National University of Science and Technology

FACULTY OF COMMERCE

DEPARTMENT OF ACCOUNTING

SECOND SEMESTER EXAMINATION PAPER: 2011/2012

DATE:	**MAY 2012**
SUBJECT:	**STRATEGIC MANAGEMENT ACCOUNTING: CAC4205**
TIME ALLOWED:	**THREE HOURS 30 MINUTES (3½) HOURS**
MARKS:	**100**

INSTRUCTIONS TO CANDIDATES

1. Answer all **three** questions
2. Use the examination book provided
3. Use black or blue pen
4. Begin each question on a new page and
5. Submit all answer books

QUESTION 1 (50 MARKS)

Pepe Group Ltd – Case date: 1990

Introduction

The Pepe Group first impinged upon the public's consciousness in March 1985 when it was floated on the Unlisted Securities Market (USM) – the UK's mini stock exchange- with a capitalization of over £22 million. The company was founded in March 1974 by three Kenyan Asian brothers-Nitin, Arun and Milan Shah. Like many other entrepreneurial ventures-and entrepreneurs for that matter- it had relatively humble origins.

Nitin Shah came to Britain from Kenya in 1969, aged eighteen. His first three working years in UK included a variety of jobs. Eventually he ended up working as a window-dresser. Often this involved undertaking tasks for some of the leading multiple tailors- a process which stimulated his interest in clothes and fashion. During this time, an opportunity arose for him to start selling clothes wholesale to small shopkeepers, as a commissioned agent, for a manufacturer. Subsequently he began to sell direct to the public through the medium of a weekend stall in the Portobello Road market. This venture proved so profitable that he gave up his weekday job and rented another stall on the King's Road, which he opened every day.
While Nitin Shah may have been the main entrepreneurial driving force behind Pepe, his brothers Arun and Milan have also played significant roles in its development. Arun, who was the eldest brother, was an accountant by training. Milan, the youngest of the three, was aged nineteen when Pepe was formed in 1974.

The Shah brothers began their new venture with a stall on the King's Road market. The initial cash requirement of the business was £350. This consisted of £50 for a week's rent in advance, £200 for a lock-up shutter for the stall and £100 for fitting out the stall. Unfortunately, no clearing bank would lend them the money or grant them an overdraft. However, they obtained the cash from a small London bank- the Meghraj- which had been established by fellow Kenyan Asians. The relationship has continued until this day- Pepe still banks with the same people, although as it has expanded, it has employed other banking groups as well.

One of the difficulties of running a clothing distribution business is the need for a considerable amount of storage space for the clothes. The brothers were forced to use the garages of friends and relations for a while. Eventually, the business outgrew this possibility. By then, however, it had been decided to move from a market stall to a shop in King's Road.
This involved a considerable increase in risk since a significant amount of capital would be tied up in the fabric of the building. In spite of its growing prominence, the company still had difficulty in obtaining finance for its operations. Fortunately, however, its relationship with the Meghraj bank continued to thrive.

By 1977, the business had been built up to such an extent that the brothers were forced to choose between the wholesaling and retailing arms of their operation. In the event, they decided to focus their efforts on the faster growing wholesaling activities. The capital, which was released by the sale of the retail outlet, was then used to purchase a warehouse near to the King's Road to stock the garments. It was at this time that the decision was taken to develop Pepe as the brand name for the range of jeans and fully coordinated casual wear, which they were trading in.

When the Shah brothers began their wholesaling operations, the rapid growth in the market for casual wear, and particularly jeans, meant that their biggest competitors had large order books and were not in a position to satisfy market demand. Therefore, there was plenty of ‘market room’ for a company like Pepe. The brothers decided to concentrate their effort initially on smaller retailers since many of these were not being adequately sourced by the larger (mainly US) manufacturers. Indeed, they knew from their own (bitter) experience how smaller companies were often treated by their larger ‘brethren’. Yet just supplying small independent retailers was not likely to provide sufficient business to sustain Pepe’s continuing growth. The company needed to obtain access to the large multiple retailers. Eventually contracts were obtained with John Lewis and the Burton Group amongst others. The small retailer was not ignored. As Pepe has grown, however, it has been forced to direct its efforts towards the more established shops rather than market traders.

Manufacturing-sourcing policy

As has already been indicated, when Pepe started out it had relatively little cash available for any type of investment. This impacted upon its policy relating to the sourcing of fabrics for its garments. Its relatively small volume requirement in the early days meant that availability, rather than cost, was the primary determinant of its sourcing policy. As the size of its business increased, cost considerations came more and more to the fore.
In the first instance, Pepe turned to Hong Kong to obtain the larger quantities which it required for its expanding business. In its move towards larger volume production, however, Pepe had no intention of sacrificing quality for quantity. Indeed contracts are drawn up tightly to try to ensure that its quality standards are maintained. It generally takes seven or eight months for a new manufacturing unit to attain the standards which are demanded by Pepe. Around 90 per cent of the company’s orders are now produced in Hong Kong. The exceptions to the general rule are some shoes and sweatshirts. Pepe considers that its policy of contracting out the manufacture of its garments has generally been a successful one. As Nitin Shah has commented:
“I would make jeans in Britain if I could. But here we have to make allowances to suit the manufacturer’s production line. In Hong Kong we just tell them what we want, when we want it and it arrives. We can even build in flexibility over the selection of the final colours. We’ve tried using British manufacturers but they can’t give us the same service at a competitive price.”

On only one occasion has Pepe become involved in the manufacture of its own garments. This was in 1979 through a Kenyan joint venture, the outcome of which was fairly disastrous. The problem was that although the Kenyan company had been successful at manufacturing dresses, it had not previously produced jeans. As a consequence, it suffered from quality control problems, and the experience led the brothers to make two important policy decisions. First of all, they decided not to go into manufacturing themselves but to concentrate on buying and selling- the design, development and marketing of their products. Secondly, they determined to stick with experienced manufacturers and not to attempt to obtain too great a degree of manufacturing process innovation. By contrast, product innovation is a sine qua non of its in-house operations.

Product market strategy

The Shah brothers entered the wholesaling market at a time when there had been a rapid growth in the demand for casual wear of all types. From its earliest days, however, Pepe has concentrated its efforts on jeans to a disproportionate extent, in spite of a number of forays into the market for coordinated casuals. Today, jeans still represent the bulk of its sales.
During the 1970s and 1980s, however, considerable changes have taken place in the jeans market (see Appendix 4.1 to this case). In some cases, these changes have led to Pepe having to ask its manufacturers to change the wash of their jeans within only six weeks or so. Therefore, flexibility and ability to respond to fairly rapid changes in fashion are an essential component of the ability of a company, such as Pepe, to survive in the jeans business.

Pepe’s current jeans product market strategy is based upon a portfolio of five brand names, each of which has its own distinctive appeal and identity. First of all, there is the Pepe brand itself. This is the original brand and is the leader in the group’s international activities. The Pepe brand, which is targeted at fashion-conscious men and women in the 15-25 age bracket, consists of two main elements. First of all, there are basic denim jeans, which are offered all the year round basis, and secondly there is a casual collection offered on a seasonal basis. The jeans brand is from time to time strengthened by the addition of jeans related products. The latter have included footwear, marketed under licence, leather jackets and a range of accessories such as belts and watches. It is envisaged that bags, hold alls and grips also will be introduced.

The Big Stuff Company brand is more ‘classical’ in nature than the Pepe brand. It seeks to combine the essentials of classic leisure wear with more contemporary fashions. The BISCO brand is aimed at both men and women in the 16-25 age group.

In January 1987, Pepe bought Buffalo, a French distributor of jeans and casual wear. The Buffalo brand, which was designed in Bordeaux initially for the French market, has its own distinctive French flavour. Moreover, its sales are biased heavily towards women, although it caters for both sexes in the 16-24 age group.

By contrast, Hardcore is a tough, masculine brand based upon a traditional ‘macho’ image. Since it was introduced in 1982, it has developed its own clearly defined niche within the men’s jeans market- namely the 16-35 age group.

Corporate culture, management style and philosophy

Pepe has displayed many of the typical attributes of an entrepreneurial type of organization. In fact, the history of the company is a ‘rags’ to riches story, as was indicated earlier. Immigrants to Britain seem to be more likely to start their own business than the average member of the indigenous population. Since the 1930’s , the Jewish community has been recognized for its entrepreneurial attributes, and more recently Asian immigrants, such as the Shah brothers, have begun to assume a greater prominence in this respect.

There is now a considerable amount of evidence to suggest that immigrant communities are more willing than the indigenous population to put in the hard work and take the risks, which are required to establish and build a business. Different cultural norms and community support patterns seem to reinforce the tendency towards independence and personal achievement, which is an important entrepreneurial characteristic.

Flexibility is another entrepreneurial characteristic and one, which is displayed by Pepe. Flexibility involves ‘bending the rules’ and building the business upon personal relationships. ‘Bending the rules’ does not mean operating in an illegal or illicit manner, simply a willingness to take the sort of risks which a typical modern hierarchical organization might find unacceptable. An example of the latter is the appointment of a number of family members to key positions within the company. This should not be seen as a form of nepotism, rather it fits in with the strong sense of family duty, which exists within immigrant communities. Even today, many members of the Shah family are involved with Pepe’s operations both at home and overseas.

The same philosophy applies to Pepe’s extended family of suppliers and customers. The company has engendered loyalty amongst its customers by being as helpful as possible. Examples of such helpfulness include good payment terms, availability of supply and willingness to allow retailers to change their breakdown of styles after they have been ordered. These concessions mean that Pepe, in turn, has to get the same sort of flexibility from its suppliers. The establishment and maintenance of long-term relationships is the means of accomplishing this objective. Indeed many of Pepe’s suppliers have been manufacturing for the company for five to ten years. This length of relationship is relatively unusual in the clothing trade.

From its earliest days, Pepe’s management workload has been £divided among the three Shah brothers. Nitin has looked after its product and design team. Arun has been responsible for strategy and finance and the coordination of the company’s operations. Milan has looked after sales. In spite of this division of labour, the brothers run the business with a high degree of consensus and consult each other about important decisions.

As the company has grown, a more formal management infrastructure, complete with a board of directors, has been instituted. In February 1985, a non-executive chairman was appointed to the board. He is Roger Rowland, director of the merchant bank Morgan Grenfell. Rowland had been introduced to the Shah brothers by a mutual friend Lester Luer, who is now one of Pepe’s auditors. Nevertheless, effective control of the company remains in the hands of the brothers who own roughly half the company’s shares.

Company financing

The development of Pepe during the 1970s was reflected in a steady expansion in its turnover and profitability. During the late 1970s and early 1980s, however, losses were incurred due to a number of unfortunate events. By the 1983/4 financial year, however, profitability had recovered and had reached a total of just under £1m.

In 1984, the Shah brothers decided to turn their attention to the US market. The numbers of its customers rose rapidly following its attendance for the first time at a number of major US trade exhibitions. The growth in Pepe’s sales which took place during the mid 1980s occurred not only because its customer base was growing but also because sales to existing customers increased.

As Pepe grew, so did its funding requirements. Since borrowing against future orders was becoming increasingly difficult, the company was faced with a choice between consolidating its business and accepting a lower rate of growth or obtaining some sort of equity financing. It chose the latter course of action, and so in March 1985 five and half million shares, representing just under on quarter of the group's equity, were sold at 100p on the Unlisted Securities Market (USM). This sale raised over £5m for investment purposes. Initially, Pepe's share price dropped on the USM. However, by the time of the stock market crash of October 1987 it had risen to 375p, before falling again to 225p.

Since the flotation of the Pepe Group in March 1985, the company has gone from strength to strength, with average sales growth being roughly 50 per cent per annum. (Appendix 4.2 to this case contains Pepe's financial details, while Appendix 4.3 provides some industry standard ratios for comparative purposes.) Turnover in the year ending 31 March 1990 is expected to have been over £100 million with profits of over £10m.

Appendix 4.1 The jeans market

The hey-day of the jeans industry was unquestionably during the 1960s and 1970s. During this period, denim jeans became the unofficial uniform of young people all over the world. As a result, the jeans market must be considered to be a globalized one.

During the early 1980s, however, a significant proportion of young people came to regard denim as an embarrassing relic of their parents' (misspent) youth. This may be seen as one reflection of the generally more conservative attitudes, which prevailed during this period. As a consequence, sales of jeans in the United States declined from 500 million pairs in 1981 to 430 million in 1985. In Europe, the fall was even more dramatic, in percentage terms, over the same period-from 250 million to 150 million pairs. The result of this market trend was a spate of plant closures worldwide. Two of the best-known names in the industry- Levi and Wrangler - became private companies following leveraged buyouts.

During 1985, a revival in the jeans market occurred, stimulated by Levi's successful reintroduction of its five pocket, fly button 501 jeans- first in the United States then in Europe. This development, which was backed by a heavy advertising campaign, may be seen in terms of a more general appeal to nostalgia in society, which was prevalent at that time. A craze for hand-washed jeans- those with a marbled finish- also helped to boost sales temporarily. However, this fad had fizzled out by 1988 by which time overall sales were static again.

A more important trend during the late 1980s was for the jeans market to become increasingly fashion conscious. Traditionally, the style of jeans has changed relatively slowly and manufacturers have relied on making standardized products at high volume. This has tended to accentuate the importance of production economies of scale. As a consequence, manufacturers have tended to adopt cost leadership strategies. More recently, however, rapid changes in style have required companies to exhibit greater flexibility.

Table 4.1 Jeans market 1987

United States (490 m pairs)		Europe (180 m pairs)	
Levi Strauss	24%	Levi Strauss	11%
Lee	14%	Wrangler	3%
Wrangler	10%	Lee	2%
Guess	3%	Lee Cooper	2%
Others	49%	Pepe	2%
		Others	80%

Examples of ‘fashions’ in the late 1980s include the ‘worn in’ look and jeans with ready made rips at the knees and/or thighs.

In spite of the above ‘fads’, the more general trend during this period has been towards a more stylish product. Designer jean companies, such as Guess in the United States and Pepe in the United Kingdom, have generally done well. Of the major manufacturers, Levi (thanks to its 501s) and Lee, which has always been seen as a stylish brand, have prospered. By contrast, Wrangler and Lee Cooper have suffered from their ‘cowboy’ and ‘old fashioned’ images respectively. Table 4.1 indicates the market shares of the leading companies in 1987 in both the United States and Europe.

In an attempt to reverse the adverse trend in its UK fortunes, Wrangler initiated a major TV advertising campaign during 1988, as did Lee. This followed an expansion of such activity by Levi and Pepe. Each of the campaigns had one thing in common-a targeting of adolescents, the chief consumer of jeans. In the United States, a different ‘tack’ has been adopted for demographic reasons. In that country, there will be a contraction in the teenage population and an increase in the over 25-age group during the 1990s. Therefore, Levi, for instance, has introduced ‘506s’‘generously cut’ for those who find it difficult to squeeze into ‘501s’.

A common feature of the strategic response of the major manufacturers to their new business environment has been a decision to withdraw from European manufacturing and source their output from contract manufacturers in the Far East. The unquestioned European leader in this respect has been Pepe.

Appendix 4.2 Pepe Group Ltd financial details

Table 4.2 Pepe: Five –year trading summary

	1989	1988	1987	1986	1985
	£000	£000	£000	£000	£000
Turnover	97,461	72,241	50,242	31,113	19,906
Profit on ordinary activities before taxation	12,756	8,408	5,905	4,208	2,633
Taxation	5,019	2,875	2,010	1,718	1,177
Profit on ordinary activities after taxation	7,737	5,533	3,895	2,490	1,456
Minority interest	240	180	160	47	36
	7,497	**5,353**	**3,735**	**2,443**	**1,420**
Earnings per share	31,9p	22,8p	15,9p	10,4p	7,8p

Table 4.3 Pepe: Consolidated profit and loss account (for the year ended 31 March)

	1989	1988
	£000	£000
Turnover	97,461	72,241
Cost of sales	57,970	43,162
Gross Profit	39,491	29,079

Other operating expenses (net)	25,889	19,816
Operating Profit	13,602	9,263
Interest-net	846	855
Profit on ordinary activities before taxation	12,756	8,408
Taxation	5,019	2,876
Profit on ordinary activities after taxation	7,737	5,532
Minority interest	240	180
Profit attributable to members of the holding company	7,497	5,352
Dividends	1,410	1,059
Retained Profit for the year	6,087	4,293
Earnings per ordinary share	31,9p	22,8p
Dividends per ordinary share	6,0	4,5p

Table 4.4 Pepe: Consolidated balance sheets (as at 31 March)

	1989	1988
	£000	£000
Fixed assets		
Tangible assets	9,924	4,821
Investments	-	-
	9,924	4,821
Current assets		
Stocks	11,419	6,479
Debtors	34,367	19,552
Cash at bank and in hand	4,774	3,925
	50,560	29,956
Current liabilities: Creditors		
Accounts falling due within one year	31,310	18,035
Net current assets	19,250	11,921
Total assets less current liabilities	29,174	16,742
Creditors:		
Amounts falling due after more than one year	6,306	4,179
Net assets	22,868	12,563
Capital and reserves		
Called-up share capital (1)	2,350	2,350
Share premium account	4,609	4,609
Revaluation reserve	3,452	-
Profit and loss account	11,744	5,131
Shareholders' funds	22,155	12,090
Minority interest	713	473
	22,868	12,563

(1) As at 31 March 1989, shares in issue were 23,500,000

Appendix 4,3 Selected financial ratios

Table 4,5 Selected financial ratios: Standard Industrial Classification Code 6160- wholesale distribution of textiles, clothing, footwear,etc. (56 companies)

Ratio	Lower Quartile	Median	Upper quartile
Return of capital (%)	5.9	19.3	34.3
Return on assets (%)	2.9	8.0	16.3
Profit margin (%)	1.2	4.7	9.8
Stock turnover (x)	4.1	6.9	12.7
Credit period(days)	67	45	27
Liquidity(x)	1.2	1.4	2.2
Acid test(x)	0.5	0.8	1.3
Debt gearing(x)	12.8	0.0	0.0
Income gearing (x)	47.3	14.1	0.3

Required:

(a) Using key ratios that calculate liquidity, profitability, activity and solvency, prepare a financial appraisal report of Pepe for the period 1987-9 and compare Pepe's performance with the industry average. **(20)**

(b) Evaluate the business strategies, which Pepe has pursued to case date. **(10)**

(c) How should Pepe attempt to compete in the jeans market during the three years following the case date? **(10)**

(d) Pepe has enjoyed relatively rapid growth in the ten years up to the case date. Identify those factors, which may limit its future growth prospects. **(10)**

QUESTION 2 (25 MARKS)

The Zvavuya Division of Muchavona Ltd produces a component, which it sells externally, and can transfer to other divisions within the company.

Zvavuya Division has been set a performance target for the coming financial year to achieve a residual income of $500,000.

The following budgeted information relating to Zvavuya Division has been prepared for the coming financial year.

(i) Maximum production/sales capacity 800,000 units.

(ii) Sales to external customers 500,000 units at $3. 70.

(iii) Variable cost per component: $2. 50.

(iv) Fixed costs directly attributable to the division: $140,000

(v) Capital employed :$ 2000,000 with a cost of capital of 13%

The Tongai Division of Muchavona Ltd has asked Zvavuya Division to quote a transfer price for 300,000 units of the component.

Required:

(a) Calculate the transfer price per component, which Zvavuya Division should quote to Tongai Division in order that its budgeted residual income target will be achieved. **(5 Marks)**

(b) Explain why the transfer price calculated in (a) may lead to sub-optimal decision making from the point of view of Muchavona Ltd as a whole. **(5 Marks)**

(c) Tongai Division now establishes that it requires 400,000 components. A quote has been obtained for Brainstorm Ltd, an external supplier, for the supply of 400,000 components at $3.40 each. However, Brainstorm is not willing to quote for only part of the requirement of Tongai Division. Another external supplier, Chemai Ltd, is willing to supply any quantity of the components at $ 3.60 each.

Assume that Zvavuya Division is willing to supply components to Tongai Division as required. For each of the separate cases below, calculate the transfer price that would be quoted to Tongai Division, the decision that Tongai would reach and the impact that this would have on Zvavuya's budgeted residual income.

- **(i)** at an average price per component for the quantity required, such that the budgeted residual income of Zvavuya Division will still be achieved; **(3 Marks)**
- **(ii)** at an average price per component which reflects the opportunity cost of components transferred; **(3 Marks)**
- **(iii)** at prices per component which reflect the opportunity cost of each component. **(3 Marks)**

(d) State which of the bases for transfer prices in (c) should lead to profit maximization for Muchavona Ltd and calculate the reduction in company profit, which should arise from the operation of each of the other transfer price bases in comparison. **(6 Marks)**

QUESTION 3 (25 MARKS)

At Christmas, I buy either expensive presents at $20 each or cheap ones at $5 for the children in my family. I have 12 children to buy presents for (though I may buy more than one present for a child). I must buy expensive presents for my three favourite children. However, cheap presents tend to weigh 5 kgs, while expensive ones weigh only 1 kg. In order to make Santa's sack look right, I want the presents to weigh at least 20 kgs.

Required:

(a) Set up in Linear Programming form and solve the problem of buying the presents to minimize the costs. **(12 Marks)**

(b) It takes 1 hour to choose each expensive present but 2 hours to choose each cheap present. Set up in Linear Programming form and solve the problem of buying the presents in the shortest possible time. **(13 Marks)**

END OF EXAMINATION PAPER