

## **MANAGEMENT CASE STUDY MAY 2015 EXAM ANSWERS**

### **Variant 4**

**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-4>

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

#### **Trigger 1**

##### **TQM**

The basic principles of TQM are very consistent with our requirements in this case.

The first is “get it right first time” aiming to achieve 100% quality on the basis that costs of prevention are less than the costs of correction. Clearly, safe and lawful shipping operations require that we always operate within acceptable limits because errors could lead to a serious accident.

The second basic principle is of continuous improvement, i.e. that it is always possible to improve. Maintaining an unblemished safety record could actually lead to complacency if it seems that accidents don't happen. Striving for improvement is one way to motivate crews to remain vigilant.

TQM would require monitoring of performance that should offer Flote the means to defend any shortcomings in the event of an accident.

TQM would force us to focus on the matters that would affect our safety record and so we would focus on the factors that drive performance.

TQM would provide a very visible emphasis on sound performance for crew members. Being forced to measure and report performance will deter slacking.

##### **Management reporting**

There should be frequent reports from each ship on performance, at least monthly reports on the factors that indicate that standards and quality are being maintained.

Breaches and accidents should be reported to the relevant head office departments in real time.

Ships' captains should be given prompt feedback on their reports in order to demonstrate the company's interest in performance.

Financial reports would include confirmation that budgets are being spent on designated matters. For example, training and inspections should be conducted in accordance with budgets.

Non-financial measures would be a major part of the performance report and might include inspection deficiency rates, environmental pollution incidents and time lost through crew injury. In the case of events such as injuries, the captain should be responsible for submitting a detailed narrative report on the circumstances.

The ship's instruments may be monitored electronically and transmitted back to head office for scrutiny as a further control.

### **Potential risks**

The most important risk associated with this proposal is reputational. Flote has an excellent reputation and experience of complying with Zeeland's strict maritime regulations. OceanCargo has a poor reputation at present and Flote will be exposed to criticism if it chooses to link itself to the company and is then involved in an incident.

The reputational issues may be more than public relations problems. Flote may find it difficult to obtain the necessary clearances to use ports and docks if the company is implicated in an accident. Customers may not wish to be associated with a shipping company that causes environmental damage.

Legally, OceanCargo owns the ships and remains responsible for them, so Flote would not be directly responsible for any fines or other costs, unless that was expressly imposed in the contract.

There may be problems associated with the ships that Flote is not aware of and that could make it difficult and/or expensive to discharge its obligations under the contract. Similarly, there could be operational issues associated with operating in the waters around the Sparrow Islands that make it difficult to ensure compliance with the requirements. For example, there may be very limited facilities for the safe and legal discharge of ballast.

There are upside risks. Flote may be able to generate a contribution from what is essentially nothing more than the company's good name. The cost of supervising additional crews may be very small and Flote will be able to charge a healthy margin over costs.

## **Trigger 2**

### **Motivating and inspiring the staff**

The most visible form of motivation would be to promote some of Flote's senior officers to take charge of these vessels. Captains could be moved from smaller Flote ships to larger OceanCargo ships or promoted from first mate of Flote ships to captain of smaller OceanCargo vessels. That would mean that captains would view being moved as a positive change that would enhance their career and so they would be encouraged to maintain this upward trajectory. The captains and other senior officers will set the tone for ships' operations.

All crew members should understand that they remain part of the Flote organisation. Their career advancement opportunities should not be adversely affected by serving on an OceanCargo ship. Perhaps there could be an expectation that these are regarded as challenging assignments for reliable crew members.

Training is key. All crew members should be provided with comprehensive training in Flote's procedures and the TQM approach so that there can be no misunderstanding of their responsibilities. The training will also demonstrate that the company is prepared to invest time and effort in their performance and so it must be important to Flote that they comply.

Performance should be monitored and feedback provided. It would be preferable to reward crews who meet and exceed expectations rather than simply penalise failure.

Individual performance is crucially important on a ship. Each individual crew member has a vital role to play in ensuring safe and efficient operations and that fact should be emphasised at every opportunity in training and in measuring performance.

### **Change management**

Change management affects the existing crews of OceanCargo, the Flote crew members who will transfer and the Flote crew members who will have to deal with an influx of new colleagues. These changes will have to be extremely rapid because the impetus is created by the need to retain a valuable contract. Flote will have to ensure that all of the changes are communicated clearly and that all parties are kept as fully informed as possible.

OceanCargo's existing crew will have to be notified of the proposals and the impact on their jobs will have to be clarified. In particular, it will have to be made clear whether these people will be made redundant or whether they may be invited to apply for jobs with Flote, either to continue with their old ships or to take up places to fill vacancies arising on Flote's crews.

The crew members transferring from Flote will have to be briefed very clearly on the company's expectation of them. Their responsibilities relating to the smooth operation will involve more than simply doing their own jobs properly. They will have to induct and assist new staff who are joining Flote. They will also have to do this while learning the safe and efficient operation of unfamiliar ships and navigating in unfamiliar areas.

Crew members who stay with Flote may have to deal with the distractions afforded by the possibility of promotions to fill vacancies at more senior levels. It is likely that colleagues transferring to OceanCargo operations will tend to be fairly senior. These crew members will have to deal with the social implications of introducing new shipmates into crews without leaving them feeling alienated. They will have to ensure that standards are maintained throughout the period of transition.

### **Trigger 3**

#### **Identify stakeholders**

OceanCargo will be a client of Flote because it will be dependent on us for the staffing and management of its ships' operations. Our effectiveness could have a significant impact on their reputation for safety and reliability.

The government of the Sparrow Islands will be stakeholders because the islands are dependent on shipping companies to export this important mineral. The efficiency of the ships' crews will have an impact on the local environment, which has significant implications for the tourist industry.

The crew members who work for OceanCargo at present are stakeholders because their jobs will change. Many will find themselves depending upon Flote's decisions to determine their future employment.

The importers of galgillum will be stakeholders because any disruption could affect their production levels. The Islands export one month's production at a time in a single ship, so the supply of the mineral will have a potentially erratic flow.

*Any of the other possible stakeholders should be given credit, provided there is a credible justification.*

#### **Power/Interest**

OceanCargo will have relatively little real power over Flote because it would be too disruptive to break the contract and replace Flote. Interest will be high because of its dependence on Flote to ensure that its reputation is restored through a period of sustained safe operation.

The government of the Sparrow Islands has a very high level of power because they can exclude any shipping company from their waters (indeed they have done so). Their interest is also extremely high because the foreign exchange earned from the export of galgillum depends on the availability of a safe and reliable shipper. They will also have a high interest in preserving their marine environment.

The crew members have relatively little power because there is a labour surplus in the industry. The work is also being deskilled, which makes it relatively easy to replace them. Their interest is very high because of this. They will struggle to find new jobs in the event that Flote makes them redundant because of the reputational effects of having worked for GlobalCargo.

The power of importers depends on their numbers and their involvement in the selection of a shipping company. A single importer who chooses the company will have considerable power, but a large number of individual buyers may not be able to influence this contract. Their interest could be high because they will depend on the provision of a consistent and reliable delivery.

#### **Communication strategies**

Flote should share the management reports that it prepares for its own purposes with GlobalCargo. Their client will be interested in statistics about accidents, injuries and other factors that indicate security. These reports should, however, be edited to remove any information that deals with commercially sensitive or proprietary information, such as the costs associated with servicing this contract.

The government may not require a great deal of information from Flote because it is likely to monitor Flote's actions for itself. Flote should aim to develop trust by reporting openly about performance issues, including any breaches or accidents. The government may then be more inclined to trust Flote's conduct.

Threatened crew members must be kept as fully informed as possible. Media speculation may make them feel threatened and it is in Flote's interests to keep ahead of the news by emailing crew members and sending out regular bulletins. Flote may wish to have the opportunity to make job offers to the better employees and so it is desirable to encourage them with any positive information about the criteria for being retained.

Informing the importers may be largely a matter of public relations. Flote should ensure that the importers are satisfied with the company's performance standards.

## **Trigger 4**

### **Would the new company be a subsidiary of Flote?**

The crucial question hinges on whether Flote controls Flote Minerals. Owning 20% or even 40% of the equity will tend to suggest that it does not. The fact that OceanCargo owns the other 60% of the shares suggests that it may claim to have a controlling interest, which would negate any such claim by Flote. Ownership at that level tends to suggest that the company is an associate rather than a subsidiary, but OceanCargo's potentially controlling interest may mean that Flote Minerals is not even that.

Flote will have control over the operations of the ships, which is a significant matter. Presumably, OceanCargo will retain control, through its 60% shareholding, over other important matters, such as sales and other aspects of management.

The one possible argument in favour of Flote's control is over the question of its right to block proposals. The fact that OceanCargo cannot really exercise its majority ownership without Flote's permission could suggest that Flote has something close to control, but even that would be insufficient to claim that there is a parent-subsidiary relationship.

If Flote Minerals is a subsidiary then all of its revenues and expenses will be consolidated into Flote's group financial statements. If the company is profitable then that could enhance the Flote Group's overall performance.

The bigger implication is over the subsidiary's property, plant and equipment. When the ships were transferred to the newly formed company they should have been valued at their fair value. That is actually a highly subjective figure which could have implications for the fair presentation of Flote's consolidated financial statements.

The other implication is that Flote's investment in Flote Minerals' equity would be eliminated from the consolidated financial statements and be replaced with the fair value of the subsidiary's PPE. The investment in equity would be determined as the fair value of the consideration, which would be the present value of the wages that Flote will have to pay. That is potentially a difficult estimate, but one that could be relatively small in comparison to the value of the ships, so it could have major implications for the company's ROCE.

## **Transfer pricing**

Transfer pricing is often regarded as a very contentious issue because it can have the effect of enabling a group of companies to recognise profits in countries with low tax rates. The idea is to set transfer prices between group members so that a company in a high rate country is charged more for the purchase of goods and services from a fellow group member located where rates are lower.

Some companies do consider tax to be a valid issue to be considered when setting transfer prices, although it has led to companies being criticised for failing to pay a realistic tax rate and so passing the burden of tax on to more responsible taxpayers.

The need for transparency and fair treatment suggests that one factor that should be allowed for would be the open market value of transactions between third parties. Tax authorities often insist that transfers be recorded at their arm's length price.

There is also a motivational factor to be taken account of. If the managers concerned feel that they are being overcharged or undercharged for transfers then they will be demotivated. That can lead to dysfunctional behaviour, such as the purchase of goods and services from

third parties where that would be a cheaper source than the internal transfer price offered by a fellow group member. Such transactions will often mean that the overall profit is reduced because the cost to the group of the goods is cheaper than the cost of buying an equivalent from an external source.

### **Ethical issues**

The CIMA Code of Ethics provides us with the fundamental principles of Integrity, Objectivity, Professional Competence and Due Care, Confidentiality and Professional Behaviour.

Integrity suggests that Flote should not abuse its structure to underpay tax. Tax law reflects society's needs for a fair tax charge and the use of artificial arrangements to pay less tax is arguably unethical and lacking in integrity.

Professional competence would suggest that transactions should be priced in such a way as to reflect their true costs. It is difficult to claim that the accountants have acted in a competent manner if transfer prices are set in a manner designed to understate tax or to give one manager an advantage over another in terms of management reports on profit.

There may be issues associated with professional competence because of the emotive issues associated with transfer prices. The accountancy profession's reputation is undermined when companies pay artificially low tax charges. If the company is fined or penalised for applying an artificial tax avoidance scheme then the public will be concerned that accountants have acted in a manner contrary to the public interest.