

MANAGEMENT CASE STUDY NOVEMBER 2016 EXAM ANSWERS

Variant 1

The November 2016 Exam can be viewed at

<https://connect.cimaglobal.com/resources/november-2016-management-case-study-exam-variant-number-1>

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SECTION 1

Debbie's arguments

The basis on which Debbie has determined these figures has to be considered. For example, it seems strange that we spend such a large amount on HR for each phone that we manufacture. Perhaps there has been a lack of transparency in our costings, which ought to be addressed. There may be scope for introducing efficiencies now that the cost has been identified, which could negate some of the merit in switching. It seems unlikely that the HR cost could be variable and it may not even be entirely due to the employment of manufacturing staff, so the cost may not be saved if we outsource production because we will still incur HR costs.

Debbie's focus appears to be on the perceived value of the phones in the hands of the consumer, which is understandable given that she is coming in from a retail background. To that extent, she is correct in stating that consumers will not pay more for a phone just because of our buying activities. From our perspective as manufacturers, we cannot add value to bought-in components without buying those components and without managing the resulting inventory. So these activities are integral to the creation of a sellable product.

Spending an average of F\$9.47 per phone on warranty costs may be an investment in consumer goodwill. It may not add perceived value in itself when customers are choosing phones, but there will be a loss of goodwill if we leave customers unsupported. We may be left to bear this cost even if we outsource the manufacture of the phones, depending on the agreement with the manufacturer.

Finally, we need to consider whether Debbie is comparing like with like on the phones themselves. We need to consider value added from the consumer's perspective. If the bought-in phones are of poorer quality or finish then the cost saving will be of little consequence.

Culture

Concepts of culture can be classified and discussed in a variety of different ways.

Debbie's comment that Portafone is proud of its reputation as a manufacturer implies that we have a task culture. It appears to have been taken for granted that Portafone exists to design and manufacture mobile phones. The managers responsible for these tasks have worked together to keep the product line fresh and to manufacture in sufficient quantity to meet market needs.

Handy regards the task culture as being associated more with tactical management. The fact that Debbie appears to be questioning the direction that has been taken so forcefully implies that she believes that too little attention has been paid to strategic matters. The company has followed a particular direction with very little attention paid to alternative strategies.

Debbie's stance implies a move to a power culture. That is consistent with the pursuit of the vision of a key person (herself). Debbie's power culture would offer scope for making Portafone more adaptable.

The danger of this new direction is that she may alienate the existing management team. Portafone has clearly enjoyed success in its present form and so any suggestion change may be interpreted as a criticism. Clearly, some managers will be threatened by the fact that their areas of expertise may become redundant under Debbie's proposals.

SECTION 2

Risks arising from offshoring

Our departure will be unpopular in Farland and that will generate adverse publicity. That may lead to regulators and politicians in our home country wishing to take a negative approach toward us in order to show their support for public opinion. Arguably, that may not be a particularly serious problem because they will have to operate within the law in terms of any dealings that they have with us.

The move may appear somewhat aggressive and selfish and that may affect consumers' attitudes. Having said that, we will be moving jobs to Europe, where we have significant sales, so many of our customers may actually support the move. We sell popular products that consumers like to own and so they may not be deterred from buying a Portafone device just because of some adverse publicity that many people will quickly forget.

There could be issues of quality control if we are shifting production to a third party manufacturer. At present, we have an incentive to take quality very seriously because we are making products that will be sold with our name on them. The new manufacturers will not have the same level of incentive.

Finally, the move is prompted by a desire to cut costs. There is a risk that the planned savings will not materialise. In particular, the contract with the manufacturer will have to be renegotiated from time to time and we will be at a disadvantage once we have shed our manufacturing capacity. We may lose a great deal of control over our company's future business.

Accounting implications

The most significant change that will occur is due to the elimination of Portabuild's property, plant and equipment from our financial statements. It would appear that 83% of our property, plant and equipment will be sold. Having very few tangible assets may make us appear far less substantial and there could be fears that we will have a limited borrowing capacity.

Some of the balances will have to be transferred to other members of the Portafone group and so there will be no net impact on our consolidated financial statements. For example, the inventories will be kept within the group until they can be sold and so there will be no impact. The liabilities will also have to be either settled or transferred, thereby leaving them in the consolidated financial statements.

The goodwill in the consolidated statement of financial position may include some goodwill from the acquisition of Portabuild. That will have to be eliminated, although the amount is not particularly significant. However, even a small goodwill balance may be significant when the PPE in Portabuild is removed.

The consideration received will have to be shown as an asset. It may not be particularly substantial because we are not really selling Portabuild as a going concern. We may have a substantial loss in our statement of profit or loss.

SECTION 3

Negotiation

The main issue arising is that we will be losing a lot of the flexibility that we have at the moment with regard to tweaking designs. For example, a change in component prices may make it cost effective to redesign a phone slightly in order to take advantage of, say, cheaper components. The basis of our contract with Smake may not offer them any great advantage if they use cheaper parts and so they may resist change.

We may deal with this threat by having a clause in the contract that enables Smake to share in any savings arising from the substitution of parts that requires a design modification. That would limit the upside to Portafone, but any such savings are likely to be marginal in any event. We might also require a more significant penalty in the event that Smake refuses to adapt a design and so imposes additional costs or reduces the marketability of our phones.

The bigger problem will arise when we introduce new phone designs because those may require Smake to incur significant cost or disruption. For example, a new phone design could have additional hardware, such as sensors that improve functionality but also require the manufacturing process to be more complicated. Smake may be unwilling to agree to a new design without first imposing some changes that are intended to make the manufacturing easier or cheaper.

We might address that by having a fairly regular upgrade cycle and timing that to coincide with the renegotiation of Smake's contract. It would then be easier to replace Smake in the event that it would not cooperate over upgraded designs. We might also agree to pay a realistic amount for any new designs that are likely to be more expensive to manufacture.

Transfer prices

Tax authorities generally insist that companies price internal transactions on the basis of 'arm's length' rates that prevail on the open market. That way, the seller reports the same profit regardless of whether the buyer is a fellow group member or a third party trader. Ideally, Portafone should find a basis for determining the objective, market price for the phones being transferred between group members.

The basic problem is that Portalog is selling branded products that may not have an observable market price for comparative purposes. Most mobile phone manufacturers will make direct sales to network providers and retailers and so there will not be an intermediate market for sales from the manufacturer to a distributor. One problem that creates is that the tax authorities in Northland might argue that almost any price that is less than the price charged to retailers is artificially low.

One approach that we might adopt is to ask other industry members about their internal pricing. That would give us some basis for arguing that our internal pricing is in line with industry practice, which would demonstrate some link to arm's length pricing. That might be persuasive, although the pricing might be artificial throughout the industry and the authorities might reject this basis.

Alternatively, we might simply ask the tax authorities to meet with us and to negotiate a realistic price. We might be able to reach a realistic settlement because we are a high-profile company and Northland's government would be keen for us to settle and, hopefully, expand. The only real problem is that a price that Northland regards as fair may be regarded as unacceptably high by the tax authorities in Farland.

SECTION 4

Restating monthly management reports

The sales staff almost certainly realise that they have been fortunate with respect to the margins, but they will still be encouraged by being associated with this success. The danger is that the sales staff will feel that some of the credit for their contribution is being taken by another department, such as treasury. They may not fully understand the impact of the currency movement and so they may not appreciate why the adjustment is even necessary.

We might soften the blow by making it clear that we will make a similar adjustment regardless of the direction of any future currency movements. The margin will decline if the N\$ strengthens and the sales staff should be assured that they will not be criticised or penalised in that event.

The sales staff may be counting on a particular level of bonus, having done the arithmetic, and they will be disappointed when that amount is reduced. This will appear to be unfair because they can see that the company has enjoyed a good spell and they will feel that they were part of that. They may have made plans on the basis of the additional bonus and those may have to be curtailed.

One response would be to pay most or even all of the bonus on the original basis for just this month. That could be described as a goodwill gesture that is intended to share the benefits of the currency movement. We might also argue that the original bonus scheme would leave the sales staff exposed to currency movements, which would be unfair to them and their families.

Commentary on the figures

The CIMA Code of Ethics provides a good starting point for discussing this issue.

The basic question that arises here is that of interpreting duties such as professional competence and due care. It could be argued that the management team has satisfied all requirements simply by presenting figures that comply with all relevant accounting standards. The study and interpretation of those figures is, after all, the responsibility of the shareholders and other users. As directors, we may even be accused of lacking objectivity if we attempt to interpret the financial statements for the shareholders.

The duty of integrity requires us to be straightforward and honest. If we publish figures that we know to be open to misinterpretation then we are failing in our duty if we do not alert the shareholders to that concern. The danger is that better informed readers will benefit at the expense of those who do not understand the business issues. We are essentially distorting the truth by keeping the facts about the changes to the business model separate from the accounting statements so that shareholders are misled.

Objectivity requires that we should not be motivated by self-interest. We argued against comparison with Maltone when it suited us to do so. Keeping silent would be misleading and would be motivated by a desire to capitalise on the shareholders' misunderstanding. Essentially, we are threatening to punish the shareholders for their scepticism of our analysis in previous years.

This would be a breach of professional behaviour because we would be undermining our credibility as a management team. Truth can be distorted by presentation and context and the shareholders may feel let down if we do not alert them to the possibility that they will misunderstand the figures in the financial statements. Many of the readers will understand the whole picture in any case and so we will gain nothing by remaining silent.