

MANAGEMENT CASE STUDY NOVEMBER 2017 EXAM

ANSWERS

Variant 2

The November 2017 exam can be viewed at

<https://connect.cimaglobal.com/resources/november-2017-management-case-study-variant-2>

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Task 1

ZX core competencies

Our core competencies should be those which support our business objectives. One of ZX's business objectives is 'to provide quality office furniture through highly skilled employees...' Our highly experienced and skilled design and production staff are a core competence, as their knowledge, skill and experience would be difficult to replicate in the industry and is likely to be highly valued by our customers.

A second core competence is related to another of our business objectives, that of 'to exceed customers' expectations in product design, delivery and cost through continuous improvement and customer interaction'. ZX has a strong focus on exceeding customer expectation, both in terms of innovation and high levels of customer service and interaction with our customers. This is a core competence as this focus on the highest levels of quality and customer service are highly valued by our customers.

Our third business objective of 'maintain focus on quality design and production' is also a core competence as quality of design and production is likely to be the main priority of our customers and by excelling at this, it will drive us towards achieving sustainable competitive advantage.

These core competencies are suitable for the KorLux project because they appear to match exactly the expectations set out by Mr.Chen. So, although we may be currently operating in a different sector of the overall general furniture market, it would seem that our core competencies are certainly applicable and transferable to undertaking a project such as the KorLux project.

Risks of accepting the KorLux project

There are a number of potential risks we should consider before commencing such a project.

Firstly, there is potential for contractual risk, in that KorLux clearly has very exacting standards and expectations and we would need to know exactly what these are along with any penalties for not achieving them. As this is the first time working on such a project and in this area of the furniture market, this is a large potential risk for us and project management of such a contract will be challenging.

Should this project fail in any way, our reputation in the industry could be severely damaged. This is likely to be a high-profile project and failure to deliver the high standards expected could result in damage to existing business and most certainly hamper any future contract extension with KorLux.

There is however a potential upside risk here, in that should the project be successful, our reputation may be enhanced and this may open up a whole new area of opportunity in the furniture market for us. However, we should also bear in mind the potential impact this contract could have on our existing customers, as we risk damaging our relationship with existing clients if we lose focus upon their needs during this contract period with KorLux.

There is a risk associated with using KorLux's existing mahogany supplier. We have never used this supplier before and we may have difficulties in working with them, particularly due to their overseas location which could timing issues and communication difficulties. It is also likely that this supplier will be a significant stakeholder and partner in this project and therefore we must consider the potential operational risks of working with them.

There is also a risk of working so closely with the KorLux staff as part of our design and project management team, and we will need to ensure that relationships and boundaries are established early on. As a business, we have a particular way of operating and the expected level of involvement by the KorLux staff could hinder our procedures and result in conflict and poor motivation. This may ultimately impact on the overall success of the project.

There may also be a financial risk associated with currency fluctuations between our currency and the supplier's home currency.

Task 2

Recognising the revenue of the Kordia hotel fit outs

IAS 18 provides the rules for revenue recognition and generally requires that revenue is recognised in accordance with the substance of the arrangement between an organisation and the customer.

IAS 18 defines revenue as the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity. The main issue with revenue is determining when it should be recognised in the financial statements. In terms of having received payment in advance, there is nothing wrong legally with this as it is up to KorLux if they want to pay us in advance.

However, from a commercial point of view we haven't carried out the work yet so, as the costs have not yet been incurred, it would be financially misleading for us to show the proceeds of the sale.

The basic principles applied are that revenue should only be recognised when it is probable that future economic benefits will flow to our organisation and these benefits can be measured reliably. Revenue from the sale of goods should be recognised when all of the following criteria have been met:

- the significant risks and rewards of ownership have transferred to the buyer
- the seller does not retain continuing managerial involvement or control over the goods
- the revenue can be measured reliably
- it is probable that economic benefits will flow to the organisation (i.e. the customer will pay for the goods)
- the costs to the seller can be measured reliably.

Therefore, in the case of KorLux making a payment in advance for the three hotels not yet completed, this cannot be treated as revenue. The furniture for these three hotels has not yet been manufactured and therefore there has been no transfer of risks and rewards of ownership, or of managerial involvement and control. In this case, the payment in advance should be credited to deferred income and recognised as a liability in the statement of financial position.

NB candidates referring to IFRS 15 instead of IAS 18 were given credit for this approach.

KorLux project performance

Financial performance

Current gross profit for the first three hotels is at 25%, compared to budget of 30%. This will need to be monitored over the remaining fit-outs to ensure that cost of sales does

not continue to rise. It would appear that the cost of sales has been higher than expected, likely to have been driven by the required overtime needed to hit the deadline expected by KorLux. This needs to be investigated further. Are staff struggling to meet the deadlines imposed by KorLux?

The final gross profit margin for the whole project is 33%, which is higher than our normal gross profit margin of around 30%. We must keep a closer eye on the production and fit out costs for the remaining three hotels if we are to achieve the target gross profit percentage.

Non-financial measures

Importantly, we have met our deadline for delivery for the first three hotels and the customer reaction so far has been very positive. Therefore, we appear to be keeping our customer happy. The level of re-works of completed items is higher than planned, which is possibly a result of inexperience in this kind of hand-crafted manufacturing process. This needs to be monitored over the rest of the project to establish if additional training is required for staff to ensure consistency of production output. The level of raw material wastage is also higher than target, which is clearly in line with the measure discussed previously related to re-works. This needs to be addressed, as this will clearly affect the overall profitability of the project if this continues. A slightly worrying result is the level of staff absenteeism on the project, which is higher than we would expect. We need to look into this to assess the motivation of the staff involved in the project and the support we are giving them.

Key stakeholders interested in these performance measures

Obviously, our key stakeholder in this project is the customer. They will be interested in the quality and timing aspects of the project. It will be important to ensure that we communicate with KorLux on project progress in terms of completion units and dates of delivery. KorLux will also be interested in quality and therefore communication with them on our quality management performance will be very important. In fact, involving KorLux in quality inspections could be useful.

Our staff are also key stakeholders in this project and we must communicate with them on the expectations of quality standards and the importance of meeting deadlines. Staff are the key resource in the delivery of this project and keeping them fully involved in understanding its progress and the requirements of successful completion will be critical. Again, staff will be particularly interested in the quality performance measures and we must communicate any indicators which show quality standards are not being met. This must be done in a timely manner to ensure any problems are rectified quickly.

Senior management will be most interested in the financial performance of the project and these measures must be presented to the senior management team on a regular basis throughout the life of the project. They will be keen to assess the success of this project and the likelihood of future contracts with KorLux and other similar contracts in the future.

Task 3

The learning curve effect and financial risk of using an overseas timber supplier

The graph presented by Anna Brent demonstrates the learning curve effect: the tendency for labour time per unit to reduce over time as staff become more familiar with the task. For a learning curve to apply to this project, the following conditions need to be met:

- Production needs to be labour-intensive.
- The production process should be repetitive.
- Labour turnover should be low.
- There should be no prolonged breaks in production.

It is clear that the KorLux project meets these conditions. However, the learning curve may not be fully applicable to further development of the project, as should KorLux extend the contract to include the proposed further 20 hotels, then the original learning effect is likely to be lost.

We could also consider the experience curve, which is a broader concept where the effects of other costs of production in addition to labour are considered.

Application of these concepts could be very useful to ZX in identifying an appropriate budget and work scheduling for the KorLux project.

Budgeting and standard-setting

The learning curve could be particularly useful to assist us in budgeting. This is because budgets and standards will only provide reliable benchmarks to measure actual performance against if account is taken of the learning curve effect. Therefore, it is difficult to set labour standards where a learning curve applies and therefore standards should not be set until the 'steady state' has been achieved.

Work scheduling

Understanding the learning curve allows us to improve scheduling of labour and enable deliveries and fit out to take place on time. As KorLux will have exacting standards for fit out, it will be important to schedule these effectively.

Financial risks of using the mahogany supplier in Dotta

To realise the value of our foreign-denominated cash out flows, we will need to exchange foreign currency for domestic currency. The wood supplier is likely to want to be paid in their local currency. As we wouldn't normally have dealings in Dotta's currency, we will be exposed to transaction and translation risks. We will need to pay the invoices as and when they become due, even if it is not a good exchange rate at the time, between K\$ and the Dotta currency. This could mean that the cost to us is greater or, if we are lucky, less than we would expect had the invoice been in K\$.

As we will try to negotiate contracts with set prices and in particular set delivery dates, in the face of a potentially very volatile foreign exchange market in Dotta, with exchange rates constantly fluctuating, we face a risk of changes in the exchange rate between the foreign and domestic currency. The risk lies in the change in the exchange rate between the time we sign a contract with the supplier and the time we come to pay. As transaction risk has a potential impact on our cash flows we should hedge against such risk exposure.

However, firstly we should assess the degree of exposure we face, which will be dependent on whether the size of the contract with this supplier is going to be material, how long the hedge period (the time period before the expected cash flows occur) will be and the expected volatility of the exchange rates in Dotta during the hedge period.

To protect ourselves against this risk, we could undertake a range of hedging techniques. Firstly, we could insist that all transactions are carried out in K\$ and that we will pay for all imports in our home currency. This will need to be agreed with the supplier and indeed may be preferable to them.

We could also undertake leading or lagging whereby we delay payment to the supplier if we think the currency will depreciate or we could negotiate early settlement if we think the currency is likely to appreciate. This will require careful monitoring.

We could do nothing and hope that any exchange fluctuations are not significant and over the period of the contract may merely even themselves out. However, this is likely to be risky, dependent on the level and direction of volatility.

Transaction risk could also be hedged using a range of financial products such as a forward contract, where we can buy and sell a currency, at a fixed future date for a predetermined rate, i.e. the forward rate of exchange. We could also use an option to buy a currency at an exercise price on a future date. If there is a favourable movement in rates we would allow the option to lapse, to take advantage of the favourable movement. The right will only be exercised to protect against an adverse movement, i.e. the worst-case scenario.

Task 4

Continuous improvement

Continuous improvement, or kaizen, is a method for identifying opportunities for streamlining work and reducing waste. It is important for ZX, as it ensures that we as an organisation maintain an ongoing process of improving products, services, and procedures to improve customer satisfaction, quality, safety and profit. As one of our key business objectives, by following a process of continuous improvement this should assist in us achieving our overall mission. It should be a systematic process undertaken by ZX, which identifies and eliminates waste so that ongoing, measurable gains are routinely achieved and we can continue to achieve competitive advantage in the office furniture market.

Continuous improvement to the investors is to improve financial results, to the board it is to improve the business results, to the middle management it is to improve the processes, and to the design and production staff it is to improve the activities and functions in which they are involved. In order to achieve all of these objectives (and therefore achieve continuous improvement), our performance measurement system should assist in:

- Identifying key areas of ZX's business that need improvement.
- Diagnosing and analysing the reasons behind low performance identified.
- Planning and implementing changes necessary to improve performance in a quantifiable or measurable way.
- Monitoring the results to find whether they achieved the expected results.
- Developing a closed-loop control system to promote continuous improvement.

Performance measurement is a tool for continuous improvement. To facilitate continuous improvement, performance measures need to be deployed right down to operational teams within our design, procurement, production and fit-out teams, who can use them to monitor, control and improve their daily activities. Performance measures should be simple to understand and use and be relevant to the users. It is also important to make a clear distinction between improvement indicators and control indicators. Improvement indicator is one that needs to be measured for an improvement. Control indicators are those that do not require improvement but must be monitored.

Kaizen, lean production and Six Sigma all rely on systematic closed-loop systems using measurement as a tool for continuous improvement. The essence of continuous improvement for ZX is to constantly seek ways in which our products and processes can be improved, so that greater value can be delivered to our customers at ever greater levels of efficiency.

Delegation of responsibility for continuous improvement

There are many reasons why the senior managers of ZX should delegate responsibility for continuous improvement to the staff. Firstly, it allows for better decision making, as those staff closest to the business processes we are trying to improve are making the decisions. Our production and design staff are those individuals with the appropriate

skills to make the decisions relating to those factors which will enable us to achieve continuous improvement. Importantly, it should also provide our staff with more interesting work, increase job satisfaction and therefore should increase motivation and encourage higher levels of quality.

In planning delegation therefore, ZX's senior management team must ensure that:

1. We define the limits of authority delegated to staff in terms of expectations of the levels of responsibility for continuous improvement.
2. The staff are competent to exercise the delegated responsibilities. This will require full communication with all staff involved to assess levels of competence and potential areas for skill enhancement and training.
3. We allow those staff involved the full use of that delegated authority without constant checks and interference from the senior managers.
4. Staff are not overloaded. They will already be stretched with working with new customers and with new production techniques, so any further responsibilities must be monitored and evaluated to ensure staff are not put under too much pressure.
5. Every staff member has the reasonable skill and experience in quality management. If not, necessary training and support must be given.
6. Appropriate authority only should be delegated. Staff must not feel that senior managers are somehow shirking their own responsibility for quality management.
7. Time is set aside for coaching and guiding and also quality management initiatives such as quality circles.

The delegation of responsibility for continuous improvement should aim to create an environment that elicits the best from our staff, which should lead to increased job satisfaction and the successful accomplishment of our organisational goals.