

MANAGEMENT CASE STUDY MAY 2015 EXAM ANSWERS

Variant 3

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-3>

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Trigger (a)

Cost impact of re-registration

Arguably, the operating costs will change very little in total, and may even increase.

We can expect a number of costs to remain unchanged: port charges and fuel account for more than half of the cash-based operating costs and they are unlikely to be affected by re-registering.

Insurance costs may increase because insurers may be nervous about Flote's ships being maintained to a lower standard. We may be able to convince the insurers not to increase our premium, but we may have to agree to operate the ships in a manner that equates to the standards imposed by being registered in Zeeland in order to do so.

Administration costs may reduce slightly because we will have less supervision from the registration authorities. Although that cost may be offset by the additional disclosures and negotiations that we have to make with our insurers.

Repair and maintenance costs could reduce if we believe that our ships are being maintained to an unnecessarily high standard because of Zeeland's regulations. We may be able to reduce the frequency of checks and inspections and to carry out less frequent preventative maintenance.

The cost of depreciation may also reduce if the less stringent requirements mean that our ships can have longer useful lives. Zeeland's regulations may make it cheaper to scrap a ship than to maintain or repair it to Zeeland's high standards, but lower standards could make some of those costs discretionary.

Crew costs are unlikely to change significantly because we will probably still require the same size of crew regardless of registration. We may be able to employ less qualified crew members because the technology associated with ships is improving and potentially replacing the need for highly qualified crew members. We may be able to spend less on crew safety and first aid training by offering our own unaccredited course that covers the same material, but does not carry the cost associated with being certified.

Downside risks

Customers may be reluctant to entrust us with valuable cargoes and so we could lose revenue. At present our ships are registered with a strict jurisdiction, which means that our ships are likely to be, and are perceived by the customer to be, safe and reliable. Those perceptions could change in the event that we register with a less stringent authority. The fact that we are changing registration means that customers will have no way to be certain of the standards to which we will operate in the future, or how that might affect our reliability.

Port authorities may be reluctant to trust us to use their facilities. Cargo ports tend to be associated with busy waterways and harbours require careful manoeuvring. There may be concerns that our ships will be more likely to cause delays or to pose a risk to other shipping because of less stringent maintenance or less qualified crews.

We could find ourselves blamed for an incident and be forced to pay significant damage. At present if we were accused of negligence over, say, an oil spill we could defend ourselves on the basis that we are certified to Zeeland's high standards. If we have switched to the authority that has the lowest standards in place then we may be accused of lax standards and it will be more difficult to refute such an accusation.

The changeover could be unsettling for Flote's employees. The re-registration could be perceived to be a prelude to moving our operations overseas and making the employees based in Zeeland redundant. Ships' crews may also feel that their jobs will be at risk.

Trigger (b)

Change management process

The first step is to clarify the changes that are to be made. Flote's management should consider the possibilities that re-registration offers and decide which might be in Flote's best interests. The fact that a change is possible does not mean that it should be implemented, so this will require a careful cost-benefit analysis.

Flote should create an ad hoc team to manage the process, with a brief to start with the basic principle that the previous system was expensive to operate. The team should develop a list of options for presentation to Flote's board, with the savings and risks clearly identified for each.

The board will have to ensure that any changes that are to be made are clearly specified. For example, if the first aid arrangements are to be changed on ships then Flote's new standard of provision will have to be clarified exactly. The nature and extent of changes should be clarified so that staff do not exaggerate their importance. For example, changing safety training programmes will not necessarily expose crew members to greater risk.

Employees should be encouraged to view the changes as positive. For example, explain that reducing costs may protect job security in the medium to long term.

Motivating and inspiring crew members

Ideally, the changes should be made in an inclusive and participative manner. Crew members should be asked to comment on each specific proposal and management should demonstrate a willingness to take those comments seriously.

It may be possible to offer crews the opportunity to participate in some of the savings associated with the changes. For example, crew members could be paid a bonus for taking the responsibility for training new employees in health and safety at sea to supplement less rigorous training before joining the ship. Such participation could actually prove more effective in delivering performance, while motivating crews.

There should be clear systems for monitoring and reporting on implementation. Crew members should be empowered to feed back their opinions on the effects of the changes as part of the implementation. That will give them the reassurance that management will be given the opportunity to revise or even to withdraw any changes that are shown not to be cost-effective.

Trigger (c)

Business relationships

Ideally, any business relationship should be designed to be “win-win” for both parties. We should use our bargaining power to ensure that we obtain an acceptable level of service at a realistic cost. We should probably not push shipyards to accept unprofitable deals, otherwise we could end up with a poor quality service. Nevertheless, we have a large number of ships and their maintenance follows a schedule, so we can book the work well in advance. We can, therefore, make bookings long before work becomes urgent and so it will be difficult for the shipyards to pressure us.

Flote could exert subtle pressure by using a range of different shipyards. Every yard manager would then be aware that their work was open to comparison with that of competing shipyards. To avoid overdoing that pressure, Flote could be very specific about the standards that are to be applied in conducting maintenance. Flote's large fleet means that it has a sound understanding of the operation and maintenance of ships and the time that a refit should take under efficient conditions. Flote should express its expectations very clearly and should agree to pay a realistic fee for the work.

Flote should encourage shipyards to work for other companies, even though they are competitors. If shipyards can compete for work on the basis that they service Flote's ships and use that in their promotion then they will have an even greater incentive to keep Flote satisfied.

Engine management units

The key to minimising cost is to determine the annualised replacement costs. That requires the total net present value to be divided by the appropriate annuity rate. In the case of this exercise, that would give annualised rates of $Z\$160,700/0.893 = Z\$179,955$, $Z\$287,640/1.690 = Z\$170,201$ and $Z\$424,300/2.402 = Z\$176,644$. *This calculation was not required in order to obtain maximum marks.*) The replacement period that gives the lowest annualised cost should be selected. In terms of net present value, the cheapest annualised equivalent is to replace the units every two years. That will maximise the net present value of future cash flows and so is consistent with maximising shareholder wealth.

Having said that, the annualised cost of the two year cycle is only a little less than the costs associated with one and three year cycles and so this need not be a major factor in the final decision.

The three year cycle is potentially the most risky with respect to running costs and resale. Having said that, the cash flows may be a little less erratic because there will be no need for \$K250,000 per ship every year.

The annual replacement cycle has the advantage of relatively low risk. The resale value is relatively easy to predict. There is less risk that the unit will develop a fault that is costly to rectify.

There are non-financial issues. For example, it will be easier to maintain the units if they are replaced frequently. Indeed, they may not require any maintenance beyond routine servicing.

Frequent replacement will involve more frequent orders, which may ensure better relations with the supplier. Flote may receive preferential treatment, perhaps in terms of priority for delivery. The supplier may offer discounts and other incentives. The supplier may request feedback from Flote and so Flote may be able to influence future designs that should make them better suited to the company's requirements.

The units may be more reliable if replaced more frequently. A breakdown at sea could be dangerous and could lead to delays in shipping time.

There could be social responsibility factors. Replacing a unit every year will create far more externalities than if it is replaced every three years. Apart from the disposal of the units themselves, there will be the carbon footprint associated with delivery and safe disposal. The use of new devices could, however, improve the fuel efficiency of the ships. It may be possible to resell or trade in the devices, which would mean that another company was using Flote's old equipment rather than buying new, which would offset the footprint of frequent replacement.

Trigger (d)

Impairment review

Impairment reviews generally require a decision to be taken concerning how to determine the relevant figures correctly. The recoverable amount is the higher of two figures and both are likely to exceed the asset net book values if the depreciation policy is reasonably conservative. A rigorous impairment review would be too expensive to conduct as a matter of routine and it is debatable whether it would yield any useful information.

The problem is that any subsequent losses on the disposal of assets could suggest that management and the external auditor were reckless in failing to make impairment adjustments. There could be significant reputational damage.

Determining the recoverable amount of a ship will be complicated because it will be difficult to arrive at accurate and verifiable figures for net realisable value and net present value. If that ship is subsequently sold at a loss then it may appear that the impairment adjustments were made carelessly.

Net realisable value requires an understanding of how much a ship would sell for on the open market. Ships may change hands reasonably frequently, but it is unlikely that they will do so in an open and public manner, so it will be difficult to determine the market value of a particular ship with any accuracy.

The determination of net present value requires an estimate of future cash flows and also the discount rate. Both of those variables are susceptible to disagreement and both may change quickly in line with global economic factors. The value of cargo ships will depend heavily upon the state of the global economy, with demand for many of the goods that are traded internationally being affected by interest rates, employment levels, exchange rates and so on.

Specific problems

We have demonstrated that the demand for global shipping is depressed by virtue of the fact that we have made an impairment adjustment on our port facilities. It is a natural extension of that for the external auditor to ask why the net book values of our ships were not adjusted as well.

We have put some of our ships into storage, as evidenced by the \$Z 6 million spent on storage costs. It is difficult to argue that our ships have a healthy recoverable amount when the whole industry is taking ships out of service.

Any sales of ships that do occur at the moment are likely to be forced upon their owners. That, coupled with excess capacity, means that any sales that are observed are likely to be at artificially depressed prices.

The fact that many ships have been taken out of service means that future cash flows will be depressed, at least in the short term. Having said that, if major economies are depressed then various governments will be keen to stimulate growth and so the cost of capital may be reduced, which will partly offset the impact of reduced cash inflows on net present value.

The fact that some ships are being put into temporary storage implies that the shipping industry regards this as a short to medium term problem. Otherwise, the ships could be scrapped and sold for their metal content. That may do little to reassure the external auditor, but the ships are all likely to have an intrinsic value that is virtually impossible to observe.

Flote has the further complication of owning ships that are best suited to the transportation of manufactured goods. Any temporary decline in demand may affect container shipping more than, say, the transportation of economic staples in tankers and bulk carriers.