CIMA

Chartered Institute of Management Accountants

OPERATIONAL CASE STUDY NOVEMBER 2016 EXAM ANSWERS

Variant 2

The November 2016 exam can be viewed at

https://connect.cimaglobal.com/resources/november-2016-operational-case-study-variant-2

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SECTION 1

EFFECTIVE BRAND MANAGEMENT

Financial and non-financial benefits

An effective brand management strategy, which will involve bringing the Marici Power brands under the umbrella of the Wala Group marketing plan and TrueValue, seeks to establish long-term benefits by creating a recognisable and attractive set of brands in the eyes of the customer base. Ultimately, the benefit is improved profitability through the brand.

Non-financial benefits include:

- A stronger way to connect with our installers and distributors, by talking to them about what TrueValue means for them and all of the Wala Group brands. The brand should dovetail with our wider marketing efforts. By using the TrueValue brand, the advertising and launch of new products could be carried out from a very strong platform.
- This can help develop further trust and confidence in the brands and the group, which should generate customer loyalty. Although our product may be a long-term one-off purchase for the end customer, there may be some repeat business for example through the ongoing servicing of the product. We would certainly hope to achieve loyalty and repeat purchases from our installers and distributors (so they choose our brands over our competitors and therefore repeat sales are increased).
- It also offers differentiation from the competition, to distinguish our organisation and brands from our competitors, so acts as a source of competitive advantage. This should lead customers to prefer our products and, possibly, to pay premium prices for them. Unless our installers and distributors are tied to exclusive contracts, then this differentiation could be a key to us achieving preferred supplier status with them.
- It enables us to connect with our customers at a deeper level, to talk about areas such as quality and service, rather than focussing on price.

These lead to financial benefits such as:

- A recognised brand may enable us to charge higher prices giving an immediate boost to revenues and profits. Our installers and distributors may be willing to pay these higher prices if, in turn, the end users are also prepared to pay high prices for the brand.
- An increase in customer loyalty should lead to increased sales which should then lead to greater profitability.
- The brand is a valuable asset. If this appears on the statement of financial position, then this represents a visible aspect of the company's wealth. Even if it does not, then it is still valuable because future business and profits will flow from it.

Ways to incorporate digital marketing

For Marici Power the customers are distributors and installers, so our customer model is a business to business (B2B) one. Therefore the majority of our digital marketing will be to these customers rather than to the end customer. Our installers and distributors represent a relatively small, and known, number of customers. This helps us in targeting our digital marketing efforts rather than engaging in speculative mass marketing to a much wider audience.

Digital marketing is the promotion of brands using electronic media, such as email, the internet, mobile phones or social media. Compared to non-digital methods, digital marketing has the benefit of being able to monitor and evaluate the marketing in a timely and cost-effective way (for instance by monitoring what is being viewed on an internet page).

The type of information that we may wish to disseminate would include corporate developments, specific product developments, special offers, competitive performance, and independent reviews.

Internet - our website should promote the TrueValue message so that any visitors to the website will receive a consistent message. It also allows us to deliver a good quality, up-to-date message. Our other marketing can direct customers to our website, with specific parts of the website dedicated to different types of customers. The company website needs to be up-to-date, well designed and easy to navigate. Since this will be accessed by a range of different interested parties, then they all need to be directed quickly and easily to those pages that are of particular interest to them. For example, perhaps the installers would be more concerned with practical technical issues to a degree that distributors would not.

Email – email can provide sophisticated segmentation opportunities so that messages and promotions can be sent via email to specific segments of our market, so helping to develop a more intimate customer relationship where possible. For instance, if a distributor specialises in only one of our products, then we can focus our messages on that alone.
It is important here to distinguish our e-mails from the frequent junk mail that the installers and distributors will undoubtedly receive. E-mails should be sufficiently significant and interesting to encourage the distributors and installers to want to read them.

Social Media Marketing - social media sites such as Facebook and Twitter have a large number of users, and whilst firms use these sites for marketing purposes and market research this is mainly used for B2C (business to consumer) models. However it is useful to monitor brand name mentions on these sites to capture any reviews of our products or our competitor products. Consumers are using social media more recently for raising the profile of customer complaints, and the message can reach a large number of people very quickly, so knowing about this and conducting an appropriate response is very important.

Useful life of a purchased brand name

A purchased brand name is classed as an intangible asset under IAS 38 Intangible Assets, which is defined as an identifiable non-monetary asset without physical substance.

The entity must assess the useful life of an intangible asset as either finite or indefinite. An intangible asset with a finite useful life should be amortised over its expected useful life, whereas an intangible asset with an indefinite useful life should not be amortised (but should be tested for impairment at least annually). It is very unusual for an intangible asset to be deemed to have an infinite life.

There are four main issues that should be considered in determining useful life; expected usage, possible obsolescence, industry stability and market demand. There are some interrelationships between these issues and they can be considered in the Marici Power/Wala Solar situation as follows.

We operate in an industry that has a degree of stability, but that has (and continues to) experience some dramatic changes. There has been considerable growth in the industry as solar power has become more widely accessible and acceptable. This has inevitably increased competition as new entrants have sought to exploit the profit opportunities of an expanding market. The early demand for the products was impacted by the generous government incentive packages. However, changes to government policy have sometimes adversely affected demand which has undermined the industry stability. The extent to which the industry can sustain itself with little or no government incentives will be a factor in determining the useful life of the brand.

The possible obsolescence of the products and brands is the next issue. How long do we expect solar power to be required? There is optimism here that this will be a very long time indeed. As an ultra-long-term renewable energy source, we can reasonably expect solar power to be used long after fossil based energy sources have ceased to be significant. However, obsolescence can also arise due to technological changes. How soon might we expect our current technology to be superseded by new technology (perhaps one that is significantly cheaper or more efficient)?

We should also consider the demand for the product represented by the brand. There may be an assumption that the output from the products (which is electricity) will continue indefinitely. However, will electricity continue to be required in the same volumes as it is today?

SECTION 2

ZERO BASED BUDGETING

Setting the budget

Using ZBB, every activity has to be justified (in comparison to incremental budgeting where the figures from last year are used as a base). ZBB is applicable for discretionary costs, where any expenditure or the amount of the expenditure is at the discretion of management. In the case of the Finance Department there is clearly discretion over how much we spend and the Finance Director has determined the activities that are the object of incremental decision packages. In this case, the addition of an internal audit function and the expansion of the management accounting function.

The Finance Director will have scrutinised each activity by asking whether the activity should be undertaken at all, how much of the activity should be done and to what standard. These would be in addition to the base package (which would be a minimum spend). The base package would be considered essential. We need to determine what the base package can achieve and how the benefits can be measured and evaluated.

The next step is to prepare a number of alternatives decision packages (so in this case it would either be whether to create an internal audit function and/or expand the management accounting function). The Finance Director will have considered how each activity should be done and how much each alternative would cost. ZBB encourages creative thinking concerning different ways of achieving objectives. We would need further information about the internal audit function to evaluate the benefits and likewise with the option of expanding the management accounting function; what would be the expected benefits in terms of control, risk management and improved decision making?

The evaluated packages should then be presented to the budget committee for a final decision about how we will actually operate the Finance Department next year. In making this decision, the budget committee will take a wider view over the whole organisation. This will include resource constraints (not the least of which will be cash) and the conflicting calls upon these constrained resources. The budget committee would review each of the decision packages and decide the resources that should be allocated to the Finance Department depending on the combination of activities that are approved.

ZBB can result in significant cost savings, as all activities and costs are budgeted from scratch, but can also mean an increased budget for a function/activity based on the evaluation, or the same budget as before.

Conflicting purposes of budgeting

When developing the budget for the forthcoming year the plans for that year are taken into account and their likely effect on revenue and costs is estimated. However there are a number of areas that could cause conflict when the budget is used for performance evaluation.

For example, one purpose is for the accurate planning of resources. If the budget for the sales team reflects what we genuinely believe we will sell, then we can gear our production to this volume. We can plan for raw material purchases, labour requirements, overtime, machine usage and so on with confidence. However, the motivational aspect of budgeting suggests that sales targets should be such that we encourage the highest possible efforts from the sales team. It is argued that targets should be higher than those that are actually achievable but only marginally so. In this way, sales staff are motivated to achieve a target that they think is possible, but that is not so difficult that it becomes demotivating.

Clearly if we set motivating budget targets that are not quite achievable then there are concerns about planning on this basis. We would probably plan for too many raw material purchases, too much production and too much inventory. A further concern is that, if we set a challenging but not quite achievable target, we might penalise the sales team for falling short of it. This would be unfair and demotivating if the actual performance was as good as could reasonably be expected and was an improvement in the previous year. It might therefore be appropriate to use different budgets for different purposes; a motivating target for the sales team, but a realistic target for resource planning.

Circumstances during the budget period may have changed from what was anticipated, as inevitably there is always an element of uncertainty in the budget. This can be particularly evident where there is a chance of significant changes during the year. The market environment in which Marici Power operates is changing rapidly. There is uncertainty surrounding raw material prices and the potential effect of the cut to government subsidies on sales demand. The integration of Marici Power also raises question about the future including the changes to the branding strategy and the potential release of new products which may not be included in the budget.

For performance evaluation other factors may affect the usefulness of the budget. For example, if the production department do not meet their budgeted production this could detrimentally affect the sales team’s performance or delay the release of a new product.

If performance evaluation is linked with the rewards system, sales team may try to set easy sales targets, in the knowledge that these would be exceeded, in order to increase their rewards.

To minimise these conflicts a rolling budget (also known as a continuous budget) could be used, so that rather than using a static annual budget for the target for the year, projections are produced each month to reflect any changes in the underlying assumptions of the budget. As actual sales figures become available for each month these are updated in the rolling budget in place of the forecast figures, and a further month is added to the rolling budget.

SECTION 3

MAINTENANCE COSTS AND EMPLOYEE ENGAGEMENT

Labour cost budget for maintenance department

The first steps in introducing activity based budgeting are to identify cost pools or activities and to establish a cost driver for each activity. The schedule provided by Alex shows four cost pools and their cost drivers. We can build up the budget by each activity in turn.

For each of the activities we need to estimate the time taken to carry out the activity. This could be done by asking the maintenance function staff to provide estimates, or by conducting a work study over a short period of time. The cost of idle time will also need to be included in the budget. There will be periods when not all of the maintenance team will be fully occupied. We also have to take into account lunch breaks and rest breaks. We also need to recognise that experienced members of the maintenance function are likely to take less time on an activity than a new member of staff. This will be particularly relevant as additional members of staff are expected to be required. The new staff will need training and will go through a learning curve for the different activities that are undertaken.

For each activity, we then need to estimate the number of cost drivers that we expect to be performed within the budget period. For example, for repairs we would estimate the total number of faults that we expect to arise and then multiply this by the time required to carry out the repair to give the total hours needed. The estimate for the number of cost drivers could be based on information from previous year, if available, adjusted for changes in the expected activity level.

We need to establish the costs per hour for each activity. For example, do repair staff get paid more than cleaning staff? Each of the total times can be multiplied by the labour costs per hour to give the cost of each activity. We would also need to add any employer related costs to the total cost for all activities.

The breakdown of activities and the cost driver for each activity should be analysed in more detail to check that the activities chosen are appropriate and that the cost drivers are a good reflection of the cause of the cost arising.

If the activities do not arise smoothly throughout the budget period, then the costs may need to be budgeted by month. We should also be aware of any anticipated pay rises that might arise during the budget period and factor these into the budget.

Incentive schemes / employee engagement

A good incentive scheme links reward to improved performance, and helps to give a clear direction to employees of where their efforts are needed most. Clear communication of objectives and a financial reward based on these objectives can increase employee commitment, motivation and engagement. We need to consider whether the group or the individual scheme will be more effective for Marici in enhancing morale and motivation. We also need to consider which will be deemed fairer by our staff. The incentive scheme will be a morale and motivation factor in itself.

An incentive scheme based on individual performance is motivational to the employee as they can see their own efforts and achievements being recognised and rewarded directly. However, this may encourage selfish thinking which we would not wish to encourage. There can be difficulties in determining an individual's performance level where outputs cannot objectively be determined by individuals. This leads to performance assessment being subjective, and can lead to a notion of bias.

A group incentive scheme, or as you suggest an incentive scheme based on the organisation's overall performance, is based on the performance of the identified group (for instance the maintenance team achieving or exceeding their targets). Collective team work might be a worthy outcome of a group scheme, but we need to be careful that high performing employees are not penalised by their rewards being dragged down by an average that includes the efforts of less able/hard working colleagues. A scheme based on the organisation's overall performance (usually measured by meeting or exceeding a target profit) encourages employees to work together across different departments and parts of the organisation (for instance with Wala Solar head office) as they are all working towards the same goal. This type of scheme can prove very popular when times are good, but can be the cause of resentment when the business is not doing as well. Employees may perceive that they have contributed well and achieved their objectives but it is another part of the organisation, or external forces, that have meant that the overall incentive has not been achieved.

My recommendation would be to consider a combination of the two schemes – an element of incentive for an individual's performance against carefully prepared and agreed objectives, and a further, larger, element based on the overall performance of the Wala Solar group to encourage employee interest and engagement with the new group.

SECTION 4

IMPACT OF PROPOSED POLICY CHANGES

Changes in accounting policy and our change in estimated useful economic life

A change in accounting policy can be made where there is a change in an accounting standard or where it can be justified on the grounds of improving the reliability of the information in the financial statements. Where the change in accounting policy has a material effect on either current, prior or future periods certain disclosures are required, namely the reasons for the change, the nature of the change, the fact that comparative information has been adjusted and the amount of adjustments for current periods and comparative periods.

IAS8 requires retrospective application of a change in accounting policy, which means that the change of policy needs to be applied to transactions, events and conditions in all comparative information. So all comparative information should be restated as if the new policy had always been in place, with amounts relating to earlier periods reflected in an adjustment to opening reserves of the earliest period presented.

In this instance this is not actually a change in accounting policy. It is instead a change in accounting estimate, in that the useful economic life of the assets will be amended so that we are in line with the treatment adopted by group. Such a change will be carried out prospectively and will impact the profit for this year and future years. We will need to calculate the depreciation on our assets for 2016 as carrying value divided by the remaining useful economic life based on an overall life of 8 years.

For many assets it is likely that the remaining life will be reduced which will lead to an increase in the depreciation charge and a reduction in profit for 2016.

JIT – Performance measures

Number of quality failures or Number of machine breakdowns
JIT production provides no buffer inventory to cover for quality problems. Accordingly, the reporting of quality issues becomes of vital performance. Quality is essential for JIT to work – with materials arriving just in time to produce the finished product good quality control prevents any delays or stoppages in the production pipeline that would prevent JIT from working.

Number of incorrect deliveries received or Number of late deliveries
Vendor rating is needed to determine if suppliers are performing to the required standard. As suppliers will be delivering in smaller batches and more frequently, we will need an efficient system to record the deliveries, preferably with an automated checking of them against purchase orders. The number of incorrect or late deliveries received from individual suppliers would be measures that could be used in rating suppliers.

Average delivery time or Throughput time
JIT relies on speed in terms of delivery of materials and in production of the products. The lead time between ordering the material and the material being delivered is therefore of vital importance. Throughput in production must be fast so that customer orders can be met by production. Without fast throughput it will be necessary to hold some inventory to meet customer orders.

Material handling time or Set-up time

The JIT philosophy is based on continuous improvement and the elimination of waste. Waste is defined as any activity that does not add value. This would include unnecessary movement of material or people including moving material from one production area to another. Set-up time is also non-productive. The aim is to achieve quick set-up times and low cost set-ups.