



## **GATEWAY CASE STUDY May 2018 EXAM ANSWERS**

### **Variant 2**

The May 2018 exam can be viewed at

<https://connect.cimaglobal.com/system/files/resource/Gateway%20Variant%202%20Qs%20May%202018.pdf>

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### **Section 1**

#### **Direct customer profitability**

Servicing this contract will mean either diverting capacity from existing routes in order to operate the school run or creating additional capacity. Diverting capacity will involve a significant loss of revenue because the morning school run coincides with the time of day that commuters are travelling to work by bus. Creating capacity will lead to buses and drivers who will have relatively little to do during quiet times of day, after the morning run has completed.

Changing numbers could also have an effect on the profitability of this contract. For example, an increase in the number of children travelling on a particular route may mean that an additional bus will have to be scheduled. That will not necessarily be compensated by having fewer buses on the other routes and so it could simply be an additional unforeseen cost.

If Menta Blackston wins this contract then it will have to ensure that it offers a totally reliable service because any missed service will leave young children in a vulnerable situation. That could lead to further costs or lost revenues if, for example, a driver is sick or a bus is broken down, because that could require a regular fare-paying

service to be cancelled in order to cover the school run . If that happens frequently then there could be further consequential losses such as the loss of customers to other bus companies, although that will be difficult to quantify.

School buses could be the subject to changing rules and regulations relating to safety and security. It may be difficult to establish how much those costs will be during the term of the contract For example, if the rules require seatbelts, then there will be the cost of fitting those and a constant cost of maintenance.

## **Revenue recognition**

The proposed accounting treatment will mean that a whole year's revenue from the contract will be recognised during a three month period in the financial year. That may be acceptable, subject to meeting the conditions for the recognition of revenue as set out in IAS 18 Revenue. This treatment will significantly increase profits in the first year of the contract, although it will then lead on to a year's revenue being recognised in each remaining year of the contract, at least until the contracted revenue has been recognised. The final year of the contract may not reflect the work actually undertaken that year

The principal criteria set out by IAS 18 are that future economic benefits will flow to the entity and that those benefits can be measured reliably. There are further criteria relating to revenue from the sale of services, with it being possible to measure the stage of completion of the contract and it being possible to measure the seller's costs reliably. These criteria amount to asking whether a service has actually been provided before anything can be recognised in the financial statements.

The principal criteria are clearly met in the case of this contract. The School Board will sign a contract that commits it to paying for the service. There is very little risk of default if a payment is due from a public sector entity, which means that the future economic benefits can be measured reliably.

IAS 18 defines revenue in terms of creating gross economic benefits. In other words, the service provider must have actually provided a service in return for the promise of a fee before it can recognise revenue. If signing the contract was sufficient to justify the recognition of revenue, then Menta Blackston could recognise the whole five years' revenue immediately

At most, Menta Blackston will be able to recognise the revenue from the first four months of the contract The only other possibility would be if the contract permits specific costs to be recovered from the School Board then any such costs that are incurred in setting up the service can also be recognised as billable.

## **Section 2**

### **Bidding strategy**

Bids for contracts are generally conducted in secret, without the bidders knowing who else has actually placed a bid and what they have offered. The analysis will, hopefully, help Menta Blackston to understand what the competition is likely to do. For example, both Blackbus and Swift Bus are larger than Menta Blackston, which suggests that both have the resources to make a competitive bid. Menta Blackston needs to consider whether the two companies will bid against it and, if they do, whether they will bid aggressively or whether they will set a relatively high price.

Blackbus is a “tiger” competitor and is much larger than Menta Blackston, which could mean that it will aim to win the contract at all costs and could bring economies of scale that will enable it to undercut Menta. If Menta is to bid against them then it may have to set its prices at the lowest possible level, with very little margin for contingencies and for profit. However, the analysis also indicates that Blackbus tolerated Troveline having the school bus contract. That suggests that it may be very protective of its market share for fare-paying passengers and is willing to see others take business that is peripheral and potentially unprofitable.

Swift Bus is a “selective” competitor, which suggests that it will only bid against Menta and Blackbus in the event that it perceives some benefit in doing so. That raises the concern that any competing bid from Swift Bus will be carefully designed to beat Menta. The analysis suggests that Swift Bus has no particular advantage in terms of size and scale in bidding against Menta, which suggests that it may struggle to undercut Menta in pricing. However, Swift Bus has a history of innovation that enables it to respond to competitors at relatively little cost. Menta should attempt to pre-empt that by considering whether it could enhance the service that it offers in ways that might impress the School Board.

While the analysis is useful, Menta Blackston has to focus primarily on its own needs from this opportunity, initially ignoring the fact that it may be competing against other bus companies. There is little point in winning the bid by pitching the lowest price if that is so low that the contract will run at a loss. Even here, the analysis may help Menta Blackston to decide whether it is worth bidding at all. If the competition is likely to be too strong then there is no point in investing significant amounts of time and money in developing a detailed bid that is likely to fail.

### **Performance measures**

The revenues from this contract are fixed in advance, so the costs associated with this contract will have to be monitored carefully because any overspend will eat into profits. Variances should be broken down between those that are due to

inefficiencies or mismanagement and those that are uncontrollable. For example, if the price of fuel rises then it will cost more to operate the buses, but there is very little to be done about that, other than to note that the costs of servicing the contract are increasing.

The financial reporting should also reflect the responsibility for any additional costs incurred. It may be that the School Board will change its requirements during the course of the contract and those changes ought to be recorded for discussion. For example, if an additional school is opened and Menta Blackston is required to increase the number of routes covered then it may be legitimate to go back to the School Board and request an additional payment.

Non-financial indicators should focus on preventing problems with the School Board. For example, it is important to keep a record of any late-running services, but any incidence of lateness will be flagged as a serious matter by the School Board. Menta Blackston could address this concern by identifying measures that forewarn of problems rather than simply record them after a problem has occurred. It may be worth recording the departure times from the depot each morning, with a target departure that allows a certain amount of slack in case of traffic problems. If buses are leaving close to the latest possible times then that could be investigated before that starts to result in late arrivals.

It would also be important to report on the contribution that the service makes, with records of the numbers of children carried. The School Board cannot tell whether children use the bus service or whether they walk or are driven to school by their parents. Drivers should use their ticket machines to track the number of children boarding at each stop each day of the service, so that Menta Blackston can be ready for any questions about whether the service is cost-effective.

## Section 3

### Ethics

As a bus company, we have to accept responsibility for passenger safety. It would breach the concept of integrity if we did not make every reasonable effort to make our buses safe. Integrity requires us to be straightforward, honest and truthful. Offering to carry fare-paying passengers implies that our buses are safe and so it would be dishonest to skimp on safety. It is also rather dishonest to argue that passengers would not wear seatbelts because some would and those passengers are being denied that opportunity. If we do not wish to fit seatbelts because of cost then we should make that point openly and permit passengers to make an informed decision about whether they wish to travel on our buses [1]

The argument about the effectiveness of the seatbelts appears to have been driven by the cost of fitting them. That appears to be a breach of objectivity. Objectivity forbids decisions from being biased by conflict of interest. It would be a breach of objectivity to argue that seatbelts would be ineffective just because they are expensive to fit. It could be argued that the board has an ethical duty to maximise shareholder wealth and that fitting seatbelts could put Menta in breach of that duty. It could be argued that the only objective response to that dilemma is to leave it to regulators to resolve. If the law does not require seatbelts then perhaps the government's view is that the need for seatbelts has yet to be proven.

The principle of professional competence and due care requires us to understand the risks associated with passenger safety. It is almost certain that there will be ongoing research into road traffic accidents and the causes of injuries for different categories of road users including bus passengers. As a company, Menta should keep up to date with the findings of such research, with a view to ensuring that any new developments are taken into account in enhancing safety. It may be that passenger seatbelts have been regarded as ineffective in the past, but that view may change and Menta should be open to updating its policies with regard to matters such as fitting seatbelts.

### Driver responsibility

Making drivers responsible for making passengers wear seatbelts will add significantly to the driver's workload. Some passengers may be reluctant to wear them, delaying the departure of the bus.

If drivers do not check that belts are being worn then Menta could face legal consequences arising from injuries caused to passengers who chose not to wear belts or those injured by unrestrained passengers in the event of a collision. Passengers may claim that Menta has been reckless in permitting them to travel without ensuring that seatbelts were being worn.

The responsibility for making seatbelts compulsory would only be realistic if buses were equipped with sensors that identified passenger who were not wearing theirs. It would be impossible for the driver to physically check that seatbelts were being worn after every stop, and passengers could easily disengage their seatbelts after the check.

It will only be acceptable to make failure to enforce the seatbelt rule a disciplinary matter if Menta adequately supports and equips the drivers in the event a problem. For example, drivers ought to be trained to deal with passengers who refuse to wear their seatbelts. They should also be given clear and effective procedures to follow in the event of a refusal, such as the ability to summon assistance.

Drivers should also be given full support in the case of any consequences of disagreements with passengers. For example, Menta ought to support its drivers in the event that a passenger refuses to wear a belt. It would also be desirable for buses to be fitted with video cameras that keep a record of any interaction, again to protect the driver in the event of a dispute.

## **Section 4**

### **Provision**

IAS 37 Provisions, Contingent Liabilities and Contingent Assets sets out the requirements relating to provisions very clearly. The first requirement is that Menta Blackston has a present obligation as a result of a past event. The accident constitutes a past event. It may not, in itself, necessarily constitute a present obligation, so further matters will have to be considered.

It must be “probable” that there will be an outflow of resources as a result of this event, which suggests that there is at least a 50% chance of payment being made. We need to seek advice on the likelihood of a payment. Our own legal advisers can tell us whether or not this case is likely to result in us paying compensation.

It must be possible for the liability to be estimated reliably. It should be possible to make an estimate based on the claimant’s past earnings and the prognosis for her injury. Our lawyers should be able to advice on the likely cost of compensation for pain and suffering.

### **Auditor**

The external auditor has a responsibility to carry out a number of reviews and checks on behalf of the shareholders and to report on their findings. In this case, we appear to have a potential disagreement over the need for a provision, which will put the external auditor in a difficult position if we cannot reach agreement. In the first instance, we will have to consider our position carefully and discuss the matter with the external auditor, with a view to either us agreeing to provide or the auditor agreeing that no provision is necessary.

If we are unable to reach an agreement with the external auditor then it will be necessary for the auditor to reflect that in the audit report in the financial statements. That will not necessarily directly affect our ongoing relationship with the auditor because the auditor will have discharged all responsibilities. It may prove unacceptable to Menta’s board to continue with the same firm in the event that the auditor is forced to make a negative comment in the financial statements.

### **Pricing**

The first question we need to ask is whether demand for our services is elastic. It may be that many of our customers are forced to travel on our services because there is no alternative. In that case, a moderate increase in fares to cover the costs of fitting and maintaining seatbelts will have relatively little impact on demand. We can justify the price increase on the cost of the seatbelts, further reducing any concerns expressed by passengers.

We should also consider whether our competitors will follow us in fitting seatbelts. Our example may encourage the local government to insist that all passenger buses have seatbelts and so we may not be uncompetitive for long. It may be that we can delay the increase in our fares until the competition fits its seatbelts and so we will be able to avoid being the only company that increased its fares. We might even be

able to negotiate with our competitors that we will all fit seatbelts in the interest of public safety.

If we cannot rely on inelastic prices or having competitors follow our lead then we have to consider whether customers will see buses fitted with seatbelts as offering any added value that would encourage them to pay a premium for fares. That might be a matter for market research, although it seems unlikely that customers would pay more for the sense of security offered by seatbelts. Most bus passengers will be used to travelling on buses without wearing seatbelts and so they may believe that they are unnecessary. Furthermore, bus accidents are, thankfully, rare and so passengers may perceive the risk as too slight to justify an additional payment.