Professional Level – Essentials Module

Business Analysis

Wednesday 12 December 2007

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

This paper is divided into two sections:

Section A – This ONE question is compulsory and MUST be attempted

Section B – TWO questions ONLY to be attempted

Do NOT open this paper until instructed by the supervisor.
During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.
This question paper must not be removed from the examination hall.

The Association of Chartered Certified Accountants

Paper P3

Section A – This ONE question is compulsory and MUST be attempted

The following information should be used when answering question 1.

1 Introduction

The island of Oceania attracts thousands of tourists every year. They come to enjoy the beaches, the climate and to explore the architecture and history of this ancient island. Oceania is also an important trading nation in the region and it enjoys close economic links with neighbouring countries. Oceania has four main airports and until 1997 had two airlines, one based in the west (OceaniaAir) and one based in the east (Transport Oceania) of the island. However, in 1997 these two airlines merged into one airline – Oceania National Airlines (ONA) with the intention of exploiting the booming growth in business and leisure travel to and from Oceania.

Market sectors

ONA serves two main sectors. The first sector is a network of routes to the major cities of neighbouring countries. ONA management refer to this as the regional sector. The average flight time in this sector is one and a half hours and most flights are timed to allow business people to arrive in time to attend a meeting and then to return to their homes in the evening. Twenty five major cities are served in the regional sector with, on average, three return flights per day. There is also significant leisure travel, with many families visiting relatives in the region. The second sector is what ONA management refer to as the international sector. This is a network of flights to continental capitals. The average flight time in this sector is four hours. These flights attract both business and leisure travellers. The leisure travellers are primarily holiday-makers from the continent. Twenty cities are served in this sector with, on average, one return flight per day to each city.

Image, service and employment

ONA is the airline of choice for most of the citizens of Oceania. A recent survey suggested that 90% of people preferred to travel ONA for regional flights and 70% preferred to travel with ONA for international flights. 85% of the respondents were proud of their airline and felt that it projected a positive image of Oceania. The company also has an excellent safety record, with no fatal accident recorded since the merging of the airlines in 1997. The customer service of ONA has also been recognised by the airline industry itself. In 2005 it was voted Regional Airline of the Year by the International Passenger Group (IPG) and one year later the IPG awarded the ONA catering department the prestigious Golden Bowl as provider of the best airline food in the world. The courtesy and motivation of its employees (mainly Oceanic residents) is recognised throughout the region. 95% of ONA employees belong to recognised trade unions. ONA is perceived as an excellent employer. It pays above industry average salaries, offers excellent benefits (such as free health care) and has a generous non-contributory pension scheme. In 2004 ONA employed 5400 people, rising to 5600 in 2005 and 5800 in 2006.

Fleet

Fleet details are given in **Table 1**. Nineteen of the Boeing 737s were originally in the fleet of OceaniaAir. Boeing 737s are primarily used in the international sector. Twenty-three of the Airbus A320s were originally part of the Transport Oceania fleet. Airbuses are primarily used in the regional sector. ONA also used three Embraer RJ145 jets in the regional sector.

Table 1: Fleet details

	Boeing 737	Airbus A320	Embraer RJ145
Total aircraft in service			
2006	21	27	3
2005	21	27	3
2004	20	26	2
Capacity (passengers)	147	149	50
Introduced	October 1991	November 1988	January 1999
Average age	12·1 years	12·9 years	6·5 years
Utilisation (hrs per day)	8·70	7·41	7·50

Performance

Since 2004 ONA has begun to experience significant competition from 'no frills' low-cost budget airlines, particularly in the international sector. Established continental operators now each offer, on average, three low fares flights to Oceania every day. 'No frills' low-cost budget airlines are also having some impact on the regional sector. A number of very small airlines (some with only one aircraft) have been established in some regional capitals and a few of these are offering low-cost flights to Oceania. A recent survey for ONA showed that its average international fare was double that of its low-cost competitors. Some of the key operational statistics for 2006 are summarised in **Table 2**.

Table 2: Key operational statistics for ONA in 2006

	Regional	International	Low-cost Competitor Average
Contribution to revenue ($m)			
Passenger	400	280	Not applicable
Cargo	35	15	Not applicable
Passenger load factor			
Standard Class	73%	67%	87%
Business Class	90%	74%	75%
Average annual pilot salary	$106,700	$112,500	$96,500
Source of revenue			
On-line sales	40%	60%	84%
Direct sales	10%	5%	12%
Commission sales	50%	35%	4%
Average age of aircraft	See Table 1		4.5 years
Utilisation (hrs per day)	See Table 1		9·10

ONA have made a number of operational changes in the last few years. Their website, for example, now allows passengers to book over the internet and to either have their tickets posted to them or to pick them up at the airport prior to travelling. Special promotional fares are also available for customers who book on-line. However, the website does not currently allow passengers to check-in on-line, a facility provided by some competitors. Furthermore, as **Table 2** shows, a large percentage of sales are still commission sales made through travel agents. Direct sales are those sales made over the telephone or at the airport itself. Most leisure travellers pay standard or economy fares and travel in the standard class section of the plane. Although many business travellers also travel in standard class, some of them choose to travel business class for which they pay a price premium.

In the last three years, the financial performance of ONA has not matched its operational success. The main financial indicators have been extracted and are presented in **Table 3**. In a period (2004–2006) when world-wide passenger air travel revenue increased by 12% (and revenue from air travel to Oceania by 15%) and cargo revenue by 10%, ONA only recorded a 4·6% increase in passenger revenue.

Table 3: Extracted Financial Information

all figures in $m

Extracted from the Balance Sheet

		2006	2005	2004
Non-current assets				
Property, plant and equipment		788	785	775
Other non-current assets		60	56	64
	Total	848	841	839
Current assets				
Inventories		8	7	7
Trade receivables		68	71	69
Cash and cash equivalents		289	291	299
	Total	365	369	375
Total assets		**1213**	**1210**	**1214**
Total shareholders' equity		250	259	264
Non-current liabilities				
Interest bearing long-term loans		310	325	335
Employee benefit obligations		180	178	170
Other provisions		126	145	143
Total non-current liabilities		616	648	648
Current liabilities				
Trade payables		282	265	255
Current tax payable		9	12	12
Other current liabilities		56	26	35
Total current liabilities		347	303	302
Total equity and liabilities		**1213**	**1210**	**1214**

Extracted from the income statement

		2006	2005	2004
Revenue				
Passenger		680	675	650
Cargo		50	48	45
Other revenue		119	112	115
	Total	849	835	810
Cost of Sales				
Purchases		535	525	510
	Total	535	525	510
Gross Profit		314	310	300
Wages & Salaries		215	198	187
Directors' Salaries		17	16	15
Interest payable		22	21	18
	Total	254	235	220
Net Profit before tax		60	75	80
Tax Expense		18	23	24
Net Profit after tax		42	52	56

Future Strategy

The management team at ONA are keen to develop a strategy to address the airline's financial and operational weaknesses. One suggestion has been to re-position ONA itself as a 'no frills' low-cost budget airline. However, this has been angrily dismissed by the CEO as likely to lead 'to an unnecessary and bloody revolution that could cause the death of the airline itself'.

Required:

(a) Using the information provided in the scenario, evaluate the strengths and weaknesses of ONA and their impact on its performance. Please note that opportunities and threats are NOT required in your evaluation. (20 marks)

(b) The CEO of Oceania National Airways (ONA) has already strongly rejected the re-positioning of ONA as a 'no frills' low-cost budget airline.

(i) Explain the key features of a 'no frills' low-cost strategy. (4 marks)

(ii) Analyse why moving to a 'no frills' low-cost strategy would be inappropriate for ONA.

Note: requirement (b) (ii) includes 3 professional marks (16 marks)

(c) Identify and evaluate other strategic options ONA could consider to address the airline's current financial and operational weaknesses.

Note: requirement (c) includes 2 professional marks (10 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 A clothing company sells 40% of its goods directly to customers through its website. The marketing manager of the company (MM) has decided that this is insufficient and has put a small team together to re-design the site. MM feels that the site looks 'amateur and old-fashioned and does not project the right image'. The board of the company has given the go-ahead for the MM 'to re-design the website'. The following notes summarise the outcomes of the meetings on the website re-design. The team consists of the marketing manager (MM), a product range manager (RP), a marketing image consultant (IC) and a technical developer (TD).

Meeting 1: 9 July attended by MM, RP, IC and TD
The need for a re-designed website to increase sales volume through the website and to 'improve our market visibility' was explained by MM. IC was asked to produce a draft design.

Meeting 2: 16 August attended by MM, RP, IC and TD
IC presented a draft design. MM and RP were happy with its image but not its functionality, suggesting that it was too similar to the current site. 'We expected it to do much more' was their view.

Meeting 3: 4 September attended by MM, RP and IC
IC produced a re-drafted design. This overall design was agreed and the go-ahead was given for TD to produce a prototype of the design to show to the board.

Meeting 4: 11 September attended by RP, IC and TD
TD explained that elements of the drafted re-design were not technically feasible to implement in the programming language being used. Changes to the design were agreed at the meeting to overcome these issues and signed off by RP.

Meeting 5: 13 October attended by MM, RP, IC and TD
The prototype re-design was demonstrated by TD. MM was unhappy with the re-design as it was 'moving too far away from the original objective and lacked functionality that should be there'. TD agreed to write a technical report to explain why the original design (agreed on 4 September) could not be adhered to.

Meeting 6: 9 November attended by MM, IC and TD
It was agreed to return to the 4 September design with slight alterations to make it technically feasible. TD expressed concerns that the suggested design would not work properly with all web browsers.

At the board meeting of 9 December the board expressed concern about the time taken to produce the re-design and the finance director highlighted the rising costs (currently $25,000) of the project. They asked MM to produce a formal cost-benefit of the re-design. The board were also concerned that the scope of the project, which they had felt to be about re-design, had somehow been interpreted as including development and implementation.

On 22 December MM produced the following cost-benefit analysis of the project and confirmed that the word 're-design' had been interpreted as including the development and implementation of the website.

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Costs	$50,000	$10,000	$10,000	$10,000	$10,000
*Benefits	0	$15,000	$25,000	$35,000	$35,000

*These benefits are extra sales volumes created by the website's extra functionality and the company's increased visibility in the market place.

On 4 January the board gave the go ahead for the development and implementation of the website with a further budget of $25,000 and a delivery date of 1 March. TD expressed concern that he did not have enough developers to deliver the re-designed website on time.

Meeting 7: 24 February attended by MM, RP, IC and TD
A partial prototype system was demonstrated by TD. RP felt that the functionality of the re-design was too limited and that the software was not robust enough. It had crashed twice during the demonstration. He suggested that the company delay the introduction of the re-designed website until it was complete and robust. MM declared this to be impossible.

Conclusion
The re-designed website was launched on 1 March. MM declared the re-design a success that 'had come in on time and under budget'. On 2 and 3 March, numerous complaints were received from customers. The website was unreliable and did not work with a particular popular web browser. On 4 March an emergency board meeting decided to withdraw the site and reinstate the old one. On 5 March, MM resigned.

Required:

Most project management methods have an initiation or definition stage which includes the production of a document that serves as an agreement between the sponsors and deliverers of the project. This may be called a project initiation document or a project charter. Defining the business case is also an important part of the initiation or definition stage of the project.

(a) Explain how a business case and a project initiation document would have helped prevent some of the problems that emerged during the conduct of the website re-design project. (15 marks)

(b) Analyse how effective project management could have *further* improved both the process and the outcomes of the website re-design project. (10 marks)

(25 marks)

3 Local neighbourhood shops are finding it increasingly difficult to compete with supermarkets. However, three years ago, the *Perfect Shopper* franchise group was launched that allowed these neighbourhood shops to join the group and achieve cost savings on tinned and packaged goods, particularly groceries. *Perfect Shopper* purchases branded goods in bulk from established food suppliers and stores them in large purpose-built warehouses, each designed to serve a geographical region. When *Perfect Shopper* was established it decided that deliveries to these warehouses should be made by the food suppliers or by haulage contractors working on behalf of these suppliers. *Perfect Shopper* places orders with these suppliers and the supplier arranges the delivery to the warehouse. These arrangements are still in place. *Perfect Shopper* has no branded goods of its own.

Facilities are available in each warehouse to re-package goods into smaller units, more suitable for the requirements of the neighbourhood shop. These smaller units, typically containing 50–100 tins or packs, are usually small trays, sealed with strong transparent polythene. *Perfect Shopper* delivers these to its neighbourhood shops using specialist haulage contractors local to the regional warehouse. *Perfect Shopper* has negotiated significant discounts with suppliers, part of which it passes on to its franchisees. A recent survey in a national grocery magazine showed that franchisees saved an average of 10% on the prices they would have paid if they had purchased the products directly from the manufacturer or from an intermediary – such as cash and carry wholesalers.

As well as offering savings due to bulk buying, *Perfect Shopper* also provides, as part of its franchise:

(i) Personalised promotional material. This usually covers specific promotions and is distributed locally, either using specialist leaflet distributors or loosely inserted into local free papers or magazines.
(ii) Specialised signage for the shops to suggest the image of a national chain. The signs include the *Perfect Shopper* slogan 'the nation's local'.
(iii) Specialist in-store display units for certain goods, again branded with the *Perfect Shopper* logo.

Perfect Shopper does not provide all of the goods required by a neighbourhood shop. Consequently, it is not an exclusive franchise. Franchisees agree to purchase specific products through *Perfect Shopper*, but other goods, such as vegetables, fruit, stationery and newspapers they source from elsewhere. Deliveries are made every two weeks to franchisees using a standing order for products agreed between the franchisee and their *Perfect Shopper* sales representative at a meeting they hold every three months. Variations to this order can be made by telephone, but only if the order is increased. Downward variations are not allowed. Franchisees cannot reduce their standing order requirements until the next meeting with their representative.

Perfect Shopper was initially very successful, but its success has been questioned by a recent independent report that showed increasing discontent amongst franchisees. The following issues were documented.

(i) The need to continually review prices to compete with supermarkets
(ii) Low brand recognition of *Perfect Shopper*
(iii) Inflexible ordering and delivery system based around forecasts and restricted ability to vary orders (see above)

As a result of this survey, *Perfect Shopper* has decided to review its business model. Part of this review is to re-examine the supply chain, to see if there are opportunities for addressing some of its problems.

Required:

(a) Describe the primary activities of the value chain of *Perfect Shopper*. (5 marks)

(b) Explain how *Perfect Shopper* might re-structure its upstream supply chain to address the problems identified in the scenario. (10 marks)

(c) Explain how *Perfect Shopper* might re-structure its downstream supply chain to address the problems identified in the scenario. (10 marks)

(25 marks)

4 The country of Europia has an extensive historical and industrial heritage. It has many tourist sites (such as castles, palaces, temples, houses and factories) which attract visitors from home and abroad. Most of these tourist sites have gift shops where visitors can buy mementos and souvenirs of their visit. These souvenirs often include cups, saucers, plates and other items which feature a printed image of the particular tourist site.

The Universal Pottery Company (UPC) is the main supplier of these pottery souvenir items to the tourist trade. It produces the items in its potteries and then applies the appropriate image using specialised image printing machines. UPC also supplies other organisations that require personalised products. For example, it recently won the right to produce souvenirs for the Eurasian Games, which are being held in Europia in two years time. UPC currently ships about 250,000 items of pottery out of its factory every month. Most of these items are shipped in relatively small packages. All collections from the factory and deliveries to customers are made by a nationwide courier company.

In the last two years there has been a noticeable increase in the number of complaints about the quality of these items. The complaints, from gift shop owners, concentrate on two main issues:

(i) The physical condition of goods when they arrive at the gift shop. Initial evidence suggests that 'a significant number of products are now arriving broken, chipped or cracked'. These items are unusable and they have to be returned to UPC. UPC management are convinced that the increased breakages are due to packers not following the correct packing method.

(ii) Incorrect alignment of the image of the tourist site on the selected item. For example, a recent batch of 100 cups for Carish Castle included 10 cups where the image of the castle sloped significantly from left to right. These were returned by the customer and destroyed by UPC.

The image problem was investigated in more depth and it was discovered that approximately 500 items were delivered every month with misaligned images. Each item costs, on average, $20 to produce.

As a result of these complaints, UPC appointed a small quality inspection team who were asked to inspect one in every 20 packages for correct packaging and correct image alignment. However, although some problems have been found, a significant number of defective products have still been delivered to customers. A director of UPC used this evidence to support his assertion that the 'quality inspection team is just not working'.

The payment system for packers has also been such an issue. It was established ten years ago as an attempt to boost productivity. Packers receive a bonus for packing more than a target number of packages per hour. Hence, packers are more concerned with the speed of packing rather than its quality.

Finally, there is also evidence that to achieve agreed customer deadlines, certain managers have asked the quality inspection team to overlook defective items so that order deadlines could be met.

The company has decided to review the quality issue again. The director who claimed that the quality inspection team is not working has suggested using a Six Sigma approach to the company's quality problems.

Required:

(a) Analyse the current and potential role of quality, quality control and quality assurance at UPC. (15 marks)

(b) Examine how adopting a Six Sigma approach would help address the quality problems at UPC. (10 marks)

(25 marks)

End of Question Paper