Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY FEBRUARY 2017 EXAM ANSWERS

Variant 2

The February 2017 Exam can be viewed at

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SECTION 1

Determining costs of producing different film products

The basic difficulty is that the film production process creates large quantities of material that may be edited together in a host of different ways. For example, a scene could be filmed more than once, with each version filmed from several camera angles. This is a necessary part of the production process to allow for editing and we may not necessarily spend more in order to enable the creation of different products. If we are to determine the profitability of providing, say, airline versions then we must identify the cost drivers associated with creating those versions because many of the costs associated with the creation of the airline version would have been incurred anyway. For example, we appear to have agreed to pay B$30m to the two main actors. Charging a proportion of that against the airline version makes sense only if we paid that extra B$1m for the dubbing exercise.

Production costs may not be driven to any material extent by the need for different film products. We might shoot the film in such a way that we have flexibility at the editing stage. For example, the collision at the end of our car chase was filmed from four different angles to enable us to edit that scene together effectively. We probably did not know in advance that we would make little or no use of one of those angles for the main feature when the scene was planned and shot and so the additional cost of the extra camera position was not incurred as a direct result of the need for a less violent end to the chase in the airline version.

It may be that the marginal costs of creating a different product at the post-production stage are very limited. For example, the cost of editing five versions is unlikely to be five times greater than the cost of editing only one because all five versions are likely to be very similar in terms of the shots that are used. The incremental editing costs for each new version are probably restricted to making cuts, or possibly re-editing very specific and focussed scenes to make them acceptable to, say, Asian regulators or airline customers.

Menteen should start by looking at the budgets prepared at the pre-production stage and determine which of the budgeted costs are being planned specifically in order to meet the needs of the airline market. For example, if a less explicit version of a particular scene is to be shot for the airline version and for no other reason the airline contract is driving that additional shooting cost. This review should allow for the possibility that some costs would be regarded as unnecessary if the airline version was not under consideration and those costs ought to be included.

Filming strategy

The fees paid by the airlines are less than 1% of Menteen's total revenues and so it would seem illogical to permit the airlines to drive the production strategy. Having said that, if the marginal cost of making the airline versions is minimal then it may be desirable to retain this source because it amounts to almost 8% of operating profit. Menteen has to clarify the actual strategic issues associated with being able to service the airline contract in order to fully understand whether those costs are acceptable.

Menteen can only produce a certain number of films at any one time because of constraints such as the availability of directors, actors and studio facilities. The danger in making too many films that are rated 15 or below is that Menteen will be unable to afford to produce some films that may be suited to the adult audience. Making insufficient films for the adult market, in order to accommodate the airlines, could cost Menteen slots in the cinemas that will be filled by other studios.

Presumably, a significant proportion of the films produced by Menteen will be rated 15 or below and so the airline contract will not be a major constraint. Indeed, Menteen is likely to film a range of family-friendly films as part of the mix and those will require little or no adaptation. Producing a diverse range of films will be consistent with maximising cinema sales and that should be sufficient to address the needs of the airlines in the process.

Menteen could reduce the disruption by working with the airlines while projects are at the pre-production stage. It should be possible to negotiate a realistic schedule of films in pre-production that would meet the needs of both the cinemas and the airlines. Menteen is always evaluating proposals and ideas and can delay the commencement of any given project without too much difficulty.

SECTION 2

Recognition of revenue

IAS 18 Revenue sets out a number of criteria that are applicable in this case. Our starting point is to establish the nature of the contract, so that we can determine the application of

IAS 18. The key issue is the extent to which the outcome of the contract can be measured reliably. We also need to be able to able to determine the stage of completion of the contract.

The cash inflows themselves are likely to flow to Menteen in accordance with the terms of the contract. The airline industry has its risks, but these are large companies with whom we have a long-term relationship. The stage of completion is a matter of the provision of films, many of which have already been made, which is Menteen's core business. The costs that we are yet to incur may be regarded as fairly predictable because we have to offer a diverse mix of films and so we can focus on the average cost per airline version.

Stephen's basic argument is that Menteen's obligations have been largely met. Most of the films that will be used by the airlines have already been made and so it is simply a matter of making the copies available. Even if some of the films are yet to be filmed, it could be argued that there is a back catalogue of suitable films and that the airlines would probably be able to choose a satisfactory mix of 'classics'.

Recognising all of that revenue in one lump sum would be potentially misleading because it would imply that all of the revenue had been earned in the year of signing. Furthermore, IAS 18 suggests that the most appropriate method of recognising this income would be on the straight line basis over the five years. If we argue that the films that will be included in this part of the contract are already in or possession then we should recognise the B$40m in five annual instalments.

Separate department

Measuring effectiveness

The measures should focus on looking ahead because it may be too late to identify dissatisfaction if it leaves us paying a penalty or even losing the contract altogether. Proactive and predictive measures might include regular reports on the number of meetings with airlines, with a senior manager's endorsement that the relationship with the airlines appears to be sound. It would also be useful to have an agreed schedule of airline films that articulates with Menteen's production schedule.

Retrospective measures would include complaints or the imposition of penalties. In the event of such problems the department ought to be asked to furnish a reason for the complaint and the airline response. There should also be a clear statement of the action plan to minimise the risk of such complaints arising again in the future.

Behavioural implications of establishing a cost centre

The basic question is whether the department's management and staff might be demotivated by the fact that they are regarded as a cost centre. The revenues from airline contracts appear to be fairly limited and so the department may be viewed as a peripheral part of Menteen as it is. Creating a cost centre means that there is little formal recognition of the revenues arising from the department's activities. There would be little to encourage the department to do more than keep the airlines from cancelling their contract. The department may even be reluctant to pass on information that could help Menteen to expand the airline contract because the department head may be concerned that additional costs will be incurred while pursuing this opportunity, with no flexing of the budget to allow for this.

Establishing a cost centre could prove counter-productive if airline executives are going to expect to be entertained when they are invited to industry screenings or when we arrange private showings of the latest films. If the department is a cost centre then there may be little incentive to offer worthwhile entertainment. Skimping on entertainment could be misinterpreted as a sign that Menteen does not take these customers seriously. Having said that, a realistic budget would help avoid the associated risk that the costs of dealing with clients could get out of hand if managers are keen to expand their budgets through overspending.

SECTION 3

Risk evaluation

The public is generally interested in the posts made to social media and they can prove influential. If large numbers of potential filmgoers see these posts then they may be persuaded that the film is disappointing. The size of this risk may be related to the number of posts, which should be limited to the numbers of long-haul airline passengers who watched the film and chose to post about it.

Film fans are often keen to experience particular films for themselves and they may not be put off by adverse comments. The comments may even spark off debates online that have the effect of drawing attention to the film. Having said that, any negative publicity may deter some filmgoers from buying tickets for the film and poor initial sales may reduce the total uptake.

Big Data would lend itself to the analysis of the effects of media posts. It would certainly be possible to establish whether there is a correlation between comments and ticket sales, which would enable Menteen to determine whether there is a need to mitigate any risks. This might be complicated because the impact of social media may be influenced by demographic factors, such as younger people reading social media posts and therefore not reflecting the views of older viewers. The results might give an insight into the impact of social media on younger audiences, but not necessarily all filmgoers.

The Big Data approach could also be confused by the fact that airline passengers may not be typical of the cinema-going public. For example, they may rarely attend cinema and so their views may diverge from those of filmgoers in general. They may also confuse any geographical analysis of the comments because, by definition, they may not be posting from their home country. It may also be difficult to isolate the effect of having watched on an airline screen because their posts may simply comment on the film itself.

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Persuading airlines

Our starting point is to fully understand the airlines' interest in selecting films. Knowing why they might choose Armada gives us a first step towards persuading them not to use it. We should draw on our experience of past dealings and consider the views of the managers who have negotiated with the airlines.

If the airlines' only motivation is to entertain passengers then we might point out that some films cannot really be enjoyed to their full while sitting in an airline seat. We might offer to fund market research into passenger experiences in the hope that they will support our view. We almost certainly have our own market research data that we can adapt into a report that we could take to the airlines.

Our biggest problem will be if the airlines wish to show 'big' films so that they can promote them on airline web pages and on the opening screen of the entertainment system. In that case, the passengers may be impressed by the fact that these films are available to them even though they do not actually enjoy them when viewed during the flight. The films will have a halo effect on the airlines' overall offerings.

We might be able to reach a compromise with the airlines through offering incentives. One possibility would be to offer additional films to airlines who agree either to avoid the blockbuster movies or are prepared to delay showing them until after they have been released in the cinemas. Another possibility would be to promote other forthcoming releases more heavily, partly to build recognition in the event that the airlines choose those instead.

SECTION 4

Building an effective team

The first issue is that the team will have to move quickly. It may be helpful to have a senior manager in charge, possibly even Anton. Time is of the essence because the idea will be difficult to protect and preparing a report for submission to the board may slow down a final decision unless there is a board member in place. The team will also have to be able to make decisions on the content that will be offered and the potential for making the films on offer attractive to short-haul passengers, which is a further reason for having Anton in charge.

The team will have to include someone with the necessary technical skills to advise on tablet design and software. Issues such as making the tablets robust enough to survive being handled by passengers and allowing for recharging in the confines of the plane are all important. We may consider involving a potential manufacturer because it is unlikely that Menteen will have the appropriate expertise on staff.

We should include expertise in marketing to consider the desirability of the content that we will make available. We do not wish to erode the desirability of current releases to cinemagoers and to long-haul airline passengers by making them available through this service. We need to be able to establish whether consumers will pay USD 10 or 15 to rent a film that is soon for release on DVD.

Clearly, the airline will have to be represented on the team because they are involved in funding. Also, their input will be crucial to our understanding of the viability of the project. They can, for example, conduct market research and possibly even a pilot study of the rentals.

Share price

Arguably, the share price is a function of future dividends. In theory, the market discounts future dividends at the cost of equity and that determine the share price. It follows that a decrease in dividends could see the share price fall.

The dividend valuation model takes account of recent dividends and future growth rates. The future growth is not necessarily determined through historical observation. It is future expectations that matter.

It would be possible for this year's dividend to be reduced or even suspended and for us to inform the stock market that we have done so in order to finance a potentially lucrative project. If the market accepts that possibility then the growth rate that would be factored into the share price would be the expected average rate looking forward. In other words, it would be possible for the dividend to decrease in the short term and for the share price to remain constant or even increase.

The likelihood of the share price increasing depends on market perceptions. It makes very little difference that Menteen's board is confident that the dividend will recover if the market does not share that prospect. This may be viewed as a very risky proposition given that there would be significant scope for competition.