

Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered	Student Notes
Workshop 1			
1. Introduction	<ul style="list-style-type: none">• Presentation• Group discussion		
2. Ethics in business	<ul style="list-style-type: none">• Case study• Group discussion	Ch. 1	Pg. 1 – 13
3. Executive management	<ul style="list-style-type: none">• Case study• Formal presentations	Ch. 2	Pg. 14 – 25
4. Management reporting	<ul style="list-style-type: none">• Case study• Formal presentations	Ch. 4, 5 & 6	Pg. 26 – 39
Workshop 2			
5. Reboot	<ul style="list-style-type: none">• Presentation• Group discussion		To be released after completion of Workshop 2
6. Treasury operations	<ul style="list-style-type: none">• Case study• Formal presentations	Ch. 8, 10 & 11	
7. Corporate finance	<ul style="list-style-type: none">• Case study• Formal presentations	Ch. 12, 14, 15, 17 & 19	
8. Conclusion	<ul style="list-style-type: none">• Presentation• Group discussion		

You are expected to have studied the relevant chapters of the Learning Pack and completed the pre-workshop materials thoroughly prior to attending the workshops. It is important for you to become familiar with the workshop materials as they will be raised for discussion throughout the workshops.

Please remember to bring a calculator with you to the Module B Workshops.

Ethics in business – Pre-workshop exercise

Part (a)

(a) Key considerations from each person's perspective

LP reference: Part (a) refers to Chapter 1, Ethics in business

Mr. Nigel Yip, CEO (and Hong Kong CPA)

- So far, Nigel acted upon the recommendations of the Head of New Product who did not thoroughly research the new product before recommending it to market. Both the Head of New Product and Nigel were keen to introduce new, innovative product. Because of this, Nigel probably did not ask enough probing questions or conduct his own follow-up research/outsource this to a staff member.
- Nigel has a responsibility of CEO to be thoroughly informed of all relevant information before signing off on new products or initiative. As stated above, he failed in this. It is his ultimate responsibility as CEO that the product went to market even through the clinical trials showed a negative result.
- Nigel correctly commissioned an internal review after the death and correctly kept the Chairman informed. He now has the report and has not yet done anything with it. Nigel now has a clear choice – to release the information or to keep it quiet?
- Nigel now has many factors to consider, and he needs to ensure he behaves correctly in terms of his personal ethics, in accordance with the HKICPA Code of Ethics, Hong Kong Securities Exchange listing and disclosure rules, and law.
- Nigel needs to consider how to manage the Head of New Product (who is currently still employed and under performance management) and Dr. Yeo, head of medical research.
- Nigel also needs to consider damage to his reputation as an accountant. Can he amend for his past failings? Can he still be a member of the HKICPA? Has he bought the industry into disrepute?
- Another major consideration for Nigel is damage to Tango in terms of share price, future plans for expansion, business strategy, brand, prestige and customers.
- Nigel also needs to consider the seriousness of the case – a death has occurred, other people fell ill – and could it happen again? Morally, should he take some personal responsibility for what has occurred?
- Finally, was this a scandal waiting to happen? Do the practices of Dr. Yeo and his laboratory need a thorough review? Are there other products currently on the market which were released to market without adequate clinical trials. This is a serious consideration.

Mr. David Chan, Chairman and major shareholder

- David has no involvement in the scenario until the death had occurred and he was given a report arising from the internal investigation. New product trials probably do not require Chairman or Board approval so this is not an issue.
- David now has the report and has not yet done anything with it. David now has a clear choice – to release the information or to keep it quiet?
- David's role as chairman – does this situation need to be reported to the board? Does he need to discipline Nigel? Or can Nigel continue on and lead 'from the front'? Will keeping the situation quiet enhance or distract from his relationship in the business community?

- David's role as major shareholder – how will this affect the share price? Should he sell some of his shares in case the whole scandal is made public (which would be insider trading and illegal)? If he makes the scandal public how much money will he lose personally?
- David now has many factors to consider, and he needs to ensure that he behaves correctly in terms of his personal ethics, in accordance with the HKICPA Code of Ethics, Hong Kong Securities Exchange listing and disclosure rules, and law.
- Another major consideration for David is damage to Tango in terms of share price, future plans for expansion, business strategy, brand, prestige and customers.
- David also needs to consider the seriousness of the case – a death has occurred, other people fell ill – and could it happen again?
- Finally, was this a scandal waiting to happen? Do the practices of Dr. Yeo and his laboratory need a thorough review? Are there other products currently on the market which were released to market without adequate clinical trials? This is a serious consideration.

Dr. Tony Yeo, Head of Clinical Research at Beauty Land Laboratory (BLL)

- Dr. Yeo may be in serious trouble – with the law (being found legally negligent in passing the clinical trial) and with the medical profession (malpractice for passing the clinical trial). He has a lot at stake – his profession, his reputation, criminal prosecution – in fact, this scandal may ruin Dr. Yeo professionally and personally.
- There are reasons for him passing the clinical trial – work stress, and distraction because of his upcoming holiday – however are these adequate excuses in a situation where a death resulted?
- Additionally, Dr. Yeo stated on the report that more clinical trials on humans must be conducted. Does this limit his liability? And in fact, does this mean he is not responsible for the subsequent approval of the product while he was away?
- On the other hand, if Dr. Yeo thought the product needed more clinical trials, then why did he give both trials a POSITIVE – READY FOR MARKET stamp? Does passing the clinical trial cancel out his later suggestion for more clinical trials? But if he thought this, then why did he pass the trials? And what procedures are in place (or are not in place) that allowed this to be passed to the Head of New Product. Dr. Yeo is responsible for all actions of the lab, irrespective of whether he is present or not.
- Finally, was this a scandal waiting to happen? Do the practices of Dr. Yeo and his laboratory need a thorough review? Is this a sign that there is something seriously wrong with the practices or Dr. Yeo and/or his lab? Are there other products currently on the market which were released to market without adequate clinical trials?
- Dr. Yeo also needs to consider the seriousness of the case – a death has occurred, other people fell ill – and could it happen again? Morally, should he take some personal responsibility for what has occurred?

Lucy Lee, business analyst (and Hong Kong CPA)

- Lucy has a difficult choice. Should she risk her position in Tango, her reputation and her career to release the full report to the media? Whistle-blowers are often victimised and have their lives and careers ruined.
- On the other hand, what if she does nothing and the full report is never revealed? She would be complicit in a cover-up which could cause even more damage to her reputation, career and ambitions (if the cover-up became public).

- Lucy also needs to consider the seriousness of the case – a death has occurred, other people fell ill – and could it happen again?
- Lucy needs to ensure that she behaves correctly in terms of her personal ethics, in accordance with the HKICPA Code of Ethics, Hong Kong Securities Exchange listing and disclosure rules, and law.
- Lucy also needs to consider damage to her reputation as an accountant. Her actions will now have a direct impact on her role - if she keeps quiet, can she still be a member of the HKICPA? Has she brought the industry into disrepute?

Part (b)

- (b) Ethical issues identified in the scenario

LP reference: Part (b) refers to Chapter 1, Ethics in business, Section 2 – the HKICPA Code of Ethics

Key learning points/issues: Part (b) examines the Code of Ethics in the context of the ethical case study. Students must identify the ethical issues and apply these issues directly to the Code of Ethics. **Four of the five key principles of the Code** (integrity, professional competence and due care, confidentiality and professional behaviour) are contravened to some extent in this scenario. Students must **identify these principles** and state **how they have been threatened** from the perspective of their allocated person and from the CPA perspective.

A fundamental principle of the Code of Ethics is **integrity** - being straight forward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.

There are several instances of non-compliance, or potential non-compliance, with this principle:

- Nigel and David are now faced with a dilemma involving potential non-compliance – they have the internal report and they have a responsibility to be straightforward and honest with this information. They have a responsibility to not be knowingly associated with information that “omits information required to be included where such omission would be misleading”. The current information released to the public omits important information and is misleading. By keeping the report private they are omitting such information. They would be in direct contravention of the principle.
- The same also applies to Lucy – she has a responsibility to not be “knowingly associated with information where she believes the information contains materially false or misleading statement, has been furnished recklessly or omits information required to be included where such omission would be misleading”. She has become aware of an internal report which differs from the public statements made about the scandal, and if she keeps this information to herself she would be in direct contravention of the principle.
- Dr. Yeo’s behaviour, whilst not in direct contravention of the principle, has brought the integrity of his profession and Tango into question.

A fundamental principle of the Code of Ethics is **professional competence and due care** – the need to act diligently and in accordance with professional standards. There are several instances of non-compliance, or potential non-compliance, with this principle:

- Nigel has contravened this principle because he did not conduct enough research or ask questions about the new product before allowing it to be released to market on a trial basis. He did not even ask to view the complete clinical trial report. He has failed to carry out his assignment diligently or to exercise professional competence.

- Dr. Yeo has contravened this principle because he passed the clinical trial as **POSITIVE – READY FOR MARKET** when there was an infection arising from the second trial. His later recommendation to conduct more clinical trials should have indicated to him not to pass the product. He has failed to carry out his assignment diligently or to exercise professional competence. This raises the question – was this lack of professional competence and due care a one-off or is it standard practice at BLL?
- Nigel and David both have an obligation to act diligently on behalf of employees, shareholders, the board, customers and the general public. They should demonstrate professional competence and due care, and, accordingly, it is their shared responsibility to conduct themselves in a manner consistent with the good reputation of Tango and the beauty industry. For Nigel, he also has to consider the reputation of the HKICPA.

A fundamental principle of the Code of Ethics is **confidentiality** – the need to respect the confidentiality of information acquired as a result of professional and business relationships, and the need to not disclose any information to third parties with proper and specific authority unless there is a legal or professional right or duty to disclose.

- Nigel, David and Lucy are all under threat of contravening this principle if they release the report to the public. **HOWEVER**, this information may well have to be released – **they may all have a legal or professional right or duty to disclose**. They are all faced with this ethical dilemma – while this information is deemed commercial-in-confidence, it potentially involves a case of negligence resulting in death – this would present them with a legal right and a duty to disclose the information.

A fundamental principle of the Code of Ethics is **professional behaviour** – the requirement to comply with laws and regulations, and avoid action that discredits the profession. There are several instances of non-compliance, or potential non-compliance, with this principle:

- Nigel, David and Lucy are all under threat of contravening this principle. By keeping the internal report private, they could be covering up the criminal behaviour of Dr. Yeo (negligence) and any other negligence found to be committed by staff of Tango (including themselves if accused of a cover-up). They are also at risk of discrediting Tango and the beauty industry more generally.
- Nigel and Lucy are also in danger of contravening the HKICPA Code of Ethics, of which they are members. They are at risk of discrediting accounting and finance professions more generally.
- Dr. Yeo is in contravention of the principle as he may have committed negligence (criminal) and medical malpractice (medical rules). He has discredited the medical profession, the beauty industry, and Tango.

The Code of Ethics outlines a range of different threats to these fundamental principles.

Under the Code of Ethics Nigel Yip faces two threats: **self-review** and **self-interest**. He made an incorrect decision to allow the product to go to market on a trial basis, and he now needs to re-evaluate that judgement. This incorrect decision was one of a series of events which led to a person's death. Nigel must now ensure he does not allow self-interest to allow him to cover up his role in the scandal – this will impact his career, his reputation, any shares he has in Tango and perhaps result in legal action.

Under the Code of Ethics David is facing the threat of **self-interest** in that it may be in his (and Tango's interest) to keep this situation as quiet as possible and avoid scandal. He has a large financial and professional stake in Tango.

Under the Code of Ethics Dr. Yeo faces two threats: **self-review** and **self-interest**. Dr. Yeo made a serious error, which has resulted in the death of another person. He must now ensure he does not

allow self-interest to allow him to cover-up his role in the scandal – this is a major threat as Dr. Yeo faces criminal charges, and personal and professional ruin.

Under the Code of Ethics, Lucy may face the threat of **intimidation** if she chooses to become a whistle blower. She also faces the threat of **self-interest**, as becoming a whistle-blower will affect her personally, financially and professionally.

Under **Part C** of the Code of Ethics relating to **Professional Accountants in Business (PAIB)**, as CEO Nigel has an “absolute duty to comply with the fundamental principles contained in Part A of the Code”. The Code states that “professional accountants are encouraged, therefore, to establish an ethics-based culture in their employing organisations that emphasises the importance that senior management places on ethical behaviour” and that “professional accountants (are required to)... apply safeguards to eliminate the threats or reduce them to an acceptable level”.

The errors made by BLL and then the Head of New Product suggests there may be a problem with medical sign-off and procedures in Tango. These are a significant threat and must be safeguarded against. Nigel has an absolute responsibility to explore the option that these events are a sign of culturally or procedural issues at Tango, and is NOT an isolated incident.

Part (c)

- (c) **Using the 3-step strategy for solving ethical dilemmas, highlight the best solution or course of action**

LP reference: Part (c) refers to Chapter 1, Ethics in business, Section 4 – Solving Ethical Dilemmas and Section 2 – the HKICPA Code of Ethics

Key learning points/issues: In Part (c) students learn how to apply the 3-step strategy for solving ethical dilemmas to an ethical scenario. They must show they have worked through the three steps, applied the Code of Ethics throughout these steps, and come to a supported and ethical decision. This decision should be from the perspective of their allocated person and as a CPA.

Mr. Nigel Yip, CEO and Hong Kong CPA

Options	<p>Nigel now has two options:</p> <p>Option 1: Keep the internal report quiet and do not disclose it to anyone. Make sure that all the parties involved in Tango (Dr. Yeo and the Head of New Product) also keep their role in the scandal quiet. Also ensure that David keeps the report quiet. Ensure that anyone else in Tango (such as Lucy and the CFO) is kept quiet. All this may be done through threats (threat of disclosure or being fired) and/or positive actions (such as promotions or cash bonuses). Ensure there is a full cover-up. Tango does make some payment to victims without admitting liability. These payments ensure the victims do not pursue further action. There is no internal review of culture or procedure.</p> <p>Option 2: Inform the media of the full situation, suitably manage Dr. Yeo and the Head of New Product and make full disclosure to the Board. If Dr. Yeo is charged with negligence, then offer him full legal support. Make suitable compensation payments to the family of Patient X and to the other injured patients. Admit liability. Ensure there is a full review of BLL and any other areas of Tango as required. Implement necessary regime and cultural change in Tango. Review own behaviour and adjust accordingly.</p>
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<p>Step 1</p> <p>Analyse the consequences</p>	<p>Option 1 consequences:</p> <ul style="list-style-type: none"> • He will protect his reputation and position Tango, as well as his position and any financial stake he has in Tango. • He is protecting Dr Yeo from personal and professional ruin; as well as criminal charges and likely disbaring from the medical profession. • He is protecting David and the board from any reputational damage. • He is ensuring that there is no further damage to Tango share price, customer retention or reputation. • He makes payment to the victims (and their families) but they do not achieve justice – there is no admittance of wrong or liability. Money without justice is hollow and is a lower quality good than justice in this case. • He has the potential to make the situation much worse if the cover-up is then uncovered – and the damage to all participants and Tango may be catastrophic. • He does not review his, or any other person's, behaviour. Nothing is learned. • He allows a similar incident to happen again – which may result in further medical incompetence and even deaths. • He is breaking the law by participating in a cover-up of negligence. • He is breaking core principles of the HKICPA Code of Ethics. <p>Option 2 consequences:</p> <ul style="list-style-type: none"> • He allows the victims and their families full justice and compensation. • By initiating and implementing a review of internal practices he is attempting to ensure that this incident never happens again. • He is risking severe financial and reputational damage to Tango. • He is allowing Dr. Yeo to be punished for his role in the scandal. • He may be opening himself up to criminal prosecution. • He is risking severe personal reputational damage. • He may lose his job as CEO and suffer other financial consequences. • He is attempting to ensure that there are no further (later) consequences of the scandal.
<p>Step 2</p> <p>Analyse the actions</p>	<p>Option 1 actions:</p> <ul style="list-style-type: none"> • This option is not fair or truthful to the victims and their families. It does not respect their rights or their dignity. It treats these persons (and the deceased) of being of less importance than the employees of Tango. • This option is best for serving the self-interest of all the employees of Tango (if it is not discovered). It is fair to them if they do not want to face the consequences of their actions. • This option is clearly immoral in terms of honesty, transparency, and the value of human life.

	<ul style="list-style-type: none"> • This option denies natural justice. • This option allows for the scandal to occur again which endangers the community as a whole. Again, the value of life of the employees and shareholders is higher than that of the general public. <p>Option 2 actions:</p> <ul style="list-style-type: none"> • This option is the most fair and truthful to the victims and their families. It recognises the dignity of the deceased and the rights of survivors. They are seen as equally important as Tango. • This option admits wrong and allows for natural justice. • This option ensures that those responsible for taking a human life are punished. • This option is not fair to Dr. Yeo, particularly if he is the only one who is made criminally responsible. • This option means that the risk of such an event occurring again is minimised. This recognises the value of human life and the rights of the general public.
<p>Step 3 Make a decision</p>	<p>Option 2 provides the best mix of quality over harm. Although there is the risk of personal, professional and financial harm to Tango and to the individuals involved, this has to be balanced against the risk of future deaths from treatments, and the need for justice to be achieved.</p> <p>The fact that Dr. Yeo may face criminal charges and ruin is the biggest consequence of Option 2, but the fact is that his (and others) actions resulted in a death. Remember, in this case, human life must be valued against all else.</p> <p>The risks to Nigel himself are low in comparison – he may lose his job and his reputation as a worst-case scenario. However, if he takes Option 1, and it is discovered, then the consequences are much, much worse.</p>

Mr. David Chan, Chairman and major shareholder

<p>Options</p>	<p>David now has two options:</p> <p>Option 1: Keep the internal report quiet and do not disclose it to anyone. Make sure that all the parties involved in Tango (Dr. Yeo and the Head of New Product) also keep their role in the scandal quiet. Also ensure that Nigel keeps the report quiet. Ensure that anyone else in Tango (such as Lucy and the CFO) is kept quiet. All this may be done through threats (threat of disclosure or being fired) and/or positive actions (such as promotions or cash bonuses). Ensure there is a full cover-up. Tango does make some payment to victims without admitting liability. These payments ensure the victims do not pursue further action. Ensure that there is no internal review of culture or procedure.</p> <p>Option 2: Inform the media of the full situation, suitably manage Dr. Yeo, Nigel, the Head of New Product and make full disclosure to the Board. If Dr. Yeo is charged with negligence, then offer him full legal support. Make suitable compensation payments to the family of Patient X and to the other injured patients. Admit liability. Ensure there is a full review of BLL and any other areas of Tango as required. Ensure that Nigel implements necessary regime and cultural change in Tango.</p>
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<p>Step 1 Analyse the consequences</p>	<p>Option 1 consequences:</p> <ul style="list-style-type: none"> • He will protect his reputation and position in Tango, as well as his position and any financial stake he has in Tango. • He is protecting Dr. Yeo from personal and professional ruin; as well as criminal charges and likely disbaring from the medical profession. • He is protecting the rest of the board from any reputational damage. • He is ensuring that there is no further damage to Tango share price, customer retention or reputation. • He makes payment to the victims (and their families) but they do not achieve justice – there is no admittance of wrong or liability. Money without justice is hollow and is a lower quality good than justice in this case. • He has the potential to make the situation much worse if the cover-up is then uncovered – and the damage to all participants and Tango may be catastrophic. • He does not review his, or any other person's, behaviour. Nothing is learned. • He is complicit in allowing a similar incident to happen again – which may result in further medical incompetence and even deaths. • He is breaking the law by participating in a cover-up of negligence. • He is breaking core principles of the HKICPA Code of Ethics. <p>Option 2 consequences:</p> <ul style="list-style-type: none"> • He allows the victims and their families full justice and compensation. • By overseeing a review of internal practices he is attempting to ensure that this incident never happens again. • He is risking severe financial and reputational damage to Tango. • He is allowing Dr. Yeo to be punished for his role in the scandal. • He is attempting to ensure that there are no further (later) consequences of the scandal.
<p>Step 2 Analyse the actions</p>	<p>Option 1 actions:</p> <ul style="list-style-type: none"> • This option is not fair or truthful to the victims and their families. It does not respect their rights or their dignity. It treats these persons (and the deceased) as being of less importance than the employees of Tango. • This option is best for serving the self-interest of all the employees of Tango (if it is not discovered). It is fair to them if they do not want to face the consequences of their actions. • This option is clearly immoral in terms of honesty, transparency, and the value of human life. • This option denies natural justice. • This option allows for the scandal to occur again which endangers the community as a whole. Again, the value of life of the employees and shareholders is higher than that of the general public.

	<p>Option 2 actions:</p> <ul style="list-style-type: none"> • This option is the most fair and truthful to the victims and their families. It recognises the dignity of the deceased and the rights of survivors. They are seen as equally important as Tango. • This option admits wrong and allows for natural justice. • This option ensures that those responsible for taking a human life are punished. • This option is not fair to Dr. Yeo, particularly if he is the only one who is made criminally responsible. In fact, it makes him a scapegoat. • This option means that the risk of such an event occurring again is minimised. This recognises the value of human life and the rights of the general public.
<p>Step 3 Make a decision</p>	<p>Option 2 provides the best mix of quality over harm. Although there is the risk of personal, professional and financial harm to Tango and to the individuals involved, this has to be balanced against the risk of future deaths from treatments, and the need for justice to be achieved.</p> <p>The fact that Dr. Yeo may face criminal charges and ruin is the biggest consequence of Option 2, but the fact is that his (and others) actions resulted in a death. Remember, in this case, human life must be valued against all else.</p> <p>The risks to David himself of taking Option 2 are very low in comparison – he may lose financially from a drop in Tango share price, but his reputation and position will remain intact. However, if he takes Option 1, and it is discovered, then the consequences are much, much worse.</p>

Dr. Tony Yeo, Head of Clinical Research of Beauty Land Lab (BLL)

<p>Options</p>	<p>Dr. Yeo has two options:</p> <p>Option 1: Dr. Yeo decides that, now that Tango has copies of the clinical trial review, to blame the Head of New Product and the CEO of ignoring his requests for more clinical trials for the sake of bringing product to market. He states that his report was correct – and that he was correct to pass the product based on only one case of septic shock. He then says that all of this occurred while he was on annual leave so none of it is his fault. He denies that there are any procedural or cultural issues at his laboratory. He also raises issues of high work levels and stress.</p> <p>Option 2: Dr. Yeo takes full responsibility for the death of the patient and admits that he should not have passed the criminal trial. He states that he was both stressed and distracted when he wrote the report, and that his recommendation for further trials should have been more prominent. He allows a full review of practices at his laboratory and in Tango. He places the decisions about his future in the hands of Nigel and David and the results of their internal report.</p>
<p>Step 1 Analyse the consequences</p>	<p>Option 1 consequences:</p> <ul style="list-style-type: none"> • By shifting the blame he avoids criminal prosecution. • He avoids potential disbaring from the medical profession. • He avoids potentially serious consequences to his personal and professional reputation.

	<ul style="list-style-type: none"> • He avoids severe financial loss resulting from criminal prosecutions and loss of medical licence. • He will probably lose his position at Tango by shifting blame to the CEO (or be forced to resign). • He will suffer some reputational damage by shifting the blame (through gossip etc.), but this will not be as bad as the damage from admitting culpability. • By avoiding prosecution, he denies the victims and their families access to justice. • He does not review his, or any other person's, behaviour. Nothing is learned. • He is complicit in allowing a similar incident to happen again by denying any error on behalf of the lab – which may result in further medical incompetence and even deaths. • He is breaking the law by participating in a cover-up of negligence. • He is breaking core principles of the HKICPA Code of Ethics. <p>Option 2 consequences:</p> <ul style="list-style-type: none"> • The consequences of Dr. Yeo for taking this option are severe: <ul style="list-style-type: none"> ○ Potential loss of liberty (jail sentence) ○ Loss of ability to generate income (job and medical license) ○ Loss of professional reputation ○ Loss of personal reputation and relationships ○ Destruction of career • This option also makes Dr. Yeo the only person made responsible for the scandal and disregards any role played by company culture or other people in the organisation. He is the “scapegoat”.
<p>Step 2</p> <p>Analyse the actions</p>	<p>Option 1 actions:</p> <ul style="list-style-type: none"> • This option is not fair or truthful to the victims and their families. It does not respect their rights or their dignity. It treats these persons (and the deceased) of being of less importance than Dr. Yeo himself. • This option is best for serving the self-interest of Dr. Yeo and him alone. It is fair to them if he does not want to face the consequences of their actions. It must be noted that Dr. Yeo faces severe consequences from admitting his liability. • This option is clearly immoral in terms of honesty, transparency, and the value of human life. • This option denies natural justice. • This option allows for the scandal to occur again which endangers the community as a whole. Again, the value of life of the employees and shareholders is higher than that of the general public. • He allows the victims and their families full justice and compensation. • By allowing a review of internal practices he is attempting to ensure that this incident never happens again.

	<ul style="list-style-type: none"> • He is risking severe financial and reputational damage to Tango. <p>Option 2 actions:</p> <ul style="list-style-type: none"> • This option is the most fair and truthful to the victims and their families. It recognises the dignity of the deceased and the rights of survivors. They are seen as equally important as Tango. • This option admits wrong and allows for natural justice. • This option ensures that Dr. Yeo takes responsibility for his role in taking a human life. However, he is not the only person to blame. There were issues with stress, culture, and the corporation and all other parties escape persecution. Only one person responsible for taking a human life is punished. • It creates a scapegoat in Dr. Yeo (which is morally wrong). • This option means that the risk of such an event occurring again is minimised. This recognises the value of human life and the rights of the general public.
<p>Step 3</p> <p>Make a decision</p>	<p>This is a very difficult decision for Dr. Yeo, as he has so much to lose by making the correct ethical choice.</p> <p>Option 2 provides the best mix of quality over harm. The huge risk to Dr. Yeo's future has to be balanced against the risk of future deaths from treatments, and the need for justice to be achieved. The fact is that his (and others) actions resulted in a death. Dr. Yeo, as a medical doctor, knows that human life must be valued against all else.</p> <p>Therefore, he must choose Option 2, as he did play some role in the loss of a human life. The best result for Dr. Yeo is to take Option 2 but to ensure that he is not the scapegoat. He should work with Tango for cultural change, and try to ensure that other parties are also punished for their role. This may be difficult.</p>

Lucy Lee, Business analyst (and Hong Kong CPA)

<p>Options</p>	<p>Lucy now has three options:</p> <p>Option 1: To prepare the figures as requested and to keep quiet about the internal report. She can choose to stay completely out of the situation and continue on with her work.</p> <p>Option 2: To report her concerns to Jenny Kwok (CFO) and/or to Nigel Yip (CEO) and state that she feels there may be a cover-up happening. In this way, she has raised her concerns with management and then leaves the decision up to them. She takes no further action.</p> <p>Option 3: Lucy may realise that Tango is not going to take any further action. She feels strongly about this and decides to leak her copy of the internal report to the media. She becomes a "whistle-blower".</p>
<p>Step 1</p> <p>Analyse the consequences</p>	<p>Option 1 consequences:</p> <ul style="list-style-type: none"> • She will protect her reputation and position at the company, and her ability to generate income and provide for herself and her family. • She will not harm any career progression at Tango. • She will be seen by Jenny and Nigel as a "team player" and will probably be rewarded.

- She is protecting Dr. Yeo from personal and professional ruin; as well as criminal charges and likely disbaring from the medical profession.
- She is ensuring that there is no further damage to Tango share price, customer retention or reputation.
- There is the potential to make the situation much worse if the cover-up is then uncovered – and the damage to all participants and Tango may be catastrophic.
- By not reporting her knowledge, she also becomes complicit in allowing a similar incident to happen again – which may result in further medical incompetence and even deaths.
- She is breaking the law by participating in a cover-up of negligence.
- She is breaking core principles of the HKICPA Code of Ethics – even though she took a copy of a commercial-in-confidence document the contents of the document make this allowable under the Code.

Option 2 consequences:

- She is taking some risk to her reputation and position at the company, and her ability to generate income and provide for herself and her family.
- She may harm her career progression at Tango.
- It is likely that Jenny and Nigel will not be happy with Lucy for raising these concerns.
- This is an important first step in uncovering the scandal and she must try approaching management first with her concerns.

Option 3 consequences:

- She is risking severe financial and reputational damage to Tango.
- She is allowing Dr. Yeo to be punished for his role in the scandal.
- She is risking severe personal reputational damage as whistle-blowers are often attacked by the company and the media.
- She will most likely lose her position at Tango.
- If she does not lose her position, then she will probably suffer discrimination or issues with gaining future promotion.
- She may find it difficult to find other employment.
- Her whistleblowing will allow victims and their families full justice and compensation.
- Her whistleblowing is attempting to ensure that this incident never happens again.
- Her whistleblowing may spark a review of practices across the industry and result in future lives and injuries being prevented.

<p>Step 2</p> <p>Analyse the actions</p>	<p>Option 1 actions:</p> <ul style="list-style-type: none"> • This option is not fair or truthful to the victims and their families. It does not respect their rights or their dignity. It treats these persons (and the deceased) of being of less importance than the employees of Tango. • This option is best for serving the self-interest of all the employees of Tango (if it is not discovered). It is fair to them if they do not want to face the consequences of their actions. • This option is clearly immoral in terms of honesty, transparency, and the value of human life. • This option denies natural justice. • This option allows for the scandal to occur again which endangers the community as a whole. Again, the value of life of the employees and shareholders is higher than that of the general public. <p>Option 2 & 3 actions (<i>applicable if Option 2 works and her approach to management results in them making the report public – if not, then the results of Option 3</i>):</p> <ul style="list-style-type: none"> • These options are the most fair and truthful to the victims and their families. It recognises the dignity of the deceased and the rights of survivors. They are seen as equally important as Tango. • These options admits wrong and allows for natural justice. • These options place Lucy's self-interest at a lower level than the importance of human life. • These options ensures that those responsible for taking a human life are punished. • These options may not be fair to Dr. Yeo, particularly if he is the only one who is made criminally responsible. • These options means that the risk of such an event occurring again is minimised. This recognises the value of human life and the rights of the general public.
<p>Step 3</p> <p>Make a decision</p>	<p>Option 1 makes Lucy complicit in the cover-up and if she chooses this option, then she has made an incorrect ethical decision.</p> <p>Option 2 is the middle road. She is risking some career damage by raising her concerns with Jenny Kwok and/or Nigel Yip. However, she is showing some concern and bravery. Option 2 is an important first step and she should carry out Option 2 prior to Option 3.</p> <p>However, if Option 2 does not work and the full details of the scandal are still covered-up, then Lucy has no option but to become a whistle blower under Option 3. This will be a difficult decision for Lucy and will probably come at great personal cost (at least initially). However, the issue is important and the loss of human life is involved. If she makes this brave choice, it will be the right one ethically.</p>

Executive Management – Pre-workshop exercise

Part (a)

Conclude whether the power of each force is high, medium or low. Identify at least four points for each of five forces. In your analysis also consider the sixth force – complementarity and list at least four complementors.

LP Reference

Chapter 2, Section 7.

Key learning points: Students will conduct a full market analysis through the completion of a Porter's five forces model exercise on Tango.

Threat of new entrants	Threat from substitute products
<p>Scale economies: Is available in all four sectors. All providers can provide the services across many centres and achieve some form of economies of scale. Because beauty and fitness is a service industry, the extent of scale economies is limited.</p> <p>Product differentiation: Can be difficult to differentiate in a crowded and fragmented market. Tango has made itself the high-end quality provider and is a leader in this area. Product differentiation is essential to succeed.</p> <p>Capital requirements: The investment in the Beauty Land Laboratory is the highest capital requirement cost. Fitness equipment is also a high capital investment. Most premises are rented (75% for Tango) so capital for property is not high.</p> <p>Knowledge requirements: Medium. This is a large and fragmented market with lots of trained fitness and beauty personnel. Apart from the expertise at Beauty Land Laboratory knowledge requirements are not a barrier to entry.</p> <p>Switching costs: Low. It is very easy for customers to switch any of the products or to give them up altogether</p> <p>Access to distribution channels: Low. There are many beauty product suppliers to choose from – this is a crowded market.</p> <p>Cost advantages of existing producers: New treatment testing and knowledge provides some cost advantage to Tango. E-commerce is not a major factor because it is chiefly a personal service industry (with the exception of the retail product arm)</p>	<p>Retail products</p> <ul style="list-style-type: none"> - Cosmetics - Jewellery - Clothing - Other ways to spend discretionary funds such as restaurants, entertainment <p>Slimming and fitness centres</p> <ul style="list-style-type: none"> - Yoga and meditation centres - Dance schools - Dieting clubs - No exercise at all - Low or no cost exercise (walking, cycling, swimming) - Team sports and clubs - Home exercise machines - Cost of switching is low (or even a cost saving). This keeps prices at a firm price ceiling <p>Spa and massage</p> <ul style="list-style-type: none"> - Meditation - Medical massage - Not a lot of substitutes in this area as massage is specialised <p>Beauty and facial</p> <ul style="list-style-type: none"> - Home retail products (in evidence at the moment e.g. when money is tight you might cancel your facial but still buy a face cream) - Cosmetics (well-known that sales of lipstick increase in recessions)

<p>Conclusion: Threat of new entrants is low.</p>	<ul style="list-style-type: none"> - Clothing - Lifestyle changes (exercise, sleep, change of diet) <p>Conclusion: Threat from substitute products is medium and varies between the four product areas.</p>
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Bargaining power of customers	Bargaining power of suppliers
<p>There are many customers and each one is relatively small. This means that there is not much impact if one buyer moves, but if many buyers leave at once (say due to brand damage from negative media reports) there is a very large impact</p> <p>Most products are standardised and can be copied</p> <p>Switching costs are low to non-existent</p> <p>These are all luxury items – customer is not very reliant on the product – they can change provider or, if necessary, give up the product</p> <p>Each customer will buy one or more service, potentially across many product areas. Each purchase is relatively small</p> <p>Product quality, especially in beauty and facial, is very important. As price is relatively similar across the industry, the main differentiator is quality of product</p> <p>Conclusion: Bargaining power of the customer is high; despite the fact that each customer is small individually they can easily switch or stop purchasing all together.</p>	<p>There are many and fragmented suppliers to the beauty and fitness industry</p> <p>In the retail space, Tango is reliant on one supplier from France. This supplier has some power as they have a monopoly. However, Tango has the power of the brand and the distribution channel and would be easily be able to source another quality supplier if required</p> <p>Unknown if suppliers have other customers outside Tango but fair to say that most of them probably only operate in the beauty industry (unless they are a conglomerate or a pharmaceutical company)</p> <p>The supplier's product is essential to all four areas. You cannot provide the service without the required creams/essential oils etc. Essentially, Tango is a service provider and a product distributor</p> <p>Conclusion: Bargaining power of suppliers is medium. The power of suppliers is balanced by the large volume of the players in the beauty industry.</p>

Rivalry among current competitors	Additional 6 th force - complementors
<p>Growth in beauty is still relatively strong.</p> <p>Sales of retail is expected to grow</p> <p>Slimming and fitness market is retracting so the competition in this segment area would be the most intense</p> <p>Tango is the high-end price and quality provider. Competitors would not be competing on price but on the quality of the product</p> <p>Low switching costs increase rivalry</p> <p>Conclusion: Rivalry among current competitors is high. Competitors are fragmented and numerous. Each segment faces segment and focused competitors. This means rivalry is intense in each segment but not across all product areas.</p>	<p>Fashion industry – work together to increase interest in fashion and beauty</p> <p>Media – good media about beauty and fitness generally. The media projects the “ideal” of beauty and the power of this force on the beauty industry cannot be underestimated</p> <p>Healthcare providers – working together to increase demand for fitness/slimming/relaxation or medical massage etc.</p> <p>Cosmetics – retail cosmetics working with beauty to tie in beauty treatments with cosmetic products</p> <p>Each product segment of Tango is a complementor to all other segments</p> <p>There is policy and government interest in general fitness and wellbeing (but not so much in beauty)</p> <p>Media and public interest in general fitness, wellbeing and in the beauty industry</p>

Note. Students should be able to make a clear list of each force and **highlight both positives and negatives**. They should then be able to use these points to back up their assessment of the power of each force. As an extension activity, they can then make an assessment of the overall profitability of the industry based on this analysis.

Tango Strategy Planning

A strategy study group has recently prepared a report which presents four possible strategies which could be adopted as the one core strategy for Tango in 2013 and 2014.

Jenny Kwok, CFO, has gathered you all together to discuss the report at the monthly management committee meeting. The management committee needs to decide on the one strategy to present to the Board.

Kwok has asked you to evaluate **four proposed strategies** using recognised models, evaluate the options and consequences of implementing each option, and ultimately conclude on the best strategy recommendation for the management committee to take to the Board.

Kwok asks you to divide into four groups. Each group is to consider **one** of the following strategies:

- (a) Focus/differentiation through new market (customer segment): Developing the current business by opening new beauty clinics for men in Hong Kong.
- (b) Focus/differentiation strategy through acquisitions in new market (geographical): Expanding the business into other countries in South East Asia (Malaysia and South Korea) through acquisition.
- (c) Divestment and reinvestment of funds: Divestment of the slimming and fitness centres and using sale proceeds to focus on the retail sales business (which has been showing the strongest rates of revenue growth).
- (d) Cost leadership strategy: Increasing profits by reducing costs, and waiting until growth prospects in the industry are stronger before making new investment.

Required

- (a) **In your group, prepare a list of positives and negatives for the assigned strategy. Use the conclusions from the Porter's five forces market analysis you prepared prior to the Workshop to assist. Identify at least six positives and six negatives for the strategy.**

Note. It is recognised that there may be many more than six possible items under each category, and that acceptable answers may vary in content.

- (b) **Prepare a presentation to the Workshop group on the results of your group's assigned strategy. Select a group representative.**
- (c) **The Workshop group should then discuss all the presentations and conclude which strategy should be pursued and presented to the Board. Use Porter's Generic Strategies to assess the four options and decide on the appropriate choice.**

Strategic Position and Analysis

For the business strategy workshop each group was asked to consider **one** of the following strategies:

- (a) Focus/differentiation through new market (customer segment): Developing the current business by opening new beauty clinics for men in Hong Kong.
- (b) Focus/differentiation strategy through acquisitions in new market (geographical): Expanding the business into other countries in South East Asia (Malaysia and South Korea) through acquisition
- (c) Divestment and reinvestment of funds: Divestment of the slimming and fitness centres and using sale proceeds to focus on the retail sales business (which has been showing the strongest rates of revenue growth)
- (d) Cost leadership strategy: Increasing profits by reducing costs, and waiting until growth prospects in the industry are stronger before making new investment

It is understood that there may be many more items than those included in the sample answer. All answers are acceptable as long as candidates are able to effectively argue the case for the item's inclusion if requested.

Part (a)

LP reference

Part (a) refers to the work prepared in the pre-workshop exercises. LP references are Chapter 2, Section 7.

Key learning points

Students must learn to critically assess their option and provide a clear set of positives and negatives for implementing a particular strategy. Students need to be able to use completed market analysis (Porter's five forces model) and strategy comparison tools (Porter's generic strategies) to assess the suitability of a business strategy.

Positives and negatives for the assigned strategy

Strategy 1 – Focus/Differentiation: New market (customer segment)

Open a new range of beauty clinics for men in Hong Kong.

Positives	Negatives
<p>This has the potential to be a very lucrative new market if Tango can utilise its existing brand power and quality product and successfully implement in the new market – medium risk but potentially high return</p> <p>If Tango is first to market with an innovative new diversification strategy then the chances of success are greater</p>	<p>Competitors may be launching a similar strategy (or may have already done so)</p>
<p>Emerging market in the Western world due to the rise of the “metrosexual” and the increasing awareness of beauty treatments for men</p>	<p>This is a new area so there is a risk</p> <p>R&D costs may be high - it is essential that the R&D in this area is conducted thoroughly and acted upon</p>

Positives	Negatives
	This may still target the high end customer base (i.e. men who can afford to pay for the beauty treatments)
Lower cost than Strategy 2 (Focus – Differentiation through acquisition in new market)	Medium to high cost strategy compared to cost leadership (Strategy 4) or divestment (Strategy 3)
Leverages off the success of the current beauty product and Tango brand recognition – beauty is the best performing sector	
Leverage off existing staff and knowledge in the beauty sector	Some cost in training staff on beauty treatments for men
May be able to utilise existing beauty treatments and products and “re-brand” them for men	Investment required in new men’s beauty treatment products
	Some product R&D cost through new innovative products tested through Beauty Land Laboratory
	Costs associated with new premises and set up
May be able to use existing beauty clinics and simply launch a rebranded product within the new clinics	Need to ensure that the current product offering for women is not impacted by new male market so using existing premises may not be an option
New premises may be the best solution to keep the services for men and women separate	May have to incur cost on new premises and this increases the risk of the venture (as well as the costs of failure)
Will be able to leverage off existing brand recognition and reputation for quality when marketing to the male market	High costs for marketing and public relations
Could leverage off existing brand recognition and customers to source new male customers	
This strategy captures the rise of the Asian middle class which is on the increase – the time is right to continue expansion in the Asian luxury market	Is this the right strategy or is the high end market starting to stagnate (as evidenced by the growth in the retail product area which is cheaper and easier to access)
Continue to grow Tango as a luxury brand in Hong Kong	Diversification could weaken current female beauty clinics if the services provided to men was not perceived to be at the same level
Could use existing cash reserves to fund costs, no need for large capital investment or borrowings	
Can use existing suppliers where appropriate which will create cost savings and synergies	Suppliers may not have the capacity to supply male beauty products Different and new suppliers will need to be sourced – different products and different expertise needed
Diversification will allow Tango to find and create synergies across all businesses to create cost efficiencies	May take valuable expertise, management focus and suppliers away from current businesses

Strategy 2 – Focus/differentiation: Acquisition in new market (geographical)

Continue with growth of business outside of Hong Kong. Extend operations to other areas of SE Asia, namely Malaysia and South Korea. To establish operations in these countries, Tango should identify suitable acquisition targets.

Positives	Negatives
Hong Kong market saturated so growth needs to be sourced from outside and expansion may be the only option	Strategy may take focus off the existing markets at a time when focus needs to be on cost and brand leadership in current markets
This is a high risk, but potentially high return strategy	
Method of leveraging off, and continuing the growth of the brand, in other Asian locations	If the acquisition proves a mistake this could cause brand damage to Tango outside of the new market and in existing markets
Would be able to utilise some existing distribution connections and channels, as well as accessing important new ones through purchase	Buying existing product and channels makes it more difficult to implement scales of economies
Acquisition means Tango is buying R&D, marketing, sales and know-how in those areas	
Marketing and advertising strategy can be transferred over to new market	Like R&D, it will have to still be localised to new product
New markets will open up new operations and new opportunities	
Growth through acquisition is a lot faster than organic growth	It is faster, but it comes at a lot higher cost. This is the costliest of all the strategies presented
Tango will be acquiring brand recognition in the new markets as well as existing customers	Is this necessary? Or is Tango's brand strong enough in SE Asia so that it does not need to acquire to enter new markets
Acquisition in new markets can be less costly than entering a new market under the Tango brand	Acquisition costs will impact on share price and dividend payments initially
Could utilise existing cash reserves to make acquisitions	Acquisition is costly. Tango is proud of its cash reserves and lack of borrowings.
Tango is buying local staff, knowledge, expertise, customer loyalty	Cultural problems when integrating the new acquisitions into the Tango "way" – these are often major issues with acquisitions and often important knowledge expertise is lost from the acquisition targets
Tango may want to look at joint ventures instead of acquisition – this would be more cost effective and could be a good way to "try it out"	There are a lot of negatives with JVs, including financial, ownership issues, lack of control, cultural differences
	Does Tango have a history of acquisitions?
SE Asia is a growth area, especially in luxury market. As the Asian middle-class grows, so does their discretionary spending and the demand for luxury products, such as beauty	Is now the right time for any expansion of business? The world economy is still shaky, it may be better to consolidate. Also, should there be a re-focus on the lower end of the market as evidenced by the growth of the retail product.

Strategy 3 – Divestment: Sale and reinvestment of funds in retail product

Sell/shut-down the Slimming and Fitness centres and invest cash from sale in the fast-growing retail sales operation in Hong Kong, Singapore and mainland China

Positives	Negatives
<p>Divestment is an important strategy to raise funds for investment in another sector.</p> <p>Divestment of Slim 4 U Now will enable new investment in the retail arm, which is showing strong revenue growth.</p> <p>This is a medium risk, medium return strategy</p>	<p>Tango has cash reserves and the ability to invest in the retail arm without divesting Slim 4 U Now.</p>
<p>Tango wanting refocus energies on core products – namely its beauty and massage arms</p>	<p>Retail is a relatively new product for Tango and is not a “core” product. Divestment to invest in retail is a shift away from core services</p>
<p>Retail is the future – the trend is away from beauty treatments (which targets the higher market) and towards the sale of retail beauty products which can appeal to a wider market</p>	<p>Retail is a very competitive sector and the threats from competitors is large. Retail is vastly different to the service sector which is Tango’s core offering.</p>
<p>Slimming and fitness services generally on a downward trend and the sector is no longer profitable.</p>	<p>Is the downward trend always going to continue? Tango needs to conduct extensive R&D to ensure that the market no longer wants slimming and fitness services. Or is this just a fashion and will pass?</p>
<p>A well-managed divestment can enhance the core beauty brand and refocus energies.</p>	<p>Divestment (particularly if the product is simply shut down, not sold) can cause brand damage. This will need to be managed.</p>
<p>Selling off Slim 4 U Now at a profit and refocusing on retail may increase share price and dividend payments.</p> <p>It may allow the market to more accurately reflect Tango’s growth and income prospects</p>	<p>Slim 4 U Now is not yet operating at a loss, just a breakeven. Is this an overreaction?</p>

Strategy 4 – Cost leadership

Reduce cost and improve profitability in current businesses in order to be in a better position for future growth.

Positives	Negatives
<p>The global economy is still shaky and this holding strategy means that a solidly-performing business has a chance to consolidate</p> <p>This is a low risk, low return strategy</p>	<p>When will the economy improve or will it get worse? Consolidation is safe but it runs the risk of being taken over by competitors or external economic events</p>
<p>Reduction of costs is always an excellent strategy and could be implemented across the board</p>	<p>How tight are costs at the moment – is their room for extensive cost cutting without services being impacted upon?</p> <p>Cost cutting may impact the quality service that Tango is renowned for; which may in turn impact upon customer numbers</p>

Positives	Negatives
Cost-cutting can achieve a good rate of growth while incurring low risk	High profit growth cannot generally be achieved by cost cutting alone
Keeping costs low means keeping price low which keeps competition out	Cost cutting can also give competitors to use funds to aggressively target customers
Staff will be working as efficiently as possible and any “time wasters” will be weeded out of the company	Cost cutting can impact badly on culture and staff morale, leading to a loss of staff and knowledge expertise
Focus on cost now and building profitability will allow Tango to finance growth opportunities in the future	Could be missing out on important opportunities for growth while consolidating (e.g. competitors may release new products/target new markets)
Cost cutting could be reflected well in share price and value of the underlying assets	Or it could have the opposite effect – a lack of growth or innovative strategy could be viewed badly by the market

Part (b)

Key learning points

In this section students are working critically to develop a confident, persuasive and coherent business presentation that delivers key points within the required timeframe. The group itself develops the presentation but the skill of actual presentation falls to allocated members.

Part (c)

LP reference

Chapter 2, Section 12

Key learning points

Students should apply **Porter’s generic strategies** for strategic choice for assessing the four strategic options presented and to decide on the appropriate choice. Students will need to demonstrate **how** they reached their proposed strategy and effectively argue for the implementation of their strategy.

Note: The suggested answers below are the opinions of the author only and are only provided as guidance. Students may be able to present persuasive arguments for or against the implementation of any of the strategies listed.

Strategic choice using Porter’s Generic Strategies

Porter presents three generic strategies – cost leadership, differentiation and focus (by either cost leadership or differentiation). Porter believes a firm must choose one of these three, or be stuck in the middle.

Using Porter’s generic strategies the choice is between being the lowest cost producer (Strategy 4 – **cost leadership**) OR making the product different from the competitors (straight **differentiation** which does not apply to any strategy explored) OR specialising on a segment of the market (**focus** by either cost leadership or differentiation). There are two focus strategies explored, both of which are focus – differentiation (Strategy 1 and 2).

Strategy 3 – divestment and reinvestment of funds into the retail product – does not neatly fit into Porter’s generic strategies. Applying Porter’s theory of competitive advantage however, this is still a competitive strategy meaning it ‘takes offensive or defensive actions to create a dependable position in an industry, to cope successfully with ... competitive forces and thereby yield a superior

return on investment for the firm'. For this reason, we can consider Strategy 3 using the generic strategies model.

Strategy 1

Focus/differentiation through new market (customer segment): Developing the current business by opening new beauty clinics for men in Hong Kong.

- A focus strategy such as this gives the security of developing another niche market and insulates Tango from competition
- Superior performance is required to excel in the new niche market – for generic strategies to work the company must dominate in the focus area
- There is currently no product in the area so Tango is well placed as market leader to provide the new niche product
- Tango may sacrifice economies of scale by going for another niche market in the beauty area (but may still be able to access some economies by utilising current premises and products used by the female beauty clinics)
- Porter recommends it is better to pursue a form of focus strategy, it is easier to dominate a niche than the whole market

Strategy 2

Focus/differentiation strategy through acquisitions in new market (geographical): Expanding the business into other countries in South-east Asia (Malaysia and South Korea) through acquisition

- A focus strategy such as gives the security of developing another niche market through geographical spread
- Superior performance is required to excel in the new niche market; for generic strategies to work the company must dominate in the focus area
- This means they must make acquisitions of the best quality and market leading beauty companies in Malaysia and South Korea and ensure that the Tango beauty brand becomes number one
- There is already a lot of beauty clinics in both areas so domination of the market is likely to be a long-term strategy unless core acquisition targets are successful
- Tango can still utilise economies of scale as they are still offering the same product but in a different market (except that acquisitions generally must stay separate for some time after buy-out)
- Porter recommends it is better to pursue a form of focus strategy, it is easier to dominate a niche than the whole market – this also relates to a new geographical market

Strategy 3

Divestment and reinvestment of funds: Divestment of the slimming and fitness centres and using sale proceeds to focus on the retail sales business (which has been showing the strongest rates of revenue growth)

- A defensive strategy as it is divesting of a non-competitive product line
- An offensive strategy as it is using those funds to narrow focus on the retail product line (this element could classify as a focus/differentiation strategy)

- Focusing on retail is therefore a form of focus strategy and adoption of this strategy could be viewed as a 'stuck in the middle' approach to gain competitive advantage which many companies successfully pursue
- Complete divestment will free up resources for reinvestment, but will also mean a complete exit from that segment and closing off that segment for future competitive advantage. Tango would need to ensure that the slimming and fitness segment was on an ongoing downward trend and/or that they no longer wanted to focus on that element
- Divestment successfully ensures a narrow focus for the other product areas and assists in creating ongoing leadership in the remaining niche areas
- In terms of retailing beauty products this is a crowded and competitive market and this makes it harder for Tango to excel in this niche
- Tango can utilise economies of scale
- Porter recommends it is better to pursue a form of focus strategy, it is easier to dominate a niche than the whole market

Strategy 4

Cost leadership strategy: Increasing profits by reducing costs, and waiting until growth prospects in the industry are stronger before making new investment

- This is an internally focused strategy and does not relate to market demand. Market share is very important in this sector and this strategy does not focus on it
- Reliant on achieving economies of scale in each of the four product sectors as well as across the company
- Tango is a service industry and it can be difficult to ensure economies of scale in service industries. Extensive cost savings may be difficult to source
- They may be able to achieve the learning curve – by producing the most beauty and massage services (for example) they can achieve lower average costs than their competitors
- Beauty industry is based on perceptions of quality and the 'experience' and Tango is the market leader in this area
- Porter recommends it is better to pursue a form of focus strategy, it is easier to dominate a niche than the whole market
- Tango would need to concentrate on reducing overheads and improving productivity
- Access to favourable sources of supply
- Cost leadership suggests that only one company in the sector can successfully pursue the strategy. So, does Tango want to be that company seeing that it is the market leader in the sector on high-priced, top-end beauty services? Will becoming cost leader sacrifice this focus on quality?

Strategy conclusion

Using Porter's generic strategies the recommended strategy is Strategy 1: *Focus/differentiation through new market (customer segment): Developing the current business by opening new beauty clinics for men in Hong Kong.* In summary:

- Cost leadership is only available to one company in the sector and the focus of Tango on high-end/high-quality would make it too difficult to be cost leader in such crowded market (ruling out Strategy 4)

- Porter recommends it is better to pursue a form of focus strategy, it is easier to dominate a niche than the whole market
- There are already a lot of beauty clinics in Malaysia and South Korea so domination of the market is likely to be a long-term strategy unless core acquisition targets are successful. Acquisition is an expensive strategy and is deemed high risk for potentially high return. When compared to Strategy 1, market expansion in this manner is not as favourable (ruling out Strategy 2)
- Tango may not have to divest its slimming and fitness centres, and needs to further explore whether their decline is a long-term trend. It may want to focus on the retail market, but this is a tough and crowded market where the threat of new entrants is extremely high. Retail is not a core offering of Tango, and it would be very difficult to become market leader (ruling out Strategy 3)
- Strategy 1 affords the best opportunity for competitive advantage using a focus differentiation strategy. This is a new, niche product and Tango could use its existing brand and resources to launch a quality product which is first to market. These are two steps that would place it in a good place to become and remain market leader.

Management Reporting: Pre-workshop exercise

This exercise is in three parts. The first part should be a straightforward financial analysis of the financial performance of a division that only just achieved break even in the most recent year, and whose sales revenue fell substantially in comparison with the previous year.

This should encourage students to think about the limitations of the information that they have, and what more information they need to provide better analysis of costs and profitability. This is the focus for the second part of the exercise.

The third part of the exercise asks students to think in general terms about pricing policy, and whether the company's current policy of market-based pricing and charging high prices is suitable for a division that is struggling with falling sales and low profitability. This should encourage students to think about prices and unit costs, and also about the importance of sales volume for profitability, especially in a division with high fixed costs.

LP references

Part (1) Chapter 5 paragraph 3. Also possible relevance of Chapter 6 paragraphs 2 and 3. These deal with financial performance reporting.

Part (2) Chapter 4, with particular emphasis on paragraphs 2 – 4. Also possible relevance of Chapter 6 paragraphs 2 and 3. These deal with different methods of presenting divisional performance reports.

Part (3) Chapter 4, paragraph 5. This deals with approaches to pricing.

Key learning points

Financial performance reports should present information in a form that is useful for management, and appropriate for the nature of the business. In a simple form of performance report, variable costs and discretionary or controllable costs should usually be identified separately.

Students should note that 'modern' management accounting methods, such as activity-based costing and quality costing, are not always appropriate for the information requirements of management

A market-based approach to pricing cannot ignore sales volume and unit costs. A cost-based approach to pricing similarly cannot ignore sales demand.

Suggested solution

Part 1

Only limited information is available for financial analysis. The following comments seem appropriate.

- (1) The Slimming and Fitness (Slimfit) division made no profit and no loss in 2012.
- (2) We have no information about costs in 2011, but sales revenue fell by over 35%, from HK\$51 million in 2011 to HK\$33 million in 2012. It seems likely that the division reported a profit in 2011 and that its performance in 2012 is much worse.
- (3) The profitability report for the individual slimming and fitness centre, which made a small loss, is possibly typical of all slimming and fitness centres in the company. The main costs are labour costs and occupancy costs, and the centre earns revenue by providing a range of different services and courses. The gym is the largest revenue-earning aspect of its operations, but the centre seems to need all the various courses and activities and does not rely mainly on one particular service.
- (4) It is possible that the centre's management is considering ways of reducing costs, but any cost-cutting measures had not taken effect before the end of 2012. Any cost reduction activities are likely to involve lower labour costs or lower occupancy costs.
- (5) Although the division made HK\$0 profit in 2012, this was after charging head office overhead costs of HK\$4 million. Similarly, the loss of the individual centre was HK\$65,000 but this was after charging a share of head office overhead costs of HK\$620,000.
- (6) Assets of the division at the end of 2012 were HK\$20 million and liabilities including deferred revenue were HK\$16 million, so that net assets were just HK\$4 million. If profit is measured as profit before head office overhead costs, the division achieved a return (ROI) of 100%. Similarly, if the division were charged notional interest on its capital employed, it would record positive residual income for the year, before deducting head office costs.
- (7) The division and the individual centre both seem to be cash flow positive, although we do not know how much new spending on capital equipment was made for the division in 2012. Assuming no change in receivables or payables (which are fairly small amounts), cash flows for the division in 2012 were about HK\$8 million before payments for new equipment (= \$0 profit + depreciation HK\$5 million + head office overheads charge HK\$4 million).

Part 2

The information available does not indicate what might be the effects on profitability of a decision to close the division, or to close any individual slimming and fitness centre. It also fails to indicate which costs are subject to management control and so which are, to some extent, discretionary costs, and costs which cannot be avoided as long as the division or individual cost centre remain operational and are not closed down.

We are told that most costs of the division are fixed, but it would also be useful to know whether some costs may be variable and if so, what variable costs are in relation to sales revenue.

It seems that except for head office costs, a large proportion of the costs of each centre are directly attributable to the individual centre, and that there are few shared overhead costs within the Slimming and Fitness (Slimfit) division. Costs are therefore managed at the level of individual slimming and fitness centres rather than at divisional level. However, this may be an incorrect analysis, and some costs may be controllable at divisional management level. For example, some

trainers may be employed at divisional level, rather than at centre level, and may be used in more than one slimming and fitness centre.

A suggested form of cost and profitability analysis, for individual centres and for the division as a whole, is as follows.

	HK\$
Sales	X
Less: Variable costs (if any)	<u>(X)</u>
Contribution	X
Less: Discretionary costs or costs that are controllable at individual centre level	<u>(X)</u>
Profit controllable by centre management	X
Less: Discretionary costs or costs that are controllable at divisional level	<u>(X)</u>
Profit controllable by divisional management	X
Less: Share of head office overhead costs	<u>(X)</u>
Net profit or loss for the division	<u>X or (X)</u>

In addition, each centre should establish a system for analysing the gross profit from each of its courses and activities, by deducting their directly attributable costs from the revenue they earn.

This will help management to assess the probable effect of closing courses, or perhaps reducing the number of some types of course or activity and increasing the number of other types of course.

The cost and profitability analysis suggested here could be established using a simple spreadsheet model.

Note. Students may consider other approaches to costing.

Activity based costing. It seems unlikely that ABC has much to contribute to the analysis of costs and control of operations, in view of the fact that most costs are probably incurred at an individual centre level. The potential for savings in overhead costs seem limited.

TQM. There could be an argument that the company should consider total quality management as an approach to managing costs whilst improving the quality of service to customers and the efficiency and effectiveness of operations. However, the benefits of TQM would arise gradually over time. TQM does not seem an immediate solution for Tango.

Part 3

Merits of high pricing

The high pricing policy of the company is a form of market-based pricing, which is linked to the company's strategy of promoting a high-quality brand image for Tango. When a company wants to achieve a strong position in the high quality sector of the market, it probably needs to charge high prices.

The price strategy of Tango appears to be one of acting as the market leader on pricing, rather than following the prices set by competitors. There could be a strategic advantage in being regarded as the market leader and price setter.

High pricing will also enable the company, if it wishes, to have a market skimming policy for any new form of beauty treatment that it introduces, charging a high price for new 'wonder' treatments before they become more established in the market (when prices will then come down).

In some industries, high pricing also ensures that the business operates with high contribution/sales and high gross profit ratios. However, since Tango's costs appear to be mainly fixed costs, this is not a particular advantage.

Since most costs are fixed, the company must achieve at least sufficient revenue to cover (high) fixed costs. By setting prices at a high level, the company needs a smaller number of unit sales to break even and make a profit.

Limitations of high pricing

The main limitation of a policy of charging the highest prices possible is that costs may not be considered as much as they should be. If a company operates with a high level of fixed costs, it is important that revenues should be sufficient to cover those costs. High pricing is likely to affect the volume of sales demand, and revenue depends on both sales volume as well as unit sales prices. A policy of maximising sales prices may not result in revenue maximisation.

The company should also be careful about pricing its products and services aggressively, and charging prices that customers consider excessive, even for the quality of service provided. If a company acquires a reputation for 'greed' and excessive pricing, it may discover that the strategy of high pricing is no longer successful and that customers are switching to the services provided by competitors.

A high pricing strategy is also vulnerable to a change in customer attitudes towards price. This may have happened in the case of the Slimming and Fitness division. If market prices have fallen in this sector of the market during 2012, Tango will have been forced to reduce its own prices, even though it remains a relatively high-priced product and service provider.

Summary

Pricing is a difficult balancing act. The company needs to charge high prices in order to achieve the market position that it has targeted in its strategy. At the same time, it needs to consider the effect of high prices on sales demand and the need to cover costs and make a profit.

Management Reporting: Case 1

Part 1

The directors have been discussing with senior management a proposal to open two or three clinics to provide facial and body treatments exclusively for men. The services on offer would include, for example, tattoo removal, treatments for facial wrinkles and treatments to restore hair growth.

Each centre will initially employ two specialists, who will provide treatments and also advice to clients. It is estimated that each consultant will work 1,800 hours a year, and two-thirds of their time will be revenue-earning.

A special brand name for the clinics, Sigma Male, has been suggested. The target customer group will be professional men in the age range 30 to 60. Management agrees that for these clinics to be a commercial success, it is crucial that customers should associate them with high quality and desirable treatments. However, there is some concern about the prices that customers will be prepared to pay.

After a short initial advertising campaign to create brand awareness, the company will rely on occasional marketing, word-of-mouth recommendations, internet advertising and the Sigma Male web site to obtain clients.

Equipment will be installed to provide a range of different treatments. Each item of equipment will be used exclusively for certain types of treatments. With the exception of the equipment, most of the costs of each centre will be general running expenses that cannot be attributed directly to specific treatments.

After discussions with her colleagues in the finance department, Jenny Kwok has decided that target pricing and target costing must be used to establishing prices for the services provided by the clinic, and she wants ideas and suggestions about how this method of pricing and costing should be used.

Required

- (a) **Explain the advantages of target pricing and target costing for the proposed new clinics, and suggest what the practical difficulties might be if Tango management wanted to use this approach.**
- (b) **Recommend measures that the company should take to identify target prices and target costs for the new clinics.**

Part 2

Nigel Yip is aware that there is growing resentment among the management of the three other divisions about the transfer prices charged by the Product Sales division for materials. The Product Sales division acts as a central purchasing unit for the entire group. In 2012, about two-thirds of the products that it purchased were sold through its retail outlets. The other one-third were transferred to the other divisions. The transfer prices charged for these products are their full market price.

The manager of the Beauty and Facial division argues that if he has to pay full market price for transfers from the Product Sales division, he should be allowed to make his own purchases directly from external suppliers. Nigel Yip disagrees with this suggestion, because he wants consistency in the products used throughout the group. Consistency will be lost if individual divisions and centres

are allowed to make their own purchasing decisions. In addition, he thinks that decentralised purchasing will add to costs and create unnecessary inefficiencies.

The company now buys all its products from France. Suppliers and products from other countries have been considered, but these do not have the same high fashion and high quality appeal of French products.

However, supplies from France are known to be limited, and if the Product Sales division continues to expand its retail sales operations, sourcing of products from other suppliers and other countries will have to be considered.

Required

Giving your reasons, suggest what the transfer pricing arrangements should be for pricing transfers of products from the Product Sales divisions to the other three division in the Tango group.

Management Reporting: Case 1

The workshop exercises are in four parts. They cover a range of issues relating to divisional performance and pricing strategies. The exercises deal with the business as a whole, and in particular the more profitable areas of the business.

LP reference

Part 1. Chapter 4 paragraph 7 which deals with target pricing and target costing.

Part 2. Chapter 6, paragraphs 5 – 7 and 11 – 13. This deals with transfer pricing.

Part 3. Chapter 4, paragraph 9. This deals with customer profitability analysis.

Part 4. Chapter 5, particularly paragraph 4. This deals with non-financial reporting.

Key learning points

Part 1. Students should understand the nature of target pricing and target costing, and should be able to consider how it might be applied in practice. They should also recognise that as a method of pricing and costing, it is a more appropriate technique for manufactured products than for services.

Part 2. Students should understand the problems created by transfer pricing, and the problems there may be in reaching agreement of an appropriate transfer price, when the transferred product is not in restricted supply and also when it is.

Part 3. Students should understand the nature of customer profitability analysis, but also recognise that it is not always an appropriate method of analysing profitability.

Part 4. Students should be able to identify a range of non-financial or partly non-financial performance measures for a business, and explain their possible value for management control purposes.

Suggested solution

Part 1

- (a) Tango could use target pricing and target costing for the activities or services in the Sigma Male centres. Initially this will help management to decide whether it will be possible to sell its services to customers at a price that customers are prepared to pay and that also enables the centres to operate at a profit. This will allow management to review the decision about whether or not to open the Sigma Male centres, before making a firm commitment.

Target pricing and target costing are particularly useful when new products or services are developed, because if there are problems with achieving the target cost, the product or service can be re-designed in order to reduce costs. It is easier to re-design products that are at the design and development stage, in order to reduce costs, than it is to re-design products and services that are already developed and sold to customers.

There are some problems with the use of target costing, however.

- (1) Tango is considering whether or not to open the new centres/clinics, and a large proportion of the costs of the clinic may be general overheads, such as building occupancy costs and administration costs. It is difficult to include general overhead costs within a target cost. The focus should be on controllable costs for the new products or services.

- (2) There are not many variable costs, and most costs are fixed. Costs that are directly attributable to specific treatments will include the costs of the specialist equipment and the costs of the specialist labour. These are likely to be fixed costs, or mainly fixed costs. A target unit cost for these treatments will therefore depend on sales volume. In other words, the target cost will depend on assumptions about sales demand, which makes target costing less reliable than when a large proportion of costs are variable costs.
- (3) Treatments for clients will be non-standard. It is impossible to standardise services of this nature. For example, some clients will need more attention than others, and may need longer treatment. Tango would therefore need to decide what the cost units should be for which target costs should be planned.

These problems are substantial, and it is possible to argue that target costing may not be an appropriate approach to planning how the new clinics should operate and how it should seek to operate at a profit.

- (b) The following measures are recommended.
 - (1) Tango management must decide what treatments it proposes to offer clients of the new Sigma Male clinics.
 - (2) For each of these treatments, it must establish whether customers expect to pay a fixed price for a full course of treatment, or whether they expect to pay a variable rate, such as a price per treatment hour. This is necessary in order to decide the cost units for which target prices and target costs are needed.
 - (3) Unless Tango is already aware of current market prices for similar treatments offered by competitors, Tango should undertake market research to establish the strength of demand from men for the treatments that it proposes to offer and the prices that clients might be willing to pay. Target prices should be based on a realistic assessment of what is acceptable to the market, combined with Tango's strategic view of the position it wants to establish in the market. Tango is likely to want to charge relatively high prices, but these must be realistic.
 - (4) Having established a target price per course of treatment, or a target price per treatment hour, Tango should decide what profit margin it wants to achieve and therefore what the target costs should be. This process requires management to make assumptions about the volume of demand for treatments at the clinics. The target cost must include elements of cost such as the cost of specialist equipment and the labour cost of the treatment specialists. These costs are mainly fixed costs; therefore an assumption is required for both equipment and specialist labour about volume of usage/treatment hours per year.
 - (5) Management should make an initial estimate of directly attributable costs per course of treatment or per treatment hour, for each of the treatments it plans to offer, based on the assumption of capacity usage/sales volume. This estimated cost should be compared with the target cost. If the estimated cost exceeds the target cost, management must consider ways of reducing costs so that they come down to the target level. Without more detailed information, it is not possible to assess how easy or difficult this task might be, although one method of reducing estimated costs is to increase the assumption about capacity usage.
 - (6) Since any estimate of expected costs will be dependent on the assumption about sales volume/capacity usage, capacity usage will be a critical aspect of the target cost. Controlling actual costs will involve trying to control the actual volume of demand for the clinic's treatments and services.

- (7) If management are unable to reduce estimated costs to the target cost level, this means that the company would not expect to make the required amount of profit from the new clinics at the assumed volume of sales demand and the target sales prices. This would raise questions about the financial viability of the new clinics.

Part 2

Students should recognise the various issues to consider when setting transfer prices between operating divisions in a company. The answer should give some consideration to the fact that in the future, there may be a limit on available supplies from France, which means that there will be an opportunity cost involved in transferring products to the other divisions instead of selling them externally through the retail outlets.

The current transfer pricing arrangement is unreasonable. The Product Sales division is acting as an intermediary between the market (French suppliers) and the other three operating divisions. For acting as an intermediary, it is charging full retail prices.

The manager of the Beauty and facial division makes a reasonable argument. In principle, the division could buy directly from suppliers in France and obtain a much lower purchase price. Because the division would not buy in the same quantities as the Product Sales division, the prices for buying directly from France would probably be higher than the prices obtained by the Product Sales division.

Nigel Yip is correct in his view that purchasing should be centralised and all purchases from France should be made through the Product Sales division. This arrangement will probably result in lower purchase prices and more efficient purchasing administration. It may also help Tango to establish good relationships with the French suppliers – and good supplier relationships are important.

The other three operating divisions might argue that a more appropriate transfer price should be the actual cost of purchases from France. We are informed that about two thirds of purchases were sold externally through the retail outlets and about one third of purchases were transferred internally to the other divisions in 2012. Total sales for the Product Sales division in 2012, including internal transfers at full retail price, were HK\$57 million and the purchase costs of these sales were HK\$19 million. The gross profit mark-up on cost was therefore 200%. The purchase cost of products transferred internally were therefore HK\$6 million, but the transfer prices charged were HK\$18 million.

If transfers had been at purchase cost and not at full retail price, the profits of the Product Sales division would have been HK\$12 million lower, and the profits of the other divisions would have been higher. (For the Beauty and Facial division profits would have been HK\$8 million higher – HK\$47 million instead of the HK\$39 million actually recorded. The profits of the Spa and Massage division would have been over HK\$3 million higher ($= 2/3 \times \text{HK\$5 million}$), and so would have been 50% higher at HK\$9 million. Even the Slimming and Fitness division would have recorded a small profit.

The transfer prices should be re-negotiated, because they are distorting divisional performance. Product Sales division should receive a transfer price in excess of purchase cost, to reward the division for its purchasing activity. Without head office involvement, it is unlikely that the divisional managers will agree on price, because of the big difference between purchase cost and retail price. If Product Sales division accepts a much lower transfer price, its reported profits will be affected significantly.

It is suggested that the minimum transfer price should be the price that the three operating divisions might be able to obtain by purchasing directly from French suppliers (if these prices could be established or estimated), plus a margin to reward the Product Sales division for its purchasing administration work.

The future

A different situation will arise if supplies from France are limited, and the Product Sales division is able to sell all purchases from France externally through its retail outlets. The opportunity cost of transferring products to the other divisions will then be their full retail price.

However, the other three divisions could still argue that they would pay less for French products if they were allowed to compete for purchases and buy directly from French suppliers themselves.

A situation could arise where the divisions compete with each other to buy restricted supplies, and in doing so push up the market price of the products. This would be unacceptable to Tango, because it would simply result in higher costs and lower profits.

It is suggested that if supplies from France are limited, Tango senior management should establish whether the company should seek to sell these products externally, at full retail price, or whether it would benefit the company more to transfer products to the other three operating divisions.

- (a) If the decision is to sell everything externally, there will be no transfers, but management must decide on a new policy for sourcing materials for the three divisions.
- (b) If the decision is that the Product Sales division should continue to supply the three other divisions with the products from France as they need, the transfer price should be reviewed. The opportunity cost of transfers for the Product Sales division would be the external sales price. Even so, this would be an inappropriate transfer price because the other divisions could still, in theory, try to buy the products direct from the French suppliers. It is suggested that the minimum transfer price should still be the price that the three operating divisions might be able to obtain by purchasing directly from French suppliers (if these prices could be established or estimated), plus a margin to reward the Product Sales division for its purchasing administration work. Since purchase prices would be higher because supplies would be restricted, the minimum transfer prices would be higher.

However, it is probable that the divisional managers will be unable to agree negotiated transfer prices, and intervention from head office will be needed to resolve the problem.

Management Reporting: Case 2

Part 1

The company has commissioned a report from a firm of management consultants. The report is about profitability for the company and ways in which profits could be increased.

The management consultants have made a number of different suggestions. One of these is that the company lacks focus in targeting its customers. Some types of customer are more profitable than others. A research survey has found that on average, female clients between the ages of 30 and 35 and between the ages of 55 and 60 spend more on courses and treatments than any other group of clients. This appears to be the case in Singapore and mainland China, as well as in Hong Kong. A surprisingly high proportion of clients also buy treatments and courses from two or three of Tango's divisions. For example, clients for beauty treatment often also visit the company's spas or enrol on a slimming or yoga course.

Recommendations from the management consultants include the following.

The company should encourage cross-selling by each division. For example, the Spa and Massage division should do cross-selling of beauty treatments for clients, and the Beauty and Facial division should try to sell the spas and massage treatments to their clients. Divisions should be paid a commission for everything that they successfully cross-sell.

In addition to measuring the profitability of each of the four operating divisions and individual centres, Tango should also monitor the profitability of different client groups by age, and focus sales and marketing effort on the most profitable customer groups.

Required

- (a) **Explain the benefits of customer profitability analysis.**
- (b) **Suggest measures that Tango might take to introduce reporting on customer profitability into its management reporting system.**

Part 2

Nigel Yip and Jenny Kwok agree that the current management information system in Tango is insufficient for the needs of management and must be improved.

One aspect of reporting that they are considering is the use of a range of different performance measures, including non-financial information. Currently, management reports focus entirely on costs, profits and return on assets. Nigel and Jenny agree that this financial focus is too narrow.

They have asked a small working party to suggest how performance reporting should be extended.

Required

Provide examples of additional performance measures that could be used to help management monitor and control operational performance in the company. For each of the performance measurements that you suggest, explain how the information would be of assistance to management in controlling business operations.

Management Reporting: Case 2

Part 1

- (a) The benefits of customer profitability analysis depend on whether some types or categories of customer are more profitable or less profitable than others; and whether the company is able to focus marketing and sales efforts on the most profitable types of customer in order to improve profitability.

Customer profitability analysis would involve identifying different categories or types of customer, and measuring the revenues and costs that are attributable to each customer type. The general principle is that some types of customer provide more sales revenue than others, and some types of customer cost more.

In the case of Tango, most operating costs are fixed costs. This suggests that it will be difficult to allocate costs directly to different customer types and distinguish between them on the basis of cost. Customer profitability analysis may therefore, in the case of Tango, be a matter of analysing sales revenue from each category of customer. The most profitable categories of customer would be those that provide the largest amounts of revenue to the company.

The management consultants have suggested that the most profitable categories of female customer by age are those in the 30 to 35 and 55 to 60 age groups. If this is correct, customer profitability analysis by Tango would probably suggest that the company should concentrate more on selling to these age groups.

However there is an alternative argument, based on customer lifetime value (CLV). In the longer term it may benefit the company more to focus on 'capturing' customers at an early age and trying to develop a good relationship with these customers throughout their life. It may therefore be better in the long term for the company to target its marketing efforts on younger women.

- (b) If Tango decides to experiment with customer profitability analysis, it must first establish a database of its customers, past and present. It has been assumed that the appropriate method of segmenting customers is according to their age. However this may be a misjudgement. It may be more appropriate to segment customers according to job or lifestyle (professional women, non-working women etc), or to segment them geographically, or to segment them in other ways. To consider which method of customer segmentation is most appropriate, the company needs to record a variety of data about customers (for which their approval should be required) so that analysis of revenue from different customer groups can be made.

As stated earlier, it may be difficult to attribute costs to different customer groups, unless customers are segmented geographically. The analysis of 'profit' may therefore be an analysis of revenue.

Records of revenue earned from each customer group should be collected and stored in a central database. If historical records do not exist, the company will need to build a database for the future, and it may take a long time before the database is sufficiently large to provide useful analysis.

Tango should also consider how it will use the information on customer revenue or profitability. Information has value only if it is used to create value. If the information cannot be used, it has no value.

If the company can identify which categories of customer are the most profitable, it must have methods for targeting these customers, and focusing more resources on them. If the company would use advertising and marketing methods to target the most profitable customer types, it may need to spend more on advertising and marketing than it does at the moment. In 2012, spending on these activities was only HK\$12 million or about 1.9% of annual revenue. This seems to be a small amount for such an important business activity.

In conclusion, it is by no means clear that customer profitability analysis would be of great value to Tango, because of the practical difficulties in analysing costs and selling and marketing to different customer groups. My personal recommendation is that it would be an inappropriate use of management time and effort to attempt to establish a CPA system for Tango.

Part 2

A critical factor in evaluating answers should be the potential value of the performance measures to management. Will the information provided by the performance measurements help management to understand and control business operations, or costs and profitability, better?

Suggested solution

The segmental performance information indicates that for the Beauty and Facial division Spa and Massage division and Slimming and Fitness division, the main costs (except for 'other costs' which we cannot analyse from the data provided) are labour costs and occupancy costs. These are also significant costs for the Product Sales division.

The performance of the divisions therefore depends to a large extent on the efficiency with which these resources are used.

Specialist labour

Employees who deliver treatment to clients will not spend all their time providing treatment. However the revenue that they earn will vary according to the number of hours that they spend providing treatments. The efficiency or effectiveness in using these employees could be measured in the following ways:

- Percentage of time spent providing treatment
- Number of hours per month/year spent providing treatment
- Revenue per specialist per year
- Revenue per hour spent providing treatment

Course leaders/trainers

In the Slimming and Fitness division, the efficiency and profitability of course leaders will depend on the size of classes. Measures of performance for these members of staff could be:

- Average class size
- Ratio of customers to trainer numbers
- Average revenue per trainer

Administrative staff

Employees may be divided between 'front line staff' who deal directly with clients and 'back office' staff who do administrative work, For each division, and for each centre or clinic within each division, a suitable performance ratio might be:

- Ratio of front line staff numbers to administrative staff numbers
- Ratio of customer numbers to administrative staff numbers.

Retail staff

In the Product Sales division, there may be inefficiency in the numbers of staff who are employed in each retail outlet. A useful performance measure may therefore be:

Sales revenue per period per retail staff member, or

Sales revenue per period per retail staff member hour worked (since there may be part-time employees)

Use of space

Use of space can be measured by the annual revenue per square foot of space. Information is available to calculate these measurements for three of the divisions in 2012.

	<i>Beauty and Facial</i>	<i>Spa and Massage</i>	<i>Slimming and Fitness</i>
Revenue, 2012	\$470 million	HK\$95 million	HK\$33 million
Space (square feet)	166,000	45,000	24,000
Revenue per square foot	\$2,831	\$2,111	\$1,375

These figures help to demonstrate the poor performance of the Slimming and Fitness division in 2012. The division is not generating enough revenue from the space that it occupies.

Equipment

The company uses equipment to provide treatment to clients. When this equipment is expensive, it is important that it should be well-utilised during its useful life. For expensive items of equipment, there should be some measure of utilisation.

For example, a measure could be: Hours in use/Hours available for use. A low ratio might indicate that the company is not making sufficient use of its equipment, and so may not be selling enough of certain types of treatment.