

MANAGEMENT CASE STUDY MAY 2015 EXAM ANSWERS

Variant 5

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-5>

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Trigger 1

Collaborative process

Disadvantages

Involving managers in the setting of KPIs is more time consuming than senior management simply imposing them. By definition, that involvement will require time to be spent on discussion and debate.

Managers might need training in order to fully understand the implications of the choices that they are agreeing to. That could, however, mean that managers will be better equipped to understand the business and to make better management decisions.

Managers may focus on setting KPIs that make their responsibility centre appear to be well managed. That could prove a distraction from maximising the performance of the entity as a whole, which really requires the perspective of senior management looking down from above.

Managers involved in setting their own KPIs may lobby for less challenging targets in order to make them easier to achieve. If they are simply overruled then there is little point in having any consultation. Indeed, if the consultation is not genuine, and senior management override what has been set with different targets then managers will be demotivated.

However the collaborative process does have advantages:

If managers feel that their voice is heard and their opinion is important their motivation will improve.

If managers have a say in determining the level of KPIs then they are more likely to work hard to achieve the targets, if only because they have been involved in setting the performance measures and have agreed to them.

Lower level management will have more detailed knowledge of their area of the business and be in a good position to determine what targets are achievable in practice.

Dysfunctional responses to KPI targets

The key to managing dysfunctional behaviour is to monitor all available information about performance and to hold managers accountable for their actions. For example, if a ship suffers a serious mechanical breakdown in an area not covered by KPIs then the captain should be asked to explain how the problem occurred. If it is clear that the captain had deferred necessary maintenance in order to reduce costs and increase the profit from a voyage then senior management should treat that as a disciplinary matter. At the very least, it should be made clear to the captain concerned that a bad judgement had been made and that will be reflected in his performance evaluation.

Flote could make it clear that captains and other managers should be free to request the KPIs to be set aside when the need arises. For example, a captain might make it clear that a detour is being taken to avoid an area where piracy has been reported. In such a case, the captain should not be penalised for a delay in arrival or an increase in fuel consumption.

Certain absolutes should be set for managing performance. For example, health and safety should never be compromised, neither should be safety of a ship. It will never be accepted that achieving a KPI target is a valid reason for straying from these absolutes.

Reports should always be supplemented by narrative that comments on the individual scores and also on the overall performance. That means that a manager who has done badly on some measures can offer a mitigation for that at the time of submitting the report. For example, if a loss occurs because of a major increase in the price of fuel then there is little point in holding managers liable unless they could have been expected to hedge the loss.

Trigger 2

Report to Harold Fisher

If you are convinced that the project is worthwhile, and wish to convince the board, then there are two key issues to consider:

the negative NPV calculation

those factors which are less easily quantified.

The NPV is currently marginally negative. It would clearly be possible to make “a few adjustments” as requested and produce a positive NPV.

It is clear that fuel prices are volatile and hard to predict as they are affected by many factors. The difference between high and low forecast prices in any given year is considerable.

For example if we look at the percentage difference between the high and low projections we can see that this is very significant, and increases the further ahead in time we are projecting – please see the table below.

Clearly selecting high oil price forecasts would be sufficient to give a positive NPV result. On the other hand low forecasts could make the NPV more negative. The question that this raises is whether it is acceptable to base a forecast on the desired outcome. If oil prices are expected to be low and to remain so then it would be unacceptable to argue that an increase should be anticipated purely to enhance the project’s NPV.

The 2014 appraisal used the then current fuel prices. Revising the DCF calculations using forecast prices would be a sensible adjustment.

One valid approach would be to calculate the breakeven point – i.e. at what fuel price would the project have a zero NPV, and then look at the probability that prices will be at this level or higher. Given the volatility of forecast fuel prices probability analysis would be useful.

	Low	Central	High	% difference low-high
2015	92.4	112.7	131.7	43
2016	91.1	114.0	135.2	48
2017	89.9	115.4	138.8	54
2018	88.6	116.8	142.5	61
2019	87.4	118.2	146.2	67
2020	86.2	119.7	150.1	74
2021	85.0	121.1	154.1	81
2022	83.8	122.6	158.2	89
2023	82.7	124.1	162.4	96
2024	81.5	125.6	166.7	105
2025	80.4	127.1	171.1	113
2026	79.3	128.6	175.6	121
2027	78.2	130.2	180.3	131
2028	77.1	131.8	185.1	140
2029	76.1	133.4	190.0	150
2030	75.0	135.0	195.0	160

The appraisal is based on the assumption that no costs are incurred in respect of removing ships from service – this may be optimistic and should be reviewed. Clearly including costs in respect of this would make the project appear less attractive.

The discount rate should be reviewed to ensure it is still appropriate. The WACC may well not have changed in the year but even a small alteration in the discount rate may have a large NPV impact.

New quotations for the refit work should be obtained as the price may have changed. It is also possible that the technology has developed further during the year so the fuel savings may also have altered.

However, whilst you are in favour of “adjusting” the NPV calculations in order to achieve a desired result, this is not advisable. The DCF analysis should be based on the best estimates available with appropriate allowance for uncertainty.

There are additional factors which may help to persuade the board that this project should go ahead.

Many customer companies now have their own environmental KPIs and offering a less polluting shipping service may help to increase market share for Flote. It would be possible to explore this with sales and marketing staff to see if they have any indication that clients are considering pollution levels when choosing a cargo shipping service.

The volatility of fuel prices represents a risk for Flote. Reducing fuel consumption will reduce this risk.

Refitting the engines may extend the useful life of these well used vessels. This should be investigated. In the short term an extension of the useful life could reduce the depreciation charges.

Trigger 3

Briefing memo on related party issue

Related party transactions must be reported in accordance with IAS 24.

The first point is to decide whether this would be a related party transaction.

A member of Flote's key management would be a related party, as would a family member of the key management personnel. In this case it would appear that the proposed purchase of the engines would meet the definition of a related party transaction.

Flote needs to disclose information about related party transactions in its financial statements so users can evaluate the significance of those transactions. Shareholders may then question the reasons for buying the service from a related party rather than an independent supplier. The disclosures will include the value of the transaction and the amount of any outstanding balances.

IAS 24 requires these disclosures because the transactions might not have been carried out at arm's length. There is no indication here that the transaction is inappropriate but the transaction must be disclosed in the interests of transparency and full disclosure.

Discussion notes on Sea Lode's announcement

SeaLode have decided to refit vessels with more fuel efficient engines and have made a press announcement regarding this. They see two advantages: reduction in future fuel costs and increased demand for their services as customers select them as a more environmentally friendly form of transport.

The board of Flote will have formed their own view on future oil prices and the probability of cost savings making the project worthwhile. The decision by SeaLode should not affect this.

The impact on customers and the wider market environment is more complex. It would appear that SeaLode intend to use the refit for marketing purposes. Whether this impacts on Flote or not depends on the extent to which Flote and SeaLode compete for the same clients and whether or not these clients are now more likely to choose SeaLode.

An additional factor is that both Flote and SeaLode would have to take vessels out of service to carry out the refit. The press release has given Flote information on the timing of SeaLode's refit. Even if Flote do intend to refit, it might be worth timing the work so that they are in a position – with a complete fleet – to take advantage of the fact that SeaLode may not be able to offer a full service.

Flote's sales and marketing team should be asked for their views on how likely it is that a more environmentally friendly service would attract more customers.

Flote can also adopt a "wait and see" approach, monitoring whether the refit is increasing SeaLode's market share and also monitoring fuel cost. Rejecting the project now does not necessarily mean not carrying it out in the future.

Trigger 4

Collaboration and communication

The company of ship fitters is experienced and they should be able to manage the process of refitting the ships. But the logistics of scheduling the timing of removing vessels from service, and ensuring that client service is not affected, will be the responsibility of Flote

A team at Flote will be needed to manage the process. This team will need to communicate effectively with the refitting company. This communication will be both formal and informal. Formal communication will include plans, procedures, performance reports and meetings and the communication of management decisions. Informal communication is likely to include face to face conversations, emails and text messages as part of the communication between individuals from both companies.

The contractual agreement between Flote and the refitters will be of key importance and will set out what we can expect in terms of price, quality and timeliness of the work. But the collaboration will also depend on good communication between the two teams. In particular, there will need to be plans in place to cover what happens if there is a problem with either timing or quality of work.

Managing the project

The refit will be a project for a team at Flote, and will need a specific group of specialists to accomplish it. CIMA defines project management as “the integration of all aspects of a project, ensuring that the proper knowledge and resources are available when and where needed, and above all to ensure that the expected outcome is produced in a timely, cost effective manner.”

The project team will have to measure the constraints of time, cost and quality. They will also have to manage the logistics of scheduling shipping without the ships that are undergoing refit. This scheduling will be complex. Ships will be based in different places and will have to steam to and from the shipyard without cargo. This will add costs and time to the process. Selecting the order in which ships are refitted will have to take account of planned workload, since some may be committed to long term cargo contracts which will have to be rescheduled to other vessels. It is possible that in order to meet commitments to clients, Flote could take a ship or ships out of storage for the duration of the refitting project. This would incur costs but protect client service levels.

The five project management process areas are:

Initiation

Planning

Execution

Controlling

Closing/completion.

A regular reporting period should be set up so that the team can report progress to the board.

Control systems will be needed to prevent, identify and correct any deviations from the plan and revise plans and targets if necessary.

Management of performance will include checking the quality of work carried out by the refitting company. A specialist company may be needed for inspection work.

The control of time will be achieved by monitoring the completion of milestones built into the project schedule. It will clearly be very important that vessels are returned to service on time as Flote will have committed to carrying goods for clients using them. Regular progress reports should also be received from the refitting company.