CHARTERED ACCOUNTANTS EXAMINATIONS

PROFESSIONAL LEVEL

P5: STRATEGIC MANAGEMENT

WEDNESDAY 17TH JUNE 2015

TOTAL MARKS – 100: TIME ALLOWED: THREE (3) HOURS

INSTRUCTIONS TO CANDIDATES

1. You have fifteen (15) minutes reading time. Use it to study the examination paper carefully so that you understand what to do in each question. You will be told when to start writing.

2. This paper is divided into TWO sections:

   Section A: One (1) compulsory question.
   Section B: Four (4) Optional questions. Attempt any three (3).

3. Enter your student number and your National Registration Card number on the front of the answer booklet. Your name must **NOT** appear anywhere on your answer booklet.

4. Do **NOT** write in pencil (except for graphs and diagrams).

5. The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and depth of the answer.

6. All workings must be done in the answer booklet.

7. Present legible and tidy work.

8. Graph paper (if required) is provided at the end of the answer booklet.

SECTION A

Question one is compulsory and must be attempted.

QUESTION ONE

Read the case below entitled "**SMART ATTIRE ENTERPRISES"** and answer the questions that follow.

SMART ATTIRE ENTERPRISES

Smart Attire Enterprises was established in the early 1990s during the euphoria of economic liberalization and privatization by Mwiko Nawa who had retired from the Zambian civil service after serving for twenty-five years. Using his retirement benefits and a loan from the Development Bank of Zambia, he decided to set up a retail shop in Lusaka which specialized in selling men's shirts. When Smart Attire Enterprises began in the 1990s, it faced competition from other retail outlets owned principally by Asians who sold a variety of clothing to the low and middle class. Mwiko quickly discovered that Asian-owned shops were a force to reckon with: they operated as a cartel and, as a group, were able to buy merchandise in bulk and at a discount from wholesalers who in turn bought merchandise from suppliers based in India. This enabled these shops to sell their merchandise at relatively low prices. Because they collaborated closely, they were also good at supporting each other by exchanging market information. One example of this collaboration was that no individual shop experienced stock-out situations as they were able to supply each other merchandise at short notice. However, most Asian-owned shops were also renowned for low quality, hence their strategy to target the low and middle class.

When Mwiko first entered the retail business, he realized that his business, along with other African-owned businesses, were small operators with little purchasing power. To generate store traffic, Mwiko decided to stock and specialize in men's internationally branded shirts from well-known companies in South Africa and Italy. Since the African-owned retailers did not have high sales volume, the South African and Italian companies set the price. This meant that the retailers had to look for other ways to cut costs, which they did by emphasizing self-service in stripped-down stores located in the suburbs where land was cheaper.

Retailers such as Smart Attire Enterprises purchased their merchandise through wholesalers, who in turn bought from manufacturers. The wholesaler would come into a store and write an order, and when the merchandise arrived, the wholesaler would come in and stock the shelves, ensuring that the branded merchandise received the best display in the shop. Retailers were expected to pay wholesalers for this 'expertise' in displaying merchandise. However, Smart Attire Enterprises found this arrangement unsatisfactory because it added to the cost a consumer would pay for a shirt. Moreover, at the instigation of suppliers, wholesalers were not enthusiastic about serving a company that built its stores in places away from the city center. They would do it only if retailers paid higher prices.

The founder of Smart Attire Enterprises, Mwiko Nawa, refused to pay higher prices. Instead he took his fledgling company public and used the capital raised to build a distribution center to stock merchandise. The distribution center would serve not only his store but other stores within a 10-kilometre radius, with trucks leaving the distribution center daily to restock the stores. Because the distribution center was serving a collection of stores and thus buying in larger volumes, Nawa found that he was able to cut the wholesalers out of the equation and order directly from manufacturers in South Africa or Italy. The cost savings generated by not having to pay profits to wholesalers were then passed on to consumers in the form of lower prices which enhanced the growth of Smart Attire Enterprises. This growth increased its buying power and thus its ability to demand deeper discounts from manufacturers.

Today Smart Attire Enterprises has turned its buying process into an art form. Industry sources estimate that as much as 10 percent of all retail sales in Zambia are made in a Smart Attire Enterprises store. This has made the company the largest single buyer of clothes and given the company enormous bargaining power over its suppliers. Suppliers of nationally branded products are no longer in a position to demand high prices. Instead, Smart Attire Enterprises is now so important to its suppliers that it is able to demand deep discounts from them. Moreover, Smart Attire Enterprises has itself become a brand that is more powerful than the brands of manufacturers. People don't go to Smart Attire Enterprises to buy branded goods; they go to Smart Attire Enterprises for the low prices. This simple fact has enabled Smart Attire Enterprises to bargain down the prices it pays, always passing on cost savings to consumers in the form of lower prices. Since 2010 Smart Attire Enterprises has become a preferred distributor to suppliers of clothing.

Required:

(a) Describe the competitive forces that obtained in the industry. (20 marks)

(b) Evaluate the extent to which the nature of competition has affected the strategic position of Smart Entire Enterprises. (20 marks)

[Total: 40 marks]

SECTION B

Answer any Three (3) questions in this Section.

QUESTION TWO

Every organisation gauges its performance, mainly, from the financial point of view. This analysis is frequently done using financial ratios.

Explain with illustrations the four (4) types of ratios often used by financial analysts.

[Total: 20 marks]

QUESTION THREE

(a) Culture facilitates strategy implementation in the process of developing strategy. Therefore, culture and strategy must be compatible.

Evaluate the five (5) factors that are necessary for an effective strategy implementation. (10 marks)

(b) A matrix organisation is a structure with two (or more) channels of command, two lines of budget authority and two sources of performance and reward.

Describe any five (5) strategic advantages of this type of organization structure. (10 marks)

[Total: 20 marks]

QUESTION FOUR

(a) Describe and evaluate Porter's three generic competitive strategies. Give instances of the three generic competitive strategies in Zambia. (12 marks)

(b) A butcher is swamped with complaints from his customers that the beef he is selling is too hard. The butcher realizes that this is true because the animals he buys from villagers are rather old and the villagers have been unwilling to sell him young animals which would enable him to supply tender meat in his butchery.

Analyse the significance of a backward integration to the butcher. (8 marks)

[Total: 20 marks]

QUESTION FIVE

(a) E-commerce is the process of buying and selling goods and services electronically by means of computerised business transactions, commonly through internet as is the case with purchase of used cars from Japan.

Discuss four (4) lessons that should be learned from the use of E-commerce and its impact on business activities. (8 marks)

(b) Corporate parenting is the search for a fit between the skills of the corporate centre and the strategies of strategic business units (SBU's) so as to add value to those SBU's.

Discuss the strategic requirements of each of the four (4) corporate parenting roles. (12 marks)

[Total: 20 marks]

END OF PAPER

P5 STRATEGIC MANAGEMENT SOLUTIONS

SOLUTION ONE

This is a compulsory question and carries a total of 40 marks, evenly divided between question (a) and (b). In Question One (a), the candidate is expected to identify and describe three competitive forces, that is, industry rivalry, bargaining power of suppliers and bargaining power of buyer. In Question One (b), the candidate is expected to show the position of Smart Attire Enterprises with respect to suppliers (wholesalers)

(a) Using Michael Porter's model of five competitive forces, the nature of competition of competition which obtains in the industry described in the case falls into three categories. First, there is industry rivalry among retailers of clothing. All retailers – both Asian retailers and African retailers traded in clothing and in this respect they were rivals to each other. The Asian-owned shops, however, seemingly had a competitive advantage in pricing and product availability over the African-owned retailers because of their link to Indian suppliers and the collusion that existed among them. However, the Asian owned retail shops had to contend with the image of low quality. Second, there is bargaining power of the supplier characterized by the ability of wholesalers to determine prices and offer merchandise of low quality to retailers. Smart Attire Enterprises are however able to respond through product differentiation by specializing in men's shirts and sourcing their merchandise from South Africa and Italy. Smart Attire can be said to have pursued a product differentiation strategy. Third, the action by Smart Attire Enterprises of establishing a distribution center and eventually growing into a big buyer that now sought discounts from the suppliers and was a preferred buyer to suppliers created a situation characterized by bargaining power of a buyer.

(b) When Smart Attire Enterprises began its operations, it faced competition characterized by the bargaining power of suppliers. It bought merchandise from wholesalers who determined the quality of its merchandise and set prices. So powerful were wholesalers that they could walk into a Smart Attire Enterprises shop and decide on how the merchandize they supplied would be displayed and at what price it could be sold. Even when a retailer decided to lower costs by trading in a cheaper location, wholesalers could only supply them with merchandise at a higher cost. Smart Attire Enterprises found itself in a situation in which supplier (the wholesaler) power was high: there was a concentration of suppliers; the retailers were many and fragmented; the switching costs from one supplier to another were high; the wholesaler could easily enter into the business of the retailer or refuse to supply to a retailer when the margins were low as was the case when retailers chose to locate in cheaper areas. Upon having an own distribution center, Smart Attire Enterprises gained power over its suppliers. It had bargaining power of the buyer because its volume of purchases were high; it

was able to buy directly from manufacturers and thereby circumvented wholesalers; it could negotiate discounts from suppliers; the suppliers business now depended on securing the buyer's patronage; and there were implicitly other sources of supply.

SOLUTION TWO

Every organization gauges its performance, mainly, from the financial point of view. This is more important if it is to meet its creditors and other operational obligation without difficulties. There are four main types of financial ratio, often used by financial analysts. These ratios which measure profitability, liquidity, leverage and activity of an organisation help to monitor the organisations' performance relative to the industry and its various periods of operation.

1. **PROFITABILITY RATIOS**

Increase in cash is an inadequate measure of business success because commercial value is, at any time in a "going concern" business, held in many forms other than cash. It is generally held therefore that measures of profit have been developed as attempts to show this overall increase in value resulting from the operations of a period. The three common ratios used here are:

(1) Profitability of the business
(2) Rate of return on capital employed
(3) Profit margin.

2. **LIQUIDITY RATIOS**

It is quite possible for a business to be profitable and yet fail to meet its obligations because it is unable to collect in cash sufficient to meet debts as they fall due. Reasons for this state of affairs include delays between paying for purchases and collecting the proceeds of the related sales and substantial increase in the volume of business, which may be very good for profits can result in overtrading and serious liquidity difficulties unless additional funds for working capital are made available.

The most commonly used is the current ratio which relates the current assets to current liabilities. A healthy level of the ratio was 1 to 2. A large current ratio is not necessarily a good sign. It may mean than an organisation is not making the most efficient use of assets. The weakness lies in the sense that it implies that all current assets are available to pay off current liability.

3. **LEVERAGE RATIOS**

These ratios identify the sources of a firm's capital-owners and outside creditors. The term leverage refers to the fact that using capital with a fixed interest charge will amplify either profit or loss in relation to equity of holders of common stock. The most commonly used ratio is total debt divided by total Assets.

Total debt includes current liabilities and long term liabilities. This ratio is a measure of the percentage of total funds provided by debt. A total debt to total assets ratio higher than 0.5 is usually considered safe only for firms in stable industries.
The ratio of long-term debt to equity is a measure of the extent to which sources of long term financing are provided by creditors. It is calculated by dividing long term debt by the shareholders equity.

4. **ACTIVITY RATIOS**

These ratios indicate how effectively the firm is using its resources. The asset turnover ratio indicates how efficiently management is employing total assets and is calculated by dividing sales by total assets.
The ratio of sales to fixed assets is a measure of the turnover on plant and equipment. It is obtained by dividing sales by net fixed assets. It is advisable to compute the figures for a number of years to find a trend for meaningful comparisons for the activity ratios. It has been suggested that industry figures for asset turnover will vary with capital - intensive industries and those requiring large inventories will have smaller ratios.
The accounts receivable turnover is another of the activity ratios. It is a measure of average collection period on sales. A too low ratio could indicate the loss of sales because of a too restrictive credit policy. If the ratio is too high, too much capital is being tied up in accounts receivable, and management may be increasing the chance of bad debt. The formula for this ratio is the sales divided by the accounts receivable. We shall then find the average collection period by dividing the days in the year by the accounts receivable turnover.
Inventory turnover is estimated by dividing sales by average inventory. Since inventory are normally carried at cost, it would be more accurate to use the cost of goods sold in place of sales in the numerator of this ratio.

SOLUTION THREE

(a) Issues that are necessary for effective implementation of strategy:
- Structure that is appropriate,
- Shared values
- Staffing – people orientation
- Systems – practice, procedures and routines of the organization
- Skills – distinctive competencies
- Styles of management.

(b) Strategic advantages of the matrix organization include
- Gives formal attention to each dimension of strategic priority.
- Creates checks and balances among competing viewpoints.
- Facilitates capture of functionally based strategic pits, in diversified companies.
- Promotes making trade-offs on the basis of "what's best for the organisation as a whole"

- Encourages cooperation, consensus-building, conflict resolution and coordination of related activities.

SOLUTION FOUR

This question has two parts. Part (a) carries 12 marks which are shared evenly between the three competitive strategies. Part (b) carries 8 marks

(a) The three generic competitive strategies proposed by Michael Porter are Product differentiation, Market Focus and Low Cow. A product differentiation strategy involves gaining competitive advantage over rivals by creating a difference in the product offering which is valued by customers. It is the perceived difference which appeals to the customer. The difference can be in the form of performance, such as, differences which are associated with quality differences or the compromise between price and quality. Loyalty to brands illustrates the competitive advantage of product differentiation. The Market Focus (or Niche) strategy involves a firm concentrating on a segment of a market in which a competitor is unwilling to participate and thus avoiding a mass market in which a rival is likely to participate. A firm may pursue o market focus strategy on the basis of cost or a combination of differentiation and market. A Low cost strategy is embarked on when a firm seeks to lower costs in any areas of its functions and passes on the lower costs to its customers in form of lower costs that its rivals. Some of the ways of achieving lower costs are through by producing in large quantities to obtain economies of scale, exploiting technology which reduces costs or increases productivity, minimizing overhead costs, acquiring materials from cheaper sources or negotiating favourable terms with suppliers.

A word of caution about generic strategies is in order. In product differentiation, competing products may be so strong that new product differences do not sway customers from their preferred brands. Secondly, customers must be sensitive to differences and lack of education and perceived risk may make customers reluctant to 'experiment' with new differences. The effects of low cost strategy can be compromised by market rigidities. In Zambia where demand all too often exceeds supply, there is less motivation to seek cost economies which can be passed on to customers by way of low prices. Market focus is now being compromised by population mobility. It is becoming increasingly difficult to design a product to meet the specific needs of a particular target market.

(b) The situation described in the case calls for the butcher to pursue an external growth strategy. This is where a firm seeks growth by integrating or acquiring another business that increases the business of the butcher by generating synergy with ranching. It involves the purchase of, or an arrangement with, firms that are behind or ahead of a business in its value added chain. By integrating

with cattle ranching, the butcher will ensure that tender meat can be supplied to his butchery. In this way, customers will purchase the tender meat which they want. In the present scenario, however, the butchery business is unrelated to the cattle ranching by villagers: presumably the villagers do not breed cattle with the butchery in mind and hence the villagers' unwillingness to sell young cattle. Yet it is the young cattle that are preferred in the butchery business. To boost his business, the butcher must integrate cattle ranching into his business by having establishing a cattle ranching business or purchasing a cattle ranching business where he will be assured of getting tender meat.

SOLUTION FIVE

a) There are key realities and challenges for developing strategy in the internet age as there are new, and rapid changes in technology. However, there is need for modern business to learn lessons as it carries on its business using e-commerce.

These include the following:

- There are a lot of ways to make money on the internet. These may be done singularly or in combination and includes, collecting fees from subscribers through postage of their newsletters, selling advertising space, selling goods and services directly to other businesses or end customers, collecting transactions and collecting commissions for bringing together buyers and sellers.
- Customer loyalty is built with reliable brands and catching websites. Attractive websites can have many visitors but few or no sales. When doing business at internet speed, websites need to satisfy three criteria: (1) high – quality layout and graphics; (2) fast, responsive service; and (3) complete and up-to-date information. A trusted brand name can further enhance the ability to draw the same customer back again.
- There is need to identify the company's core competencies to determine which of their assets and tasks that will give the company distinct competitive advantage it need to keep. Popular accounts of e-commerce conjure up the vision of "virtual organizations" where an entrepreneur and a handful employees run a large business with little more than just an internet set up. Most of the operational functions are contracted to a network of providers.
- Cannibalism can pay. Traditionally it is believed that one should never allow one line of business or sell a product that cannabalises your present sells. It is now known that one lesson from e-commerce s contradicts this rule. E-commerce often requires a quick revolution rather than a slow evolution. Managers and employees are reluctant to turn their backs on comfortably familiar assumptions, tools , facilities techniques, and work habits.

- Everyone is a potential competitor. One major consequence of the e-commerce revolution is a blurring of traditional boundaries between industries. It is a factor that all that are doing a similar or related business exposed to e-commerce are potential competitors when there is profit potential.

b) The following are the strategic requirements under each role of a corporate parent.

1. Portfolio management
   - Identifying and acquiring undervalued assets,
   - Divesting low-performing SBU's quickly and good performers at a premium.

2. Portfolio Restructuring
   - Identifying restructuring opportunities'
   - Intervention in SBU's to transform performance,
   - Sale of SBU's when restructuring is complete or market conditions are favourable.

3. Portfolio skill transferring
   - Transferring skills to give competitive advantage to SBU's,
   - Ongoing transfer of skills,
   - Identification of appropriate skills to transfer.

4. Portfolio Activity Sharing
   - Sharing activities to provide competitive advantage to SBU's
   - Identification of benefits of sharing which outweigh costs,
   - Overcoming SBU resistance to sharing.

END OF SOLUTIONS