1	393.7	287.9	(35.7)	323.9
Less taxation paid	(45.0)	(79.4)	(67.6)	(66.7)	(5.4)	(67.4)
Net operating profit after tax	630.4	542.7	326.1	221.2	(41.1)	256.5
Capital charge	(588.2)	(232.4)	(603.2)	(236.5)	(624.0)	(243.9)
Economic value added	42.2	310.3	(277.1)	(15.3)	(665.1)	12.6

Balance sheet provided to calculate the capital charge.

	2018		2019		2020	
	Products $m	Interior Design $m	Products $m	Interior Design $m	Products $m	Interior Design $m
Net assets	9,316.1	3,583.1	9,611.2	3,696.6	10,046.4	3,864.0
Add back depreciation	160.3	57.3	144.2	51.5	91.0	32.5
Research and Development 2018	165.3	96.4				
R & D balance of 2018			82.7	48.2		
Research and Development 2019			98.1	57.3		
R & D balance of 2019					49.0	28.7
Research and Development 2020					102.9	60.0
Marketing 2018 - balance	161.4	135.9				
Marketing 2019 balance			117.4	88.8		
Marketing 2020 balance					111.1	79.4
Training - no adjustment required						
Net operating assets	9,803.1	3,872.7	10,053.6	3,942.4	10,400.4	4,064.6
Capital change at 6% of net assets	588.2	232.4	603.2	236.5	624.0	243.9

Part (c)

Comments

The first point to make is that 2018 can be largely ignored. As the adjustments have been made beginning in that year, the figures are therefore distorted as the costs that would be coming through from previous years for R & D and Marketing are not shown. This accounts for the significant increase in profit shown in 2018 under the EVA calculation. Ideally, we would need to restate these years by adjusting for previous years. The analysis becomes more relevant as the years progress, and by the time we get to 2020, we can see the full effect of the adjustments. The R & D and marketing adjustments merely shift expenditure between the years and will only have a significant impact on EVA™ in the long run if expenditure on these items increases or decreases. Where this becomes more useful is when making comparisons between different companies, or perhaps in the case of HW, if a comparison of EVA™ was made at the subsidiary level. The different levels of investment in R & D and Marketing would then become more apparent if one subsidiary were investing heavily in marketing compared to another, that is, it could be said that one subsidiary was investing in the future to generate future revenues, compared to the one that was merely seeking to maintain sales.

The overall impact is that the company is, in fact, destroying shareholder value rather than generating it. The Products side of the business performing much worse than the original profit and loss account shows, but what is perhaps more interesting is that the Interior Design is not doing as well as first thought. The product range is hit quite hard by R & D, and marketing and the allocation of these costs might require more investigation, but the analysis gives management some ideas as to where value might be added.

While the figures are interesting and provide some insight into the effect of the investments in marketing and R & D, it is dangerous to read too much into the figures at this stage. What it does show is that the company is finding it difficult to generate returns that cover the cost of capital as before the charge for capital costs, only the Products part of the business is generating a loss. The net assets allocated to the Interior Design business seem to be high compared to the products section of the business, and more information might be useful as to how this figure is derived. Also, the taxation figure appears to be high compared to other parts of the business, but this could be due to taxation allowances received by the products division (which presumably includes the manufacturing business), reducing the tax charge allocated to products.

Chapter 10, Activity 22 – HW Inc. Transfer pricing

Part (a)

Calculate each transfer price described in the scenario.

Factory Offer		$
	Normal selling price	240.00
	Less: variable selling and distribution costs Sales force salaries are fixed so VC = carriage $400,000/100,000	4.00
	Adjusted selling price	236.00
Interior Design Offer	Standard variable (direct) manufacturing costs (7,200 + 4,600 + 800) $12,600,000/100,000	126.00
	Variable manufacturing overheads $200,000/100,000	2.00
	Variable manufacturing costs	128.00
	PLUS 20% profit margin	25.60
	Variable manufacturing costs plus mark-up	153.60

Op Directors suggestion	Full manufacturing cost plus 15% based on 100,000 units $1,760,000/100,000	176.00
	Plus 15%	26.40
		202.40
	Full manufacturing cost at full capacity of 120,000 which could also be used to arrive at the fixed costs	
	Variable costs $12,800,000/100,000	128.00
	Fixed overheads 600 + 3,000 + 1,200 = $4,800,000/120,000	40.00
		168.00
	Plus 15%	25.20
		193.20

Part (b)

Where there is spare capacity, the only extra cost to the Factory of producing and selling one additional unit is the variable manufacturing costs. Therefore, the Factory would be willing to supply at anything over the variable manufacturing cost; that is, below this, they would lose money from selling to the Interior Design business. However, it would be good for the Factory to make a profit on their sale for motivational purposes.

The Interior Design Business (ignoring issues of quality for the moment) would not wish to pay more for the product than they could obtain an alternative product for in the external market, that is, $180. As the Factory product is of better quality, then the Interior Design business should be willing to pay up to at least the external alternative as it is getting a better product for less money.

When there is spare capacity, the transfer price could be negotiated between $128.00 and $180.00.

Part (c)

When there is no spare capacity, the situation changes for the Factory, as to sell a product to the Interior Design business means it cannot make an external sale. It loses the contribution on that sale (note we say contribution as it will still incur the fixed costs, whether it sells a product or not, so when it sells a product, it is contributing to fixed costs and profit).

This is where the opportunity cost becomes useful. The opportunity cost is the benefit foregone from the next best alternative course of action.

In the first instance where there is spare capacity, we could say that the next best alternative is not to produce a product at all, in which case the Factory saves the marginal or variable costs of manufacturing, i.e., $128.00. Therefore, this is the opportunity cost of producing the extra unit. However, when the external sale is made, the Factory incurs the variable cost of manufacturing and makes a contribution, so if the chance of an external sale is lost by selling to the Interior Design business, HW Inc. actually loses the contribution as well. Therefore, the contribution lost in this instance when there is no spare capacity is the selling price less the variable manufacturing costs ($240.00 - $126.00 - $2.00) $112.00. Therefore, the opportunity cost of producing one extra unit and selling to the Interior Design business is the variable manufacturing cost plus lost contribution. $128.00 + $112 = $240. (Note that this could be adjusted by the distribution costs not incurred which would leave us with the adjusted selling price).

The key point is that if we use the opportunity cost of $240 as the transfer price, then this deters the Interior Design business from buying from the Factory which is the right decision from HW Inc.'s position as if an external sale is lost, the company as a whole loses money. This is the basis of a contention that if the opportunity cost is used, the correct decision is always made for the benefit of the company.

The obvious decision to follow up with is whether it is worth investing to increase the capacity of the Factory, which is a different but related decision.

Chapter 10, Activity 23 – HW Inc. Benchmarking

Part (a)

Benchmarking is a means of comparing the performance of an organization (or individual or subgroup) with another with the aim of learning and making improvements. It is important to note that it is not just a copying exercise as the context in which the improvements are being implemented need to be taken in to account. For example, if HW Inc. benchmarked against a competitor that was much smaller (or larger) than HW Inc., the relative size of organizations may mean that economies of scale are a significant factor. The smaller competitor will not enjoy the economies of scale that HW Inc. can use, or conversely, that a larger competitor achieves benefits from economies of scale that HW Inc. cannot hope to emulate. Therefore, a meaningful comparator needs to be found.

One of the key advantages of benchmarking is that it can aid in setting aspirational targets that are linked to strategy, particularly if used as part of the initiatives within the balanced scorecard. This could be important for HW Inc. at this time due to its poor performance in recent years. It can also encourage innovation, something that HW Inc. might be able to use to improve its relative competitive position. It can also help to motivate employees via the use of targets but also because benchmarking involves all employees. It is not a process that is undertaken in isolation but should be inclusive and engages employees at all levels.

There are difficulties, however, that HW Inc. needs to be aware of when undertaking benchmarking exercises. If targets are set and continuously missed, it can have the opposite effect of motivating employees but can demotivate them. Also under certain forms of benchmarking, for example, competitor benchmarking, there is a danger of disclosing confidential or commercially sensitive information in an effort to gain some benefit from the exercise, that is, there may be a temptation to reveal too much information. The danger of just copying what others do is also a temptation without taking the time to assess how best to implement an improvement in HW Inc.'s particular context, that is, management get focused on the benchmark itself rather than learning from what they have found. It could also mean that HW Inc. becomes like other companies in the high street and loses that extra element that sets it apart from the competition. It also assumes that suitable partners can be found with which to benchmark.

However, used correctly, benchmarking can be a particularly useful tool for improving the operations and performance of a business.

Part (b)

There are many classifications under which benchmarking is considered. These include internal and external, formal and informal, as well as others. The typical types of benchmarking that might be appropriate for HW Inc. are as follows:

- Internal – comparing one operating unit or function with another in the same company, for example, one retail outlet against another, or one production unit against another. It is, however, essential to be aware that outlets in different parts of the country, or indeed countries themselves, may be affected by different factors within their local context, although the operations may be the same.
- Functional / activity – internal functions are compared with the best external practitioners regardless of industry, for example, inventory control with a supermarket, or website navigation with organizations that are in the business of providing information and advice online.
- Competitor – with direct competitors, including reverse engineering techniques, that is, direct competitors of HW Inc., but again we need to be careful that it is a meaningful comparison. This tends to be appropriate for aspects that can be benchmarked via publicly available data, for example, product ranges, prices, and so on.
- Strategic – aimed at strategic action and organizational change, for example, launching a new product range, or product development. Even benchmarking against companies that have successfully turned around a loss-making position to one of profitability could be a possibility for HW Inc.
- Industry – there may be some industry standards that can be used, for example, general statistics on footfall, conversion rates, and staffing levels in the retailing sector.

Part (c)

There is no one definitive process for benchmarking, but a typical series of stages that HW Inc. could follow is outlined below:

1. Establish benchmarking objectives – it is essential to have a clear idea of what it is HW Inc. wishes to achieve and what aspects of the business they are benchmarking.
2. Establish a mixed skills benchmarking team – benchmarking is inclusive and is not undertaken just by accountants. A team of people with a mix of skills and knowledge of the specific area is usually required. This also facilitates a sharing of knowledge and understanding within the company.
3. Develop relevant KPIs – the performance indicators must be developed before collecting data as this determines what data is required. It is also important to recognize that the data must be available from both parties if benchmarking with another organization.
4. Choose an organization or business unit against which to benchmark – choosing an appropriate benchmarking partner is essential as the benchmark must be meaningful and one from which HW Inc. can learn. Also, if external, the partner will wish to learn from the exercise as well, that is, mutual benefit – this process can take time to find a suitable partner.
5. Measure own and partner’s performance – the obvious stage of measuring the performance of both parties on a comparable basis.
6. Analyze data & discuss results – once collected, the data needs to be analyzed. It should also be recognized that the reason why there are differences in performance needs to be discussed as this may not always be apparent; that is, HW Inc. needs to understand the “why” behind the difference.
7. Implement change – any improvements that could be made need to be implemented, which brings into play change management issues as employees need to be included in the process.
8. Monitor improvements – the impact of changes needs to be monitored, and often this is not immediately apparent as to why performance has or has not improved, particularly if several things have been changed as there may not be a direct link.
9. Publish success – an important step often overlooked is to publish the success of the exercise as this can act as a motivating factor for employees.

Part (d)

Benchmarking can also be used as a means of developing new initiatives that can be implemented as part of a balanced scorecard approach to performance management. Also, in relation to competitors, it can aid the determination of strengths and weaknesses as part of the corporate appraisal or SWOT analysis. Therefore the process and outputs of benchmarking exercises can be used in conjunction with other techniques to aid the development of strategy and the achievement of objectives.

Value creation activities can be benchmarked to identify critical activities in the industry, or sources of strengths and weakness, as mentioned above. Costs of quality is another area where benchmarking is particularly useful, as well as in target costing as a means of making improvements to processes or functionality, design, and so on, to meet the target cost.

Chapter 10, Activity 24 – HW Inc. Divisional performance

Looking at this from the viewpoint of HW INC.

Part (a)

- Decisions should be made based on NPV calculations.
- In this case, there is an Rp90,000m initial investment and an Rp31,500m net cash flow (150,000 - 118,500)
- As the cash flow is the same amount per year, we can use the cumulative discount factor

<u>NPV Calculation:</u>

- Rate - 7 Years at 10% = 4.868
- -90,000 + [(150,000-118,500) x 4.868] = Rp63,342m

Therefore, the decision would be that this project is one that HW Inc. should pursue.

Note that we have used the Rp90,000m (assumed to be incurred in year 0), essentially ignoring the initial development costs as these are sunk costs, and for NPV, we are concerned with future cash flows. Whatever happens, HW Inc. will not get the Rp30,000m initial costs back. However, when undertaking RoI calculations, we would include the total investment as we are interested in the return on total investment rather than the timing of future cash flows.

However, if you take the viewpoint of the Indonesian division, the head office wants them to reimburse the initial development costs.

Looking at this from the viewpoint of the Indonesian division

<u>NPV Calculation:</u>

- Rate - 7 Years at 10% = 4.868
- -120,000 + [(150,000-118,500) x 4.868] = Rp33,342m

We can see that it is still a positive number, but it highlights a difficulty where two parts of the business see the decision as being something slightly different. Therefore, care needs to be taken when reviewing divisional performance, and if you work for a head office, always take into account how the division might view the proposed project, as they might take a different viewpoint. It also highlights the significance of who bears the costs in joint developments with head office as this can influence decision making in surprising ways.

Part (b)

Return on investment

	Current	New Project	Combined
	Rp,m	Rp,m	Rp,m
Sales	540,000	150,000	690,000
Less			
Cash operating expenses	400,000	118,500	518,500
Depreciation	41,000	17,143	58,143
Divisional profit	99,000	14,357	113,357
Return on investment	99,000/450,000 x 100 = 22%	14,357/120,000 x 100 = 12%	113,357/570,000 x 100=20%

Note depreciation of new project/ (90,000 + 30,000)/7 = 17,143

We know the organization should want to take this project forward, but the manager would refuse to do this if they are judged on ROI. So, using Residual Income

	Current	New Project	Combined
	Rp,m	Rp,m	Rp,m
Divisional profit from above	99,000	14,357	113,357
Capital charge at 10% of capital employed	-45,000	-12,000	-57,000
Residual income	54,000	2,357	56,357

Capital charge is calculated as:

Capital charge at 10% of capital employed	450,000 x 10% = -45,000	120,000 x 10% = -12,000	570,000 x 10% = -57,000

Part (c)

Under the RoI method, the divisional management may view the project as reducing their overall average RoI and hence not be that motivated to undertake the project, even though it is yielding a percentage return above that required by the head office.

The Residual Income method increases the residual income and, therefore, would encourage the division to undertake the project. Thus, the RI is a preferable method. It is similar in a way to the NPV calculation in that it produces an absolute value. Therefore if it is positive, it encourages acceptance, whereas if negative, it discourages acceptance. There may be instances when a project with a negative NPV is strategically advantageous to undertake, but the principle is the same.

However, a difficulty is in establishing the cost of capital, as with the NPV, if a higher cost of capital is used in the calculation, it will reduce the resultant value of the RI or NPV. We could also argue that the depreciation rate chosen will impact on the RI, as it does with RoI, whereas NPV works on cash flows, so the fact that RI uses accounting information, and historical asset values, could mean that a true evaluation is not being undertaken. As with RoI, it also depends on the size of the return in relation to the investment. Is it 1,000 on an investment of 1,000,000 or 10,000? Although both produce a positive RI, we would probably argue that 1,000 on 10,000 is much better and that 1,000 from 1million is not that good. It might mean more if RI is expressed as a percentage! For example, 0.1% compared to 10%.

RI is said to be a better measure to use as it takes away some of the motivational influences of the RoI percentage. Still, for new investments, the NPV should always be undertaken, as this ignores the accounting policies issue.

Chapter 11, Activity 25 – HW Inc. Sustainability

The following elements indicate that HW Inc. takes CSR seriously (remember that this is based on a real company, so the activities do take place in a global company).

HW Inc. has a group CSR framework – therefore, this guides the behavior of all subsidiary companies.

Each business creates its own CSR plans based on local stakeholder engagement. This provides some autonomy and ensures that each part of HW Inc. engages with their local stakeholders, but within the group guidelines, as the plans are submitted to the CSR committee. It also ensures local buy-in to the plan as they created it, and it not imposed by the head office.

HW Inc. allows employees time to contribute to the local community. The company is, therefore, committing resources to the CSR strategy.

Training is provided, and HW Inc. also has a qualification developed for its CSR champions. The knowledge gained by these champions is also shared around the group.

The CSR policy sets targets around sustainability issues and is divided into four main areas: community, environment, marketplace, and workplace.

The local champions provide commitment and local input, together with the support network provided, enables and encourages the sharing of experiences and ideas around the group to develop a form of organizational learning. The action group ensures that something is done rather than just talking about issues. Champions are supported by the group CSR director and coordinator. This provides a mechanism to ensure that good practice is shared but also demonstrates the head office commitment to CSR and its process within the group.

The finance department is heavily involved in both gathering, analyzing, and preparing the information for CSR reports, as well as providing an audit check on its accuracy. The audit is necessary because the report is published, and therefore the accuracy needs to be checked in case it leaves the company open to criticism later.

Chapter 11, Activity 26 – HW Inc. Sustainability and the accountant

Sustainability

Sustainability is defined as environmental, economic, and social sustainability and sustainable development is concerned with ensuring that actions are taken with due consideration being given to future generations.

Accountants are often involved in preparing the annual CSR report, which many companies now produce to demonstrate and report on actions they are taking to ensure that they act responsibly. In a way, this has increased the degree of accountability and transparency in managing and reporting on organizational performance, something that accountants are always involved in through the stewardship and corporate governance roles within an organization.

Accountants are well placed to contribute to sustainability in the area of performance management. The balanced scorecard approach to performance management can be a useful way of capturing sustainability aspects of performance. There is some debate about the best approach to include these, for example, should sustainability be incorporated within the corporate balanced scorecard, or should there be a separate sustainability scorecard. An argument to suggest that it should be included within the corporate scorecard is that if a separate scorecard is created, it can have the effect of marginalizing the sustainability scorecard. In the case of HW Inc., it would perhaps be best if they implemented a single scorecard approach incorporating sustainability elements within the normal perspectives. This is the recommended approach as HW Inc. does not make a virtue out of sustainability, that is, it does not seek to use it as a competitive advantage, and therefore would not benefit from having a separate scorecard.

The accountant can also contribute by assisting in monitoring the environment for changes in industry standards that might require a more sustainable approach by industry members. For example, the current concerns about energy usage, and recycling of products, using sustainable sources of materials, exploitation of low paid workers in developing countries to manufacture clothes. Accountants would not necessarily look for these aspects in particular, but when monitoring economic factors and business-related media reports, the accountant may come across items that they can share, or at least make sure that someone in HW Inc. has seen the item. Large organizations often channel such information through their communication department, if they have one, who is responsible for making sure that the relevant management team members are up to date with issues in their area of responsibility. This could be considered as contributing to social sustainability.

A prominent area where accountants can contribute is in the development of controls, particularly the diagnostic controls, typically plan or budget versus actual, which in accounting terms is budgetary control and part of economic sustainability. Also, encouraging the use of interactive controls, whereby employees are encouraged to take control action and a culture of learning is created. Benchmarking exercises also aid this perspective and the use of initiatives on the balanced scorecard, so that employees are encouraged to challenge the way things are currently done. Accountants can contribute to training programs by increasing the financial awareness of all employees and thus contribute to the development of staff, not just as an employee, but also in broader terms to develop as a person, which contributes to social sustainability.

Specific costs can be monitored, such as energy costs, which do not only have sustainable aspects but also benefit the company in achieving economic sustainability by reducing and managing costs more closely. If this reduces energy usage, it also contributes to environmental sustainability. For example, one of the aspects of HW Inc. stores is the ambiance to which lighting is a key part. ‘Bright and airy’ is often used to describe the interior of the stores – this could be viewed as unnecessary use of energy by some, and therefore ensuring that this is achieved in an energy-efficient way could be significant, not just in cost terms but also for the public image. Similarly, reducing wastage (costs of quality) in the product or improving efficiency/effectiveness of manufacturing processes in the factories. The use of the value chain analysis linked to ABC can aid this process and highlight areas where significant improvements can be made, which also increases the sustainability of HW Inc.

As mentioned above, specific techniques can be used to aid the improvement of sustainability best practices. Benchmarking exercises can be useful as a means of identifying the sustainable practice of other companies that can be implemented within HW Inc. Also, when developing new products, the concept of lifecycle costing would consider the recycling of product elements at the end of their useful life as well as the cost of design and manufacture. This could provide savings across the industry. Target costing could also be employed to aid sustainable product development.

HW Inc. is in the process of conducting a future potential review and will, therefore, be making strategic decisions and accountants are in an excellent position to evaluate strategic options by way of a cost-benefit analysis, and including the tangible and intangible costs and benefits. For example, considering the impact on employees within the rationalization of stores is considering the social aspects of the decision. Therefore, HW Inc. needs to take into account the sustainability aspects of the decision when evaluating various options.

Overall, the management accountant can make a significant contribution to the sustainability of businesses. Even contributing to halting the decline in profits of HW Inc. is contributing to economic sustainability. After all, if a company is not profitable, it will not be around long enough to contribute to the sustainability of the planet. Hence the 3 P maxim: profit, people, and the planet.