CIMA

Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY MAY 2016 EXAM ANSWERS

Variant 3

The May 2016 exam can be viewed at

https://connect.cimaglobal.com/resources/management-case-study-exam/may-2016-management-case-study-exam---variant-3

Section 1

Task 1

Commercial implications

Jud has a valid point in that the goal of the patient selecting laser surgery is to remove the need for spectacles. This would, in theory mean that previous customers who have regularly bought spectacles, could then have laser surgery provided by IC and cease to buy from IC in future, leading to loss of revenue. However, this argument only holds if existing IC customers come to IC for the laser surgery. If IC does not offer the service, customers could easily go to an alternative surgical clinic. IC would then lose future business anyway, so it could be argued that IC might as well offer the surgery as customers who wish to correct their vision in this way will find the service easily accessible elsewhere. Even if IC does lose some business as postulated by Jud, it is possible that the profit from the surgery outweighs the lost future profits on spectacle sales.

The market for spectacles in Zeeland is massive, with approximately 65% of the population wearing them. The problem for IC is not lack of a market, it is maintaining/increasing their share of it. Given that the state does not pay for the surgery there will inevitably remain a proportion of spectacle wearers who would like surgical treatment but cannot afford it. In addition there will be those who prefer not to have surgery or whose eye conditions are not suitable for laser correction.

In addition, Zeeland has an aging population and age related presbyopia is not suitable for correction by laser surgery. This group will be likely to continue to wear spectacles, and indeed might have to return to doing so if their vision deteriorates in later life following earlier and successful surgery.

In summary, Jud has a valid point in that if IC provides surgery to an existing customer they are likely to lose future spectacle sales, but given the size of the spectacle market it is unlikely that this will have a serious impact on sales. It is also highly unlikely that any IC customer choosing surgery will be deterred from the treatment by having to go to an alternative supplier for it.

Task 2

Ethical issues

A useful starting point is to consider the CIMA code of ethics, we should act with integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

The lack of a track record does not of itself make offering this service unethical. The service may be a new one for IC, but the surgeons hired by IC should be appropriately qualified and experienced. The same applies to other clinical staff who may be required. Clinics will have to be set up with appropriate equipment and experienced staff will be needed to ensure, for example, that high levels of hygiene are achieved. It is highly likely that there will be some form of state regulation of clinics offering surgical treatment and IC will have to comply with this.

If IC were to falsely claim that they have a track record of offering surgery, this would be misleading and unethical. It would breach the principle of integrity.

Similarly it would be unethical to offer the service without putting in place the resources, staff, premises and equipment, to do so to a high level of competence. We would not be acting with professional competence and due care.

Our decision to go ahead with this proposal should be made with proper professional judgement. We should not offer the service if we cannot do so competently and our decision making should not be biased by the potential profitability of doing so. Failure to take a decision on an appropriate basis would be a breach of objectivity.

Section 2

Task 1

Predicting cash flows

The main problem we will face is that this is a completely new business venture for IC. It will therefore be harder for us to access accurate information on which to base our appraisal.

It is unlikely that we will be able to gather any information from our existing staff unless any of them happened to have worked in a laser surgery clinic.

If we recruited staff with appropriate experience to help us with the appraisal then we could draw on their knowledge, but unless we could secure their services on a short term contract we would be committing to recruiting staff before ascertaining whether or not the proposal is viable. In addition, such staff would have a massive incentive to demonstrate that the project was indeed viable as this would improve their own career prospects with IC. Other IC staff would not have the specialist knowledge needed to challenge the assumptions underpinning the appraisal.

IC could search to see if any existing staff do have relevant experience. An appraisal team could be set up and it may be possible to recruit people with specialist knowledge on a consultancy or temporary basis. Alternatively a specialist consultancy with appropriate staff could undertake an appraisal for us.

The team could undertake research by reading articles in trade press to gain background knowledge. The financial statements of laser surgery providers could also give indicators of likely

One possibility could be to undertake a pilot scheme which would increase our knowledge of the industry. This could possibly be done by buying an existing clinic with a good reputation rather than setting one up from scratch. Another suggestion might be a joint venture with an existing provider.

Overall, it will be difficult to gain enough information to decide whether or not the proposal is viable without committing to it, for example by recruiting staff. It might be appropriate to conduct as much initial research as possible without commitment, and then undertake a pilot to give more information.

Task 2

Accounting ratios

We need to be clear that we will be focussing on the initial start-up phase of this project. IAS 38 *Intangible assets* requires that we treat start-up costs as expenses during the years in which they are incurred. It is inevitable that there will be significant start-up costs for this venture because we will need to hire clinical staff to enable us to train them in the operation of the equipment and the specific procedures that IC Optical will be using. There will almost certainly be further start-up costs associated with having our premises inspected for all appropriate health and safety certification, such as hygiene and so on. All of these costs will reduce operating profit for the year ended 31 March 2017, which will reduce most profitability ratios, including gross profit % and return on capital employed (ROCE).

We will have a further problem with return on capital employed. We will have to invest heavily in property, plant and equipment and those assets will be reflected in the statement of financial position as at 31 March 2017. The laser surgery business will not be operation for the whole year, which means that there will be little or no profit. Thus, capital employed will increase but there will be little or no return to offset that and so return on capital employed will decline. The impact on this ratio will be affected by the decision to rent rather than buy premises, but then we will have a smaller capital employed, but an even smaller return because we will have to start paying rent while the clinics are being converted and fitted out

The other main impact on the financial statements will be the gearing ratio. The basis on which the new venture is funded will impact on the gearing ratio immediately. If we plan to borrow then the gearing ratio will increase immediately. That will be a problem because we will have an increased gearing at the same time as a decreased return on capital employed, so we will appear more risky and less profitable. In the longer term, the gearing ratio will diminish because of additional retained earnings, but that will be a gradual effect and it will take some time to take effect.

Section 3

Task 1

WACC

At present, IC has total borrowings of approximately Z$440 million. Developing a chain of clinics would cost approximately Z$100 although this amount is not yet known with certainty. The impact would be an increase in total borrowings of approximately 25%. However, the whole amount would not be required immediately or in a single tranche, so the impact of additional borrowing would be incremental. However, the announcement of the proposal will presumably include enough information for the market to be aware of the full borrowing requirement, so any reaction of the market will be to the full impact of the proposal.

The increase in borrowings may be expected to lower our WACC. The WACC is the weighted average of the cost of borrowing and the cost of equity. Debt is cheaper than equity and attracts tax relief which further reduces the effective cost to IC, provided IC is making sufficient profits to make use of the relief.

However, if there is an adverse reaction from the market, this will not be the case. If lenders consider that IC will be too highly geared with the additional borrowing in place, they will take the view that their risk has increased and will consequently increase the interest rate charged. Depending on the amount of this increase, this could outweigh the impact of an increased proportion of debt and cause an increase in WACC.

WACC is also affected by the cost of equity – the return required by shareholders. If they view this project as risky, and therefore take the view that the overall risk of IC has risen the return they require will rise. Again, each incremental addition of a clinic may not be sufficient to impact the risk of IC, but the total project is large enough to have a significant effect. The announcement will be of the total project so this is what the market will react to. Persuading shareholders that this project is in the best interests of IC is therefore crucial, but it is possible that they could view the project as viable AND high risk, and therefore want to go ahead but also require an increased rate of return.

Task 2

Using retained earnings

The most immediate implication is that the shareholders might interpret this as "bad news" and so IC Optical's share price may fall. The argument that we are planning to invest the funds retained in a positive NPV project may be less credible than a worry that the company simply cannot afford to pay. Shareholders will normally expect the companies that they invest in to be reasonably self-sufficient with respect to funding projects and so they will be confused by this proposal.

Some shareholders may be inconvenienced by this proposal because they depend on their annual dividend for income. Shareholders may have invested in IC Optical in part because of the company's dividend policy because they prefer a regular income. There may be adverse tax implications for shareholders if a company changes its dividend policy without warning.

A key point when negotiating with shareholders will be to specify the time period for which dividends are to be suspended. If this is to be a long term change in dividend policy, persuading shareholders may be much more difficult than if the board merely propose to suspend dividends for a year or two.

IC will know who their shareholders are. Some may be major institutional investors who hold large blocks of shares and who manage their investments in a professional manner. IC Optical could start negotiations by speaking to any such major shareholders to establish how they would feel about suspending the dividend. Apart from taking their advice, these shareholders' actions will influence the rest of the stock market if we suspend the dividend.

It will also be important to convince shareholders that the project is in their best interests. The potential business benefits will have to be highlighted in the hope that the markets can be persuaded that the company will prosper when the project comes to fruition.

Section 4

Task 1

Risks of offering eye surgery

One important risk is that a patient's sight could be damaged by laser treatment in an IC clinic. Although patients will be warned that damage could occur in a very small percentage of cases, if this occurred in the early days of IC offering laser treatment there could be considerable reputational damage for IC. There could also be high costs involved were the patient to sue IC, particularly if they could demonstrate negligence. In order to mitigate this IC should ensure that appropriately qualified and experienced staff are used, premises and equipment are fit for purpose, patients sign a consent form and insurance is taken out.

The reputational damage from such an incident would potentially damage IC's business as opticians. IC currently has a very good reputation in the industry. In reality, problems with laser surgery would not mean that IC's ability to prescribe and supply spectacles was impaired. However, customers might well not differentiate between the two services. It might be advisable to set up the new clinics under a different name.

Another risk relates to the uncertainty surrounding this new venture. Since it is a new business area for IC, it may be that there is less confidence in the projected figures. It could be that the new venture is not as profitable as anticipated, for example because demand is lower than expected or costs higher. Withdrawing from the market would then potentially cause reputational damage. The project should be researched as well as possible and a pilot scheme might be an appropriate way of reducing uncertainty.

There could be a technology risk. IC will set up new clinics with new surgical equipment, but as the technology develops, newer more sophisticated techniques may need updated equipment. IC may not have the resources to keep chasing more up to date machinery, which specialist chains of surgeries may be able to do. It could be possible to mitigate this risk by leasing kit under an agreement which allows for regular upgrades.

There may be a funding risk. This will be an expensive venture to set up, and funding it could put pressure on ICs cash flows and make it difficult to fund other projects in the future. The project should be carefully appraised and sufficient funding arranged before commitment is made.

Task 2

Excluding company from consolidated financial statements

Jud’s proposal would fail because of the requirements of IFRS 12 *Disclosure of interests in other entities*. The standard was published with the specific intention of making it impossible to conceal interests in the manner suggested by Jud. Laser would fall within the definition of a “structured entity” as defined by IFRS 12. That would require us to provide extensive disclosures about our involvement with the company that may actually draw greater attention to the business risks that we are bearing through this venture.

Even if IFRS 12 did not apply, we would be required to show our investment in Laser at its fair value. That would mean that any volatility in Laser’s business could be reflected in a change in the fair value of our investment and so we would be forced to account for gains and losses. IC Optical’s statement of Comprehensive income would be almost as exposed to the risks borne by Laser as if Laser was part of the group. Indeed, the accounting for the gains and losses on this investment could draw greater attention to the business risks than if we simply treated Laser as a subsidiary.

Jud’s proposal is highly unethical. Basically, he is suggesting that we go to some expense to create a structure that is intended to mislead the shareholders. If his proposal could be made to work from a technical accounting perspective, he is effectively suggesting that we exploit a loophole in the accounting requirements. The whole area of excluding subsidiaries from consolidated financial statements has been one of the key areas in creative accounting and has led to many accounting scandals. It will be almost impossible to justify Jud’s treatment if it is picked up in the business press and the shareholders question our motives.