

# **MANAGEMENT CASE STUDY AUGUST 2016 EXAM ANSWERS**

## **Variant 4**

**The August 2016 Exam can be viewed at**

<https://connect.cimaglobal.com/resources/management-case-study-exam/august-2016-management-case-study-exam---variant-number-4>

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*CIMA will not accept challenges to these answers on the basis of academic judgement.*

### **SECTION 1**

#### **Requirement 1**

The first problem is that the product is new and we have no experience of making processors. Our engineers have no real experience of working in this area and so we may be unable to achieve the necessary savings. This is a complex project to impose on our engineers as their first attempt at target costing.

The extent of the reduction to target seems daunting. Our initial costing suggests that each unit will cost W\$19,500 and we need to reduce that to W\$16,000, a reduction of 18%. Unless our initial costing were ridiculous, we are going to struggle to make those changes without risking quality.

The nature of the product suggests that there is a limited scope for engineering savings. The processor itself requires all of its functionality and the case is unlikely to have any dispensable functions. There is unlikely to be much scope for saving money by, say, removing a feature.

The fact that this is a new product at the design stage means that we can approach the manufacturing process from afresh. There may be changes or synergies that we can adopt without undue harm. It may be possible to share facilities with existing products and spread the costs that way.

## **Requirement 2**

The team should be led by engineering, because the primary role of target costing is to find cost-effective approaches to making savings. There should also be representatives from finance and marketing because those disciplines will have roles to play in valuing savings and evaluating the impact of any changes of future sales. All team members should be encouraged to comment freely and to propose changes from their perspective.

Ideally, team members should have some experience or expertise in product development. It may be necessary to look for an engineer who has prior experience of working for a company that manufactures components. The marketing department should be represented by a colleague who has experience of the HPC sector because this product is all about a niche capability.

The most important factor in evaluating the team is that any recommendations it makes should be practical and safe. It should be stated clearly from the outset that any plan to achieve the target cost is effectively a commitment to making the product at that price. The target cost is unattainable and the team should be regarded as ineffective if the savings are theoretical or are not permissible because of, say, quality considerations.

With that in mind, we may need to evaluate the process followed by the team and agree that the exercise was a success even if it did not bring about a plan to achieve the target cost. It should be made clear that this is essentially a feasibility study and that it may not be possible to achieve that goal. The team should be regarded as having succeeded even if the target cost cannot be achieved.

## **SECTION 2**

### **Requirement 1**

The year end is 30 September, so any expenditure on development before 30 September 2016 has to meet the criteria set out by IAS 38 for capitalisation. The board's intention is crucial because the final decision to proceed is not expected before around 31 December 2016 and so the outlay prior to 30 September 2016 may have to be written off. Expenditure after that date can be capitalised once the decision to proceed with the product has been taken.

The expenditure is going to require a major influx of funding. SparkSpace will either have to make a substantial share issue or take out a large loan. SparkSpace is already highly geared, so the company may have to issue fresh shares.

The project will generate little or no revenue during the year ended 30 September 2017. The finance costs of any debt will have to be borne as will the depreciation charged on the new property, plant and equipment, so profits will decline. Return on capital employed will decrease in the short term, although it is hoped that it will increase in the longer term once sales commence.

This is a new product and the assets that are being acquired appear to have a specialist nature. There may be a risk of impairment if the new processor does not sell well. That could lead to the newly acquired assets being written off against profits.

### **Requirement 2**

SparkSpace's share price may fall if the stock market is unsure whether this project will succeed. The product is new and untested in the market place. SparkSpace will be unlikely to have published many details about the product in order to avoid passing information to competitors.

SparkSpace should issue a press release concerning the intended function of this product. Once we are at the stage of making the final investment we will need to break silence in order to promote the product to potential customers. The fact that strong sales are anticipated will signal confidence to shareholders and customers alike.

The fact that this product gives SparkSpace a means to differentiate itself is important. Its existing products are essentially generic and the company competes on price. Those sales will continue, but SparkSpace can now argue that it can use this new product to promote itself in terms of product features and it may be implied that other innovations will follow.

The margins on this new processor are less exposed to competitive pressure. If a customer needs the new capability then it has no choice but to buy from SparkSpace. Even if there is a limit to the amount that would be paid, we can afford to charge a slightly higher margin or even adopt a price skimming strategy initially.

### **SECTION 3**

#### **Requirement 1**

Goodwill will be determined at the date of acquisition, based on the fair value of the shares that we issue to acquire control. The goodwill on acquisition will be retranslated every year end and so there will be currency gains or losses as the years pass. Those will be taken to other comprehensive income and reflected in the statement of financial position.

Net assets will be treated in the same manner, with opening net assets effectively retranslated and open to currency movements. Again, gains and losses will be taken to the statement of financial position, through other comprehensive income. The subsidiary will be wholly owned, so all of the gains and losses will accrue to the group.

Multibild's profit for the year will be translated at the average rate for the year. If Multibild's sales and expenses are all priced in E\$ then that may have an impact on the reported profit. A steady profit from year to year could be increased or decreased by currency movements.

Gains and losses on trading will remain within the group and so they will not affect us overall. They could, however, have an impact on the profits of the individual group members. That could be demotivating if the reported earnings become volatile or if there is a systematic drift that has a long-term impact to the detriment of one group member.

#### **Requirement 2**

Setting the prices in E\$ simplifies matters for Multibild and its managers. They will be credited with the same amount, regardless of currency movements. That means that they will not be exposed to the possibility of a loss if the rate halves.

The converse of that is that the management team at SparkSpace itself will be totally exposed to currency risks, with processors varying in price from  $E\$34,000 / 0.60 = W\$56,667$  to  $E\$34,000 / 2.90 = W\$11,724$ . That could be demotivating when the actual rates are used in internal management accounts, although the board could minimise that risk by recognising that the currency gains and losses will remain within the group. Thus, it would be possible to make an adjustment to cancel the impact of currency movements on the SparkSpace profit in Westland.

The engineering solution would leave most of the currency risk in place because the processors will always have to be imported. Importing the case currently costs  $E\$3,500/2.00 = W\$1,750$ , which is far cheaper than the  $W\$4,000$  that making it domestically would cost.

The currency rate would have to fall to  $W\$4,000/3,500 = E\$1.14 = W\$1.00$  to make the domestic manufacture worthwhile.

The present transfer price has been determined externally by revenue authorities, which avoids the potential demotivation associated with an artificial price. None of the managers can feel aggrieved that their transfer price has been manipulated.

## **SECTION 4**

### **Requirement 1**

We might use the CIMA Code of Ethics to provide a basis for dealing with this conflict.

The sales department cannot really claim to be objective over this issue. Imposing any restriction will, at best, leave sales unchanged and, at worst, will restrict sales. Agreeing that the sales department should limit sales will only make its job more difficult.

Company's should act with integrity. It is debatable whether Graphmark can be sold freely without breaching this because we now realise that the product can be used in harmful ways, it is clearly necessary to make sales to survive, but companies should refrain from selling goods that are dangerous or that harm users or bystanders. These news stories may actually stimulate further harmful sales and so this may become an even bigger issue.

SparkSpace cannot claim to have acted with professional competence and due care if it permits customers to decide on the uses to which Graphmark can be put. It may not have been apparent that the product offered unsavoury capabilities when it was first launched, but SparkSpace now knows better. The company cannot abdicate all responsibility for the use to which its product might be put to by buyer.

This product also breaches the principle of confidentiality. Even though face recognition is but one aspect of its function, the device creates the ability to identify bystanders without their knowledge. There is so much available online, that it is possible to link these reports to other sources, such as photographs on social media. That makes it possible to breach privacy in ways that might be deemed unacceptable. For example, a government agency might generate a list of names of people who attended a peaceful and legitimate protest.

### **Requirement 2**

The most immediate risk could be that SparkSpace will be criticised as selling an immoral and dangerous product. That could taint the company in making sales for both Graphmark and its other products. Customers may not wish to be associated with SparkSpace and our competitors sell products that are almost identical to our own.

Linked to this risk is the danger that we will be tainted by association with businesses that operate in aggressive ways. For example, the provision of further debt to consumers who have been identified as being at risk because of existing borrowing may be deemed immoral by many. Graphmark seem ideally suited to such businesses and that is hardly flattering for other potential customers who have legitimate uses.

We could be the subject of legal action by a bystander who suffers a loss. For example, an error in recognition could lead to a defamatory post that causes some damage. SparkSpace may be exposed to claims from injured parties.

The cases that are being highlighted could lead to changes in the law. If there is a clamp down on the use of this type of software then legitimate customers could also be affected. It

may be more profitable in the long run to forego dubious sales, with a view to having more freedom in the future.