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) The usual learning curve model is $Y = ax^b$

Where

Y is the average time per unit for x units

a is the time for first unit

x is the cumulative number of units

b is the learning coefficient and is equal to (log 0.8 + log 2) = -0.322 for a learning rate of 80%

Given that a =10 hours and learning rate if 80%, you are required to calculate:

- **I.** the average time for 20 units
- **II.** the total time for 30 units
- **III.** the time for units 31 to 40

Given that log 2 = 0.301, Antilog of 0.5811 = 3.812

log 3 = 0.4771, Antilog of 0.5244 = 3.345

log 4 = 0.6021, Antilog of 0.4841 = 3.049 [$1^1/_2$+$1^1/_2$+3=6]

(ii) Boraco Ltd. has been offered supplies of special ingredients S at a transfer price of ₹15 per kg by chhotaco Ltd. which is part of the same group of companies. Chhotaco Ltd processes and sells S to customers external to the group at ₹15 per kg. Chhotaco Ltd. bases its transfer price on cost plus 25% profit mark-up. Total cost has been estimated as 75% variable and 25% fixed.

You are required to:

Discuss the Transfer prices at which Chhotaco Ltd. should offer to transfer special ingredient S to Boraco Ltd. in order that group profit maximizing decisions may be taken on financial ground in each of the fallowing situations:-

- **I.** Chhotaco Ltd. has an external market for all of its production of S at a selling price of ₹15 per kg. Internal transfers to Boraco Ltd. would enable ₹1.50 per kg of variable packing cost to be avoided.
- **II.** Conditions are as per (I) but Chhotaco Ltd has production capacity for 3,000 kg of S for which no external market is available.
- **III.** Conditions are as per (II) but Chhotaco Ltd has an alternative use for some of its spare production capacity. This alternative use is equivalent to 2,000 kg of S and would earn a contribution of ₹6,000. [3+2+2=7]

(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) Enumerate the steps involved in target costing? [3]

(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]