CGMA MANAGEMENT CASE STUDY AUGUST 2019
EXAM ANSWERS

Variant 2

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Section 1

Requirement 1: Competitor analysis

Our starting point would be to conduct a search for cruise holidays that are offered in that region. These should be relatively easy to find because all cruise companies will be actively seeking passenger bookings. Company websites will then identify the ships that are being used and we will be able to estimate their capacity, if the capacity figures are not a matter of record. The number of passengers who actually book will be more difficult to estimate, but we might consider looking at availability on websites. If there are no cabins available on some cruises then we will know that they are fully booked. We might also look for evidence of discounts offered for late bookings, which would imply that competitors are struggling to fill their ships.

We should look at historical growth in competitors' capacity. If they are launching ships or replacing older ships with newer ones of larger capacity then that is a clear sign that the market is expanding. A search through the business press would quickly reveal stories about cruise ships being ordered and built for the companies who operate in this region. We should also look to see whether cruise operators from outside the region are using our strategy of relocating ships to the Eastern Ocean. Growth in capacity indicates that the market is growing, but it also indicates that we have more competition because the other cruise companies will be as keen to fill their ships as we are to fill ours.

We should also consider the extent to which we are capable of capturing a realistic market share in that region. We cannot guarantee that our ability to fill places is sustainable in the event that capacity grows. If we cannot capture market share then we may struggle to compete in this market because it will not be cost-effective for Cruisecalm to market itself in that region. Passengers may then be drawn to larger cruise companies who can maintain a strong presence, spending on advertising and encouraging travel agents to place bookings with them. We need to determine whether we can differentiate our cruises from the others that are on offer from existing companies and potential entrants.

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Requirement 2: Evaluating marketing department

The most immediate challenge is that we have relatively little understanding of this market. We were fortunate enough to have unexpected demand from customers living in that region, but we did not design our product with a view to generating that revenue. If we do not understand the market then we will not be able to produce a realistic assessment of the potential sales that we might generate. The Marketing Department could feel that they are being judged against a relatively meaningless target and so they could be demotivated. For example, we might have gained short-term custom, which could attract local competitors who have a better understanding of the needs of passengers from that region and subsequent sales could be very poor.

We will almost certainly involve the Marketing Department in planning this new venture. There would be a natural tendency for the Marketing team to offer a conservative prediction of potential demand for planning purposes so that they have readily achievable targets. We will deploy ships to the region, based on those plans and, so, the basic sales target for the Marketing department will be to fill those ships. If that target is achieved then there will be nothing left to sell because we will be unable to sell more cruises if all of our ships are committed.

The need to commit ships to this venture also means that sales targets will essentially have to rise in quite significant increments. At present, we send a single ship for the winter season. Increasing the target would increase capacity by drawing in a second ship that would have a capacity of 3,500 passengers. The Marketing department could feel overwhelmed by every increase in the number of ships.

Our lack of experience in this market will make it difficult to understand the needs of passengers from that region in terms of additional sales. We have little experience of the extent to which they will pay for shore excursions, meal upgrades, or whatever and so it will be difficult to hold the Marketing department accountable. If we set excessive targets then there could be a risk that passengers are irritated by constant attempts to sell them products that they do not particularly want while they are on holiday .

Section 2

Requirement 1: Risks

The first risk arises from the fact that we will be counting on the ship to operate at 85% of capacity in order to break even. There is a very narrow margin between success and failure on this venture and it would take only a relatively small decline in bookings to make this a loss-making project. The project extends over the next ten years, which is a long forecasting period for a new venture in an unknown market.

The project requires a significant initial investment in the refurbishment of the ship, which will be virtually impossible to recover in the event that the project fails. The ship will be painted and refurbished in a colour scheme that is unique to Cruisecalm and so it will have no value to any prospective buyer if it is decided to abandon the project and dispose of the ship . That cost does not become a sunk cost until we have committed ourselves to proceeding, so it is a valid risk in terms of the evaluation of the project.

The terms of the lease may also make it difficult to abandon this project without significant expense. If we are unable to operate the ship at a profit then the ship's owners are unlikely to be willing to permit us to return it to them because other potential lessees may be reluctant to take it over. Cruisecalm could find itself being forced to operate the ship at a loss for the remainder of the lease period.

The condition of the ship and the need to have it overhauled and refurbished creates a number of risks. The ship has been out of service for several years and so the extent of any repairs and maintenance will be difficult to determine. The ship could prove unreliable once we take control of it. The work required to make the ship fit for service will also be complicated, which will create the risk that the ship will not be ready to join the fleet in time for the first scheduled cruise. That could lead to adverse publicity because of cancelled holidays.

Requirement 2: Impact on financial statements

The agreement falls within the requirements of IFRS 16 *Leases*. Cruisecalm will have the rights to use the ship for a period of time and in return for a consideration, which means that the arrangement falls within the scope of the standard. It does not meet any of the potential exemptions set out in the standard because it is a long-term lease and the underlying asset is of high value.

The lease liability will be capitalised in Cruisecalm's statement of financial statements at the present value of the payments that have been committed for the next ten years. This total should be divided between the amount of the principal value that will be payable within one year, which will be shown as a current liability, and the remainder, which will appear as a non-current liability. The non-current element will increase Cruisecalm's gearing ratio and will make the group appear more risky. The current liability will affect the liquidity ratios based on the statement of financial position.

This arrangement will also increase the property, plant and equipment by the total of the capitalised value of the lease, plus the N$60 million paid to refurbish the ship. That will then have to be depreciated over the ten-year life of the lease. The interest on the lease liability and the depreciation will both reduce profit. Capital employed will also be increased, so the profitability ratios may be adversely affected. The overall impact on profitability really depends on the success of the cruise route as a business venture. The net effect on operating profit will, hopefully, outweigh the cost of interest and depreciation by enough to overcome the increased capital employed.

Cruisecalm will be required to disclose the nature of the lease in the notes to the financial statements. One potential issue is that the ship will not belong to Cruisecalm and so it will be necessary to clarify that it is not, for example, a legally-owned asset that might be pledged as security.

Section 3

Requirement 1: Pricing and target costing

The usefulness of target costing depends on having the ability to determine the price that the market would pay for a product. That can then be adjusted for the required profit per unit to establish the maximum that Cruisecalm can afford to pay for that product. The passenger feedback suggests that passengers do not regard the present product as offering good value for money and so it may be appropriate to attempt to reduce costs in order to pass on savings in the form of lower fares. There is, however, a complication in this case because Cruisecalm is new to the market and it now has the opportunity to create a differentiated product. It may be more profitable for Cruisecalm to continue to charge prices that are relatively high and to focus on the quality of the cruises when marketing. The passengers who have cruised with the company were prepared to pay those prices and they do not actively disagree with the suggestion that they would book again.

Rather than being concerned about price, Cruisecalm could adapt the existing cruises for this market without spending a great deal. If passengers enjoy informal entertainment and activities then it would cost very little to organise events such as quizzes and sports tournaments. If passengers enjoy themselves more then they will be more likely to feel that their cruise offered value for money. In any case, much of the cost of a cruise is discretionary, depending on whether passengers wish to pay for excursions and so on. That suggests that passengers can work towards achieving their own target price.

The refurbishment of the MV Southern Queen might not be the best place to start with in terms of cutting costs because it could prove expensive to rectify any false economies at this stage. Cruisecalm must bear in mind that it is competing in a market that generally strives to offer new and exciting experiences aboard cruise ships. If the focus of the refurbishment is on cutting costs then the market may gravitate towards other ships and other cruise lines. It may be more realistic to market cruises on the basis that they are a relatively expensive way to vacation, but they are enjoyable because expenses are not spared.

Requirement 2: Culture

An entity's organisational culture can be described in terms of the entity's prevailing attitudes and norms. In the case of Cruisecalm, the organisational culture has developed in response to meeting the needs and expectations of passengers from Norland. Cruisecalm is a service organisation that has a high degree of interaction with its customers when they are aboard its ships. There is a danger that the expectations of customers from the Eastern Ocean will not be met because crew members will not understand what these passengers expect of them.

The first challenge is in understanding what passengers from this region actually want and expect. It will take more than just feedback forms to give Cruisecalm the necessary understanding. Cruisecalm has been successful in creating an ambience that suits passengers from Norland and surrounding countries, but that has led to shared values amongst crew members that are not particularly appropriate for this new market. That creates a problem in this case because crew members will not necessarily realise that they need to adapt and they will require specific training in order to help them do so.

The second challenge is that passengers from Norland may book cruises on the MV Southern Queen and could be disappointed that the service that is being offered does not meet their expectations. Attempting to meet the needs of both passengers from Norland and those from the Eastern Ocean region may lead to neither group being satisfied. In the age of social media, any such discontent could lead to poor online reviews and could discourage future bookings.

The first challenge might be overcome by recruiting as many customer service staff as possible from other cruise lines that operate in the Eastern Ocean region. The MV Southern Queen will be a new addition to the Cruisecalm fleet and so a crew will have to be recruited anyway. Staff with experience of providing an acceptable cruise experience in that region would be able to develop programmes and train colleagues who have been transferred from elsewhere in Cruisecalm.

The second challenge might be overcome through specific branding of the cruises aimed at passengers from the Eastern Ocean region. Passengers would then book in the knowledge that they should expect a more informal and relaxed atmosphere. That branding would make it possible to differentiate cruises on the two ships, so that Cruisecalm could offer two types of cruise in that region, with each meeting the needs of different target markets. The focus of any such branding, and any associated advertising, should be on the features of the cruise on offer. That would avoid any sense of discrimination or exclusion on the grounds of nationality of passengers.

Section 4

Requirement 1: Evaluation of deposit policy

The starting point would be to consider the overall profitability of the cruise companies that operate extensively in the Eastern Ocean in order to establish whether they are generally profitable. The number of passenger cancellations will not appear in their financial statements, but one would expect large numbers of cancellations to reduce activity ratios such as asset turnover. Cancellations would also affect the gross profit percentage (or operating costs as a percentage of revenue) because of the costs of provisioning ships that will then sail with empty cabins that have not been paid for.

Cruisecalm could also multiply the current liability of customer deposits by 50 in order to estimate the value of the cruises that have been committed under a 2% deposit. That value could be expressed as a percentage of revenue in order to estimate the extent to which cruise companies are prepared to tie up places on cruises under this policy. If that percentage is consistent over time and also across cruise lines then it could be argued that the 2% deposit has been found to be sufficient for passengers from that region.

Cruise companies publish cruise prices online and through travel agents. Cruisecalm could estimate the average price per cruise for each of the companies that operates in that region. Dividing the average fare into the reported revenue would give the number of bookings sold and completed. Cruise lines tend to publish the passenger capacity of their cruise ships so it would be possible to estimate the extent to which the companies are selling space to passengers who complete their bookings.

Cruisecalm could analyse social media posts that refer to holidays and look for key words and phrases that might refer to bookings and cancellations. That would not give accurate figures, but it would permit a rough estimate of the cancellation rate. Cruisecalm could then compare that estimate with the cancellation rates for past cruises, for which a 10% deposit was taken, and also bookings in Norland. That should give some insight into whether deposits make much difference to final sales.

Requirement 2: Cancelled bookings

The need for a provision should be considered in terms of the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The definition of a provision requires that there be a present obligation, with the probability that there will be an outflow of resources. The fact that Cruisecalm will be committed to sailing, albeit with fewer passengers, in the event of cancellations could be viewed as falling within this scope, but only if there will be costs incurred in respect of the cancelling passengers. In the absence of such an “onerous contract” to operate a loss-making cruise, we might argue that there is no need for a provision.

Hopefully, Cruisecalm could argue that it would take an unlikely number of cancellations to make such a provision necessary and that the probability of that occurring would be low. Certainly, other cruise companies in that region would have been reporting losses if such problems were a regular occurrence. Also, the costs could be mitigated by reselling the cancelled cruises, even at a discount, or by reducing orders for food and other consumables so that the threat of a loss is mitigated.

The concept of integrity would require that Cruisecalm should honour any commitments, which could require running a cruise at a loss. The company knows that customers are making a significant commitment because they have to organise annual leave and so a cancelled cruise could cost them their holiday, even if they refund all costs in full.

Loss making cruises do create a potential conflict of interest between the interests of the shareholders and those of the passengers. The concept of objectivity requires that Cruisecalm should not permit the needs of the shareholders override the commitment made to the passengers. If the company wishes to have scope for such cancellations then it should make that possibility clear at the time of booking.

The concept of professional behaviour requires Cruisecalm to comply with all relevant laws. In this case, the company is forming a contract with the passengers and it is obliged to honour that contract unless circumstances make it impossible to do so.