

MANAGEMENT CASE STUDY MAY 2015 EXAM ANSWERS

Variant 2

The May 2015 Exam can be viewed at

<https://connect.cimaglobal.com/resources/management-case-study-exam/may-2015-management-level-case-study-exam---flote-variant-number-2>

These answers have been provided by CIMA for information purposes only. The answers created are indicative of a response that could be given by a good candidate. They are not to be considered exhaustive, and other appropriate relevant responses would receive credit.

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

Trigger (a)

Comparison of operating costs

There is a strong argument for stating that SeaLode's operating costs are better controlled than Flote's.

Firstly, SeaLode's total costs are significantly lower than Flote's when expressed as a percentage of revenue. Some of the costs are not directly comparable, though. One obvious example is that SeaLode does not operate its own terminals and so it does not incur any terminal running costs.

SeaLode's revenues have increased slightly since 2014 and yet total operating expenses have decreased. Flote has cut back far more significantly with a decrease of approximately 10% in revenue and a reduction in operating expenses of roughly 12%. SeaLode's figures actually look healthier because Flote has put some ships into storage and cut back hard on staff salaries. SeaLode has managed to avoid such aggressive cost-cutting moves, which suggests that the company is maintaining and utilising its overall capacity and has avoided damaging staff morale.

Flote's cost of bunker fuel is much greater than SeaLode's, which implies some inefficiency because they have similar numbers of ships. It may be that the difference is partly due to the fact that SeaLode operates a range of different ship types and the routes followed by, say, tankers or bulk carriers could be more direct and use less fuel

SeaLode's intermodal costs are much less than Flote's, although that could be a reflection of different systems for loading and unloading. For example, SeaLode's tankers and bulk carriers will be loaded and unloaded using pipelines, which will be much less labour-intensive to operate than the cranes used for Flote's container ships.

SeaLode spends significantly more on wages and salaries and perhaps the greater efficiency is due to SeaLode employing better qualified staff who can work more efficiently or perhaps SeaLode has effective incentive schemes in place that motivate better performance.

SeaLode charged significantly less than Flote in depreciation, amortisation and impairment. It is debatable whether the costs are comparable because of the discretion involved in setting such accounting estimates. But it could indicate that SeaLode has a more effective maintenance strategy that offers a longer expected useful life for the ships or SeaLode uses less expensive ships to service its operational needs.

SeaLode's business model

The fact that SeaLode has both increased its share price and almost maintained its operating profit is a healthy sign with respect to the business model. Flote has enjoyed a much more modest growth in share price and its operating profit has been less robust.

The two main differences between the companies is that SeaLode is focused entirely on shipping and it offers a range of different shipping systems. The concentration on shipping gives SeaLode far greater flexibility compared to Flote. If the area around one of Flote's ports suffers an economic decline then the port will be adversely affected, at least until the area recovers. Ships that are being used on unprofitable routes can be sent to a more prosperous region with little incremental cost.

SeaLode also has greater diversity in its fleet. Container ships can carry many different products, but a global recession will reduce demand for the transportation of many of the finished goods that are shipped in containers. There will be a demand for the products that are carried by SeaLode's tankers and bulk carriers regardless of the state of the economy. There will always be a demand for crude oil and fuel and the bulk carriers will transport food staples such as grain and rice.

Overall, SeaLode has been able to generate a much greater contribution from its operations than Flote in both years for which we have data.

Flote could enter the markets for tanker and bulk carrier operations, but that would require significant investment in the necessary ships. It would be expensive to compete with SeaLode in those markets. It would also be necessary to find customers who ship the products transported by SeaLode. It is unlikely that many of Flote's existing customers would require both tankers and bulk carriers in addition to container ships because they are likely to be used by very different industries.

Trigger (b)

Comparison of financial performance

The most immediate and important difference is that SeaLode has a much higher return on capital employed than Flote, which implies much more effective management of assets. I am, however, concerned that SeaLode's ROCE was suspiciously high in 2013 and has remained at exactly the same level in 2014. The figures seem suspiciously high, as if they have been manipulated somehow. One possibility is that SeaLode's assets have been understated because of an off-balance sheet financing arrangement. The book value of SeaLode's property, plant and equipment is lower than Flote's book value for ships. If SeaLode has other items included in PPE other than ships then it may have some assets off balance sheet.

SeaLode's gearing ratio is very similar to ours, despite the fact that their strong profitability could have supported additional borrowing in order to expand even further. That could support the argument that SeaLode has not reported all of its borrowings in order to lease assets off the statement of financial position.

The difference could also be due, at least in part, to greater efficiency in operations. SeaLode has the same number of ships and no other source of income and yet their revenues are much higher than ours. Perhaps they keep their ships operating at close to full capacity whereas we do not. Or perhaps they use older or less expensive ships than we do so that their asset turnover is much better than ours.

SeaLode's performance has surged in 2015. Perhaps they enjoyed the benefit of a windfall that has skewed their results. For example, a major government contract that was highly profitable could have boosted their results in comparison to ours.

Oil prices

Flote's absolute cost of bunker fuel is higher, so any decrease in the price of oil should give Flote a larger benefit in terms of reducing fuel costs. Clearly, both companies will benefit and SeaLode's ability to operate more efficiently will continue to be an advantage even if bunker fuel is less expensive.

Oil prices could have an impact on demand for both companies' services. If oil is cheaper then there is likely to be greater demand for tanker shipping and so SeaLode will see an increase in revenue from that. It is possible that the factors that affect oil production will change the supply side. For example, some oil exporters may actually reduce production and so SeaLode may lose some of its existing demand.

Both companies may also see an increase in demand if the reduction in oil prices stimulates global trade. Cheaper oil will reduce many manufacturers' production costs. Consumer disposable income may also increase, stimulating demand and therefore production of goods. In the short to medium term that will stimulate demand for container shipping and so both companies will benefit from participating in a larger market. SeaLode may see greater need for some bulk carrier cargo, such as iron ore and coal if the decline in oil prices stimulates demand for items such as cars that require more steel.

It may be difficult for Flote and SeaLode to take full advantage of any increase in demand because there is surplus capacity in the shipping market. It will be possible to compete for the additional demand, but it may be difficult to increase prices in doing so because other companies will bring ships out of storage.

Balanced scorecard

The three remaining quadrants are discussed below:

The customer perspective

The key here is to appear efficient and reliable to our customers.

We might, for example, measure our revenues in order to establish whether they are growing, both in terms of the financial value of sales and the number of containers shipped.

We should review our customer lists. Are we retaining existing customers and are we finding new customers? Repeat business suggests that existing customers are satisfied and new customers imply that our reputation is satisfactory.

How do customers respond to requests for feedback? Do we receive positive scores for the quality of our service and do customers indicate that they will do business with us in the future?

Internal process perspective

What must we do well in order to satisfy our stakeholders and customers?

Factors such as delays and late deliveries must be measured and analysed. Delays due to avoidable matters, such as missing berthing slots or breakdowns attributable to poor maintenance are more serious than delays due to factors such as adverse weather conditions.

What are the numbers of claims of damage to containers that were in our custody? Customers need to be satisfied that their goods are in safe hands and are protected against loss or damage.

How efficient are our loading and unloading procedures? Ideally, we would wish to load a container at the port of origin and unload it for the first time at its destination. If we stack containers efficiently then the number of intermediate movements will be minimised, although it is unlikely that we could ever eliminate this.

Learning and growth perspective

What do we need to be able to do in order to achieve our vision?

We should study the competencies that our staff require and chart our progress in supplying them. For example, our crews must be qualified to operate and maintain our ships as efficiently and effectively as possible and we can measure training days and qualifications obtained.

Given the small sizes of our crews, we should consider the extent to which cross-training is provided to ensure the best use of staff. For example, training all crew members in advanced first aid will negate the need to carry medics.

We should link incidents to training needs. If, for example, damage to cargoes arises because of crane handling then we should ensure that crane operators are better trained.

Trigger (c)

Implications for accounting information systems

The system will have to identify containers that are available for rent. That will require a change in the booking system, because Flote cannot necessarily tell whether a container being booked into the system is full or empty.

The system will have to make it possible for customers to state whether or not a container is both empty and available for use in return for a fee. If bookings are made online then it will have to be clear that these bookings are available and customers will have to know how to book them correctly.

The system will have to be able to cope with the additional demands of routing more container journeys and tracking the containers. Containers that are to be rented from their point of origin to their final destination may have to be taken to a holding area, then to the rental customer for filling, then to the cargo destination, then back to the container's owner. That is potentially four journeys in place of one.

The system will have to enable Flote to schedule the rental of empty containers so that they know where empty containers can be shipped to on this new basis. It may prove troublesome to return a container from some local destinations because they will have to be delivered by road or by rail and the associated inconvenience and cost could outweigh any income from the container rental. Flote Logistics will have to develop an effective algorithm for determining which journeys are viable for rental customers who are looking at the availability of containers.

The system will have to cope with calculating rental fees and establishing how these are to be shared between the container owners and Flote. There will be accounting issues, with large numbers of invoices for the rentals. This system will generate large numbers of relatively small payments to third parties and it will have to incorporate acceptable controls to ensure that Flote is not defrauded.

Relationships

The relationship will be complicated because all three parties will have needs that are potentially in conflict. The new venture will be more successful if all three parties are very flexible. For example, an empty container will be more likely to be rented if the owner can wait longer for its return. If the parties are unwilling to compromise then there may still be cases where a renter can be found with needs that match the availability of an empty container, but the potential benefits will not be as great.

The starting point really has to be the container's owner. The owner has to state when the container should be returned, even if the return journey is to be empty. Flote can then maintain a database of available containers, with details of space on ships. In principle, if a container is not needed urgently then Flote could rent it out for almost any journey regardless of the direction of travel, provided there was capacity on ships that would permit the rental customer's goods to be delivered and the container to be returned to the container owner.

The three parties need to reach agreement over questions of liability. For example, who will bear the cost of goods are damaged because of a fault in a container? Who will be liable if a delay occurs in the return of a container which causes its owner some inconvenience?

Flote also has to take care not to make this service too efficient or it could lose revenue. This facility effectively reduces the number of containers being carried, each of which generates revenue for Flote. Flote may benefit if customers believe that the service adds value. For

example, the container owners may use Flote rather than competitors if they can offset rental charges against their shipping costs and rental customers may be new customers who would not otherwise use Flote.

Trigger (d)

Describing the environmental benefits

The fact that many containers are transported empty means that a potentially significant proportion of the emissions and other adverse environmental effects caused by container shipping could be said to be unnecessary. Flote could claim to be saving that proportion of the emissions and consumption of scarce resources. This would reduce the number of voyages by ships and by trains and trucks.

The ethical problem is that the claims could be misleading because they are likely to overstate the environmental benefits. It is unlikely that this venture will reduce the number of journeys made by container ships because it is unlikely that it will be possible to eliminate sufficient container movements to do so.

Arguably, many containers will have to make a larger number of land-based movements and so the venture might actually increase environmental damage. The proposal may require more diesel for trains and trucks to move empty containers from the container owners' point of delivery to the rental customers' point of loading.

There could even be an argument that Flote will encourage more goods to be manufactured and shipped if it manages to reduce the cost of shipping.

Overall, it is likely that the proposal will have some environmental benefits, but they are likely to be marginal. In that case, it would be unethical to claim that the primary aim is to reduce environmental impact.

Challenges

It may be difficult to recruit good staff because team members, particularly managers, may regard the venture as high risk from a career point of view. If the venture fails then those associated with implementation may feel that there is a stigma associated with failing to deliver on a highly visible project.

Staff may be defensive and unduly risk-averse in their initial operation of the scheme. They may invest too much time and effort in sending defensive memos and emails to senior management to justify any decisions and to seek unnecessary guidance and feedback.

These concerns are likely to be compounded by the fact that the new venture is likely to start slowly. The first requirement will be to encourage container owners to sign up and to keep patience if there is little immediate demand. Then the rental customers will have to be identified and encouraged to use the service.

Flote may struggle to motivate managers to support and encourage the new venture because it may be viewed as competing with the mainstream business for revenue as well as for resources. It may become difficult to motivate the sales staff and others who have contact with customers to promote the venture or to point out that it may be possible to rent space in an empty container instead of making a traditional booking.