

## **MANAGEMENT CASE STUDY FEBRUARY 2017 EXAM ANSWERS**

### **Variant 3**

The February 2017 Exam can be viewed at

<https://connect.cimaglobal.com/resources/february-2017-management-case-study-exam-variant-number-3>

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### **SECTION 1**

#### **Target costing**

The use of target costing is complicated by the fact that the work is being undertaken by a third party and so we do not necessarily have knowledge of the factors that drive the costs. Glowplug might not be willing to discuss cost savings with us at this stage because it will cost them revenue. There is very little advantage to them in telling us how to pay them less. Glowplug could have priced the contract on the basis of the volume of work that has been commissioned and it could withdraw some of the discounts in the event that it is asked to do less.

Menteen does, however, have some expertise in managing and commissioning CGI because Glowplug was founded by a former member of staff setting up an independent company. Mentee's producers have recent experience of working with their own in-house studio and so they may be able to make an informed judgement about some of the cost implications of changes. It may also be possible for one or more of the producers who have worked with Jamil Unni to approach him in any renegotiation to help overcome some of the possible barriers to seeking a cost reduction.

One possible approach that we might take would be to revisit the scripts and decide which effects are required for the film and which are merely desirable, rather than vital. For example, the opening sequence of Poverty Row sounds like a significant artistic achievement and it may set the tone for the whole film. Even if that is true, we need to be clear about whether we need to spend the B\$15m because it drives the story as a piece of entertainment, or whether it is simply part of the director's artistic ambition for the film.

One of the challenges associated with using target costing in this case is that cinema tickets and DVD prices are not related to the cost of making a film. Film studios do not compete on price. The revenues from any given film may be driven by factors such as critics' reviews

and word of mouth. It may be that spending less on CGI will be a false economy if doing so reduces the appeal to audiences. For example, part of the challenge of promoting Dinosaur Crash 3 could be convincing audiences that it offers something new that they did not see in the first two films and that may require the full B\$80m investment in CGI.

### **Accounting for Glowplug**

From a purely business perspective, it is clear that Glowplug is essentially part of the economic entity. Glowplug provides a vital element of the product that Menteen creates. The two entities work closely, to the extent that Menteen appears to buy all of Glowplug's output. The fact that Menteen has commissioned Glowplug for the next four films suggests that it is heavily dependent on Glowplug for its CGI needs.

The relationship between Glowplug and Menteen does not appear to meet any of the criteria set out in IFRS. For example, Menteen cannot control Glowplug and so Glowplug is not a subsidiary as defined by IFRS 10 Consolidated Financial Statements. In the same vein, Menteen is not exposed to the variable returns from Glowplug's performance, which means that there is no need for a disclosure under IFRS 12 Disclosure of Interests in Other Entities. Glowplug does not even fall within the definition of a related party as defined by IAS 24 Related Party Disclosures because Jamil's employment as a manager in Menteen ceased before Glowplug was established and Menteen did not finance Glowplug's creation as part of any severance package.

In terms of the shareholders' understanding, it is debatable whether excluding Glowplug from the Menteen Group's consolidated financial statements makes a significant difference.

Including Glowplug in the Menteen Group's financial statements would have the effect of making Menteen's directors accountable for the resources made available by Glowplug to the business of making films. Most of those resources are likely to take the form of intangible assets that would not meet the recognition criteria for inclusion in Glowplug's statement of financial position. Thus, including Glowplug in the group would not lead to the recognition of the core resources brought to Menteen by Glowplug in the form of expertise in developing CGI.

In the same way, treating Glowplug as an ordinary external supplier means that Menteen's financial statements show the fees paid for CGI as an expense, without cancellation of any profit element charged by Glowplug. That may be viewed as reducing Menteen's profits if it is viewed as a purely economic entity. From a stewardship point of view, Glowplug's profits cannot ever be enjoyed by Menteen's shareholders and so the inclusion of Glowplug in the group would overstate Menteen's ability to pay dividends to the shareholders.

## **SECTION 2**

### **Charge-out rate**

Even though Glowplug and Menteen are separate entities, they are collaborating on a major project. There is scope for mutual benefit provided the basis on which staff time can be made available to Glowplug can be agreed. The fact that the two entities are independent of one another means that any price will have to be a realistic basis that benefits both side rather than, say, artificially reducing taxable profits. Menteen has to ensure that the rate charged allows for the additional costs that will be borne because of this arrangement. The staff in Menteen's in-house CGI department are busy and the work that they are presently engaged in will still have to be done. It may be necessary for Menteen to subcontract these tasks to an external consultancy other than Glowplug or use less skilled staff from elsewhere in Menteen. Menteen should not agree to release staff to Glowplug for any less than the cost of the work that will have to be undertaken in some other way.

We need to make it clear to Glowplug that it is unrealistic to expect us to provide our staff at cost. Glowplug will be selling us the work undertaken by our staff under this arrangement back to us at a profit and so they can afford to pay a margin on top of cost. We have a duty to earn a profit whenever we can and so we should not sell resources at cost price unless there is some other commercial advantage to us.

The charge-out rate should reflect the non-financial issues associated with this arrangement. Menteen's in-house CGI staff will learn additional skills through being seconded to Glowplug. They may also be motivated by the opportunity to engage in more challenging tasks. Setting the charge-out rate at a level that discourages Glowplug from using seconded staff may cost Menteen a valuable training opportunity. It may even be worth agreeing to bear a loss if the longer term benefit is that the in-house department can accept responsibility for more challenging assignments.

### **Selection and HR issues**

We need to consider the skills and experience that are required at Glowplug and also in Menteen's CGI department. We should start by requesting details of the work that will be undertaken by the staff on secondment and also the schedule of work that is planned for the in-house team. Ideally, we will be able to split the CGI staff in two in such a way that both sets of commitments can be undertaken in a satisfactory manner. If not, we may be able to organise the secondment so that key staff are brought back to Menteen as and when they are needed in-house. We may bias the team on secondment towards the more skilled and experienced staff, who would have the potential to learn more and so may enhance the CGI team when they return.

Staff preferences may be an issue. Some staff may be reluctant to work for Jamil because they resent the fact that he did not take them when he established Glowplug. Others may be keen to experience working with the latest technology and to involve themselves in some of the more advanced projects that Glowplug handles. If there is more demand for secondment

than places available then it may be desirable to set an objective criterion such as seniority in order to choose between applicants.

The first challenge is that we could lose some of our CGI staff to Glowplug. Presumably, their need for additional staff could become a permanent feature if our requirements continue to expand and Jamil may offer the best staff promotion or other benefits to move. We have to monitor staff motivation before and during this assignment and be ready to match any offers that are made against our best interests.

The second challenge is that the staff who are sent on secondment may feel demotivated when they return to Menteen. We should take care to ensure that we debrief returning staff to ensure that they are still challenged and motivated in working for Menteen. We may have to invest in training or bring some more work in-house in order to create a satisfactory working environment.

### **SECTION 3**

#### **Key risks and ethical considerations**

There is a potential upside risk in that audiences might flock to see the film in order to see and feel for themselves what the publicity is about. This story has given the film a great deal of publicity and it may attract the typical audience of an adventure film. This risk has a high likelihood because the film is basically an adventure story, which should appeal to those seeking thrills. The impact may be difficult to predict because many of those potential audience members may have attended the film anyway.

Some cinemas may be unwilling to show the film in case they are held responsible for injuries. Again, there could be consequential injuries. For example, a dizzy customer could fall down a staircase and injure others, who may not have even seen *Liner Rescue*. The risk of cinemas being reluctant to show the film is fairly high because of the publicity. The consequences would depend on whether other cinemas could take up the capacity because audience members can go to virtually any cinema in any town, leaving total revenues unaffected.

From an ethical point of view, Menteen's Board should act with professional competence and due care. It is unacceptable to simply accept this risk without obtaining informed and impartial advice. There is sufficient reason to believe that screening the film in its present form would risk distress and even injury to audience members. Menteen needs to commission further testing and seek appropriate advice. There could be financial risks as well as health risks and so the board has a duty to the shareholders as well as audiences.

Menteen's board also seems to be in danger of breaching the concept of objectivity. The advice that has been received from Glowplug is hardly impartial because Jamil may have to

bear some of the cost of any rework. Furthermore, this is an opportunity to showcase a number of innovations that could be of value on other projects. It would clearly be in Menteen's commercial interest to accept this advice because it will enable the film to be

released on schedule and with the benefit of the notoriety associated with the special effects, but that is hardly an objective response to the risks to public safety.

### **Motivational issues**

The basic worry is that both the producer and the director left Menteen exposed to those risks without seeking clarification or confirmation by the board. Glowplug was essentially asking the film's management team for permission to experiment with Menteen's audience members. It would appear that the producer and director could have taken a decision that exceeded their authority.

The director is responsible for the management of the film's creation in terms of artistic issues. In the case of an action thriller, those issues will be judged by the film's impact on audiences. It may be that the director was keen to take a shortcut by offering an experience that would immerse the audience in the story, even if that was at the expense of a minority of viewers who would be affected. Ideally, Menteen's board should establish what the logic was behind this decision in case its film directors attempt to push boundaries in future projects.

The producer's role is concerned with the commercial success of the film, which would have been linked to the film crew's ability to deliver an immersive and exciting feature film. It may be that the use of this new technology gave the producer an affordable means to create such an experience. *Liner Rescue* is a sequel, which generally means that there is a need to surpass the original film in order to impress critics and audiences. There could be a concern that the producer has essentially cut a corner by using an untried technology to deliver an enhanced experience.

We might argue that this event implies an agency problem within the structures created for film production. In this case, both the producer and director agreed to accept a risk. In the event that it paid off then both would have benefitted in terms of their careers. If the risk went wrong then the cost would be borne by Menteen. The essence of this is that these managers acted in their own interests rather than those of the company.

## **SECTION 4**

### **Convertible securities**

The first issue is that the bond will have to be analysed to show the split between debt and equity. The starting point is that we need to determine the net present value of the debt phase of the securities, which requires us to identify a comparable bond, namely a non-convertible bond with a comparable risk rating. Menteen does not have any such bonds of its

own in issue, which means that we have to identify a suitable comparison. Ideally, a company in the film industry whose non-convertible bonds have a similar risks and duration.

We will have to take the possibility of a conversion into account when calculating the EPS. That will not be difficult, but it could complicate the understanding of EPS and the market's

response. Different readers will have their own views on whether the conversion will occur and so their appreciation of the diluted EPS will differ.

Interpreting the financial statements will be complicated by the fact that the cash flows are now rendered slightly unpredictable. We cannot be certain whether the bonds will be redeemed or converted. Menteen may have to raise cash in order to repay the bondholders if they elect to have their loans redeemed.

The gearing ratio will also be complicated. While the bonds are undoubtedly loans prior to conversion, the fact that they can and will be converted rather than being redeemed may mean that the gearing ratio could be overstated for some reasons. There could be different understandings of the risks associated with finance.

### **Change management**

There is going to be a complicated process of adjustment with respect to Jamil and his return to Menteen. Glowplug's value is essentially a function of Jamil's expertise and so we need to ensure that we do not alienate him. We may have to allow Glowplug to retain its autonomy within the Menteen Group. We may also have to motivate Jamil by offering to maintain the technical edge that the company has through ongoing investment in the latest IT facilities and appropriate staff appointments.

Glowplug's CGI experts may feel a little concerned at the implications of the changes for them. We need to act quickly to ensure that they are well informed. There could be motivational issues if Glowplug is sold for B\$100m because they may not be entitled to any of that. We need to demonstrate that we value their contribution, perhaps through the creation of a bonus scheme or a substantial pay rise.

The role of the in-house CGI department has to be clarified. Glowplug's CGI professionals may feel aggrieved that they may be asked to absorb these new colleagues, with a consequential possibility that they could find themselves managing routine and uninteresting projects. Ideally, Menteen should explain that Glowplug is to remain a cutting-edge design studio.

Glowplug's staff may start to be concerned about the long-term future. Previously, the company chose to work exclusively with Menteen, but there was always scope for working for other studios. Menteen may not necessarily need them to remain at the peak of their profession because the style of films that they make could change. Preserving Glowplug's autonomy, possibly by simple measures such as leaving the physical location unchanged, could leave scope for a future in which Glowplug would revert to its independent status or even act for Menteen's competitors.