MANAGEMENT CASE STUDY AUGUST 2017 EXAM ANSWERS

Variant 5

The August 2017 exam can be viewed at

https://connect.cimaglobal.com/resources/august-2017-management-case-study-variant-5

SECTION 1

Competitor analysis

Arguably, any car design involves a number of compromises between, say, performance and economy. Aurora faces the same challenges as any other manufacturer in that any given design of car will be unique and most manufacturers will attempt to differentiate their products by focussing on those differences. It is, however, possible that there will be trends and even fashions in terms of determining which attributes are promoted most heavily. For example, the prices of electronic accessories such as satnavs may fall to the point where they can be fitted as standard in even base models.

Clever marketing can alter customers' perceptions of what they need from a product. That is particularly true of products that involve status and satisfy emotional needs as well as practical, such as cars. Careful management of design and marketing can enable car manufacturers to persuade customers that a particular criterion should determine buying decisions. If done properly, that can mean that the manufacturer can be ready to launch a new product with the marketing message attaching heavy emphasis to one particular feature, such as being the fastest car in its class.

Ideally, Aurora will lead such trends rather than follow them. Being the first to market with a particular feature will create a sense of innovation and it will gather more publicity. However, it may prove difficult to change customers' perceptions in the face of an aggressive marketing campaign from competitors. Persuading customers to buy a car because it has good fuel economy may be difficult if Platt has already convinced them that speed is all that matters. It may be far more realistic to follow a successful lead introduced by a competitor and to position Aurora's product range to capitalise on that lead in the short term, with a view to leading the next wave when customers start to get bored and need a change.

One major advantage of following competitors is that competitors may be vulnerable to improved versions of existing designs. For example, if Platt is selling its cars on the basis of performance then it is likely to be possible to adapt existing designs to make them faster than their counterparts in the Platt equivalents. Customers are likely to be open to such a tactic because they have already been persuaded that performance is key and so it may be more cost-effective to simply surpass Platt's designs than to create a whole new trend.

Key risks

The most obvious problem is that making a car that is very fast will encourage reckless driving if buyers are determined to take advantage of the additional power. There could be a spate of accidents due to a combination of aggression and a lack of skill in handling that power. Aurora may well find its reputation being damaged by complaints that a dangerous product has caused death or injury. Even if the real culprit is the driver, who is responsible for choosing to drive faster than road conditions would dictate as being safe.

One response to mitigate this risk would be to make the cars too expensive for most drivers to afford. Aurora might also advise insurers that the car is potentially more dangerous than ordinary models and that a high premium should be charged. That would enable Aurora to incorporate the new models into its advertising and so benefitting from a 'halo' effect, without many of these cars actually appearing on the road. That might restrict sales to a clientele who are more mature and who already own quite powerful cars and so the high performance may be less likely to be abused.

Another risk is the threat that competitors will respond by increasing the power and performance of their own cars so that ours are no longer the fastest. If we respond then that may prove expensive because each incremental boost in performance is likely to be disproportionately expensive. There will also come a point where a car cannot be made any faster while remaining legally driveable on public roads.

The most effective mitigation is probably to avoid the threat altogether by building high-performance cars in line with the new trend, but promoting them on the basis of a subjective feature such as styling or driving pleasure . If the cars are designed so that, say, the suspension and brakes make it pleasurable to drive the car when using its speed and acceleration in a responsible manner then it will be difficult for a competitor to claim to have surpassed that. Such an approach also creates the possibility of showcasing Aurora’s engineering skills to best advantage, which might enhance the company’s reputation further.

SECTION 2

Disposal of subsidiary

The most immediate impact will be that Track's net assets of W$480m – 28m = W$452m will be compared to the consideration of W$150m, creating a significant loss on disposal. That loss is likely to be a significant percentage of the Aurora Group's profit for the year. That loss will not be adjusted to take account of unimpaired goodwill being eliminated because Track was 'created' meaning that it would never have been purchased as a going concern and so goodwill would not have arisen. Similarly, there is no NCI to offset against the potential loss because Track is 100% owned.

On an ongoing basis, the subsidiary's sale will reduce group revenues by a relatively small proportion. The cost of sales will also be avoided, although many of those costs will be in the form of purchases from fellow group members and so the group's earnings might not increase by much, if at all. The statement of financial position will also be enhanced by the elimination of the cumulative loss earned post acquisition and that will increase retained earnings slightly. The overall impact on an ongoing basis is really too small to matter.

Relationship with finance function

It would appear that the finance function has failed to take the initiative in developing a working relationship with Track. The impetus behind the creation of Track would have led to the recruitment of managers and staff who were keen to meet customers' needs for racing cars and those professionals are unlikely to regard finance as a priority. The finance function could have met with Andy Barr at an early stage to discuss the ways in which it could offer support in terms of feeding back on Track's financial performance. The finance function would have had to take such an initiative, or have been sent in by Aurora's management, because the management at Track would have had little incentive to seek out this support.

The finance function should have paid closer attention to Track's financial performance. It is likely that Track is a very small part of Aurora and so it may have been relatively easy to pay little attention to it in the initial stages. Ideally, a realistic response to the early losses would have led to a dialogue with Andy Barr. That would have made it clearer that it was unacceptable for Track to sell cars at less than cost. Any such discussion should have allowed for the possibility that the nature of Track's business model would make it difficult to guarantee that every car would make a profit.

Race wins

The initial reasoning for the creation of Track has been to 'meet the needs of racing enthusiasts'. That implies that Track was established to create fast cars in response to demand. Presumably, initial sales must have demonstrated that there were customers willing to buy Track's output because it would not have had the opportunity to see its cars perform in races at the time of its creation. It should have been possible for Track to structure sales contracts in terms of the specific parts and modifications that it would fit to any given car being ordered. That would make the customer responsible for the cost-effectiveness of any given components. More expensive parts could be obtained and fitted at an agreed price at the outset of the build.

Track should be able to demonstrate a value to Aurora in terms of non-financial indicators other than race victories. For example, Track's engineers will be developing an understanding of new technologies that could have potential application to Aurora's road cars. The number of technical innovations attributable to Track would be well worth monitoring. There should also be a realistic evaluation of the positive publicity created by Track. Many of the customers who buy and race Track's cars are competing in races that are not widely publicised in the media and so Track's reputation may be high amongst amateur and semi-professional racing drivers, but nobody else. Ideally, Track should have been evaluated in terms of the number of positve news stories in the mainstream media.

SECTION 3

Pricing

We need to be careful when pricing Velocity because we could end up drawing demand away from the existing Sport models. If Velocity is only a little more expensive and is significantly more desirable, then customers may be unwilling to buy Sport. We might aim to skim the market by setting a significant premium over the cost of Sport for Velocity, in the hope that there will be enough customers who would be prepared to pay this premium price. Skimming might also underline the exclusive nature of the car and would perhaps make it even more desirable.

We need to be aware of the pricing of similar high performance models that are sold by our competitors. Demand for Velocity may be relatively inelastic in the sense that many enthusiasts will pay very little attention to the price when the car is being considered on its own merits. Demand is more likely to be elastic with respect to the premium being charged by Aurora over a comparable model sold by, say, Platt Motors. This is a complicated matter that will be linked to the perceived benefits of the car, which may require Aurora to engage and interact with potential buyers.

There could be indirect pricing issues in terms of the features that differentiate Velocity from Sport. For example, if Velocity has different and distinctive wheel rims then it might be worth selling those as an upgrade to Sport. The upgrades could be sold at a significant margin over the cost and so few customers could afford many of these options, so it would not be cost effective for a customer to specify them all and end up with a car that looks like Velocity. This would effectively amount to a further use of price skimming. Dealers might be given some discretion over the pricing of such options in order to boost sales of Sport at difficult times of year when there are fewer active car buyers.

Integrating Track

The first problem with integrating Track is that the company’s engineers are concerned with making cars as fast as possible to win races. They have not had any particular responsibility for doing so in a cost-effective or commercially viable manner. That might lead to conflict between Track and the research and Development department.

The most practical response to this would be to put Research and Development’s staff in charge of the project and to ask Track to support them as and when requested. That would enable Track to develop, say, an exhaust system that will maximise the flow of air through the engine, thereby improving that aspect of performance. Research and Development could then evaluate the results and decide whether the improvements are worth the extra cost.

The second problem is that Track does not have any particular expertise or experience of mass production. All of the cars that it has produced are essentially already built and Track then adapts and modifies these cars by hand. That could lead to problems whereby a design feature would add only a small amount to performance, but could lead to a significant increase in the cost of production.

It might be possible to second some of Track’s engineering staff to an assembly plant, just to learn more about the issues associated with mass production.

Observing the different processes might make it easier to see how much effort, say, adding an additional fastener to secure a component adds to the difficulties of assembly and quality control. This could also create opportunities for Track's engineers to see opportunities for the efficient and cost-effective addition of features to the design.

SECTION 4

ABC

The basic question is whether ABC would provide any meaningful insights that would justify the additional costs of setting up and operating an ABC system. It would be necessary to identify the cost drivers that create the various factory infrastructure costs and to investigate how much each product costs. In principle, we could obtain some useful insights. For example, we might discover that some products are more expensive to produce than we had first imagined.

Taking the costings for the Aurora Saloon as representative, the first thing that we see is that production overheads are actually only a relatively small proportion of total manufacturing costs. That suggests that we need to focus our attention on the direct manufacturing costs because the overheads are relatively insignificant in determining overall costs. There is still a theoretical possibility that some feature of, say, making the Comfort model attracts a disproportionate overhead cost, but that seems unlikely.

The fact that each car is built in its own dedicated assembly plant further undermines the argument for implementing ABC. We know that the manufacturing overheads relating to Aurora Saloon are accurate as far as the model as a whole are concerned because they can be linked to that factory. The fact that there are only three models, all broadly similar, reduces the scope for identifying anything surprising about overhead costs.

The final issue is the extent of the automation, including the ability of the robots to adapt as they go. We do not have to stop the production line and reconfigure in order to set up for a switch to a different model. Even the selection of different parts for the optional extras is done automatically and without any interruption of the process.

Segmental reporting

Insufficient analysis

IFRS 8 permits us to aggregate segmental information, provided we meet the criteria set out in the standard. The initial question is whether the different models that Aurora produces have different economic characteristics. That cannot be determined simply by asserting that they are different. We would have to establish whether the factors that affect demand for, say, Economy v Comfort are different.

If we determine that these potentially reportable segments do have different characteristics, then we will have to consider their materiality. If some categories sell in very small quantities then it might be argued that the breakdown would add very little in the way of useful information. Apart from the criteria set out in IFRS 8, it might also be helpful to compare Aurora's disclosures with those of other manufacturers. It would be very unusual for any company's segmental analysis to report each separate product.

Ethical issues

Meeting the letter of the IFRS while disregarding the spirt falls within the definition of ‘creative accounting’. That undoubtedly breaches the principle of integrity because it is hardly straightforward and honest to adhere to a rule in a potentially misleading manner. Creative accounting creates the impression that the financial statements have been prepared honestly when, in fact, there is missing information.

This approach also breaches the concept of professional behaviour because it undermines the credibility of the accountancy profession. Users of financial statements will be concerned that the information they received was incomplete, but they will be even more concerned to learn that the incomplete information complied with the standards. Creative accounting can only create the impression that the accounting standards are inadequate and that the profession does not meet users' needs.