

MANAGEMENT CASE STUDY FEBRUARY 2017 EXAM ANSWERS

Variant 4

The February 2017 Exam can be viewed at

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SECTION 1

Target costing

We need to consider the relationship between costs incurred and the selling price. The programme will be attractive to broadcasters if it attracts viewers, which will attract advertisers, we need to develop an understanding of the implications of spending more for viewing figures. If we spend too little on, say, special effects then we may be left with a programme that is unattractive to both viewers and broadcasters. We might aim for a certain level of production values and then work backwards in order to determine the lowest price at which that can be met. There could be an argument for spending more on certain key episodes, such as the opening episode to capture viewers' attention and the closing episode, in the hope of fuelling demand for a second series. If we aim for an acceptable total cost for the series then we may find it easier to produce an acceptable product at a realistic price.

It would be helpful to start with the fees that we intend to pay to the lead actors because we need to pay a realistic amount in order to attract major stars. It cost B\$22m+ 8m = B\$30m to hire the two leads for the film version which ran for just under two hours and we are planning to shoot almost 12 hours' of content with a provision target cost in the range of 12xB\$9m = B\$108m and 12xB\$12m = B\$144m. Apart from the fact that the lead actors may demand higher fees if they are major stars, identifying the leads will also have implications for the production values that we must aim for because a major star may insist on a high-quality production.

We should hire a competent and experienced television producer to manage this project from the outset. Hiring in that expertise will make it easier to establish how much it would cost for, say, the background music for a television series. There are different priorities

associated with making television and film. Film audiences require higher production quality because of the big screen and cinema-quality sound systems.

The producer may be able to identify discretionary costs that can be classified according to whether they are vital, important or desirable. For example, special effects may be edited out of the script if there is an alternative way to tell the story without loss of the dramatic effect. There could also be scope for savings, such as by using the same location to represent different places by changing signage and camera angles.

Recruiting stars

The basic problem is that film stars appear to think of television as a less prestigious medium. Accepting a television part may be viewed as a sign that their box office appeal is waning and that they may not be offered starring roles. A television programme may be viewed as a more disposable and less valuable product than a film. Film requires more engagement from the audience, with a need to actually go to the cinema, whereas television is simply watched in the home.

The fact that OWM - the series is based on a film of the same name invites comparison between the film and the television programme. It is unlikely that we can maintain the production values across almost 12 hours of television as we did in a two hour film and so the television audience is likely to be a little disappointed, no matter how well the programme is made. The stars may be unwilling to risk their reputations on a programme that is unlikely to be particularly well received by the critics and the viewing public.

The first approach would be to research the changes that have been taking place. It would appear that a small number of high-quality programmes have been commissioned by other channels. We could argue that Menteeen is attempting to open up the market for film-quality television programming that it can use to take its expertise into the television industry. The recent transitions by major film stars could suggest that it would be prestigious to be in the first rank of major stars being offered a role in a top television programme.

We might also consider a bundling arrangement whereby the stars will be offered the contract for one or more interesting film roles in return for them agreeing to participate in the television programme. Apart from the financial incentive, the announcement that the actor has film roles signed up will reduce any suggestions that their move to television is either permanent or an indication of a declining career. We can negotiate the timing and the format of the announcements of the different roles to maximise the positive publicity for the actor.

SECTION 2

Budgetary participation

As a matter of principle, it would be foolish for any business to establish a major undertaking without setting targets to guide the senior management team. This project will have a very

high profile and the shareholders will be looking for evidence of progress, even at the end of the first year. The decision to proceed should have been based on a formal investment

appraisal and the initial budget should set out the initial implementation of the plan for television programming.

The key to making the budget useful is to recognise that these are the first two years of a new direction for Menteevee and so the targets have to be relevant to that initial phase. We might, for example, budget in terms of the cost of making OWM - the series, and set some further initial targets for the development of new programming. Those targets would be achievable and would be designed to get the project under way. Setting detailed targets for revenue and profit could risk a dysfunctional response on the part of the management team that could weaken the venture in the medium to long term.

Hannah and Roger must be involved in budgeting for the project because they may feel threatened by the imposition of targets on which they were not consulted. They have a right to be involved because they are presently in senior and respected positions and they will be risking their reputations as producers if they are seen to fail to meet budgets. We can manage the risk of budget padding by making sure that Hannah and Roger are participants, but they will not be solely responsible.

There is a danger that Hannah and Roger will not fully understand the commercial aspects of television programming, which will be different from those of film making. Having said that, if we bring in experts from the television industry to assist and advise us, they may not be fully engaged in the development of programmes with these production values and starring major film actors. There is now doubt that we need to include producers with film experience in the budgeting process and so we might as well involve Hannah and Roger.

Performance management framework

Ideally, there should be a clear strategy for Menteevee with an associated mission statement, which may be implicit. It is crucial that Hannah and Roger have a clear set of objectives. For example, is Menteevee's mission to aim for high-quality programming that exploits synergies with Menteevee's film-making activities? Such a mission could lead to the creation of a potentially lucrative market niche. Alternatively, Menteevee could simply be aiming to establish itself as a credible rival to the production companies that aim for the television market in general. Such a strategy might then lead to the creation of a wider range of opportunities for the exploitation of Menteevee's skills.

Once the strategic direction has been established then one approach to putting it into effect could be the development of a balanced scorecard. For example, if we assume that Menteevee is to aim for high-quality programming then we might develop a balanced scorecard in order to support the pursuit of that strategy. What do we have to do in order to make high-quality television series that can be sold to premium-rate television companies? A more specific strategy to support that vision can then be developed in order to set a direction for the company. For example, should we aim to dominate a particular type of programming,

such as comedy or crime? That strategy should then be the starting point for developing the targets on the BSC itself. We can start to think about the various things that will have to be

accomplished in order to achieve our strategy, such as learning to recruit film stars to television roles.

As a priority, we would have to establish the areas where we need to develop in order to put the strategy into effect. For example, under processes, we may have to develop editing skills because we need to learn how to edit each programme down to the required standard length while making each appealing to the viewer. Menteevee's management may have a short-term target associated with the recruitment of suitable editors with experience of the television industry. In the short-term, Menteevee will not develop until it can actually produce sellable programmes and so these processes may be given priority during the initial stages.

In the longer term, Menteevee will have to identify the performance indicators that will determine the company's success. For example, the focus might shift to the customer perspective, with management having to demonstrate that Menteevee can develop programmes that will be popular with broadcasters and viewers. The number of pilot programmes produced would be a useful starting point because it would indicate that the company is making progress towards a viable creative output. The viewer satisfaction ratings would be a good basis for the measurement of the quality of the programmes that are being produced initially.

SECTION 3

Disciplinary action

Arguably, we do need to take some action against Jason because he is an employee, just like everybody else and we risk further outbursts from him and from other members of the cast and crew if we ignore this incident. Jason's behaviour may well have cost us B\$2m when we reshoot the half-completed scene and he has the ability to force us to spend far more if we are forced to reshoot from the beginning. The danger is that we will have to work with other actors in other roles and on different projects and they may start to behave in costly and unacceptable ways if we do not deal with this effectively.

We do have to conduct a full investigation first, though, just in case we are behaving unfairly. We need to be clear about the extent to which Jason has been overworked and the extent to which his concerns were communicated to the director and producer. It would, clearly, be both unfair and counterproductive to discipline an employee who left work because of illness brought about by overwork.

The most effective form of disciplinary action would be low-key and, ideally, non-confrontational. Ideally, the producer would meet with Jason and his agent and would discuss the factors that caused the incident. The needs of both Jason and Menteevee would

be discussed and an agreement would be reached as to how matters might differ in the future. We should seek a commitment from Jason that this will not recur, albeit with an

agreement on our part as to how we might rearrange the schedule to allow him sufficient time to rest.

The danger if any disciplinary action is disproportionate is that Jason could abandon the series, leaving Menteevee exposed to the total loss of the project. A major film star can probably afford to forego the fees from a project and so we cannot necessarily force him to modify his behaviour by threatening to dismiss him. We may also risk losing him from Menteen projects altogether if he decides not to accept any film roles that we offer him.

Capitalisation

IAS 38 *Intangible Assets* sets out very clear criteria for the recognition of intangible assets. It must be probable that we will receive the expected future economic benefits from this project. We must also be able to measure the costs reliably, which is not an issue because it is a discrete project for which separate costing can be recorded.

Before we can assess future economic benefits we need to know whether the television channels still be willing to buy and broadcast the show. Presumably they will. If anything, the publicity in the newspapers will increase interest in the show. They may, however, withdraw if they fear that we will be unable to complete the series or if we will deliver it late.

That raises a related issue. We cannot capitalise the costs unless we are confident that we will be able to complete filming and so be in a position to sell the show. We need to evaluate the information that we have gathered from our discussions with Jason and be reasonably confident that he is likely to complete the filming without major problems. Overall, we need to know that revenues will be “probable” which implies more likely to occur than not or at least 50% certain.

Even if we are sufficiently confident in the prospects of completion to capitalise the costs, we must decide whether we wish to do so. We may feel that there is a risk that the costs will have to be written off as a result of an impairment review if we do not complete or if the broadcasters pull out. We may feel that it would be inappropriate to capitalise these costs if we are faced with doubts as to the long-term commercial viability of the project.

SECTION 4

Pricing

We are in a market that is dominated by a relatively small number of major buyers. The major broadcasters may not feel that they need to compete too vigorously for new

programmes because there are plenty of studios and large numbers of potential projects. Ideally, we would prefer to sell OWM to a major multinational network, but we can assume that these target customers are either unwilling to take OWM or they are not yet ready to decide.

Selling the programme to Beenet for B\$60m could be a form of penetration pricing. It will give us the opportunity to build brand recognition in the television market, particularly if the programme attracts strong viewing figures. Beenet may be more willing to promote OWM because it is a local product that might appeal to local viewers and so we could obtain massive amounts of positive publicity.

Beenet's deadline could suggest that they are concerned that there we will receive a better offer from a larger company. Beenet are clearly experts in this market and their concerns could suggest that we should hold out for more in terms of market potential. There have been relatively few programmes starring major film stars and it may be possible to aim for more of a premium pricing of this programme.

Given that filming is well under way, we should ignore the production costs that have been committed to date. We need not worry unduly about making a profit, unless the savings from abandoning filming would exceed the potential revenues from the sale of the completed show. Even then, there is an argument that the shareholders would prefer us to complete the project and attempt to earn a profit from it.

Cost of equity

Selling OWM at a breakeven cost could affect the market's perception of risk. Arguably, the capital markets value companies on the basis of their future dividends, which are then discounted at a rate that reflects risk. If Menteen is unable to make a profit from a major film project than the shareholders may be sufficiently concerned that they will increase the required rate of return from the future dividend stream, which is effectively an increase in the cost of capital.

When we first announced the development of OWM the market would have taken a view as to the likely impact of that on future risks and rewards of investing in the company. The fact that we are moving in a new direction would spread the risks and so make us less exposed to any downturn in the cinema industry. That could have led to a decrease in the cost of equity at that time. Perhaps, the failure to make a profit from OWM will simply force the cost of equity to revert to that in force when Menteen was wholly dependent on film.

Perceptions of risk may be influenced by the shareholders' understanding of the board's competence. Menteen already makes sales of its film broadcasting rights to television broadcasters and so the apparent failure of OWM may suggest that the board does not fully understand the television industry. That could lead to concerns that future revenues from the sale of broadcasting rights will be affected and so the cost of equity could increase.

The shareholders may rely on the financial statements to evaluate risks. Selling at a breakeven price will create the impression of poor margins. That would mean that any

further downturn in sales would lead to a more significant impact on profits. That could only increase the shareholder's perceptions of risks, unless Mentee's management can address that concern by publishing details of the strategy that they are putting in place to improve profits or withdraw from the television market.