

## **CGMA MANAGEMENT CASE STUDY AUGUST 2019** **EXAM ANSWERS**

### **Variant 4**

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

#### **Section 1**

##### **Requirement 1: Customer satisfaction**

The arguments seem to depend on the area in which the staff are employed. The housekeeping and customer service staff do not appear to require the motivation of passenger feedback, because the passengers have their own informal feedback mechanism through gratuities. There is clearly very little need for Cruisecalm's management to motivate the staff when the passengers are doing so very effectively for themselves. It could also be argued that the satisfaction levels with these staff matter very little, because they have almost no impact on important factors such as whether they would recommend Cruisecalm or would book another holiday. Indeed, passengers in week 8 were highly satisfied with the restaurant staff, but did not seem to like the food that they were served.

The evaluation of customer services staff is even more fraught, because passengers appear to be indifferent to the quality of the service. The risk is that staff will start to indulge in dysfunctional behaviour in order to avoid having poor personal scores. For example, staff members might grant requests, even when doing so would be costly or disruptive to Cruisecalm. Indeed, they might even agree to requests in a manner that affects other passengers' wellbeing. Passengers who request a change of cabin could be moved to cabins that have already been allocated to passengers who have not yet joined the ship.

It could be argued that these questions ensure that Cruisecalm is not taken by surprise in the event that staff start to put less effort into their jobs. There could, for example, be an issue with one particular ship, or with a group of passengers who had decided not to give gratuities during their cruise. Such dissatisfaction could cost repeat bookings and could lead to friends and family being actively encouraged not to take cruises with Cruisecalm. The fact that the response rate is very high, at 74%, suggests that there is no need to remove the questions in order to make the feedback easier to provide.

##### **Declining scores**

Cruisecalm is in competition with at least two other cruise companies and also with the holiday industry in general. Cruisecalm has at least a week to impress every passenger who embarks on one of its cruises. During that time, all it really has to do is provide the level of service that it has offered in the past and that it advertises in its promotional materials. Virtually all passengers will take further vacations in the future and will discuss their past vacations with friends and family and so positive impressions will help Cruisecalm to compete with other providers. The fact that

scores are declining is a worry, because it may suggest that Cruisecalm is failing to make good use of this opportunity to prevent future revenues being lost to competitors.

It is difficult to tell whether the declining scores really reflect future behaviour and spending patterns. Cruisecalm has only two direct competitors, namely Wavelyne and Saldine, both of which are smaller and operate down-market from Cruisecalm. That suggests that passengers may have little choice other than Cruisecalm, assuming that they enjoy cruises that offer high quality. The competitors will not be aware that Cruisecalm has received this negative feedback and so they will not be equipped to make good use of it.

Competitive advantage can only be measured in relative terms. If the factors that affect scores also affect competitors, then Cruisecalm will not necessarily lose any competitive advantage. The prevalence of social media posts and other forms of communication may have the effect of raising unrealistic expectations by consumers, whether of goods or services. Passengers may offer negative feedback about a cruise immediately after its conclusion, but will not necessarily switch to a different company when they next decide to book a holiday. Online research may indicate that there is always a risk of a disappointing experience and at least the cruises that they have had in the past with Cruisecalm are a known quantity.

## Section 2

### Requirement 1: Total quality management

The purpose of TQM is to prevent quality errors from occurring, so that complaints are not made in the first place and external failure costs are avoided, at least as far as possible. In this case, there have clearly been two quality errors in respect of the cleanliness of the corridors adjacent to Mr. Jones' cabin, which will have affected not only Mr. Jones, but the other passengers whose cabins were nearby. Firstly, the designated cleaner who was responsible for that area was negligent in failing to keep it clean and, secondly, there was no follow-up once the problem was reported to check that the work had been done since. It is generally cheaper to prevent costs than to rectify them once they occur, and that is clearly the case here because a cleaner had been paid to clean the corridor, suggesting that the marginal cost of keeping the corridor clean is effectively zero.

TQM stresses continuous improvement, which means that zero errors should be a goal, with constant effort to reduce errors. In this case, the Guest Services Adviser should have made a follow-up inspection to ensure that the dirty corridor had been cleaned properly. A prompt inspection would have made it possible to avoid further irritating the passenger. A TQM programme would require the cleaners to identify problems that may cause quality errors. It is, for example, possible that the corridor was cleaned thoroughly on a regular basis, but quickly became dirty. Under TQM, the cleaners would identify problems and would recommend changes that might help to resolve them, such as replacing the floor covering with something that did not trap dirt. It might even be worth implementing quality circles so that groups of crew members can address problems and identify responses more effectively.

TQM will not prevent every quality issue from arising and, in some cases, it may be impossible to attempt to do so because a solution would be unduly inconvenient or expensive, thereby creating prevention and appraisal costs. Mr. Jones' complaint that his allocated cabin was noisy because of a nearby elevator could only really have been prevented by switching him to a quieter part of the ship whenever a space became available and putting another passenger in his original cabin. Continuous improvement would be possible to a limited extent if Cruisecalm was willing to spend more on soundproofing any machinery on board ship that might disturb passengers. Even then, there would still be scope for disturbance. In this instance, "quality" would have to be determined in relation to the fact that a cruise holiday will necessarily expose passengers to some noise from shipboard systems and that passengers will have to accept such disruption as part of their choice of holiday.

### Requirement 2: Cooperation

The most immediate challenge is that the individual members of Hotel Department staff may have their own agendas with regard to their interaction with passengers. That was highlighted by the fact that Mr. Jones singled out for praise the cleaner who had failed to keep the corridor outside of his cabin. It may be that the cleaner saw some advantage in focusing on cleaning passenger cabins, because of the possibility of such positive feedback and of gratuities, such as that provided by Mr. Jones.

The feedback from passengers tends to suggest that some roles are more likely to be appreciated than others. That might deter staff in roles that are traditionally valued by passengers from working closely with others, because those staff will be aligning themselves with colleagues whose scores will dilute their own. They may resent any suggestion that they should accept a collective responsibility for overall passenger satisfaction when they already appear to be succeeding in their own areas.

One response to the challenge of individual agendas would be stop passing on detailed passenger feedback to individual members of staff, so that they felt less pressure to prioritise positive comments. Staff appraisals could focus on the impressions of supervisors and managers, who may be more objective about the overall performance of their staff. It may also

be possible to reduce the emphasis on personal gratuities by having passengers pay them to a central location and sharing them in accordance with a formula.

A greater sense of collective responsibility might be created by having a broader approach to feedback that forces staff to work together. For example, the feedback regarding the restaurants suggests that passengers like the waiting staff but are unhappy with the food, which suggests that there is a wasted opportunity. If the feedback took a broader view of the overall dining experience, then the waiting staff could be given more of an incentive to ask about the food and to give the kitchen staff a better indication of how to improve.

## Section 3

### Requirement 1: Cash flows

The biggest challenge will be in predicting the revenues that this investment will generate, if any. The first challenge is in estimating the cash revenues that Cruisealm will generate from upgrading its kitchens. The investment will only generate revenues if the new kitchens deliver the promised improvements in meals and that leads more passengers to book cruises. Prospective passengers will not necessarily be willing to pay more for a cruise, or even to take one at all, just because Cruisealm claims that its kitchens have been improved.

One response to that challenge would be to invest the N\$10 million to upgrade a single ship that was scheduled to carry a number of repeat passengers. During the cruise, the Guest Services staff could organise some focus groups of repeat and first-time passengers in order to obtain feedback on the meals and, crucially, on whether the food was good enough to have them book a repeat cruise. The facilitator of the focus group should aim to identify the benchmarks against which passengers' measure the quality of meals served aboard ship. The Head Chef's belief that Cruisealm should aim to offer more elaborate meals may be misguided.

The second challenge will be to determine the operating costs associated with this investment, because the purchase of new kitchens will not necessarily be the only factor in preparing meals to the passengers' satisfaction. Even if the new kitchens are more efficient and offer scope for greater automation, the more ambitious menus may require additional staff time and more expensive ingredients. The additional costs may be difficult to predict because it may require an iterative process, with feedback on the new meals from passengers' to ensure that satisfaction has improved.

The second challenge might be dealt with by extending the focus group exercise and asking small numbers of passengers to comment on planned menus. The present ships' kitchens would not permit the new menus to be tested on all passengers, but they would permit small batches of improved meals to be prepared for passengers to sample and comment on. If a range of changes can be tested over the course of a cruise, say, then it might be possible to establish just how much additional expense will be required in terms of labour and ingredients.

### Requirement 2: Deferred tax

The impact on deferred tax depends on whether there is a difference between the manner in which tax depreciation is charged in comparison to accounting depreciation in Norland. The financial statements suggest that there is. Cruisealm's statement of financial position shows that it has a liability for deferred tax, which suggests that the rate of tax depreciation could be higher than the rate at which Cruisealm depreciates its property, plant and equipment (PPE) for accounting purposes. The fact that the 31 December 2019 liability was significantly more than the previous year's comparative in a year in which the net book value of PPE increased further confirms that possibility.

The deferred tax balance will have to be updated in line with the requirements of IAS 12 *Income Taxes*. The investment will result in an inflated tax depreciation allowance that will exceed the depreciation charge, which will create an originating temporary difference. The originating temporary difference will be multiplied by the tax rates that are expected to apply when the temporary difference reverses, which will probably be estimated by assuming that the current rate will continue into the future.

The increase in deferred tax, arising from the originating temporary difference, will have the effect of increasing the tax expense for the year. While that will make the tax expense higher than the tax charged on profits for the year, it will have the effect of making the tax expense for the year ended 30 April 2020 a more realistic reflection of the economic reality. Most of the profitability ratios that the shareholders are likely to calculate rely on performance figures that are gross of tax in any case and so many measures of performance will be unaffected.

The statement of financial position will show the increased deferred tax liability as a non-current liability. That will have the effect of increasing the gearing ratio, which many shareholders will use to understand the manner in which Cruisecalm is funded. Even though deferred tax is not a loan, it could be said to recognise the fact that tax law permits the payment of tax to be postponed. This will increase capital employed, so the return on capital employed will be reduced, even though the operating profit figure will not be affected.

*Note: Credit was awarded for relevant discussion of the news report in the pre-seen that described the high rate of tax depreciation on PPE in Norland.*

## Section 4

### Requirement 1: Share price

The Board members who believe that there is a relationship between dividends, dividend growth and the share price are correct. The relationship is not, however, historical. The relationship is between expected future dividends, possibly allowing for growth, and the cost of equity. The relationship takes account of the cost of equity ( $k_e$ ), as required by the shareholders. The formulae effectively express the share price as the net present value of the estimated dividends that the shareholders will receive into the indefinite future.

According to this model, the new kitchens will increase Cruisealm's share price if they enable the company to increase its dividends in the future. Hopefully, improving the menu would increase revenues and profits, which would offer the prospect of increased dividend payments. The additional revenues would have to exceed the additional costs, including depreciation, before the additional dividend would be sustainable.

The investment could also reduce the cash that is available for dividends in the short term. In that case, Cruisealm may be forced to pay a slightly smaller dividend than had been expected, which could reduce the share price quite substantially when the dividend is announced and incorporated into the valuation model. However, the model may not be applied in such a naïve manner and the shareholders may be reassured that any short-term disappointment with the dividends will be more than offset by future dividend growth.

The model also takes account of the cost of equity. As for any exercise involving the valuation of future cash flows, the required rate of return should take account of risks. If the perceived risks associated with future dividend payments are affected by the investment in the kitchens, then the present value of the future dividends will be affected. In the context of this model, that is another way of saying that the share price will change. Overall, that complicates the implications for the share price, if this is viewed as a risky venture. Dividends will, hopefully, be expected to increase. At the same time, they will have to be discounted at a higher required rate of return.

### Food quality and delegation

The first risk is that future costs may be difficult to predict, with greater preparation time and more expensive ingredients. That could leave Cruisealm faced with higher fixed costs associated with preparing the new food and greater volatility in ingredient prices if the ships are forced to buy higher quality ingredients. Food is already a significant element of operating costs (more than 10% of the operating costs of MV Krono and MV Batvia) and so any increase could prove problematic.

The feedback that led to the proposal to upgrade meals was based on discussions during focus groups. There is no guarantee that passengers will actually like the new menus. The suggestion is that meals are presently viewed as a little bland and boring, but such food generally lends itself to a wide audience, even if they do not particularly enjoy it. A more adventurous menu could actually alienate some passengers, who will feel that their tastes are not being catered for, which could reduce future bookings.

Delegating meal plans could prove beneficial because the catering managers could be more responsive to passenger feedback in the course of their cruise. The cooks on board a particular ship might be skilled at cooking a particular type of dish that is more popular with passengers than the set menu items. Care would, of course, have to be taken to ensure that all tastes are satisfied, otherwise there could be a minority of passengers who feel left out because they dislike, say, spicy food.

Delegation could also make use of the fact that the ships will be restocking with fresh produce most days. That would make it possible for the catering manager to meet with the chef and plan meals that took account of local specialities in forthcoming visits. Apart from offering a wider variety, the local produce in different ports might be cheaper than goods that have to be imported.