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Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY NOVEMBER 2016 EXAM ANSWERS

Variant 2

The November 2016 Exam can be viewed at

https://connect.cimaglobal.com/resources/november-2016-management-case-study-exam-variant-number-2

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SECTION 1

Risks associated with immediate launch

The most immediate risk is that the modifications will not work and that some of the phones will catch fire and injure customers. In everyday use, a phone catching fire could have huge consequences, such as causing a motorist to crash or threating the safety of an aircraft. Given that Portafone is aware of this risk, it will almost certainly be held liable.

Portafone's reputation will be at risk because it will be perceived as a company that puts profit before the safety of its customers. It will be very difficult to justify the decision to launch the phone without full and thorough testing. Both Dring and Dare will have incentives to make it clear that they were concerned and so the story will be very likely to become public.

There could be other problems arising from the modifications. For example, making the case out of thinner materials may make it distort and the phone may fail in the process. Releasing an unreliable product may be almost as damaging to Portafone's commercial interests as releasing a dangerous one.

There is an upside risk in that a timely launch would capitalise on market interest and consumer expectations. Any delay could lead to consumers losing interest. A delayed launch could also create the impression that there are problems with the phone's reliability.

Project management

There has been a lack of proper ownership of this project. It is unacceptable that the external design companies should be claiming to have done their individual jobs properly while the resulting parts do not fit and work together. There should have been a team within Portafone's Research and Development department taking full responsibility for the whole project, so that the responsibility for the problems with the prototypes remained in-house.

Proper ownership would have addressed the lack of co-ordination between Portafone and the two outside companies. The external design companies should have been submitting samples and models to Portafone and staff there should have been checking that all dimensions were within design tolerances. Then a formal decision could have been taken as to how to rectify any compatibility issues.

The responses by the external companies imply a blame environment. Neither company could quite meet the specifications that had been imposed by the design and both attempted to deal with that by submitting a component that did not quite meet the specification. A more constructive ‘no surprises’ environment would have encouraged the designers to have approached the main design team at a much earlier stage to report that there were issues. Perhaps the overall design could have been modified slightly to accommodate the design problems with the battery and the case.

The short deadlines have robbed Portafone of the scope to redesign. That may have been a conscious decision because the products have a short lifecycle and there are commercial and marketing considerations, but there is little opportunity to adapt to the problems. It might have been possible to address partly by setting far stricter criteria for the designers, so that a battery that was even fractionally too large would be deemed unacceptable. That would have meant that Dare and Dring would not have tried to pass off slightly out-of-spec items at the last minute.

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SECTION 2

Accounting implications

The cost of the batteries will not be in doubt, but we will be spending F$33.4m on inventory that may have to be discounted or even scrapped. We know already that the batteries will not meet their design specification, which raises the threat of scrappage. From an accounting point of view, it is unclear whether the slight limitation of the design brief is sufficient to impact on the resale value.

On a related note, we would have to consider whether the batteries are to be treated as a separate item, or as part of a Trams phone. Portafone will not be selling the batteries as standalone products and they may have been built into phones by the year end. Even if the phone has to be discounted slightly because of the battery problems, the overall evaluation of cost versus NRV may be favourable when we examine the phones.

Presumably, Portafone's marketing activities will provide information that will be of use in addressing this accounting problem. Focus groups and market research should be conducted in order to decide how best to proceed with the launch of the new model. If that information suggests that the launch should proceed then it will also inform the accounting decisions concerning the need for a provision against inventory.

The market's response to the battery issue should be well established before the financial statements are finalised. The launch will probably indicate immediate success or immediate failure. We may be confident that any adjustments can be determined accurately and recorded as an adjusting event after the reporting period.

Sales force motivation

The sales force is essentially making sales to the network providers and major retailers, which will have implications for the motivation of the sales staff. Sales staff will almost certainly develop close and ongoing relationships with individual customers and they may be concerned that they will lose credibility if the press for sales of a product in which they lack confidence. This is a classic case of dysfunctional behaviour.

This is a serious problem because there are other manufacturers who will be quick to exploit any gap in the market. For example, Maltone will almost certainly be launching new products of its own around the holiday period and we could lose market share. The network operators will be likely to place reduced orders for Trams if our own sales force is keener to push for existing lines instead.

The easiest way to address the problem would be to identify the main concern and take steps to address it. We could offer a realistic warranty or an assurance that the batteries will be replaced in the event that they prove unacceptable to the market. In that case, the sales force will be more willing to sell them to their corporate clients.

The alternative would be to set firm targets and make it clear to sales staff that they are expected to achieve those. We may offer an enhanced bonus for exceeding the target, so that sales staff are encouraged to press for Trams. It would be counterproductive to impose penalties, although we may threaten to discipline any staff who are found to be advising customers against stocking up on Trams.

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SECTION 3

Target costing

We need to make quite a significant saving of F$15.04/315.04 = 5%. There is unlikely to be scope in saving anything on the power management component because we have just negotiated that cost. We may have to find a large number of very small savings in order to get the overall price down.

One challenge is that many of the costs appear to be the same as for our previous model. That implies that we have had these costs under review for some time and have been unable to change them. We might be able to have the engineers review those aspects that are under our direct control, such as asking whether there could be any savings in the manufacturing costs.

We should investigate the big ticket items that have pushed the price up, such as the case. Presumably, the cases used on the old model were of an acceptable quality and so we might be able to find a way to make or buy a presentable phone case that costs a little less than F$52.70. The engineers might be asked to assist us in reengineering these parts.

Our engineers may help us to argue that the battery price is excessive because the designers at Dring did not achieve their design brief. The incremental cost of the new battery is a major part of the problem. The slim design forces us to use a bespoke battery, but we may be able to force a better price out of the supplier.

Co-operation

It is unacceptable for any employee to refuse to work with any colleague, regardless of their perceptions. Such divisions will lead to inefficiencies and incomplete resolution of problems. Communication with external stakeholders may be compromised by conflicting messages.

The engineers should be told in no uncertain manner that their job is to design products that can be sold at a profit and that will maximise shareholder wealth. Portafone does not exist to provide its engineers with an exciting environment in which they can develop products that interest them. Technical perfection may carry a financial cost that is unacceptable to the market.

Engineering should regard Finance as a facilitator. It is not in Finance’s interests to reject sound product ideas that have a commercial value. If Finance did not exist then the engineers would not have the tools and facilities that enable them to undertake their design and development activities.

This response should be fed back to Finance with a view to improving communication. Ideally, Finance should deal with any other department in a helpful and constructive manner. If it is necessary to reject a proposal then the reasons for doing so should be clarified so that the engineers are encouraged to submit further proposals that have a clearer commercial logic in the future.

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SECTION 4

TQM

TQM is an important concept for Portafone.

Firstly, the end users of smartphones are frequently interested in social media and other online communications. If a phone fails then it is relatively easy for a user to post that bad experience online, which could discourage potential users. Portafone sells aspirational products that are likely to be tainted by associated with poor workmanship.

Any failures in a mobile phone are likely to be serious and noticeable. Users are likely to be left in no doubt that their phones have failed and that they have a flaw. These devices are such an integral part of users' lives that they are likely to be posted on social media.

The design of a mobile phone may mean that any manufacturing defect is almost impossible to rectify. Once the parts have been assembled and fixed in place they may be too fragile to remove and recycle. It may be cheaper to discard the phone and make a replacement.

Dependence on subcontractors and suppliers need not interfere with the approach taken to TQM. Portafone can inspect incoming assemblies and parts, preferably before they are assembled. Suppliers' contracts can specify a high level of reliability. There is no excuse to tolerate a lower level of performance from an external supplier.

Implications for WACC

The weighted average cost of capital (WACC) is effectively the rate demanded by the financial markets for a company's long-term funding. Future cash flows are (at least implicitly) forecast and discounted at a rate that takes account of risk. The lower the WACC, the lower the cost of finance and so one interpretation of an increase in share price may be that the market is actually looking for a lower rate of return from the investment.

WACC does not necessarily affect the actual costs of existing funding arrangements taken out by the company. An increase in required rates will affect the value of the financial instruments on the market. That may signal that any fresh finance that is being raised will come at a higher cost, but it will not affect the cash flows on existing funds.

If Portafone issues fresh equity shares at a time when the share price is depressed then it will have to issue more shares in order to raise a given level of funding. That will dilute the shareholders' existing equity more than would otherwise be necessary, but it would have no direct impact on the company itself. Arguably, the additional cost will be borne by the shareholders rather than by Portafone.

The increase in share price probably signals improved expectations concerning future cash flows. In a sense, maintaining that higher price will require the directors to deliver on those expectations. That might lead to the board working harder to find other ways to deliver improved profits, which could be viewed as a commitment or even a form of cost.