Chartered Institute of Management Accountants

CIMA

May 2017 Strategic case study examination

Pre-seen materials

Contents

You are the Senior Manager in Fizz which is a large company that manufactures soft drinks. Fizz has its head office in Nortland and is quoted on the Nortland Stock Exchange. You report directly to the Board and advise on special projects and strategic matters.

Nortland uses International Financial Reporting Standards.

Nortland's currency is the N$.

The soft drinks market

Any drink that does not contain alcohol is classed as a soft drink.

Retail sales of soft drinks in Nortland amounted to N$12.3 billion in the year to 31 December 2016.

Soft drinks can be split into two main categories: carbonated soft drinks (CSDs) and still drinks. Carbonated soft drinks have carbon dioxide (CO_2) gas dissolved in them in order to create bubbles when they are opened and consumed. Still drinks do not contain CO_2 gas.

CSDs include a wide range of drinks, such as cola, fruit-flavour drinks and sparkling water. Some drinks contain caffeine to make them refreshing. Some contain a high concentration of caffeine or another stimulant and additional sugar so that they can be marketed as "energy drinks". Some CSDs are sold as "mixers" because they are generally mixed with alcohol before consumption.

Still drinks include fruit juice and juice-flavoured drinks, still water, dairy-based drinks such as flavoured milk, and squashes, which are sold as concentrates and are diluted with water before drinking.

Care has to be taken with the words "flavour" and "flavoured" in the food industry. A drink can be sold as, say, "orange flavour" if it tastes like orange juice, even if the flavour has been derived from artificial flavouring. The drink would actually have to contain orange juice in order to be described as "orange flavoured".

Manufacturers have two main distribution channels for their products:

- The off-trade comprises bulk sales to major retailers and wholesalers who supply smaller retailers. The final consumers who buy these drinks will be expected to consume them off the vendor's premises.

  Off-trade products are packaged as cans and bottles, ranging from individual servings of 250ml, 330 ml or 500ml up to 1 litre, 2 litre or 3 litre bottles for sharing.

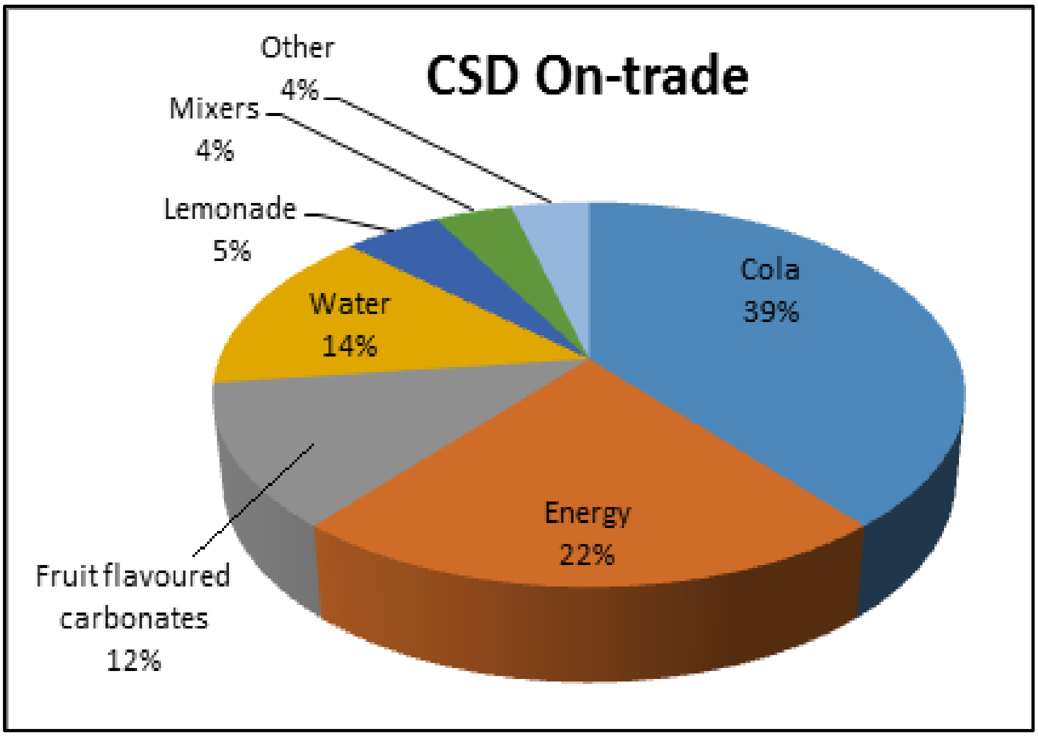
  Some major retailers sell their own-brand drinks alongside branded products from manufacturers such as Fizz. Own-brand products accounted for 23% of the off-trade market by value in 2016.

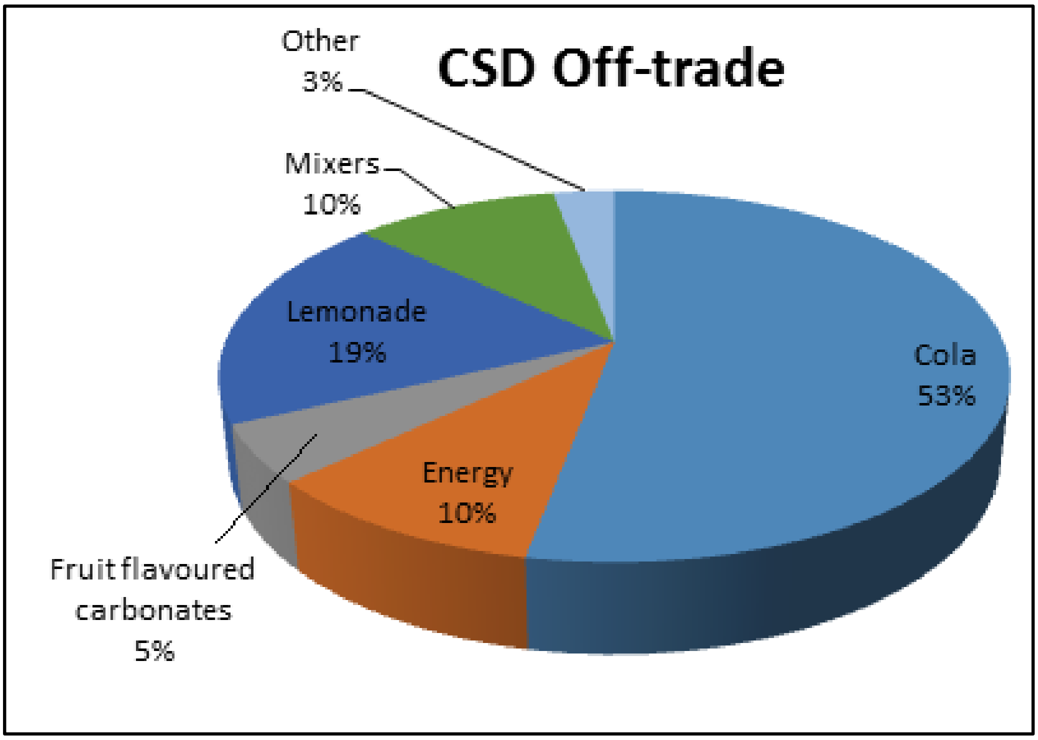
- The on-trade comprises sales to cafes, restaurants, bars and other outlets where consumers are expected to consume the drinks on the premises. Major on-trade outlets will buy directly from the manufacturer, but there are also wholesalers who service the on-trade channel.

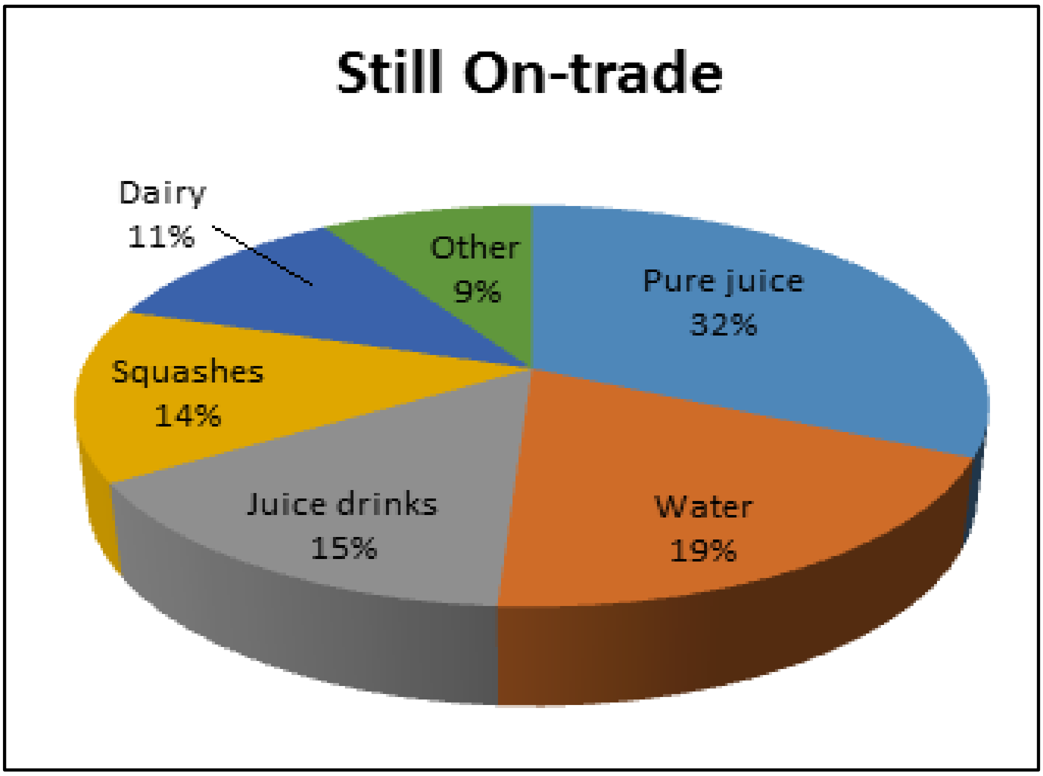
  

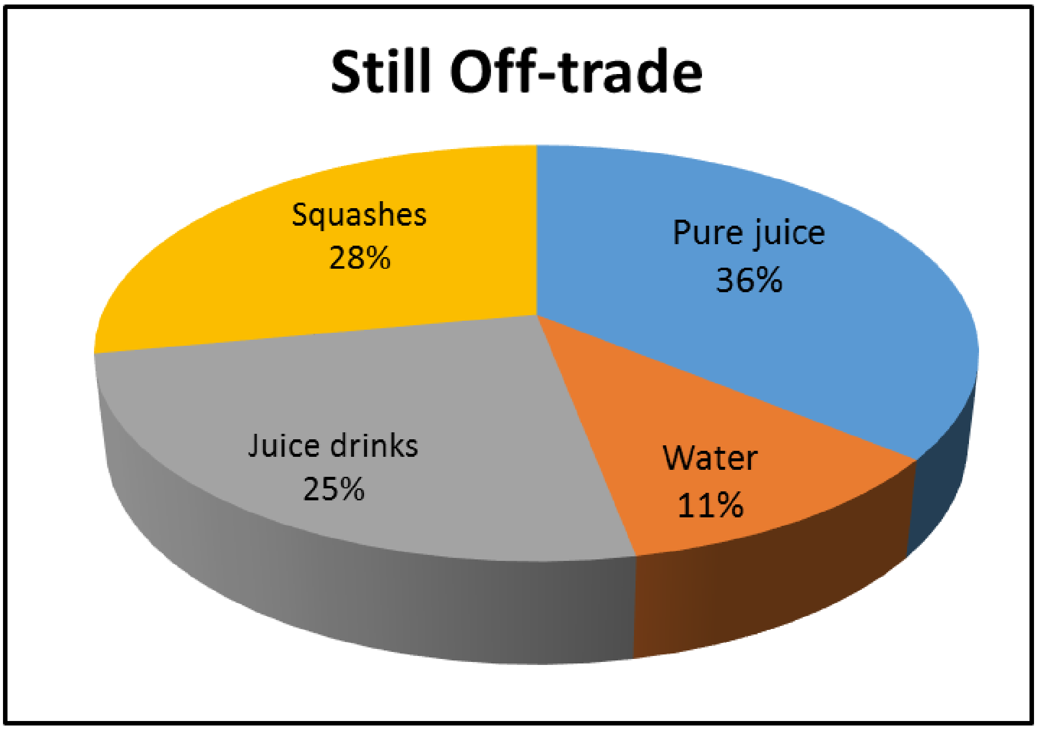
  On-trade sales can be in the form of cans or bottles for consumption on the premises or as syrups that are pumped through a soda fountain dispenser that mixes the syrup with carbonated water to create drinks that are sold by the glass. Bars often sell small cans and bottles as mixers, or they can add a small dash of a soft drink from a dispenser.

Nortland's overall soft drinks market breaks down by retail sales value as follows:






Still On-trade
Dairy 11%
Other 9%
Pure juice 32%
Squashes 14%
Juice drinks 15%
Water 19%


Still Off-trade
Squashes 28%
Pure juice 36%
Juice drinks 25%
Water 11%

Off-trade sales are split 49% CSD and 51% still by value. On-trade are 72% CSD and 28% still.

Retail sales of soft drinks in Nortland totalled N$12.3 billion in the year to 31 December 2016, of which N$8.2 billion was off-trade and N$4.1 billion was on-trade.

Retail prices are significantly higher for on-trade sales and so on-trade sales account for approximately 10% of soft drink sales by volume, despite being roughly 33% by value

Company background

Fizz was founded by the Clann family in 1890. The company's first products were marketed as refreshing tonics that were designed to settle mild stomach upsets and to help invalids to keep themselves hydrated.

Fizz sells soft drinks (non-alcoholic). The company manufactured 422 million litres of soft drinks in the year to 31 December 2016.

Fizz was listed on the Nortland Stock Exchange in 1962. The Clann family still holds 18% of the company's shares.

Several of Fizz's earliest products are still in production, most notably Froot, a carbonated soft drink that is very popular in Nortland and has a growing global market.

The company's main products are:

CSD (carbonated) drinks	
Froot	The company's most popular product that has changed very little since it was first sold as "Fizz Fruit Drink" in 1890. The drink's name had to change to Froot in the 1960s because changing consumer protection legislation would have required a significant increase in the amount of fruit, as opposed to fruit flavourings, contained in the drink. Froot is widely available from on-trade and off-trade outlets throughout Nortland. Froot has a refreshing taste. The regular version is sweetened with corn syrup, which contains a great deal of fructose, a naturally occurring sugar, but there is also a sugar-free version that is sweetened artificially. A 330ml can of Froot contains about as much caffeine as a cup of coffee.
Fizz Carbonated	Fizz sells a range of carbonated drinks, including Fizz Cola, Fizz Orange and Fizz Cream Soda. These drinks sell steadily through the off-trade sector, but they are not market leaders. Fizz Carbonated drinks have both regular and sugar free versions and they contain the same level of caffeine as Froot.
Funn	Funn is a range of energy drinks that are marketed primarily at consumers in their teens and early 20s. A can of Funn contains a significant quantity of sugar to give the consumer an energy boost and a concentrated shot of caffeine, equivalent to drinking three cups of coffee or three cans of a traditional carbonated drink such as Froot.

Still drinks	
Clann Cordial	Clann Cordial is a concentrated drink that is mixed with water before consumption. It comes in a range of fruit flavours. It is sold through the off-trade channel.
Joocy Juice	Joocy Juice is a range of real fruit juices that are sold in 1 litre cartons. Juicy Juice is a premium brand. It is made by harvesting fruit and having it pressed locally. The resulting juice is then packaged into cartons immediately and shipped to Nortland for sale. Fizz's competitors use concentrated juice. They extract the juice and then evaporate away most of the water content. The concentrated juice is then shipped to Nortland in tanks. The juice is reconstituted by adding water before packaging it in cartons. This process is far cheaper, but the process affects the flavour of the juice and removes some of its vitamin content. Joocy Juice is made by extracting the juice and packaging it on-site. The resulting juice is said to taste better and have a higher vitamin content because it has not been processed to extract the water.

In addition, Fizz sells Clann Spring Water in both carbonated and still versions. The water is collected from a spring that surfaces in a plot of land close to Fizz's factory in Nortland. Both still and carbonated water is packaged in cans and bottles for sale through off-trade and on-trade.

Fizz is one of the largest manufacturers of soft drinks in Nortland.

Fizz's main competitor is Qwench which manufactures its own range of CSDs and still drinks. Qwench also has the franchise to bottle and sell a global-brand of cola drink. The cola drink's manufacturer makes and sells its drink in the USA. It achieves global sales by selling its drink as a concentrated syrup, which it sells in bulk to a designated franchisee in each national market. The franchisee dilutes the syrup with carbonated water and sells it in bottles and cans that are identical to those made by the original manufacturer. Qwench generates 45% of its revenues from this franchising arrangement.

The manufacturing process

Carbonated drinks, including Froot, are largely water, although this is combined with a host of other ingredients that are necessary to create not only the flavour, but also the colour and the physical sensations associated with consuming these drinks. For example, acids not only preserve the product, they create a sharpness to the drink and stimulate saliva flow.

The water used in the drinks must be very pure. Apart from health risks, any impurities or bacteria could taint the flavour and could result in rapid deterioration, including clouding of the product which would make it unsaleable. Fizz filters and sterilises all water.

There is a cooking process to create the syrup that provides the colour and the distinctive taste of each drink. The syrups are highly concentrated so that they can be combined with the purified water and the sugar or artificial sweeteners to create the basic drink. All that needs to be done to complete the production process is the addition of CO_2.

Finally, the carbonated drinks are bottled or canned and the filled containers are sealed to prevent the escape of the CO_2 gas.

Clann Cordial is made in a very similar manner, although there is a much higher concentration of syrup and the product does not contain CO_2.

All of Fizz's carbonated drinks and cordials are manufactured at a single factory, with several production lines. The factory has canning and bottling facilities on site and a distribution centre.

Joocy Juice is made by pressing fresh fruit, with the resulting juices filtered and packaged immediately by third parties located close to the origin of the juice. The packaged juices are shipped to Nortland. The logistical arrangements for the transportation and delivery of the juices are managed by Fizz's distribution centre. Some of the juice is delivered directly to customers, such as major supermarkets. The remainder is delivered to the distribution centre at Fizz's factory.

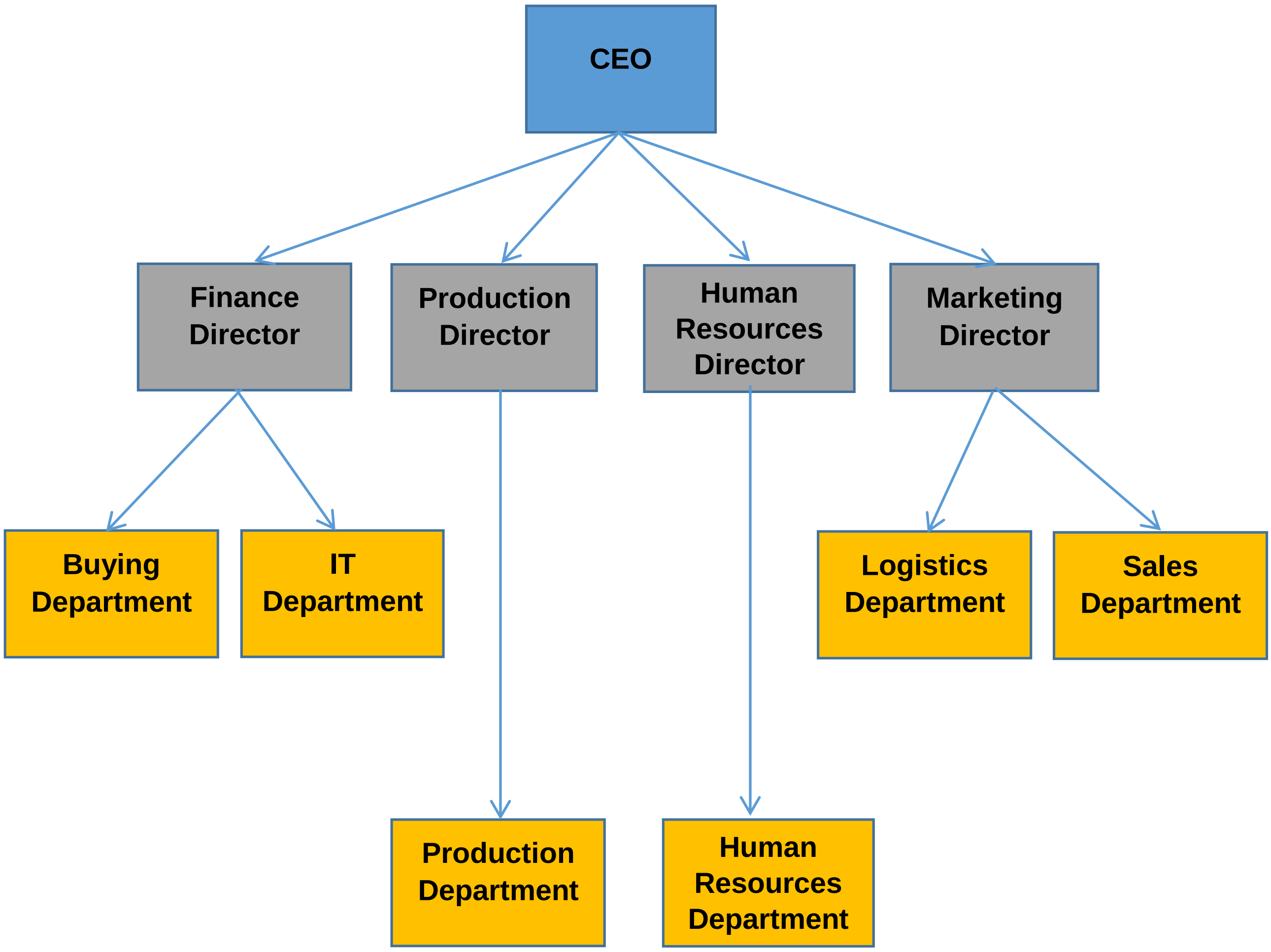
Cost of making a can of Froot

The costings of making a 330ml can of Froot are as follows:

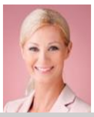
	N$
Raw materials	
Carbonated water	0.0038
High fructose corn syrup	0.0788
Colouring	0.0074
Phosphoric acid	0.0045
Natural flavours	0.0900
Caffeine	0.0023
Aluminium can	0.0500
Total materials	0.2368
Labour	0.0300
Manufacturing overheads	0.0250
Shipping	0.0600
Total cost	0.3518

Fizz also sells Froot in 500ml cans, 1 litre and 2 litre bottles and as cartons of concentrated syrup for sales to bars, cafes and restaurants that are equipped with soda fountains.

Organisation Chart



Fizz's Board

	Walter Clann, Chairman
	Hong Li, Chief Executive Officer (CEO)
	Mary Shannon, Finance Director
	Anthony Renfrew, Marketing Director
	Simon Bridges, Production Director
	Gayle Forbes, Human Resource Director
	Dora Matthews, Non-Executive Director
	Bilal Bhatti, Non-Executive Director
	Donald Froost, Non-Executive Director
	Michelle Adams, Non-Executive Director

Risk register extracts

Risk	Likelihood 1=Unlikely 5=Very likely	Severity 1=Minor impact 5=Major impact	Risk factor (LxS) Low Risk 1-8 Medium Risk 9-14 High Risk 15-25	Control	Responsibility
Operational					
Problems with product safety.	2	4	8	Constant quality checks are conducted at each stage in the manufacturing process.	Production manager
Supplies of raw materials may be interrupted.	3	4	12	Fizz takes pride in selecting only high quality and dependable suppliers.	Chief buyer
Failure of key IT systems.	3	5	15	Fizz maintains backup systems.	IT manager
Disruption of deliveries.	3	5	15	Fizz works closely with all relevant authorities and monitors factors such as the weather.	Logistics manager
Commercial					
Intellectual property rights may be compromised.	3	3	9	Fizz invests in trademark and other forms of protection. Legal enforcement is used when necessary.	Board

Commercial continued					
Legislation or tax penalties to discourage the sale of high calorie products.	**2**	**5**	**10**	Fizz maintains good relations with government.	Board
Changing consumer tastes may lead to declining sales.	**4**	**5**	**20**	Fizz conducts constant market research.	Sales manager
Financial risks, including volatility in currency and commodity prices.	**4**	**5**	**20**	Financial markets are kept under constant review.	Finance manager

Fizz strategy

The Board of Fizz is committed to pursuing the following strategies:

Maintain growth in core markets

Fizz is well established in Nortland, selling a wide range of popular soft drinks.

There could be opportunities that would be worth exploiting. For example, demand for bottled water is increasing and the Clann Spring Water brand is not particularly prominent.

Fizz needs to retain the values associated with its product range, whilst ensuring that new products are developed.

Exploit global opportunities

Fizz is essentially a domestic manufacturer, with considerable strength in its Nortland base. Fizz has had limited success in exporting Froot, with most exports being to supply retailers in holiday destinations that are popular with tourists from Nortland, who wish to buy familiar products. It is extremely difficult to break into mainstream drinks retailing.

Develop consumer trust

Soft drinks have been associated with a number of health scares in recent years and Fizz must take care to develop both products and marketing strategies that can overcome such difficulties.

Extracts from financial statements

Fizz
Consolidated income statement
For the year ended 31 December

	2016	**2015**
	N$m	**N$m**
Revenue	336.2	365.3
Cost of sales	(166.4)	(175.6)
Gross profit	169.8	189.7
Operating expenses	(94.0)	(92.3)
Operating profit	75.8	97.4
Finance costs	(1.1)	(0.4)
Profit before tax	74.7	97.0
Income tax expense	(8.7)	(10.3)
Profit for year	66.0	86.7

Fizz
Consolidated statement of financial position
As at 31 December

	2016	2015
	N$m	**N$m**
Non-current assets		
Intangible assets	141.9	109.2
Property, plant and equipment	116.0	109.8
	257.9	219.0
Current assets		
Inventories	21.4	19.8
Trade receivables	68.0	69.8
Cash and cash equivalents	10.4	7.0
	99.8	96.6
Total assets	357.7	315.6
Equity		
Share capital and share premium	17.6	17.6
Retained earnings	255.2	220.0
	272.8	237.6
Non-current liabilities		
Borrowings	21.3	10.4
Deferred tax	10.1	9.8
	31.4	20.2
Current liabilities		
Trade payables	45.3	47.8
Current tax	8.2	10.0
	53.5	57.8
	357.7	315.6

Extracts from financial statements of Fizz's closest competitor

Qwench
Consolidated income statement
For the year ended 31 December

	2016	**2015**
	N$m	**N$m**
Revenue	1,690.1	1,882.2
Cost of sales	(703.5)	(753.4)
Gross profit	986.6	1,128.8
Operating expenses	(654.1)	(680.5)
Operating profit	332.5	448.3
Finance costs	(27.2)	(30.9)
Profit before tax	305.3	417.4
Tax on profit	(42.9)	(36.5)
Profit for year	262.4	380.9

Qwench
Consolidated statement of financial position
As at 31 December

	2016	2015
	N$m	N$m
Non-current assets		
Intangible assets	702.7	704.6
Property, plant and equipment	332.1	305.0
	1,034.8	1,009.6
Current assets		
Inventories	118.8	109.5
Trade receivables	379.1	359.8
Derivative financial instruments	67.4	-
Cash and cash equivalents	316.3	184.3
	881.6	653.6
Total assets	1,916.4	1,663.2
Equity		
Share capital and share premium	140.3	140.3
Cash flow hedge reserve	68.3	(4.8)
Retained earnings	774.5	592.8
	983.1	728.3
Non-current liabilities		
Loans	340.0	386.3
Deferred tax	49.3	46.1
	389.3	432.4
Current liabilities		
Trade payables	505.1	463.2
Derivative financial instruments	-	4.6
Current tax	38.9	34.7
	544.0	502.5
	1,916.4	1,663.2

Qwench

Accounting policy extracts

Derivative financial instruments

Derivatives are initially recognised at their fair value whenever derivative contracts are entered into. They are subsequently re-measured at their fair values.

The gain or loss on re-measurement to fair value is recognised immediately in the statement of profit or loss, unless they are accounted for under hedge accounting. Where the instruments qualify for hedge accounting, recognition of any resultant gain or loss depends on the nature of the item being hedged.

Where hedge accounting is applicable, Qwench documents the relationship between hedging instruments and hedged items, as well the risk management objectives and strategy. Qwench also documents the basis on which it believes the hedge to be highly effective in offsetting changes in fair values or cash flows of hedged items.

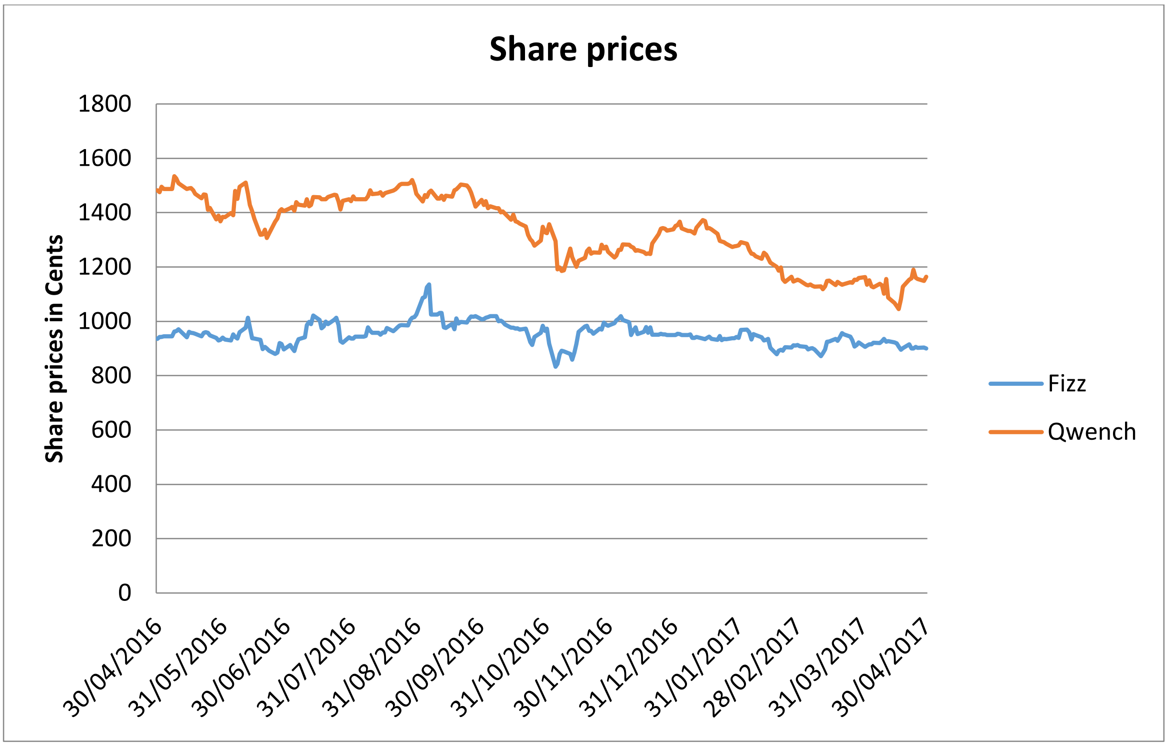
Cash flow hedges

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges are recognised in other comprehensive income.

The gain or loss relating to any ineffective portion is recognised immediately in the statement of profit or loss.

Cumulative amounts recognised in other comprehensive income are recycled through profit or loss in the period when the hedged item affects profit or loss.

Share prices for Fizz and Qwench



Some Industry & Market Ratios

	Soft Drink Industry Median	Stock Market Median
Share Price/Sales Ratio	1.77	1.67
Share Price/Earnings Ratio	26.20	20.59
Share Price/Book Ratio	6.05	1.96

Press clippings

Daily News

Are soft drink manufacturers ignoring obesity risks?

The blog site "Fighting Fat" has been running a hugely successful campaign against the sugar in soft drinks that children love. There are now over 500,000 bloggers on the site.

The soft drinks manufacturers are fighting back with their own publicity claiming that parents need to take some responsibility themselves and prevent their children drinking so many sweet fizzy drinks.

Many schools have banned sugary drinks in their snack shops due to parent and government pressure.

Financial Daily News

12th May 2017

Fizz's profits fall

The publication of Fizz's 2016 results saw share prices fall slightly. This was not unexpected and the share price fell only slightly.

The company's Board released a statement reassuring shareholders that trading conditions in 2016 had been difficult due to increasing competition from soft drinks manufacturers overseas and that Fizz had in fact "done well".

Industry analysts noted that Qwench, Fizz's largest competitor, had already reported a far more severe decline in profits and so Fizz's performance dip had been expected.

Daily News

The True Cost Of Sugary Drinks

The increasing incidence of obesity is having a profound effect on the nation's health and is diverting increasing amounts of resources from the health service.

Fatty foods used to be the main cause of obesity, but foods and drinks with high sugar content are emerging as more significant causes.

Governments are increasingly concerned about the rising costs of illnesses such as type 2 diabetes and cancer, which have risen alongside an obesity epidemic. The battle between food companies and governments may be only just beginning; if health systems fail under the strain of obesity-related diseases, regulators will act to prevent rather than treat them afterwards.

Several countries are introducing legislation to help curb intake of sugary foods; health warnings, sales taxes, banning of junk foods in schools, restrictions on advertising to children and reduced portion sizes will become more prevalent.

Daily News

Health Watchdog Issues Warning on Energy Drinks

The current fashion for young adults to drink energy drinks has led to a warning from the medical profession concerning the safety of those drinks.

Energy drinks are sold as “dietary supplements”, which means that there are fewer restrictions on the concentration of the stimulants that give them their refreshing properties. Legally, soft drinks cannot contain more than 71mg of caffeine in a can, but there is no legal limit on the quantity that can be added to an energy drink. Some products contain as much as 400mg per can, equivalent to drinking several cups of strong coffee.

Most consumers are aware of the effects of caffeine but many do not realise that energy drinks usually contain other stimulants as well, such as guarana, which is essentially a compound of caffeine. Doctors are concerned that consumers do not fully understand the risks that they are taking.

Dr Surya Prakash, a consultant physician specialising in eating disorders, warned consumers that consuming that quantity of caffeine could increase blood pressure and might affect behaviour. He recommended that consumers should not drink these products on a daily basis and that they should never drink more than one can in a single day.

