

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

Variant 5

These answers have been provided by CIMA for information purposes only. The answers created are indicative of a response that could be given by a good candidate. They are not to be considered exhaustive, and other appropriate relevant responses would receive credit.

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

Section 1

Requirement 1: Relocation

The primary activities in Cruisecalm's value chain relate to the creation of added value through the provision of a service. It could be argued that the relocation will have little impact on inbound logistics because purchases of fuel, food and other materials associated with running the ship are purchased locally by ships' crews in any case. Ships will take delivery of their orders in the various ports of call and so very little is likely to change, provided the new administrative arrangements do not affect payments to suppliers, which could disrupt services if ships cannot collect.

Operations involves the actual provision of cruises. At first glance, it could be argued that the relocation will have very little impact on cruises because the ships are located overseas and operate remotely in any case. There will be no need to replace crew members or recruit differently. The biggest concern could be the relocation of shipyard liaison, which ensures that major repairs and modifications are carried out properly. It will be a similar story with maintenance work. Each ship is expected to spend two weeks in dry dock every few years and it will be imperative that all work is completed on time or departures will be delayed. This aspect of support is a fundamental element of operations and so it is possible to reduce costs by relocation.

Outbound logistics involves ensuring that customers receive the service that they have purchased. The relocation could affect matters because Cruisecalm must be aware of any difficulties associated with flights, which will depart from Norland, do not disrupt passengers' travel arrangements. It may be that the relocation will make it more difficult for Cruisecalm to monitor flights and to ensure that the impacts of delays and cancellations are understood.

Marketing and sales can be divided between the direct sales that are made through Cruisecalm's website and those that are made through travel agents in Norland. In principle, online sales can be organised from anywhere and the company's website can be maintained from anywhere that has an internet connection. Problems could arise in maintaining contact with travel agents in Norland, who may be less inclined to promote Cruisecalm's holidays if they start to lose contact with the company.

Finally, service could be a problem because passengers may require advice before travelling and may wish to offer feedback or make complaints after their return. If contact is made via a call centre that set up in a foreign country then potential passengers may be put off and returning passengers may decide not to rebook.

Requirement 2: Redundancy

Staff will start to look for new jobs once the redundancy notice has been issued, which could disrupt administrative operations in the short term. The departure of staff members, before they have handed over properly to the replacement team, could lead to errors and might disrupt operations. The staff will also be demotivated, because their briefings will be to enable their replacements to take their jobs from them.

Ships crews could also start to fear that Cruisecalm will replace them with foreign workers who can do their jobs more cheaply. In the short term, that could prove demotivating, with passengers noticing a reduced quality of service because of this. There is even a possibility that crew members in key deck or engineering roles will resign and disrupt sailings, because their presence is required for operational and/or safety reasons before the ship can go to sea.

The disruption during the handover might be best dealt with by offering attractive redundancy terms that will only be granted if staff members remain in post until a designated date. If Cruisecalm augments the statutory redundancy payments, then staff may feel that the company has done something to address the inconvenience associated with losing their jobs. The payments may also reduce the pressure to obtain a new job immediately and make staff less desperate to take the first job that is offered to them.

Effective communication is important, otherwise problems could arise because staff may be unsettled by unfounded fears that they could be made redundant. Cruisecalm should send a very clear signal to ships' crews that the redundancies are due to the potential savings associated with moving the administrative functions overseas. The signal has to be clear and credible, but should not create ill feeling amongst the staff who are losing their jobs in Norland. It may be sufficient to prepare a clear statement that will go to every member of staff that announces the redundancy package in very clear terms, but stresses that the changes will be restricted to those employed in the administrative offices in Norland.

Section 2

Requirement 1: Goodwill on acquisition

The first challenge is in determining the fair value of the company's separable net assets as at the date of acquisition. Angelo appears to hold a large amount of land, which may prove difficult to value because it occupies a key location overlooking the docks. The size and location of the land could mean that there are no observable comparisons that might be used to determine its fair value.

The second challenge is the fact that the owner is retaining 10% of the equity, which is to be valued at its fair value. That could be a problem because the company is unquoted, otherwise Mr Llosa would not have a 100% stake. Mr Llosa could have insisted on retaining a small percentage of the company for personal reasons that do not reflect the fair value of the holding. It may not necessarily be logical to argue that the 10% holding can be valued on a proportionate basis to Cruisecalm's payment for the remaining 90%. Mr Llosa's stake in the company may be too small to exert any meaningful influence, which could reduce its fair value.

The first challenge might be overcome by investigating whether any other land has been sold in the area of the Islandia docks in the past few years. If so, it might be possible to establish a rough market value for the land that we will acquire as part of the deal. The alternative would be to identify alternative sites for the office building that we plan to erect in that area, with a view to establishing how much a similar site would cost.

The second challenge might be overcome if there is a quoted company in that business in Islandia. Islandia appears to be a maritime country and, so, there could be other businesses that offer the same service. If we were able to identify a quoted company, then we could use a model such as the dividend growth model to identify factors that could be input into a calculation of a fair value for Angelo's shares. If we cannot identify a similar company in Islandia then, hopefully, we will be able to find one in another country that has a similar economy and business culture.

Requirement 2: Net present value

The most significant factor will be Angelo's ability to ensure a sound liaison with shipyards that have been tasked to build and repair Cruisecalm's ships. This may be a matter of concern because Angelo is located in Islandia and Cruisecalm intends to continue to use shipyards in Norland, at least initially. Any issues with the quality or speed of completion could easily outweigh any savings that might be offered by switching to Angelo. It should be borne in mind that the liaison will have to be maintained at a distance because of location.

The fact that Angelo will be acquired as a going concern means that it will have ongoing commitments to its existing clients. Those may interfere with Angelo's ability to absorb the additional work that will have to be undertaken on behalf of Cruisecalm. If Angelo gives Cruisecalm priority, then it could be faced with penalties in respect of delayed work for third parties, which, again, could outweigh any savings in terms of operating costs.

Angelo's contacts could offer significant savings in the medium to long term, if it can recommend yards that can provide high quality work at a saving. If such potential savings can be realised, then Angelo's NPV could be far greater than the operational cost savings that had been anticipated. The risks associated with this change could require the savings to be discounted at a higher rate of return to allow for the problems that might occur.

The availability of building land at Angelo's premises could offer further cost savings that would translate into a higher cash inflow. The land could be used to extend the office space at Angelo to accommodate the other administrative staff who will be taken on by Cruisecalm. That would make it even cheaper to relocate those functions to Islandia and might improve efficiency because of the whole administrative base being in a single location.

Section 3

Requirement 1: Transfer prices

We need to be clear about what Angelo is actually doing for the group as a whole, otherwise it will be difficult to defend any transfer prices on the basis that they reflect. The company is acting as a consultancy and intermediary between Cruisecalm and the third-party shipyards that are doing the construction and repair work on its fleet. There could be scope for misunderstanding by the Islandian Government if Angelo is acting as an intermediary in major contracts without actually earning a great deal of money itself.

The fact that Angelo conducts work for third parties suggests that it should charge Cruisecalm on the same basis as its external clients. That would suggest that there is a sound commercial basis for the pricing policy and, so, it would be more difficult for the Islandian Government to argue that the company is under-pricing sales to fellow group members. Historical evidence that Angelo has used this pricing model since before it became a member of the Group will further strengthen this argument. It would also be consistent with the guidance set out in the OECD's 1994 guidelines on transfer pricing.

If Cruisecalm receives any form of discount from normal commercial rates, then the reason should be both justifiable and clearly documented. If Angelo claims that it grants the discount because of the scale of business that it does for Cruisecalm, then it would be helpful if it could show that it makes similar concessions to other clients who provide that scale of business. The figures should also show that Angelo makes a realistic profit overall from the work that it does for Cruisecalm, even after granting the discount.

Ideally, Angelo's reported earnings will be sufficient to show that it is returning an adequate profit and paying an acceptable rate of tax in Islandia. Cruisecalm may have to consider whether it should pay slightly more for work done by Angelo in order to pre-empt an investigation by the Islandian tax authorities. It may be cheaper to pay a little more tax than might be strictly necessary, especially as the Government may be inclined to press any investigation in order to demonstrate that it is being effective in managing the local economy.

Requirement 2: Project team

The team should include representatives from Cruisecalm, from Angelo and from at least a representative shipyard. Angelo will find it necessary to assume responsibility for implementing plans that were made by the existing liaison team and the yards that Cruisecalm has traditionally done business with. Angelo may not have had any previous dealings with the shipyards who have been contracted to do the work.

Cruisecalm should be represented by members of Marine Operations and Finance. Angelo needs to be briefed on the specific issues associated with the work that Cruisecalm's ships require. It will also be necessary to discuss the budget for planned and committed work as well as agreeing the approach that should be taken to future work that will be entirely Angelo's responsibility. The project team members from Angelo should be senior managers from the business, ideally from the Board. Briefing Angelo's senior staff should help to ensure that the changeover results in an environment in which the work entrusted to the company is conducted in an environment that reflects the Group's approach to quality. Senior staff will also have the confidence to speak out on matters that concern them, even if they are dealing with senior managers from elsewhere in the Group.

It would be ideal if the project team could include the present head of the liaison team, even if that person is due to be made redundant. It would be a sound investment to pay that person to continue on a consultancy basis for the duration of the handover, to ensure that Angelo fully understands Cruisecalm's approach to ship maintenance. The head of liaison would also be able to make useful introductions to contacts in shipyards and in the engineering departments aboard ships.

Section 4

Requirement 1: Currency reserve

The movements on the currency reserve will have an impact on the book value of the group's assets. Angelo's net assets will be retranslated at the exchange rate in force on each year end. If the exchange rate changes in the course of the year then the opening balances will be retranslated at the year end at the new rate. That will lead to a currency gain or loss, depending on whether assets exceed liabilities and also on the direction of the change. The goodwill on acquisition will also require retranslation at the yearend using the closing rate, leading to a further gain or loss on exchange.

Currency gains and losses are split between the Group and NCI, with the Group share being recognised in other comprehensive income. Thus, gains and losses will not affect the profit for the year. Gains and losses will be taken directly to a currency reserve, which will accumulate a debit or credit balance which will show the net impact of currency gains and losses over time. Taking the gains and losses to reserves means that they will not have a direct impact on profitability ratios, other than potentially changing equity and thereby increasing or decreasing the denominator in return on capital employed.

The accumulating balance on the currency reserve will have the effect of increasing or decreasing equity, depending on whether the balance on the currency reserve is a debit or credit. That could affect a number of ratios. A succession of currency losses could create a debt balance on currency reserve, which would increase the gearing ratio. A succession of gains would create a credit balance, which would reduce the return on capital employed. Unfortunately, any such impact on shareholders' understanding could be misleading because the adjustments reflect accounting adjustments to book values and so not necessarily mean that the Board has any additional resources with which to generate revenues.

Requirement 2: Savings

The decision to reduce selling prices of cruises should be based on an evaluation of pricing and its potential impact on demand. Cruisealm's business model involves the sale of a high quality product that is sold at a relatively high price in comparison to the market. If the company can achieve good occupancy figures on its cruises, then it would make very little sense to charge less, even if the operating costs have reduced.

Cruisealm's prices are determined by an algorithm that reflects factors such as the time remaining before a cruise departs, the number of empty cabins and so on. The algorithm already permits the company to reflect spare capacity in selling prices. Any pricing decisions relating to spaces on cruises that are due to depart soon should really take account of marginal costs only. The costs of maintaining the ship itself are fixed and, so, it would make sense to disregard those costs in any case, if there are unsold cabins on a cruise that is due to depart shortly .

If costs and savings are discussed frequently in the context of setting selling prices, then the relationships between Finance, Marketing and Marine Operations will become complicated. Marketing might consider pressuring Marine Operations to spend less on maintaining and operating ships because doing so would justify reducing selling prices . Marine Operations is responsible for ensuring that its ships can be operated safely and legally, but that does not necessarily mean that every outlay on maintenance is actually necessary. Both Marine Operations and Marketing could start to pressure Finance into intervening in any such disputes. The three functions will find it far easier to cooperate if Marketing and Marine Operations have agreed policies for ship maintenance and pricing, which are left to operate without interference. Finance should only suggest changes if there are major changes that require the business model to be reconsidered. It could be argued that constant interaction between the three functions might simply cause friction and distract from the basic business.