Cambridge International AS & A Level

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BUSINESS STUDIES **9707/32**

Paper 3 **October/November 2015**

CASE STUDY **3 hours**

Additional Materials: Answer Booklet/Paper

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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 an HB pencil for any diagrams, graphs or rough working.
Do not use staples, paper clips, glue or correction fluid.
DO **NOT** WRITE IN ANY BARCODES.

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

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.

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Genco Ovens (GO)

Genco Ovens (GO) manufactures a large range of ovens for business customers such as schools, factories and food processing businesses that prepare and cook food in large quantities. The ovens are produced in GO's factory which employs 105 production workers. GO was established in 1998 and grew rapidly until 2014. Shareholders have benefited from high returns. Table 1 shows selected accounting data for GO over the last two years. The directors are concerned about the decline in revenue but this is due to economic conditions resulting from the Government's anti-inflation policy. GO's market share has actually risen over the period by 4%.

Table 1: Selected accounting data for GO

	Year ending 31 May 2014	Year ending 31 May 2015
Revenue	$14m	$12m
Profit (before tax) for the year	$2m	$1.8m
Gearing ratio: $\frac{\text{non-current liabilities}}{\text{non-current liabilities + equity}} \times 100$	60%	65%

Upgrading production equipment

The existing production equipment in GO's factory is 15 years old. It does not use the latest digital controls and is becoming unreliable. The Operations Director has investigated the options available to GO and two alternative production systems have been identified as potentially suitable. System 1 is fully automated with digital controls. These allow the machinery to manufacture and assemble ovens of different sizes and different design features. System 2 is partly automated and is less adaptable to changes in sizes and design features. Some manual jobs are still required at the end of this system's operations such as fitting oven doors and packaging. Some other data about these two systems are shown in Table 2. GO's total output of ovens in 2014 was 4000 units.

Table 2: Comparing the two production systems

	System 1	System 2
Capital cost	$5m	$3m
Annual overhead cost excluding production workers' salaries	$2m	$1m
Number of production workers required	16	50
Average annual salary per worker	$31 250	$20 000
Forecast contribution per unit	$833	$800
Maximum capacity	6000	5000
Break-even level of output	3000	See **2(a)**
Margin of safety based on 2014 output	1000	See **2(a)**
Profit at maximum capacity	$2.5m	See **2(a)**

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Marketing to businesses

GO markets its products through trade fairs and direct selling to large businesses and Government buyers. It has a large sales team who attend the trade fairs and also sell directly to business customers. GO has an up-to-date website and also prints large numbers of brochures and leaflets as additional forms of promotion. Publicity is obtained through articles in trade catering magazines.

Market development – selling to consumers

A recent market research report indicated that consumer demand for large household ovens was increasing and the size of the market could reach $300m in 2016. The Managing Director, Jez, told last month's Board meeting: 'Our smallest oven model could be adapted for the consumer market with new colours, more attractive controls and glass doors. 'Tested by industry' is the unique selling point we could use to help market the ovens.'

The Marketing Director recognises the potential offered by the consumer market. She used to work for a leading manufacturer of consumer kitchen equipment. 'We will have to devise a completely new marketing plan if this market development is going to be successful', she said when responding to Jez's idea.

Sales department – budget variances

'The downturn in sales in 2014/15 has resulted in some significant budget variances from our Sales Department', reported the Finance Director recently. 'I am showing you this example from the South-East region which is typical of other regions' he said (see Appendix 1). 'We issued the budget for the financial year 2014/15 to all regional managers in May last year. Budgeting for a whole year helps planning. The budgets we set at head office lead to fairness and coordination between regional offices. I know that sales have been disappointing mainly because of factors outside of their control but the managers have not made the efforts needed to keep to the overall budgets! Perhaps the managers did not know that they could have adjusted prices in their regions to compensate for the weaker demand.'

Management consultant report (see Appendix 2)

Three years ago Jez commissioned a management consultant to research growth strategies that GO could adopt. No action had been taken on the findings of the report as industrial oven sales were still increasing at that time. Now that this market is becoming smaller, Jez discussed the report again at a recent Board meeting. 'Can I remind you of the consultant's main conclusions?' he said. 'We need to make some important strategic choices. We could continue as we are and just extend our products to appeal to the consumer market. Alternatively we could also decide to pursue one or both of the growth strategy options proposed by the consultant. We will have to consider the potential financial cost of these and the possible loss of control if we need to raise capital from a public share issue.'

Most of the other directors were in favour of choosing at least one of the consultant's proposed strategies. Jez had to remind them that the findings were three years old. 'The basic conclusions are likely to be valid as the underlying analysis is still accurate and appropriate' suggested the Marketing Director. 'We should not worry too much about potential loss of control as many of the existing owners of GO, including ourselves, would be keen to invest more without a public share issue.'

Appendix 1:
Budget and actual data for GO's South-East region – financial year to 31 May 2015

	Budget	Actual	Variance A = Adverse F = Favourable
Sales (units)	400	350	50 A
Average price per unit	$3000	$3000	-
Revenue	$1 200 000	$1 050 000	$150 000 A
Sales employees' basic salaries	$65 000	$68 000	$3000 A
Sales employees' commission payments	$30 000	$24 000	$6000 F
Local advertising costs	$40 000	$60 000	**x**
Other regional marketing costs	$14 000	$12 000	**y**
Contribution to head office and factory costs	**v**	**w**	

Appendix 2:
Summary of 2012 management consultant report for GO

Section of report	Main strength	Main weakness
Legal status: private limited company	Directors are main shareholders.	Currently, no access to public share issue to finance growth strategies.
Sales performance	Excellent growth record in recent years supported by good brand name.	Dependent on industrial market for ovens in one country.
Current organisational structure: Departmental structure; hierarchical; centralised	Consistent decision making; narrow spans of control reduce risk from delegation.	Rigid and inflexible. Slow vertical communication. Unsuited to the needs of the two proposed growth strategies.
Financial position	Profitable business, high proportion of profits reinvested.	Gearing ratio is high to finance growth of business.
Growth Strategy 1: Establish a marketing division in country Y, a large potential export market	Country Y's economy is expanding rapidly. Existing oven manufacturers are very profitable.	Financial risks might be high due to competitive market.
Growth Strategy 2: Take over a producer of freezers and air conditioning units to diversify product range	These products are often bought at the same time as ovens when industrial users re-equip their kitchens.	GO has no experience of product development strategies.

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Section A

Answer **all** questions in this section.

1 Analyse the potential benefits and limitations of GO's high gearing ratio. [10]

2 **(a)** Refer to Table 2. Calculate for System 2:

(i) break-even level of output [3]

(ii) margin of safety based on 2014 output level [2]

(iii) annual profit based on maximum system capacity. [3]

(b) Using your results to **(a)** and any other relevant information, recommend to GO's directors which production system to purchase. [14]

3 Discuss the factors that may determine the success of GO's entry into the consumer oven market. [16]

4 **(a)** Refer to Appendix 1.

(i) Calculate the values **v** and **w**. [4]

(ii) Calculate the values **x** and **y**. [2]

(iii) Identify whether the variances you have calculated for **x** and **y** are adverse or favourable. [2]

(b) Assess the usefulness of the budgetary system used by GO. [10]

5 Assume GO enters the consumer oven market **and** adopts Growth Strategy 1 (see Appendix 2). Discuss appropriate changes to GO's organisational structure. [14]

Section B

Answer **one** question in this section.

6 Discuss the importance to GO of undertaking strategic analysis before making a decision about future growth strategies. [20]

7 Evaluate the importance of strategic management to the future success of GO. [20]

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