UNIVERSITY OF CAMBRIDGE INTERNATIONAL EXAMINATIONS
General Certificate of Education Advanced Level

BUSINESS STUDIES **9707/31**

Paper 3 **May/June 2011**

CASE STUDY

3 hours

Additional Materials: Answer Booklet/Paper

READ THESE INSTRUCTIONS FIRST

If you have been given an Answer Booklet, follow the instructions on the front cover of the Booklet.
Write your Centre number, candidate number and name on all the work you hand in.
Write in dark blue or black pen.
You may use a soft pencil for any diagrams, graphs or rough working.
Do not use staples, paper clips, highlighters, glue or correction fluid.

Section A
Answer **all** questions.
Section B
Answer **one** question.
The businesses described in this question paper are entirely fictitious.
You are advised to spend 40 minutes on Section B.

At the end of the examination, fasten all your work securely together.
The number of marks is given in brackets [ ] at the end of each question or part question.

This document consists of **5** printed pages and **3** blank pages.

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Asia Clothing (AC)

The current situation

Asia Clothing (AC) is a private limited company. All of the shares are owned by the Bappoo family. The company manufactures a wide range of fashion clothing for women. 90% of its output is purchased by three large chains of retail fashion shops in Asia. Increased competition in the retail market has led to these three retailers insisting on:

- Lower prices so that the retail shops can become more competitive
- Faster production of new styles.

The Bappoo family members have held several meetings to discuss how they can meet these demands from these customers.

Meeting the demands: Lower prices

Abu, the Managing Director, understands that if AC does not meet these demands the company will lose orders quickly. 'There are so many other clothing manufacturers who would be delighted to supply these three retailers', he told the other directors at a recent Board meeting. 'If we lower our prices to the retailers by 10%, as they have demanded, we will make no profit at all. We must look at every means possible of cutting our own costs.'

Meeting the demands: Faster production of new styles

The concept of 'fast fashion' – putting the latest fashions into shops within weeks of the new styles appearing – is a new challenge to AC. It is well-known for rather traditional designs and well-finished products. 'Younger consumers are less concerned about how long a dress lasts for – they want the latest styles and they want them now!' Abu told the directors. 'We have to be more flexible and adaptable. That means improving the speed of our communications with fashion designers and fashion show organisers, as well as with the retailers who buy our clothes.'

Communication problems

Lack of investment in information technology means that internal and external communication methods used by AC are outdated. Customer orders are received by telephone. As a result, errors have been made in noting the precise requirements of the retailers. The postal confirmation of the orders often takes several days. Designs for new styles are sent on paper to AC's material cutting and sewing sections, rather than using CAD (Computer Aided Design) technology with direct electronic links. AC orders cloth from suppliers once a month and this leads to high inventory (stock) levels.

The managers use face-to-face communication with individual workers and work teams, but this takes up much time and reduces hourly productivity. Managers communicate with each other daily through the use of internal 'memos'.

Future expansion – organic growth or takeover of Fancy Fashions?

The Bappoo family have always made company growth a key objective. The founder of the company and the present Chairman, Nilesh, has undertaken a study of two growth options for the business. Forecast net cash flows of these options are shown in Appendix A.

Option 1: Organic growth - extending two of the existing factories

Economies of scale should allow a small reduction in average costs. These new facilities could be used to produce clothes for men which major customers are often asking AC to manufacture for them. The capital cost has been estimated at $8m.

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Option 2: Take over Fancy Fashions (FF)

FF is one of the country's best known manufacturers of leather clothes – a product that AC does not make. The business is being sold by a friend of Abu's for $12m. FF has two modern factories. Most workers are part-time and it is rumoured that very young workers are employed and paid some of the lowest wages in the fashion industry.

Uncertain economic environment

All of AC's operations are located in Country A. This country is well located as transport routes to other countries are good. The population is quite small so only 10% of AC's clothes are sold in Country A. Recently, the economy of the country has grown very rapidly and the Government is now taking policy action to prevent inflation becoming a problem. Recent macro-economic data and future forecasts are given in Appendix C. Abu believes that these policy changes and their consequences might have a great impact on AC which imports cloth but exports most of its clothing. The Operations Director has suggested closing factories in Country A and opening new ones located in countries even closer to AC's main markets.

AC's award for corporate social responsibility (CSR)

'I am pleased to announce that the clothing company AC has been voted the country's top business for corporate social responsibility' said the presenter of Country A's famous annual CSR awards. The directors of AC have always taken pride in their employment and ethical policies. 'Doing the right thing' has been a Bappoo saying for many years. The company's ethical code includes these statements:

- We will always only buy cloth from suppliers who use adult labour and environmentally friendly production methods
- We will never accept or offer bribes
- We treat all workers as equals and offer permanent contracts of employment.

For several years Abu and the rest of the Bappoo family were convinced that this well publicised CSR policy helped the company both gain huge contracts from retailers and keep the best workers motivated. However, doubts have been raised about whether this CSR policy really is important to AC's future success. Other factors influencing success will be the increased globalisation of the clothing market and world economic conditions.

Fire disaster

AC has a strict quality system. However, last year a huge batch of cloth was received from a supplier that was wrongly marked: 'Fire resistant – ideal for children's clothes'. In fact it was just ordinary cotton cloth. Thousands of items of children's clothes were made up with it and then disaster struck. A child was badly burned when she stood too close to a fire wearing one of AC's skirts that caught alight. The newspapers condemned both the shop and AC, the manufacturer. Abu, as soon as he heard of the report, followed a pre-prepared plan and withdrew all clothes made with the cloth, offering shops and consumers full compensation. AC paid for the injured girl to have the best medical treatment and donated $1m to a children's charity. The cloth maker was removed from AC's list of approved suppliers. Sales of AC's products fell by only 3% over two months and then increased again. In contrast, a competitor, who makes cheaper clothes than AC, had tried to hide a pollution spill of poisonous dye into a local river. Many bathers were taken ill and the company has been fined $3m by the Pollution Control Office.

Appendix A: Forecasted Net Cash Flows, $m

End of year	Option 1 – organic growth	Option 2 – takeover of FF
0	(8.0)	(12.0)
1	3.0	5.0
2	5.5	6.0
3	4.5	7.0

Net Present Value (at 12% discount rate) of Option 2 = $2.87m

12% discount factors:
Year 1 0.89
Year 2 0.79
Year 3 0.71

Appendix B: Budgetary data for Asia Clothing, $m

For year ending 31 May 2011	Budget	Actual data
Sales revenue	35	36
Cost of materials	12	14
Direct labour costs	4	4.5
Management costs e.g. salaries	3	3.5
Marketing costs e.g. trade exhibitions	1	2
Other overhead costs	9	9
Profit	6	3

Appendix C: Economic data for Country A

	2010	2011	2012 (forecast)	2013 (forecast)
Annual GDP growth, %	12	10	5	4
Annual rate of inflation, %	15	12	6	6
Interest rates, %	3	4	8	6
Profit tax, %	20	20	35	35
Income tax, %	30	30	40	40
Change in the country's average exchange rate, %	–5	–8	+3	+4

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Section A

Answer **all** questions in this section.

1 Analyse the advantages and disadvantages for AC of greater use of electronic methods of communication. [10]

2 **(a)** Using data in Appendix A, calculate:

(i) The Payback Period for **both** Option 1 and Option 2 [4]

(ii) The Net Present Value after 3 years for Option 1 (at 12% discount). [4]

(b) Comment briefly on the likely accuracy of the net cash flow data in Appendix A. [4]

(c) Discuss, using your results from **(a)** and other information, whether AC should expand organically (Option 1) or take over Fancy Fashions (Option 2). [14]

3 **(a)** Refer to Appendix B. Calculate **all** the variances between the budgeted and actual data. Indicate whether each one is adverse or favourable. [6]

(b) Evaluate any **two** ways in which the business might reduce its costs. [8]

4 Evaluate the impact that the trends in the macro-economic data (see Appendix C) could have on AC's future profitability. [16]

5 Assess the importance of AC's corporate social responsibility (CSR) policy to the company's future success. [14]

Section B

Answer **one** question in this section.

6 Evaluate the usefulness of methods of strategic analysis to the directors of AC before making major decisions about the future growth of the company. [20]

7 Discuss the importance of contingency planning to AC. [20]

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