MANAGEMENT CASE STUDY AUGUST 2016 EXAM ANSWERS

Variant 1

The August 2016 Exam can be viewed at

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SECTION 1

Key cost questions

We need to ask about the volumes that LMC is assuming. Presumably, LMC believes that it will be ordering electronic components in sufficient bulk to obtain discounts that will enable it to compete with the existing hardware vendors. We need some reassurance that these volumes are actually achievable. Has LMC conducted sufficient market research to enable it to be confident in these projections?

Has LMC made sufficient allowance for the cost of buying components? At present, the hardware vendors provide it directly with the components that are required and so LMC may have little experience in this area. Has it made allowance for the administrative costs associated with placing orders and managing inventory? Established hardware vendors may buy in sufficient quantity to receive volume discounts. Is LMC confident that it can buy parts at an economic price? Has LMC conducted any preliminary discussions with part manufacturers concerning the pricing of components?

Has LMC allowed for the costs of shipping to a single major customer in Westland? Our requirements may mean that LMC has to ship frequently, but in relatively small quantities and that may be expensive Will that put LMC under pressure to restrict our supply line or to sell to additional customers in Westland? How will the completed units be shipped to us and has LMC identified a cost-effective shipping method?

Relationship with existing vendors

The nature of the industry suggests that SparkSpace has very little to fear in this case. There are various hardware vendors whose products are fairly generic. If one or more refuses to sell to

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SparkSpace then SparkSpace will simply order from another. If vendors surrender business to their competitors then they will lose volumes.

The relationships between the hardware vendors and the value added retailers does not appear to be particularly close to begin with. The business model appears to sell a generic product in volume with a small margin. The hardware vendors do not appear to offer value added retailers such as SparkSpace any real benefits that might be withdrawn in the event of the loss of any goodwill.

SparkSpace is likely to be a fairly small customer for any of the major hardware vendors. The loss of business while SparkSpace was buying from LMC will not be so noticeable that the vendor is likely to have a policy not to supply SparkSpace in the event that further orders are placed in the future. The value added retailers such as SparkSpace probably place varying levels of orders with the hardware vendors and so there will be an expectation of such interruptions in ordering history.

There is nothing to prevent SparkSpace from placing some orders with their traditional suppliers during this period. It would make sense to place some orders, up to the 20% limit agreed with LMC with the existing suppliers, just to offer a point of comparison with the products supplied by LMC. SparkSpace can channel those orders in such a way as to manage any negative feedback.

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SECTION 2

Risks arising from poor health and safety

There are a number of issues affecting the likelihood of LMC's practices being uncovered.

The fact that LMC is located in a low wage economy might mean that the country will attract the attention of the media and of charities concerned with workers' welfare from the developed countries. Having said that, there will be many factories in the country that are likely to operate in a similar manner and so there could be a low risk of LMC being singled out in any particular investigation.

The major hardware vendors appear to have used LMC for fabrication work without any adverse consequences. There could, however, be a danger that the standards were higher when LMC served those customers and that it might be tempted to cut corners in order to bring down its selling prices.

The keener prices being offered by SparkSpace might trigger questions as to how the company's supply chain has changed. It would be relatively easy for, say, a journalist to identify the new supplier and to investigate the factory.

SparkSpace also has to consider the consequences of any publicity.

SparkSpace's reputation will be damaged by any association with unsafe working practice. The major hardware vendors may claim that LMC operated responsibly before, when it supplied them, and that SparkSpace has behaved irresponsibly.

Many potential customers will have a commitment to ethical trade and will be unwilling to buy servers that are associated with the abuse of workers. The products themselves are generic and so SparkSpace can easily be replaced by another supplier.

The publicity may affect the whole of the company's business, including the HPC servers that are built in Wesland. The media are unlikely to distinguish different business operations because that would complicate the story.

Cultural values

The most immediate question is whether this will even succeed. The employees may resent the interference in their working practices and they may resist. SparkSpace may simply encourage shoddy work, with employees cutting corners in other ways to maintain output.

LMC's management may become distracted, particularly if they are satisfied with things as they are. There may also be different attitudes being communicated by other LMC customers from other countries. The standards in force in Wesland may differ from those in operation elsewhere and other buyers may seek different levels of safety.

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SparkSpace may be accused of missing the point of this arrangement. LMC's employees may be willing to sacrifice their health and safety in order to achieve a living wage. SparkSpace's management may be open to accusations of imposing standards from a developed country that cannot be maintained in poorer nations. If the health and safety standards force LMC out of business then SparkSpace may be criticised in the media for imposing its values without due care.

SparkSpace may be adding significant costs to this arrangement if it finds it necessary to monitor compliance. Margins are tight and there is little point in moving to a low cost supplier if time and money are to be spent on monitoring that supplier's practices. It may be possible for SparkSpace to adopt a free rider approach if other LMC customers are inclined to monitor health and safety performance from their perspective.

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SECTION 3

Transfer prices

The most immediate issue to be agreed arises from the relationships with Datafuse and Countbox. If the transfer prices are set to cover the operating costs of the logistics centre then any transfer price is unlikely to be regarded as fair by any party to this venture that is ordering fewer blade servers than the other.

There could also be issues arising from any disparity in the parties' needs for logistical support. It may, for example, involve more effort and expense to ship blade servers to Wesland than to Countbox's home country.

The tax authorities in SDC's host country may be concerned if the company does not report a realistic profit. Those concerns could also be mirrored by tax authorities in the parties' home countries if there is a perception that profits are being recognised in a country with a low tax rate.

Any surplus built up by SDC may create problems depending on how it is to be returned to the venture parties. There could be exchange controls in place that complicate the repatriation of profits to Wesland and other countries.

The simplest approach might be to structure transfer prices in terms of the arm's length prices that would have been charged by the hardware vendors. Each party would be able to document those prices to the others and to the tax authorities. They would be able to argue that these are valid and commercially defensible transfer prices and so there can be little scope for treating them as artificial. The margins are small in this industry and so it is unlikely that there will be a significant surplus building up overall in SDC.

Accounting treatment

The three parties have joint control because each has to agree to any management decisions. This makes SDC a joint arrangement, under the terms of IFRS 11 *Joint arrangements*. This requires SparkSpace to account for its investment using the equity method of accounting. Presumably, the three parties will have rights to SDC's net assets and so SDC will be a joint venture (*it would be equally acceptable to answer on the basis that SDC is a joint operation*).

SparkSpace will record its investment initially at cost.

Over time, if SDC makes profits then SparkSpace will recognise its share (presumably 1/3) in its financial statements. SparkSpace's share of any post acquisition reserves will be added to the carrying value of the asset in SparkSpace's statement of financial position.

The investment will have to be reviewed for impairment. This could be an issue if, for example, there is a risk that the contract with LMC will not be renewed. There is also the question of the relationship with the other two parties, which could also cause a break up.

Finally, there could be unrealised profits to adjust for. The whole point of this arrangement is that SDC will sell goods to SparkSpace and it is almost certain that those sales will be at a profit.

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SparkSpace will have to identify any unsold blade servers at its year end that were originally acquired from SDC and eliminate its share of the unrealised profit.

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SECTION 4

Impact on share price

In theory, SparkSpace's market capitalisation should increase by W$18 million because of the net present value of this project. That would increase the share price pro-rata. The share price is related to expected cash flows and this project has been evaluated as being expected to offer cash flows that exceed the cost of capital associated with the initial investment. This is, however, a theoretical increase. There is no guarantee that the directors will announce the project in sufficient detail when the funds are committed and the market cannot respond to information that it does not have. There is also a possibility that the markets will not agree that the prospects for the project are as predicted by management. The change in the market price will be driven by expectations.

The rights issue is more complicated. The discount will reduce the share price itself because the new shares are being sold for less than their present market price. The issue will increase the number of shares in issue by one tenth, which suggests that the new project is fairly significant. The big question is whether the market will accept that the cash raised will generate a good return. The decrease of W$0.60 is very much a theoretical reduction and the share price might actually increase if the rights issue is understood as a gesture of confidence by management.

The dividend growth model is effectively a mathematical short cut for determining the net present value of future dividends. The share price will increase if the rate of growth in dividends is expected to increase, but it will take more than an unexpected dividend increase to bring that about. The crucial question is the rate of growth anticipated by the market. Even if management fully intends to maintain such a growth, there is no guarantee that the markets will be convinced and so the hoped for gain may not arise.

LMC's SWOT analysis

Strengths

LMC has considerable experience of assembling blade servers.

LMC is located in a low wage economy, which offers the ability to minimise operating costs.

LMC has been briefed in manufacturing quality control by the major hardware vendors and has been trained in their processes.

Potential customers will already have experience of using those servers, even if they have borne a different brand.

The established sales have created the necessary distribution infrastructure.

The devices themselves are generic and future enhancements to, say, processor technology is unlikely to require any further skills or investment from LMC.

Weaknesses

LMC has no brand name and so end users may not be willing to accept LMC blade servers.

LMC has no experience of many of the operational aspects, such as purchasing and logistics.

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LMC’s output is very generic and the company could easily be replaced by a customer.

The established hardware manufacturers may be willing to cut selling prices in order to prevent LMC to gain a foothold.

There are very low barriers to entry and potential customers could build their own assembly plants.

Media interest in employment practices could offset LMC’s cost advantage.

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