Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY MAY 2016 EXAM ANSWERS

Variant 1

The May 2016 exam can be viewed
https://connect.cimaglobal.com/resources/management-case-study-exam/may-2016-management-case-study-exam---variant-1

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Section 1

Task 1

Cost effectiveness

The fact that competitors offer this service indicates that it is viewed as cost effective by them. A detailed appraisal would have to be carried out looking at the initial set up costs, incremental revenues and costs of the proposal. It may be difficult to estimate revenues, we need to consider both the potential for additional revenue from additional charges for an express service, and the potential for increased market share- or protection of existing market share arising from this. We should be able to assess the costs with reasonable certainty but forecasting revenues will be more difficult, it may be possible to carry out some market research to assess likely demand and also research the experience of our competitors.

Quality control

Ensuring that quality is not affected by the express service is important and should be possible. Work scheduling will need to ensure that express orders are dealt with promptly but sufficient time should be allowed to meet the usual quality standards. Quality inspections should also be incorporated into the schedule. It may be the case that some more complex lenses cannot be made within the express timescale. If this is so then it should be made clear to shop floor staff that the express service is not available for such prescriptions.

Workload scheduling

It should not be necessary to have technical staff sitting idle waiting for express orders. Staff could be allocated a normal, non-express work schedule and then diverted from this to respond to express orders. There would need to be a cut off time by which express orders were placed in order to allow for efficient completion of the work.

Carrying out a pilot scheme could be an appropriate way to test the likely level of demand, and provide practical evidence of work scheduling and quality control issues. If successful the project could be rolled out more widely once any problems have been resolved.

Task 2

The proposal exposes us to a number of risks:

Setting up the new facilities would require significant capital expenditure. We may not easily access funding for this, there could be cash flow impacts and undertaking this proposal may mean that funds are not available for alternative projects. We can mitigate this risk by carrying out a careful appraisal of the project and ensuring appropriate funding is in place and that the project meets our investment criteria.

Running additional production facilities will require an increase in the number of appropriately qualified production technicians. Such staff may not be easily available. We could mitigate this risk by taking advice from appropriate recruitment consultants. We may also be able to train staff in our existing facilities and move them to the new units once they are appropriately skilled.

Managing the new units may stretch the resources of the management team, who will have more individual units to oversee and may be working over a larger geographical area. We may need to recruit more managers to mitigate this, or change the management structure.

Customer satisfaction will depend on prompt delivery of spectacles as well as a quality product. We will be dependent on the services of couriers, who may be unreliable, or unavoidably delayed in traffic particularly in cities where we are most likely to be offering this service. We can insist on service level agreements with courier firms and only use those who offer a reliable service. We can also communicate with the customer, for example texting them to inform them that their spectacles are ready for collection, or warning them of any delays.

We could spend heavily on new facilities and then find that demand for the new service is much lower than anticipated, or that whilst customers might like their glasses delivered same day they are not prepared to pay additional fees for this service. Whilst some customers might like a rapid service others prefer to give considered thought to their choice of frames, perhaps visiting the store several times before making a selection. We could mitigate this by carrying out a pilot scheme before rolling out the service more widely, and by market research into customer preferences.

Section 2

Task 1

Selection of team members should be done with care. If we have an existing, appropriately qualified team then their use could save us from having to go through the stages of team formation as detailed by Tuckman. If such a team is not available then we will need to form a new group from staff drawn from existing parts of the organisation or recruited externally.

We need to take account of the aspirations of staff. Those taking part in the new team may see this as a career advancement opportunity, if the project is successful then they may be able to play leading roles in the future rolling out of the project. On the other hand if the pilot is unsuccessful they may fear for their own future prospects. This could lead to over optimistic analysis of the projects performance by staff who are highly invested in its success.

Leadership of the team is important, the team leader will not only have to manage any technical issues, they will also be required to build effective relationships with the existing staff in branches implementing the project, and also report the results upwards so that the board are appraised of progress in a timely and effective manner.

We also need to take account of the geographical issues. We may be asking staff to relocate temporarily to work on the new project. Staff with families and established homes in other parts of the country may well be unwilling to do this.

Task 2

Advise on the evaluation of the success of the pilot scheme and on whether the team should select measures.

The most important role of the pilot scheme is to give us an insight into potential demand for the new service. Ideally, it will reflect the potential demand from customers if this service becomes a permanent feature of the services offered by IC Optical. Arguably, a successful trial will reflect potential demand and it may be viewed as a success if we conclude that there will be insufficient demand to make it worthwhile.

In terms of the commercial information that we will gather we need to know the proportions of customers who are prepared to pay a premium for priority treatment. We also need to know how much disruption the priority service will cause to the operations of the shops and the laboratory. It may be difficult to test these issues fully during the trial because the feedback may be distorted by teething problems or by a lack of customer awareness.

We could, in principle, adopt a balanced scorecard approach to help us to address the objectives for the pilot scheme. A balanced scorecard will force us to identify a range of measures and KPIs that should ensure that the pilot study itself provides IC Optical with the greatest benefit. There should be less risk of the team members setting themselves a relatively undemanding set of objectives and thereby making it easy for them to appear to have been successful.

We need to be careful in permitting the team to have too great a say in setting objectives. Their input is important, but they will see this as a highly visible project that could have a positive impact on their careers. It will always be preferable to have been associated with a successful pilot study and the team may attempt to establish the terms and measures in such a way that they can demonstrate their success.

Section 3

Task 1

Success

The measure of success in calculating sales may be complicated by the fact that the results took a few months to respond. One possibility is that it took a while for demand for this new service to grow, although that is slightly strange because customers will not buy spectacles frequently. One major concern is that the upward trend in sales had very little to do with the same-day service. There could have been some other driver, such as another promotion across the whole company.

The figures do not show any causal link between the service and the additional sales. Overall sales increased by 123 units, but more than 600 customers paid for it. That may mean that customers will pay for the service when it is offered, but it may not be instrumental in generating additional sales. There is an upward trend in sales of progressive lenses that already affects our sales and the original budget suggests a static monthly demand had been assumed.

While the financial results are potentially encouraging, we need to back this up with non-financial measures. For example, how has this service affected customer satisfaction? Will this generate additional demand, perhaps through word of mouth recommendations? Did the large proportion of refunds affect our reputation badly and is the promise of a same-day service a risk? Are staff willing to promote a same-day service when they may already be busy with routine work?

Task 2

NPV

At face value, Jo is proposing that we spend C$8m per laboratory or C$80m on this expansion. It would be reckless to commit to such an investment on the basis of a rough analysis of a small-scale pilot study. The board has a duty to the shareholders to ensure that their wealth is invested responsibly and that any large-scale investment is justified.

The NPV analysis requires a detailed investigation of expected future cash flows. That requires an understanding of all of the assumptions and their justification. Skipping that step would send a very clear message to management that favoured projects can be implemented without adequate study and so out overall control environment would be compromised.

The use of WACC is probably justified on the basis that this is essentially an expansion of the business overall. That is, however, an assumption that will have to be explored.

Firstly, the business risks may be greater than envisaged and so the cost of equity may increase because of this investment. We are proposing to sell more of our most expensive product and customer demand may not keep respond to our expectations. We may also be displacing sales of less expensive products and so the additional margin may be less than anticipated overall.

Secondly, we will have to find the extra funding from somewhere and that could affect the weightings of debt and equity. The most likely prospect is that we will borrow and that could affect our gearing ratio and the tax shield on borrowing.

Section 4

Task 1

I would like you to explain what the financial reporting implications be of the acquisition and the fair value adjustments required.

If after the share purchase IC controls Carson then Carson will be a subsidiary of IC. This means that IC has the rights to returns from Carson and the ability to affect Carson's performance through its power over Carson. This is usually said to be the case if IC owns for than 50% of the voting rights.

If Carson is a subsidiary we need to use acquisition accounting. IC and Carson's assets, liabilities, income and expenses will be combined in full. We will need to recognise goodwill. The share capital of the group will be the share capital of IC only. Any intra-group balances and transactions will be eliminated. Both companies must use the same accounting policies. Any non-controlling interest must be shown separately from the equity of the owners of the parent. Profit and comprehensive income are attributed to the owners of the parent (IC) and to the non-controlling interest.

If IC reach agreement to purchase all the shares then there will be no non-controlling interest.

Goodwill must be calculated as the difference between what IC pay for the shares and their fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

If IC pays cash for the Carson shares then the value of the cash is not debatable, but if IC offers shares in IC then the air value of those shares must be considered.

We also need to measure the fair value of Carson's net assets at the date of acquisition. This may include brand names and patents which are not recognised in Carson's own financial statements. Guidance on measuring the fair value of assets and liabilities is provided in IFRS 3.

Task 2

Also, please advise on how we should assimilate their staff into our teams following the takeover.

We would need to begin by assessing the staff who will be joining IC. We will need to be aware of their current roles, terms and conditions of employment, salaries and the management structures under which they are working.

There may be legislation in place protecting the new employees, for example they may be entitled to employment with IC on no less advantageous terms than they worked for Carson.

Since the intention is to use Carson's production facilities to produce spectacles for IC's branches, it is likely that we will have to create new teams made up of staff from both companies. These teams may go through the Tuckman stages of team formation.

The impact on our existing staff also needs to be considered. It is possible that the Carson staff are employed on better terms and conditions than are offered to IC staff, which could cause discontent and resentment which would make forming well-functioning teams more difficult.

We will need to consider appropriate methods of rewarding the teams based on their performance. It will be important that their performance is appraised fairly and that rewards are sufficient to motivate them. Making sure that staff can see a career path within the new structure will be an important motivational tool.

Good team leadership will be vital, we will need to select team leaders carefully and make sure that that reporting lines are clear and appropriate.