Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY NOVEMBER 2015 EXAM ANSWERS

Variant 2

The November 2015 Exam can be viewed at

https://connect.cimaglobal.com/resources/management-case-study-exam/november-2015-management-case-study-exam---abc-solutions-variant-number-2

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CIMA will not accept challenges to these answers on the basis of academic judgement.

SECTION 1

Interpreting costings

The figures are not comparable as they stand.

Option 1 covers two years and option 2 covers three. We would have to calculate an annualised rate of return. That calculation would have to separate the cash flows because option 2 has a mixture of the replacement of the servers every six years and the running costs that are annual, but fixed for three. Unless there is a need to pay for maintenance or upgrades, the license fees are effectively one-off payments,

Annualised cash flows would require assumptions to be made about the likelihood of an extension. The annualised equivalent for the licences and the servers would have to allow for the possibility that they will not be used for the full lives of the assets.

The costings for option 1 make no allowance for the need to replace hardware in the longer term.

The costings for option 2 make no allowance for the cost of the surplus capacity that is effectively being given to the client. That may not be an incremental cost, but there could be opportunity costs associated with committing that capacity to this project. The possibility that another contract could have been won and managed within that capacity should have been considered. There could also have been scope for downsizing and reducing costs by running this capacity down.

The two projects have different risks. Option 2 may be riskier because we have to make a significant capital investment at the outset and we may not be able to recover those costs if the contract is terminated for any reason. On the other hand, if we proceed with Option 2 we will have taken responsibility for the new employees, but we will have no real flexibility in employing them elsewhere in the event that we lose this contract, because they are located 200 kilometres away. We need to determine appropriate discount rates for each of the two projects in order to make their annualised equivalents comparable.

Strategic perspective

Neither model is necessarily inconsistent with the basic strategy of selling IT services. ABC should be willing to undertake either role provided it can do so at a profit.

Having said that, ABC does not normally take over other companies' data centres and so we have very little experience of doing so. We could find that it is difficult to operate the data centre at a profit because we are assuming that we can shed 20 out of 52 staff and still maintain service quality. Our assumptions may be valid, but Dairy Fresh must have had some reason for retaining such a large complement of staff. We may discover that the level of redundancy will be resisted, which will put us in a difficult position if we insist and something subsequently goes wrong. We may appear to have acted recklessly.

Making 20 people redundant could affect ABC's reputation. That may not be a strategic problem, but it could be a serious issue in the short term.

Option 2 is far more consistent with ABC's current strategy. Bringing business into ABC's data centre offers potential for improved economies of scale and other synergies. It will be easier to manage operations if it is located at a centralised facility, rather than being dispersed to client locations. Running additional capacity through ABC's central facility will generate additional experience and expertise in those operations, which could make it easier to attract other clients in the future.

The three year period in option 2 also gives us more of an opportunity to retain the client on the longer term. We have a year longer to remedy any initial problems and to demonstrate that we can offer a high standard of service.

Section 2

Key risks

In the short term, we could face serious initial problems that could lead to security breaches. For example, expanding capacity at our data centre could place additional strain on electrical supplies that could have unpredictable consequences. Similarly, the additional volume of transactions could place a strain on data bandwidth that could slow down responses or otherwise disrupt services.

Over the longer term, there could be software problems that could take some time to emerge. It will be extremely difficult to ensure that there are no inconsistencies or errors in interfacing with Dairy Fresh customers, particularly if a third party updates or upgrades the EDI software. This is also a potential area that could leave us exposed to external threats such as hacking by fraudulent or mischievous third parties.

We are agreeing to respond quickly, but there could be communication problems that could lead to disputes. We might not be aware that access is slow or even unavailable unless the problem is communicated to us by the client. We will be dependent on the quality of the information passed to us by contacts, who may not have sufficient IT skills to communicate the nature of the problem accurately.

We may have no way to tell whether an outage affects more or less than 30% of all users, so we may have to treat every notification as critical in the first instance, at least until a subsequent notification downgrades an incident to severe.

The definition of a severe incident is open to interpretation. Users may feel that the system is not operating correctly because of subjective perceptions. Dairy Fresh staff may submit spurious reports in the first instance because the costs of any false positive report will be borne by ABC and it may not wish to delay and lose control over sales or cash flows in the event that a real problem is not reported.

Evaluation

We need to have a clear protocol in place for responding to incidents. We need to maintain detailed logs of our responses to all incidents. These logs should be reviewed as a matter of routine and our data centre managers notified of the results to ensure that standard procedures are being enforced at all times. Any breach, no matter how small, needs to be investigated further and managers informed that they failed to apply policy. Our response times are measured in minutes and so any delay or omission could prove very expensive. Managers should be commended for successful interventions, otherwise the feedback process will be seen as wholly negative.

The causes of incidents should also be investigated and classified. Incidents due to compliance failures on our part should be flagged for review and potential disciplinary action. Managers will be more motivated if they know that they will only be held responsible for failures that have been deemed their responsibility. Some incidents may be potentially preventable, but it may not be cost-effective to implement safeguards and so we should not penalise managers who are caught out by such an event.

Motivation cannot focus too heavily on the response to incidents because, hopefully, there will be very few incidents and so managers' performance will not be subject to meaningful review. Ideally, we need to encourage managers to take preventative measures in accordance with ABC's standard operating procedures.

Regular internal audit investigations into compliance, with maintenance and monitoring regimes will help. These investigations may have to take account of the fact that the data centre will operate on a 24 hour, three shift basis. Ideally, there should be potential for an unannounced visit at any time of day to ensure that, say, security arrangements are in line with policy even late at night.

Management should feedback comments on internal audit reports in order to demonstrate support for the process.

Section 3

Pricing

The starting point should be that ABC needs to make a realistic profit. Failing to do so is irresponsible because the contract will consume scarce resources in terms of staffing and management time that could be better spent elsewhere.

The argument about penetration pricing is misleading because the only market that is being penetrated is Dairy Fresh. Selling to Dairy Fresh might enable us to pitch to other clients on the basis of our experience, but that is not the same thing.

If our profit is insufficient then we could easily encounter some additional cost and find that the contract becomes loss making.

Perhaps we should aim to set the minimum at the 40% margin we usually insist on, otherwise it might be felt that we are desperate for business. We might find that all future negotiations with clients are affected if word gets out.

Clearly, we could give a small discount for the sake of goodwill and in order to enable the CEO of Dairy Fresh to save face.

Negotiations

We should start from the basis that we need to agree an acceptable price or the job isn't worth doing. If that is our motivation then we will have a psychological advantage if nothing else.

We should present the CEO with the key facts. The contract is for a vital service that the company will depend on for its continuation. It seems short sighted to negotiate the cheapest price. Leaving no profit margins on the contract restricts the flexibility to allow for an acceptable standard of service in the event of unforeseen circumstances.

We should also stress our competence. If Dairy Fresh needs the best then it will have to pay. Demanding a realistic fee is a sign of confidence.

We might attempt to find a compromise by offering extra reports or other benefits that will cost us little but that could have value to the client. That could help to settle the deal and it will demonstrate some flexibility on our part.

Section 4

Recognition

This argument is highly reminiscent of justifications that have been offered in the past for so-called 'creative accounting' scandals. The basic argument is that there are no specific rules to prevent us from recognising revenue in a particular period. That does not necessarily make it logical to recognise revenue in the manner stated, even if it is not expressly forbidden.

The recognition of revenue is governed by IAS 18 *Revenue*, which will be replaced when IFRS 15 *Revenue from Contracts with Customers* becomes effective *(Candidates were awarded credit for referring to either standard.)*

IAS18 sets out criteria for the recognition of revenue from a transaction:

- Revenue can only be recognised when the amount can be measured reliably. It will be difficult to separate the annual fee of K$ 1.4 million to reflect the sale of setup versus ongoing data processing.
- It must be probable that we will receive these economic benefits. Our performance is subject to review and approval by Dairy Fresh and so we cannot be certain that future service fees will be receivable.
- It must be possible to measure the stage of completion reliably. IT projects often require time to identify problems and rectification can be costly. It could be difficult to argue that all of the setting up and coding will occur in the first year because there could be an unspecified amount of corrective work in year 2 and even in year 3.
- Costs to complete must be known. It may be difficult for us to establish how much the basic data processing will cost in years 2 and 3 because there may be unanticipated problems. It could be reckless to recognise as much revenue as planned.

From a common-sense point of view, most readers of the financial statements would struggle to understand the argument that more than one third of the annual fees could be earned in any given year.

Persuading auditor

Auditors are supposed to be independent, so it should be impossible for us to bully them in the event that they believe we are in breach of accounting standards. The audit firm has a responsibility to form an opinion and to report on the fair presentation of the financial statements.

As qualified accountants, external auditors are bound by very similar ethical standards to those set out in the CIMA Code of Ethics. The fundamental principles would have a role to play here.

Integrity would require the auditor to be straightforward and truthful. If the auditor believes that the suggested accounting policy is inappropriate then it would be a breach of this principle to accept the figures.

Objectivity requires the auditor to be unbiased. The auditor should reach an independent opinion and should not be persuaded into accepting an unacceptable set of accounting policies.

The auditor will also be unwilling to behave in a manner that might impair the firm's reputation. If the financial statements push accounting standards to their limits then users of the accounts may feel let down by their auditors. That could leave the auditor open to accusations of dishonesty, which could cost the firm business. There could also be claims for compensation from users who feel that they have been let down by the auditor.

The converse to this is that the auditor may be keen to retain the support of management. Any dispute over accounting policies could lead to the firm being replaced. The external auditor is likely to be the only third party to review the accounting policies in any great detail and the accounting policies note is not always particularly detailed. It may not be apparent that the auditor has accepted a slightly contentious policy.