

MANAGEMENT CASE STUDY FEBRUARY 2017 EXAM ANSWERS

Variant 1

The February 2017 Exam can be viewed at

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SECTION 1

Budget realism

The specific points that require attention should reflect the problem that we face, namely that producers have an incentive to understate the expected cost of completing a project in order to secure funding. Many of the cost estimates associated with the project will be open to understatement because we are planning to film in new countries, where the costs will be difficult to verify. Other costs are largely discretionary and would be open to the producer requesting more to be spent. For example, the director might support a request for further special visual effects, beyond those in Marta's budget, in order to enhance the film.

As a starting point, we might consider a number of broad reality checks to minimise the risk that Marta would commit Menteen to an overspend. How does the total compare with the actual cost of other major features that have been shot overseas? The fact that every film is unique does not alter the fact that our experience has given us a rough benchmark. What is her track record in terms of completing films within the original budget and has she been guilty of requesting additional expenditure on previous projects?

ZBB would require the budget to be recreated from scratch, thereby forcing a fresh look at the costs and the assumptions. That is often associated with questions of whether the costs should be incurred at all, but it also forces an overall discipline on the budgeting process, with nothing being taken for granted. The initial question is whether we already own the rights to use this story and, if not, how much they will cost to acquire. If we accept that the film's success requires a link to a well-known book then the cost of negotiating these rights can be estimated on the basis of past experience. The project can be abandoned if we cannot acquire the rights for a realistic amount and so there is little scope for manipulation at this stage. The producer

should work with the writer of the screenplay to develop a script for submission to the board, with a complete list of characters and of scenes that will have to be shot. In accordance with

ZBB principles, the screenplay should allow for the costs of elements that will affect costs. For example, each character will require Menteeen to employ an additional actor and each scene will require additional production costs. Each of these elements will have to be justified as necessary in order to make an entertaining and successful film.

All production costs should be estimated as accurately as possible at this stage. The fact that we are planning to shoot in new locations suggests that we should invest greater effort in terms of determining the costs of, say, hotel rooms for the cast and crew, with advance bookings and other steps being taken to avoid price changes. The ZBB approach should be applied to any overspends by refusing to tolerate any adverse variances without, at the very least, demonstrating that they are not discretionary. The board should be consulted before any changes are made to the script that would involve additional cost. Marta should be informed that any requests for additional funding will be refused unless she can demonstrate that, say, an additional scene will make the final film more commercially successful.

Deliverables

Listing individual work packages will give us the ability to track costs on an ongoing basis. The knowledge that she will be held accountable in this manner would deter Marta from manipulating the budget to an excessive degree because the board will be alerted when cost overruns are reported. If we discover that the budget is wholly inadequate at an early stage then it will be easier to abandon the project.

The nature of film-making means that there will be a sequence of individual elements that can be created in any logical sequence. Breaking the production schedule down into work packages is a natural extension of what we do already. It would not be unrealistic to request the opportunity to view footage on an ongoing basis and to review total costs accumulated to date.

Managing the costs of these deliverables on an ongoing basis would make it more difficult to manipulate budget slack. For example, if a scene goes over budget then it might be tempting to spend less on a subsequent filming in order to keep the budget on track. The danger then is that the overall quality of the film may be impaired by shortcuts that have been motivated by budgetary constraints.

Costing individual work packages could prove difficult because many costs will be common to a significant element of the project. For example, a filming a cavalry charge as part of a battle may be very expensive, but it may be difficult to establish just how much of the cost of accommodating and supporting the cast and crew was attributable to that sequence. Treating the total cost of filming at that location would avoid the apportionment issues, but could lead to the work packages being too large to exercise control.

SECTION 2

Interest in Destiny

Destiny does fall within IFRS 12's definition of a 'structured entity'. Destiny has been structured in such a way that neither Menteen nor AsiaFilmBank can exercise any control over operations. Destiny's management team is required to act in accordance with contractual arrangements rather than the instructions of their shareholders.

The substance of this arrangement is that Menteen is entitled to receive 50% of the variable returns that Destiny will receive. Those returns are under the direct control of Menteen, though Menteen's control of the production decisions made by Battle and the marketing activities of Menteen Distribution. Thus, Destiny is a subsidiary of Menteen. AsiaFilmBank's investment will have to be shown in Menteen's consolidated financial statements as non-controlling interest.

Menteen will be required to disclose its interest in Destiny and so the shareholders will be aware of its exclusion from Menteen's consolidated financial statements. Those disclosures may encourage the shareholders to press for further information or to restate the figures using their own estimates of how consolidation would affect the financial statements. That may lead to speculation about Menteen's ratios, which could prove more harmful than the inclusion of Detsiny as a subsidiary.

The most significant impact of any restatement of Menteen's performance will be the additional capital employed arising from incorporating the estimates of the additional NCI into the group accounts. That will reduce Menteen's return on capital employed. It may also affect profitability ratios because the total revenue recognised by Destiny will be recorded.

Share price

At the very least, the auditor's refusal to accept the financial statements will mean that the audit report will offer the shareholders cause for concern because they will regard the financial statements as controversial. The shareholders' trust in the fair presentation of the financial statements may be impaired and so the share price may fall. The problem may go beyond this one entity because Menteen has other film projects that may be financed using this approach.

The shareholders may not fully understand accounting standards, but they will generally be aware that the directors have some discretion in applying accounting standards. The auditor's report may create the impression that the directors have attempted to mislead them. The possibility of an 'accounting scandal' may reduce the share price.

The external auditor provides a commercial service by expressing an opinion on the financial statements. The auditor's livelihood depends on being able to sign up clients and retain them. The shareholders are likely to regard the resignation of an auditor as a significant signal that there are problems at Menteen.

The resignation of ABCD will raise further concerns because Menteen lost its previous auditor only a year ago. The loss of a second auditor in two years will be regarded as a particularly worrying sign because it implies a lack of character on the part of Menteen's board. It may be assumed that ABCD satisfied themselves of the circumstances surrounding their predecessor's departure, so their unexpected departure only a year later implies a serious concern with Menteen's governance, which can only reduce the share price.

SECTION 3

Birch Barnaby

The most obvious approach would be to discuss the changes with Mr Barnaby with a view to a compromise. His concern is not so much that we have removed the ballroom scenes as that he believes the story is being rendered illogical by the alternative. It may be that we can revise the story in different ways in order to achieve the same result without having to restore the costly balls.

In the absence of a compromise, we might resort to enforcing our legal rights. If Mr Barnaby delays our project or fails to discharge his agreed duties then we may be forced to threaten court action against him. While that would be undesirable, it would deter any further refusal to accept subsequent changes to his story.

We need to be careful in motivating Marta because she could resort to dysfunctional behaviour, such as agreeing to all of Mr Barnaby's demand. Our starting point should be the storyline and outline screenplay that emerge from pre-production. Marta has to either deliver a film that corresponds to those or give us a good reason for having made any changes.

As producer, Marta is responsible for the entire project. One way to motivate her to deal with Mr Barnaby would be to make it clear that she is responsible for any further communication with him. That would then be no need to create any separate mechanism for motivating her because senior management would not enter into any discussion with Mr Barnaby. If she permits his concerns to delay or jeopardise the quality of the film then her career will be at stake.

Mitch Bradd

The starting point for the evaluation should be a highlighted version of the script, with each of Mitch's scenes highlighted to show the stunts that involve his character. Stunt professionals should analyse each of those stunts in order to identify the likelihood of an accident and its likely severity. The professionals should also highlight the extent to which risks can be controlled and managed. For example, the stunt team will have far less control over the behaviour of a galloping horse than over the behaviour of a stuntman who is to be filmed

fighting with Mitch. In this context, the risk analysis should be extended to cover the specific risks that Mitch will face. For example, having Mitch film a fight scene probably exposes the stuntman playing his adversary to a much greater risk than that faced by Mitch himself.

The production team should extrapolate this analysis to establish the consequences of these threats. For example, if Mitch is killed or severely injured then he may have a significant claim against Menteen, which would ultimately be borne by the insurance company. There may also be the risk of the project having to be abandoned, or filming to be repeated with another star in the event that death or serious injury prevents Mitch from being able to continue. We also need to consider the extent to which the insurers may be liable for costs arising from less severe injuries that disrupt filming. For example, if Mitch breaks his leg then it may be possible to continue, but only after allowing time for him to recover and possibly also rearranging the schedule.

The starting point in demonstrating that the risks have been mitigated would be for the stunt professionals who have evaluated the risks to comment on the skills and training that Mitch would require for each stunt. Clearly, Menteen would then have to show that any such training will be provided. The stunt professionals may also be able to recommend ways in which the stunts themselves can be modified in order to accommodate Mitch's skills and experience. For example, the underwater scenes might be filmed in a studio set rather than in open water, where the risks of a disaster will be far greater. It may also help to satisfy the insurance company if some of the scenes are rewritten or even edited out in order to avoid exposing Mitch to excessive risk.

We may be able to mitigate the risk of disruption to the filming schedule by filming the stunts towards the end, so that scenes that can only be filmed using Mitch himself are completed before he risks injuring himself. That would give Menteen the option of proceeding, with a stuntman in Mitch's place, in the event of an accident. We may be able to minimise the risk of a legal claim by providing Mitch with a very detailed briefing of the risks associated with each stunt, with a separate waiver signed by Mitch and his advisers to acknowledge that he has given his informed consent to be exposed to the associated risks. Finally, Menteen could agree to accepting some of the risks, perhaps setting an excess for the policy so that Menteen bears the risks associated with, say, the first B\$1m of any claim. That would demonstrate good faith and should reassure the insurer that Menteen has an incentive to take all reasonable precautions.

SECTION 4

NPV criterion

Determining the NPV requires us to make an assessment of both production costs and potential revenues. Production costs are relatively easy to predict because we have some

discretion over the expenses that we will incur and some costs, such as actors' fees, may be fixed by a contract at the start of the project. Future revenues are a far more complicated proposition because we cannot necessarily tell what the audience reaction to a film will be. For example, the film could receive very poor reviews and audiences may decide not to see it. Or other studios could release similar films before ours and audiences could be bored with the idea of, say, another light romantic comedy.

The revenues from a film are often spread over several years, allowing for revenues from DVD sales, television rights and other factors such as merchandising. We could overcome those problems to some extent by using simulation to determine the sensitivity of NPV to various estimates and assumptions. We could, for example, build models to predict future revenues using past information about similar films and could analyse the results to determine which of those factors has an impact on the accuracy of the model.

Once we have a set of NPV figures at our disposal, we would have to rank them, taking into account the various constraints that we face. For example, we might have several films that would be highly profitable, but they all require the same actors and so we cannot make them all. We might also have to allow for capital rationing so that we do not make more than one or two of the more costly films at any given time.

It may be that ranking films according to NPV will make very little difference to our scheduling and cash flows over time. By the time we allow for conflicting commitments for the various actors and avoid making too many films of the same type then we might have a very narrow range of options available to us. It may be that we should focus on our key business skill of making a diverse range of good quality films. Ideally, some of those will exceed expectations and that will compensate for the disappointments.

Financial reporting

Whenever we buy film rights we must decide whether those costs meet the criteria for recognition as assets. Recognition requires that it is probable that there will be a future economic benefit from the investment and that the costs can be measured reliably. The question of future economic benefit is difficult to determine because it appears to be common for us to buy more film rights than we can actually use.

Each separate investment should be evaluated at the time of purchase to establish the likelihood that a film will actually go into production. The rights that are likely to be exercised should be capitalised as intangible non-current assets. Those costs can then be transferred to the cost of making the resulting film and can be written off over the commercial life of that film.

The cost of rights that have been capitalised will have to be checked for impairment at each reporting date. The value of the rights may have to be written down to zero in the event that there is some doubt as to whether the film will actually be made, although it may be possible to recover all or some of the cost by selling the rights on to another company, in which case that would be the recoverable amount and the extent of the impairment would be reduced.

The alternative to capitalising these payments would be to recognize them immediately as an expense. That means that Menteen could appear to be making losses when it is investing in rights that will form the basis for future film production. That could deter investment in all but the safest projects, which could stifle Menteen's creativity.