PAPER – 15: BUSINESS STRATEGY AND STRATEGIC COST MANAGEMENT

The following table lists the learning objectives and the verbs that appear in the syllabus learning aims and examination questions:

	Learning objectives	Verbs used	Definition
LEVEL C	KNOWLEDGE What you are expected to know	List	Make a list of
		State	Express, fully or clearly, the details/facts
		Define	Give the exact meaning of
	COMPREHENSION What you are expected to understand	Describe	Communicate the key features of
		Distinguish	Highlight the differences between
		Explain	Make clear or intelligible/ state the meaning or purpose of
		Identity	Recognize, establish or select after consideration
		Illustrate	Use an example to describe or explain something
	APPLICATION How you are expected to apply your knowledge	Apply	Put to practical use
		Calculate	Ascertain or reckon mathematically
		Demonstrate	Prove with certainty or exhibit by practical means
		Prepare	Make or get ready for use
		Reconcile	Make or prove consistent/ compatible
		Solve	Find an answer to
		Tabulate	Arrange in a table
	ANALYSIS How you are expected to analyse the detail of what you have learned	Analyse	Examine in detail the structure of
		Categorise	Place into a defined class or division
		Compare and contrast	Show the similarities and/or differences between
		Construct	Build up or compile
		Prioritise	Place in order of priority or sequence for action
		Produce	Create or bring into existence
	SYNTHESIS How you are expected to utilize the information gathered to reach an optimum conclusion by a process of reasoning	Discuss	Examine in detail by argument
		Interpret	Translate into intelligible or familiar terms
		Decide	To solve or conclude
	EVALUATION How you are expected to use your learning to evaluate, make decisions or recommendations	Advise	Counsel, inform or notify
		Evaluate	Appraise or asses the value of
		Recommend	Propose a course of action

Paper 15 - Business Strategy and Strategic Cost Management

Full Marks: 100 **Time allowed: 3 hours**

This paper contains 4 questions. All questions are compulsory, subject to instruction provided against each questions. All workings must form part of your answer. Assumptions, if any, must be clearly indicated.

1. **Read the case and answer the following questions:**

JET Airways (JA) Attempted Acquisition of Air Sahara (AS)

When AS announced that it was exploring opportunities for private placement of its equity, airline companies such as Spice Jet showed an interest in acquiring a stake in the company. At this time, however, JA did not express any interest in acquiring a stake in AS. Instead, Kingfisher Airlines, an airline owned by Vijay Mallya, chairman of the UB group, was considered a serious contender for AS. Mallya intended to speed up his growth plan in the aviation industry and believed that a merger with AS would help him achieve this objective. He negotiated with the company for a while but ultimately pulled out saying that the price set for AS was too high.

By this time, price had become the main concern for most of the potential acquirers. Analysts too opined that a valuation of around US$1 billion for an airline that was in debt was a bit too much.

Some industry observers believed that JA had overvalued AS and hence overpaid for acquiring the company. According to analysts, AS was not a profitable airline and hence the price paid was more than what the airline was actually worth. Alok Dalal, research analyst, India Infoline, commented, "The deal is favorable to Jet in terms of operational efficiencies but it is not so in terms of financials, as Jet has paid a much higher price." He added, "Sahara's financials are not as strong as compared to Jet." Defending the deal, Goyal said, "We've done serious valuation after studying similar deals done abroad. We've analyzed what happened when TWA sold to American Airlines or when Pan Am sold to United Airlines. We know what we are doing." It was also believed that although JA had gained certain synergies from the acquisition, it also had the difficult task of turning around the loss-making AS. Analysts expressed concern that JA would concentrate on making AS profitable at the cost of its own performance.

After JA's announcement of its decision to acquire AS, a member of the Rajya Sabha (the Upper House of the Indian Parliament) complained that JA would create a monopoly in the domestic airline industry by controlling almost half the market.

This would not be in the best interests of consumers and investors, the member said. The deal between JA and AS also faced opposition from airlines like Kingfisher Airlines and GoAir.

In fact, four airlines, Kingfisher Airlines, GoAir, Air Deccan, and IndiGo formed an alliance called Indian Airline Operators' Association (IAOA) before the formal announcement of the JA and AS deal was made.

The purpose of the alliance was to appeal to the government for equitable allotment of parking slots and prime-time departure slots. Later, however, Air Deccan backed out of the alliance.

Capt. Gopinath, CEO of Air Deccan, said, "I am not part of (Mallya's) alliance. I don't want to be a part of an airline group to take on Jet. What I am not looking at is an association which includes only a segment of the industry, as that would not represent the larger interest of the industry. "

Analysts opined that though JA had acquired a dominant position in the Indian airline industry, it would need to work hard to sustain this position in the long run. This was because several new private carriers were expected to enter the industry in the next few years.

Observed Alok Sharma, vice president, AS, "Traffic is booming, but as we see it, capacity growth will overtake traffic growth in the next few years. Last year, traffic grew by 20 percent to 25 percent, but load factors of full service carriers were still 70 percent or so."Also, IA and AI were taking steps to improve their operations. IA, which had been making losses since 2000-01, had become profitable in 2004. The airline also undertook a major re-branding exercise in December 2005 with a view to enhancing its image. IA and AI were also expected to go in for Initial Public Offerings by mid-2006. Reportedly, the GoI intended to sell around 20-25 percent of the stakes in these companies.

Required:

(i) Discuss the opinions of analysts expressed after Jet Airways acquired Air Sahara.
(ii) Describe the steps taken by major Airlines of India to improve the operations.
(iii) Discuss the challenge faced by the company after announcement of acquiring the Air Sahara.
(iv) Explain the strategic role of the Management Accountant in reference to merger and acquisition. **[5+4+5+6]**

2. Answer any two questions from (a), (b) and (c): [2 x 15 =30]

(a)

(i) Define Strategic Drift. Describe how an organization prevents strategic drift?
(ii) Discuss Contingency Planning and its seven steps process. **[(1+5)+(2+7)]**

(b)

(i) Explain the objectives of SWOT Analysis and its Advantages and Criticisms.
(ii) "Many organizations in order to achieve quick growth use strategies such as mergers and acquisitions."- Justify. Also discuss various types of mergers. **[(2+3+2)+(3+5)]**

(c)

(i) Distinguish between Vertical Integration and Horizontal Integration.
(ii) Discuss the limitations of Value Chain Analysis.
(iii) Enumerate the Important characteristics of Corporate level strategy.
(iv) "The process of Strategy formulation basically involves six main steps." – Explain these six steps. **[3+3+3+6]**

3. Read the case and answer the following questions.

Motorola manufactures wireless telephones. Motorola is deciding whether to implement a JIT production system, which would require annual tooling costs of ₹15,00,000. Motorola estimates that the following annual benefits would arise from JIT production:

- Average inventory would decline by ₹ 70,00,000, from ₹ 90,00,000 to ₹ 20,00,000.
- Insurance, space, materials-handling, and setup costs, which currently total ₹ 20,00,000, would decline by 30%.
- The emphasis on quality inherent in JIT systems would reduce rework costs by 20%. Motorola currently incurs ₹ 35,00,000 on rework.
- Better quality would enable Motorola to raise the selling prices of its products by ₹ 30 per unit. Motorola sells 30,000 units each year.

Motorola's required rate of return on inventory investment is 12% per year.

(i) Calculate the net benefit or cost to the Motorola from implementing a JIT production system.
(ii) What other nonfinancial and qualitative factors should Motorola consider before deciding whether it should implement a JIT system?
(iii) Suppose Motorola implements JIT production, (I) Give examples of performance measures Motorola could use to evaluate and control JIT production, (II) What is the benefit to Motorola of implementing an enterprise resource planning (ERP) system?

[5+6+(5+4)]

4. Answer any two questions from (a), (b) and (c): [2×15=30 marks]

(a)

(i) A company has just completed the manufacture of 40 units of a new product. The manufacturing costs are –

Direct materials	2,00,000
Direct Labour : 8000 hours at ₹ 20 per hour	1,60,000
Variable Overheads	80,000
Special Tools (re-usable)	10,000
Fixed Overhead apportioned	1,00,000
Total	5,50,000

The Company's policy is to add a profit of 12% on Selling Price.

The Company received another order for 120 units of this product for which the Company quoted, based on its policy on absorption cost basis, a price of ₹ 15,625 per unit. The Customer struck the order to ₹ 11,000 per unit. The company is short of work and so is keen to take up more orders but it is reluctant to accept this order price because it is against the policy to accept any price before its cost. The Company experiences a Learning Curve of 90%.

Compute the gain or loss arising from acceptance of the order or ₹ 11,000 p.u. and advise the Company suitably. **[5+1]**

(ii) AB Cycles Ltd has 2 divisions, A and B which manufacture bicycle. Division A produces the bicycle frame and Division B assembles rest of the bicycle on the frame. There is a market for both the sub – assembly and the final product. Each division has been treated as a profit center. The Transfer Price for the sub-assembly has been set at the long run average market price. The following data are available to each division –

Estimate Selling Price for Final Product	₹ 3,000 p.u.
Long-run Average Market Price for sub-assembly	₹ 2,000 p.u.
Incremental Costs of completion sub-assembly in Division B	₹ 1,500 p.u.
Incremental Costs in Division A	₹ 1,200 p.u.

Required:
1. If Division A's maximum capacity is 1,000 units per month and sales to the intermediate market are now 800 units. Should 200 units be transferred to Division B at the long run average price basis?
2. Calculate the Transfer Price, if the Manager of Division B should be kept motivated?
3. It outside market increases to 1,000 units, should Division A continue to transfer 200 units to Division B or sell entire product to outside market? Discuss. **[2+2+3]**

(iii) Why 'Lean Accounting' is needed? **[2]**

(b)

(i) The Marketing Director of a Company engaged in the manufacture and sales of a range of products wants to increase the market share and for the purpose proposes to spend ₹5,00,000 on advertisement campaign.

Two alternatives sales budget have been put forward as under:

Products	A	B	C	D
Budget: (Units'000)				

A:Before advertisement	360	560	520	300
B:After advertisement	380	590	545	315
The selling prices on variable cost data are as under:				
Selling price/Units	₹20	₹24	₹50	₹42
Direct materials/Unit	₹8	₹11	₹25	₹21
Direct Labour/Units	₹3	₹3	₹6	₹5
Variable Overheads/Unit	₹2	₹2	₹4	₹3

Direct labour hour rate is ₹5 per hour. Fixed overheads amount to ₹51,40,000 per annum. The production capacity is limited to 15,00,000 direct labour hour for the ensuring year. A and C however, could be bought on subcontract basis at ₹17 and ₹40 per unit respectively for sale.

Required:

Present a statement showing profitability of the proposed scheme and state weather the investment in the advertisement campaign is worthwhile. **[8+4]**

(ii) All-Win Co. manufactures and sells 15,000 units of a product. The Full Cost per unit is ₹ 200. The Company has fixed its price so as to earn a 20% Return on an Investment of ₹ 18,00,000.

Requited:

1. Calculate the Selling Price per unit from the above. Also, calculate the Mark-up % on the full cost per unit.
2. If the Selling Price as calculated above represents a Mark-up % of 40% on Variable Cost per unit, calculate the Variable Cost per unit.
3. Calculate the Company's Income if it had increased the Selling Price to ₹ 230. At this price, the Company would have sold 13,500 units. Should the Company have increased the Selling Price to ₹ 230?
4. In response to competitive pressures, the company must reduce the price to ₹ 210 next year, in order to achieve sales of 15,000 units. The company also plans to reduce its investment to ₹16,50,000. If, a 20% Return on Investment should be maintained, what is the Target Cost per unit for the next year? **[(½+½)+½+½+1]**

(c)

(i) State cost of quality? How it can be reduced? **[1+2]**

(ii) Bharat Consumer products employ 10 trucks of 10 tonnes capacity to deliver products to their distributors. The vehicles return empty on the return journey. The following data refer to the month of May 2014:

	Budget	Actual
Load Carried (tones)	4,000	3,800
No. of truck trips	500	450
Journey hours	3,000	25,000
Loading Time (hours)	1,000	800
Km. Travelled	25,000	25,000
Diesel used (litres)	12,500	13,000
No. of drivers	12	12
No. of mechanics	5	5
Fixed costs	₹8,000	₹8,000
Cost per litre of Diesel	1.00	0.95
Wages per driver per month	1,000	1,050
Wages per Mechanic per month	800	900
Shares for Repairs	2,000	2,500

Prepare statement for management detailing budgeted and actual operating cost. Also give your comments on performance. **[5+4]**

(iii) State the term Margin of Safety? How it is calculated? **[2+1]**