Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY PRACTICE EXAM ANSWERS

Variant 2

The Practice Exam can be viewed at
http://www.pearsonvue.com/cima/practiceexams/

These answers have been provided by CIMA for information purposes only. The answers created are indicative of a response that could be given by a good candidate. They are not to be considered exhaustive, and other appropriate relevant responses would receive credit.

CIMA will not accept challenges to these answers on the basis of academic judgement.

Section 1

From: Management Accountant
Sent: 13th Feb. 11.18 am
Subject: National Air's newspaper advertisement

Is our price advantage sustainable?

That is a fairly complicated question. On the basis of Cents per ASK, we have a significant cost advantage. In the short term, that will persist. The following factors must be taken into consideration in comparing those statistics:

As a starting point, our costs are significantly lower on the basis of Cents per ASK. If we go through the components of the total, we see that we have slight efficiencies in areas such as fuel and IT, which implies a degree of efficiency on our part.

More significant differences appear to arise from differences in our business models. If National Air wishes to compete as a low-cost carrier then it could easily copy our refusal to provide in-flight meals. That single change would reduce their cost disadvantage significantly.

Other cost savings would be more difficult to replicate. For example, staff costs and engineering are functions of airline safety legislation and so there is little immediate scope for undercutting us. National Air does fly to many more countries than we do and so they could have the opportunity to have their aircraft serviced to the same high standard in countries that have lower wage rates. We would have to make special flights without passengers to make the same savings.

In the short term, National Air is dependent on more expensive airports because they are the hub for long-haul flights. That makes it more expensive for them to fly into Capital City. They could, however, reduce their ticket prices on this key route because many of their passengers will be travelling on to a final destination and the profit from the long-haul flight will offset any lost revenue from a fare reduction on the short-haul sector.

Some of our savings may diminish as a result of our own success. For example, the growth in our services to Capital City Eastern Airport mean that the landing fees there may increase in response to the greater demand and we could lose some of our cost advantage.

The absolute cost advantage is also relevant. National Air has nine daily flights on the key route between Northtown and Capital City, compared to our three. If they wish to be seen to be cheaper than we are then they would have to run three times as many flights at a loss, which could be a significant cost.

We need to be careful about comments on cost advantages because National Air has a much more complicated business model, using different types of aircraft and allowing for connecting services. It may be that some of the cost differences shown in their average Cents per ASK would be less pronounced if they were to furnish figures for their short-haul services only.

National Air's entry to the low-cost market

Threat of new entrants:

There would be little or nothing to prevent National Air from entering this market. In principle, they would only have to cut ticket prices on their existing services and they would be in the low-cost market.

There would be a threat to their existing customer base. Their newspaper advert shows that they are keen to retain customers who enjoy the benefits associated with full-cost airlines.

It is debatable whether there is a great deal of brand loyalty in this market, but National Air would have the question of brand identity to deal with. Customers do not regard them as a low-cost airline.

Threat of substitute products or services:

There is a limited amount of competition on any given route. Most cities are served by one or two airports at most and it is impractical for many airlines to compete for the same route. National Air probably could not afford to commence flight operations from the smaller airports used by the existing low-cost airlines.

Bargaining power of customers (buyers):

Customers typically choose flights online and so they can easily compare prices. If National Air wishes to compete on price then they will have to at least match the prices in existing markets and, perhaps, undercut them in order to build market share.

Bargaining power of suppliers:

National Air already purchases most of the inputs that it requires from the same suppliers that we do. It is unlikely that they would wish to operate from the same airports that we do, but it is very likely that the airports would be glad to sell any vacant capacity to National Air because it would be prestigious to serve such a major airline.

Intensity of competitive rivalry:

The low-cost airline market is highly competitive. We would be forced to resist any attempt by National Air to take our business. Other low-cost airlines would be equally keen to meet this challenge.

Section 2

This report considers the performance of Longfly to our own and that of National Air. It also considers the market for low-cost, long-haul flight.

Ratio analysis

The first thing to note is that this is Flylong's first year of operation. The company is in a state of transition and so we should be careful not to read too much into these results and comparisons. Our figures have also been affected by specific events, such as redundancy costs and the compensation that we had to pay to West Airport. Even taking those factors into account, we failed to make an operating profit last year whereas Flylong did.

The first thing to note is that Flylong generated a healthy profit in its first year of trading. Operating profit as a % of revenue exceeded that of National Air, although that is probably to be expected because the latter is obliged to incur expenses on providing a higher standard of service and comfort. Flylong's return on capital employed was significantly lower than National Air's. Given that National Air is an established airline and has the potential for significant economies of scale, one possibility is that we can expect Flylong's return on capital employed to increase as it expands.

Flylong's average revenue per seat was much lower than National Air's, which implies that it may be able to increase prices slightly once it has penetrated the market.

Flylong was able to achieve a low fuel cost as a % of revenue, which is surprising because the low-cost model implies a limited revenue per seat sold. It may be that Flylong has identified a limited number of routes for this first year of operation that offer either the ability to operate closer to full capacity than ourselves and National Air or they have identified routes that lend themselves to efficiencies, such as fewer delays requiring wasted fuel.

If Flylong can scale up its business while maintaining contribution and profitability per seat then this would appear to be a viable business model. The company is quite highly geared compared to Fly-jet, which implies that it may struggle to borrow in order to grow, although the purchase of additional aircraft means tahgt the company will have valuable and readily realisable assets that it could use to secure any additional funding.

Potential market

The fact that low-cost, long-haul services have not been offered to date suggests that this may not be a particularly viable business proposition. Long-haul flights are likely to be forced to use larger aircraft that must operate from major airports. That puts them in direct competition with established, traditional airlines who may be able to compete strongly while the low-cost airlines are attempting to establish themselves.

Low-cost, short-haul airlines were able to create a niche of their own because they compete to an extent with long distance rail and bus services. They were able to get started and grow to a viable size without necessarily having to compete directly with traditional airlines.

According to National Air's ratios, long-haul services are dominated by business passengers. It is possible that business passengers will be unwilling to tolerate the lack of amenities of a low-cost airline when they are used to travelling in greater comfort.

It is fair to say that low-cost airlines have been very successful in changing passengers' expectations of air travel. It may be that, in time, the expectations of long-haul passengers will change also. Flylong managed to sell a large number of tickets, despite the lack of comfort. The very high proportion of leisure passengers in the first year's business suggests that there are large numbers of individuals who are keen to fly long-haul at low cost in order to visit family or for recreation. If Flylong can maintain that customer base in the short to medium term then it should be able to establish a viable route network without having to compete too directly with the traditional airlines. In time, that would provide a strong base from which to expand by moving gradually into the business market.

Section 3

Negotiating with Major Aerospace

The key to a successful negotiation is to determine what both parties have to gain and to aim for a win-win outcome **[1]**. Perhaps the biggest question is pricing and the extent to which Major Aerospace will grant us a discount and so there is an immediate source of conflict.

Our interest is as follows:

We will be seen to be the initial launch customer for this prestigious new aircraft, which will generate positive publicity and underpin our status as a major airline.

Our greater involvement in the design process may enable us to tailor the new aircraft more towards our needs.

If we have priority over other airlines then we may enjoy a period when we are the only ones in the marketplace offering flights in this new aircraft.

The fact that we will be placing a large order means that we will be able to seek a significant discount from the list price.

Overall, it would be highly desirable for us to reach an agreement with Major Aerospace.

Their interests in the deal are as follows:

Clearly, they will be keen to make a contribution from the order. We could, potentially, be ordering 74 aircraft to replace our fleet.

Our order would show that their aircraft was a credible alternative to the planes currently being operated.

Fly-jet is associated with low running costs and so our position as launch customer will demonstrate that the aircraft is efficient and suitable for low-cost airlines.

The starting point should be for both sides to acknowledge that there is benefit to both sides from our purchase of this aircraft. The next step is to identify the potential conflicts because those are the areas where discussion is most needed.

Our role as preferred customers will require some negotiation. We will wish to have the new aircraft designed to maximise passenger capacity and minimise running costs. Major Aerospace will probably wish to ensure that the aircraft is suitable for as many airlines as possible and that could lead to design compromises. We need to clarify just how much influence we will have and who the other preferred customers will be.

In the same vein, we also need to have some agreement over our priority for deliveries. It would suit us to have our entire order delivered before any other airline receives any aircraft. Major Aerospace will wish to sell to as many customers as possible and may even prefer to make sales to airlines that not placed a firm order.

The negotiation of pricing will be a zero sum game. We may wish to pay a higher price than to drive the hardest possible bargain over the other issues listed above.

Risks

The first risk is whether the aircraft will deliver its design potential. Major Aerospace may find it impossible to make the aircraft as reliable or as economical as they intend, but we will be committed to the purchase before such problems become apparent.

This is a complicated design project and there could be delays in completion and delivery. Major Aerospace could, for example, be held up by the agency responsible for certifying the aircraft's safety . Delays could disrupt our operations and make us appear disorganised.

New aircraft often have initial teething problems that can affect passenger perceptions **[1]**. We could lose revenues in the event that the new aircraft is perceived as unsafe or unrealisable, even if those perceptions are unjustified.

The transition to the new model could be complicated. Our flight crews and engineering staff will have to be trained to fly and maintain the new aircraft. During the transitional period we could have the difficulties of operating two models of aircraft and that will create significant logistical difficulties.

The total cost of acquiring this new aircraft will have to allow for the proceeds of selling our existing planes. Second hand aircraft are a commodity, but their value may be affected by economic factors such as fuel costs or employment rates. If the selling price is depressed then the net cost of buying the new aircraft will increase.

Switching to this new aircraft could create a significant upside risk in terms of positive publicity. We may be perceived as an innovative and progressive airline that is at the forefront of applying new technology. We could attract additional passengers.

Section 4

From: Management Accountant
Sent: 25^{th} Feb. 10.40 am
Subject: Managing flight attendants

Communication and mentoring

The basic objective here is that we wish our flight attendants to act in accordance with Fly-jet's values. We have a situation where members of staff work at remote locations in stressful environments and so there has to be some commitment to professionalism in dealings with customers.

Communication of our values would permit a degree of control over the message that is being communicated to staff. We could describe our expectations of staff in as clearly as possible.

The danger is that we know what we are saying, but we cannot necessarily know exactly how our statements are being understood. We are asking staff to put the company's needs before their own in many cases, which may lead to some resentment and so could be counterproductive.

It would be ideal if there could be a more interactive form of communication. If flight attendants could respond to our message then we could have a better understanding of how it has been received. A dialogue would also encourage staff by showing that we care about how they feel and are prepared to listen to their side.

Mentoring would enable us to draw upon the loyalty of experienced staff. Flight attendants will be forced to adapt to the airline's operational needs. More experienced staff should be able to present that in a reasonably positive way and to demonstrate that it is possible to enjoy working for Fly-jet despite the occasional sacrifice.

Mentoring has the advantage of creating the face to face dynamic that is missing from a policy based upon communication. Junior staff can talk their concerns through with their more experienced colleagues. The downside is that mentors may not necessarily be committed to addressing colleagues' concerns. The fact that a flight attendant has stayed with the company does not necessarily mean that he or she is committed to serving Fly-jet's needs.

Team building

The first issue that would have to be overcome with respect to the creation of a team of mentors is the identification of suitable individuals. The fact that a flight attendant has reached a position of seniority does not necessarily mean that he or she is a suitable role model in terms of being flexible and available. It may be useful to develop some basic criteria for identifying suitable members of staff. For example, their personnel evaluations may indicate their adaptability.

Mentors may find it difficult to arrange regular meetings with their supervisees. Teams of cabin staff are small and may be subject to frequent change, so it may be difficult for a mentor to develop a relationship with a particular person. It may be possible to address that problem by taking account of such pairings when scheduling flight rosters.

It will be difficult for team members to meet to exchange ideas and to provide feedback. That could prove discouraging to mentors, and could lead to inconsistencies in the training being provided. It may be possible to create some cohesion through the use of an electronic forum so that mentors can share ideas and ask one another questions.

The role of the mentoring team could become confused and that could lead to a loss of direction. The mentoring function could start to take on some of the characteristics of supervision given that cabin crews tend to be teams of three and one member of staff is senior. It is important to ensure that the role of the mentors is constantly clarified and reiterated.