CGMA MANAGEMENT CASE STUDY AUGUST 2019
EXAM ANSWERS

Variant 3

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Section 1

Requirement 1: Penetration pricing

Cruisecalm is considering a new product that will be marketed on the basis of its low price and so penetration pricing might be a good way to build presence in this market. Penetration pricing normally leads on to price increases once a market base has been established, but that will not necessarily be the case here. The budget cruise operation could continue as it is initially established, providing it proves profitable. Cruisecalm is considering this pricing model in response to declining bookings and it will now have the opportunity to observe whether a reduction in selling prices has any impact on demand.

The most immediate concern is that the proposed changes will not offer sufficient cost savings to make it possible for Cruisecalm to reduce its selling prices sufficiently to make a real difference. The monthly operating statements of MV Krono and MV Batvia show monthly payroll costs of N$2.4m and N$2.3m respectively, which are relatively small proportions of the monthly operating costs. Even if payroll could be reduced by half, it would not create a great deal of scope for reducing cruise prices.

Penetration pricing could be difficult to implement because Cruisecalm's two principal competitors are already occupying the low-cost segment of the cruise market. Passengers who have travelled with Wavelyne and Saildine in the past may be inclined to rebook with those companies rather than risking switching to Cruisecalm's new product, which may prove disappointing. Cruisecalm may be forced to sell low-cost cruises at a loss, at least initially, in order to penetrate this segment of the market. In which case, it may make more sense to offer its existing services at a reduced cost in order to rebuild volume.

The product may also compete directly with Cruisecalm's conventional cruises and further reduce the volume of bookings on those. Passengers will be cruising on the same ship as before, possibly eating the same food if they would have opted for the buffet restaurant and with a slightly less elaborate stage show. If the price of the "no-frills" package is sufficiently low to compete with Wavelyne and Saildine then Cruisecalm's existing passenger base may be very tempted to experiment with the low-cost option.

Requirement 2: Emergent strategy

The first advantage is that an emergent strategy can free the Board of the constraints that might be imposed by intended strategies that have been set in the past and have reflected the business environment that was in place at that time. The Director of Marketing's proposal is intended as a response to declining bookings, which are a clear indication that the intended strategy is not working as well as would be hoped. The proposal to offer low-cost cruises is, at least, a response to the possibility that traditional cruises have become too expensive to attract previous levels of custom.

The freedom to follow emergent strategies can offer scope for adaptation in responding to changes in the business environment that may be rendering the existing business model unsuitable. In this case, Cruisecalm is faced with declining bookings, which could suggest that the original intended strategy of maintaining quality in return for high selling prices is threatening the company's future. The proposed low-cost venture will require very little investment and, in this case, has the advantage of being easily reversible.

Emergent strategies can be sources of resistance and instability. Senior members of the management team may feel the need to resist strategies that seem to diverge or distract from the intended strategy. If there is sufficient resistance from key members of the management team then the new strategy venture could fail through a lack of management support, rather than because of limitations of the concept itself.

The pursuit of emergent strategies could prove a distraction from the successful pursuit of the intended strategy. In this case, the Board has not conducted any detailed investigation into the causes of the disappointing booking figures. There is no guarantee that cutting prices will stimulate demand. It might be more realistic to establish why the intended strategy is not working before experimenting with ventures that will take time and will commit resources.

Section 2

Requirement 1: Evaluating investment

The most immediate challenge with any investment in information systems is that the projected cash flows are difficult to predict with any certainty. We know that there is a potential gain, but that may not be sufficient to justify the significant outlay. We do not know what benefits we will receive until the system is in place and we can compare the actual results with historical bookings. We hope that giving potential passengers reliable and accurate prices for cruises will increase our sales, but we do not know the extent to which that will happen. A new system will require a significant outlay and we do not necessarily know the extent to which overpricing is a relevant factor in the loss of bookings.

The second challenge is that the Board must have a clearer indication of the relevant options that are available. The Director of Finance has presented this as a choice between operating with a flawed booking system and spending N$80 million on a completely new system. Given that the flawed booking system is unreliable and appears to be costing revenue, the Board will have little choice but to invest in the new package if that is the only alternative under consideration. There could be more cost-effective responses to the problems with the booking system, though, which would save both time and money. The solution proposed by the Director of Finance appears to offer very little in the way of added value, other than the urgently needed correction of the mispricing.

The first challenge might be overcome by conducting an exercise to quantify the extent of the mispricing under the existing system and the extent to which the errors are affecting bookings. Cruisecalm could have sales staff analyse a number of dropped bookings and have them calculate the correct quote manually. If the quoted price is overstated by a very small percentage then it is unlikely to have caused the customer to quit. These customers have already input their contact details, so it would be possible for Cruisecalm to contact them and offer then the same cruise with the correct price. The customers' responses to such corrected quotes will help determine whether the investment in a more reliable booking system might improve revenues. If there are very few sales on the basis of corrected quotes then there is little point in buying the package.

Cruisecalm's sales and systems staff should investigate whether the system does have to be replaced in its entirety. Booking systems are designed to be updated for changing prices and so the Director of Finance's belief that it has been updated too often may prove unfounded. Analysing the incorrect quotes might make it relatively easy to establish which part of the system requires an update and so it may then be possible to correct the errors. It should also be possible to look back to establish whether the start of the dropped bookings coincided with an update or upgrade, which would help to narrow down the change that ought to be investigated. In evaluating the revenues from the purchase of the new system, it should be borne in mind that there might be a high risk that any new system will contain errors, even if it is a standard package.

Requirement 2: Bond

The treatment of the bond is set out in IAS 32 *Financial Instruments: Presentation*. The bond is a financial instrument that falls within the scope of the IAS and is not subject to any of the exclusions. The bond is a financial liability because it imposes a contractual obligation to deliver cash to another entity.

The cost of the bond should be determined in relation to the discount against face value at the time of issue. The bond will be worth N$280 million at the time of redemption, but the buyers will pay only N$200 million at the time of issue. The N$80 million discount will be recognised as a finance charge on an accruals basis over the five-year life of the bond.

IAS 32 will require Cruisecalm to recognise a liability of N$200 million at the issue date of the bond, which is clearly the economic substance of the arrangement. There will be an annual interest charge that will be determined as the rate of compound interest that will increase the

N$200 million to N$280 million over five years. The annual interest will be recognised as a finance charge in Cruisecalm's statement of profit or loss.

The annual interest charge will not be paid to the bond holders, so it will have the effect of increasing the value of the non-current liability in the statement of financial position. The liability will be transferred to current liabilities when the bond's repayment date falls within one year. It will be settled by a cash payment at the end of year five.

Section 3

Requirement 1: Resolving conflict

We need to start by investigating the reason for this conflict. Hopefully, the conflict is attributable to the two directors having a different perception of the business issues associated with the choice of ship. It may be that there are personal disagreements between Danny and Mavis, which could be far more difficult to identify and resolve. As a starting point, it would make sense to have a third director meet with both Danny and Mavis and ask them to explain their concerns, with a view to seeking a response that is in Cruisecalm's overall best interests.

Once the basis of the conflict has been identified, we need to accept that the two directors will be protective of their respective functional areas. Marine Operations is responsible for providing the ships with which to service the many cruises that Cruisecalm has committed itself to providing and Marketing must sell places on the new budget venture. That suggests that it might be preferable to involve the whole Board in the final decision, with the trade-offs between objectives being considered from the company's point of view.

The conflict between Danny and Mavis appears to involve low co-cooperativeness and high assertiveness, which makes it difficult to reach an optimal consensus. That generates the sense of competition that manifests itself in both attempting to maximise their respective interests. That could lead to ongoing problems between the two directors, regardless of how the conflict over the ship is resolved.

Ideally, the Board as a whole will manage to eliminate the cause of this conflict by clarifying the respective responsibilities of the two directors so that the conflict is resolved. For example, it could be made clear to Danny that Marine Operations is responsible for ensuring that all 15 ships are available to meet their respective commitments and that it makes no difference whether any given ship is being used for low-cost or traditional cruises. In the same vein, it could be put to Mavis that Marketing's sales targets will take full account of the size and quality of the ship that is converted for this purpose, which could reduce the attractiveness of the newer and larger ships.

Requirement 2: Benchmarking

This new venture will have a high profile, both within Cruisecalm and externally. It is natural that Mavis will be nervous about the manner in which her performance will be measured. It will be potentially difficult to achieve targets that have been set in comparison with the existing business. For example, the fact that fares will be lower would mean that Marketing would have to aim for higher occupancy rates in order to achieve comparable revenues to a ship offering conventional cruises. Operating costs may also prove difficult to manage, given that the need to make savings will have to be set against the need to give the passengers value for money so that they give positive feedback. There are relatively few areas in which costs can be reduced and excessive savings, such as serving very cheap food, will make the passenger experience unpleasant.

It could be argued that Mavis' arguments are slightly self-serving and irrelevant at this stage. For example, there is very little point in offering low-cost cruises unless Cruisecalm can make a profit from them. Some costs will be the same for a low-cost cruise as for the existing cruises. For example, all ships require the same number of deck and engineering staff, regardless of the type of cruise being offered. Cruisecalm's Board must be able to determine whether the low-cost model is a viable alternative to the more upmarket cruises that are already on offer. Benchmarking costs and revenues in the proposed manner will make it easier for the Board to understand whether the new venture is viable.

Mavis' staff should also be realistic about the nature of the product that is being offered. The MV Concourse will be modified slightly so that only buffet meals will be provided. Cruisecalm already sells cruises on the basis that passengers can opt to eat in buffet restaurants. The sales staff are already experienced at selling cruises that feature this dining option and so they have no reason to be demoralised. It would be useful to benchmark operating costs and revenues as proposed, provided the targets are realistic and allow for the nature of the cruises that are being offered. It should also be possible to reassure Marketing staff that their performance will be reviewed in the light of experience and that full account will be taken of any problems that arose due to the design and implementation of the low-cost cruises.

Section 4

Requirement 1: Ratios

We need to bear in mind that Cruisecalm has 15 ships, so the conversion of even one ship could affect our figures to a fairly significant extent, given that it accounts for 1/15 = 7% of capacity . That is a large enough proportion to have a material impact on overall performance, depending on how the new business model will affect the figures for the converted ship.

Revenues from the low-cost ship will be 20% lower than for a conventional ship, assuming the same occupancy level. That is offset by a 5% reduction in operating costs, although that appears to be less sensitive to occupancy. The occupancy rates for the low-cost ship may be a little higher, though, because 100% of the capacity has been sold in comparison to only 90% to date for the conventional ships.

The most important profitability ratio is return on capital employed, which reflects management's ability to generate operating profits from the investment in the company. The new ship will have reduced group operating profits to some extent, even if that has been offset slightly by the possibility of improved occupancy. It will also have increased capital employed because the company will have invested in the modification of the ship. It is difficult to offer an upside when return on capital employed declines, other than to argue that the business environment made it difficult to maintain profitability and that management has done well to minimise the extent of the reduction.

The reduction in fare per passenger will also reduce ratios such as the gross profit percentage or operating profit as a percentage of revenue. We will also appear less efficient in terms of our ability to generate revenue from assets because the asset turnover ratio will decrease. These ratios are open to interpretation and it may be argued that a reduction is desirable in this case because the alternative would be to sell a lower volume of more expensive products that would not be attractive to the market. The fact that the conventional ships have a good occupancy should mean that our ratios will be higher than those of Wavelyne and Saildine, our two closest competitors, who aim for a lower-quality market niche.

Requirement 2: Marketing issues

The first challenge is that Cruisecalm's bookings have been disrupted for reasons that are not clearly understood. Advance bookings were disturbingly low until three months ago, but have since recovered dramatically. It may be that the introduction of budget cruises has diverted some passengers away from full-cost cruises, especially given that demand for low-cost cruises has been high. It is equally possible that the publicity associated with low-cost cruises has attracted passengers into the market for cruises and that sales have been stimulated across the range.
It would be difficult to obtain credible feedback from customers concerning their reasons for choosing a budget cruise. Those who did opt for a budget cruise in place of a conventional cruise may be reluctant to admit to that because such responses would discourage Cruisecalm from continuing with its budget cruises. Passengers may also be influenced by the wording of any such surveys and may be careless in their responses. They might agree that they would have booked a full-cost cruise rather than budget, even if that is not the case.

Before the introduction of the low-cost cruises, all of the company's Hotel Department staff will have focussed on providing an enjoyable cruising experience, albeit at a relatively high price. Staff will also have been motivated to sell dining upgrades and other extras to passengers who have already demonstrated their willingness to spend heavily on their holiday. The shift to a budget model will require a change of attitude that could cause conflict and possibly demotivate staff, at least until they are accustomed to the new culture.

The changes need not be particularly far-reaching in terms of the corporate culture. Firstly, the only crew members who will have to adapt will be those in customer-facing jobs on board one ship. They will have very little contact with colleagues on other ships in the normal course of events. It may be difficult for senior management to communicate the changes in attitude that might be required in respect of a shift to the low-cost model. The biggest risk may be due to crew members becoming stressed that they no longer have sufficient resources to provide the previous levels of comfort and service that they have become accustomed to.