Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered	Guidance Notes
Workshop 1			
1. Introduction	• Presentation • Group discussion		
2. Ethics in business	• Case study • Group Discussion	Ch. 1	P.g 1 – 10
3. Executive management	• Case study • Formal presentations	Ch. 2	P.g 11 – 24
4. Management reporting	• Case study • Formal presentations	Ch. 4 & 6	P.g 25 – 35
Workshop 2			
5. Reboot	• Presentation • Group discussion		To be released in 2nd batch
6. Treasury operations	• Case study • Formal presentations	Ch. 8, 10 & 11	
7. Corporate finance	• Case study • Formal presentations	Ch. 12, 13, 14 & 17	
8. Conclusion	• Presentation • Group discussion		

Part A Ethics in Business

Ana Dimitru works at Fast Trans. On 1 March she raised concerns with her supervisor, Stefan Popescu, that the safety airbags (a localised component) were not being correctly installed in the *Beep Beep Coyote 5*. Stefan took no action.

One month passed. Ana then wrote a letter to the owner of Fast Trans, Razvan Lazar, highlighting her concerns. Fast Trans conducted an internal investigation and reported to KCC that there was no issue with airbag installation. Razvan's report highlighted a staff discipline issue and Ana was changed to the night shift to avoid working with Stefan.

Production continued. Last month, David Chan, CFO of KCC, received a call from an industry safety watchdog, the European New Car Assessment Program. The watchdog let David know that they had received a letter from Ana Dimitru on the air bag installation at the plant, and had subsequently uncovered three instances of air bags not inflating upon impact in the Romanian-produced *Beep Beep Coyote 5*. No fatalities or serious injury had occurred. David immediately informed Timothy Chai who launched an internal investigation. KCC's investigation reveals that:

- Air bags have not been correctly installed in the models since 1 February. The defect is that the front passenger air bag has a 5-10% chance of not inflating upon impact
- 20,000 vehicles with this defect are on the market
- Ana Dimitru has been subject to intimidation by her shift supervisor and colleagues

Required:

In your group, consider this scenario from the viewpoint of one of the following persons:

- **Timothy Chai, Managing Director of KCC**
- **Razvan Lazar, Owner of Fast Tran SRL**
- **Ana Dimitru, the whistle-blowing employee**
- **An advocate from the European New Car Assessment Program**

In the group discussion, consider the following:

(a) Note down the key considerations of your allocated person in the scenario by analysing the scenario from their perspective.

(b) With reference to the HKICPA Code of Ethics, what does the group consider to be the ethical issues faced in this scenario?

(c) Broadly following the last four steps American Accounting Association (AAA) Model, what does the group consider to be the best solution or action taken to address the situation? When using this model students need to focus on:

(i) Impact of the issues on the person (Question (a) above)

(ii) Alternative options available (Steps 4 and 5 of the model)

(iii) The consequences of any actions (Step 6 of the model)

(iv) The final decision (Step 7 of the model)

Note: The final decision should be made from two perspectives - that of the allocated person and the CPA.

Part A Ethics in Business

Solution

(a) **Key considerations** from each person's perspective

CLP reference: Part (a) refers to Chapter 1, Ethics in business

Timothy Chai, Managing Director of KCC

- Needs the JV to work as he will lose prestige and reputation if it does not succeed
- First venture into overseas JV means his personal position as Managing Director may be in jeopardy if it fails
- His personal financial interests in KCC could be severely jeopardised if the situation is not managed correctly
- There is a worst-case potential that KCC will cease operation which would ruin Timothy's professional and personal reputation, as well as severely dent the personal wealth and wealth of the Chai brothers
- Consumers could commence legal proceedings against KCC

Razvan Lazar, Owner of Fast Tran SRL

- As a small to medium business owner Razvan's JV with KCC is under jeopardy, this could threaten his other existing JVs and factories
- There is a worst-case potential that Fast Trans SRL will cease operation which would ruin Razvan's professional and personal reputation, as well as ruin him financially
- If the JV with KCC fails then other automobile manufacturers and/or Chinese investors will not wish to enter into arrangements
- Ana Dimitru could start legal proceedings against Fast Tran SRL
- KCC could start legal proceedings against Fast Trans
- Potentially, consumers could start legal proceedings against Fast Trans

Ana Dimitru, the whistle-blowing employee

- Ana's primary personal concern is to support her two children. This would be paramount in her mind
- Ana needs to maintain her reputation so she can seek continued employment at Fast Trans or employment elsewhere
- Ana has already sacrificed personally and professionally to complain up to this stage, so she wants to make sure that "justice" is achieved

The advocate from the European New Car Assessment Program

- Professionally, the advocate needs to maintain the standards of the European car industry and control passenger safety. This is his paramount concern at all times
- He has no concern for the future of KCC or Fast Trans
- He should have some concern for the future of Ana Dimitru and protect her identity as a whistleblower. He would want to ensure that her treatment meant whistleblowers would come forward in the future
- Personally, he wants to protect his position and career advancement opportunities

(b) **Ethical issues** identified in the scenario

CLP reference: Part (a) refers to Chapter 1, Ethics in business, Section 2 – the HKICPA Code of Ethics

Key learning points/issues: Part (b) examines the Code of Ethics in the context of the ethical case study. Students must identify the ethical issues and then apply these issues directly to the Code of Ethics. **The key principles contravened in this scenario are integrity, professional competence and due care, professional behaviour and self-interest.** Students must identify these principles and state how they have been threatened from the perspective of their allocated person and from the CPA perspective.

The list below outlines all possible **ethical issues** identified in the scenario. Note that these are **common across the four 'roles'** but that each role will hold a different perspective on the issues identified.

- Not telling customers about **known risks** to the company's products. This may result in consumer death or injury and severe company financial and reputational risk. Razvan Lazar has acted unethically in this area as he did not investigate the initial compliant adequately. KCC management has acted unethically as they accepted the Fast Trans report without further investigation.
- Both Fast Trans and KCC **allowed production** on the Beep Beep to continue after the initial report in April. The initial Fast Trans investigation did not clearly show adequate investigation of the installation of the airbags and no recommendations for change were made. It is clear that both companies "hoped the issue would go away" and allowed production on a defective product to continue.
- A **fundamental principle** of the **Code of Ethics** is **integrity**. There are several instances of **non-compliance**, or potential non-compliance, with this principle.
  - Stefan Popescu did not act immediately upon Ana's concerns.
  - Razvan decided to conduct an internal investigation on a very serious issue without telling KCC. KCC were only informed of the results.
  - Both Stefan and Razvan decided to change Ana's shifts to night shift, effectively punishing her. They deliberately acted contrary to the Code of Ethics which clearly states that leadership should 'stress the importance of ethical behaviour and the expectation that employees will act in an ethical manner' and that the company should have 'policies and procedures to empower and encourage employees to communicate to senior levels within the employing organisation any ethical issues that concern them without fear of retribution.'
  - KCC senior management accepted the first report at face value and did not investigate further. This is a very new joint venture and it is unacceptable that KCC did not investigate the first issue/compliant arising from the situation.
  - Timothy Chai now has a chance to act with integrity in acting upon the current reported findings.
  - The only person who has acted with integrity throughout is Ana Dimitru.
- A fundamental principle of the Code of Ethics is **professional competence and due care.** Fast Trans has not acted within this principle as they been fitting airbags incorrectly and have **allowed** this **situation to continue** after being made aware of a potential issue. KCC has acted contrary to the principle as they did not check that extra components (such as airbags) were being correctly installed into their knock down kits. KCC has a significant duty in this area, as they are effectively allowing a faulty vehicle to market. It is their reputation that will be damaged.

  The consumer advocate has acted with professional competence in first reporting the issue to KCC.

- A fundamental principle of the Code of Ethics is **professional behaviour.**
  - Potentially, Fast Trans has not complied with the **relevant laws and regulations** for the installation of airbags. This means that KCC has also not complied with these laws.
  - Both companies have placed the automobile industry into **disrepute** through non-compliance and through subsequent inadequate investigation and inaction.
  - Fast Trans has discriminated against and **intimidated** at least one employee, contravening international employment conventions if not individual national law.
  - Timothy Chai now has an opportunity to demonstrate professional behaviour.
- Under the **Code of Ethics** the **chief threat** facing all parties is **self-interest**. Stefan acted with self-interest in **not reporting** Ana's complaint. Razvan acted with self-interest by keeping the investigation in-house and blaming a staffing issue. Fast Trans could not have such an important issue threaten their new joint venture. KCC management acted with self-interest by taking the initial report at face value. The future actions of Timothy Chai are threatened by self-interest.
- Ana has been the victim of intimidation. Stefan has been the direct perpetrator but Razvan and KCC management are both indirectly responsible through creating an environment which allowed this to occur.

(c) Broadly using Steps 4-7 of the AAA Model, identify the issues, assess the consequences and highlight the best solution or course of action

CLP reference: Part (c) refers to Chapter 1, Ethics in business, Section 5– the American Accounting Model and Part 2, Section 2 – the HKICPA Code of Ethics

Key learning points/issues: In Part (c) students learn how to broadly apply the AAA Model to an ethical scenario in order to determine the issues being faced, the alternative available, the consequences of each alternative and to finally come to a final decision. This final decision should be from the perspective of their allocated person and as a CPA.

Important note: The AAA model should only be broadly referred to in the workshop as a potential model students could use when making ethical decisions. Note that the main purpose of the activity is for students to identify the following:

- Impact of the issues on the person (answered in (a) and (b) above)
- Alternative options available (Steps 4 and 5 of the model)
- The consequences of any actions (Step 6 of the model)
- The final decision (Step 7 of the model)

Timothy Chai, Managing Director of KCC

Step 4 **Specify the alternatives**	**Alternative 1:** Timothy could do nothing. He would choose to **ignore** the report and wear the risk of 5-10% of airbags being defective. He would authorise Fast Trans to continue production. **Alternative 2:** Timothy could instruct Fast Trans to immediately change the airbag installation process and testing to ensure correct installation from this point forward. He **would not recall** current vehicles and wear the 5-10% risk. He informs the consumer advocate that the problem is now addressed but keeps quiet on the number of vehicles on the market with the default. **Alternative 3:** Timothy could instruct Fast Trans to immediately change the airbag installation process and testing to ensure correct installation from this point forward. Timothy would then instruct a total product **recall** (passing cost onto the joint venture). He would issue a media statement drawing attention to their actions and assuring the company of their dedication to safety, and putting the client first – above cost.
Step 5 **Compare values and alternatives. Is a decision clear?**	This is about a defective product so Timothy is unable to do nothing. He must institute either Alternative 2 or Alternative 3.
Step 6 **Assess the consequences**	Calling for a total product recall will be financially damaging and potentially catastrophic. It will also result in significant brand damage in Europe. It will definitely harm the JV relationship, perhaps terminally. Allowing the current vehicles to stay in the market is risky – Timothy is taking the risk that the 5-10% risk of faulty air bags is actually overstated and/or that serious death or injury will not occur. He is acting unethically by asking David to not inform the advocate of the correct situation. However, if he keeps it quiet he is (potentially) avoiding extreme financial and reputational damage. However, if a death or injury was to occur, or the cover-up is exposed, then the financial and reputational damage would be magnified.
Step 7 **Make your decision** **(as Timothy and as a CPA)**	**Timothy** **Alternative 3** is the correct decision following the HKCPA Code of Ethics. The risk of keeping the defective products on the market is too great and would clearly go against the principles of **integrity, professional competence and due care** and **professional behaviour**. Timothy and KCC will need to act against **self-interest** and demand a total product recall with the subsequent publicity and resulting brand damage. He should investigate the operations of Fast Trans and try and continue the joint venture if it appears that it was an isolated experience. He needs to reinstate Ana and take any other appropriate action. He needs to ensure that this situation does not occur again. Unfortunately, if Fast Trans is unwilling to change, then he may need to terminate the joint venture. Timothy will need to make full disclosure of all issues to all stakeholders. **CPA** From the CPA perspective, the course of action would have to be exactly the same as for Timothy. In fact a CPA would have to insist that Timothy take the actions outlined in Alternative 3.

Razvan Lazar, Owner of Fast Tran SRL

Step 4 **Specify the alternatives**	**Alternative 1:** Razvan could insist that the report from KCC is wrong and continue to **do nothing**. He would ask for another investigation to counter KCC's findings and maintain it was a disgruntled staff member. He would block any attempt to change procedures and continue supporting the intimidation and changed working hours of Ana. **Alternative 2:** Razvan could partially **accept the findings** of the report but still change the airbag installation process. He would not support a product recall and refuse to pay for any suggested recall. While reinstating Ana to her daytime hours he would continue to tacitly foster a toxic employment culture where whistle-blowers are punished. This could effectively push Ana into leaving the company at some later stage. **Alternative 3:** Razvan could fully **accept the findings** of the report and immediately change the airbag installation process. He could support Timothy on a total product **recall** and wear at least a proportion of the cost of this recall. He would reinstate Ana to her day shift and provide a full apology. He would provide Stefan with management training in this area. He would change employment culture and practices.
Step 5 **Compare values and alternatives. Is a decision clear?**	Alternative 1 would be difficult to implement without a contrary professional opinion insisting that the air bags were not defective. It is also clearly unethical. By reinstating Ana to her day time hours in Alternative 2 he is ensuring all legal requirements are met. Tacitly fostering intimidation of employees is illegal if proved.
Step 6 **Assess the consequences**	Supporting a total product recall will be financially damaging and potentially catastrophic for Fast Trans. It may terminally damage the JV. Not offering to pay for any part of a product recall may also terminate the JV relationship. Supporting Timothy in allowing the current vehicles to stay in the market is risky – together the JV is taking the risk that the 5-10% risk of faulty air bags is actually overstate and/or that series death or injury will not occur. In joining KCC in a cover up Rezvan is (potentially) avoiding extreme financial and reputational damage. However, if a death or injury was to occur, or the cover-up is exposed, then the financial and reputational damage would be magnified. Apologising to Ana could be construed as admitting culpability and he could be subject to damages. However it is more likely that by not addressing Ana's situation she will be forced to leave the company and could sue for unfair dismissal. Acting unethically in relation to Ana could create hostility within the employee group. Changing work culture will inevitably result in discomfort and push-back, perhaps from Stefan, other employees and other supervisors.

Step 7 **Make your decision** **(as Razvan and as a CPA)**	**Razvan** **Alternative 3** is the only correct solution following basic ethical guidelines and the guidelines of the HKICPA Code of Ethics. Razvan must now implement all measures outlined to **save** his **JV relationship** and any ongoing reputation. He has already suffered severe reputational and staff morale damage and it will be difficult for Razvan and the JV relationship to survive. **CPA** Any CPA would need to insist that Razvan acts according to Alternative 3. They should introduce clear behavioural guidelines and a monitoring system, as it is clear that Razvan has a tendency to act unethically when presented with a difficult issue.

Ana Dimitru, the whistle-blowing employee

Step 4 **Specify the alternatives**	**Alternative 1:** Ana could accept the report findings and a full apology plus reinstatement to her daytime hours. For this to occur, she promises to **not discuss** the issue with any internal or external parties. **Alternative 2:** Ana could accept the findings of the report and leave the company, disillusioned by her treatment as a whistle-blower. She would **seek a payment** for keeping 'quiet' upon resignation. **Alternative 3:** Ana could accept the findings of the report and leave the company, disillusioned by her treatment as a whistle-blower. She would **accept no payment** on leaving and continue to monitor the situation externally. **Alternative 4:** Ana could continue her employment whilst ensuring that management are acting upon the findings of the report. If she is not satisfied, then she contacts the consumer advocate and perhaps even the press. She continues to **agitate for change**.
Step 5 **Compare values and alternatives. Is a decision clear?**	All of the options above are possible – some of them are directly contrary to the principle of **integrity**, a principle Ana has acted with thus far. While seeking a payment to keep 'quiet' is unethical it may not be illegal if it is seen as exit payment.
Step 6 **Assess the consequences**	Ana could lose her job and therefore her livelihood if she continues to agitate for change. She is a single mother and the consequences of job loss could be devastating. Ana could be subject to further intimidation and threats if she continues to agitate for change. This could extend to her family. If Ana keeps quiet and a defective product is issued she could be implicated in any cover-up. This could impact future employment prospects and her financial situation if legal action is taken. If Ana leaves without any compensation for her mistreatment then she is left financially disadvantaged and with high stress. She may have gain a reputation and find it difficult to secure alternative employment.
Step 7 **Make your decision** **(as Ana, and as a CPA)**	**Ana** Alternative 1 would be accepted were both KCC and Fast Trans instituting a full product recall. Ana's objective would have been achieved and keeping quiet would not contravene any ethical codes. Alternative 2 is acting against the principle of integrity as she would be accepted a payment to keep quiet. It is not acceptable. Alternative 3 is acceptable is Ana chooses to leave the company and this is best for her self-interest. She may in fact be happier outside the company. **Alternative 4** is acceptable if it is in Ana's self-interest to stay within the company. It would be **easier** for her to **monitor** KCC and Fast Trans' actions from **within** the company.

	CPA As a CPA, Alterative 4 is the best course of action. Alternative 1 could still be seen as contrary to the Code as it is asking an employee to "keep quiet". **Alternative 2 is clearly wrong** – offering a payment to keep quiet is a contravention of any ethical code. Alternative 3 is acceptable is Ana herself wishes to leave the company. **Alternative 4** is best as it shows the CPA has **balanced the needs** of the company with the needs of the employee.

An advocate from the European New Car Assessment Program

Step 4 **Specify the alternatives**	**Alternative 1:** The advocate could monitor KCC to ensure the issues are addressed. He chooses to keep the situation as an issue between himself and KCC and to **not involve his management**. **Alternative 2:** The advocate could monitor KCC to ensure the issues are addressed. He chooses to inform management of the situation and institute a formal monitoring program. He does **not** make the complaint **public**. **Alternative 3:** Immediately after the telephone call, the advocate and his management issue a **media release** outlining the issues with the Beep Beep Coyote 5.
Step 5 **Compare values and alternatives. Is a decision clear?**	Alternative 1 is not acceptable. Not informing management suggests that the advocate and KCC have an “arrangement” in place, clearly against the Code of Ethics.
Step 6 **Assess the consequences**	By not making the complaint public the advocate gives KCC the opportunity to make a decision and take action to implement it. It maintains its relationship with KCC and by consequence, other manufacturers. Making the compliant public forces KCC to take action quickly. It warns other manufacturers to clearly look at JV procedures. It enhances the public reputation of the European New Car Assessment Program. It may reduce consumer confidence in vehicle safety generally.
Step 7 **Make your decision** **(as the advocate and as a CPA)**	**The advocate** As discussed above, **Alternative 1 is unacceptable**. Both Alternatives 2 and 3 are correct solutions following the HK Code of Ethics – the main decision is the consequences for and against making the compliant public immediately. **CPA** A CPA could support and recommend **either Alternative 2 or 3** under the Code of Ethics.

Part B Executive Management

Part (a) Solution

Carry out a comprehensive **SWOT** analysis of KCC. In this identify at least six items under each category and list them in order of priority to the organisation.

The sample answer provides many more than six items for each category. It is ranked according to the author's perception of priority to the organisation. It is understood that they may be many more items than those included in the sample answer and that the ranking of priority may vary significantly.

All answers are acceptable as long as candidates are able to effectively argue the case for the item's inclusion and its ranking if requested.

CLP reference

Chapter 2, Section 9.1.

Key learning points: Students will conduct a practical **corporate appraisal** through the completion of a **SWOT** exercise on KCC.

Strengths	Weaknesses
Strong financial position – 24.4% rise on 2008 sales Profits available to invest in R&D Healthy balance sheet Publicly listed company means ability to raise funds quickly Romanian joint venture allows greater access to European import market Percentage share of SUV and pick-up market has remained constant in PRC for some time (8+ years) Location in Kunming as an emerging auto manufacturing centre after Shanghai New product model released in 2009 well received Medium market position Good brand recognition in PRC Good reputation for after-sale service Strong and committed leadership	Inadequate and low cost support of the R&D department R&D department has never been "first to market" Current set of SUV and pick-ups may be reaching the end of their product life cycle without further innovation No differentiated products – SUVs and pick-ups are the same as competitors No recent history of product diversification or product innovation Company size relative to competitors – currently too small to: - compete in R&D locally - make inroads into international markets - compete with larger PRC auto manufacturers to enter into joint venture with overseas car manufacturers Little brand recognition outside PRC Two production plants in Kunming both producing pick-ups – doubling up of costs Limited integration of 2004 acquisition, particularly on operational side, to date Two head offices means cost duplication Current problems with Romanian production JV could damage (perhaps severely) inroads into European market Overall high production costs Ageing production equipment in Kunming plants

Opportunities	Threats
PRC government rebate on small displacement passenger vehicles opens up an opportunity to develop and release new product offerings Continued PRC government subsidies for rural automobiles opens up increased markets for existing pick-ups Continued PRC government subsidies for rural automobiles opens up opportunities for new large vehicle products KCC has electric car developed and tested in time for anticipated PRC government initiatives being implemented Potential for acquisitions are strong because of the number of smaller PRC manufacturers PRC general economic boom continues into foreseeable future Growth of PRC emerging middle class continues well into the future The increasing power of the Chinese consumer means they will want to continue to "upgrade" models, coupled with the Chinese old model replacement policy continuing Likely global economic recovery leading to increased international market KCC can capture general global goodwill towards development and world number #1 position of PRC automobile industry Market for joint ventures with foreign car markets expanding due to PRC world number #1 position Positive change in government policy in Romania and other joint venture production nations	Competitors have already capitalised on government subsidies for small displacement passenger vehicles by releasing product first PRC government does not go ahead with expected initiatives on alternative powered vehicles Sales growth on existing products impacted by PRC introducing the planned government subsidy for alternative powered cars Competitors have also developed and patented electric cars ready for product release Government stops initiatives for automobile subsidies in rural PRC therefore reducing the local market for pick-ups Protracted global recession or developed nations fall back into recession Potential for concrete global emissions targets to be established. Any targets placed on PRC to medium and long term will impact on internal car boom and the broader economic growth European/environmental policies will begin to shrink that market for larger vehicles such as pick-ups and SUVs Chinese cars perceived as low quality in developed market Substitutes arise in developed countries due to environmental polices – public transport, bicycles. Local market organically reaches saturation point Market for JV with foreign car makers already saturated by earlier entrants/larger companies Increase in price of raw production materials Decrease in availability of raw production material Increased entrants to the domestic market Change to local government policy for Romanian joint venture have a negative impact Chinese consumer becomes more discerning concerning price, quality, safety, after sale service and reliability and KCC products are left behind American auto manufacturing industry stages recovery (possible, albeit unlikely)

Note: Good students should be able to make a summary of the SWOT analysis, suggest ways to overcome the internal weaknesses and external threats and to make use of the strengths to fully capture the opportunities available.

Part (b) Solution

In this section students are required to complete an **Ansoff product-market matrix** of KCC. In this matrix identify at least three points under each category (option). Use the **conclusions from the SWOT** you have prepared in part (a) to assist.

The sample answer can provide many more than three items for each category. It is understood that there may be many more items than those included in the sample answer.

All answers are acceptable as long as candidates are able to effectively argue the case for the item's inclusion if requested.

CLP reference

Chapter 2, Section 11.2

Key learning points: Students will conduct a **strategic choice analysis** through the completion of an Ansoff product-market matrix.

Solution

(a) Current products and current markets: Market penetration

- (i) Increase market share of pick up and SUV markets in PRC
- (ii) No product differentiation in an already crowded market so this may be difficult
- (iii) Low risk strategy but potentially a low gain
- (iv) Continued PRC government subsidies for rural vehicles means that increased market penetration in this area is possible
- (v) If rural subsidies discussed above cease then further market penetration may be impossible in a larger vehicle market
- (vi) Current market has reached saturation point
- (vii) No capital investment needed
- (viii) No R&D cost
- (ix) Would need to differentiate on price to achieve increased market which may impact profit if costs are kept high

(b) Present products and new markets: Market development

- (i) Increase international market through the Romanian joint venture
- (ii) Increase international market through further joint ventures (production)
- (iii) Seek out a partnership with overseas car manufacturers
- (iv) As using existing products and joint ventures, little capital investment is required
- (v) No R&D costs
- (vi) Current products may not be suitable in new markets – larger vehicles are no longer warranted

(c) New products and present markets: Product development

(i) Enhance R&D capability to create new product

(ii) High capital investment in up-skilling R&D

(iii) Need to ensure that existing PRC market is ready for new products (e.g. electric cars, smaller vehicles)

(iv) PRC government rebate on small displacement vehicles means that point (iii) above has been established for smaller vehicles

(v) Global consumer take-up of electric cars has so far been disappointing so new product development is more risky in this area

(vi) Exploration of other new product options in PRC and existing international markets

(d) New products and new market: Diversification

(i) Enhance R&D capability to create a new product in a new market

(ii) Largest capital investment of all options as (i) investment in new products and (ii) research of new market

(iii) New markets may not want existing product so new products must be launched in order to succeed in the new markets

(iv) Diversification is a high risk strategy

(v) New resources and investment – new R&D, new sales team, new marketing research and approach

(vi) If existing markets have reached saturation point (which they may have) then diversification is potentially the only solution to achieve large scale growth

(e) Withdrawal

(i) If market for larger cars fall then withdrawal from SUV or pick up market may be required

(ii) Any product withdrawal not possible without replacement product

(iii) Closing down second factory (instead of consolidation). This may result in exit barriers – redundancies and employee dissatisfaction

(iv) May need to examine withdrawal if development of new product fails. Potential exit barriers is manager hesitation at stopping project

(v) Withdrawal from Romanian joint venture agreement (particularly due to ethical and product quality as discussed in Session 2)

(f) Divestment, demerger and privatisation

(i) Divestment and demerger only apply to KCC

(ii) Potential to sell-off 2004 acquisition in pick-up trucks although consolidation/withdrawal are probably better options

Part B Executive Management

David Chan, CFO, has gathered you all together for a KCC organisational business strategy planning session.

KCC needs to decide on a cohesive and unified corporate strategy for the medium-term. David has asked you to evaluate **four proposed strategies** using recognised models, evaluate the options and consequences of implementing each option, and ultimately conclude on the best strategy recommendation for David to take to the Board.

David asks you to divide into four groups. Each group is to consider **one** of the following strategies:

- Cost control
- Growth in existing markets and/or existing products
- Expansion into new markets
- Development of new products

Required:

(a) In your group, prepare a list of positives and negatives for the assigned strategy. Use the conclusions from the SWOT and the Ansoff product-market matrix you prepared prior to the workshop to assist.

(b) Prepare a presentation to the Board on the results of your group's assigned strategy.

Part B Executive Management

Solution

Key issues on financial accounts

The financial accounts give rise to the following considerations for students to assess prior to the workshop:

- Operating profit margin is unsatisfactory as manufacturing cost accounts for 82% of revenue. **Cost control** should be considered immediately.
- KCC has **ample cash** at hand (1.3 billion RMB) with **minimal long term debt**. This indicates that KCC finances business growth through short-term financing and working capital. Short debt is dangerous as it may take some years to see any reasonable return from new product investment or market investment. Long-term debt may be more appropriate.

Consideration of Four Strategies

For the **Executive Management** workshop each group was asked to consider **one** of the following strategies:

- Cost control
- Growth in existing markets and/or existing products
- Expansion into new markets
- Development of new products

It is understood that there may be many more items than those included in the sample answer. All answers are acceptable as long as candidates are able to effectively argue the case for the item's inclusion if requested.

Part (a) Solution

CLP reference

Part (a) refers to the work prepared in the pre-workshop exercise. CLP references are Chapter 2, Section 9.1 and Section 11.2. Students should also refer to the case study material.

Key learning points

Students must learn to critically assess their option and provide a clear set of **positives and negatives** for the implementing a particular strategy. Students need to be able to use completed corporate analysis (**SWOT**) and strategy comparison tools (**Ansoff** product-market matrix) and apply these to assessing the **suitability** of a business strategy.

Solution: Positives and negatives for the assigned strategy

Cost control

Positives	Negatives
Clear options for cost savings available which may lead to substantial production savings (two Kunming facilities producing pick-ups, secondary option of two head offices)	Any redundancies may affect company reputation and relationship with PRC government
Current manufacturing costs are too high compared to revenues and cost savings must be made	Any redundancies may affect staff morale and production
Because there are clear cost-saving options this is a clear solution which can be implemented quickly	Implementing cost control may mean a lack of concentration on market expansion and development of new products – competition may take further steps ahead
Evidence of joint venture in Romania shows that cheaper manufacturing alternatives are possible	Romanian joint venture shows that relinquishing control without adequate supervision leads to mistakes. It demonstrates that KCC may not be “ready” for JVs.
Combining the two Kunming production facilities (or the closure of one) will mean future acquisitions can be integrated more easily	Unlikely to find lower cost production centres than in Kunming (when Kunming is operating efficiently)

Growth in existing markets/existing products

Positives	Negatives
PRC rural subsidies means the Chinese market for pick-ups will continue indefinitely so clear growth strategy	Domestic market for pick-up trucks will immediately fall when rural subsidies cease or are no longer effective
PRC general market is still buoyant and the boom is expected to continue	KCC may not be able to rely on the continued growth of the PRC economy and middle class to support growth indefinitely
Cost control will only deliver savings and will be relatively ineffective without market/product growth	KCC existing products have a certain shelf life as they are not environmentally-friendly in that they are large and run on diesel/petrol. Future high growth is expected in small and alternative powered cars worldwide – particularly in developed markets.
Growth in international markets will continue due to Romanian production joint venture	Changes to global environmental policy (both at an international and domestic level) such as the setting of new emissions targets could have a large impact on existing markets and product suite.
Biggest opportunity for international market is to enter into a joint venture with a foreign auto manufacturer	KCC is too small to grow international market as it cannot attract a joint venture, and it would be unable to develop further into existing international markets without a joint venture It may also be likely that KCC will be entering into the joint venture strategy after its competitors
PRC automobile industry reputation constantly improving which will foster growth in existing markets	Too little return and potential growth to expand with the existing product suite only
Will deliver increased revenues without the high cost of new product R&D	The international market is in decline and this is expected to continue

Expansion into new markets

Positives	Negatives
Access to funds available for increased marketing into new international markets (will not need new funds raised) – relatively low cost when compared to development of new products by R&D	KCC is too small to grow international market as it cannot attract a joint venture, and it would be unable to develop into new international markets without a joint venture
Already has JV in Romania to leverage into European markets	Market may not actually exist to expand into due to external environment factors – global recession, smaller/more efficient cars required product, decrease in private car ownership in developed world
Perceived increasing quality of Chinese cars in the developed world and the number one status means this is an excellent time to expand the market	Cost of expansion into new markets too prohibitive to consider doing so independently (without a foreign car joint venture), particularly compared with larger and stronger competition
Take the joint venture production model into other targeted growth areas e.g. Middle east, Africa and therefore costs of exporting significantly reduced	
Potential for joint venture with foreign car maker is the best idea for expansion into other international markets	

Development of new products

Positives	Negatives
Environmental policies world-wide give existing products a set shelf-life meaning that KCC has no choice but to innovate and release new products	Cost for new R&D is too high starting from its low base – this is a large investment that needs long-term finance
Car industry globally and domestically show that KCC must innovate in R&D to stay competitive	Any new product development is too expensive with a joint venture with a foreign car maker
Clearly fits with company mission and values of innovation and integrity	Unknown return – if new market products arise from R&D will they be: • First to market? • Cutting-edge compared to competition • Innovative when compared to competition
Raising finance to invest in R&D is also good for brand, industry reputation, marketing, staff morale and shareholder morale	Although alternative powered cars are environmentally-friendly and there may by future PRC subsidies all global feedback and sales to date show they are not as efficient or effective as standard vehicles, and have not yet transferred over to sales.
This strategy is potentially the highest return of all strategies proposed	The whole strategy is very high cost, but there is potentially a very high return

Part (b) Solution

Best Strategy

After listening to all presentations decide on the best strategy for David to recommend to the Board.

CLP reference

Chapter 2, Section 14.1 and 14.2

Key learning points

Students should apply the **JS&W** (**E**xploring **C**orporate **S**trategy) **checklist** for assessing the four strategic options presented and to decide on the appropriate choice. Students will need to demonstrate **how** they reached their proposed strategy and effectively argue for the implementation of their strategy.

Solution

Note: The suggested answers below are the opinions of one person only and are only provided as guidance. Good students should be able to present persuasive arguments for/or against the implementation of any of the four strategies.

Cost control

Suitability	Fits company mission and the values of efficiency and reliability Low cost Clear cost savings to be made
Acceptability	All stakeholders would see that having duplicate production plants is wasteful Although the managers and employees at the second production plan (2004 acquisition) will probably resist the change, all other stakeholders such as the board and shareholders would be extremely supportive
Feasibility	Easily and quickly achieved as clear duplication has been identified Ultimately this strategy will reduce resources and time
Conclusion	**Yes – must achieve** Cost control is a low-risk and easily achieved strategy. It should be implemented as soon as possible

Growth in existing markets/existing products

Suitability	Fits company mission and values of efficiency and reliability Does not fit with company value of innovation Continued growth will ensure enhanced brand recognition in new markets
Acceptability	Acceptable to stakeholders as no/little cost Unacceptable to stakeholders as strategy is not innovative or forward-thinking May not be seen to be creating a large enough return
Feasibility	Would require no/little capital investment If PRC rural subsidies for large vehicles continue then market growth may be achievable Concerns that market for larger vehicles may be reaching saturation point
Conclusion	**No** Strategy does not generate required growth Existing market for existing products may have reached saturation point Too difficult to achieve product or cost differentiation

Expansion into new markets

Suitability	Fits company mission and the values of innovation and integrity Will achieve growth and new market penetration which is required for KCC expansion and competitive growth
Acceptability	Acceptable to stakeholders as a lower capital investment than the development of new products Stakeholders will be concerned that existing product suite is not suitable to new markets
Feasibility	KCC already has a joint venture in place which provides access to the new markets KCC is too small to attract a quality overseas car manufacturer partner
Conclusion	**No** Expansion into new markets is required, however the existing product suite is probably not suitable to more sophisticated car markets While this strategy may be possible in some new markets it may not be possible in all new markets Current state of international market, and the difficulties faced with KCC entering it, means a better strategy is to achieve growth in the domestic market

Development of new products

Suitability	Fits company mission and the values of innovation and integrity Current market and products have reached stagnation and new product is required to stay competitive
Acceptability	This is a high risk strategy and would involve large capital investment All stakeholders would have to be happy with the risk and with corporate financing options
Feasibility	Not immediately achievable but still feasible Will require capital raising to fund cutting-edge R&D
Conclusion	**Yes** The strategy carries the highest risk and the highest investment, but potential for the highest return Given the current state of KCC, the industry, and future car and environmental regulation, product development to develop the domestic market is essential

Part C Management Reporting

Solution

CLP reference

Chapter 4, Section 2

Scenario No. 1 – Traditional Costing (Existing Method)

Part 1

Cost Items for SUV Steel Body Shell	Cost Data	
Direct materials per unit	**11,800**	
Direct labour hours per unit	30	
Hourly labour rate per (RMB)	104.00	
Direct labour cost per unit	**3,120**	(30 x 104)
Overhead rate per direct labour hour (DLH)	92*	
Overhead allocated per unit (using plant-wide rate)	**2,760**	(30 x 92)
Total cost per unit (RMB)	**17,680**	
Total cost per month (RMB)	**58,344,000**	(3,300 x17,680)
Memo - Batches per month (1 per day)	30	
- Units per batch	110	
- Units per month (30 x 110)	3,300	

The plant-wide manufacturing overhead (OH) rate, used in all departments of the KCC Plant 1, is based on direct labour hours (DLH) calculated on an annual basis as follows:

Plant-wide Overhead Rate	Annual
Budgeted annual total manufacturing OH (RMB)	800,000,000
Divide by budgeted annual direct labour hours (DLH)	8,700,000
Plant-wide manufacturing OH rate per DLH (RMB)	92*

* rounded figure (91.95)

Part 2

(a) Implications for pricing under the traditional method

The traditional costing method illustrated in this scenario is an example of absorption product costing, since both fixed and variable manufacturing overhead costs are "absorbed" into the cost of the product. This would therefore provide the basis for "absorption cost pricing" of the company's products.

Note, however, that true absorption cost pricing would need to include in **"full product cost"** both the variable and fixed administration and selling expenses. That is, those costs "below the line" of product gross margin.

Whether this absorption cost data is useful for pricing may depend partly on the **competitive nature of the market** into which the company's vehicle products are being sold. It is likely that there will be significant price pressure in those markets and that some form of "target cost pricing" may be appropriate.

(b) Potential issues arising from cost calculation using traditional method

There are few advantages of the traditional method of product costing for costing such components as the steel body shell for an SUV. However, one **"advantage"** is that the use of a plant-wide rate to allocate manufacturing overheads to products is **simple, easy to understand,** and does not cost a lot to design and implement. This is because the use of such a single cost driver as direct labour hours utilises a measure that is likely to be already available – direct labour hours in the steel body shell department.

However, there are a number of **issues that arise when using the traditional method.**

Issue 1**:** the use of a single rate based on labour hours is **unlikely to capture the cost diversity** that exists in such a department as the steel body shell.

Issue 2**:** the use of a plant-wide rate, rather than a departmental rate is extremely coarse and is **unlikely to discriminate** among the various production departments at KCC.

Issue 3: **not all relevant costs** will necessarily be captured in the plant-wide rate.

Issue 4**: overhead costs** (2,760) **are not the major costs** in the steel body shell department – direct materials are (11,800). That being so, it could be argued that cost management efforts should be focussed on direct materials, and that a simple method of tracing manufacturing overheads to products is all that is needed.

(c) Solution to address potential issues

Issue 1: The use of a single rate based on labour hours is **unlikely to capture the cost diversity** that exists in such a department as the steel body shell.

Solution: Using such a **single volume-based driver** as direct labour hours to allocate manufacturing overhead costs is **very coarse**. Candidates should instead use the **ABC system** (under scenario 2) which identifies six separate manufacturing overhead cost drivers, including some that are not output volume based, and therefore provides a more accurate depiction of the cost structure. From here, management can more clearly ascertain which overhead costs can be cut.

Issue 2*:* Second, the use of a plant-wide rate, rather than a departmental rate is extremely coarse and is **unlikely to discriminate** among the various production departments at KCC.

Solution: Management needs to break the costing down further under traditional costing (like identifying activities under ABC costing) to provide a **departmental rate**. This is essential as KCC needs to cut manufacturing costs.

Issue 3*:* Not **all relevant costs** will necessarily be captured in the plant-wide rate.

Solution: Candidates need to use the ABC system of analysis which more clearly focuses on the **drivers of the manufacturing overhead cost**. Again, this analysis needs to be undertaken at a departmental level.

Issue 4: **Overhead costs are not the major costs** in the steel body shell department – direct materials are.

Solution: Future cost management efforts should be focused on direct materials, and that a simple method of tracing manufacturing overheads to products is all that is needed for analysis.

Scenario No. 2 – ABC Costing (Proposed New Method)

Part 1

Activity based costing overhead rates	Driver	Total Cost	Driver Units	Unit Rate
Direct materials purchase orders	# Orders	260,000	200	1,300.00
Direct materials handling	Kg	466,000	49,000	9.51
Machine power	MC Hrs	68,000	480	141.67
Machine set-ups	Batches*	78,000	30	2,600.00
Product finishing	# Units	592,000	3,300	179.39
Quality inspections	# Units	560,000	3,300	169.70

(*): Production is on batch mode.

ABC Costing for SUV Steel Body Shell	Per Unit	
Direct materials	**11,800**	
Direct Labour	**3,120**	
Overhead (ABC)		
Direct materials purchase orders	1,300.00	
Direct materials handling	9.51	
Machine power	141.67	
Machine set-ups	2,600.00	
Product finishing	179.39	
Quality inspections	169.70	
Sub total overhead cost	**4,400**	
Total cost per unit (RMB)	**19,320**	
Total cost per month (RMB)	**63,756,000**	(3,300 x 19,320)

Part 2

(a) Implications for pricing under ABC

Activity based costing is, by definition, an **absorption costing system** for calculating the manufactured cost of the product at the factory door. As such, it will **still need** to be enhanced by adding selling and administration costs to obtain "full product cost" for pricing purposes.

However, the absorption product cost calculated by the ABC system is likely to be **more accurate** than that signalled by the traditional system, and therefore will provide a better basis for **informed pricing decisions.** That is, if the manufacturing overhead cost increase signalled by the SUV body shells is replicated in the other components for the vehicle, it is likely that pricing decisions have been based on **inaccurate** cost information.

On the other hand, the total manufacturing overhead cost to be allocated to all products will presumably be unaltered, so there may be some **cross-subsidisation** among vehicle components, and possibly among SUVs and other vehicles. To find this out, a full ABC pilot exercise may be justified. This will inform pricing decisions for all products.

Whether ABC absorption cost data are useful for pricing may depend partly on the **competitive nature of the market** into which the company's vehicle products are being sold. It is likely that there will be significant price pressure in those markets and that some form of "target cost pricing" may be appropriate.

Note: Good candidates may point out that ABC overhead cost analysis may pinpoint areas where costs may be shaved in order to meet cost targets, e.g. cost savings potential in purchasing, materials handling, set-ups, finishing, and inspection.

(b) Cost reduction identification and solutions

Issues

The ABC system signals areas where **cost reductions** may be targeted. From the ABC analysis, it is clear that the largest manufacturing overhead items on a total cost basis are machine set-ups (2,600) and direct materials purchase orders (1,300). These findings may not be revealed by the traditional costing method of which all manufacturing overhead costs are absorbed into the product unit using only one driver, i.e. labour hours.

Solutions for cost reduction

Management should examine the high cost areas, perhaps **redesigning the materials procurement system**, and seeking ways to **reduce machine set-up times and costs**.

Part C Management Reporting

The CFO, David Chan, is becoming concerned that the overheads seem high in the ABC model than the traditional model. He wonders which model is more useful and effective in cost control and price setting.

Case 1

Traditional Costing and ABC Costing

Traditional Model

Refer to the **Scenario No. 1** of the pre-workshop exercise. Labour costs have been relatively constant since 2000. Starting from 2010, direct labour costs per unit is RMB3,120 which is 10% higher than labour costs in the previous year.

Required:

(a) Could the initiative of reducing labour costs bring down the unit cost significantly?

(b) If not, what further actions would you recommend?

ABC Model

Refer to the Scenario No. 2 of the pre-workshop exercise. Your group have found out that the machine set-up overheads seem high in the ABC model. This is proved by comparison to industry data below.

ABC machine set-ups overhead rates	Driver	Total Cost	Driver Units	Unit Rate
KCC Ltd	***Batches***	***78,000***	***30***	***2,600***
GAA Ltd	Batches	68,000	30	2,267
SBBP Ltd	Batches	66,000	30	2,200

Required:

(c) What does this tell us about KCC's machine set-ups? Highlight the issues and possible solutions.

Case 2

Target costing

The new model SUV (*Beep Beep Coyote 5*) is coming under price pressure in the market. KCC currently wholesales the vehicle at RMB80,000. KCC operates the SUV on a tight margin and production costs, such as those incurred on the manufacture of the SUV steel body shells, are currently high in comparison to competitors.

One competitor has introduced a similar model to the market at a wholesale price of RMB75,000. This has prompted KCC to consider ways to reduce their price, while still maintaining a desirable margin on product cost. You are provided with the following additional data:

Current wholesale price of Beep Beep	**80,000**

Manufacturing margin	**RMB mil**	**Per cent**
Total SUV revenues	3,150	100%
Total SUV direct manufacturing costs	2,591	82%
Total SUV sales margin	559	18%

Current reported cost structure for Beep Beep	**RMB**
Current price	80,000
Current margin (18%)	14,400
Current direct manufacturing cost	65,600

Current direct manufacturing cost breakdown	**RMB**
Steel body shell per unit (*)	17,680
Engine	7,950
Drive train	6,540
Electronic system	5,730
Brakes and safety equipment	5,780
Wheels and tyres	6,370
Dashboard including electronics	7,700
Seating and interior trim	4,200
Painting and polishing	2,400
Final quality inspection	960
Road test	290
Total current direct manufacturing cost	65,600

** using traditional costing method*

Required:

(a) Calculate the target cost for the *Beep Beep Coyote 5* which would meet the competitor's price while also maintaining the current sales margin of 18%.

(b) Outline how KCC should conduct the target costing exercise.

(c) Recommend which of the direct manufacturing costs could be targeted for cost reductions. Highlight the issues and possible solutions.

Part C Management Reporting

Solution

Case 1 – Traditional Costing and ABC Costing

CLP reference

Chapter 4, Section 3

Traditional Model

(a) Does reduction in labour cost equal reduction in unit costs

While an increase in 10% is important and must be examined, **reducing labour costs only will not** provide KCC with the cost savings it requires.

Product designers at KCC likely will find the numbers in the activity-based costing approach **more believable and credible** than those in the simple labour-based system. In a machine-paced manufacturing environment, like KCC, it is unlikely that direct labour hours would be the major cost driver of manufacturing overhead costs.

(b) Other recommended actions

KCC product designers still need to conduct an audit on how the costs of the product can be reduced; for example, **use fewer parts**, require **fewer activities on the machines**, and find other ways to **reduce the number of machine hours** in the SUV body shell manufacturing area. Good students should be able to comment that reduction of labour costs is only part of this solution.

ABC Model

(c) Analysis of machine set-ups

This tells us that KCC's machine set-ups are too high and KCC needs to bring them down to stay competitive and reduce the price of the SUV.

Realistically, KCC should be able to **bring costs down from a unit rate of 2,600 to 2,333** (70,000/30, assuming a total cost reduction from 78,000 to 70,000). This still places its set-up costs higher than the two competitors but at least brings it within the same framework. Ideally, **KCC should match set-up costs to 2,200 per unit**.

The high machine set-ups indicate that the machinery is **worn out and/or out of date**. If this is the case then KCC needs to make **capital investment in new machinery and plant** to bring costs in line with competitors. It could also indicate that there are **inefficiencies in the set-ups process**. KCC should investigate current processes, compare them with the industry benchmark, and **implement more efficient workflows**.

Case 2 – Target costing

CLP reference

Chapter 4, Section 5

(a) Target cost for the Beep Beep SUV meeting competitor price and current margin

Competitor's price	75,000	
Less required margin (18%)	13,500	
New total cost target	61,500	
Cost reduction required	4,100	(65,600 – 61,500)

(b) How to conduct the target costing exercise

Ideally the target cost for such a product as the Beep Beep SUV should **focus on reducing all costs in the "value chain"**, while maintaining the desired functionality and quality of the SUV. The value chain costs include such "upstream costs" as research and development, and product design; and "downstream costs" including marketing, distribution, and after sales service. But, this exercise addresses direct manufacturing costs only, and it is assumed that the total cost reduction will be sought from direct manufacturing costs.

In carrying out the target costing exercise, there are some **basic principles** that will need to be followed. These are:

- Work with the company's engineers to understand fully the **functions performed by the various components in the vehicle**. These functions are summarised in the 11 components of direct manufacturing costs (steel body shell, drive train, electronic system, etc)
- Investigate the importance that customers place on the **various features of the vehicle**. For example, do customers place more importance on safety features, road handling qualities, or such sophisticated electronic applications as GPS systems.
- Understand how the different features relate to the **functions performed by the various features**. For example, SUV customers may not necessarily desire a sophisticated automatic drive chain, but prefer the "driver control" of a manual system. This may enable a simpler and less costly drive train to be installed.

(c) Targeting direct manufacturing costs

In targeting direct manufacturing costs to deliver the RMB4,100 cost reduction desired, it would be wise to follow a **"Pareto approach"** and address first the largest cost items. In rank order, the **7 largest** are:

Cost Components	Cost (**traditional**)
1. Steel body shell	17,680
2. Engine	7,950
3. Dashboard including electronics	7,700
4. Drive train	6,540
5. Wheels and tyres	6,370
6. Brakes and safety equipment	5,780
7. Electronic system	5,730

Note, however, that these costs are based on a traditional costing and may not truely reflect the actual cost of the components. We have already seen that the ABC cost for the steel body shell is **RMB19,320** rather than **RMB17,680** as shown in the previous costing calculations.

Recommendation

Ideally, what is needed is a **thorough ABC analysis** of the cost of all the major components of the SUV. This may identify areas where manufacturing overhead cost reductions can be made, while still maintaining the functionality and quality of the vehicle. We have already seen in the case of the steel body shell, that the ABC analysis revealed some potential areas where cost reductions might be possible. These areas include product finishing, quality inspections, materials handling, and materials ordering. In addition, it may be possible to reach some agreements with suppliers to reduce the cost of raw materials, and to seek out ways that labour productivity may be improved.

Note that KCC uses traditional costing instead of ABC when costing and pricing products. This is extremely rare in the auto manufacturing industry.