

Question – Armstrong Stores

Armstrong Stores (Armstrong) is a listed business with a chain of 126 general department stores in South Postland. The company is known for the high quality of its products, mainly food and clothing. The majority of its goods are sourced from trusted manufacturers and branded under the company's own 'Strongarm' label.

Currently, Armstrong faces a tough competitive environment with all the major players in its market trying to secure their positions. Poor economic conditions worldwide have significantly affected South Postland. Consumer spending is falling throughout the economy and there is no immediate likelihood of a resumption of growth.

Armstrong's Chief Executive Officer (CEO) has recently conducted a strategic review of the business in the context of the current economic recession. He has identified the following strategy as critical for Armstrong's success:

- Focus on key customers – those who are occasional shoppers but not currently loyal to the business
- Ensure Armstrong's offering addresses their needs
- Cut out costs which do not address these customers' priorities
- Amend current processes to meet this new focus
- Build for the future with a programme of sustainable development.

The company now needs to address the impact of this new strategy on its performance measurement systems. Armstrong uses a balanced scorecard to assess its strategic performance and the scorecard is used to connect the business strategy with its more detailed performance measures. The CEO has asked you to consider the implications of the new strategy for the performance measures used by the business.

Currently, Armstrong uses Economic Value Added (EVA), earnings per share (EPS) growth and share price performance to monitor its financial performance. The company has supplied data in appendix 1 which the CEO wishes to see used to assess the financial performance from the shareholders' perspective. She has asked that you explain the problems of capturing performance with these particular metrics and also, how they may affect management's behaviour.

Finally, in order to aid refocusing the company, the CEO has requested a report to the board comprehensively benchmarking the current performance of Armstrong. The board need to have benchmarking exercise explained and then the results described. Appendix 2 contains data analysing Armstrong, its two main competitors and statistics provided by the government of South Postland. A junior analyst has already correctly completed the preliminary calculation work for benchmarking in Appendix 3. The CEO has requested a critical assessment of these different sources as well as the comments on the results of the analysis.

Appendix 1

Financial data for Armstrong Stores

	2008	2009
	\$m	\$m
Operating Profit	505.7	435.1
Interest	40.2	77.6
Profit before tax	465.5	357.5
Profit for the year	353.8	271.7
Average number of shares in issue	1,600m	1,600m
	2008	2009
Economic value added (EVA)	\$306m	\$110m
Stock market information		
	2008	2009
South Postland market index	1,115.2	724.9
Retailing sector index	2,450.7	1,911.5
Armstrong Stores (average share price)	\$2.45	\$2.08

Appendix 2

(a) Comparative data

		BS stores		CS Stores		Armstrong	
		2008	2009	2008	2009	2008	2009
Revenue:							
– Food	\$m	1,542	1,538	2,100	1,978	1,985	2,025
– Clothing	\$m	1,234	1,222	2,723	2,610	2,450	2,475
Total	\$m	2,776	2,760	4,823	4,588	4,435	4,500
Profit for the year	\$m	142	127	294	193	354	272
No of stores		81	83	167	186	119	126
No of suppliers		3,400	3,100	4,200	4,200	4,122	4,468
No of warehouses		6	6	8	9	7	7

(b) Government statistics

Market totals – Revenue	2008	2009
– Food Retail \$m	12,403	12,656
– Clothing Retail \$m	25,792	22,500

(c) Armstrong data for 2009

Region by region
(South Postland is split into three large regions)

	Acelon	Baselon	Caselon	
Revenue:				
– Food	\$m	648	810	567
– Clothing	\$m	792	1,114	569
Total	\$m	1,440	1,924	1,136
Profit for the year	\$m	87	111	73
No of stores		37	51	38
No of warehouses		2	3	2

Appendix 3

Junior Analyst's working papers

(a) Comparative data

Change yr on yr	BS stores	CS Stores	Armstrong	
			2008	2009
Revenue:				
– Food	-0.3%	-5.8%	2.0%	
– Clothing	-1.0%	-4.1%	1.0%	
Total	-0.6%	-4.9%	1.5%	
Profit for the year	-10.3%	-34.5%	-23.2%	
No of stores	2.5%	11.4%	5.9%	
No of suppliers	-8.8%	0.0%	8.4%	
No of warehouses	0.0%	12.5%	0.0%	
Market share				
– Food	12.4%	12.2%	16.9%	15.6%
– Clothing	4.8%	5.4%	10.6%	11.6%
Revenue per shop				
BS stores	CS Stores	Armstrong	2008	2009
2008	2008	2008	2008	2009
\$m				
34.27	33.25	28.88	24.67	35.71

(b) Regional data for Armstrong

		Acelon	Baselon	Caselon	Total
Revenue per shop	\$m	38.92	37.72	29.90	35.71
Profit margin		6.0%	5.8%	6.5%	6.0%

Required:

- 1 **Describe the four perspectives of the balanced scorecard showing how the new strategy of the business as outlined by the CEO links to the different perspectives. Illustrate your answer by suggesting appropriate performance measures for Armstrong for each of the detailed points within the strategy.** (8 marks)
- 2 (a) **Assess the financial performance of the company using the three shareholder performance indicators.** (5 marks)
(b) **Critically evaluate the use of these performance metrics and how they may affect management's behaviour.** (6 marks)
- 3 **Prepare a report to the board on a benchmarking exercise using the information given in the appendix:**
(a) **Evaluate the benefits and difficulties of benchmarking in this situation.** (4 marks)
(b) **Evaluate the performance of Armstrong using the data given in the question. Indicate what further information would be useful and conclude as to the performance of the company.** (8 marks)
Professional marks for appropriateness of format, style and structure of the report. (3 marks)
(34 marks)

Answer

Solution

1 The four perspectives of the balanced scorecard are:

- Financial – how do we optimally serve our shareholders' interests?
- Customer – how should we present ourselves to our customers?
- Internal business process – what processes are critical to achieving our customer and shareholder goals and how can we optimise these?
- Learning and growth – how do we maintain our ability to change and grow?

The new strategy addresses these perspectives in different ways. Ultimately all of the perspectives will have financial effects whether in the short or long term interests of our shareholders.

Focus on key customers – this directly addresses the customer perspective and will require the collection of the profiles and needs of these customers in order to generate market growth and so improve our financial position. Suitable performance measurement would segment our market (for example, by customer age or gender) and identify our changing market share within each segment.

Ensuring we meet key customer needs – again addresses the customer perspective but will also impact on the products/services that Armstrong offers and so affect the process perspective. Suitable performance measures from the customer perspective would be levels of repeat business and customer satisfaction and from the process perspective, Armstrong will measure its product range and quality. Range would be measured against competitors while quality could be measured subjectively against competitors or internally by level of customer complaints or returns. **Cost cutting** – this connects to the process perspective as it seeks to focus the business on value added activities. Suitable performance measures would be efficiency savings generated by removing or reducing unnecessary processes/products. Armstrong could possibly look to simplify its supply chain by cutting the number of suppliers with which it deals.

Amend current processes to meet the new focus – clearly, this takes the process perspective and measurement of this objective will be by way of the achievement of goals in a specific change programme to assist the other objectives.

Programme of sustainable development – this objective looks to the future and this is the learning and growth perspective. Suitable measures for this area would include the company's carbon footprint (its CO₂ output), the efficiency of energy use of the business and the level of packaging waste generated.

2 (a) **Armstrong's financial performance**

The year on year performance of Armstrong has declined with earnings per share falling by 23%. Normally, this would imply that the company would be heavily out of favour with investors. However, the share price seems to have held up with a decline of only 15% compared to a fall in the sector of 22% and the market as a whole of 35%. The sector comparison is the more relevant to the performance of Armstrong's management as the main market index will contain data from manufacturing, financial and other industries. Shareholders will be encouraged by the implication that the market views Armstrong as one of the better future prospects for investment.

This view is substantiated by the positive EVA for 2009 (\$110m) which Armstrong generated. EVA has fallen by 64% from 2008 but it has remained positive and so the company continues to create value for its shareholders even in the poor economic environment.

(b) **Evaluating the financial metrics**

The indicators each have strengths and weaknesses. EVA is a widely used indicator which aims to capture the increase in shareholder wealth that the company generates. It uses amended traditional profit based information in order to approximate the net present value method of appraising an investment. Thus, EVA provides a clear focus on the major objective of most commercial entities. However, its calculation requires a large number of adjustments to the traditional accounting figures, for example the need to calculate the economic rather than accounting depreciation, the need to distinguish between cash flow and accruals and to distinguish between expense and investment. This makes the method less easily understood than the two other measures currently used by Armstrong.

EPS growth is important to shareholders as it relates to dividend growth which is a fundamental variable used in the calculation of share value (Dividend valuation method). It is a widely used measure by equity analysts and so is a key driver of share prices. However, it is based on accounting profit and only captures year on year change and so can be subject to short-term manipulation if the trend over a number of years is not considered.

Share price performance reflects the capital performance of an investment but tends to be volatile and subject to significant fluctuations outside of the control of management. It will be the figure that most shareholders turn to in order to get a quick impression of their investment performance but it can lead to judgements being formed on the basis of that short-term volatility which are more appropriate for speculators rather than investors. . The use of an average share price in this instance should help to ameliorate such problems but the averaging method and time-period should be further investigated.

The impact of these metrics on management is intended to focus their activities on improvement of financial performance for shareholders. The danger of EPS growth and share price is that these may be manipulated in the short-term in order to demonstrate improvement but at the risk of impairing long-term performance. EVA partially tackles this issue through its use of adjusted accounting figures (e.g. depreciation) but suffers from lack of clarity in its calculation compared to these other metrics.

Workings:

	2008	2009
(W1) Economic value added (EVA)	\$306m	\$110m (down 64%)
(W2) EPS (profit for year/av no of shares)	2008 0.221	2009 0.170 (down 23%)
(W3) Stock market information	2008	2009
Main market index	1,115.2	724.9 (down 30%)
Retailing sector index	2,450.7	1,911.5 (down 22%)
Armstrong Stores share price	\$2.45	\$2.08 (down 15%)

3 To: Board of Armstrong Stores
 From: A Accountant
 Date: Today
 Subject: Benchmarking performance

This report describes the benefits and problems associated with benchmarking the company's performance. Then, the performance of Armstrong and its two main competitors is calculated and evaluated.

(a) Benchmarking methods

Benchmarking is a business improvement technique. There are different types of benchmarking. Internal benchmarking is where similar operations in different parts of the company under consideration are compared with each other and also with an internally generated target. External benchmarking is where the company's results are compared to those of other companies. There are different types of external benchmarking: one where competitors are used as comparators and another where a company with similar operations (eg warehousing), which is not a direct competitor, is compared. The aim of benchmarking is to identify where best practice lies and then to analyse what constitutes the best operational practice so this can be implemented across the business.

The main advantages and disadvantages concern the availability of benchmark information and its applicability to the business. Internal comparison between regions in Armstrong will be easy but may not yield dramatic improvements as the regions are probably already in relatively close contact. Any improvements identified from this exercise should be easily applicable as the systems will be broadly the same.

External benchmarking in this case means comparison to competitors where the possibility of radical new ideas is greater but the difficulty will lie in obtaining sufficiently detailed information to identify the best practice business process. Of course, it will be difficult to negotiate an information sharing arrangement with a competitor due to the commercially sensitive data being exchanged. However, there exist some government schemes which require subscriber companies to supply data and then provide them with anonymised industry data in return.

It would be easier to obtain information from a company which is not in direct competition with Armstrong but which has similar functions such as purchasing and warehousing. However, there are likely to be more significant differences in the objectives and functions of the activities being compared and so it may be harder to apply the lessons from the competitor to Armstrong's operations. Data has not been supplied to allow this analysis in this case. Armstrong could seek out companies which have industry awards in these functional areas and then negotiate an information sharing agreement.

(b) Armstrong's performance benchmarked

Comparing Armstrong to its competitors, it is clear that Armstrong has done well to increase its total revenues but this has come at the cost of a significant fall in profit compared to BS Stores. Armstrong should look into its pricing policy as it may have been buying sales by offering heavy discounts and these may not be sustainable in the long term. The CS Stores drop in profit is greatest of all but this may be explained by problems in the range or quality of its products. CS Stores opened 19 new stores in the period but there has been an overall fall in revenue of 4.9%. Armstrong should analyse CS offering to its customers in order to avoid making the same mistakes. BS has increased profitability and this seems due to a reduction in suppliers and presumably the overhead costs of managing those relationships. Armstrong should examine BS Stores sourcing policy to see if it can simplify its supply chain in a similar manner.

In terms of market share in food, Armstrong has maintained its position against slight falls in its competitors. In clothing, all the companies have made gains and this may indicate a trend to consolidation or failure of smaller stores of which Armstrong may be able to take further advantage.

In revenue per shop, Armstrong has outperformed its competitors, however, this may be due to Armstrong having a larger average store. This question could be answered by finding out the average store area for the three companies. Regionally, the Caselon area stands out with poor revenue per shop and it has an unusual mix of food and clothing compared to the other regions where clothing predominates. Further work will be needed to identify if this is due to a different range being offered by managers or if there are regional variations in customer preferences.

Conclusion

In conclusion, Armstrong appears to be performing well with increased market share during the decline. The company must guard against the danger of eroding margins too far.

Indicative Marking Schedule

1 0.5 mark per explanation of each perspective, up to 2.
1.5 marks for comments discussing each of the performance measures including the link to the new objectives, up to 6.

Total: 8 marks

2 (a) Comments: 1 mark per point up to maximum of 2 on EPS and share price (together) and maximum of 1 on EVA.
(Maximum 3)

Workings:

1 mark for calculation of EPS and 0.5 each other calculation, up to maximum of 2.

(b) Up to 2 marks on each metric and 2 marks on impact on management behaviour (Maximum of 6)

Total: 11 marks

3 (a) 1 mark per point made; 2 for explaining benchmarking and 2 for advantages/disadvantages (maximum 4)

(b) 1 mark per point made up to 5 for analysing the computations,
1 mark per point made up to 3 for suggesting further work and
1 mark for a conclusion (maximum 8)

Professional marks (format, style and structure of report) are available up to a maximum of 3.

Total: 15 marks

Total for question: 34 marks