



OPERATIONAL CASE STUDY November 2018 EXAM ANSWERS

Variant 5

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SECTION 1 - Variance analysis:

Fee income price variance

The adverse fee income price variance for full fee members is at least partly due to the decision to offer discounted membership fees as this was not reflected in the original budget. It will also be partly due to the discounting by gym managers of the gyms that have been affected by the competitor company opening nearby gyms. It would be useful if this variance was broken down into its planning and operational element.

The fee income price variance for student members is favourable which suggests that perhaps more student members are from gyms in the city centre areas, which have a higher membership fee than in other areas. A further breakdown between the average fees in different areas would also be helpful.

Fee income mix variance

The fee income mix variance is adverse which reflects the split between full fee members and student members. There is a higher percentage of student members than budgeted and as student members have a lower average fee the variance is adverse. It would be helpful to discover why the mix is different to budget and a further breakdown of membership numbers in different areas would be useful.

Fee income quantity variance

The quantity variance is based on the total number of actual members at the budgeted mix. The total number of members per gym are below budget which will be partly as a result of the late opening of the new gyms and partly due to the competition from the competitor who may have attracted some of our existing and potential members to its gyms.

Feedforward control

Feedforward control is where budgeted results are compared against a forecast. By preparing a forecast of membership income for the financial year and comparing this to the budget it will enable our managers to be pro-active and to take control action to prevent the adverse

situation arising. This compares to feedback control where actual results are compared to budget.

This type of control mechanism will be of significant benefit to GymFit since it will trigger action to increase our membership numbers and reduce the projected gap between the forecasted numbers and the budget. The current estimated C\$6 million deficit in fee income will have a major impact on profit as most of our costs are fixed. Whilst there is nothing that can now be done about the late opening of the new gyms, it may still be possible to spend more in promoting the new gyms which will have the effect of increasing members at a faster rate than planned. Similarly, the opening of competitor gyms nearby is obviously a problem however we do not want to get into a price war with the competitor company and we need to take action to avoid this happening. We could stop the GymFit managers from using indiscriminate discounting and perhaps offer, for example, a price match guarantee to match the membership fee of any gyms within a 2 mile radius of our gyms. Other types of promotion should also be considered, for example, offering additional free classes.

Suggested change to useful life of gym equipment

IAS 8 Accounting policies and estimates

Accounting policies are the principles, bases, conventions, rules and practices applied by an entity which specify how the effects of transactions and other events are reflected in the financial statements. Any change to accounting policies are recognised retrospectively. However, the change in the useful life of the gym equipment is not a change to an accounting policy but a change to an accounting estimate.

When preparing financial statements, inherent uncertainties result in estimates having to be made and subsequently, these estimates may need to be revised. A change in accounting estimate is an adjustment of the carrying amount of an asset or liability, or related expense, resulting from reassessing the expected future benefits and obligations associated with that asset or liability.. The useful economic life of an asset should be reviewed periodically to ensure that it still reflects the period over which the asset will generate economic benefit. Any change in the useful life should be treated as a change in accounting estimate and the new method should be applied prospectively in the current and future accounting periods; depreciation charges of earlier periods should not be altered. Going forward the depreciation charge will be calculated as the carrying value of the asset at the point that the estimate is changed divided by the remaining useful economic life.

An increase in the useful life of the gym equipment would therefore, as suggested by Ethan, result in a lower depreciation charge for this year in the statement of profit or loss and consequently a higher profit. The brought forward net book value for the equipment will not be restated. The non-current asset section of the statement of financial position will show a higher net book value for property, plant and equipment due to the reduced depreciation charge for the year.

Ethical selection of accounting policies

As an accountant, however, we must follow the guidelines laid down in International Financial Reporting Standards and CIMA's Code of Ethics when recording all financial accounting information.

We should be objective in our judgement of estimates and not be tempted to choose a policy that helps to improve financial results. We should act with integrity being honest in all professional and business relationships and should not knowingly be associated with information where we believe that the information is misleading. Professional competence and due care impose obligations on all professional accountants to act in accordance with applicable technical and professional standards when applying judgement for accounting estimates and treatment.

Whilst I understand the pressure to improve the profits for the year, we must adhere to these regulations and guidelines when producing the financial statements of GymFit. It would appear that the change being suggested by Ethan does not relate to a reassessment of the future economic benefit of the gym equipment but is rather an attempt to improve the financial result. I would therefore not recommend increasing the useful life of the gym equipment.

SECTION 2 - Advantages and disadvantages of outsourcing IT

Advantages

The advantages of outsourcing will include potential cost savings in running the IT function and reductions in capital expenditure on equipment purchases.

From an operational viewpoint, senior management can concentrate on the company's core competence of running gyms rather than being concerned about the IT facilities and the information it is producing. Outsourcing would enable us to focus on our core business and by so doing become more specialised and proficient in that business without the distractions of carrying out other functions in which we have limited expertise. The outsourced IT Company will have the competencies and are the 'experts' in systems development and implementation. They will also be responsible for keeping up with any technological changes and therefore we would not have to worry about having a specialised team to deal with this.

Cost control can be enhanced as formal negotiations with the IT Company will ensure that a realistic conclusion is reached with mutual agreement on costs and service levels. This can be lost when functions are performed internally; the function itself can become self-fulfilling with its own hierarchical structure. Outsourcing organisations are often able to provide services at a lower cost than if we were to carry out the activities in-house. The cost of services charged by an external provider may often be lower because of the particular expertise and economies of scale that the provider enjoys.

Other advantages include the potential flexibility to increase or decrease IT capacity at relatively short notice, which will facilitate and enable us to match our requirements of growth in the number of gyms and members.

Disadvantages

However, care is also needed when outsourcing IT requirements as we will become very dependent on the IT Company. It is essential they understand our business processes which will be important in setting our requirements. It will also be important that the IT Company has knowledge of the type of IT system operated by GymFit.

Other potential problems are a loss of confidentiality and loss of competitive advantage. If we are looking for an outsourcer with our specialist requirements, it may be that they also have similar clients, potentially our competitors.

We will be locked into a contract, the terms of which will need careful consideration as subsequent adjustments may be costly and difficult to achieve in the short term. As such, service levels and requirements will need to be clearly understood and agreed, otherwise costs may be more than anticipated with the IT Company using technology updates to justify cost increases.

We should also consider the impact on our staff. The outsourcing of IT will potentially result in staff redundancies and we should try if possible to avoid this by negotiating with the outsourcer to take on our existing staff.

A further important consideration is the potential loss of expertise. It may be that the knowledge and experience of staff associated with the IT function is also embedded in certain business processes. A loss of this knowledge may be detrimental to the business and care should be taken to protect such knowledge.

Comparison of pricing Options A and B

Graph of IT Company charges

It is clear from the graph that we would be indifferent between the two options at 570,000 members. Our budgeted average number of members for 2018 is 522,000 and as discussed earlier, our member numbers are below budget. It would be cheaper therefore under the current situation to use Option B and pay the variable charge per member. If we expect membership numbers to grow to above 570,000 then based on the current level of charges, we would be better with Option A. At our current growth rate, we would expect to reach 570,000 members in late 2019. The graph illustrates how the IT company charges are related to volume and the point of indifference in terms of fees paid to the provider. However, in order to make a choice between the two options we would also need to consider the cost of administering the agreement and the cost savings shown in the table.

Relevant costs

The cost of administering the agreement can be ignored as it is the same under both options. The net cost savings for Option A are C\$100,000 higher than under Option B which would effectively lower the fixed cost line in the CVP graph for Option A by C\$100,000 and reduce the indifference point to around our 2018 budgeted average number of members.

An alternative approach would be to compare the costs of outsourcing with the costs savings from outsourcing. We can see that under Option A the cost benefit from outsourcing is C\$300,000, if the administration costs are ignored. If the same benefit was to be achieved under Option B the costs for Option B would need to be C\$1,100,000 (C\$1,400,000 – C\$300,000). From the graph, we can see that a cost of C\$1,100,000 under Option B would equate to approximately 520,000 members. Therefore, for Option B to be the preferable option member numbers would need to be lower than 520,000.

Recommendation

I would therefore recommend Option A as the preferable option based on the potential future growth of member numbers and the additional cost savings.

Other factors

- The decision to outsource may result in staff redundancies. What effect are the redundancies going to have on staff morale and motivation? It may however be possible to negotiate with the outsourcing company to ensure that they incorporate our existing staff into their operation.
- The retention of staff in-house who have knowledge of the member services system may help to mitigate any future risks if the outsourcing company experiences difficulties.
- The relationship with the outsourcing company is very important so we need to be clear of exactly what services are going to be providing under each option to avoid the risk of unplanned expenditure and future disputes. The decision should not just be based on price but also consideration of the quality of the provision under each option.

SECTION 3: Sustainability practices and benefits

Sustainable practices

We need to consider appropriate sustainability targets relating to the running of our existing premises and carrying out the refit of new premises and the best ways of achieving these targets.

The operations within the gyms should be designed to minimise waste, reduce energy use and also reduce carbon emissions. This can be achieved by the logical application of energy saving equipment throughout the premises. We could use LED lighting throughout the gyms and fit a system to automatically switch off lights in parts of the gym which are not being used. In terms of the gym equipment, we should ensure that wherever possible we use equipment that generates energy by its usage.

The gym equipment should utilise components which can be recycled and that are sourced from sustainable inputs. The ability to recycle the equipment at the end of its useful life should be a priority when sourcing a supplier.

With regard to the purchasing policy for materials for the refit of the gyms, only products from a sustainable and ethical source should be used. Sustainable development policies should form a key role in supplier selection, with those that score highly given priority.

Supplier location is also a key factor, the less transport required then the lower the carbon emissions associated with manufacture.

Impact of adopting sustainable practices

The adoption of sustainable practices throughout the business should increase efficiency and reduce waste which will in turn reduce costs and increase profits which will be beneficial to our shareholders.

Sustainable development should also help us in portraying a positive image to reinforce our brand. External stakeholders, including investors, suppliers and customers, may more readily associate with the company and create a positive image for our gyms.

Internal stakeholder support may be gained as a result of our improved image we will be able to attract and retain the best employees. Employee motivation may increase, and a positive company culture will result.

All these factors combined will generate a positive image for the company both internally and externally and increase loyalty from our members and a more positive attitude to the brand.

Environmental cost reporting

In an environmental cost report, there are four categories of environmental cost: prevention, appraisal, internal failure and external failure.

Environmental prevention costs:

These are the costs that we incur to prevent an environmental impact from happening.

This would include costs that we incur to mitigate our environment impact such as installing a system to automatically turn-off lights within parts of the gym which are not actually being used.

Environmental appraisal costs:

These are the costs incurred in order to assess whether we are complying with internal or external environmental standards and policies.

The company should expect to incur appraisal and inspection costs, such as the costs of carrying out an environmental audit, to ensure compliance with environmental regulations and to avoid penalties for failing to comply.

Environmental internal failure costs:

These are the costs that are incurred in order to mitigate any environmental impacts that the business has created. These are costs that are borne by the business.

During the fit-out of our new premises we will generate a lot of waste. An example of an internal failure cost is the cost that the company will incur in disposing of the building waste.

Environmental external failure costs:

These are the costs that the environment suffers as a result of the actions of our business in generating harmful emissions or causing other external failure costs as a result of our product.

The re-fit process is likely to cause pollution of the atmosphere in terms of dust and noise. Whilst the costs associated with the pollution, such as health care costs, may not be directly borne by the company it is important from a corporate and social responsibility perspective that the company is seen to mitigate these costs.

Suggested performance indicators

The following would be relevant performance measures to use to measure our environmental performance:

Tonnes of building waste sent to landfill:

Waste is an environmental problem and particularly waste that has to be disposed of in landfill sites. We should work with our contractors to ensure that when our gyms are being re-fitted that as little waste as possible is sent to landfill sites.

% of gym equipment that is user powered:

Part of our environmental policy should be to reduce the amount of electricity consumed therefore the more of our equipment that is user powered the less electricity that will be consumed.

SECTION 4: ZBB for discretionary costs

Zero-based budgeting process

A zero-based budgeting approach is different from an incremental budgeting approach. As we can see from the current Marketing Department budget, we currently budget by cost item. However, the first stage in implementing a zero-based budgeting (ZBB) system is to identify the activities. The marketing department's main activities are market research; promoting and advertising our members proposition for new gym openings and existing gyms; raising brand awareness and determining pricing strategies. The budget will therefore be split by these activities. So, for example, the staff salaries will be determined by activity. The advertising costs will also be determined for each activity rather than by cost type. The marketing manager will need to consider whether each activity is necessary, how much of each activity is required and how well should each activity be done, the alternative ways of carrying out each activity and finally how much each alternative would cost.

For each of the activities we would need to develop decision packages. A decision package is essentially an analysis and costing of different ways in which the objectives can be achieved. In terms of market research, the objective must be to provide market intelligence to management to support decisions regarding the choice of location of new gyms, projected member numbers and the impact of different marketing methods on the growth of member numbers. Decision packages can either be mutually exclusive or incremental. Mutually exclusive decision packages might be either to employ our own staff or to set up a contract with an external party to run this aspect of the marketing function. Both of these would potentially achieve the objective, and each will have different costs associated with it. These mutually exclusive decision packages could be further broken down into incremental decision packages. For example, the decision package to employ our own staff, could be split into a base package and then one or more incremental packages. The base package could be to employ one person to cover all of our market research in relation to new gyms and another person to provide market research on existing gyms and projected member numbers.

The third stage, once all the decision packages are identified, is to review and rank each one on a cost-benefit basis. This can be an extremely difficult process particularly in relation to marketing expenditure; predicting the potential benefits of advertising or promotions requires an in-depth knowledge of the market and relies on the accuracy of the estimates made. Once the decision packages have been ranked, budget resources should then be allocated on this basis.

Zero-based budgeting effect on efficiency and costs

ZBB focuses attention on activities and the achievement of objectives. It would encourage our managers to question what is currently done and to seek alternatives which are better and at lower cost. This would lead to the identification of non-essential costs and inefficiencies and their removal from the budget. ZBB is very much future focussed unlike the current system of incremental budgeting which is backward looking and bases next year's budget on what has happened in the past thus carrying forward inefficiencies.

The decision packages that are accepted into the budget will need to be fully justified. Hence the budget should reduce budget slack and potential inefficient use of resources.

ZBB would require higher levels of involvement of all levels of our staff since significantly more information would be required to complete the budget. The involvement of more of our employees in the budgetary process would not only raise levels of both budget awareness

and budget acceptance but also might generate useful ideas and promote job satisfaction across the wider staff. However, ZBB is time consuming and expensive and it must be clear that the benefits outweigh the costs involved.

What-if analysis in cash budgeting

When cash budgets are prepared, there are a very large number of assumptions and estimates, for example, the estimated fee income each month, the estimates of costs and the assumptions about when suppliers will be paid. Any of these estimates and assumptions could turn out to be inaccurate.

Sensitivity analysis or 'what-if' analysis involves asking what-if questions and finding out by how much the expected results will change if some of the forecasts or assumptions are altered. We could look at the impact on cash of changing the amount or the timing of different cash flows. For example, what if our fee income is 10% less than predicted, or what if our planned capital expenditure is two months later than forecast?

The main benefits of doing this is to enable us to put contingency plans in place. Depending on what the results of the analysis show, management might decide to take action to reduce the potential risks or to deal with any cash deficits or surpluses arising. We can also potentially change the timing of some elements of the cash flows.

There are a number of steps that we could take to plan for any cash deficit arising including:

- a. Approaching the bank to arrange additional short-term borrowings or arrange/increase overdraft facilities.
- b. The statement of financial position as at 31st December 2017 shows investments of C\$200,000. Assuming we have not already done so, we could sell these although we would need to consider any penalties that may be imposed as a result of early withdrawal / sale;
- c. We could review the finance methods for our capital expenditure on gym equipment and /or the fit-out of new gyms. It may be possible to arrange different forms of finance or change / renegotiate the payments dates on the finance;
- d. We could also consider the timing of our dividend payment to shareholders;
- e. We could consider postponing revenue expenditure such as advertising expenditure. We should be careful however as whilst advertising expenditure tends to be classified as discretionary expenditure a reduction or delay in the expenditure may result in reduced member numbers at a later date;
- f. It may be possible to bring forward the planned disposal of non-current assets. If the asset is not required, we could sell the asset sooner or perhaps arrange with the purchaser to pay a deposit.