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E1 Organisational Management



Operational Case Study Exam (also relevant to E1 and P1)

Any business that shuns its corporate social responsibilities in pursuit of a quick profit is running a serious strategic risk. Taking short-cuts in quality management can cause long-term costs that can cripple the biggest of firms. When faulty goods pose a safety threat, these costs can go far beyond the financial

By Peter Stiff

Imagine a terrible world where companies could do whatever they wanted to profiteer with impunity. Without laws, ethical codes and other systems of accountability to control them, they would be free to pollute the environment and endanger lives, with no sense of morality or corporate social responsibility. In such an “anonymous business” world, there would be little need for a company to make reliable goods, because no one would have the right to return them for a refund if they weren’t fit for purpose. Consumers would forever worry that, say, the cars they were driving were potential death traps owing to some undisclosed **design flaw or manufacturing short-cut**.

Fortunately, laws and ethical codes do of course exist to hold businesses to account for their actions and protect the public and the environment. There have been many occasions where companies have misbehaved and tried to get away with it – eg, Texaco’s dumping of chemical waste in Amazonian Ecuador in the late 20th century. But, in this age of social media, any failure to exercise corporate social responsibility is likely to be widely exposed. It’s therefore in an organisation’s best interests to avoid any wrongdoing.

When a company does not comply with regulations, follow codes of practice or meet public expectations, it risks damaging both its reputation and its bank balance. Conversely, firms that are seen to honour ethical codes (eg, adhere to Fairtrade standards), be ecologically conscious (eg, use renewable energy) and produce high-quality goods (eg, make reliable cars) often thrive, with happy customers and goodwill all round.

Ultimately, this means that there are a number of costs to a company that don’t apply directly to producing goods and driving profits. Let’s start with those associated with quality. You may be thinking: “Wait a minute – I thought that we were talking about corporate social responsibility.” But quality is, in many ways, a CSR matter. Arguably, customers are a company’s most important stakeholder group. Quality is a key business issue, because it’s a key issue for most customers. This means that it’ll also be a key issue in the Operational Case Study Exam.

When you evaluate the pre-seen material, you should consider the importance of quality to the company concerned and how this is managed. The unseen material provided in the exam will often present a scenario under which quality could be compromised. Analysing this and making suitable recommendations is the key to a good answer. Quality is also covered in both E1 and P1, so it’s a topic you need to know well. Based on material taken from Astranti’s P1 and E1 study texts, I will focus on some of the

key knowledge you need on this topic by examining the concept of quality and then discussing total quality management (TQM) and quality costs.

Transport of delight?

To understand the changing face of production over the past 50 years and how it relates to the quality, consider the contrasting approaches and fortunes of two big car manufacturers, General Motors (GM) and Toyota. The latter grew its business on the basis of quality, while the former almost failed as a result of quality problems.

Although GM sold more cars than any other manufacturer throughout much of the 20th century, the US firm’s tale is renowned in management circles as a lesson in what not to do when it comes to running a business in a changing world. GM failed to adapt, losing its place as the number-one car maker – and billions of dollars along the way. It reached its nadir in 2009, in the aftermath of the global financial crisis, when the US government spent \$50bn to rescue it from bankruptcy. Since the bail-out, the company has recovered partially and is “profitable”, but it’s now only the world’s sixth-largest car maker.

At its peak in 1979, GM operated 150 assembly plants and employed more than 600,000 people. The oil crisis of 1973 had caused fuel prices to soar, so smaller and more fuel-efficient cars were becoming increasingly popular. This was bad news for GM, whose bestselling models were big gas-guzzlers. An influx of compact and economical Japanese cars started to pose a challenge, especially as it soon became clear that they were also more reliable. By 1986, GM was forced to start closing factories and making redundancies. Above all else, it was the sheer size of GM that led to its decline. Its scale had bred inertia, inefficiency and an ingrained culture that was hard to change. The owners made several attempts to change the philosophy of the organisation, including entering a

joint venture with Toyota in a bid to learn “the Toyota way”. Although new methods were introduced successfully at a few of its plants, the innovations failed to spread more widely and GM’s inefficient, low-quality culture prevailed. Although it generally produced luxurious, high-spec cars, they remained poorly made and unreliable.

The United Automobile Workers, a union representing many of its employees, was a big barrier to change. It was so large and powerful that any attempt to introduce practices that could be seen as a threat to jobs was usually soon quashed by **the threat of strike action**. On top of all this, GM was burdened with massive pension and healthcare costs resulting from a postwar agreement making generous provisions for its retired employees.

Founded in 1937, the Toyota Motor Corporation grew at its fastest rate in the 1970s and 1980s, with a focus on efficiency and quality enabling it to penetrate markets worldwide. The Japanese firm enjoyed a seven-year stint as the world’s number-one car manufacturer until 2015, when Volkswagen took its place. The German company has since come under **heavy fire for rigging its engine emission tests**, of course, so its grasp of the top spot is far from certain.

One of the keys to Toyota’s success has been its use of TQM. This approach is based on maintaining an organisation-wide culture of quality. It is a key focus at the strategic level, which then becomes part of everyone’s work all the way down the hierarchy.

TQM is based on three main principles:

- Getting it right first time. Rather than solving quality problems, a successful TQM programme will prevent them from happening in the first place, with the ultimate goal of “zero defects”. This concept is based on the idea that by preventing errors you avoid all the costs of reworking products, dealing with warranty claims etc.
- Customer focus. Under TQM, quality is ultimately judged by the extent to which consumers’ needs are met. In the

1970s Toyota produced a range of economical compact cars, capitalising on the fact that drivers were seeking models that were cheaper to run, given the steep rise in fuel prices. More recently, the Toyota Prius became the first mass-produced petrol-electric hybrid vehicle, aimed at an increasingly environmentally aware group of consumers.

– Continuous improvement. This is an ongoing commitment to keep refining every process in the organisation. Unlike GM, where there was a historic cultural opposition to change, Toyota would routinely adopt new processes as part of its continuous improvement programme. The goal was to embrace change as the norm and always be seeking opportunities to do things better.

Whenever a production problem was discovered in a Toyota factory, the assembly line would come to a halt and a solution would be sought. This meant that fewer faulty cars would reach the end of the line and also that the problem would not recur. In the long term this led to a near-flawless final product and virtually no waste.

By contrast, technical problems and poor workmanship were rife at GM, regularly resulting in faulty products. Yet the production line would rarely be stopped, leaving the causes unidentified and meaning that the defect rate did not improve. The fact that managers’ incentives were based on production volume, rather than quality, compounded the situation.

For TQM to work, full participation and teamwork is essential. All employees, including directors, are required to consider quality factors in the work they do and come up with ideas for improvement. It means motivating and training all staff to embrace the quality ethos. At Toyota, the small teams of workers who would perform tasks together were encouraged to suggest refinements. By contrast, there was a notorious lack of respect between managers and workers in GM’s factories. Motivation and productivity suffered as a result. When the company tried

to introduce a more participative, team-based culture, it didn’t take hold. This was attributed to the idea that the managers didn’t want to relinquish their power and that the workers didn’t want to give up their dream of one day being promoted to a managerial role.

Under TQM, the organisation’s suppliers are also expected to play their part. GM had a history of acquiring companies in the supply chain, which led to a reduction in quality of its cars’ components because these suppliers, once they were brought in-house, were less motivated to improve their products. An external supplier would risk losing business if the quality of its output were to dip, but the internal suppliers felt free to focus on reducing costs, rather than ensuring quality.

In 2014, 29 million GM vehicles had to be recalled after an ignition switch fault that stopped the engines of moving cars and deactivated their airbag systems was found to have caused hundreds of crashes, several of them fatal. The company was fined \$35m for being slow to recall the cars, having been aware of the fault for some time, but the reputational damage helped to wipe about \$3bn from its market capitalisation. Even the normally reliable Toyota incurred huge costs, totalling an estimated \$5bn, when a **dangerous flaw affecting the throttle pedals** of several models prompted a series of recalls in 2010. Quality failures can be extremely costly, therefore, and the goal of TQM is based on the premise of averting such costs.

The cost-quality balance

Quality costs can be split into two categories: conformance and non-conformance. Conformance costs are those associated with prevention, inspection and improvement to avoid future problems. They can be divided into:

- Prevention costs – eg, those incurred in training employees, who should then be able to work to a higher standard, or in procuring higher-quality materials.

- Appraisal costs. These are incurred through quality checks – eg, the costs of employing inspectors and using testing equipment.

Non-conformance costs are those that arise from inadequate quality. These can be divided into:

- Internal failure costs. These are incurred when failures are identified within the organisation – eg, the costs of scrapping or reworking faulty products.
- External failure costs. These are the costs of repair, replacement or recall when a product fails after reaching the consumer. They also include the decline in future revenues caused by the loss of customer trust and goodwill.

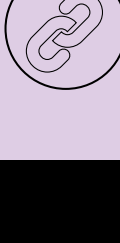
The level of quality desired has to be weighed up against the cost involved in ensuring it – there is always a balance to be struck. This is where management accountants can play their part by examining the costs versus the benefits of varying levels of quality.

TQM versus standard costing

You may recall from your studies that standard costing involves identifying the standard (expected) cost of a product and then using that figure to calculate variances and value inventory. Unfortunately, standard costing and TQM are not compatible in many ways. The reasons for this include the following:

- Under TQM, achieving the highest possible quality, rather than hitting predetermined cost targets, should be the main focus. Standard costs are therefore irrelevant in a system of continuous improvement.
- Typically, a just-in-time inventory control system is used under TQM. The aim is for there to be no inventory, so the standard cost for inventory valuation has little relevance.
- Standard costing focuses on production costs, while TQM focuses on quality costs. For example, in standard costing we may be interested in finding out how many units are produced per machine hour, but under TQM we would be

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