

**MANAGEMENT CASE STUDY NOVEMBER 2017 EXAM**  
**ANSWERS**

**Variant 1**

The November 2017 exam can be viewed at

<https://connect.cimaglobal.com/resources/november-2017-management-case-study-variant-1>

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**Task 1**

**Benefits to ZX of setting up a manufacturing plant overseas**

*Financial*

Like RiPlan, ZX should gain the benefit of reduced labour costs which could significantly improve our profit margins, even if we also chose to reduce our prices to attract more customers.

Should we be able to reduce our prices to customers, we should also see an increase in revenue. Sales could also be possible to corporate clients in the new local market which could increase our overall sales and profit.

We may also benefit from lower property and utility costs, which could be passed on to our clients. We would also have to seek out a range of local suppliers of raw materials and, depending on our chosen location, they may be cheaper than our current Kordia-based suppliers. However, any reduction in raw material costs would need to be weighed against any increase in costs due to additional transportation charges, local taxes and increased quality checks.

We could also take advantage of any government grants or incentives which may be available to encourage investment in particular countries. This could be a significant financial benefit in terms of tax incentives and set-up costs.

*Non-financial*

As stated above, this could be an opportunity to open up our products to new markets. Up to now, we have only operated in Kordia. It may help us increase brand recognition further afield. In an increasingly global economy, greater international brand awareness

may be necessary for us if we want to continue to expand. This may be particularly relevant if the Kordia office furniture market reaches saturation point.

We may be able to source and work with a wider range of suppliers, who may offer us more choice in raw materials and new ideas to improve our range of products to benefit the final customer. We may also be located closer to some of our key timber suppliers which may improve stock control and also improve control over our chain of custody.

Taking this initiative would show financial providers (as well as potential investors, should we decide to seek a stock market listing in the future) that we are aware of industry changes and flexible enough to turn a threat into an opportunity.

### **Business risks of manufacturing overseas**

Manufacturing overseas could introduce barriers to communication that may get in the way of timely production and delivery of goods. Foreign managers and workers may not have a solid understanding of our language, which could lead to confusion or miscommunications about production quantities, costs and deadlines. Time zone differences can make it harder to schedule meetings and create a lag in response time with electronic communications.

Overseas suppliers could increase their prices, which may reduce the cost benefit of manufacturing overseas over time. In addition, if a supplier falls on hard times it may be unable to complete orders, resulting in an interruption of the supply chain. If we chose to move production back to Kordia in the future, it may take years to reach the level of performance we would have enjoyed had we kept production at home all along.

We will also lose all of the goodwill and relationships we have built up with local Kordian suppliers. These relationships have taken many years to build up and could result in a significant loss of jobs in these organisations, severely affecting the local economy.

Our reputation and brand may be damaged by manufacturing overseas. We may be viewed as giving domestic jobs to foreign workers, which can lead to a negative public image. We may need to spend extra money on advertising and public relations to make up for sales lost due to bad press. We will also have the reputational damage of having to make our own production staff redundant and may incur significant costs in redundancy payments. We will also have to consider the risks of poor motivation and morale of those staff remaining in Kordia. Customers may stop buying from us as the products are no longer made in Kordia and Kordian businesses may now consider that our quality output will be reduced.

Another risk that we may well be exposed to is currency risk. As a manufacturer, we would have to pay at least some of our bills in the local currency (we would definitely have to pay employees in their local currency, even if we were able to convince local suppliers to allow us to pay them in K\$). We would then be exposed to the fluctuation in exchange rates between the local currency and K\$.

## **Task 2**

### **Value analysis**

We could use value analysis to identify any unnecessary cost elements within the components of our furniture and design services. Any costs that do not add value to our design activities or furniture products should be eliminated. Value analysis should lead to the reduction of components used in our furniture products, the use of alternative, cheaper components and the standardisation of parts across several product lines. The general method we should follow is as follows:

- As part of the design stage, we need to determine the function of each item of furniture and each component that is used within it and identify the existing costs associated with individual components. We then should develop alternative solutions to the needs met by the components. This may involve our design team in recommending design changes, manufacturing method, materials used, etc.
- In terms of inbound logistics, we could develop better relationships with our suppliers so that we always get supplied with the very best quality timbers and maybe negotiate with them to supply us at a lower price if we buy larger quantities at a time. Conversely, we could look to improve our operations by reducing cost by holding lower inventories, even though we would then not be able to obtain quantity discounts.
- With regards to operations, focusing on reducing wastage would help to bring the cost per unit down without compromising on quality.
- In terms of outbound logistics, we could look to be more efficient with our deliveries by grouping together orders for customers in similar locations. As long as we encourage our customers to plan ahead then they are likely to be happy to wait a day or two for their delivery if it will help to reduce the overall cost to them.
- In terms of the sales activity, we already have a good system of working closely with our customers, right through from enquiry to delivery. However, we could discuss with them further about the key aspects of the products that are important to them. There may be some features of the products that would be common to many orders, so if we can standardise some of these, whilst still enabling the customer to have an overall design that is unique to them, we could build in savings here.

### **Value engineering**

Applied to ZX, value engineering would require us to undertake a systematic and organised design approach to ensure we provide the necessary functions in a project at the lowest cost. We would need to look for the substitution of materials and methods with less expensive alternatives, without sacrificing our furniture's functionality. The main difference between value engineering and value analysis, is that value engineering is focused solely on the functions of various components and materials, rather than their physical attributes. For example, we could consider the design of partition screens which can also be used as booths to increase their functionality.

### **Sale and leaseback proposal – impact on financial statements**

Regarding the proposed sale and leaseback arrangement on our manufacturing plant that has been initially discussed with the bank, IAS 17 Leases defines a lease as an agreement whereby the lessor (the bank) conveys to the lessee (ZX), in return for a payment or series of payments, the right to use an asset for an agreed period of time.

Firstly, we would need to assess whether the lease arrangement is a finance lease or operating lease. Recent conversations suggest that this would be an operating lease arrangement, where the significant risks and rewards of ownership of the plant will have transferred to the bank and we will just be renting it from them.

However, given that the lease term is 20 years, this may indicate that the arrangement is in fact a finance lease. One of the key factors that determines whether an arrangement is a finance lease is whether the lease term covers the majority of the useful life of the asset. If it does then there would be a number of consequences we must consider, which are as follows:

We will have to pay a rental charge to the bank under a finance lease arrangement but the rental will be charged as a loan repayment. Any profit made on the sale and leaseback must be deferred and recognised over the lease term. Therefore, profits would need to be recognised equally each year over the term of the lease, rather than the whole profit being recognised immediately. However, the depreciation charge will increase following a sale and finance leaseback, since IAS 17 requires assets to be revalued when legally 'sold'.

The asset should remain on the statement of financial position and would therefore continue to be depreciated over the shorter of the lease term or the useful economic lifetime. Therefore, this would not result in increased short-term profit, as depreciation will in fact have to be included.

The lease would effectively be treated as a loan secured on the plant and therefore a liability would be recognised upon commencement of the arrangement. Interest would then also need to be recognised on this liability which would lead to a further expense over the lease term.

The impact in the financial statements may not therefore be what ZX desires. Gearing would increase due to the recognition of the liability and the profit would be recognised over the next 20 years. Depreciation would further reduce profits. Therefore, I would suggest that before pursuing this arrangement with the bank, further discussions are carried out to determine a suitable lease period and to discuss the implications of both types of leases. If it is treated as an operating lease then there will be a boost to this year's profit. However, we need to make it clear that this is a one-off benefit and that we need to take into account future lease payments. This could distort any comparative measures that we rely on for our long-term decision making.

**NB candidates referring to IFRS 16 instead of IAS 17 were given credit for this approach.**

### **Task 3**

#### **Stakeholders and the information we need to communicate to them**

##### *Customers*

Differentiation must primarily focus on the needs of our corporate clients. Our customers determine our expectations of levels of quality and from the achievement of this we will also achieve high levels of customer satisfaction.

Our clients will need to know what makes our products better from the rest of the market and why that differentiation is of value to them. They will need to know what makes our products superior to our competitors, in terms of design, functionality, quality and sustainability and excellence in customer service activities, such as after-sales support.

##### *Suppliers*

Differentiation based on quality will not succeed unless it is supported by other key components of our value system, such as our suppliers of raw materials. If our raw materials are of the highest quality then we have the best chance of achieving quality products and high levels of customer satisfaction.

Suppliers will need to know our exact requirements both in terms of raw material quality specifications and delivery schedules. Customer satisfaction will be affected not only by the quality of the product but by the on-time delivery of our products, which clearly will be affected by late deliveries by suppliers. Suppliers need to know the role they play in our value system and be made to feel like an important part of the whole manufacturing process. Involving some of our key suppliers in the design process could assist in this.

##### *Employees*

Our employees, particularly those involved in our primary activities of design, manufacture and fit-out are critical to the achievement of a differentiation focus. If employees do not buy into a focus of the highest level of quality and customer satisfaction then it will certainly fail.

Employees will need to know exactly what customer expectations of quality are. The standards for quality in terms of wastage levels, lead times and customer satisfaction ratings must be clearly explained to employees and any training necessary to achieve these must be given. Employees will also expect to know what benefits they may receive from the achievement of these high levels of quality and customer satisfaction (for example bonuses).

#### **Performance measures to monitor and promote improvements in quality and customer satisfaction**

A useful tool which we could consider implementing in ZX is the balanced scorecard. This would help us to focus on a range of financial and non-financial performance measures to assist in monitoring and promoting performance in quality and customer satisfaction. The balanced scorecard specifically focuses on four key perspectives.

### *Internal business perspective measures*

In terms of measuring the highest levels of quality, we should be focusing on measures which monitor and drive manufacturing excellence. We should be measuring the performance of our production activities to ensure we maintain the highest standards of manufacturing quality. We would need to set exacting targets for all of these measures of performance and monitor these on a daily/ weekly basis to ensure our commitment to the highest levels of quality production.

Measures could include machine downtime percentage, raw material wastage percentage, number of units re-worked and product defect percentage. Monitoring these measures would indicate any areas of weakness in our production process which may impact on our ability to achieve the highest levels of quality output.

### *Customer perspective measures*

Customer perspective measures would help us to focus specifically on ensuring the highest standards of customer satisfaction, which is part of our differentiation focus. We should be measuring how satisfied our customers are with our products/ service in order to improve and exceed their expectations.

Measures we could use are percentage of on time deliveries, number of customer returns, number of repeat orders and customer satisfaction ratios (or number of customer complaints). Monitoring and acting upon these performance measures would assist us in evaluating more effectively the needs of our customers and how we can ensure total customer satisfaction.

### *Financial perspective measures*

We could also set ourselves financial performance targets to measure the success of our differentiation focus. Monitoring of market share percentage would enable to assess how successful our differentiation focus is, in terms of winning and retaining customers. Monitoring our revenue from repeat customers will enable us to evaluate our success in creating additional revenue from keeping our customers satisfied.

### *Innovation and learning measures*

A quality focus will require quality investment, particularly in terms of ensuring our staff are appropriately trained and motivated.

We could implement measures such as employee satisfaction ratings, number of days training per employee and number of accidents per month. These measures should assist us in monitoring how motivated and well trained our employees are which should have a direct impact on our ability to achieve and maintain the highest levels of quality and customer satisfaction.

## **Task 4**

### **Review of forecast performance 2018**

It would seem that our forecast performance for 2018 has been adversely affected by RiPlan's move overseas. However, we have to be cautious about any assumptions and possible reactions to this, as there may also be other factors involved which we must first investigate and take into consideration.

Clearly, both turnover and gross profit are predicted to decline, based on our 2017 results. It would appear that customers have been attracted by the lower prices offered by RiPlan, despite our best efforts to attract customers with our high quality focus. Also, our distribution costs have clearly increased, despite fewer sales, which appears to show a lack of control of distribution expenditure, which must be investigated immediately. Our operating profit is worryingly low, with a predicted drop of nearly 40% on our 2017 performance.

In terms of product sales, it is evident that both seating and storage solution products have been severely impacted in the last year. We must therefore look into evaluating (a) the viability of these products in the long term and (b) the actions we might take to make these products viable. If sales continue to fall in both of these product groups, we may need to consider whether to stop production and focus upon those products which appear to be holding strong against competitive threats.

However, many of our non-financial performance indicators are in fact showing a positive trend, which may indicate that our moves towards quality-focussed differentiation are indeed working. Our customer satisfaction ratings to date in 2018 are predicted to increase on 2017, as too are our on-time deliveries. These are both highly positive measures, showing that our quality-focussed initiatives are benefiting the quality of our products and our ability to manufacture and deliver effectively. We must continue to improve these indicators through commitment to quality and consideration of the needs of our customers.

There are also positive improvements in our production activities, with evidence that material wastage and machine utilisation have improved. Again, this is a positive sign. It would also seem that this range of improvements has resulted in fewer staff injuries, which is consistent with our business objectives.

Market share has fallen by 3% following a high point for us in 2017 when our market share exceeded that of RiPlan. However, it now seems that they may have regained the initiative and we must make sure that this trend does not continue.

Our response to these results must be careful. It would be dangerous to immediately reduce our own prices or cut our costs without considering the long-term consequences of these actions. We must reassess our quality focus and consider a direct marketing campaign to reinforce our quality-focussed approach. We must talk directly to current and potential customers to assess their needs.

### **Benefits of a performance appraisal system**

A performance appraisal system can bring many benefits to both our employees and ZX as an organisation.

### *Benefits to employees*

- An appraisal system provides feedback about performance at work and an assessment of competence through comparison of performance against established standards and agreed targets. This gives employees a focus for improvement and growth.
- It will identify work of particular merit and provide a basis for reward/remuneration.
- It may be used to discuss future prospects and ambitions for employees.
- It may identify training and development needs for each individual employee, again assisting in the development of skills and knowledge.

### *Benefits to ZX*

- It provides a system for assessing competence of employees and identifies areas for improvement and therefore assists in formulating corporate training needs and plans.
- It provides a fairer process for making reward decisions.
- It can improve communication between managers and employees.
- It provides clear targets linked to corporate objectives.

### **Actions to overcome resistance to performance measures**

The main resistance is likely to occur as a result of lack of knowledge and understanding of the performance measures being introduced and the impact that they may have on those staff affected. Therefore, we must communicate the proposal to use performance measures to the production staff, to ensure they understand the benefits and the implications for them. We may also want to consult staff in the affected production centres on how the performance measures should be designed and implemented to ensure that they accept them more readily. Participation in the design process of relevant and appropriate performance measures is often the most effective way to overcome resistance.

Setting an appropriate and fair bonus scheme based on performance measures may also overcome resistance. However, this will only work if the employees can see a clear and direct link between improvements in their performance with an equal increase in bonus payments.

The benefits in terms of long-term development, career progression and training opportunities must be explained clearly to employees and must also be a focus of the performance measures within the appraisal system. As an organisation, we must be sure of our reasons for measuring production staff performance and any measures used should not be implemented as a punishment but rather as a way of improving performance in order to achieve improved quality levels and customer satisfaction.