

MANAGEMENT CASE STUDY AUGUST 2016 EXAM ANSWERS

Variant 2

The August 2016 Exam can be viewed at

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SECTION 1

Commercial implications

The most obvious implication is that margins are slim in this industry and so SparkSpace will have an opportunity to undercut competition. It may be that SparkSpace can use some of the 7% price advantage to pitch a lower selling price while retaining the remainder as profit. It will be at least two years before competitors can use this model in Westland and so this will be a prolonged advantage.

SparkSpace will develop expertise in the installation and maintenance of this new model and that will give it more credibility when pitching to clients. SparkSpace's competitors will be new to this technology when it becomes generally available. They will have no access to actual operating data gathered from managing client systems.

The new model may attract a great deal of positive publicity. Being designated a preferred retailer will draw attention to SparkSpace. The model will possibly make the IT industry a little more sustainable and that will; reflect well on SparkSpace.

Given the margins at present, clients may be able to extract most of the 7% cost advantage and so SparkSpace may make very little profit from any additional sales. The risk is that the new systems will cost more to install or maintain and that the cost savings will be eroded. Speed Server's competitors will be looking at ways to match or beat any cost advantage that this model creates and any advantage may be short-lived.

Cost of quality

SparkSpace will not incur prevention costs with regard to the blade servers themselves because they will be manufactured by a third party. We will have to fully understand the choices and engineering compromises that Speed Server has taken. For example, blade servers are a standard size, so more components are being assembled in the same volume. That may create risks of overheating.

Appraisal costs may simply be a matter of running a diagnostic program and so they may be less onerous than feared. If the tests can be conducted electronically then they may not be any more costly than those applied to the traditional servers. Computer systems are also generally fitted with self-test functions that can warn operators of imminent failure.

Internal failure costs may arise from the rejection or reworking of bought in units. SparkSpace will have to invest time and effort in checking that each unit purchased is operating correctly. This may be complicated because each memory chip will be flawed in its own unique way. Speed Server's processes work on the basis that it is possible to combine four chips and obtain one good block of memory in the process. That may require quite extensive checking of each unit until the technology is proven.

External failure costs could arise from the fact that clients will be aware that we are selling them a new technology and they will take it for granted that we have tested it on their behalf. We will cause ourselves a great deal of reputational damage if we sell this product and it is responsible for system failures. We may have to commission external tests of at least an initial sample just to demonstrate the care that we have taken with this adoption.

SECTION 2

Learning curve

Our starting point would be to discuss this with our senior quality engineer. Did we learn any useful lessons during the initial trial? It may be that the nature of the technology means that different machines have different characteristics and so the learning curve may be less pronounced because the task is more complicated.

We need to break the testing down into different elements, particularly electrical versus electronic. We need to test the electro-mechanical aspects such as the cooling system separately from the electronic aspects linked to the memory capacity. The electronic aspects are likely to require more complicated tests and that will affect the rate of learning.

We might be able to conduct some field tests with the initial batch. For example, comparing the times taken by a representative sample of engineers with those required by the engineers who have some experience of working with the Powerblade might help. We can observe the changes in time taken as staff move from one machine to the next.

We might be able to obtain some useful information from Speed Server. Their staff will have experience of testing these machines. We can adjust a little for optimism in case Speed Server is keen to make this model appear more cost-effective than it actually is.

Performance evaluation

The test department could become complacent if the blade servers are inherently reliable and testing is almost redundant. The lack of failures may not be attributable to the testing that is being undertaken. Once staff start to think in those terms there is the potential for a disaster. Performance of the department may have to look beyond the number of product failures.

The focus of testing performance should be on compliance with procedure rather than the number of failures. The internal audit department might investigate the operation of the department to ensure that tests are being conducted as required. The manager could be held accountable for any failure to apply a test.

The main problem in evaluating the supervisor is that the only acceptable level of performance is zero failure. That gives no real opportunity to measure the supervisor's performance because it will be an almost binary matter of achieving or failing to achieve the zero failure goal. That could be demotivating because success may not be appreciated while any failure could be highly visible.

One solution would be to take a realistic view of any failure, focussing on the reasons and whether there is a lesson to be learned. The supervisor should only be blamed for any failures that are attributable to a lack of care in managing quality. The focus should otherwise be about developing processes to prevent a recurrence.

SECTION 3

Air traffic control system

This is a highly visible project that will attract a great deal of attention if there is a failure. This is a large and complex machine and so it will test the new technology and the risk of failure is quite high. If our server goes offline then flights will be delayed or diverted and that will attract the attention of the media. It will be well known by the industry that we were the lead company on this project and so our reputation will be damaged.

This order may stretch Speed Server because we will be looking for a very large number of units. Their manufacturing processes will be different and so they may only have limited capacity. If they are delayed then we may miss deadlines and that will be reported as a failure to complete on time.

We have no way to tell whether 20,000 of these units can be integrated in the same manner as traditional blade servers. The large number of memory chips may stress power supplies and cooling systems. That may draw our judgement into question if the units have to be replaced with a more conventional model.

There could be a significant upside risk because the air traffic control system will have to be evaluated for reliability before implementation. If our tender is accepted then other potential users may believe that our system is reliable and that may lead to further business. It is, in any case, a prestigious contract that will reflect favourably on SparkSpace.

Ratios

Our gross profit percentage could increase if we are able to retain some of the cost savings. That is potentially a positive change, but it could be interpreted as overpricing. The shareholders may be concerned that we are losing contracts through overpricing.

Our inventory turnover ratio will slow down because we may be holding units at the year end. That will make our management of working capital appear less effective. It may not be understood that there is a particular reason for holding the inventory while it is being tested.

Our quick assets ratio may decline if there is an outflow of cash in order to buy more inventory. We will appear to be less liquid. We may create the impression that we are overtrading.

Our return on capital employed is likely to increase because we will have made more profit without requiring additional investment. That will not be regarded as dysfunctional and so the shareholders might be reassured. The only real concern might be the threat of attracting competition into this new technology.

SECTION 4

Warranty provision

There does seem to be evidence that future costs could be material because of failures since the new model was introduced. The failures could take some time to manifest themselves in the other units. The only real hope is that Speed Servers will improve quality and so these initial failures may not indicate a long-term problem.

IAS 37 sets out some fairly clear requirements for the recognition of a provision. There is clearly a present obligation to customers arising from past transactions. There is clearly the likelihood of a future outflow of resources.

The biggest question is whether the future costs can be estimated with reasonable accuracy. If the amounts cannot be estimated then it would be inappropriate to recognise a liability in the statement of financial position. The big question is how such an estimate would be determined and whether the results would be meaningful.

In order to reach a final decision we need to decide whether there is a basis for estimating the liability. If not then the potential costs would be disclosed in the notes as a contingent liability. It seems unlikely that we can justify ignoring this altogether.

Negotiation

The starting point would be to identify the basis of our disagreement, so that matters can be resolved. Patrick is responsible for reporting on the fair presentation and so we might be able to persuade him that a provision would actually undermine fair presentation. The facts are not in dispute, only their reflection in the financial statements.

The most obvious basis for debate is likely to be that Patrick will disagree over the scope for quantification of the future costs. We should focus our attention on the potential uncertainty over that amount, with a view to reaching agreement. That might then leave scope for a compromise, such as agreement that the costs will be accounted for as contingent liabilities.

Ethical implications

The CIMA Code of Ethics suggests that we should avoid any action that discredits the profession. In this case, we appear to be seeking to compromise the professional judgement of another accountant whose job is to act in the interests of our shareholders. Such an action could not be justified as ethically acceptable because it would reflect badly on our own credibility as well as the auditors.

We are also supposed to act with integrity. Using economic means to bully another accountant into tolerating a misleading accounting treatment is hardly acceptable. Arguably, it would be more appropriate for us to reflect on the fact that Patrick is a fellow professional and his advice should be considered carefully. It is hardly acceptable to think in terms of our ability to inflict the loss of fee income on Patrick's firm.