Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY AUGUST 2017 EXAM ANSWERS

Variant 2

The August 2017 exam can be viewed at

https://connect.cimaglobal.com/resources/august-2017-management-case-study-variant-2

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SECTION 1

Performance evaluation

The first challenge is that Farland's new government intends to investigate subsidiaries of foreign companies for corruption. If our arrangement with Robin is discovered, this may be interpreted as corrupt and so we might be increasing the risk that the Ministry of Finance will not return the factory after the two year period. Robin's attempts to manage Aurora's interests could actually undermine the group's best interests.

It will only be appropriate to evaluate Robin's performance as an Aurora manager in terms of matters that he can control and that would not compromise his relationship with the Ministry of Finance. For example, Robin could be evaluated on the quality of the engines that he is supplying and the punctuality of deliveries. The Ministry of Finance will be keen to ensure that they can sell the engines made by the factory in order to generate revenues and so their interests will be aligned with ours.

Treating the factory as an investment centre could create conflicts in terms of timescales. It is highly unlikely that the Ministry of Finance will be prepared to permit Robin to invest in new plant and equipment, given that the intention is to return the factory to Aurora's ownership in two years. Aurora's treatment of Robin as an investment centre manager means that he is effectively being held accountable for the factory's long-term performance.

Even if Robin cannot make investment decisions treating the factory as an investment centre would make him responsible for maintaining the value of the assets that are already in place through proper care and maintenance. Again, such an approach would be consistent with his responsibility to the Ministry of Finance, who have no desire to see the factory closed down because of production difficulties. We might also ask Robin to develop a plan for any updates or replacements that can be put in place for after the return of the factory to Aurora's control..

Accounting treatment

The need to consolidate Aurora Engines hinges on the question of control. Ownership normally implies control, but that ownership is contested in Farland, where the government has taken ownership of the factory and the company's operations. The fact that other countries' courts might recognise Aurora's claims over Aurora Engines means very little if those rights cannot be enforced.

IFRS 10 defines control very clearly. The elements of control are absent from this arrangement. For example, Aurora cannot exercise its rights to hire and fire managers. Even the arrangement that it has made with Robin is, technically, an informal agreement that would be impossible to enforce. Similarly, Aurora is only likely to be exposed to variable returns from Aurora engines in the event that the company reverts to the parent after the government of Farland has completed its investigations.

The immediate impact of this loss of control, over Aurora Engines would be that the group would have to account for this as a disposal of a subsidiary, with no consideration. There would be a substantial loss on this adjustment and that would be reflected in the financial statements. The group's net assets would diminish by a substantial amount, given that Aurora Engines had assets of W$1.847m.

The ongoing financial statements would also be affected in the event that the group would no longer be able to incorporate Aurora Engine's profits. Effectively, that would increase the group's cost of sales by a figure approaching the W$647m profit that will be eliminated when inter-company sales are cancelled. This additional cost will be borne by the group and, presumably, remitted to Farland's Treasury.

SECTION 2

Value analysis

Presumably, the retail selling price cannot be increased to absorb the additional costs and so we must decide whether there is scope for modifying the designs of the different models in order to reduce manufacturing costs. Value analysis would help us to determine the value attached to the features of each model, with a view to providing that feature more cheaply or eliminating it altogether to save money. We might then reengineer the models so that their costs were brought down by the W$400 that is being added to the cost of each engine.

Most of the scope for modification appears to lie with the Comfort and Sport models. The Base model does not appear to be sold with any frills or features that could be taken out and so there is unlikely to be much benefit from reviewing that model. We need to be careful in any changes to the Comfort and Sport models because it is expensive to make those models and the additional contribution is relatively small.

We might start by holding focus groups or conducting surveys of existing owners of Comfort and Sport models to establish how important the additional features are to them. For example, do owners really find it more convenient to be able to unlock the petrol cap without using a key? The problem is that owners may not really appreciate the extent to which these features matter when discussing such changes in abstract terms. They may not listen to the audio system very often, but they may appreciate the fact that it is there.

Most of the scope for reducing costs would lie in the interior trim for the more expensive models. The features that are specific to the Sport model appear to be necessary to create a car that has better performance and can be driven safely. It may, for example, be possible to create a sense of luxury by replacing the leather seats with a better quality fabric.

Negotiations

In the short term, Farland's government will know that Aurora depends on the factory to build the engines for most of the cars that it sells. That puts Aurora at a significant disadvantage in any negotiations because the company must buy engines or it will go out of business. The increase will have a significant impact on Aurora, but it is not ridiculous. The company will still make a profit when it sells a car.

In the longer term, the price increase may undermine the point of nationalising Aurora Engines. It may become cost-effective for Aurora to find an alternative source of supply, which would leave the government with a worthless asset. The cost of doing business with Aurora Engines has increased in any event, because the profits made by the former subsidiary are no longer staying in the group.

Aurora might threaten Farland’s reputation as place to conduct business if the price increase remains in place. Foreign investors will be reluctant to locate in Farland as it is, but they may become unwilling to trade with the companies that have been taken over by the host government if they cannot be trusted to sell goods at realistic prices. If the government is presented as anti-business then the value of the assets that it controls will fall.

Aurora should take care not to make this dispute too public because the government’s position may become entrenched. The new government came to power because the previous government was seen to be open to influence and corruption from business interests. The new president may be willing to negotiate privately and make reasonable concessions in the process, but she may not feel that she can afford to be seen to be giving into Aurora’s demands.

SECTION 3

Consignment stock

From a cash flow point of view, Aurora is effectively giving the dealerships a loan. The cost of financing that loan will be included in the selling price to the dealerships. If the prices are to increase because of this new loan facility then the question of whether it benefits the dealerships will really depend on whether the price rise exceeds the cost of financing inventory at the moment. A great deal also depends on the rate at which dealership inventory turns over. If a dealership tends to sell cars quickly then the interest rate implicit in this agreement will be greater.

Aurora's cash flows will probably slow down because the dealerships now have up to six months to pay for inventory. Even if a car sells within six months, there will be a 30 day credit period before the car has to be paid for. That means that Aurora's cash balances will decline and liquidity may appear poor.

From an accounting point of view, this arrangement continues to pass the risks and rewards of ownership to the dealership at the time of delivery, even though Aurora remains the legal owner of the cars. The dealership is forced to retain the cars once they have been delivered and cannot return them. If a model of car, or even a car colour, lose their market appeal, then the dealership will struggle to sell them at a profit and will have to either accept a loss or pay for them after six months.

This means that Aurora should account for the cars as having been sold as at the date of delivery. That will create a trade receivable, which will be a current asset, albeit one that may take months to be collected. Similarly, the dealership will have to account for the cars as purchases even though they are not yet the legal owners.

Product bundling

The fact that Aurora's production processes are heavily automated means that it is possible to adapt individual cars that are on the production line very easily. Each car can be traced through the assembly process and the robotic workstations have the flexibility to select from different components for any given operation. So, the trim department could fit, say, one of several audio systems into any given car and customers could be invited to pay a premium for a better model than standard.

If a large number of value-added options were made available then the customer could end up paying significantly more for the car and much of that will be additional contribution. It would be attractive to buy such extras, even at a premium price, because they will be integrated into the car in a professional manner. For example, a satnav will look better and be easier to operate if it is built into the dashboard rather than being held in place with clips or suction caps.

Bundled extras may make it possible to stimulate sales at difficult times of year. The cost of adding some additional trim may be very little. For example, a radio that has Bluetooth integrated into it might cost very little more than a standard radio when Aurora buys them in bulk. Those upgrades could be valued by customers and their limited availability might encourage them to buy.

Customers are likely to have made the buying decision before looking at the list of extras. Thus, they will buy the car on the basis of the normal retail price. They will then decide which extras, if any, that they wish to buy. If they cannot afford to upgrade then they will still buy the basic car, which will generate some contribution for Aurora.

SECTION 4

Political risks

Political risks are likely to come from politicians who are either corrupt or have extreme views or from social unrest. It would be sensible to start by looking at the recent political history of the country. If there has been a tendency to elect moderate governments that are keen to engage with the global economy, then there is unlikely to be a serious problem. We should also consider the social conditions. If there are issues of disorder or protest, perhaps driven by minorities who have extremist view, then there will be a far greater risk of conflict.

We might draw some comfort from the presence of other multinational investors. If the country has a history of coping with inward investment and there have been very few incidents, then the risks should be far lower. Cases such as tax investigations or changes in the law to penalise companies would be signs that there could be a significant risk.

Even if the country is a low-wage economy, it would be comforting to see that there is little or no extreme poverty. Significant inequalities could create political problems such as the threat of workers being employed in inhumane conditions and the company being criticised for being involved in such an economy.

Investment

The biggest issue arising from our investment is the uncertainty concerning the future. If we were certain that the government of Farland had no intention of returning Aurora Engines to our control then we would write the investment off as a sunk cost. In that case, it would have no further bearing on our decision to proceed with the investment in the joint venture.

There is a possibility that the factory will revert to our control after two years of local ownership. It may be that the government of Farland will decide not to return the factory to our control if they fear that we will simply sell it or even close it down. It is possible that investing in the joint venture operation would cost us the opportunity to recover control of our operations in Farland. We would have to take this opportunity cost into account in deciding whether to invest in the joint venture.

The shareholders may feel that we have squandered an opportunity if we buy a share in a new factory before we have resolved the question of what will happen with regard to the existing factory in Farland. We should, at least, attempt to obtain clarification of the likelihood of the factory reverting to our control.

Response

The emergent approach to strategy formulation is regarded as a valid approach to the exploitation of opportunities that arise. Companies often face unexpected circumstances and those circumstances could provoke a strategic response that is superior to any intended strategy. Deliberate strategic direction is desirable and may even be preferable in theory, but intended strategies are not always realised.

It could be argued that accepting the opportunity to invest in the new engine design is consistent with wider strategies of developing new products and of forming strategic alliances for sharing parts and designs. The initiative for this venture may have come from Trayne Motors, but the board of Aurora should have been aware of the possibility of such approaches and they should have been receptive to the idea. The underlying strategy is wider than simply deciding to participate in this venture.

It would not necessarily have been realistic for Aurora to have dealt with the nationalisation of the Farland factory in any other way. It would be difficult to deal with such a strategic threat in a cost-effective way through foreard planning. Almost any response would have been opportunistic.