



OPERATIONAL CASE STUDY November 2018 EXAM ANSWERS

Variant 1

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SECTION 1 - Gym Refit Options:

Relevant costs and benefits of refitting the gyms

Cash flows are relevant if they arise in the future as a direct consequence of the decision under consideration. In this situation, relevant items are those that change as a result of selecting each of the three refit options.

Contractor fees and contractor overtime are relevant to the decision as these vary as a direct result of selecting option A, B or C. Similarly, the cost of refunding membership fees to compensate for the complete or partial closure of the gym is also relevant.

Option A needs fewer salaried staff during the refit, these will still be paid and this is therefore not relevant. These Managers and Assistant Managers can however be used to cover holiday or sickness at other locations which would normally cost C\$2,000 in payments to deputising fitness instructors; a relevant benefit of Option A is thus C\$2,000. There is also a relevant benefit for Options A and B as there will be a saving in the cost of fitness instructors. This can be achieved as the fitness instructors do not need to be paid when not required.

The number of members who do not renew membership does vary as a direct consequence of the option selected. This reduces future income streams and is therefore not only relevant but is likely to be significant. There is also a difference in the date that the new gym would open. As GymFit are expecting an increase in membership, Option C delays the step in income by six weeks versus Option A. This could also be significant. Differences in the level of complaints are only relevant if this creates different costs, for example in refunding membership fees or providing vouchers with a specific value.

The cost of detailed plans for the refitted gyms, C\$20,000, is committed and therefore is not relevant to the decision. Furthermore, it does not vary by option.

Additional useful information

It would be useful to know if the salaried staff, Managers and Assistant Managers, are willing and able to work in other locations as the suggested saving may not be possible. It would also be necessary to understand whether GymFit would incur additional expenses such as mileage payments or hotel accommodation when moving staff to new temporary locations. This would also reduce the value of the relevant benefit. Furthermore, we should review whether staff morale and loyalty are affected by the choice; this may be the case where, for example, Fitness Instructors are not paid for several weeks.

It would also be useful to review the available evidence around both the appropriate level of refunds and the typical percentage of members not renewing membership from GymFit's previous experience. The percentage of members not renewing membership is only an estimate and it may be apparent that this can be managed down with free day passes or allowing members free use of other GymFit locations. It may also be useful to survey members as this could give us useful information on preferences or reasons that would cause them to leave. It is important to establish a robust estimate for the number of members not renewing as this is likely to be significant.

Finally, it is worth considering any other new approaches to refit such as paying a higher amount to contractors for closing for just one week. This may be difficult to manage but may offer a lower overall net cost.

Disposal of surplus equipment

The impact of the disposal on accounting profits

The impact of the disposal on accounting profits is calculated as the excess or deficit of proceeds over carrying value. We do know that the carrying value is C\$200,000 at the start of the accounting year; this carrying value being the value of the asset after all depreciation charges to date. This will also be the current carrying value, assuming no other adjustments, as we would not normally depreciate the assets in the year of sale, but this may depend on the policy applied. Depreciation will have been charged on a straight line basis thus a fixed proportion of the cost will have been charged per year.

Where there is an excess of proceeds over carrying value, we would calculate a profit on disposal to include in the statement of profit or loss. Where carrying value exceeds proceeds, we would calculate a loss on disposal. We aim to obtain proceeds of C\$300,000, although this may or may not be achievable and we should also expect selling fees. As we would expect net proceeds, after any selling fees, to be greater than the carrying value, we should achieve a profit on disposal in the region of C\$100,000.

The requirements for taxable profits versus accounting profits

For tax purposes, we must calculate taxable profits. The impact on taxable profits will depend on whether the proceeds are above, or below, the tax written down value (TWDV). The TWDV is calculated after allowing for tax depreciation, also known as capital allowances. Tax depreciation is not however usually applied in the year of sale.

The tax written down value will differ to the carrying value used for accounting profit where the rate of tax depreciation is not the same as the rate of accounting depreciation. Tax depreciation is applied in Celtland on a reducing balance basis at 25% whereas accounting depreciation has been applied on a straight line basis for this category of gym equipment. There is thus likely to be a difference between accounting profits and taxable profits and the tax written down value is likely to differ to the carrying value in the accounts. The impact on taxable profits is therefore unlikely to also be C\$100,000, which is the expected approximate impact on accounting profits.

If the proceeds are less than the TWDV, the difference is a balancing allowance which lowers taxable profit and therefore lowers the tax charge. If the proceeds are more than the TWDV, this creates a tax balancing charge which increases taxable profit and as a result increases tax. Accounting profits are thus adjusted for tax purposes by adding back a loss on disposal (or subtracting a profit on disposal) to accounting profit and instead deducting a balancing allowance (or adding a balancing charge).

SECTION 2 - Impact on the Finance Department of the acquisition of LifeGym

Impact on Finance Department responsibilities

The existing finance team will not be joined by staff transferring from LifeGym. This means that, unless additional staff are recruited, any additional work will have to be absorbed by the existing team. This also means that knowledge will be lost and could potentially make the transfer more difficult, unless procedures are well documented at LifeGym. If such documentation exists, it may list all details of specific tasks and other useful notes.

The extra work will include financial accounting tasks such as transaction processing; additional gyms will create additional business transactions and resulting master data, data entry and monitoring of additional balances such as those for new suppliers or new employees. These transactions will be included within the existing set of financial statements hence the impact on statutory reporting is limited.

Additional gyms will have more impact on the management accounting component as there will be inevitably more analysis, profit centres, budgets and variances to manage. There is also likely to be more business decisions thus requiring more evaluation, tracking and control work by the existing finance team. There is also value in checking, or a post audit, of the message chairs as this could help guide similar future decisions; this will be undertaken by the current finance team and therefore also add to the workload.

The treasury component may add some complexity as LifeGym has a requirement for foreign currency. This may require use of techniques to manage possible foreign exchange risk. Treasury may also consider additional financing requirements, tax adjustments and management of additional cash both for and from the acquisition. The need for Internal Audit support will also increase. Whilst some of this work is likely to be short term only, associated with change, there will be ongoing requirements for finance support in the form of reviews.

Appointing an Internal Auditor

GymFit does not appear to have an Internal Audit function at present. The UK Corporate Governance code suggests that companies without an Internal Audit function should review the need for this function on an annual basis. An Internal Audit function is an important part of good corporate governance and provides valuable assurance to the directors and owners of the business by reviewing the effectiveness of internal controls and risk management processes, ensuring the efficient running of the business. As GymFit is a listed company, there will already need to be an audit committee who perform this function, ensuring adequate internal controls and integrity of the financial statements. There would be advantages in increasing audit activities to ensure that GymFit do not suffer the issues experienced by LifeGym where controls were clearly inadequate given the recent fraud. Whilst these problems were in the past, we do need to ensure that there is no repeat of such issues; GymFit controls will be imposed going forward which should be more robust.

Internal Audit is currently delivered by external experts rather than by employees. If employed by GymFit, the jobholder may find it more difficult to be independent and be unwilling to disclose issues. In order to preserve independence, the reporting lines may need some thought; the Internal Auditor may be better placed outside of finance but this may not be practical. Many of these potential issues can be avoided by continuing to use external experts employed by a firm of Accountants, in preference to employing a member of staff.

Possible changes to planning processes

Benefits of adopting rolling budgets

LifeGym operate a rolling process for budgeting. Budgets are reviewed each month and extend for 12 months. Currently, GymFit budget once per year and set the budget for the next 12 months. A rolling process offers a longer time horizon as we move through the budget year, always stretching for 12 months ahead. We note also that the LifeGym process does not demand a change in budgets each month, but it does offer an opportunity for more frequent review. A rolling approach to planning would offer additional opportunities to review the budget and ensure that GymFit both focus on and consider the prospects further ahead. This approach will thus allow the business to react more quickly to a change in the environment than the current annual process allows.

A rolling budget approach tends to be more accurate which helps to reduce uncertainty and is vital when the environment is changing because a rolling budget does not just extend the periods of the existing budget it also re-examines the nearest periods. This is a significant advantage; more attention is given to the nearest periods as they are reviewed to reduce the uncertainty caused by a long range forecast and thereby reflect the prevailing conditions. With a rolling approach, our budgets for sales, costs and the financial statements would therefore be more accurate, reflecting for example the latest expectations of the newer gyms. As a result, budgets would be more realistic, achievable and therefore more motivating.

LifeGym's rolling budget is particularly suited to planning cash-flow which needs to be reviewed regularly. It is not clear whether GymFit, as well as producing an annual cash budget, also do regular cash flow forecasting however it is important to move the focus at GymFit from profit and improve cash management. A rolling approach to cash-flow budgets will offer better visibility of cash-flow and help to identify deficits, thereby ensuring appropriate financing arrangements are put in place to avoid a shortage of funds. Visibility of cash will also allow GymFit to adjust the timing of planned expenditure to avoid any cash flow shortages. Where the cash forecasts or budgets are suggesting that there will be a surplus, GymFit can arrange to reinvest these funds to make further gains.

Recommendation

There are numerous benefits for GymFit to using rolling budgets, in particular improving the accuracy of future cash flow budgets and better reflection of the changing environment and sales expectations. Rolling budgets however can be a significant amount of work. This additional work is in preparing, checking and also in communicating the revised plans. In addition, there is limited benefit in planning further ahead: accuracy may be questionable in the medium term. It would be important to ensure that additional work is limited to where there are clear benefits, for example revisiting some budgets less frequently, potentially reviewing quarterly. Given the strong case for rolling budgets at GymFit, I would recommend that rolling budgets are implemented for some, but not all, budgets.

SECTION 3: Limiting factor analysis

How to use the schedule to decide on additional fee classes

The analysis provided by Ethan could be used to determine the combination of classes which would maximise contribution per unit of a scarce resource; this is limiting factor analysis. It appears that time, during peak mid-week evening hours, is our scarce resource or binding constraint. It would require 12 hours of time to satisfy the demand for classes but only 9 are available. Ethan's analysis has already provided contribution per class and contribution per hour of the three class options, based on the fees paid by customers, the specialist teacher fee and the number of minutes per class. Contribution per hour must be the base for our decision as it references our binding constraint.

In order to make a decision, we would need to rank the classes in descending order of contribution per hour and allocate time to satisfy the highest contribution per hour first. Any remaining hours would be allocated to the second highest contribution per hour. If any hours still remain, they would then be allocated to the third highest contribution per hour and so forth until all of the hours have been allocated.

Dance-Fit is the top priority with C\$65.00 contribution per hour and can be fully satisfied as only 1.5 hours of time are needed. Pilates has the second highest contribution per hour at C\$45.00 and is therefore our second priority: this can also be fully satisfied. Yoga has the lowest contribution per hours at C\$35.00 and should be our lowest priority.

Other factors to be considered

There are several other factors that could be considered here which could potentially improve the decision. There are, for example, numerous assumptions and estimates contained in the analysis. It is possible, for example, that specialist teacher hours are also a constraint; there is an apparent assumption that there will be enough teacher availability but this may not be the case. It is also important to consider that demand is estimated and based on an average. Errors in the demand estimate could also result in insufficient Dance-Fit or Pilates, or even empty classes. It is also possible that some classes will not be full to capacity and this would change the contribution per hour. There may, furthermore, be an issue if the studio space is allocated in hour blocks as some classes will need 2 whole blocks; this could disrupt other classes. In addition, demand may vary for different locations and it would be wise to make a decision based on the demand at each location. This is particularly true as the GymFit members may have different preferences to members in locations acquired from LifeGym.

It may furthermore be possible to increase capacity. GymFit could use the larger of the two studios which would increase class capacity which may reduce or remove the binding constraint. This would have other consequences however, potentially on the availability of places in the free classes. It may also be possible to see if additional yoga, or indeed any of the classes, could be added at other off-peak times. This would also potentially reduce the binding constraint. In addition, it may also be possible to change the length of the class. By reducing yoga to a one hour class, it may be possible to accommodate the vast majority of those who would like to take part in yoga.

It would also be useful to consider whether additional information could be helpful, including the impact of increasing the class fee charged for the additional fee classes. There could also be value in surveying demand for free classes or each type of additional fee classes along with understanding trends in popularity of these types of class.

We should also consider the impact of insufficient additional fee classes. This approach would leave insufficient provision for yoga, with less than half able to book a class which could have

significant implications for planned additional fee income in addition to customer satisfaction, retention and therefore membership income.

Induction programme

The need for an induction programme

An induction programme is a key enabler to the integration of employees transferred from LifeGym to GymFit; integration is likely to be more successful and be achieved more quickly following an induction. A well-designed induction programme is also likely to result in increased staff commitment to GymFit and as a result, reduced staff turnover. This will correspondingly reduce the costs of recruiting and retraining replacements. In addition, an induction programme will help to drive a shared ethos and so help to strengthen a positive organisational culture.

Furthermore, staff are considered key to the company's success. GymFit's values may be different to those at LifeGym and so it is essential to ensure that the new staff are able to deliver GymFit's offer to the correct standards. It is also particularly important to present a positive image of GymFit given that staff are effectively transferring from what was a previous competitor.

There is a suggestion that an induction programme is not required because transferred staff retain their terms and conditions. An induction programme contains significantly more than just an employee's terms and conditions; there are likely to be significant differences in the policies and opportunities.

The contents of the induction programme

The induction could be tailored to the circumstances given that standard terms and conditions of employment will not apply. These terms and conditions would normally form part of an induction programme. Other contents would include:

- Company details such as history, culture and mission.
- Health & safety, and in particular first aid facilities, emergency procedures and contact details for further questions or issues.
- Specific organisational details including computer access log-ons and password standards, useful telephone contacts such as the HR Manager and also security details such as restricted access areas.
- Selected employment processes e.g. absence management and booking holidays
- Company policies such as expenses policy and expense claim procedures, whistleblowing, anti-bribery, internet access and email policy.
- Training opportunities and approach to development.

SECTION 4: Total quality management

Measures of quality

Financial measures

Measures should be controllable by managers in order to influence their behaviour. These could include the following:

- The cost of refunds given to our customers at each gym as a result of factors within the manager's control. Refunds are a non-conformance cost and will directly affect profits and may also show differences between gyms that will suggest areas for improvement. This measure will encourage managers to take care to avoid those issues which have previously resulted in refunds, for example ensuring adequate staff cover which could otherwise result in cancellation of group classes.
- The cost of training, both in direct costs and in staff time, a cost of conformance. Lack of training is a major determinant of quality in the advice given to customers and interesting and effective group classes. This measure will ensure that managers focus on training, and arrange the appropriate level of staff training resulting in, for example, better fitness advice and more staff to deliver member induction sessions. This is consistent with the company strategy to achieve growth by focussing on its people.

Non-financial measures

Measures should again be controllable by managers in order to influence their behaviour. These could include the following:

- The number of complaints. This could be linked to the number of members leaving and therefore income and will be a measure of customer satisfaction. Measuring the number of complaints will ensure managers take care to manage those areas of the business that can result in complaints such as a lack of available staff or delays in mending broken equipment. Furthermore, when presented with issues, managers will be more careful to ensure that these are resolved to the customer's satisfaction where possible.
- Number of comments, both positive and negative, relating to staff from the 'Rate Your Gym' site. This is a measure of quality and can be managed through good leadership and tight operational control. Measuring staff feedback will alert and encourage managers to resolve any particular problem areas such as new staff, knowledge gaps and specific training needs.

Accounting for pensions

Calculation of the pension liability in LifeGym's financial statements

A defined benefit scheme such as the one at LifeGym may show as a surplus or pension asset on the statement of financial position or may show as a deficit or pension liability. As LifeGym has a liability, this indicates that fair value of the plan's assets at the reporting date, are less than the net present value of the plan's obligations.

Under IAS 19 Employee Benefits, the plan's assets will be measured using market value, for example using the current market price of shares in other companies held as investments by the pension plan. The obligations will depend on the pension terms and conditions and the number of members.

Details of adjustments to the statement of comprehensive income

Under IAS 19 Employee Benefits, the defined contribution scheme will see the agreed employer contributions treated as an expense through profit or loss. There are usually no other adjustments needed.

The defined benefit scheme will have a number of adjustments posted through profit or loss. These include:

- The obligation resulting from employee service in the current accounting period known as the current service cost.
- The change in the obligation resulting from previous service which arises from changes in the membership numbers or a curtailment in the scheme benefits.
- The interest cost on the obligations, effectively from discounting.
- The interest income on the plan's assets.

The defined benefit scheme may also have a re-measurement component which is posted through other comprehensive income and not through the profit or loss. This comprises actuarial gains and losses which result from changes in the estimates of the obligation or differences between the amounts paid and the estimates of those figures.

Whether the impact on the statement of comprehensive income is predictable

GymFit's defined contribution scheme is straightforward and presents no further obligations beyond the company contributions made. This is therefore predictable.

The defined benefit scheme is more complex. The amount payable from the scheme depends on a range of factors that are not easy to estimate such as life expectancy, employee's average length of service, the investment returns achieved and wage inflation. The impact on the statement of comprehensive income will therefore be much harder to predict.