

CIMA GATEWAY PRACTICE EXAM ANSWERS

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Section 1

Report to the finance director

Strategic implications of an increase in fuel prices and an evaluation of activity-based management

Fuel prices

The price of aviation fuel continues to be volatile. The political situation in major oil exporting countries has caused a recent spike in prices. This paper discusses some of the implications of a prolonged increase.

Fuel accounts for $1.7/6.8 = 25\%$ of our cost per ASK (see pre-seen). That suggests that a prolonged increase will prove costly to our operations.

Given the central role of fuel prices in the industry, we can expect to see other airlines increasing ticket prices in response to this increase in cost. It may be that we can consider passing on the increased cost of airfares to customers because prices will be rising across the industry.

Unfortunately, our position as a no-frills airline does not save us a significant amount in terms of fuel costs and so we may lose ground to the traditional airlines. For example, National Air's fuel cost is only $1.8/9.6 = 19\%$ of their cost per ASK. In other words, if we both pass on the same cost increase for fuel our fares will rise by a larger proportion than theirs and so we could lose some of our competitive position.

Clearly, many of our customers are forced to buy airline tickets and so a price rise will leave a segment of the market unaffected. Unfortunately, there are also customers who have some discretion over whether to travel (or travel is a luxury). We can expect total demand to decline in the event of a price rise. Again, that could erode some of our competitive advantage because running our aircraft at close to full capacity helps us to offer lower prices than our competitors.

ABM and target costing

Our use of ZBB (see pre-seen) and other techniques mean that we would have to do very little in order to move further towards the use of activity based management and target costing. Arguably, we have used both techniques to a large extent albeit under a different heading.

Activity based management requires that we understand the cost of providing our service. The biggest area in which we might explore that is by looking at our route network and the costs of operating from specific airports. Clearly, some routes will always be more profitable than others. Some airports charge higher landing fees and so the profitability of routes cannot be directly compared.

ABM would require us to study costs and revenues closely with a view to making a decision as to whether we could utilise resources more effectively. For example, we should study customers' buying behaviour to establish whether we have routes that feed into other services. For example, some routes may appear to be relatively unprofitable but they stimulate demand because passengers then fly on to a final destination using Fly-jet. Closing some routes may lead to a more significant loss of revenue when the onward connections are taken into account.

ABM might also help us to understand the impact of some of the processes that we use. For example, the sale of inflight snacks is difficult to cost because we are using flight attendants who would be paid anyway, but they could lead to unseen costs, such as additional cleaning costs and potential delays when readying a plane for its next flight.

Target costing would be useful because there are market forces that restrict our prices. We are likely to find it difficult to sell tickets if our competitors undercut us. We must also offer some consistency in our pricing because our prices are visible on the website and customers may be concerned that prices are excessive if routes are priced differently for flights of a similar duration.

To an extent, target costing is difficult because we cannot manage all costs. For example, engineering costs are difficult to reduce without compromising flight safety.

We are also a victim of our own success because we have already cut many costs to the absolute minimum and have eliminated many of the discretionary costs that have been identified as avoidable. It may be possible to introduce cost reductions by stealth, such as gradually increasing the selling prices of our inflight snack range or by selling more services such as premier seats.

I hope that this report is helpful. Please contact me if you have any questions.

Report to the finance director

Change management and marketing issues

Move to TQM

TQM may prove threatening to our staff because our business model is essentially to keep costs to the bare minimum. Improving on cost may lead to redundancy because staff costs are our second greatest component of cost per ASK and engineering is also labour intensive.

TQM traditionally involves staff being involved in quality circles and similar activities. Our business makes that difficult because aircrew travel and are rarely able to meet with colleagues other than those in their aircraft. It may be possible to circumvent that by communicating through email or via teleconference.

It may be difficult for us to fully understand our customers' needs in this context. We accept that many of our customer feel that we offer a less exciting and desirable service than is available from the full-cost airlines. Moving towards meeting those concerns would be difficult to accomplish without incurring additional cost, which would be unacceptable. We would have to take great care to ensure that we do not raise unrealistic expectations through this exercise.

Staff may be concerned that we will aim to raise customer satisfaction levels with a product that is quite deliberately cut back to the minimum. We aim to provide value for money, but we do not aim to meet our competitors' levels of service because it would be too expensive to do so (see pre-seen).

Marketing implications

Successful marketing implies identifying and satisfying customer needs.

The need that we aim to meet is for inexpensive and efficient air travel. We offer a product that is differentiated largely on price. To an extent, we signal that fact by making our service as basic as possible, consistent with safety and meeting basic minimum standards of comfort.

Adding services such as those that have been proposed might create the impression that Fly-jet's service should be compared with that offered by the traditional, full service airlines. On that basis, we will suffer in the comparison because we cannot match their service on quality or convenience.

Having said that the traditional airlines are attempting to cut costs in order to be more competitive with the budget airlines and so the distinction is eroding anyway (see pre-seen).

The proposal may be misinterpreted as an attempt to generate net revenues]. Customers have to pay an additional sum for those services and may feel that the cost is excessive. That may lead to a cynical sense that we are simply trying to exploit our customers. The danger is that we would have very little uptake and so have the cost of running the scheme for the sake of a small number of participants.

If the changes can be promoted adequately then we will possibly have a significant advantage because customers may fly with us in preference to our competitors for the sake of accruing loyalty points. The fact that they have paid for this membership will make earning the points all the more important to them.

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Section 3

Negotiation

Unfortunately, these proposals follow on from a period in which the company has already been forced to make staff redundant (see pre-seen). Our starting point will be to gain the union representatives' trust in our commitment to the job security of the remaining staff.

We can expect the unions to be wary because we have already sought volunteers for redundancy and were forced to make staff redundant against their will in the last round of rightsizing. Even if we agree to minimise the number of compulsory redundancies, that is unlikely to mean much because there are unlikely to be any volunteers.

It may be necessary to offer to provide an attractive redundancy package. If we offer generous terms then the unions may be more willing to cooperate because some staff may be willing to volunteer for an enhanced offer. If the financial cost of such a scheme would be too great then we could possibly offer non-cash incentives such as the provision of training programmes to make staff employable in other industries.

We should also be prepared to justify the need for cuts to the unions. If they can see that the alternative is a threat of corporate failure, under which all staff would lose their jobs then it may be preferable to recommend redundancies in order to protect the remaining jobs. Part of that line of negotiation would be the discussion of a medium-term business plan that would indicate the full extent of the cuts, with evidence that the company expected to be able to maintain staffing levels.

It might be possible to persuade the unions by extending redundancies to some senior managers as a sign that the company really does not see any alternative to job cuts.

Planning for strike action

The first thing that we need to establish is whether the unions have the ability to call staff out on strike. Have there been strikes in the past? Or have there been any failed attempts to call a strike? Supervisors should be asked to talk to their staff and to report back to the HR department on their impressions of the mood of the staff.

How many staff are members of the union? It is unlikely that non-members will strike.

What areas of the business will be affected? If the strikers are administrative staff then we can cover their absence by drawing staff from other areas. If flight staff strike then they cannot be replaced by untrained and unqualified staff because of safety regulations.

Contingency plans should be developed, including ranking the urgency of different areas. For example, some departments could bring the company to a halt if the affected, say, flight operations. Those departments would have to be maintained, if possible, by using senior managers or reassigning staff from less urgent duties.

The company should contact recruitment agencies to establish the availability of suitable temporary staff. It may be unduly provocative to bring in outsiders from the outset of the strike, but it would be comforting to have the means to do so if the action was prolonged.

Section 4

Integration

The biggest obstacle to a successful integration is that the new subsidiary may have a different culture to Fly-jet. The first priority is to make it clear, hopefully in a constructive way, that integration is necessary and that it will occur. If Fly-tours staff realise that they have no alternative then they will not resist the change.

Fly-jet's accounting staff should study Fly-tour's business and its accounting systems and processes. The two businesses are quite different, even though they are both about travel. It is important that any changes made in Fly-tours are going to serve a valid business function and are not going to compromise efficient operations.

There will also be technical issues that will have to be decided, such as software packages and reconciliation of data. Ideally, it will be possible to export Fly-tour's data into Fly-jet's system and move the staff so that the previous system continues, albeit on a larger scale.

Fair values

There are relatively few models of civil aircraft and there is a worldwide market for second hand planes. It will be relatively easy to establish a fair value for Fly-tour's aircraft by contacting brokers.

The forthcoming introduction of a new model of plane (see pre-seen) could complicate matters. If the new plane is significantly better than Fly-tour's fleet could lose value because airlines prefer to buy the new model and also because they sell their existing planes early in order to upgrade. That would create a glut of the old model on the second hand market and prices would decline.

The landing slots will be far more difficult to value because they are unlikely to be traded frequently. That means that there will not be an observable market against which to measure values. If airlines tend to change routes and abandon airlines then an airport could become less popular and so demand for landing slots could vanish unexpectedly.

The historical cost of landing rights is unlikely to have any ongoing meaning because these rights last for several years and demand could change dramatically within that period.

Transfer pricing

The first issue is the motivational issues within the company. If the cost-plus price is viewed as excessive then Fly-tours' management will be demotivated and Fly-jet's will be demotivated if it is too high.

The costs of operating an aircraft include depreciation and other costs that are determined by accounting estimates. That means that any cost-plus arrangement will be suspect to at least party.

The fact that there is a healthy charter market may create problems if Fly-tours believes that Fly-jet is charging more than the price offered by third parties. That could lead to dysfunctional behaviour if Fly-tours manage to lease aircraft externally.

The other issue is external perspectives, particularly tax. Tax authorities will often suspect that transfer prices between fellow group members are intended to move profit from one company to another in a tax-efficient manner. The tax authorities will only accept cost-plus if it is a reasonable approximation to the price that would be charged in an arm's length transaction.