Student Notes

Module B (Dec 2011)

Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered	Student Notes
Workshop 1			
1. Introduction	• Presentation • Group discussion		
2. Ethics in business	• Case study • Group Discussion	Ch. 1 & 15	Pg. 1 – 13
3. Executive management	• Case study • Formal presentations	Ch. 2	Pg. 14 – 30
4. Management reporting	• Case study • Formal presentations	Ch. 4 & 5	Pg. 31 – 44
Workshop 2			
5. Reboot	• Presentation • Group discussion		To be released after completion of Workshop 2
6. Treasury operations	• Case study • Formal presentations	Ch. 8, 10 & 11	
7. Corporate finance	• Case study • Formal presentations	Ch. 16, 17 & 18	
8. Conclusion	• Presentation • Group discussion		

Discussion points

Ethics in Business: Pre-workshop exercise

(a) Key considerations from each person's perspective.

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

Kenneth Chan, Chairman of HFIC (and Hong Kong CPA)

- Kenneth has a **reputation** as a leading businessman, and there will be some damage to his reputation if the story about Chris Lee's profits from buying and selling shares in Elite Fashion becomes known to the rest of the board of directors and to the public.
  - He will be seen to have led the board in the purchase of a company without apparently having conducted sufficient **due diligence** investigations into the ownership of the company's shares.
  - He also risks criticism from the investment community and the rest of the board for having given his support to Chris Lee as a future CEO of the company.
- He risks further extensive damage to his reputation as a consequence of his **delay** (of at least one week) in taking action after his meetings with Jonathan Lu and Chris Lee is discovered by the board and by the investment community. He has not taken decisive action, and this should raise questions about his leadership.
- If they learn about the share dealings by Chris Lee, shareholders may even demand a change in the leadership of the board, a further threat to Kenneth Chan's reputation and status.
- Kenneth will also be aware of the possible adverse effect on the **business** of HFIC if its successful Operations Director is forced to leave the company.
- He will also be aware that the company must be seen to act in **compliance** with the law and other regulations and codes of conduct, or risk damaging its reputation with investors. The matter should be checked to find out whether any Listing Rule has been breached.
- Kenneth also needs to recognise that the company must not be seen to support a director who is in breach of his duties as a director. For Chris Lee there was a conflict of interests in buying the shares in Elite and recommending the purchase of the company by HFIC, and he also failed to disclose his interest in Elite when the board considered the acquisition.

Jonathan Lu, Deputy Operations Director (and Hong Kong CPA)

- Jonathan risks damage to his **working relationship** with Chris Lee, if Chris Lee is not forced to leave the company. This could threaten Jonathan's future career with the company.
- He also risks damage to his career if his role as **informer** becomes widely known. The directors of the company and colleagues may believe that he provided the information in order to get rid of Chris Lee from the company and improve his own prospects of career advancement. This would make it difficult for him to continue to work for the company.
- If the company takes no action against Chris Lee, he may feel that he is working for an unethical company. If he is an ethical individual, he would find this difficult to accept.

- If he comes under pressure to resign from the company, he may find it difficult to find another job, or a **job** with such good prospects of career advancement.

Jian Jiang, enforcement officer at the Stock Exchange of Hong Kong Limited

- Jian has a **professional responsibility** to his employers, and to support compliance with the Listing Rules and the Code on Corporate Governance Practices.
- However, Jian is a friend of Kenneth Chan and there may be a conflict of interest between his **loyalty** to Kenneth Chan and his **responsibility** to SEHK.
- Similarly, Jian is a friend of Chris Lee and would not enjoy seeing Chris Lee lose his job and successful career prospects.
- Personally, Jian might want to protect his **friendships** with Kenneth Chan and Chris Lee
- But professionally, Jian needs to maintain the **regulatory standards** and reputation of the HKEx at all times.

Christine Wu, senior manager of Platinum Investments

- Christine Wu is a friend of Kenneth Chan and there may be a conflict of interest between her **loyalty** to Kenneth Chan and her **responsibility** to her employer.
- There is some risk of a fall in the **share price** of HFIC if the share dealing of Chris Lee becomes public knowledge, and the value of the shares held in the company by Platinum Investments would fall. This might affect her reputation within her organisation. Questions may be asked about her friendship with the company's chairman.
- If the information about Chris Lee could affect the share price of HFIC, it is **price-sensitive information**, and she has become an 'insider'.
- Her remuneration may include a performance-related **bonus**, and Christine may possibly risk some loss of annual bonus, depending on what happens in the future.

(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. All **five key principles of the Code** (integrity, objectivity, professional competence and due care, confidentiality and professional behaviour) should be considered, although not all of them are contravened in this case. Students must **identify these principles** and state **how some of them have been threatened** from the perspective of their allocated person and from the CPA perspective.

Students should also be aware that the actions of Chris Lee would appear to have been in breach of the law, the Listing Rules and the code of corporate governance practices. Chris Lee would appear to be in breach of his fiduciary duty as a director of HFIC. He made an **undisclosed personal profit** out of his dealings in shares of Elite Fashion, having recommended the purchase of Elite Fashion to the board of HFIC and having been involved in the board meeting where the decision to buy the company was taken. The ethical position of the four individuals in the question must be affected by an awareness of the nature of Chris Lee's actions.

Chris Lee has acted unethically and (probably) illegally. He purchased shares in another company, keeping his identity as the shareholder hidden, and paying a low price for the shares. He recommended a takeover of the company to his board colleagues, without declaring his ownership of the shares and he attended the board meeting where the decision to buy the company was taken. He knew that the other major shareholders in Elite Fashion would be pleased to sell their shares. So even if Chris Lee thought that Elite Fashion would be a good acquisition for HFIC, he kept his interest hidden and he made a large personal profit. As a director of HFIC, he put his **personal interests** before his **fiduciary duty** to the company. In doing so, he was in breach of corporate law, as well as the code of corporate governance. As a professional accountant he may also be in breach of the HKICPA Code of Ethics for the conduct of accountants in business.

The actions of Chris Lee have now created ethical problems for Kenneth Chan, Jonathan Lu, Jian Jiang and Christine Wu.

Although only Kenneth Chan and Jonathan Lu are members CPA members, it is useful to consider the ethical issues for all four individuals in the context of the HKICPA Code of Ethics.

A fundamental principle of the Code of Ethics is **integrity**.

- The Code states that professional accountants should be **straightforward and honest** in their business relationships, and this implies fair dealing and truthfulness. **Kenneth** may wish to keep the matter quiet, but if he takes no action, he will not be dealing honestly with other stakeholders in the matter – investors generally, shareholders in HFIC, his board colleagues and Jonathan Lu.
- In receiving information from Kenneth about the matter, **Jian** and **Christine** are faced with the problem of whether to insist that Kenneth takes action against Chris Lee, or whether to refuse to get involved and give advice.
- **Jonathan** may have acted with integrity in reporting the matter to Kenneth Chan, but there may also be a suspicion that he acted in his **personal interests** in order to remove Chris Lee from the company and improve his own career prospects.
- It is not clear why **Jonathan** was looking through the e-mails of Chris Lee. He may have been looking for information relating to a work problem, but he may also have been searching illicitly for information about Chris Lee. Did he act with integrity when obtaining the information?

Another fundamental principle of the Code of Ethics is **objectivity**. There are several instances of non-compliance, or potential non-compliance, with this principle:

- **Kenneth** should not allow concerns for his personal reputation to affect his **objective judgement** in deciding how to deal with the matter. Already, his delay in taking action suggests that he has allowed his personal interests to affect his decision about what to do.
- **Jonathan**, as stated above, may have acted in **self-interest** rather than with objectivity in reporting the share dealings of Chris Lee to Kenneth Chan.
- **Jian** and **Christine** are faced with the problem of giving advice to Kenneth Lee. Their long relationship with Kenneth may persuade them to give advice that is in Kenneth's interests rather than advice that is objectively more appropriate.
- Similarly, the advice given by **Jian** to Kenneth may be influenced by his friendship with Chris Lee. When judgement is influenced by **friendships**, there is a serious **familiarity threat**.

Another fundamental principle of the Code of Ethics is **professional competence and due care**. Accountants are expected to **act diligently** and in accordance with **professional standards**.

- This fundamental principle does not seem to apply to the four individuals in this scenario, although **Kenneth** is at risk of failing to provide suitable leadership in this situation, as chairman of HFIC.

A fourth fundamental principle of the Code of Ethics is **confidentiality**, and the requirement to respect confidentiality.

- **Kenneth** has contravened the principle by failing to respect the requirement of Jonathan Lu for confidentiality. He has given information about Jonathan to both Jian and Christine. He may also have given Chris Lee some idea about the **identity of the informer**.
- **Jian** and **Christine** have been given information in confidence by Kenneth, but if they act professionally, they may have to give the information that they have to others in their **employer** organisation (SEHK or Platinum Investments).
- **Jonathan** should expect Kenneth to respect his request for confidentiality.

The fifth fundamental principle of the Code of Ethics is **professional behaviour**. Professional accountants are expected to comply with **laws and regulations**, and avoid action that **discredits the profession**.

- **Kenneth** has possibly acted unprofessionally by delaying action in this matter, because he has taken **no action** in the one week since he was informed by Jonathan Lu about Chris Lee's behaviour. He should probably have acted more decisively and quickly. Otherwise, he has not yet acted unprofessionally. However, he should be aware that he should act professionally when dealing with Chris Lee and should not do anything that would make him tolerate a breach of the law or regulations.
- **Jonathan** appears to have acted professionally in **reporting** the matter to Kenneth Chan.
- **Jian** should behave professionally in responding to the request for advice from Kenneth, and in the subsequent actions that he takes. Whatever he does, he should not allow a breach of the **law** or regulations to go unreported. He has the reputation of SEHK and the Hong Kong stock market generally to consider.
- **Christine** should also respond professionally. If the information she has been given is **price-sensitive**, she has become an insider and must act in accordance with the law. She should seriously consider her professional duty to insist that Kenneth Chan should disclose this price-sensitive information to the stock market authorities.

The main **threat** facing Kenneth Chan is **self-interest**. He may lose his reputation if the details of the share dealings by Chris Lee become public knowledge, and he may also lose the support and respect of his board colleagues and the company's shareholders. Self-interest may have influenced the action of Jonathan Lu, but he would also appear to have acted in an ethical way. If there is a possibility that her remuneration may be affected by the disclosure of Chris Lee's actions to the stock market, Christine may have some self-interest threat too.

For Jian and Christine, the main threat is probably a **familiarity threat**, due to their friendship with Kenneth Chan and, in the case of Jian, his friendship with Chris Lee.

(c) **Using the AAA Model, highlight the best solution or course of action**

LP reference: Part (c) refers to Chapter 1, Ethics in business, Section 5 – the American Accounting Model and Part 2, Section 2 – the HKICPA Code of Ethics

Key learning points/issues: In Part (c) students learn how to apply the AAA Model to an ethical scenario. They must show they have worked through the seven 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.

Kenneth Chan, Chairman of HFIC

Step 1 **Determine the facts**	Kenneth Chan is a highly-regarded and experienced businessman, with a global reputation in the industry. He is informed by Jonathan Lu, deputy operations director, that the operations director Chris Lee has made a large personal profit by dealing in shares of a company that was acquired by HFIC. Chris Lee had recommended the takeover and had been at the board meeting where the decision to make a bid was taken. Chris Lee did not tell the board of HFIC about his transactions, and seems to have deliberately kept them hidden. This indicates that Chris Lee has acted in breach of his duties as director of HFIC. Kenneth did not take immediate action to deal with the problem, having learned from Chris Lee that the information from Jonathan Lu was true. A few days later, he decided to consult two individuals for advice. Neither of them are directors of HFIC and neither has legal expertise. Both have a professional interest in the situation. Kenneth tells them what has happened, and in doing so has possibly given them price-sensitive information.
Step 2 **Define the ethical issue**	**Stakeholders** Stakeholders who may be affected by the situation: Shareholders of HFIC Board members of HFIC Chris Lee Jonathan Lu Jian Jiang HKEx/SEHK Christine Wu The investment industry Financial media SFC/Hong Kong judicial system The Hong Kong Institute of Certified Public Accountants **Ethical issues** Kenneth has made some ethical mistakes or errors of judgement. He did not act professionally when he failed to take immediate action to deal with the problem as soon as he learned about it. It is surprising that HFIC did not have a procedure in place for dealing with confidential allegations from informers within the company. If HFIC does have such a procedure, Kenneth did not follow it. His delay in acting may be attributable to his personal concerns about his reputation and his position as company chairman. His decision to discuss the situation with two business colleagues is also questionable, because he breached confidentiality and in doing so may have given price-sensitive information to those individuals. Kenneth does not appear to have considered the interests of HFIC shareholders or investors generally.

	Kenneth must make a decision about what he should do, and he needs to assess the ethical as well as the business factors in the situation, and he should act with integrity. The longer he does nothing about the problem, the greater it might become when the story eventually becomes public knowledge. His will add to investor suspicion about the leadership and business ethics of the company.
Step 3 **Identify the major principles, rules and values**	Referring to the HKICPA Code of Ethics: **Integrity:** Kenneth should act quickly and should not allow further delay before deciding what should be done. By discussing the issue with two 'friends', he has failed to demonstrate integrity in his dealings. He does not appear to have kept Jonathan Lu informed about what he intends to do, and this demonstrates some lack of integrity in his dealings with Jonathan. **Objectivity:** Kenneth's delay in taking action suggests that he may be concerned about the effect on his reputation if the story is announced to the public, and this concern for self-interest may threaten his objectivity in dealing with the problem. **Professional competence and due care:** If HFIC has a procedure for handling confidential allegations from employee informers (a 'whistle blowing procedure') Kenneth has not followed it, and this would indicate a lack of professional competence and due care. **Confidentiality:** By discussing the matter with Jian Jiang and Christine Wu, Kenneth has breached the principle of confidentiality. There are situations where disclosure of confidential information is appropriate, such as reporting suspicions of criminal activity to the authorities. In this case, however, disclosure of the information to his two friends does not seem justified. **Professional behaviour:** Kenneth needs to consider the actions of Chris Lee, who appears to have broken the law (and Listing Rules and code of corporate governance practices). It would be unprofessional behaviour to allow a breach of the law (the actions of Chris Lee) to go 'un-punished'. **Self-interest and familiarity:** Kenneth needs to recognise that he has self-interest threats and familiarity threats (his business relationship with and personal support for Chris Lee) which may persuade him to act unethically. **Self-review:** Kenneth may also be required to justify his previous actions – in supporting Chris Lee, in allowing the ownership of Elite Fashion to go un-checked and in delaying action in dealing with the matter. If so, this will create a self-review threat, because Kenneth will want to justify everything that he has done, and will not want to confess to having made mistakes or errors of judgement.
Step 4 **Specify the alternatives**	**Alternative 1:** Kenneth decides that the actions of Chris Lee are an event in the past and will not happen again; therefore nothing should be done. **Alternative 2:** Kenneth should call an immediate board meeting and inform the other directors about what has happened, recommending that the board should inform SEHK about the actions of Chris Lee. The board should then take no further action unless the authorities decide to take their own action against Chris Lee. **Alternative 3:** Kenneth should call an immediate board meeting and inform the other directors about what has happened, recommending that the board should

	inform SEHK about the actions of Chris Lee and that Chris Lee should be dismissed from the company for breach of his duties as a director. He may also recommend that the company should consult with lawyers to decide whether there are grounds for legal action against Chris Lee to recover the personal profits that he made from the share dealing.
Step 5 **Compare values and alternatives. Is a decision clear?**	**Alternative 1** is not appropriate. If Kenneth does nothing, it is unlikely that the story can be kept hidden from the public. When investors and regulators do eventually learn what has happened, they will question why Kenneth decided to do nothing, and the situation will be worse. **Alternative 2** might be preferred if the board considered that retaining Chris Lee in the company was essential for its future success. However if the authorities take action against Chris Lee when the company has done nothing, this could damage shareholder/investor confidence in the company. However, **Alternative 3** would seem to be the appropriate choice of action.
Step 6 **Assess the consequences**	Doing nothing (**Alternative 1**) will probably only delay the consequences of adverse reaction from shareholders/investors and the stock market authorities. If HFIC has ambitions as a global company, it must be seen to act ethically. If **Alternative 2** is chosen, the failure of the board to take action to deal with the problem would raise shareholder/investor doubts about the quality of leadership in the company. The consequences for the company's reputation could be damaging. **Alternative 3** means that the company will lose the services of a successful and able director, but global companies should not rely on individuals for their success.
Step 7 **Make your decision**	**Alternative 3 is the appropriate solution**. A CPA should support and recommend only Alternative 3 under the Code of Ethics.

Jonathan Lu, Deputy Operations Director of HFIC

Step 1 **Determine the facts**	Jonathan Lu is an ambitious employee in HFIC who reports to Chris Lee, the Operations Director. Jonathan discovered that Chris Lee had made an undisclosed personal profit from share dealings in Elite Fashion, without informing the board of HFIC and deliberately keeping the facts hidden from HFIC. He discovered this information when searching through the e-mail file of Chris Lee. He informed the chairman Kenneth Lee, and asked for the matter to be kept confidential. He has not been kept informed about subsequent developments, and is presumably wondering why no action has been taken by the board of directors of HFIC. As an informer, he is probably aware that his future career in the company may be at risk.

Step 2 **Define the ethical issue**	**Stakeholders** Stakeholders who may be affected by the situation: His close family, work colleagues and the people working for him in HFIC The board of directors of HFIC Kenneth Chan Chris Lee Shareholders of HFIC HKEx/SEHK Financial media Hong Kong regulatory and judicial system The Hong Kong Institute of Certified Public Accountants **Ethical issues** Jonathan appears to have acted ethically in reporting the actions of Chris Lee to the chairman Kenneth Chan. However, he may also have acted in **self-interest**, calculating that Chris Lee will be forced to leave the company and this could improve Jonathan's own career prospects. We do not know the circumstances that led him to check through the e-mail file of Chris Lee. It is possible that Jonathan **acted unprofessionally**, by looking through the files of a colleague without permission. Unauthorised 'spying' or searching for information is improper conduct within any organisation. We have no information about Jonathan's close family. It is possible that by acting as informer, he has put his job with HFIC at risk, and so may also have put the welfare of his family at risk.
Step 3 **Identify the major principles, rules and values**	Referring to the HKICPA Code of Ethics: **Integrity:** Jonathan reported improper behaviour by his boss to the company chairman. In doing so, he may have acted with integrity – or he may have acted in self-interest. **Objectivity:** Jonathan presumably expects that action will be taken against Chris Lee and that this may benefit his own career. He may also be aware that if no action is taken against Chris Lee, his own job may be at risk. He will therefore lack objectivity in his view of what happens subsequently. If the company tries to keep the affair hidden from the public, Jonathan may be tempted to report the information to the stock market authorities or to the financial media. **Professional competence and due care:** This does not seem to be an issue. **Confidentiality:** Jonathan has asked for the matter to be dealt with confidentially, which is a reasonable request. However if the chairman of HFIC does not take action that Jonathan approves of, he may be tempted to pass his information to the press. Technically this might be a breach of his contract of employment. **Professional behaviour:** Jonathan has acted properly by reporting the matter to the company chairman, but may not have acted professionally when obtaining the information about Chris Lee's share dealings.

Step 4 **Specify the alternatives**	At the moment, Jonathan does not have any obvious course of action, except to wait and see what action is taken by Kenneth Chan or the board of HFIC. However, he may already be considering whether to report the matter to the authorities and the financial media if no action is taken against Chris Lee. **Alternative 1:** Accept the decision that is eventually taken by Kenneth Chan and the board of HFIC. **Alternative 2:** If Jonathan is not satisfied with the action (or lack of action) by Kenneth Lee, ask for a meeting with Kenneth Lee and ask for an explanation of the decision that has been taken. **Alternative 3:** If Jonathan is not satisfied with the action (or lack of action) by Kenneth Lee, report the matter to the stock market authorities (SEHK or SFC) and/or the financial media.
Step 5 **Compare values and alternatives. Is a decision clear?**	Jonathan need not make a decision yet. However **Alternative 1** would be inappropriate, because having taken initial action in reporting the matter to Kenneth Chan, Jonathan should not accept the future outcome passively. He now has too much at stake personally in what happens. His decision should be between **Alternative 2 or Alternative 3** (informing the authorities). It might also be possible to choose Alternative 2 first, and if this does not result in a satisfactory outcome, move on to Alternative 3.
Step 6 **Assess the consequences**	If Jonathan chooses **Alternative 1**, he will be uncertain about what will happen to him in the future. There is a strong possibility that he could lose his job at HFIC, but he would not know for sure. It would be stressful for him personally (and his family) to be in such a situation. **Alternative 2** means that he would have an opportunity to learn the attitude that the chairman or board of directors is taking to the situation. This will help to remove some of the uncertainty about the future. **Alternative 3** would almost certainly mean the end of Jonathan's career at HFIC, because the company would assume that he is the source of the report to the authorities or the press, and would take an unfavourable view of what he has done.
Step 7 **Make your decision**	**Alternative 2 is would be the initial solution**, but if Jonathan is dissatisfied with the explanations of the chairman or the board, he might need to consider **Alternative 3**. As a CPA member, he could seek ethical advice from the Institute in this circumstance. A CPA could support this decision under the Code of Ethics.

Jian Jiang, enforcement officer at HKEx

Step 1 **Determine the facts**	Jian Jiang is an enforcement officer at HKEx. He knows Kenneth Chan from business acquaintance and is respected by him. He is also a personal friend of Chris Lee. He was invited to a meeting with Kenneth Chan and Christine Wu, during which Kenneth Lee disclosed information about Chris Lee that could be price-sensitive, and affect the HFIC share price when it becomes public knowledge.

	If he gives advice that is accepted by Kenneth Chan, this will affect the career of his friend Chris Lee.
Step 2 **Define the ethical issue**	**Stakeholders** HKEx/SEHK and HK stock market participants Other enforcement officers at SEHK Shareholders of the HKEx Shareholders of HFIC Kenneth Chan Other board members of HFIC Christine Wu Chris Lee Jonathan Lu Financial media Hong Kong regulatory and judicial system The Hong Kong Institute of Certified Public Accountants **Ethical issues** Jian is being asked to give advice on a matter affecting a person he has known for many years (Kenneth Chan) and a friend (Chris Lee). It will be very difficult for him to remain objective, due to his familiarity with these individuals. He has been given information in confidence, but it is information that he has a professional duty to pass on to colleagues in the regulatory authorities for investigation. There is a conflict between respecting confidentiality and performing his professional duty. Some self-interest may also be involved, because if Jian does not report the matter to colleagues, his failure to do so may subsequently be discovered and he may be subject to disciplinary action by his employer.
Step 3 **Identify the major principles, rules and values**	Referring to the HKICPA Code of Ethics: **Integrity:** Jian has not shown a lack of integrity, but he at risk of doing so if he does not report the matter to his colleagues, and act in accordance with SEHK regulations. **Objectivity:** Jian's objectivity is under threat, because he is being asked to give advice by one individual that he knows well (Kenneth Chan) about a friend (Chris Lee). He has not shown a lack of objectivity yet. **Confidentiality:** Jian has been given information in confidence, and if he reports this to his colleagues, he will be in breach of this confidence. However, the circumstances (the illegal action by Chris Lee) would justify this. **Professional behaviour:** Jian should perhaps have refused to meet with Kenneth Chan to discuss Kenneth's problem, and should perhaps have advised Kenneth to approach SEHK through formal channels. In this respect he may have behaved unprofessionally by allowing his familiarity with Kenneth Chan to influence his decision.

	The ethical problem for Jian is what to do now that he has been given the information by Kenneth Chan and asked to give his advice. He should try to be honest and objective, although the familiarity threat may be strong.
Step 4 **Specify the alternatives**	**Alternative 1:** Refuse to give Kenneth Chan any advice about Chris Lee, but recommend that the matter should be discussed by the HFIC board urgently and reported to the SEHK authorities formally as soon as possible. **Alternative 2:** Advise Kenneth Chan to do nothing, and hope that the matter will not become public knowledge. **Alternative 3**: Advise Kenneth Chan that the actions by Chris Lee may not have been illegal; therefore there is no need to report the matter to SEHK.
Step 5 **Compare values and alternatives. Is a decision clear?**	**Alternative 3** would seem to be incorrect, and by giving this advice, Jian would be acting without integrity or objectivity, and in an unprofessional way. This is totally inappropriate. **Alternative 2** is also inappropriate. If the matter eventually becomes public knowledge, the advice given to Kenneth Chan by Jian will also probably be reported. He would then be exposed to the threat of disciplinary action himself for withholding important information from his employer (or failing to act on the information himself). **Alternative 1** is the appropriate course of action. It is clear that this is the right decision.
Step 6 **Assess the consequences**	If Jian chooses **Alternative 2 or Alternative 3**, he will be putting himself at risk of disciplinary action at some time in the future, if the matter becomes public knowledge. He will have tried to protect Chris Lee, but at some risk to himself. If he takes **Alternative 1**, he will have advised Kenneth Chan to take the most appropriate way forward and he will also have acted professionally. The consequence will be that the matter will be investigated and reported to the stock market. The company's shares may fall in value and Chris Lee will be dismissed by HFIC. This may be harmful to the interests of HFIC in the short term, but necessary in the longer term to protect the reputation of HFIC itself and, more generally, the reputation of the Hong Kong stock market.
Step 7 **Make your decision**	**Alternative 1 is the appropriate course of action**. A CPA could support and recommend only Alternative 1 under the Code of Ethics.

Christine Wu, senior manager at Platinum Investments

Step 1 **Determine the facts**	Christine Wu is a senior manager at Platinum Investments. She knows Kenneth Chan from business acquaintance and is respected by him. She has been a strong supporter of HFIC in the past and recently persuaded Platinum Investments to increase its shareholding in HFIC. She was invited to a meeting with Kenneth Chan and Jian Jiang, during which Kenneth Lee disclosed information about Chris Lee that could be price-sensitive, and affect the HFIC share price when it becomes public knowledge. It is possible that her remuneration may be partly performance-related and that

	her next annual bonus may be affected by a fall in the HFIC share price. If so, she has a personal interest in protecting the HFIC share price. Having received information from Kenneth Chan that may be price-sensitive, this makes her an 'insider' until the matter is made public knowledge, and this could limit her freedom of action in the future with regard to investment decisions and buying/selling shares in HFIC.
Step 2 **Define the ethical issue**	**Stakeholders** Platinum Investments SEHK/HKEx The investment industry Shareholders of HFIC Kenneth Chan Other board members of HIFC Chris Lee Jonathan Lu Financial media Hong Kong regulatory and judicial system The Hong Kong Institute of Certified Public Accountants **Ethical issues** Christine has not acted illegally or unethically, but she now faces an ethical problem. She has persuaded Platinum Investments to buy a large quantity of HIFC shares, and a public announcement by HIFC about Chris Lee could damage her reputation within Platinum Investments, and may also affect the size of her annual bonus from her employer. The information she has been given by Kenneth Chan may be price-sensitive, and she may therefore be an insider. She would be acting illegally if she acted on this inside information (by arranging for Platinum Investments to sell its shares in HFIC before the Chris Lee affair becomes public knowledge).
Step 3 **Identify the major principles, rules and values**	Referring to the HKICPA Code of Ethics: **Integrity:** Christine has not shown a lack of integrity yet, although in her self-interest she may advise Kenneth that no action should be taken. If she gave this advice, she would be showing a lack of honesty and integrity. **Objectivity:** Christine has been asked by a friend to give advice. Depending on the advice she gives and whether it is acted on, the result may be to damage the reputation and possibly the career of her friend Kenneth Chan. **Confidentiality:** Christine has been given information that may be price-sensitive. Until it becomes public knowledge, she must not act on this 'inside' information. **Professional behaviour:** Christine should act in a way that protects the reputation of the investment industry and the stock market in Hong Kong. Her advice should be to respect the law and the regulations of SEHK; otherwise she will not be acting professionally (or ethically).

	Self-interest: Christine may have to accept that she may be criticised by her colleagues in Platinum Investments for the support she has given to HFIC, and he may have to accept that her annual bonus may not be as large as she may have hoped.
Step 4 **Specify the alternatives**	**Alternative 1:** Refuse to give Kenneth Chan any advice about Chris Lee, but recommend that the matter should be discussed by the HFIC board urgently and reported to the SEHK authorities formally as soon as possible. She should then expect Jian Jiang to give similar advice. **Alternative 2:** Advise Kenneth Chan to do nothing, and hope that the matter will not become public knowledge. Platinum Investments may then sell some of its shares in HFIC.
Step 5 **Compare values and alternatives. Is a decision clear?**	Christine should choose **Alternative 1**. **Alternative 2** would be harmful to the reputation of the Hong Kong stock market and the investment industry when the Chris Lee matter becomes public knowledge. Dealing in shares of HFIC with inside information would also be illegal.
Step 6 **Assess the consequences**	If Christine chooses **Alternative 2**, she will be putting herself at risk of regulatory or legal action at some time in the future, if the matter becomes public knowledge and she is found to have been guilty of insider dealing in HFIC shares. Her reputation and career with Platinum Investments may also be damaged. If she holds shares in HFIC in her own name, she might be able to trade in the shares and make a personal profit. However, this would be entirely unethical (and illegal, as insider dealing). If she takes **Alternative 1**, she will have advised Kenneth Chan to take the most appropriate way forward and she will also have acted professionally. The consequence will be that the matter will be investigated and reported to the stock market. The company's shares may fall in value and Platinum Investments may make a loss on its investment, at least in the short term. The reputation of her friend Kenneth Chan may be damaged. These consequences would be undesirable to her, but she must accept that they are unavoidable.
Step 7 **Make your decision**	**Alternative 1 is the only possible course of action**. A CPA could only support and recommend Alternative 1 under the Code of Ethics.

Discussion points

Executive Management: Pre-workshop exercise

Part (a)

As a pre-workshop exercise, students are required to classify seven products using the Boston Consulting Group (**BCG**) matrix, with products defined as **stars**, **cash cows**, **question marks** or **dogs** according to information about the global market, the company's share of the market, and some details about profitability and future spending requirements for each product.

They should then suggest what the **future strategy** for each product should be – **to invest further**, **divest**, **harvest** or **hold**.

Finally, students should have ideas about the **advantages** or **disadvantages** of using the BCG matrix to analyse product development strategy.

The sample answer makes conclusions based on the author's perception of how products should be classified. It is understood that a different view may be taken with some products, and that the classification of some products may differ from the sample answer provided here.

All answers are acceptable as long as candidates are able to effectively argue the case for categorising each product as a star, cash cow, question mark or dog.

LP Reference

Chapter 2, Section 10.2.

Key learning points: Students will conduct an analysis of a product portfolio using the Boston Consulting Group matrix, and will use this analysis to suggest what the future development and sales strategy for each product in the portfolio should be.

Umbrellas	
Market growth rate is fairly **high** (10%), and growth within the market for HFIC products is high (20% annually). '**Reasonable share**' of the market, and market share is increasing. Growth rate expected to continue (although this assumption may be questioned). Not yet making a profit, and further investment expenditure is required.	Because market share for HFIC is growing, this product may be classified as a **Star**. If so, the future strategy for this product should be to '**build**' and **invest further** in development and advertising. **Alternatively**, the assessment may be that the growth in the global market is not particularly high, and the product is a **Question Mark.** If so, the decision may be to '**build**' and **invest further** in development and advertising, in the hope of eventually turning the product into a Cash Cow. **Alternatively**, the decision may be to **avoid excessive further spending** on development and marketing, and try to make some profit from the product before bringing its life cycle to an end.

Matching outfits for pet owners and their pets	
The **global market** is growing at a fairly **high** rate (15%), but **HFIC's sales growth** is only 10%, indicating that it is **losing market share**. The product is making a small profit, but further expenditure on development will be required to increase profitability.	The fairly high rate of growth in the global market, and declining share of the market for HFIC products, suggests that this product is a **Question Mark.** A decision should be taken about **whether to 'build'** and invest further in the product, **or to avoid further spending**, and earn limited profits from the product before bringing its life cycle to an end when it eventually becomes unprofitable.
Kids' sun hats	
There is annual growth in the **global market** but this is **not high**. Initially, **HFIC** achieved very **high growth** rates in sales for its products, and so would have been **gaining market share**. Growth in HFIC sales in recent years has fallen to the market average, and **more competitors** are entering the market. The product is profitable, although profit margins have been falling slightly. Not much further expenditure on the product range is required.	This product range would seem to be a **Cash Cow**. The product is profitable, and since very **little development expenditure** is required, the product is presumably generating cash that can be invested in other rising products. The strategy should be to **hold** the product and continue to make profits and generate cash flow.
Tennis shirts	
There is a **large global market**, but overall **growth** in the market is **low**. **HFIC** has a **small share** of the total market, and this is **not increasing**. More expenditure is needed before the product will (or may) become profitable.	This product range would seem to be a **Dog**. HFIC should **cease production** and sales of this product, having sold any inventories of the product that it still holds.
Local costume in Germany	
There is a **large local market** for this product in Germany, but there is **no growth** in the market. **HFIC** has achieved a **10% share** of the market in two years. The product is not yet profitable, but is close to breaking even. Further development expenditure is required to increase market share.	This product range would seem to be a **Question Mark**. It could become a Cash Cow if the company continues to invest in the product and as a result increases its share of the market. . A decision has to be made about whether to: (1) invest more in the product, or (2) limit further development spending and continue to make and sell the product provided that it can be made profitable in the near future.

Denim clothes	
A **recently-introduced** product range; therefore future sales growth prospects may be difficult to predict. Very encouraging sales in the first year. Strong growth rate in the global market. Further development expenditure will be needed.	Although HFIC has only recently begun to make and sell this product range, it seems to have the potential to be a **Star**. The strategy should be to '**build**' – invest in the product and continue to increase market share.
Patterned socks for men	
Global annual growth in the **market has fallen** to less than 10%, which may be considered **high** in the apparel industry. **HFIC** has a **large share** of the market, although this has been falling due to new competition. Annual sales have also been falling. The product remains profitable. Presumably, little further expenditure on development is required.	This product range would seem to be a **Cash Cow**, and is the same as for kid's sun hats. The product is profitable, and since very little development expenditure is required, the product is presumably generating cash that can be invested in other rising products. The strategy should be to **hold** the product and continue to make profits and generate cash flow.

Advantages of using BCG matrix	Disadvantages of using BCG matrix
It provides a way of analysing a **portfolio of products**, to check that there is a suitable proportion of cash cows and rising stars. It recognises the **importance of market growth and market share**, and requires an assessment of future sales growth prospects when deciding the strategy for individual products. It is a method of assessing expected sales growth, investment requirements and profitability for individual products. It can be used to assess whether successful products (cash cows) generate sufficient cash to finance development of stars (and possibly question marks). It is a way of deciding whether to cease the development/production of certain products.	It may be difficult to measure total market size and market share. It may be difficult to do an analysis with the BCG matrix for all the products that a company has in its product range. Deciding whether growth in the market is strong or weak is a matter of judgement, and will vary between industries. It is not appropriate for products with a very short life cycle, such as individual fashion products which may not last for more than one season.

Part (b)

In this section students are required to complete an **Ansoff product-market matrix** for HFIC. Students should be able to give at least one example of a suitable strategy for **market penetration**,

product development, **market development**, **diversification** (related and unrelated), **withdrawal** and **demerger**.

It is understood that there may be many more possible strategies 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.

LP Reference

Chapter 2, Section 11.2

Key learning points: Students will conduct a strategic choice analysis through the completion of an Ansoff product-market matrix.

Market penetration (Present Product and Present Market)	
This is a strategy of developing the present range of products for the company's present markets.	The company might consider a review of its **fashion design competences**, with a view to improving the appeal of its goods to customers. Alternatively, the company may review its **advertising and marketing strategies**. More effective strategies may result in a higher volume of sales. For example, the company may seek to increase its on-line sales volumes by investing more in this method of selling. If the company has more demand for its products than it has capacity to supply, a suitable strategy may be to find ways of **increasing production resources**, for example by finding more external manufacturers or by increasing its own in-house manufacturing capacity. The company is already selling products in China, but the company's market share could be developed more, for example by **opening more retail or wholesale outlets**.
Product development (New Product and Present Market)	
This is a strategy of developing new products for existing markets	The company has a **New Product** Development Group and is looking for new products to bring to its existing markets. A suitable strategy maybe to **invest more in its design team**, and put more resources into the design of new products. However, when new products are developed, there must also be arrangements for manufacturing and marketing them. The company might even consider developing **entirely new products**, targeted at existing customers (for example through its retail stores). For example, the company might develop a new

	range of household furnishings products, or household furniture items.
Market development (Present Product and New Market)	
This is a strategy of developing new markets for existing products.	The company's sales are **mostly in Europe** and, to a **lesser extent, China**. There may be regional markets where the company does not have a presence, or only a **limited presence**, such as the West Coast of the USA, or Australia. A market development strategy would be to establish retail or wholesale outlets in these regions. Instead of trying to sell the full range of products in these new regions, it may be more appropriate to begin by introducing a limited product range, such as women's fashion or the successful HF Star range only.
Diversification: related diversification (New Product and New Market)	
This is a strategy of producing new products for new markets, involving either horizontal or vertical integration.	The company may consider the **acquisition of competitor companies**. Acquisitions of competitor companies would increase market share in existing markets, and would also add to the company's product range (for example through the acquisition of new brands). The company buys most of its products from external manufacturers. A **backward vertical integration strategy** would be to invest more in manufacturing. Major suppliers may be acquired, or the company may choose to set up its own new manufacturing centres. The company has already adopted a strategy of **acquiring retail outlets** that sell its own products exclusively. It could continue to open more of its own stores.
Diversification: unrelated (conglomerate) diversification	
This is a strategy of developing new products for new markets, and is a high-risk strategy.	This strategy could involve the **acquisition of an unrelated type of company**, and it is consequently difficult to provide a useful suggestion. Due to the high risk in this strategy, it is not recommended.

Withdrawal	
This is a strategy of pulling out of selected markets or ceasing production of certain products.	The company may **withdraw from some regional markets** where sales are not strong and profits are low (or operations are unprofitable). If the company owns any retail distribution outlets in these regions, the strategy would involve selling off these assets. The company may also decide to **cease designing and selling some product ranges**, if these are not sufficiently profitable. For example the company might decide to cease producing for its Star range, and focus on its remaining three product divisions.
Demerger	
This is a strategy to split the business by dividing the company into two (or more) separate companies with separate operations.	In the case of HFIC, this would be difficult, because all its products are sold through the same distribution channels, and it is not clear how operations could easily be divided into two or more separate businesses.

Part B Executive Management

John Fordham (CEO) and Dong Li (CFO) have called a strategy planning meeting, which you have been asked to attend.

The purpose of the meeting is to consider and discuss a number of different strategy options for HFIC. The purpose of the meeting is to develop ideas for presenting to the board, together with a recommendation about which strategy to adopt as the main **business strategy of the company for the next few years**.

The **four proposed strategies** that will be considered are those described in the Case Study Scenario document. For each of the options, John Fordham and Dong Li want you to identify the type of strategy using the Ansoff matrix as a model and to evaluate the options, including the consequences of selecting the option as the company's business strategy.

You will be asked to divide into four groups. Each group is to consider **one** of the following strategies:

1 Expand business in the PRC as rapidly as possible
2 Expand business in Europe with the company's existing product ranges
3 Develop new product ranges for existing markets
4 Consolidation strategy based on improving efficiency and reducing costs

Required

(a) In your group

(i) identify the way or alternative ways in which the company may implement the general business strategy, and

(ii) prepare a list of the positives and negatives for the assigned strategy.

Note: Use the Ansoff product-market matrix to identify the type of strategy, and to assess the positives and negatives in the strategy you are considering. You may wish to use PESTEL analysis or SWOT analysis when considering the positives and negatives of the strategy.

(b) Prepare a presentation to the Workshop group on the results of your group's assigned strategy. Select two group representatives.

(c) The Workshop group should then discuss all the presentations and conclude which strategy should be pursued by HFIC and presented to the Board. Draw upon the JS&W (Exploring Corporate Strategy) checklist to assess the four options and decide on the appropriate choice.

Discussion points

Strategic Position and Analysis

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

1 Expand business in the PRC as rapidly as possible

2 Expand business in Europe with the company's existing product ranges

3 Develop new product ranges for existing markets

4 Consolidation strategy based on improving efficiency and reducing costs.

It is understood that there may be many more issues to consider than those included in the sample answer. All answers are acceptable as long as candidates are able to effectively argue the case for the inclusion of any particular idea or point, if requested.

Part (a)

LP reference

Part (a) follows on from the work prepared in the pre-workshop exercises. The ability of students to identify how a strategy may be implemented may depend on the quality of their preparation with the pre-workshop exercise. LP references are Chapter 2, Section 6.4, Section 9.1 and Section 10.2. Students also need to refer to the Case Study Scenario. They may also find it useful to consider SWOT analysis or even PESTEL analysis when thinking about the positives and negatives of each strategy. LP references for these techniques are Chapter 2, Section 6.4 and Section 9.1.

Key learning points

Students must learn to critically assess their option and recognise different ways in which a particular strategy may be implemented. They must also provide a clear set of positives and negatives for a particular strategy.

Solution: Ways of implementing the assigned strategy: positives and negatives for the strategy.

Expand business in the PRC

Strategy

This could be described as a **market penetration strategy**, if the company chooses to sell its own products in China, where it already has some distribution networks.

It could also be described as a **product development strategy**, if the company intends to create a new brand for the fashion products that it sells in China.

It could also be described as a **horizontal diversification strategy** if the strategy is implemented by merging or taking over another company that already has an established business in China, with its own branded products.

Methods of implementing strategy

There are several different ways in which a strategy to expand sales in China could be pursued:

(a) Continue to sell HFIC's **existing product ranges** and brands in China, and to **expand its distribution network**.

(b) Create a **new brand and product range** for fashion goods in China, and to sell these products through the **existing** (and growing) **distribution network** in China. These will be **lower-priced and lower in quality** than HFIC's existing branded products.

(c) Seek a **strategic alliance** or merger or takeover in China. The partner or takeover target should be an established company in China with its own range of clothing products and a **well-established distribution network**.

(a) Sell existing brands and products and expand distribution network	
Positives	**Negatives**
The company has **two global brands** (High Fashion and HF Star) and these should be **attractive to customers** as consumers **in China** increasingly demand fashion clothes.	**Prices** may be **too high** for significant market share. If **prices** are **lowered for China**, customers in other countries may **resent** the **two-tier pricing structure**, and lower prices may also damage the 'high fashion' image of the company's brands.
There should be **no significant increase** in **design costs**.	It could take a **long time** to develop market share through **organic growth**.
China is a potentially **enormous market** for fashion clothes, and HFIC should seek to achieve a high share of the market if it can.	Other competitors may have strategies for increasing their market share more quickly.
HFIC has an established brand name for its products, and there is always demand for fashion clothes. HFIC also has a design team with experience. The company should **exploit its strengths** in its existing markets.	The cost of **developing** the **distribution network** and increasing customer awareness of HFIC's products could be **expensive**, and the strategy may be loss-making for several years (or longer).
Expanding in China will **reduce** the company's **reliance** on markets in **Europe**.	The company has only **limited experience** in the market in **China**, and may need to recruit executives with suitable knowledge and experience of the market to increase market share substantially.
	The company may not be able to expand its business significantly without improving the **supply chain**, and in particular gaining more control over manufacture and manufacturing resources.

(b) Create new brand and product range for China	
Positives	**Negatives**
The new brand can be sold at **lower prices** and so should attract **higher sales** volumes.	**Profit margins** will be **low** unless products can be made cheaply.
China is a potentially **enormous market** for fashion clothes, and HFIC should seek to achieve a high share of the market if it can.	The new brand may **fail** to attract customers.
	Retail organisations in China may be **reluctant** to stock a **new brand** of clothing.
	Costs of **developing a new brand** and product range, and marketing/advertising it, could be **high**.
	Diamond Fashion will be a major **competitor**, and HFIC would need to develop a strategy for competing successfully with this company.

(c) Seek a strategic partner or merger/takeover in China	
Positives	**Negatives**
A **strategic partnership** or merger or takeover would give the company an **immediate increase** in market share, and an addition to its range of products.	It may be **difficult** to **find** a suitable strategic **partner** or takeover target.
This should make the target of a 25% share of the market within five years **more achievable**.	A strategic partnership may be agreed for only a **limited number of years**. After this time, it may be unclear what each partner will expect.
China is a potentially **enormous market** for fashion clothes, and HFIC should seek to achieve a high share of the market if it can.	
The company should obtain new managers or partners with a **good knowledge** of the market for clothing or fashion goods in China.	

Expand business in Europe with the company's existing product ranges

Strategy

This is a market penetration strategy.

Methods of implementing strategy

There are several different ways to implement a strategy to expand sales in Europe with existing products.

(a) Invest more in the customer's '**shopping experience**'. This would require more control over the retail operation, and HFIC would probably need to invest to acquire more of its own retail stores.

(b) Develop **new ways of selling** and distributing goods to the market. Online sales could be increased.

(c) **Invest more in marketing** and PR, for example through recruiting new top designers with a big reputation in Europe.

(a) Improve the customer's shopping experience	
Positives	**Negatives**
Europe is the **main market** for the company's goods. Sales have been falling. New investment should help sales to increase.	Investing in new retail centres would be **expensive**.
Customers in Europe may be attracted to new stores that provide a special shopping experience. This could be an essential strategy for **maintaining market share** in Europe in the long run.	Europe may **not** be a **high-growth market** so it may not be worth investing in new stores and/or brand revamps.
It will reinforce the company's **status** as a producer of high fashion clothing in its main markets.	Investing in Europe would mean **limited diversification**, which could be high risk.
	There is limited evidence to support the view that this strategy would be successful. It may require a **large investment** in upgraded stores, but financial returns may not be high.

(b) Develop new methods of distribution	
Positives	**Negatives**
Online selling of goods, including fashion goods, is becoming much more **important**. HFIC cannot ignore this method of selling.	To sell online, HFIC may need to establish **more distribution centres** than it has currently, or increase the size of existing centres. This is because the distribution centres will have to handle online sales orders as well as continuing to provide service the existing retail and wholesale outlets.
The company already has some **experience** with online sales.	It would also need to increase its organisation for handling **sales returns**, which will be high.
Selling online will be **less expensive** than selling through retail or wholesale outlets.	

(c) Increase spending on marketing	
Positives	**Negatives**
Spending on marketing can be subject to control through the **budget**, and annual spending can be raised or lowered each year.	Increasing marketing spending may have only a small and **short-term effect** on sales and profits.
Additional spending may be expected to increase sales, at least in the short term.	It will be a **difficult** strategy **to maintain** every year over the long term, and so cannot really be seen as a long-term strategy at all.

Develop new product ranges for existing markets

Strategy

This is a product development strategy.

Methods of implementing strategy

There are several different ways to implement a strategy to expand sales in Europe with existing products.

(a) **Develop more products** and invest more heavily in new product design and development, perhaps by recruiting more designers.

(b) Look for a company that could be a **takeover** target, to add immediately to the company's product range.

(a) Invest more in new product design and development	
Positives	**Negatives**
Successful businesses often have to **innovate** in order to continue growing.	The chances of developing successful new products may be limited, given the strength of **competition** in the fashion clothes market.
Companies may need to consider environmental issues in order to **survive** with a sustainable business in the long term.	**More evidence** is needed that 'environmentally-friendly' fashion products will be successful. Competitors may already have developed this type of product.
	The company **already** has a New Business **Development Group** and has a strategy for developing new products. It is not clear **how** this proposed strategy **would differ** from what the company is already doing, except that it could invest much more heavily in new product design.

(b) Develop new products by finding a takeover target	
Positives	**Negatives**
If a suitable takeover target could be found, HFIC would be acquiring an **established range** of new products.	Clarity is needed for this strategy. **What type of 'new' products** should the company look for?
	It may be **difficult to sell** the acquired products through the **HFIC distribution network** of retail and wholesale outlets. (This may depend on what the newly-acquired products are, and how they are branded.)

Consolidation strategy: improve efficiency, reduce costs

Strategy

This strategy is not obviously included in the Ansoff strategy matrix, which focuses on business growth rather than consolidation. To the extent that it seeks to increase profitability with existing products ad markets, it might be called a market penetration strategy.

Methods of implementing strategy

There are several different ways to implement a strategy to expand sales in Europe with existing products.

(a) Set up an executive management **project team** to look for efficiencies that can be made within the company's operations.

(b) Consolidate the **sourcing of goods**, and using a smaller number of suppliers, in order to achieve lower prices in return for bigger orders.

(a) Efficiency project team	
Positives	**Negatives**
A large organisation often has operating inefficiencies. If these can be identified and removed, costs should **be reduced**.	The term 'efficiency' may be used when 'cutting costs' would be more accurate. Cutting some expenditures, such as expenditure on advertising, could have **adverse consequences** for sales and profits.
Efficiencies may also **speed up the time** that it takes to deliver products to the market, or speed up the time needed to design new products.	Attempts to make efficiency savings have so far failed.
Cost savings may be achieved without the need for significant additional investment.	Achieving cost efficiencies may require a **change of culture** within the organisation, to one of 'continuous improvement'. This may be **difficult** to achieve.
	Cutting inefficiencies is **not** a strategy for **growing the business**.

(b) Consolidate the sourcing of goods	
Positives	**Negatives**
Costs of goods purchased from suppliers has been increasing. This is a **significant cost** and cost control measures may be essential to maintain profits without raising retail prices.	Suppliers may not have the **capacity** to increase their manufacturing output of HFIC products.
Closer collaboration with suppliers may help to provide **greater efficiencies** and cost savings in the supply chain, in addition to lower prices for bulk orders.	There is a strategic **risk** in **relying** more heavily on a small number of key suppliers.
If the company is increasing its use of just-in-time purchasing and production, it will need to rely on the efficiency of its supply chain.	

Greater **efficiency** may be achieved through consolidation of suppliers.	
The company may wish to consider taking control of supply more directly by **acquiring** some **supplier companies** or by investing more in its own manufacturing operations.	

Part (b)

In part (b) students are required to prepare a presentation to the Workshop group (of five minutes CFO presentation and five minutes Q&A) on the way in which their assigned strategy may be implemented, and on the positives and negatives of their group's assigned strategy. Select two group representatives for the presentation.

LP reference

There is no specific LP reference.

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.

Note that there are several presentations throughout the workshop so each student will have the opportunity to give a presentation.

Part (c): Strategic Choice

After listening to all presentations regroup and decide on the best strategy to recommend to the Board of High Fashion International Company Limited.

LP reference

Chapter 2, Section 14.1 and 14.2

Key learning points

Students should apply the **JS&W** (**E**xploring **C**orporate **S**trategy) **checklist** 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.

Solution

Note: The suggested answers below are the opinions of the author only and are only provided as guidance. The students may be able to present persuasive arguments for or against the implementation of any of the four strategies. There is certainly no 'correct' strategy, and any of the four strategies may be chosen.

Expand business in the PRC

Suitability	HFIC has established a presence in the market in China, but faces **significant competition** (Diamond Fashion). Without a strategic alliance or a major acquisition, it may be unable to develop its share in the market quickly. There would also be risks in creating a new low-price brand. Investing heavily in China may result in a reduction in investment and loss of business in Europe, the company's main market.
Acceptability	Shareholders would probably support a strategy of growth in a rapidly-expanding market. The HFIC design team may prefer to work on high-priced high fashion clothing, and there may be some **resistance to a low-price lower-quality range of products**.
Feasibility	It is not clear that a **strategic partner** or takeover target can be identified successfully. HFIC could probably raise the finance for a takeover bid, if a takeover target could be found.
Conclusion	**Perhaps**. A strategy that gives priority to the growing market in China is high-risk, unless there is clear evidence that a high return on investment could be achieved. There is a risk that HFIC will not achieve its target rate of growth in China, and it may lose market share in Europe by concentrating resources on the China market. The strategy would be more attractive if a strategic partner or takeover target could be identified. However, China should be a high-growth market and HFIC should seek to compete in it.

Expand in Europe with existing products

Suitability	Europe is the company's **main market** and its brands are well-established. In order to expand in Europe, the company will need to do more than **spend on advertising** and other forms of marketing. There is **strong competition**, and investing in new stores may be necessary to maintain market share. Increasing sales may be difficult, if the market in Europe is not growing at a fast rate.
Acceptability	Shareholders may find this strategy acceptable, because it focuses on HFIC's main market and is a strategy for gaining competitive advantage (through improving customers' shopping experience) and growth.
Feasibility	The company should have the **resources** to invest in **new stores** in Europe, but improvements in retail outlets will take time and could be expensive
Conclusion	**No.** HFIC should continue to develop its retail outlets in Europe, but should not make this the focus of its business strategy. The market in Europe is not expected to grow much in the future, and the company is therefore unlikely to obtain significant profits growth there. However, it is essential to invest to some extent in order to protect its European business.

Develop new product ranges for existing markets

Suitability	The company **already invests** in new product development, although this is not its main business strategy. HFIC has a large and **skilled design team** that should be capable of developing new products. However, the markets for fashion goods are **very competitive**, and HFIC may find it difficult to develop new products that will earn significant returns, given the probability that competitors will respond to any initiatives that HFIC makes.
Acceptability	Shareholders may consider that a strategy of **investing** more heavily in **new product** development is too **risky**.
Feasibility	HFIC has the financial resources to invest, but it is not clear whether it has designers with the **ability to develop new products** successfully, sufficient to achieve significant growth in the business.
Conclusion	**No**. The company should continue to develop new products, but should not invest more heavily in this strategy than it is doing at the moment. The strategy is too high-risk for it to become the main strategy for growth.

Consolidation: improve efficiency and reduce costs

Suitability	The company's **costs are increasing** and management should attempt to control these costs. However, this is a part of the normal responsibilities of management. It is not clear what improvements in profits could be achieved through this strategy. If potential savings are small, it should not be the main strategy for improving financial performance. However, it may be necessary to improve the effectiveness and efficiency of the supply chain, and a policy of relying on a smaller number of key suppliers could be essential in order to remain competitive. The current arrangements with many small independent suppliers is probably not sustainable, especially if the company increases its use of just in time purchasing.
Acceptability	Shareholders will need to be convinced that a strategy of improving the **supply chain** will produce better financial returns in the future. The board of directors may not give priority to this strategy unless they can see how it will improve the performance of the business in the future.
Feasibility	The company does **not** appear to have a culture of efficiency savings and '**continuous improvement**'. Introducing a strategy for cost efficiency and cost reductions within the company will not be easy. However, significant improvements in the supply chain (costs and efficiencies) may be achievable, and this will probably be essential if the company expects to grow.
Conclusion	**Perhaps**. This is the preferred option if a strategic partner or takeover target cannot be found in Europe. The process of purchasing/ manufacturing is an essential part of HFIC's business, and its current arrangements are probably inadequate for a business that is relying more on JIT procurement methods and that operates in a highly competitive environment.

Recommendation

The **preferred strategy** would seem to be either to seek expansion in the PRC, or to consolidate and seek profits growth, for the next few years through cost savings and efficiencies.

A suitable recommendation may therefore be to **select the strategy of consolidation, but at the same time look for a potential acquisition in the PRC**, and if a suitable acquisition target is found, to consider a change in strategy. **The key issue seems to be: 'Can a suitable acquisition target be found?'**

The group representatives are to present their final Board recommendation to the Workshop group, focusing on the reasons for the decision in comparison to the other strategies presented.

Key learning points

As with part (b), 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 the allocated members. Note to workshop facilitators that there are several presentations throughout the workshop so each student will have the opportunity to give a presentation.

Discussion points

Management Reporting: Pre-workshop exercise

This pre-workshop exercise should not present any difficulties for students. The calculations should be fairly straightforward. Figures for gross profit are given in the exercise, for each of the four product groups.

The requirement is then to absorb the other costs (before interest) between the four product groups in two ways; **first** as a **percentage of sales revenue** for each product group and **second** as a **percentage of cost of sales**.

If the students do their calculations correctly, they should find that the **profitability of the four product groups differs substantially**, especially when other costs are absorbed on the basis of the cost of sales.

This should make students start to think about two related **issues**: (**1**) the **limitations** of absorption costing and (**2**) whether some product groups maybe **under-priced**. An increase in prices may not affect sales demand significantly, and profit margins could possibly be increased. This issue will be explored in more depth in the first of the related workshop exercises.

LP reference

Students should be familiar with **absorption costing** from their earlier studies, but there is a brief reference in Chapter 4 Section 2.4. Chapter 4 Sections 3.2 – 3.5 covers pricing systems based on **absorption costing**.

Key learning points

Students should be able to calculate **product profitability** for each of the four product groups using absorption costing, and **two different bases for absorption**. To do this they will need to calculate absorption rates from data given in the pre-workshop exercise handout and also information in the income statement in the Case Study Scenario document. These calculations should not present any difficulty.

Students are then required to think about the **implications** of the **differing profit margins** for each product group. The pre-workshop handout suggests that the company may be able to raise prices to some extent **without affecting demand**. If this is true, profit margins may be increased by raising prices on the low-margin products.

The main points **to recognise** are:

(a) differences in profitability between the product groups

(b) the possibility that profitability measurements depend on the **basis used** to absorb overheads

(c) unless the absorption costing methods are **unreliable**, that something should be done to improve profitability. Either costs must be reduced for the low-margin products, or prices should be raised.

(a)(i) Product profitability: other costs absorbed as a percentage of sales revenue

All figures are in HK$ millions

Total costs before interest in 2011 = (4,186 + 3,625 + 1,150 + 674 + 816 + 2,074) = **12,525**

Absorption rate = 12,525/31,050 = **0.4033816** of Sales revenue.

	Women's	Men's	HF Star	Kids
Sales	12,880	5,096	7,483	5,591
Cost of goods sold	7,221	2,650	2,777	3,187
Gross profit	5,659	2,446	4,706	2,404
Other costs	5,196	2,056	3,018	2,255
Net profit	463	390	1,688	149
Net profit percentage	3.6%	7.7%	**22.6%**	2.7%

HF Star range of products is very **profitable**, but women's fashion and kids' fashion clothes have low net profit margins.

(a)(ii) Product profitability: other costs absorbed as a percentage of cost of goods sold

Absorption rate = 12,525/15,835 = **0.790969** of Cost of goods sold

	Women's	Men's	HF Star	Kids
Sales	12,880	5,096	7,483	5,591
Cost of goods sold	7,221	2,650	2,777	3,187
Gross profit	5,659	2,446	4,706	2,404
Other costs	5,712	2,096	2,196	2,521
Net profit/(loss)	(53)	350	2,510	(117)
Net profit percentage	(0.4)%	6.9%	**33.5%**	(2.1)%

When other costs are absorbed on the basis of cost of goods sold, the **HF Star** range of products is **even more profitable**, but women's fashion and kids' fashion clothes are loss-making.

Note: rounding differences are acceptable.

(b) Comments on current pricing policy

Absorption costing is often criticised because overhead costs are absorbed into product costs in a way that does **not represent** the actual use of overhead resources by different products.

However in the retailing industry, it is common for companies to have a **target profit margin** for most of their products, and this can be achieved if goods are priced at their cost plus a standard profit margin.

This did not happen in 2011 for HFIC. Profitability for women's fashion clothes and kids' fashion clothes was low, according to the profit measurements obtained using absorption costing.

It is possible that the absorption **costing figures** are **misleading**, but it is also possible that the low profitability of these two product groups is caused by **low pricing**.

It may be advisable to **re-assess** the profitability of the four product groups using a different costing method, such as **activity-based costing**.

However, if HFIC is able to raise prices without a significant fall in sales demand for its products, an increase in sales prices for women's clothes and kids' clothes is recommended.

An approach to raising prices would be to establish a **minimum profit mark-up** on cost for all products.

Part C Management reporting: Case 1

John Fordham and Dong Li have agreed that the low profit margins on some product groups is a matter of great concern, and that the pricing of some products should be reviewed as a matter of urgency.

Dong Li has suggested that the company should set prices that will achieve a minimum net profit mark-up of 10% on cost (ignoring interest costs). To do this prices on many products will have to be raised.

However, he has expressed some doubt about whether **traditional absorption costing** methods are a satisfactory way of measuring product costs, and he wants to re-assess the costs of the product groups using an approach based on **activity-based costing** (ABC). He believes that many of the 'other costs' in the income statement are costs of activities that should be allocated between the product groups in a way that represents their use of resources. By using an ABC approach to costing, costs may be apportioned between the four product groups in a much different way from traditional absorption costing. This would affect costs and target prices.

John Fordham agrees that product costs should be reviewed, and that the board should consider whether to introduce a new **pricing policy** and set prices that will provide a minimum **mark-up of 10% on cost**. He still holds the view that HFIC will be able to raise prices to some extent without affecting sales demand, but that the prices charged by competitors for similar products cannot (and should not) be ignored.

You have been asked to produce revised costs for the four product groups, using the financial results for 2011, and to show how much higher prices should be in order to achieve a minimum mark-up of 10% on cost.

You have already produced the following information for your analysis of costs.

(1) Gross profit in 2011: (same figures as provided in the pre-workshop exercise)

2011 figures, in HK millions	Women fashion	Men fashion	HF Star	Kids fashion	Total
Sales	12,880	5,096	7,483	5,591	31,050
Cost of goods sold	7,221	2,650	2,777	3,187	15,835
Gross profit	5,659	2,446	4,706	2,404	15,215

(2) Manufacturing costs in 2011

2011 figures, in HK millions	Women fashion	Men fashion	HF Star	Kids fashion	Total
Manufacturing outsourced	7,015	2,650	1,954	3,187	14,806
Manufactured internally	206	0	823	0	1,029
Manufacturing costs	7,221	2,650	2,777	3,187	15,835

(3) Distribution costs in 2011

	Europe	China	Rest of world	Total
Total costs	966	46	138	1,150
Sales				
Women fashion	9,979	1,364	1,537	12,880
Men fashion	4,179	306	611	5,096
HF Star	7,109	224	150	7,483
Kids fashion	3,914	1,118	559	5,591
	25,181	3,012	2,857	31,050

(4) Other operating costs* in 2011 (related to type of distribution outlet)

	Retail	Wholesale	Total
Total costs	609	1,465	2,074
Sales			
Women fashion	6,724	6,156	12,880
Men fashion	2,050	3,046	5,096
HF Star	3,030	4,453	7,483
Kids fashion	5,032	559	5,591
	16,836	14,214	31,050

* 'Other operating costs' are the costs shown under this heading in the income statement in the case study.

(5) Advertising costs in 2011

	Costs
Women fashion	260
Men fashion	105
HF Star	201
Kids fashion	73
General	35
	674

(6) Costs of design team staff and support staff for the design team (included within total staff costs in 2011)

Total cost	600

Time spent:

Women fashion	50%
Men fashion	15%
HF Star	30%
Kids fashion	5%

(7) All other costs

All other costs should be apportioned between product groups in proportion to their activity-based costs

Required

(a) Make the following analysis:

(i) Calculate the costs and profitability in 2011 of each product group, before interest costs, using an activity-based approach based on the information provided above.

(ii) Calculate the prices for each product group that would have been required to achieve a mark-up of 10% on these costs.

(iii) Compare the prices you have calculated in (ii) with actual sales revenue in 2011, and the increase in prices for each product group that would have been necessary in 2011 to achieve a minimum mark-up of 10% on costs.

(b) On the basis of your calculations, and taking into consideration any other factors that you consider relevant, recommend any price changes that you would consider appropriate for HFIC. In making your recommendations, you should take into consideration the nature of HFIC's business.

Discussion points

Management Reporting: Case 1

Case 1 of the Management Reporting workshop follows on from the pre-workshop exercise, in which students were asked to calculate the **costs and profitability** for four product groups using the absorption costing method, and to consider the implications of low profitability for pricing.

Case 1 asks students to **re-calculate** costs using a method based on the **activity-based costing** approach, using 2011 financial results, and to consider what prices should be if a **cost-plus approach** to pricing is used. Students are then asked to recommend **what changes** should be made to prices for the product groups, taking into account any factors they consider relevant to their recommendation.

Part (a) of the requirements involve computational work, but the computations are linked to each other and should be fairly straightforward. If students are able to complete their calculations with reasonable accuracy, they should be able to spend much of the time discussing the issues raised by the requirement in part (b). The emphasis of this exercise needs to be on issues raised and resultant business and pricing strategies, **not** on accuracy of the calculations.

Part (a)

LP reference

The LP reference is Chapter 4, Sections 2.4 and 2.11 for activity-based costing and Chapter 4 Sections 3.2 - 3.4 for cost plus pricing.

Key learning points

For parts (a) (b), students must demonstrate their understanding of the basic methodology of **activity-based costing** and **cost plus pricing**. The results produced from these computations will be used to assess the possible implications of a cost plus approach to pricing and to consider whether such an approach is realistic or practicable within the market for high fashion goods.

Activity-based costing method: costs and profitability

Workings and assumptions

<u>Distribution costs (1,150)</u> for each region (Europe, China and the Rest of the World) will be apportioned between the product groups on the basis of the sales for each product group in each region.

<u>Advertising costs (639) and designer staff costs (600)</u> will be allocated directly to each product group.

<u>Other operating costs (2,074)</u> for retail and wholesale distribution outlets will be apportioned between the product groups on the basis of the sales revenue from each type of outlet for each product group.

<u>All other costs (8,062)</u> will be apportioned between the product groups in proportion to the activity-based costs for each product group.

<u>Other costs</u>:

Advertising (674 – 639)	35
Staff costs (4,186 – 600)	3,586
Occupancy costs	3,625
Depreciation	816
	8,062

(i) Costs and profitability (all figures in HK$ millions)

	Women	Men	HF Star	Kids	Total
Manufacturing costs	7,221	2,650	2,777	3,187	15,835
Distribution costs:					
- Europe	383	160	273	150	966
- China	21	5	3	17	46
- Rest of world	74	30	7	27	138
Designer staff	300	90	180	30	600
Advertising	260	105	201	73	639
Other operating costs					
- Retail	243	74	110	182	609
- Wholesale	634	314	459	58	1,465
Total activity based costs	9,136	3,428	4,010	3,724	20,298
Other costs (See note 1)	3,629	1,362	1,593	1,478	8,062
Total costs before interest	12,765	4,790	5,603	5,202	28,360
Sales	12,880	5,096	7,483	5,591	31,050
Profit	115	306	**1,880**	389	2,609

Note (1): **Other costs** = **8,062** (workings shown previously). Activity based costs = 20,298. Therefore other costs are apportioned between product groups at the rate of (8,062/20,298) = 0.397182 of activity-based costs.

These figures suggest that profit margins are low for three product groups (women, men and kids), and much higher for **HF Star** (**1,880**).

(ii) and (iii) ***Price increases required for minimum profit mark-up***

Based on 2011 figures	Women	Men	HF Star	Kids
Total costs before interest in (i)	12,765	4,790	5,603	5,202
Mark-up 10%	1,276	479	560	520
Minimum sales price required	14,041	5,269	6,163	5,722
Actual sales	12,880	5,096	7,483	5,591
Shortfall	1,161	173	--	131
Minimum price increase required	**9%**	3.4%	-	2.3%

Part (b)

LP reference

Part (b) requires students to consider different approaches to product pricing. They should use the calculations for cost plus pricing in part (a), and also the costing and profitability measurements from their pre-workshop exercise. They should also consider other approaches to pricing, most importantly an approach based on market prices charged by competitors.

LP references are Chapter 4, Section 3 on cost-based approaches to pricing. Students may also wish to refer to Chapter 5 Section 3.1 to remind themselves about profitability ratios. Some students may make recommendations based on target pricing, which is dealt with in Chapter 4 Section 5.

Key learning points

Students need to understand that a **cost-plus approach** to pricing in principle will mean that a minimum profit margin will be achieved for all products, but that other factors should be taken into consideration when deciding pricing policy. With a cost plus approach to pricing, it is important to have **reliable measures** of cost. It is also important to keep costs **under control**. In addition, the prices charged for products must also depend on what customers are prepared to pay, and what competitors may charge for similar products.

The recommendation given here is suggested by the author. Other acceptable recommendations may be put forward, but these should be supported by rational arguments.

(1) The figures in part (a) show that to achieve a minimum profit mark-up of 10% on cost, products in the women's, men's and kids' fashion ranges would all have to be increased. The required increases are fairly **small for men's and kids' fashions**, but much **larger for women's fashion** products (sitting at 9% price increase).

(2) The actual minimum percentage increase in prices that would be required for each product group **depends on** the costing method used. However traditional absorption costing and an ABC approach both indicate small profit margins for women's fashion, men's fashion and kids' fashion.

(3) HF Star goods already earn a profit margin well in excess of the minimum target level. It is not clear why prices for these goods are so high relative to their cost. It is possible that over time, prices may have to be reduced if new competitors enter the market. At the moment, there is no obvious reason to reduce prices for **HF Star**. The pricing policy for this range of goods should therefore remain unchanged, and pricing decisions should be the responsibility of local sales managers.

(4) It may be possible to raise prices by a small amount without affecting sales demand. If so, profitability would be increased by raising prices to there minimum target level, to earn a mark-up of 10% on cost.

(5) However, it may not be possible to raise prices by 9%, the minimum average increase necessary for **women's fashion**, without affecting sales demand. Customers can switch to buying high fashion goods from other companies.

(6) Although John Fordham and Dong Li think that some price increases can be made without affecting sales demand, there is information to indicate that customers in parts of Europe, HFIC's main market, are resistant to price increases (due to economic conditions).

(7) In theory, a cost plus approach to pricing may encourage **excessive costs** and **wasteful expenditure**, because with higher costs there will be higher sales prices and so higher profit margins. Clearly this is unacceptable. A cost-plus approach to pricing must be accompanied by a strict control over costs and expenditures.

(8) There are several reasons why a **cost-plus approach** to pricing fashion goods may be **unsatisfactory**:

(i) HFIC produces a large quantity of different products each year. The task of calculating costs for each individual product may be **time-consuming** and **expensive**.

(ii) A cost-plus approach may result in prices that **customers** are **unwilling to pay**. If so, prices would have to be reduced to sell inventories.

(iii) Higher profits may be obtained by **selling more volume at a lower price** than a smaller volume at a high price.

(iv) **Local sales managers** or retail store managers are in a better position than accountants at head office to decide what **suitable prices** for goods in the shops should be.

(v) It may be necessary to sell the same goods at **different prices** in **different sales regions**. For example, customers in China may not be prepared to pay the same prices for their fashion goods as customers in Europe.

(9) For a global fashion company, a policy of **controlling prices from head office** is probably too **rigid** and inflexible, and some authority should be given to local managers to make pricing adjustments in order to sell products.

(10) A decision by the board that all products must earn a minimum profit margin will take away some authority of product division managers to decide the prices for the products for which they are responsible. This may create a **separation of authority and responsibility for pricing**, which is against the traditional principles of good organisation and management.

General recommendations

The board of HFIC should establish **overall profit objectives** as part of its responsibility for strategic decision-making.

However, the board should set broad objectives only, not detailed pricing policy.

Product divisional managers should have overall responsibility for pricing for products within their product group, and should set **pricing guidelines** for their products. These guidelines should take into consideration the board's overall profit objectives. At the same time, the prices charged for similar product by competitors should also influence their pricing guidelines.

Guideline prices should be the prices included in any **price lists** published by HFIC. Actual prices charged in the market place may be lower than guideline prices.

Although the fashion products of competitors will not be identical to HFIC products, many will be very similar, which suggests that **competitors' prices** cannot be ignored.

Product divisional managers should allow **local sales managers** to apply some flexibility to prices, and adjust prices slightly according to the strength of demand in retail and wholesale distribution outlets in their region.

Pricing should therefore be established with regard to both profit targets and prices for fashion goods in the market place, but there should be **sufficient flexibility** to make adjustments to prices of individual products in order to ensure as much as possible that inventories are sold.

Specific recommendations

Head office (the board/John Fordham) should discuss **small increases** in the prices **of men's fashion** goods and **kids' fashion** goods with the management of these product divisions.

Some increases in the price of **women's fashion** goods may be possible, but not **9%**. This size of price increase is likely to have an **adverse effect** on sales demand.

The manager of the women's fashion product division should be asked to consider **ways of improving profitability**. He may be asked to present a paper to the board containing proposals for making improvements. Both cost reduction and pricing should be considered.

The proposals may include the use of **target costing** when new fashion products are designed, to try to ensure that costs of new products are controlled from the design stage, and that new products can be developed at a cost and sold at a price that should provide the **required profit margin**.

Part C Management reporting: Case 2

John Fordham is not convinced that HFIC will be able to set prices for all products by adding a mark-up of 10% or more on all products, and he has asked Dong Li to consider **alternative pricing strategies**.

Dong Li has agreed that more investigation into pricing policy is required, and he has put forward two proposals for consideration.

(1) **Proposal 1**: For some of the company's best-selling products with a **long life cycle**, prices should be set at a level that is similar to the prices charged by competitors for similar high fashion products, and target costs should be established for these products that would provide a **profit margin of 10%** on the sales price.

(2) **Proposal 2**: For some products that have a **limited life cycle**, prices should **be reduced gradually** over the expected life of the product. Dong Li has suggested two life cycle pricing formulae:

(i) For products with a life cycle of a few months

Price = $P_0 - (P_0 \times 0.1m)$

Where P_0 is the initial price charged for the product when it is first introduced to the market, and

m is the number of months since the product was introduced to the market.

However if the product life cycle exceeds 6 months, there should be no further price reductions until the product is withdrawn from the market.

(ii) For products with a life cycle of a few years

Price = $P_0 - (P_0 \times 0.1t)$

Where P_0 is the initial price charged for the product when it if first introduced to the market, and

t is the number of years since the product was introduced to the market.

However if the product life cycle exceeds 5 years, there should be no further price reductions until the product is withdrawn from the market.

You will be asked to divide into four groups to consider the proposals suggested by Dong Li.

Required

(a) **Prepare a list of the positives and negatives of Proposal (1), to set target costs for some of the company's best-selling products.**

(b) **Prepare a list of the positives and negatives of Proposal (2), to introduce a life cycle pricing policy for products with a limited life. Recommend whether life cycle pricing would be appropriate for some HFIC products, clearly stating the selected products and why this strategy would be appropriate.**

Discussion points

Management Reporting: Case 2

In this exercise, students are asked to consider **two different issues**. In **Part (a)**, students should recognise that **target costing** is a way of trying to control the costs of new products from the design stage onwards, so that target prices and profit margins can be achieved for all new products. This could be appropriate for a company such as HFIC, which develops a large number of products each year and where important decisions are made during the design stage (about design features) that will affect costs and profitability.

Part (b) focuses on **life cycle pricing**, and whether this approach to pricing would be applicable to HFIC. Students need to understand what life cycle pricing is, how it might be applied in practice and whether life cycle pricing should be based on fixed pricing formulae.

Part (a)

LP reference

This exercise considers target costing and target pricing. The LP reference is Chapter 4 Section 5.

Key learning points

Students should recognise that the main purpose of **target costing** is to control the costs of a product from the **design stage onwards**. Many decisions are made at the design stage that affect future costs, such as decisions about product features and sizes that have a direct impact on costs of manufacture and distribution. For a company that continually designs new fashion products, this approach could be appropriate.

Suggested solution

Target costing and **target pricing** are closely connected concepts.

They are based on the view that when the design process for new products begins, a suitable target price should be identified. This is a price that customers will probably be **willing to pay** (and expect to pay) for the product. If a target price has been identified, and a target profit margin is established as a matter of pricing policy, it is then possible to establish a target cost.

A target cost is the **maximum cost per unit** for the product, including costs of design and development, as well as costs of manufacture, marketing and distribution and other overheads, in order to sell at the target price and earn the target profit margin.

The target cost should be established from the beginning of the **design and development process**, so that the product designers are aware of the need to keep costs within a set limit. The eventual costs of making a product are determined at the design stage, because this is when the product features are decided.

Positives	Negatives
The board wishes to achieve a **target profit margin**. If selling prices are established, a target profit margin can be achieved by producing and selling the product within a target cost limit.	Target costing is based on estimates of sales volume, because overhead costs are a substantial proportion of total costs. It may be difficult to estimate sales of fashion products accurately.
Many costs are decided at the **product design stage**, because at the design stage the features of the product (and how it should be made) are decided.	A standard target profit margin may not be appropriate for all products.
HFIC designs a large number of different products, and product design is a key aspect of its operations. Designers should be made aware of target costs.	
The approach links decisions about pricing with decisions about **cost control**.	

Part (b)

LP reference

This part of the exercise asks about the **positives** and **negatives** of **life cycle pricing**. A useful LP reference for this exercise is Chapter 4 Section 7.

Key learning points

Students need to recognise that life cycle pricing involves charging a **high price** for a **new product** when it is first introduced to the market, and **gradually reducing** the price **over the life cycle** of the product. Early buyers of a new product are often willing to pay a high price for a product that others do not have. High initial prices also help a company to recover design and development costs more quickly. Students have to consider whether life cycle pricing would be appropriate for a company in the fashion goods industry.

Suggested solution

Dong Li has suggested two **pricing formulae**.

(i) For products with a life cycle of a **few months**, the price should be reduced by 10% of the original selling price each month, until it is only 40% of the original selling price. If the life cycle continues beyond six months, there should be no further price reductions.

(ii) For products with a life cycle of a **few years**, the price should be reduced by 10% of the original selling price each year, until it is only 50% of the original selling price. If the life cycle continues beyond five years, there should be no further price reductions.

Positives	Negatives
Life cycle pricing recognises that **prices** for products may have to **be reduced over time**, in order to sustain sales volume.	The **reasons for reducing prices** are usually (**1**) growth in sales demand as a new product becomes established and (**2**) further reductions in sales price over time in order to sustain sales volume as long as possible. This pattern of sales demand may not apply to fashion goods.
Customers for fashion goods may be willing to pay a **high price** for a **new product** when it appears for the first time in the shops. As the product becomes more established and less of a 'fashion item', the price they will pay is likely to fall. Life cycle pricing would recognise this feature of sales demand.	It will be difficult to apply life cycle pricing to a large number of products, because of the **administrative problems** of continually reducing prices for many products in many different stores around the world, as well as the costs of re-issuing amended price lists.
	Reducing prices by a fixed percentage amount at regular intervals is **inflexible**. If prices are reduced over time, reductions should be in response to market conditions, not a fixed formula.
	Life cycle pricing is possibly more appropriate for **new products** that become established standard '**commodity products**' that many people buy. Fashion goods are not commodity products.
	As prices are reduced, profit margins fall unless sales volume increases. With fashion goods, reducing prices will mean lower profit margins, because sales volume is unlikely to increase by a substantial amount in response to price reductions. **Prices may be reduced to a level where products become unprofitable.** Given the low profit margins of many HFIC products, this is a significant probability.

Recommendation

HFIC should have a **flexible pricing policy**, and should be prepared to reduce prices in order to sell more of their products. However, fashion products do not necessarily have a **traditional life cycle** of **Introduction**, **Growth**, **Maturity** and **Decline**. Price reductions are only justifiable if they are made to achieve larger sales volumes during the growth stage of a product's life, or to prolong the life of a product in its maturity or decline stages. The aim of product life cycle pricing is therefore to maximise profits.

With fashion products life cycle costing is likely to lead to falling profit margins and loss-making products. **Life cycle costing is therefore inappropriate for fashion goods**.

In addition, reducing prices according to a predetermined fixed formula is inappropriate in the market for any retail products. HFIC should not have such a rigid pricing policy for any of its products.