Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY FEBRUARY 2017 EXAM ANSWERS

Variant 5

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SECTION 1

Life-cycle costing

Menteen's films would make excellent subjects for life-cycle costing. All films involve a development phase, comprising pre-production and production, followed by a revenue generating phase that follows a fairly predictable pattern. The development phase accounts for most of the cost associated with creating and even selling the "product". Furthermore, each product is a unique item in terms of its potential attractiveness to audiences. At present, it would appear that Menteen is not paying sufficient attention to the whole life-cycle, if only because of the excessive focus on the box-office takings earned during the cinema exhibition phase of distribution means that we are ignoring the significant opportunities created by other forms of distribution.

Life-cycle costing involves studying the product from its inception to its abandonment. At present, we may be a little guilty of planning product development by assessing pitches from producers. As a company, we should be aiming to put films into production so that we are well placed to meet market requirements. For example, we need to be ready to release children's films in good time for school holidays. We also need to consider the wider revenue cycles. For example, a major blockbuster film might be released to the cinemas towards the beginning of the year so that its DVD release can be timed to coincide with the gift buying period leading up to the holiday season.

The life-cycle may also allow for the needs of the other distribution channels. For example, in pre-production we should consider the needs of television companies, both subscription and broadcast. If the film is of an adult nature then we need to ensure that it is capable of being adapted for the needs of the television audience. In a similar vein, we should also consider the sensitivities of the different foreign markets and ensure that we can adapt the film to meet their needs.

One useful development of the life-cycle costing approach would be to start considering whether some films could lead to sequels and, if so, the product could be developed as a series of two, three or even four films. For example, we might extend the life-cycle top a sequel or short series by having the key talents sign contracts that commit them to one or more sequels, at Menteen's discretion. We might also develop the scripts in such a way that a sequel could be justified.

Competitive advantage

The first question is whether Menteen can develop a competitive advantage at all. Studios make films, some of which are successful and others are not. Competitive advantage lies in the ability to make and distribute films that attract a consistently high share of the available audience. Menteen has a strong brand name and considerable experience, but its competitive position will change from week to week with respect to other studios depending on the films that are on exhibition. Menteen's strength may lie partly in its ability to attract stars with a sound box office appeal, who are well known around the world.

Menteen's films are shot in English, which is a widely spoken language. That may make it easier to compete in markets such as the US and the English-speaking provinces of Canada. The popularity of One Weekend in Moscow in the North Amercian market indicates that Menteen can compete there, but it does not necessarily mean that Menteen has a competitive advantage at present. The fact that Menteen took far more from the Beeland market with this film than from the much larger North American market suggests that it does not have a competitive advantage.

Menteen makes a succession of individual films and it would be possible to tailor films to meet specific market preferences. It would be possible for Menteen to assemble, say, a French-speaking cast and commission a film that would be attractive to a French audience. The danger is that other studios, both French and international, may follow Menteen's lead, thereby driving up the market price of those resources and making it difficult to compete in a sustainable way.

Local distribution channels may not be keen to assist Menteen in developing a bigger market share in their countries. It may be regarded as risky to offer too many scarce cinema slots to foreign studios who many not continue to serve local needs once they have weakened local film studios. It may not be in cinema owners' long-term interests to give Menteen's films extended runs if that may cost them goodwill with local studios and create the risk of the loss of a local film industry.

SECTION 2

Motivation of Marketing

The basic problem here is that the revenues from overseas sales will be fixed in terms of local currencies, which then have to be converted into B$. That will enhance the value of

Menteen's foreign takings when the B$ is depressed, with the possibility that the value will be diminished if the B$ appreciates. Depending on the likely range within which the B$ may vary, that could reduce the extent to which the marketing department can manage the revenue from overseas sales.

Budget padding could occur if Marketing is evaluated on the basis of overseas revenues expressed in B$. Firstly, the marketing department may decide not to pursue sales too aggressively when the B$ is depressed. The exchange rates will compensate for any loss of revenues, which will avoid setting too high a target for future periods. Marketing may be concerned that a reversal in the currency will leave them struggling to meet any increased target.

Marketing could spend suboptimal amounts on promotional activities while the B$ is weak, underspending on advertising and other forms of promotion. That would leave them generating an acceptable level of B$ revenues while appearing efficient in terms of their management of costs. That would leave scope for further forms of manipulation, such as prepaying for the advertising of forthcoming films in order to avoid the marketing budget being reduced. Such dysfunctional behaviour would create greater scope for managing the threta that the B$ will strengthn and so reported revenues might decline in the future.

Marketing may exaggerate the difficulties associated with generating revenues when the B$ eventually strengthens and argue for a reduction in revenue targets. Any decrease will be based on expectations of future exchange rates and so there may be excessive pessimism in the selection of economic forecasts in order to pad the budget. Marketing may argue that they have little prospect of achieving a realistic level of revenues and that they would be unwilling to accept responsibility for meeting targets.

Financial reporting

Revenues will be credited to Menteen's sales account on the basis of their value in B$ as each day's takings are recorded. There will be a debit to receivables for the same amount. When the balance is remitted by the cinemas, any changes in values arising from currency movements will be recorded as a debit or credit to a currency gains/losses account. The value of any foreign currency receivables outstanding as at the reporting date will also be adjusted to reflect the exchange rates at the year end.

The size and direction of the gains and losses is more a function of the volatility of the B$ and the variation in the direction of change. If the B$ has remained low, but relatively constant, then there will be no significant currency movements to cause any adjustments to receivables. The revenue itself will be unaffected in terms of currency gains or losses.

The primary issue in interpreting the financial statements will be an understanding of any trends in revenues and profits. A weak B$ will boost Menteen's revenues, which may suggest that the company has had an excellent year. Arguably, the information is factually correct and the financial statements will present fairly and so there is no need to make a specific disclosure. The danger is that any misunderstandings may eventually reflect badly

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on Menteen's board, especially if there is a strengthening of the currency and so reported revenues decline.

The most appropriate form of explanation may be to make a simple narrative reference to the benefits enjoyed because of low B$ rate. Better informed shareholders will already be aware that Menteen has benefitted because the segmental information published by the company will provide a geographical analysis of revenues. Warning the shareholders that the profits may have been boosted in this slightly artificial manner will not necessarily reduce the share price.

SECTION 3

Goodwill on acquisition

The goodwill on acquisition will require a comparison of the consideration paid with the fair value of the separable net assets. Wordshift's separable assets are relatively modest, which suggests that the goodwill could be of the order of B$6m – (2m x 60%) = B$4.8m. Menteen should carefully consider the valuation of Wordshift's property and equipment, in the hope that their fair value exceeds their carrying value. Menteen would also consider the valuation of any intangible assets that it might be acquiring that could be capitalised in Menteen's consolidated financial statements.

The other factor that will determine goodwill is our treatment of the 40% non-controlling interest. We have to make an accounting choice as to whether to value NCI at a proportion of equity or at its fair value. Arguably, the latter will be greater, which would have the effect of increasing goodwill in the consolidated financial statements.

The goodwill on the acquisition of Wordshift will have to be evaluated on an annual basis for impairment. That means that there could be a write-off against group retained earnings. Goodwill is likely to be a relatively small proportion of group retained earnings, so the impact on the financial statements will be minimal.

Impairment is a fairly distinct possibility in this case because we are making a fairly drastic change to the business model. The fact that the existing line of business will effectively cease, with the company being repositioned, suggests that there could be a loss of the goodwill that had arisne prior to the acquisition. Furthermore, the translation staff may not be particularly good at translating movie scripts and they may not stay, which would involve a further decrease in goodwill.

Cultural issues

The first change is that the company will no longer be autonomous and working directly for a range of clients. Wordshift will be a subsidiary of Menteen, albeit with a partial retention of ownership by the existing shareholders. Menteen's style of management is likely to differ from that of Gavin Mitchell and so the culture will definitely change.

The skills required by Wordshift's translators will change significantly. At present, the company's employees appear to be English speakers who have studied their languages of choice at university. They are trained to make precise translations of documents that have to be accurate. Menteen will require them to translate scripts in a manner that lends itself to a dramatisation and that may require the ability to speak like a native speaker.

The first step in addressing any change issues is to identify any concerns that the employees may have. For example, there may now be a surplus of linguists in some languages and a shortage in others. Some linguists may fear that they will be made redundant. Menteen should act quickly to clarify its intentions with regard to any changes in staffing levels.

It would also be important to identify any and all training needs so that Wordshift's linguists can deal with the challenges associated with their new role. Perhaps Menteen should organise courses in scriptwriting so that they can produce translations that meet the filmmakers' needs. Perhaps they should be allowed to watch films made in their languages, or even spend time in those countries, so that they can write in a more natural manner.

SECTION 4

Payback criterion

Payback has many flaws, including the fact that it ignores cash flows received after the payback point and also it ignores the time value of money during the period. Having said that, payback does force the decision maker to identify relevant cash flows and so it does have some value for identifying sound projects. At the very least, payback requires a comprehensive analysis of the outlay, with some consideration of the revenues.

If the payback period is only 2.4 years then the time value of money will have very little effect. If the software delivers the anticipated savings and operates for three years or more then it will almost certainly deliver a positive net present value. The estimated value of the outlay is almost certainly being determined on a conservative basis because it values staff time at the potential selling price which is no longer applicable.

Payback focuses on the financial factors associated with a project. It may be worth considering the potential benefits from this investment on the basis of non-financial factors in addition to the immediate cash flow. At first glance it might be sensible for Menteen to fund this project because it offers a good fit to the company's business. Once the basic software is perfected then the cost of adding further languages is relatively minor, so it could be extended to allow for all of the languages that are dubbed or subtitled. It might also be possible for Menteen to code languages in a manner that better suits its needs. For example, there could be more than one version for each language. Perhaps language texts could be used from different periods so that, say, historical dramas are translated in an appropriate manner.

Menteen cannot claim any particular expertise in the design of translation software, which might reduce the overall fit of this product within its target marketplace. Menteen has considerable expertise in working with translations and languages and that aspect of the business could be stressed as a marketing point. Furthermore, Meneen's foreign language activities have to reflect the way that language is actually spoken in those countries. Menteen is also a known brand that consumers should respect and it can be argued that its overall brand recognition could make it a credible developer and vendor.

Sustainable advantage

There is very little scope for sustainable advantage in keeping the software for Menteen's exclusive use. The software will make it cheaper to dub and subtitle movies, possibly giving Menteen a cost advantage. However, film studios compete on innovation in the films that they release and not on price. The software will increase profit by lowering costs, but it will not bring in any additional revenue.

At the margins, it may be possible for Menteen to develop film versions for languages that have been too small to make subtitling cost-effective. If Menteen does so then it will open up fresh revenue streams, although it will not necessarily do so at the expense of other studios. In an sense, that would be a competitive advantage if other studios could not enter those markets. However, cinema-goers might simply spend more and go to the cinema more often if there was a wider choice and so Menteen may not have to exclude its competitors.

The main argument for releasing the software for commercial licence is that it has a host of applications and so there could be a huge market for the package. There may be many commercial users who would pay a substantial amount for this software and those revenues will be foregone unless it is released. Releasing the software may enable other programmers to develop their own versions, but even that will simply limit the rewards associated with the release, rather than cancelling them altogether.