

MANAGEMENT CASE STUDY NOVEMBER 2016 EXAM ANSWERS

Variant 5

The November 2016 Exam can be viewed at

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SECTION 1

Project evaluation

The quantitative analysis requires identification of the cash flows that will change if the project proceeds. The amounts and timings are both relevant because different discount factors will be applied to cash flows that are further in the future. That will require a careful analysis of the additional revenues that might be generated from being able to sell phones made to this higher standard, as well as the outflows associated with acquiring the machinery and the operating costs.

We would ignore the costs and revenues that will be unaffected. For example, the F\$9 million that has already been spent will not be considered because it has already been spent and cannot be recovered. We will also ignore the revenues and expenses that are expected to occur regardless of the decision to proceed. The whole analysis will require a very thorough understanding of the project, although the results will be based on estimates.

The qualitative aspects are really intended to support the quantitative. Management needs to be able to understand the risks associated with his proposal. For example, how confident are we that this new process will make phones more attractive to customers? Do we have market research to back up our findings?

Will our competitors be able to respond easily? It would appear that we can tie up Tait Welding's capacity, but there may be other ways to improve the appearance of a phone case. Could there be other developments, such as metal cases, that would negate this advantage very quickly?

Impact on the financial statements

If we decide to proceed with this project then the investigation can almost certainly be classified as development rather than research. That would permit us to treat the F\$9 million that we have spent already as an asset rather than an expense. That would increase profits.

The scrapped equipment would have to be written off, presumably at a loss of almost the whole of the F\$438 million at which it is presently shown in the financial statements. The whole

of that loss would go through the statement of profit or loss as an expense. Portafone does not have a revaluation reserve, so there would be no possibility of some of that loss being taken to reserves.

The F\$987 million would be capitalised as property, plant and equipment. The big question is how the acquisition would be financed. The company has a very large cash surplus and so it could be paid for without taking out further finance. In that case, the statement of financial position might actually be improved because a large cash surplus will always look inefficient.

The accounting ratios will not be affected drastically because the amounts are not huge in relation to the figures as they stand. Return on capital employed will decrease slightly because of the loss on disposal, but that will decrease because of the loss and its impact on equity. Gearing will increase slightly because of the write-off, but again, it will not have a dramatic effect.

SECTION 2

Accounting choice

The CIMA Code of Ethics gives us a good place to start because 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. It will be several years before our overstatement of the useful life is ever an issue and even then we could simply say that we made a mistake when we estimated the useful life. Integrity requires us to be straightforward, honest and truthful. The proposed exaggeration of the expected life is a breach of that principle.

Objectivity requires us to set aside any conflict of interest. The argument concerning asset life is effectively stating that the board should 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. IAS 16 requires that we write assets off over their useful lives. We know that the assets will not last for ten years and so we would be in breach of IAS 16.

Finally, we are expected to exhibit professional behaviour, avoiding harming our reputation. The discovery that assets had to be written off when they were only half depreciated 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.

Disciplinary action

The whole question of disciplinary action could affect the morale of the R&D department, which is an important part of the business.

In Pavel's case, we have the fact that he was acting under instructions from his boss. Disciplinary action against him would have to be carefully managed to make it clear that we are not blaming him in any way for Lucy's dishonesty. The fact that he was merely obeying instructions may not be particularly relevant.

Pavel is a professional person, who is capable of understanding that Lucy was asking him to lie. Indeed, she explained her reasoning for the request very clearly and so he was in no doubt as to her reasoning. He could, and should, have refused to follow Lucy's instruction. We should discipline Pavel in a proportionate manner, perhaps by a reprimand.

Lucy's case is far more serious. She is a Head of Department, who should be setting an example for all of her subordinates. She gave a colleague a formal instruction to distort the information in an important document. Her only justification is that she was motivated by a desire to make the company more profitable.

Lucy's actions demonstrate a lack of respect of Portafone's board. She informed a subordinate that the directors could not be trusted to make a sensible investment decision. She should face serious disciplinary action, perhaps a suspension.

SECTION 3

Project management

This is a relatively simple project, with a fairly linear collection of tasks. The biggest issue is when we will place the order with Tait Welding because the longest part of the project is waiting for them to deliver the kit. The other big decisions are the timings of the removal of the existing machinery and the upgrade to the electricity supply.

The installation will cost us two weeks' production. We might wish to consider the flexibility inherent in these timings. For example, we are under some pressure to place an order with Tait Welding, otherwise they may have a full order book. Ideally, we would wish to ensure that we were not going to disrupt production without prior planning.

The installation should be put under the control of a senior engineer, who understands the production process. That person should probably be drawn from maintenance or production.

There should be representatives from production and maintenance to handle the technical aspects of the work. Their role will be to work with colleagues who are directly involved and to report on any problems as required.

There should be a representative from marketing to allow for the possibility of delays in the resumption of production.

Key risks

The most obvious risk is that there will be a delay in the delivery of the new equipment. We will have to commit ourselves to the removal of the existing equipment at some point before the arrival of the new or there will be no room in the factory. One response would be to delay the removal of the existing equipment to the last possible minute so that we have the greatest possible assurance that the new equipment will be delivered. The second possibility would be to build up a reserve of inventory so that there is a little flexibility in dealing with any delays in production coming back on stream.

There could be damage to the machine during installation. That could be even more serious than a delay because we would have no scope for retaining or reinstalling the existing equipment. Ideally, we should pay Tait Welding to install the equipment or pay a company that they recommend. We should ensure that each step is checked carefully.

There could be quality issues with the initial output, which would discredit the improved design that we will be promoting aggressively. That could lead to a further source of delays in getting back to full production. We should ensure that all training is completed and that production staff are assessed on their competence. If possible, the installation plan should have additional time set aside for quality issues, even if that would add to the length of the process.

SECTION 4

Interpreting the report

The prevention costs appear to be very low, but that is partly because the machine has literally only just been installed. We are not necessarily skimping on preventative repairs and maintenance because the equipment has just been installed and calibrated and the ongoing maintenance cycle is just getting started. Similarly, the operatives have only just been trained on the operation of the new equipment and there is no need for any updates or refreshers just yet.

Appraisal costs are in line with before, which suggests that they are regarded as acceptable. The concern that this raises is whether that suggests that operations staff have been complacent. Perhaps there should have been more extensive checking at that stage due to the new processes.

Internal failure costs are high because the nature of a failure now generally means a scrapped unit. It remains to be seen whether that is due to poor work by Nibha's staff; we really need to establish whether those scrappages were avoidable. Regardless of whether they are due to operator error, they are a serious matter that the board should discuss.

The warranty costs are actually quite disturbing because they suggest that we have sold defective units. Presumably items returned under warranty are having to be replaced. The question that this raises is why they were in customers' hands at all and whether there is a need for more extensive quality checks.

Tait Welding

We have a difficult task here because Tait will not wish to acknowledge any failure on their part. Apart from the costs of rectifying any defects, they have a full order book. It would disrupt their operations if they sent staff to our factory. They will always have a ready excuse in saying that the customer has been operating their equipment incorrectly.

The first thing that we should do is to analyse the failures in an objective manner. We might send samples to an independent laboratory to determine the reasons for the failures. Apart from giving us an objective view, that would enable us to draw on the laboratory's expertise in case there is an explanation that does not involve Tait and we are wasting time.

We should catalogue the problems that we have had with the new equipment and also our interactions with Tait's management. We should send this information to Tait's board with a request for a commitment to address the issues. By escalating the complaint, we stand a better chance of senior management taking the initiative to help us.

The ultimate sanction would be to instigate formal legal proceedings if we believe that Tait is not living up to its promises. That would motivate them to investigate our concerns again to avoid the bad publicity associated with defending a legal action. The danger is that their position may become more entrenched because they may wish to avoid being seen to make a public acknowledgement of any failure.