

MANAGEMENT CASE STUDY NOVEMBER 2017 EXAM

ANSWERS

Variant 5

The November 2017 exam can be viewed at

<https://connect.cimaglobal.com/resources/november-2017-management-case-study-variant-5>

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Task 1

Treatment of transactions arising

This type of arrangement, as detailed in the Hondurawood proposed contract terms, is normally termed as consignment inventory, which is legally owned by one party but is held by another party, on terms which give the holder the right to sell the inventory in the normal course of business or, at the holder's option to return it to the legal owner. IAS 18 Revenue states that revenue should not be recognised until the significant risks and rewards of the goods have transferred to the buyer.

Before we decide how this transaction for the purchase of the Hondurawood hardwood should be accounted for we need to establish the following facts:

- Who is likely to bears the risks of this inventory?
- Who has the benefits or rewards of this inventory?
- Who has control of this inventory?

Overall, whichever party bears the significant risks of the inventory should recognise it in their statement of financial position.

With regard to the inventory from Hondurawood, in substance, there is a sale by them to ZX on the date that the inventory is delivered. This substance can be further verified by a number of key factors set out in the contract.

Firstly, we face the risk of slow movement or obsolescence of the inventory over the period that we hold it, which is significant based on the length of time this is likely to be, in that we are not likely to use this material for up to 9 months.

Secondly, the proposed contract makes it clear that ZX is obliged to purchase the timber even if it remains unused and we have no right of return it to Hondurawood.

We also are responsible for insuring and maintaining the inventory and we also face the risk of theft. These all point to the need for ZX to recognise the inventory in our statement of financial position.

Therefore, in accounting for the transaction, Hondurawood should derecognise the inventory and records the sale once it is delivered to us. The wood should be classified as the inventory of ZX and would be held on our statement of financial position if it remains unsold as at the year end.

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

Risks of holding large amounts of inventory

As a business, our way of operating in making goods to order on a project by project basis means that we rarely hold large amounts of finished goods in inventory. This helps our liquidity position. However, inevitably, as a business we do need to hold some raw material inventory, which will present us with degree of risk at some point.

Holding large volume of inventory requires a large amount of space to store it. Storage space like warehouses cost money to build and maintain. Storage facilities require workers to categorise and organise items and transport items from one place to another. In addition, high levels of inventory may lead to higher insurance costs, particularly in the case of high value items such as the timber supplied by Hondurawood.

In addition, certain types of inventory may become obsolete. For example, some types of wood may be perishable or may go out of fashion in terms of style in the furniture industry. Keeping a large inventory of such materials is risky because customers might not be willing to buy products at a price that is profitable when new or updated versions of that raw material become available.

Ironically, we ought to manage our inventory like cash because inventory is not like cash. It's less liquid and therefore tying up too much cash in raw materials or finished products could be detrimental to our cash flow. In particular, high value items of raw materials could affect our liquidity.

Storing excess inventory can lead to quality risks, such as degradation quality failures. If we stock high levels of inventory in anticipation of demand or for an existing order, but customers may change specifications or require different materials for future products. In this situation, would need to purchase new materials and supplies to build according to the new customer specifications. We would be better able can identify and isolate quality problems easily with a smaller inventory quantity.

There is also the risk of theft as this could be seen as a well sought-after material. Even though it would be insured (for which we will need to pay a premium), there is likely to be an excess that we would have to pay if we made a claim and it could also lead to us having to pay higher insurance premiums in the future.

Another risk of keeping a large amount inventory is that certain of our raw materials might not sell due to shifts in market demand. Some of the timber that we use may not be fashionable in the next year or so, therefore we should not hold large amounts.

Task 2

Impact of JIT on ZX operations

With JIT, when we get customer orders, only then should we plan material purchases. ZX should purchase the minimum number of items to meet customer demand. However, JIT purchasing typically results in a greater number of smaller orders and frequent deliveries. JIT purchasing may be a good way for us to enhance our business objective of continuous improvement and focus on total quality, but it is likely to be difficult to implement as a standalone process.

At stage 1 of the design and manufacturing activities as set out in our method statement, each project manager will need to work in conjunction with procurement to ensure that each detailed programme of work clearly sets out the material requirements and the JIT ordering requirements. Our procurement team may need to familiarise themselves with alternative shipping methods and identify suppliers and logistics companies who are able to consolidate loads and routes. This may require co-ordinating with other companies operating within the area.

Stage 4 of our manufacturing and design phase of the method statement will need to be revised, as no longer will the manufacturing manager be able to use the MRP system to identify and plan component inventory, as this will no longer be held. ZX senior managers will need to communicate with all production staff, stressing the importance of JIT purchasing to providing quality products and services and reducing costs, as well as convincing staff of the benefits in developing skill sets by taking on different tasks.

Stage 6 of our method statement will be particularly important as quality assurance of incoming material must now be done in a much shorter time frame and high quality material and a right first time approach is critical.

Potential advantages

By minimising inventory, resources are freed up to employ elsewhere in ZX, for example more space to increase manufacturing. This is likely to impact on stage 5 of the design and manufacturing activities of our method statement, as more space will now be available to produce more furniture. It could free our staff to focus on primary tasks, such as making goods and interacting with customers rather than managing inventory. We can train staff to work at different stages of the assembly line or at different workstations, to meet shifts in demand. A better-trained, more flexible workforce focusing on quality production can mean faster set-up or customisation of workstations and lower defect rates, which lower costs and increase customer satisfaction.

Potential obstacles

The primary disadvantage to any form of JIT implementation is its complexity. For successful JIT implementation, our senior management must rethink the entire work flow of the business, from initial intake of raw materials to final output of our finished furniture products. This is likely to have a significant effect on our method statement. Supply chain relationships require rethinking and will involve multiple suppliers, even closer locations, or suppliers that can supply materials with little advance notice. We

may encounter difficulty meeting minimum orders, requiring a different contract or a way to break up a large order over time. All goods must meet quality requirements and our staff must understand more of the entire process and shift to where they are needed as work flow ebbs and surges to meet customer demand swings. This way of working will require a sizable commitment of time and money initially, plus a change in mindset and a commitment to stay the course in implementing JIT procurement in ZX.

Barriers to change and how to manage barriers

Production centre managers could create barriers to change by the way the change is conceived, designed and implemented. Managers could make mistakes by not thinking through the objectives of JIT correctly or sufficiently thoroughly, the resources necessary and the options they are competent to undertake. Crucially, the issue of who leads the change is sometimes not thought through.

There are several factors which could cause barriers for ZX:

Lack of cooperation and co-ordination. Organisational fragmentation and conflict could occur as a result of lack of co-ordination in the required change programme. Moreover, in the case of new technology, the old and new systems may not be compatible. At the operational level, real progress is painstakingly slow and deliberate, as the minute detail of how the present systems work (or do not work) is not known. This is the problem with many business process reengineering projects, as assumptions about how things currently work are made without proper thought. Managerial actions could be about saving face, and their own department's reputation is protected at the expense of co-operation with others.

Excessive focus on costs. Production managers may focus exclusively on costs and may fail to appreciate the importance of a change that is not focused exclusively on costs (as in this case, a change to improve overall efficiency and productivity and ultimately customer satisfaction). In most managerial situations, a change that may incur more costs than current practice is unlikely to be accepted, unless the future returns are considerable.

Failure to highlight benefits. Any significant change will produce both positive and negative reactions. Education and communication may be needed to help managers perceive more positive than negative aspects of the change.

Uncertainty avoidance. At the individual level, production managers will fear the uncertainty associated with change. Constant communication is needed horizontally so that the team knows what is going on and understand how it impacts on their work. An atmosphere of fear leads to a culture of blame and negativity and the excessively defensive process of 'protecting one's own back' and a reluctance to take risks.

Fear of loss. This is of course related to avoiding uncertainty. Managers may fear not only the loss of power and status but also their jobs, especially in the procurement department and warehousing department.

Key to overcoming barriers to change by production managers is participation and education and communication. We should aim to involve managers and centre staff, usually by allowing them to use their knowledge and expertise to contribute to decision

making. This could result in production centre managers enjoying raised levels of autonomy, by allowing them to design their new roles and responsibilities in a JIT procurement system. Effective communication about the benefits of change to employees will result in their acceptance of the need to exercise the changes necessary. In addition, some support should be offered to help them overcome their fears and anxieties about change.

Task 3

The team for JIT implementation and benchmarking:

Team make-up

To make this project a success, we need the best people we can find in the organisation. The team should include the best managers from the production department. This is because we will need a versatile, well-trained and well-motivated labour force which can perform any job within reason to keep production flowing as required. The factory layout will be changed and workers will be put in JIT cells. They will then be trained to operate all the machines within cells and perform routine preventive maintenance on them. Although some of the production managers are not happy about the introduction of JIT, I hope my previous report will help this resistance to be overcome. They need to be on board for this project and view it as an opportunity in order for this JIT project to be a success.

We will need someone from our purchasing department as we will be working with our suppliers in a very different way. We will be expecting zero defects and to take delivery of stock only when we receive orders from our customers. There needs to be someone from the quality department involved as quality certification programmes will be introduced.

There is also a need for someone for the sales department. This is so we can communicate to our customers, the benefits they will receive by us using JIT. Our increased efficiency should mean orders received right first-time, on-time. We could also create an incentive to get them to share with us their data and not change an order once they have placed it with us.

With a lot of changes happening right across the organisation, there needs to be input from HR. This is to allow for potential re-negotiation of working patterns and identification of training needs for our staff. There also needs to be communication of this project as we need to be more efficient in all that we do, to continue to compete in the future. Ideally there needs to be a JIT champion, someone who will communicate and address barriers to resistance within the organisation.

Benchmarking

Although there have been concerns expressed about benchmarking, we should collectively view it as a positive initiative, not a negative for ZX. Benchmarking is a technique that is increasingly being adopted as a mechanism for continuous improvement.

The key areas we should focus on is measuring our products, services and processes against other best-performing organisations, this enables both organisations to learn from each other. The idea is to compare how our processes and activities can be improved in relation to the other organisation.

We should not view external benchmarking as a danger. If we have a confidentiality agreement between organisations, that should prevent our processes being shared with a potential competitor. If we are able to choose a company similar to ourselves who have

already implemented JIT, we can compare and learn from that organisation and perhaps avoid some of their mistakes. The adoption of identified best practice should improve performance.

There are three types of external benchmarking that can be applied here:

Competitive benchmarking

ZX should in this case, compare themselves to our most successful competitors. There will be definite problems in that competitors will be very unlikely to share data, but ZX could investigate the metrics that our competitors give to customers that we share or we attempt to bring across from our competitors. These metrics for a JIT project could include things like length of lead times it takes to make a piece of furniture.

Functional benchmarking

This type of benchmarking is very similar to our internal benchmarking but in this case allows ZX to compare functions of other companies that are not in competition with our own business involved in JIT such as sales, accounts, logistics etc. This allows us to share good ideas that will allow for better running of the business. Ideas include how to save costs and become more efficient.

Strategic benchmarking

This is where companies in the same industry might all actually share data with a third party. This allows for conclusions to be drawn about the industry as a whole and comparison of ZX to those overall results. Example of such benchmarking could be the level of sales, the amount of energy used and total output of manufacturing. This would allow ZX to see how competitive they are compared to other organisations.

Limitations

One of the major limitations of benchmarking is that we may not find a similar organisation to compare ourselves against. When we do, it could be that we cannot get hold of our competitors' data to help us compare and improve. This maybe because they are in direct competition with us and may not want to share all their data or best practice with us. The data when we do obtain it could be out of date or it may not be totally accurate. This may only allow for comparison at one point in time and may not provide guidance as to how to improve now or in the future.

There is also the possibility that this will be a very expensive exercise in terms of management time and cost. We could spend too much time focused on our internal processes and not enough on our competitors. We might also fight amongst ourselves over which idea is best, rather than implementing JIT. ZX must also be careful to use the results of benchmarking. If it does not then there is an even greater waste of management time if there is not a plan by the managers of ZX to implement JIT.

Task 4

Treatment of foreign currency transactions in the accounts

There needs to be consideration of the effect on translation of supplier invoices from BrassN into our home currency by applying the rules found in IAS 21 The Effects of Changes in Exchange Rates. ZX needs to focus accounting for individual transactions in a foreign currency with BrassN.

In this case BrassN is invoicing us in its home currency. We need to understand how we deal with and present these invoices in our accounts. We need to understand what we do with the immediate invoices (initial recognition and subsequent measurement) and then what do we do with outstanding balances we have with BrassN as the exchange rate between our two companies changes (subsequent measurement - monetary items). We also need to consider what happens to the value of stock that we hold of BrassN that will have changed in value as again the exchange rates change (subsequent measurement - non-monetary items).

Initial recognition

When we receive an invoice from BrassN, the transaction will initially be recorded by applying the spot exchange rate, i.e. the exchange rate at the date of the transaction in the Statement for Profit or Loss and in accounts payables. We need to do this with each separate invoice that we receive from BrassN as the exchange rate will be different on each of the invoice dates. This means that the result for the statement of profit or loss will fluctuate dependent on the amount of inventory invoiced and the exchange rate at the time. The cost of the locks will decrease with favourable (to ZX) exchange rates and increase if the exchange rates are unfavourable.

Unsettled transactions at year end (subsequent measurement)

At the year-end we will have outstanding balances of 'foreign' items between ourselves and BrassN in the statement of financial position. The treatment of these will depend on whether they are classified as monetary or non-monetary.

Monetary items are classified as currency held by ZX, or ZX having assets or liabilities to be received or paid in currency. ZX will may have amounts of BrassN's currency in its bank account or in petty cash. ZX will definitely have amounts outstanding to BrassN in its liabilities (payables). It may even have some receivable amounts due from BrassN. If this is case all of these items must be retranslated using the closing rate (the year-end exchange rate between ZX and BrassN). Again ZX will be exposed to potential losses or gains due to changes in exchange rates. The loss or gain caused by this exchange difference must be taken to the statement of profit or loss at the year-end.

Non-monetary items are classed as 'other items' in ZX's statement of financial position. Examples of non-monetary items are non-current assets, inventory, and investments. ZX will definitely have items of BrassN's products (locks and hinges) in their inventory. The good news here is that there is no need to retranslate at the year-end exchange rate.

The monitoring of operational and ethical issues

Performance measures to maintain supply of handles and locks

Here are just a few suggestions as to what we should measure our supplier on:

The number of on-time deliveries: just as we should measure our own outbound delivery on-time performance, so we should track the percentage of inbound deliveries received on time from our supplier BrassN. Although the criteria to classify a delivery as on time can differ from one organisation to the next, the measurement usually follows the typical percentage formula (percentage of deliveries received at their promised arrival time).

The level of non-conformance (e.g. rejects): we do not want the product that is arriving to be of a poor quality. As it is a vital part of our production process, we must ensure that the product is of an excellent quality. Even though locks and handles are a small part of our overall product offering, if we do not get them right, our customers will view our products in a very bad light.

Financial health: if BrassN are in poor financial health, this could disrupt our supply chain if they enter bankruptcy. We would be scrambling around for another supplier of locks and handles. There could be lots of pressure with lead times as we negotiate our design and volume requirements with any new supplier. This may mean that we let our customers down and lose their custom over time.

In return if BrassN hits all these targets we should ensure that we offer our own performance target and pay all their invoices in time to avoid any financial health issues and threat to our supply chain.

The issue of potentially illegal payments by BrassN

Even though this practice could be taking place with a third party supplier, all efforts must be taken to stop this practice and BrassN must behave in an ethical manner. If BrassN cannot stop the practice then potentially drastic action must be taken such as looking to find a different supplier. The reason why we must stop it is that we must have the highest ethical and professional business standards. CIMA's code of ethics mentions that inducements will threaten an organisation's objectivity and encourage unethical behaviour.

We should approach the representatives of BrassN when they visit us and informally present our evidence. If they deny any knowledge, we will get assurances that this is not happening and follow up this discussion with an email restating their belief that nothing is happening. Should it be found that they knew of any wrongdoing, we will have written evidence that we were informed to the contrary.

It would also be advisable to prepare a press release that could quickly be put out should the worst happen. I also suggest getting further legal advice to investigate what more we should do to protect our organisation.