HOW TO: BUSINESS CASE

RELEVANT TO ACCA QUALIFICATION PAPER P3

For many ACCA students there is no phrase which causes greater fear than 'Using an appropriate model or models of your choice…'. Immediately a number of problems arise:
- Which might be appropriate?
- How many?
- Choice – I might not choose correctly – I'd much rather be told what to use.
- If I choose incorrectly I've ruined my chances.

This article will look at some of these problems and will use as a subject to work on Question 1 from the June 2008 Paper P3 exam, AutoFone. This is reproduced here, with annotations. This is a typical Paper P3 Part (a) question with about three pages of information, including financial data, then three requirements.

WHAT THE EXAMINER SAID

After each exam session, the examiner issues a report, available on the ACCA website. It's worth reproducing extracts here of what the examiner said about candidates' performance in this question:
- '… the use of case study scenarios. Many candidates had a problem applying the theoretical knowledge they had learned to the context of the scenario. At this level, there are relatively few marks available for describing a model such as Porter's five competitive forces. The vast majority of the marks are for recognising the presence and effect of these forces in the context of the case study scenario.'
- 'It is important that the 15 minutes of reading time at the start of the exam is used effectively. One of the ways of making it more effective is to read the questions (ie the requirements of the case study) before reading the case study! This allows the candidate to put the case study into the context of the questions.'
- '…there is no irrelevant information in the case study scenarios. Candidates must concentrate on linking the scenario information to questions and (where applicable) to appropriate models.'
- 'As expected, most candidates chose to use Porter's five competitive forces as a framework for answering this question. … there are very clear barriers to entry signposted in the scenario and the data summarised in Table 2 provided information about industry competitors. Some candidates chose to use PESTEL and SWOT… candidates who used these two models could gain marks as they do identify relevant issues in the scenario…. Unfortunately many candidates penalised themselves by actually describing and using all three models (five forces, PESTEL and SWOT), leading to long answers with significant repetition. There is little to be gained by using different models to make the same points.'

A WORD ABOUT MODELS

Models (or frameworks) are ubiquitous in Paper P3, but it is important to realise that models are not designed to guarantee anyone a correct answer. How could they? Organisations, their strategic positions, the requirements of their stakeholders and so on come in all shapes and sizes, and no model could cope perfectly with every situation thrown at it. At best, perhaps, models are better than starting with a blank sheet of paper; they give you a structure for the information and a methodology that might help you to progress your analysis towards a conclusion, such as giving advice. Sometimes the word 'model' is rather flattering. PESTEL, for example, is little more than a checklist of potential environmental influences. This is why the examiner complains about candidates describing models; at this level in your exams they are means to an end, not an end in themselves.

Studying Paper P3?
Performance objectives 7, 8 and 9 are relevant to this exam

ANALYSIS STUDY APPROACH

A second point is that although you might not be provided with input for all parts of the model, a model can still be used. For example, there might be information about your competitors and suppliers, so Porter's five competitive forces might be of some use even if you know nothing about the other three forces. Similarly, you might be given some information about pending legal and technological changes and PESTEL can be used as a checklist to see that no other environmental factor has also been mentioned.

Of course, you do have to know the models, and occasionally you might be specifically asked to use one. At other times a specific model might be heavily hinted at (see below) because the examiner feels it would be useful in the context of the information provided. But do not get too obsessed with them. I often see discussions about whether there are 7, 8 or 9Ms to list resources, or whether tax is a political, economic or a legal influence. It doesn't really matter: you have identified that considering resources might be important and also that tax can be an important environmental influence.

You do not need to know any models that are not mentioned in the ACCA Paper P3 *Study Guide*.

MODELS (OR FRAMEWORKS) ARE UBIQUITOUS IN PAPER P3, BUT IT IS IMPORTANT TO REALISE THAT MODELS ARE NOT DESIGNED TO GUARANTEE ANYONE A CORRECT ANSWER. HOW COULD THEY? ORGANISATIONS COME IN ALL SHAPES AND SIZES, AND NO MODEL COULD COPE PERFECTLY WITH EVERY SITUATION THROWN AT IT.

CLUES ABOUT THE MAIN MODELS MIGHT BE USEFUL

The question mentions, or the scenario has information about, or we want to find out about:	**Model that *might* yield progress:**
The environment	PESTEL
Competitive position	Porter's five forces
Portfolio of products	Boston consulting group matrix; product life cycle analysis
Portfolio of companies	Goold and Campbell; Ashridge
Outsourcing	Harmon's process strategy matrix
Stakeholders	Medelow's matrix
Change management	Balogun and Hope Hailey; Lewin
Competitiveness of nations	Porter's diamond
How we make profits	Value chain; generic strategies

And then there is SWOT. SWOT will always work insofar as it is possible to allocate all effects and pieces of information to strengths, weaknesses, opportunities or threats. But it is barely sophisticated enough to be called a 'model'; it's more of a sorted list, and other models might enable more progress to be made. For example, using SWOT you could label an ambitious firm thinking of entering your market as a threat, but a Porter's five forces analysis specifically opens up the possibility of considering barriers to entry. This allows you to make a judgment about the strength of the threat and also what you might be able to do about it. Rearranging SWOT as a TOWS matrix is of more help: use strengths to capitalise on opportunities, but avoid relying on weaknesses; if there is a threat try to find a way in which your strengths can be used to defend you.

Note what the examiner said about making the same point repeatedly using different models: there's no point in doing that. Nor is there any point in trying use too many models in an attempt to show off your knowledge. Better to use two models well to let you move towards a conclusion than endless analysis but no conclusion. You will notice that the last row of the table contains 'generic strategies' as a model. These are often not thought of as a way of collecting information and are not usually considered until strategic choices are to be made. However, consideration of the generic strategies can be immensely helpful when trying to understand a business:

- If the business is successful it must be following a generic strategy: cost leadership or differentiation, each with or without focus.
- If the business is not successful, it is not successfully following a generic strategy and should be advised to try to do so.

THE QUESTION: AUTOPHONES

The suggested four-step approach is:

Step 1. Read the requirements. This will alert you to what the question is about: a takeover, opening up abroad, powerful foreign competition, maturing market, or whatever.

Step 2. Use your 15 minutes of reading time to read the question in as relaxed a manner as you can. Annotate, underline, highlight as you go – but try not to underline or highlight every word. Perhaps you could mark P, E, S, T, E, L or 'Cost leadership' against sentences as you go through. Reread several times if you need to and keep the requirements in mind. Some people fear the case study because it contains a lot of information, but these details provide you with your ammunition. As the examiner says, there is no irrelevant information, so always think what the information might allow you to surmise. Be open-minded at this stage and annotate with appropriate terms where you see fit. Try to use the strategic planning vocabulary and terminology as this will give 'hooks' to theories that might be useful. For example, the scenario uses the phrase 'our central business idea'. Essentially that is the company's 'Mission'. Remember, treat information and detail as friends: the hardest questions are often the short ones, such as 'What is life?' As mentioned above, a scenario gives you lots of ammunition with which to attack the requirements.

Step 3. Look at the financial or quantitative data. This has always been provided in the case study, but it seems that candidates adandon their particular quantitative and financial skills too easily and rush off to use strategic planning models. Odd, given that this is an exam for accountants. Would you not normally expect quantitative data to shout information at you? Look at trends, calculate a few ratios (GP%, liquidity, market share, cost per unit) and see what might be there. Financial information and strategic planning are inseparable.

Step 4. Plan you answer. Make sure you address the requirements, particularly two part requirements such 'identify and appraise' or 'describe and recommend'. Pay attention to the marks available as this will indicate how much time to spend on that part of the question.

Part (a)

Step 1: The requirements, part (a):

(a) Using an appropriate model or models, analyse the competitive environment of AutoFone's retail shops division.

Note: requirement (a) includes 2 professional marks. (20 marks)

So, you are to analyse the competitive environment. Probably the best tool is Porter's five forces, but there is no reason why PESTEL could not also be used where appropriate, or even SWOT. Therefore, you should be ready to read through the scenario, annotating it as you go (eg: C = competitors, B = buyers, Sup = suppliers, N = New entrants, Sub = substitutes. Similarly for PESTEL).

Step 2: Read the question in the light of the requirements. Annotate the question paper. The question reproduced here has been annotated with comments relating to AutoFone's competitive environment.

Step 3: **Table 1** on **page 8** shows how relatively unimportant both AFDirect and AFInsure are to the business so far. The analysis by age of customer shows that younger people are relatively keen on buying over the internet. As internet-savvy people age, this branch of the business is likely to become more important at the expense of the retail shop division.

Table 2 on **page 8** shows how the mobile phone industry has changed from a growth rate of 5% 03/04 to only 0.7% 06/07. The only way for a firm to get bigger is to gain market share so rivalry will become more intense. AutoFone has managed to increase its market share from 2003 to 2007 and itself enjoyed growth of 2% 06/07.

Also, **Table 2** shows five competitors of roughly equal size (oligopoly). Price reductions by one have to be followed by others to maintain their market shares – a potentially unstable setup

Step 4: Answer plan
- potential entrants: low threat: providers already in market; other entrants would be given poor deal
- suppliers: hardly any bargaining power (30-year contracts)
- rivalry: providers; equal sizes; technology allows rivalry over internet
- buyers: little customer loyalty despite claim that AutoFone is impartial
- substitutes: none known for the phone function
- market conditions: low growth = high competition; technology = internet competition.

Part (b)

Step 1: The requirements, Part (b):

(b) AutoFone's CEO is anxious to develop a rational and well argued case for retaining the retail shops division. **Write a briefing paper for the CEO to submit to the strategy planning committee explaining why the retail shops division should continue to form a key part of AutoFone's future strategy.**
Note: requirement (b) includes 3 professional marks.
(15 marks)

Briefing paper = memorandum to all intents and purposes. You are not asked to say *if* the retail shops division should remain important, you are asked to justify *why it should*.

Step 2: By now you will be familiar with the question, but will need to skim again in the light of the requirements. Look for reasons to keep the retail shops and ways of refuting the two directors' paper.

Step 3: Financial data.
The retail shops contribute 85% of the company's total turnover and 88% of mobile phone sales.

Retail shops are still profitable
ROCE 2007 = 5% (11/205); 2003 = 18%
GP% 2007 = 26%; 2003 = 33%
NP% 2007 = 3%; 2003 = 12%

Step 4: Answer plan
- A change in approach to pushing more profitable phones would increase profits (though perhaps at the expense of the company's reputation).
- Shops are on long leases so there could be substantial exit costs.
- Retail shops are still profitable.
- Retail shops are by far the largest part of the business.
- The brand is based on the reputation of the shops and this may be linked to the success of the internet and insurance businesses.

Part (c)

Step 1: The requirements, Part (c):

(c) The AutoFone retail shops division faces problems in remaining faithful to the original business idea of offering impartial advice to customers and developing an appropriate rewards system for its staff. **Evaluate what changes the AutoFone retail sales division should consider making to both its business idea and its rewards system.**
(15 marks)

Evaluate implies that you must make a judgment on changes that might be necessary to its business idea and reward system.

Step 2: By now you will be familiar with the question. Relevant material is in the fifth paragraph and three paragraphs between **Tables 2** and **3**.

Step 3: Financial data.
Doesn't seem very relevant here

Step 4: Answer plan

- Business idea – might no longer be viable (note success of City branch). There will now be many review sites and forums on the internet dedicated to comparing phones and greater customer knowledge.
- Mature business usually means more competition and the old ways of achieving profits might not apply any more.
- There has to be recognition in reward scheme of repair work done to phones bought from AFDirect, otherwise resentment.
- An attempt at management by objective which does not really work.
- Conflict/inconsistency: rewards closely based on profit. Managers supposed to be entrepreneurial but the City branch manager was reprimanded. If 'our central business idea' is offering independent and impartial advice, remuneration should be linked to that, not profits.
- Mission statement (or equivalent) might need to be looked at and updated. Emphasis now, perhaps, needs to be wider eg not just 'independent advice', but 'advice, service, insurance'. A one-stop shop.

INTRODUCTION

The question is reprinted here from June 2008: Autofone. The ACCA model answer is available from the ACCA website at www.accaglobal.com/students/acca/exams/p3/past_papers

AutoFone was established almost 20 years ago at the beginning of the mobile telephone boom. It was formed by a dynamic chief executive officer (CEO) who still remains a major shareholder of the company.

AutoFone brought two new concepts to the market. First, it established retail shops where customers could go and handle the products and discuss mobile phone options with trained sales people. Before AutoFone, all mobile telephones were sold through the customer directly contacting the telephone network provider (like conventional home land line services) and were generally aimed at business rather than leisure users. Second, AutoFone sold products and services from all the four major network providers licensed by the government to provide telecommunications services in the country.

Previously, customers could only choose products and services from within one network provider's range. AutoFone allowed customers to choose products and services across the range of the four providers and reflected this in the company's motto 'ethical advice: the customer's choice'.

N: not so profitable any more – barrier to entry

Sup: low supplier pressure

In 1990, AutoFone signed a 30-year supply contract with each provider. Although, in retrospect, these deals were on commercially favourable terms for AutoFone, the network providers were happy to agree these deals because none of them believed that mobile telephones could be successfully sold through retail shops. However, speaking in 2003, the managing director of one of the networks suggested 'that AutoFone had got away with incredible profit margins' when they signed the deals in 1990. The four network providers themselves had re-signed 25-year licence deals with the government in 1995. Under the terms of these deals, licences will be restricted to the four current providers until their renewal date of 2020.

N: no new entrants to networks

N: large scale = barrier to entry

Sup: low supplier pressure but locked in

Retail shops division

AutoFone currently has 415 shops around the country. To reduce costs most shops are on the edge of (but not in) the main shopping area of the town they serve. It is usual for AutoFone to sign a 50-year shop lease in return for low initial annual rental and a rent-free period at the start of the lease while the company fits out the shop to reflect AutoFone's corporate image. In 1997, AutoFone floated on the country's stock market to assist the funding of further shops and so continue its organic growth. The national coverage of its shops, the publicity generated by its CEO and a successful television advertising campaign culminated, in 2005, with it being rated by consumers as one of the top 20 brands in the country.

B: Good brand = lower buyer pressure

Management by objective?

The CEO of AutoFone established the retail shops along, in his words, ‘entrepreneurial lines’. He regards each shop as an independent business, having to achieve a profit target but without being closely monitored within these targets. He believes that the company is ‘about providing opportunity to its employees, providing them with autonomy and responsibility to achieve their goals. It is not about monitoring them every hour of the day, stifling creativity and enthusiasm’. To support this approach, sales staff are given a relatively low basic salary with a substantial element of profit-related pay linked to the profit targets of the shop. Commission is also paid to sales staff who successfully sell mobile phone insurance to the customer. Each shop is relatively small, usually employing three or four people.

In recent years the CEO has been increasingly involved in television, sports promotion and charity work. At AutoFone he has established a strategic planning committee of senior headquarters managers to develop and implement the company’s business strategy. This committee includes the two longest serving board directors. The strategy still continues to have at its heart the central business idea of giving independent and impartial advice to customers so that they can choose the best equipment and network for their needs.

Marketplace trends

Since AutoFone’s arrival into the market, two significant trends have emerged:

C: increased competition

(i) The licensed network providers have opened their own retail stores, usually in city centres. AutoFone has reacted to the opening of these shops by stressing AutoFone’s independence and impartiality. Only at AutoFone can impartial advice be received on all four competing networks and their supporting services. The CEO now refers to this as ‘our central business idea’ and, as well as being core to their strategy, it is heavily emphasised in all their promotional material.

Mission? Differentiation

(ii) Mobile phones have become more sophisticated. Many now offer integrated cameras, mp3 players, web browsers and email facilities. AutoFone offers these products in both its shops and through its internet operation. Mobile phones are either purchased outright or provided on monthly contracts. The minimum contract period with the network provider is usually 12 months.

AutoFone has itself established its own internet division, AFDirect, as a separate division within the group. It has also established an insurance division (AFInsure) offering insurance to cover loss or damage to mobile phones purchased from the company. Revenue earned from each division, analysed by the age of the customer, is shown in **Table 1** on page 8.

Analysts agree that growth in the mobile phone business is slowing down and this is supported by the figures given in **Table 2** on page 8 showing revenue from sales (both retail and Internet) for AutoFone and its competitors, the four licensed network providers, for the period 2003–2007.

THE CEO OF AUTOFONE ESTABLISHED THE RETAIL SHOPS ALONG, IN HIS WORDS, ‘ENTREPRENEURIAL LINES’. HE REGARDS EACH SHOP AS AN INDEPENDENT BUSINESS, HAVING TO ACHIEVE A PROFIT TARGET BUT WITHOUT BEING CLOSELY MONITORED WITHIN THESE TARGETS. HE BELIEVES THAT THE COMPANY IS ‘ABOUT PROVIDING OPPORTUNITY TO ITS EMPLOYEES, PROVIDING THEM WITH AUTONOMY AND RESPONSIBILITY TO ACHIEVE THEIR GOALS.

C: increased competition/technology
B: little buyer loyalty

However, while the AFDirect and AFInsure divisions are prospering, there are increasing problems in the retail shops division. Profitability has been declining over the past few years (see **Table 3**) and this has had a demoralising effect on shop employees. One shop manager commented, in his exit interview, that the profit targets were unattainable in the current market. 'They might have been appropriate in 1997, but they are not in 2007.' Staff are particularly demoralised by spending time explaining a particular product to a customer who then leaves the shop and buys the product cheaper on the internet. They have to wait for it to be delivered (usually two or three days) but they are prepared to do this to gain the lower prices offered by the direct internet-based companies, including AFDirect. It is also increasingly common for customers who have bought from AFDirect to take their phones to AutoFone's retail shops for support and service. This activity is not recognised in the shop employee's reward package.

AutoFone's central city branch

Despite the overall decline in the profitability of the shops, one branch has continually met or exceeded its profitability targets and is held up by the CEO as an example of best practice – proof that the company's approach to mobile phone selling can still be profitably applied. This is the central city branch in one of the country's most prosperous cities.

The CEO arranged for three members of the strategic planning committee to visit the shop, posing as customers, to investigate the reasons for the shop's success. They found the staff very friendly and helpful. However, they also found that they were guided towards products and services which had higher profit margins. Further investigation showed this always to be the case and so customers were sold products which were profitable to the shop, rather than those best suited to the customer's needs. On receiving this information, AutoFone's board concluded that this was unethical as it compromised their central business idea which stressed impartial advice to guide the 'customer's choice'. The manager of the shop was reprimanded and asked to adhere to company policy. He resigned soon afterwards, followed by his two assistants. The shop is currently run by temporary staff and profitability has significantly dropped.

Entrepreneurship punished

Future strategy

The two longest serving directors on the strategic planning committee are increasingly concerned about the company's decline in profitability (see **Table 3**). They have written an internal paper suggesting that the retail division should be sold off and that AutoFone should re-position itself as an online retailer of phones. They believe that the retail shops business model is no longer appropriate. They argue that a company concentrating solely on Internet sales and insurance would be a 'smaller but more profitable and focused' business. The CEO is strongly opposed to this suggestion because it was the shop-based approach to selling mobile phones that formed the original business model of the company. He has a strong emotional attachment to the retail business. The two directors claim that this attachment is clouding his judgment and hence he is unable to see the logic of an 'economically justifiable exit from the retail business'.

See **Table 3** on page 9.

Required:

(a) **Using an appropriate model or models, analyse the competitive environment of AutoFone's retail shops division.**
Note: requirement (a) includes 2 professional marks.
(20 marks)

(b) AutoFone's CEO is anxious to develop a rational and well argued case for retaining the retail shops division.
Write a briefing paper for the CEO to submit to the strategy planning committee explaining why the retail shops division should continue to form a key part of AutoFone's future strategy.
Note: requirement (b) includes 3 professional marks.
(15 marks)

(c) The AutoFone retail shops division faces problems in remaining faithful to the original business idea of offering impartial advice to customers and developing an appropriate rewards system for its staff.
Evaluate what changes the AutoFone retail sales division should consider making to both its business idea and its rewards system.
(15 marks)
(50 marks)

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TABLE 1: ANALYSIS OF AUTOFONE SALES: 2007 (ALL FIGURES IN $M)

	Age of customer					
	Under 15	15–25	26–40	41–60	Over 60	Total
Division AutoFone retail shops	5	90	60	120	65	340
AFDirect	0	15	20	8	2	45
Total sales of mobile phones						**385**
AFInsure	0	1	3	7	3	14
Group total						**399**

TABLE 2: MARKET ANALYSIS (ALL FIGURES IN $M) OF SALES OF MOBILE PHONES

Company	2007	2006	2005	2004	2003
AutoFone	385	377	367	340	320
NetAG	350	348	345	340	305
09Net	390	388	380	365	350
PhoneLine	315	315	315	305	300
NetConnex	295	295	294	290	285
Total	**1,735**	**1,723**	**1,701**	**1,640**	**1,560**

WHILE THE AFDIRECT AND AFINSURE DIVISIONS ARE PROSPERING, THERE ARE INCREASING PROBLEMS IN THE RETAIL SHOPS DIVISION. PROFITABILITY HAS BEEN DECLINING OVER THE PAST FEW YEARS AND THIS HAS HAD A DEMORALISING EFFECT ON SHOP EMPLOYEES. ONE SHOP MANAGER COMMENTED, IN HIS EXIT INTERVIEW, THAT THE PROFIT TARGETS WERE UNATTAINABLE IN THE CURRENT MARKET. ‘THEY MIGHT HAVE BEEN APPROPRIATE IN 1997, BUT THEY ARE NOT IN 2007.’

TABLE 3: EXTRACTED FINANCIAL INFORMATION FOR AUTOFONE (RETAIL SHOPS DIVISION ONLY)

Extracted financial information (all figures in $m)
Extracted from the Balance Sheet

	2007	2006	2005	2004	2003
Total non-current assets	143	140	134	128	123
Current assets:					
Inventories	345	340	335	320	298
Trade receivables	1,386	1,258	1,216	1,174	1,120
Cash and cash equivalents	345	375	390	400	414
Total current assets	2,076	1,973	1,941	1,894	1,832
Total assets	**2,219**	**2,113**	**2,075**	**2,022**	**1,955**
Total shareholder's equity	150	155	160	165	169
Non-current liabilities:					
Interest bearing long-term loans	55	50	45	40	35
Other provisions	16	15	13	13	10
Total non-current liabilities	71	65	58	53	45
Total current liabilities	1,998	1,893	1,857	1,804	1,741
Total equity and liabilities	2,219	2,113	2,075	2,022	1,955

Extracted from the Income Statement

	2007	2006	2005	2004	2003
Revenue	340	337	332	320	305
Cost of Sales	250	252	230	220	205
Gross Profit	90	85	102	100	100
Wages and Salaries	39	38	37	35	33
Other expenses	40	38	35	30	30
Interest payable	4	4	3	3	3
Total	83	80	75	68	66
Net Profit before tax	7	5	27	32	34
Tax	2	3	5	4	4
Net Profit after tax	5	2	22	28	30

Extracted from annual reports

Number of employees	1,400	1,375	1,325	1,300	1,275