Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY NOVEMBER 2016 EXAM ANSWERS

Variant 4

The November 2016 Exam can be viewed at

https://connect.cimaglobal.com/resources/november-2016-management-case-study-exam-variant-number-4

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

SECTION 1

Competitive advantage

In the short-term, the Wonderfilm product will make Portafone's products look better and feel better when customers are choosing them. The tactile texture is likely to appeal to journalists and other reviewers and will be referred to in online and print articles. Clearly, we won't publicise the fact that the coating has a built-in obsolescence and so it will have no short-term impact on sales. We can probably argue that the loss of the coating is an inevitability in the event of any criticism in the future.

Making our phones more attractive to network providers means that they will push our products harder. The networks and the retailers all stock the whole range of mobile phones and they are in a position to influence sales. For example, having a Portafone smartphone in a shop window display or on the cover of a sales brochure will enhance our sales. We may also be able to charge a little more for our products.

The built-in obsolescence benefits us as well. Smartphones are fashion items and consumers are often prepared to change their phones frequently in order to have the latest models. If our phones start to lose their lustre after 18 months then many customers will replace them and they will choose their replacement on the basis of market perceptions.

TQM

Conformance will be an issue because of the nature of this coating.

We will have to invest heavily in the prevention of defects. The coating seems to be inherently fragile and it is intended to look attractive when it is first applied. We will have to take care to ensure that our equipment is properly calibrated and our staff are well trained, otherwise the coating will not be applied correctly and the phones will either have to be scrapped or reworked.

The coatings will have to be inspected carefully before the phones leave the factory. Any blemish could accelerate the deterioration of the coating and lead to customer returns. The phones will be returned to the network providers and retailers and so repeated complaints will prove damaging.

The appraisal issues will also be significant. We need to check purchases of Wonderfilm carefully to ensure that they have been manufactured correctly, otherwise the ageing process may not happen at the required rate. We also need to keep the formula itself under review. We should probably have an alternative idea ready for when the first phones reach the end of their lives. We may wish to be able to say that the specific problem will not recur, but have a more subtle alternative ready for when the newspapers carry complaints about phones.

Internal failure is not necessarily going to be greatly affected by Wonderfilm. We will undoubtedly refuse to rework or replace phones that are 18 months old. Our biggest concern with regard to internal failure would be a breach of confidence by an employee, which might then force us to offer repairs or replacements as a goodwill gesture.

Paradoxically, external failure would manifest itself in the phones lasting longer than the planned 18 months, or the deterioration being insufficiently serious to motivate consumers to replace their phone.

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SECTION 2

IAS 38

This is clearly a question of ethics. We have the opportunity to manipulate reported profits in a manner that would not leave us exposed to subsequent accusations. If we wish to protect ourselves, then we can simply minute our intentions to proceed with Wonderfilm at a board meeting and claim that we changed our minds.

The CIMA Code of Ethics gives us a good place to start.

Integrity requires us to be straightforward, honest and truthful. Lucy's suggestion is actually deliberately asking the board to lie, because no final decision has been made.

Objectivity requires us to set aside any conflict of interest. Lucy's argument is effectively stating that the board can impress the shareholders and strengthen its position by choosing a misleading accounting policy. An objective decision would start with the facts and would report those honestly.

Professional competence and due care would require us to comply with all relevant accounting standards. We have IAS 38, which tells us that expenditure can only be capitalised if it meets six criteria. Only five of those criteria have actually been met and so we will be in breach, albeit a breach that would be difficult to prove.

Finally, we are expected to exhibit professional behaviour, avoiding harming our reputation. The reversal of such a significant accounting choice could easily cause the shareholders to question our intentions and our honesty. They may not accuse us of dishonesty, but they could question our competence.

Record-keeping in R&D

Keeping records will motivate staff to complete projects. In the absence of a formal record of time spent, projects may start to drag and research staff may waste time pursuing issues that interest them personally. Time may be wasted on highly speculative research that is not working out, but that might be rescued with luck.

Time records makes it easier for the board to be accountable for the cost of R&D. Portafone spent more than F$5.7 billion last year and the shareholders may ask why. The board must have some basis for ensuring that resources are being put to good use.

It may be misleading to maintain detailed records, though. Knowledge gained from one project might cross-fertilise others. The management of time might lead to a more specific focus on a single objective and links might be lost. Project leaders may be less inclined to share findings if the research managers believe that they are in competition for resources.

There could be dysfunctional behaviour if there are tight deadlines on projects. A manager might abandon a fruitful course of study because there is no budgeted time left to investigate further. Alternatively, managers may not embark on studies unless they have a clear expectation of success within a limited period.

SECTION 3

Risks and mitigation

Clearly, any relevant risks will be accepted.

Building a factory leaves Portafone exposed to the risks of overruns, both in cost and time. Building projects frequently involve delays and costs can occur unexpectedly. These overruns could make the factory's NPV negative.

One response to that would be to agree a fixed price with the builder. It would also be possible to include penalty clauses in the contract in the event of any delay. There should be some latitude in the contract for discussion, just in case an overrun leads the builder to cut corners.

This is a new material that will be manufactured by foreign workers in a new-build factory. The risk of an industrial accident will be high. That could damage Portafone's reputation as a responsible business.

The factory should have as many safety features designed into it as possible. Ideally, a chemical engineer should work with the architects to identify the threats and develop counter measures. All employees should complete mandatory health and safety training before they are permitted to work in the factory.

Stakeholders

We will have internal stakeholders from within Portafone and external stakeholders from outside.

The principal internal stakeholder will be Portafone's Production Director, who will be responsible for the factory's operations once it is up and running. The Head of Research and Development will also be a stakeholder because the factory must manufacture her material to her specification. The Finance Director will be a stakeholder because of the cash that will have to be invested.

External stakeholders will include the builder, who has to build the factory to the specifications and also comply with Westreach's building regulations. Westreach's government will be a stakeholder because of the health and safety issues associated with the factory. The local community will also be stakeholders because of the economic impact of the factory in terms of attracting employment and wealth.

The project team should be led by a representative from the production department, to stress that the whole point of the factory is to manufacture Wonderfilm efficiently. That person will require an understanding of the manufacturing process because the factory is intended to produce a lot of the plastic components that are used to make phones.

The builder's site manager should be on the team, to liaise and to report progress. Even though the site is overseas, the site manager can attend meeting by conference call or video conference if it is too far to fly.

The finance function must also be represented. The project will involve constant outflows of cash and the finance director has to be informed well in advance of the timing of any progress payments that are due.

SECTION 4

Borrowing

For practical purposes, it will simplify matters if the subsidiary company in Westreach acts as the owner and operator of the factory. It will make sense for the subsidiary to purchase the land and pay for the construction in € because those will be local transactions.

The funding can be organised in a number of different ways. The simplest approach would be to have the subsidiary raise a € loan in Westreach. An alternative would be for Portafone to raise the finance and make an investment in the subsidiary's equity.

The subsidiary's assets and liabilities will be translated to F$ at the closing rate at the end of every year. If the subsidiary has funded the factory using a € loan, then the translation gains and losses will be minimised because losses on the factory will be offset by gains on the loan and vice versa. If the loan was taken out in F$, then the assets would be left unhedged and there would be a more significant difference on translation**.** The net gains and losses will go to reserves, through other comprehensive income. They will not have an impact on reported profit, although they would affect equity.

It is worth noting that Portafone generates a great deal of its revenues from Europe already and so it will be exposed to gains and losses on € trade receivables if nothing else. Borrowing in € will create something of a natural hedge against those balances.

Relations with finance

The key to resolving this friction would be clearer and more open communication. It might help if there could be better interaction and engagement between the two departments. For example, establishing joint working parties to discuss the various projects that are ongoing.

The R&D staff must recognise that Portafone has to deliver value for money to its shareholders and that R&D efforts are only part of that. One of the roles of Finance is to ensure that funding is available when required and understanding that might improve R&D's perceptions of Finance. If Finance is seen to be taking an active interest in R&D and can understand the broad issues, then the R&D staff may feel a little more forgiving when Finance calls a halt to a project.

If R&D took a greater responsibility for financial planning and budgeting, then it would be possible to develop a better understanding of the concerns expressed by Finance. If a project overruns then the resources that are being consumed have to come from somewhere else in the organisation. If R&D had a little more freedom to manage financial resources then they may be better placed to prioritise projects.

It has to be clear that R&D's entire existence is dependent upon it delivering value to the shareholders. New products are developed to make wealth for the shareholders, not to provide R&D staff with interesting careers. There would be no R&D budget if it were not for the Finance department observing and reporting that value creation.