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Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY NOVEMBER 2015 EXAM ANSWERS

Variant 1

The November 2015 Exam can be viewed at

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SECTION 1

From: Finance Manager
To: Ken Burragh, Director of Finance
Re: Cocoloco

Hi Ken,

Value chain

We need to know how much Cocoloco would charge and how that would compare to what we presently spend. We need to estimate how those costs are likely to change in the future. Ideally, we need to know what scope we would have for breaking the contract and removing our equipment in an orderly manner. We need to avoid getting into a position where Cocoloco could afford to increase their service charge in the knowledge that it would be difficult and expensive to reinstate our own independent facility. We need to develop a clear understanding of how our costs would change in the event that we did relocate. To what extent would we have to maintain some sort of facility of our own? For example, we might have to employ staff to liaise between Cocoloco and our clients.

The whole point of a value chain is to establish where value might be added. We need to fully understand where our specific advantages lie. If our clients seek our storage services because we are adept at managing data then there is no great harm in us paying somebody else to power our equipment and keep the facility secure. There is no harm in admitting that a co-locator can offer even greater economies of scale in providing basic infrastructure. The danger would arise if clients started to believe that Cocoloco would be a better alternative to ABC. After all, their systems would already be operating on Cocoloco's network, so the changeover costs would be minimal. We would have to be certain that our management of the actual data processing aspect was the key to our clients employing us.

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Challenges

In some respects we are in competition with Cocoloco, even if we are considering their proposal. We need to ensure that we do not undermine their credibility in the eyes of prospective clients. We should, for example, insist that our use of their facility be kept entirely confidential, otherwise their sales staff may use the fact that we employ them to argue that we could not offer a better deal.

We need to ensure that our future needs are taken care of. Cocoloco's facility will have limited scope for expansion in terms of physical space, power capacity and data bandwidth. If our needs grow then we need to be certain that they can accommodate us, otherwise we could lose business.

Our clients will impose strict conditions on matters such as security and privacy. We will have to be certain that Cocoloco can put us in a position to assure our clients that these matters have been adequately addressed. That may mean that they will have to commission an independent review of security so that we can read the results.

We need to be able to be responsive to any other requests from our clients. If, say, a client requests that data be copied to a different medium such as magnetic tape then there will have to be some flexibility on Cocoloco's part to enable this to be provided.

We need to ensure that the relationship remains mutually beneficial. Once we are dependent on Cocoloco for the continuity of client data, it can gradually increase its charges to us until the relationship is no longer economic for us. We need to establish the parameters of any future price increases, perhaps linking them to some objective factors such as the price of electricity.

Finance manager

Section 2

Cocoloco v Kloud

Both contracts would require a long-term commitment. Kloud would expect us to pay what amounts to a rental on its hardware as well as for electricity. Cocoloco would not ask us to use the IT hardware, but we would have to be willing and able to replace it when it reached the end of its useful life.

Either contract could prove more costly than we expect. For example, we will not necessarily be able to make all of the operations staff redundant. Managers may act to protect their own staff, leaving us with fewer cost savings.

We may have to introduce our own monitoring procedures, which would offset the savings. If we discover any problems we may have to pay a great deal to rectify them because we will have lost control. There could also be indirect costs associated with the need to attribute blame, which could bring legal costs into the equation.

We should view the cost of our existing hardware as a sunk cost. If it is more cost-effective to scrap it rather than to keep on using it then we should not be concerned that it had originally been expensive. We could, however, find it difficult to persuade the shareholders of that fact and they may feel that we have been bad stewards.

Leases

This arrangement involves a contract that will require a regular stream of payments in return for this service. The pattern of cash flows might be viewed as creating a commitment that is similar to that of a lease. Cocoloco will be processing data using its IT systems and so we will be benefitting from the use of its equipment.

In this case we are buying a service that happens to be hosted on a computer server. The cash flows for the service may look similar to lease payments, but that does not create the conditions associated with lease accounting. The monthly payments will have to be earned by the co-locator on an ongoing basis, so it would be misleading to capitalise the future lease payments as a liability.

The co-locator will be processing our data on its hardware, but that does not alter our position. IAS 17 *Leases* defines finance leases in terms of the transfer of the risks and rewards associated with ownership of an asset. That is clearly not the case here because Cocoloco retains the risks and rewards and simply uses the assets to provide us with a service. This argument is supported by IFRIC Interpretation 4 *Determining whether an Arrangement contains a Lease (Candidates did not have to refer to IFRIC 4 to score full marks)*.

There could be an argument that part of the payment is for the use of the server, but the key issue here is that of control. We will never have any control over the computer hardware. The co-locator could, for example, move our data between machines for operational reasons without affecting our rights under the contract. It could even dispose of its servers without our permission provided it continue to meet our data processing requirements.

Section 3

Last in first out (LIFO)

Employees often ask for this arrangement because it favours older and longer-servicing employees. Those staff are potentially more influential and so they can often make a case at the expense of junior colleagues.

We should really retain the flexibility required to keep the staff whom we need. LIFO could lead to staff being made redundant after they have recently been appointed to fulfil a specific role. That may force us to retain less capable staff who have survived the redundancy.

LIFO could be a useful tactic employed by workers to reduce the level of job losses. The company may find it easier in the long term to make fewer staff redundant in order to avoid cutting too deeply into recent appointees.

We may also find that LIFO leaves us with higher paid staff. If we have two members of staff in the same post then the less experienced may be further down the pay scale and would be cheaper to retain.

Balanced scorecard

Financial

We are likely to be penalised for delays or lateness in the submission of data. The centre manager should be set a target of never having to pay this penalty so that any costs associated with lateness or inefficiency are being flagged.

Learning and growth

Remaining staff should be encouraged to be trained on the new system. Time spent on courses offered by the co-locator could be tracked.

We could use staff turnover as a measure of staff feeling valued. Too many departures could indicate that staff are demoralised.

Internal business processes

New reports on the throughput of data could help us to evaluate efficiency.

Customer

We should aim for zero complaints, with any flagged as a serious indicator of problems with the system.

The number of times the system is accessed by customers may indicate the extent to which it is meeting their needs.

Section 4

Return over capital employed (ROCE)

To answer this question, we need to start with the simple fact that ROCE is ‘return’ divided by ‘capital employed’. We need to consider the implications for both the nominator and denominator.

Selling the hardware at book value would simply replace the asset of plant and equipment with the asset of cash. If we use that cash to pay a dividend or to repay a loan then capital employed will be reduced and so ROCE will increase.

If we sell the hardware at a gain or a loss then there will be a further impact beyond the availability of cash to reduce capital employed. In the year of disposal, there will be a gain or loss that will affect the reported profit, ‘return’ will increase or decrease accordingly. That will lead to a persistent change in equity, which will have an ongoing effect of increasing ROCE if the sale is at a gain or reducing it if it is at a loss.

The impact on the denominator is far more difficult to predict because there will be offsetting adjustments. Reducing plant and equipment will reduce the depreciation charge. The co-locator will also be responsible for certain running costs that will no longer be charged against our profits. Offset against that will be the co-locator’s fees, which may bear little resemblance to the costs that will be replaced.

Stock options

The value of the options is based on the share price, which changes as expectations of future cash flows change. ROCE is not in itself a measure of cash flow, although an increase could make the shareholders a little more optimistic and so the share price could increase.

The shares might not change in value if the capital markets had predicted this move. If the shareholders had expected the company to cut costs then the share price would already have taken that into account.

The shareholders reaction to earnings announcements can be short-lived. Executive stock options usually have very specific exercise dates and so the share price could have reverted by the time the effects of the good news in the ROCE have worn off.

The higher ROCE could encourage the company to grant more options, in the spirit of a performance related bonus.