Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY AUGUST 2017 EXAM ANSWERS

Variant 4

The August 2017 exam can be viewed at

https://connect.cimaglobal.com/resources/august-2017-management-case-study-variant-4

SECTION 1

Overseas subsidiary

The fair value of our consideration will be measured in W$, so the fact that Beaucar is based in a foreign country will have no impact on the cost in Aurora's financial statements. The fair values of Beaucar's assets will have to be determined and those values will probably be expressed in terms of S$. In the first instance, goodwill will be calculated on the basis of fair values, translated into W$.

When we prepare Beaucar's financial statements we will have to translate the net assets into W$ at the closing rate. That could create exchange gains or losses in the event that the closing rate is different from the rate at the date of acquisition (or the opening rate for the year in the event that we are preparing group accounts for subsequent years). These gains and losses will not be accounted for any differently to the equivalent gains and losses shown in respect of existing subsidiaries that were not acquired as going concerns.

We will have a similar issue with goodwill. The goodwill figure is translated every year at the closing rate, creating the likelihood of a translation gain or loss. We have made a 100% acquisition, which simplifies the calculation of the exchange gains and losses because there is no NCI.

The exchange differences will be recognised in other comprehensive income and taken to a separate reserve. That reserve balance will accumulate unless we ever dispose of Beaucar, in which case it will be recycled through profit or loss.

The income statement will be prepared in S$ and translated at the average exchange rate for the year. That will require further adjustments to the currency gains and losses.

KPIs

The purpose of KPIs is to identify the factors that are important to the ongoing business while Beaucar is in this transitional stage. There are short-term issues to do with maintaining Beaucar's reputation for quality and luxury.We also need to measure performance in such a way that Beaucar's management maintains the company in a fit state to meet Aurora's needs once the modernisation is in place.

In the short term, we need to ensure that Beaucar continues to hand build luxury cars to the highest standard. The company almost certainly has KPIs in place to measure the effectiveness of quality control procedures and those should be monitored by Aurora. The concern would be that low morale following the takeover would lead to production staff permitting standards to slip or cutting corners. Adverse publicity arising from the sale of cars with defects will undoubtedly tarnish Beaucar's reputation and that loss will be difficult to recover.

We also need to measure staff turnover and encourage management to prevent the loss of skilled craftspeople. Concerns about automation and modernisation might leave staff afraid that they will be made redundant and so they might start looking for jobs. Making staff retention a priority and measuring the loss of staff will signal that Beaucar's management should aim to retain employees.

Beaucar's management team will also have to accept some responsibility for the implementation of the new technology and we might introduce KPIs for dealing with those. One obvious performance indicator would be adherence to the timetable, with adherence to the timeline being followed closely. There may also be more specific milestones such as the training of skilled workers to integrate themselves into an automated environment.

SECTION 2

Disciplinary action

The root cause of these mistakes should be investigated before any decision is taken. If there is evidence of carelessness then it would be appropriate to take disciplinary action. That would have the effect of sending a clear message that management takes such behaviour seriously and it should deter others. Any action should be realistic and proportionate, otherwise it could harm morale if employees are afraid of, say, being dismissed because of an error. Ideally, there should be a scale of responses, with informal discussions initially, building up through formal reprimands for repeated or very serious misbehaviour.

It may be more effective to offer additional training or counselling in case the problem is a lack of familiarity with the new technology. Staff are used to a low-technology environment and they may be intimated by the new regime. Additional training will ensure that they have the skills and confidence that they require to do their jobs properly. Removing the threat of disciplinary action in the first instance will encourage employees to be more open about the reason for their mistakes.

Redundancy

It may be expensive to do so, but Aurora could announce that there will be no redundancies for at least the first six months of operations or even the first year. That would give employees the confidence that their jobs are not under immediate threat and they would have an incentive to stay on and build cars to a high standard. Aurora should see this as being equivalent to purchasing an option to retain these employees. It will be expensive to replace these skilled people if they leave because of a fear of redundancy. Aurora should also identify any jobs that are regarded as secure in any case. For example, it may always be necessary to fit trim by hand and the workers who are skilled in that area will appreciate that confirmation.

As time passes, we should keep employees informed of progress and the likelihood of jobs being lost. It will be obvious to them if they are under employed on the factory floor and so there is no point in being dishonest. If the decision is taken to reduce staffing then it might be sensible to have a single round of redundancy, with a clear undertaking that there will be no further cuts for a designated period. Making the redundancy terms attractive and attempting to make redundancies voluntary will encourage staff that it is worth staying. If staff believe that taking another job and resigning will cost them a generous redundancy payment then they will be less likely to leave.

Kaizen costing

Kaizen costing could create a rather negative mood amongst the workforce. There is an expectation of continuous, incremental change. The Beaucar assembly staff are going through a significant transition to a completely different work environment and they may feel that further change is unsettling. The constant search for further efficiencies may be viewed as suggesting that the employees are not doing their jobs correctly and that could lead to resentment. Some of the issues raised at this stage may be due to teething problems arising from implementation rather than genuine opportunities to improve efficiency.

The emphasis in Kaizen costing is the reduction of variable cost, which could be at odds with the creation of luxury cars. While cost is always an issue and savings are always desirable, there could be a tendency for that to compromise build quality. It could be possible for, say, a door hinge to be fitted just a little more quickly, but the end result may be inferior. The craftspeople in the factory may be concerned that their new factory manager's origins in an ordinary, automated car factory mean that their skills are not valued.

SECTION 3

Cost plus 20%

The behavioural consequences of the transfer pricing system will be highly significant because Beaucar has only just joined the Aurora Group and it will be unsettling to its management team if they feel that they are not receiving full credit for their contribution to group profit. The fact that the transfer price is set on the basis of cost plus implies that the suppliers within the Aurora Group have no great incentive to keep costs under control and they may wish to overstate the measurement of their costs in the process. Given that Aurora organises production on a global basis and attempts to use parts as widely as possible, it is highly unlikely that Beaucar's management will have sufficient autonomy for these concerns to lead to overt dysfunctional behaviour. For example, it is unlikely that there is any choice but to use the Aurora engine.

The fact that Beaucar retains its own design team and has some say in the question of the suitability of parts could mean that a cost plus basis will lead to frictions during the design process. Beaucar's designers could find themselves under pressure from their own managers to design cars so that materials such as floor pans are unsuitable. Such behaviour could be dysfunctional because Beaucar can afford to pay anything up to 20% more than the original cost charged by Aurora.

Presumably, Aurora has sufficient manufacturing capacity to meet its existing needs in addition to supplying Beaucar, otherwise that would have to be taken into account in setting the transfer price. It may not be necessary to add as much as 20% to cost in order to motivate the centres supplying parts to Beaucar. Any transfer price that exceeds the marginal production costs of the additional output should encourage optimal behaviour.

From a purely motivational point of view, the cost of the parts derived from the Aurora Towncar is S$82,625. Adding a 20% margin to that will increase Beaucar's costs by S$16,525, which is a significant percentage of the profit per car shown on the costings. That means that Beaucar will show very little profit on every car that it sells, while Aurora's other group members will be showing a profit. That could threaten the workforce as well as the management team because they will be concerned that their jobs are at risk if their subsidiary is loss-making.

Segmental analysis

The first issue is whether Beaucar will create a new reportable segment of its own. It is almost certain that Aurora's board will receive separate reports on each brand of cars made by the group in order to monitor overall performance. The high level of aggregation in the segmental report at present (cars v vans) may be acceptable if all cars are subject to the same degree of business risk. It could be argued that Beaucar is likely to create a separate category of risk because it is taking Aurora into a new market, one for luxury, hand made cars. If that is the case then it would not be appropriate to combine Beaucar with the other segments.

If Aurora's board acknowledges that Beaucar is a reportable segment then it seems likely that the board will have to offer a further analysis that breaks non-luxury cars down to some extent. The markets for different sizes and categories of cars will differ because they are bought by different types of user and are subject to different competitive pressures. For example, small, economy cars are more likely to appeal to private individuals and larger saloons may be more acceptable to company buyers. The provision of additional analysis may actually help Aurora to appear more transparent and that could increase shareholder confidence.

The final issue in the treatment of joint costs and inter-company profits. Aurora will have to reconcile its totals for revenue and profit to allow for the internal transfers and allocations. The calculations may be quite complicated in the case of Aurora because of the significant sharing of components between models. This will also increase the subjectivity associated with determining each segment’s results.

SECTION 4

New model

Management issues

The management objective for this project should be specified in detail. For example, te team could be told to design a suitable car for Beaucar in a timely and cost-effective manner. In the first instance, the project team needs to be given some basic parameters, such as the broad features of the new model and the deadline for the completion of the work. These parameters should be given to the project team, otherwise the project will not have a clear objective and the design may turn out to be too radical or too expensive to manufacture.

The team should also have a detailed brief with regard to integrating the design into the context of Aurora. For example, should the basic components be adapted from existing designs produced by Aurora or should the team be free to design the car without any such constraints? The problem is that Beaucar's designers have never had to account to an external board and have never been required to use existing components and so it is important to clarify these matters.

Leadership issues

The membership of the team will require careful thought because this is the first time that Beaucar's designers have created a car for the Aurora Group. It would probably be desirable for the team to be led by an experienced designer from Beaucar and, indeed, for most of the team to be drawn from Beaucar's design department. Aurora should have one or more designers act as observers in order to advise on how best to design a car that will satisfy the Aurora Board's needs.

The team leader should be told to work closely with colleagues from Aurora in designing its cars, with the outputs and interim reports in accordance with Aurora's norms. That will offer a very clear reminded that Beaucar is no longer an independent entity that can do things in its own way. The standardised outputs will also assist in communicating the design team's needs to other parts of the Aurora Group.

Pricing

Beaucar will always charge a premium price for its cars. The designs will always be luxurious and customers will be happy to pay the associated high price for such luxury. The new design could capitalise on that, working on the basis that demand is relatively inelastic. The design team could add features, possibly using technologies developed elsewhere in the Aurora Group, so make the new car even more exclusive. A faster or better-equipped model could be sold at an even higher price than that commended by the last of the hand built cars.

Alternatively, Beaucar could capitalise on its brand name and image to develop a luxury car that can be sold at a lower price point. The company might employ focus groups and talk to existing customers to determine whether it would be possible to use the potential cost savings associated with automation to create a design that can be sold at a more accessible price point. The design team's brief would then be to develop a product that epitomises Beaucar, but that can also be sold at a price that is accessible to a wider market. Clearly, the intention is not to design a “mass market” car because that would undermine the brand’s credibility.

This would also offer an opportunity to develop an approach to product bundling, possibly using parts sourced from the Aurora Group. Beaucar could offer a wider range of options and accessories to go with its new model. These would, of course, be added-value items that would be sold at a profit. This would add to the sense of exclusivity because it would give customers the ability to customise their new cars and to own vehicles that are potentially unique. It might also enable dealers to sell cars on the basis of the basic price of the car, before adding a significant amount to the price when specifying extras.