The non-financial indicators candidates were asked to consider were surrounding quality and resource utilisation.

Answers on quality dealt with the complaints issue well, but very few talked about the new members of staff and how their performance might be suspect. The lack of a pay rise can be de-motivating and so quality might suffer, this too was rarely picked up.

On resource utilisation candidates had a mixed result. The male throughput per specialist was very high but this was perhaps due to the fact that male hair tends to be easier (quicker) to cut. The female situation was different, with fewer clients for more staff. Many candidates recognised this. Very few talked about the property utilisation at all.

I did not ask for recommendations for Oliver. This is a higher skill level than required at F5. The marking team were instructed to give some credit for sensible advice but I would not recommend this as strategy to pass F5 in the future. Sticking to the question as set is the best advice.

64 TIES ONLY (DEC 07 EXAM)

Key answer tips

This is an in-depth question on performance appraisal where the key is to be able to discuss figures given or calculated. It is also an excellent example of how the examiner wants you to be able to discuss both financial and non-financial data. Non-financial performance is one of the examiner's key motivations. The examiner has stated that 'organisations seem obsessed with financial performance measures, but the future is determined more by non-financial performance. Both are important'.

In part (a) the simplest approach is to aim for eight points and try to use the key lines of table one as headings, e.g. sales, gross profit, website development. It is more meaningful to do some straightforward numerical analysis, e.g. calculate the percentage change in gross profit, than to just include the $ figure. Ensure a comment is made about each of the key figures included. Use the information in the scenario together with any other relevant knowledge.

In part (b) aim for four separate points and try to give a balanced answer pointing out the causes for concern, e.g. a falling gross profit percentage, in addition to the positive points.

In part (c) use each line of table two as a key heading. If you have time, include some straightforward calculations, e.g. calculate the percentage change between quarter 1 and 2 and compare to the industry average. This will make the data more meaningful and will make it easier to comment.

(a) **Financial performance of Ties Only Limited**

Sales growth

Ties Only Limited has had an excellent start to their business. From a standing start they have made $420,000 of sales and then grown that figure by over 61% to $680,000 in the following quarter. This is impressive particularly given that we know that the clothing industry is very competitive. Equally it is often the case that new businesses make slow starts, this does not look to be the case here.

Gross profit

The gross profit for the business is 52% for quarter 1 and 50% for quarter 2. We have no comparable industry data provided so no absolute comment can be made. However, we can see the gross profit has reduced by two points in one quarter. This is potentially serious and should not be allowed to continue.

The cause of this fall is unclear, price pressure from competitors is possible, who may be responding to the good start made by the business. If Ties Only Limited is reducing its prices, this would reflect on the gross profit margin produced.

It could also be that the supply side cost figures are rising disproportionately. As the business has grown so quickly, it may have had to resort to sourcing extra new supplies at short notice incurring higher purchase or shipping costs. These could all reduce gross margins achieved.

Website development

Website costs are being written off as incurred to the management accounting profit and loss account. They should be seen as an investment in the future and unlikely to continue in the long term. Website development has been made with the future in mind; we can assume that the future website costs will be lower than at present. Taking this into consideration the loss made by the business does not look as serious as it first appears.

Administration costs

These are 23.9% of sales in quarter 1 and only 22.1% of sales in quarter 2. This could be good cost control, impressive given the youth and inexperience of the management team.

Also any fixed costs included in the cost (directors' salaries are included) will be spread over greater volume. This would also reduce the percentage of cost against sales figure. This is an example of a business gaining critical mass. The bigger it gets the more it is able to absorb costs. Ties Only Limited may have some way to go in this regard, gaining a much greater size than at present.

Distribution costs

This is a relatively minor cost that again appears under control. Distribution costs are likely to be mainly variable (postage) and indeed the proportion of this cost to sales is constant at 4.9%.

Launch marketing

Another cost that although in this profit and loss account is unlikely to continue at this level. Once the 'launch' is complete this cost will be replaced by more general marketing of the website. Launch marketing will be more expensive than general marketing and so the profits of the business will improve over time. This is another good sign that the results of the first two quarters are not as bad as they seem.

Other costs

Another cost that appears under control in that it seems to have simply varied with volume.

(b) Although the business has lost over $188,000 in the first two quarters of its life, this is not as disastrous as it looks. The reasons for this view are:

- New businesses rarely breakeven within six months of launch
- The profits are after charging the whole of the website development costs, these costs will not be incurred in the future
- Launch marketing is also deducted from the profits. This cost will not continue at such a high level in the future

The major threat concerns the fall in gross profit percentage which should be investigated.

The owners should be relatively pleased with the start that they have made. They are moving in the right direction and without website development and launch marketing they made a profit of $47,137 in quarter 1 and $75,360 in quarter 2.

If sales continue to grow at the rate seen thus far, then the business (given its ability to control costs) is well placed to return significant profits in the future.

The current profit (or loss) of a business does not always indicate a business's future performance.

(c) **Non-financial indicators of success**

Website hits

This is a very impressive start. A new business can often find it difficult to make an impression in the market. Growth in hits is 25% between the two quarters. If this continued over a year the final quarter hits would be over 1.3m hits. The internet enables new businesses to impact the market quickly.

Number of ties sold

The conversion rates are 4% for quarter 1 and 4.5% for quarter 2. Both these figures may seem low but are ahead of the industry average data. (Industry acquired data must be carefully applied, although in this case the data seems consistent). It appears that the business has a product that the market is interested in. Ties Only Limited are indeed looking competitive.

We can use this statistic to calculate average price achieved for the ties

Quarter 1

$$\frac{\$420,000}{27,631} = \$15.20 \text{ per tie}$$

Quarter 2

$$\frac{\$680,000}{38,857} = \$17.50 \text{ per tie}$$

This suggests that the fall in gross profit has little to do with the sales price for the ties. The problem of the falling gross profit must lie elsewhere.

On time delivery

Clearly the business is beginning to struggle with delivery. As it expands, its systems and resources will become stretched. Customers' expectations will be governed by the terms on the website, but if expectations are not met then customers may not return. More attention will have to be placed on the delivery problem.

Sales returns

Returns are clearly common in this industry. Presumably, ties have to be seen and indeed worn before they are accepted as suitable by customers. The concern here is that the business's return rate has jumped up in quarter 2 and is now well above the average for the industry. In other words, performance is worsening and below that of the competitors. If the business is under pressure on delivery (as shown by the lateness of delivery) it could be that errors are being made. If wrong goods are sent out then they will be returned by disappointed customers.

The alternative view is that the quality of the product is not what is suggested by the website. If the quality is poor then the products could well be returned by unhappy customers.

This is clearly concerning and an investigation is needed.

System down time

System down time is to be avoided by internet based sellers as much as possible. If the system is down then customers cannot access the site. This could easily lead to lost sales at that time and cause customers not to try again at later dates. Downtime could be caused by insufficient investment at the development stage (we are told that the server was built to a high specification) or when the site is under pressure due to peaking volumes. This second explanation is more likely in this case.

The down time percentage has risen alarmingly and this is concerning. Ideally, we would need figures for the average percentage down time achieved by comparable systems to be able to comment further.

The owners are likely to be disappointed given the level of initial investment they have already made. A discussion with the website developers may well be warranted.

Summary

This new business is doing well. It is growing rapidly and ignoring non-recurring costs is profitable. It needs to focus on delivery accuracy, speed and quality of product. It also needs to focus on a remedy for the falling gross profit margin.

Workings

(W1) **Gross profit**

Quarter 1:

$$\frac{218{,}400}{420{,}000} = 52\%$$

Quarter 2:

$$\frac{339{,}320}{680{,}000} = 50\%$$

(W2) **Website conversion rates**

Quarter 1:

$$\frac{27{,}631}{690{,}789} = 4\%$$

Quarter 2:

$$\frac{38{,}857}{863{,}492} = 4.5\%$$

(W3) **Website hits growth**

Between quarter 1 and quarter 2 the growth in website hits has been:

$$\frac{863{,}492}{690{,}789} = 1.25 = 25\%$$