

MANAGEMENT CASE STUDY MARCH 2015 EXAM ANSWERS

Variant 1

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SECTION 1:

Responsibility centres

The key here is to avoid demotivating the subsidiary directors and, in the process, encouraging dysfunctional behaviour. Bild's business cycle runs to more than two years because the bidding process takes time, followed by at least two years (perhaps five) for construction, followed by a further year before all retention monies can be expected.

Regular, and even frequent, reporting is necessary or the main board would be negligent in its duty to manage Bild with a view to creating shareholder wealth. It would be possible to obtain more realistic measurement of performance if we measured results, say, every five years to remain in line with the business cycle. Having said that, there would be enormous problems associated with monitoring activity and responding to problems if the reporting period was that lengthy.

The subsidiary directors' arguments are a little misleading because our budget reports do not actually monitor half-yearly profits. Rather, we track business performance on a short-term basis without necessarily drawing a conclusion about the bottom line.

It is necessary to ensure that the subsidiaries are evaluated both in terms of business won and costs incurred, which is consistent with the idea of a profit centre. The main board must see evidence that the subsidiaries divisions are actively bidding for new work, otherwise they will struggle to remain viable. There is clearly a danger that the distractions of managing existing projects will make it difficult for managers to find time to develop successful bids.

There is also a need to keep costs under control because periods of economic difficulty will mean that clients will press for the lowest contract prices and so margins will be slim. Subcontractors may respond to any lack of business by attempting to extend their contracts and overcharge in the process.

The most valid compromise would be to continue to gather the same information on a half-yearly basis, but to ensure that any comments offered by the subsidiary CEOs are fully considered as part of the main board's overall evaluation of performance.

Economic forces

Bild's client base includes both private and public sector entities. Each will be affected differently by economic forces.

Private sector companies will be unable to justify heavy investment in civil engineering projects unless they can be viewed as offering a positive net present value. During any economic downturn, the expected revenues are likely to be reduced, making the investment seem less attractive. Investments will also seem more risky and so a higher discount rate will have to be applied, again reducing demand for capital projects.

Conversely, interest rates may be lower during difficult periods because government may wish to stimulate demand. That could make borrowing for a project a little more attractive and so offset some of the concerns about investing. Periods of longer term decline may also stimulate demand for more suitable and cost-effective facilities. Companies may be forced to invest in civil engineering projects in order to remain viable.

The public sector agenda is rather different. Government still has to provide basic services despite any economic uncertainty. Investment in public sector infrastructure can be used to stimulate economic growth. Bild should pay close attention to economic indicators that could put the government under pressure, such as unemployment rates. Major building projects create work, not just for the construction staff but also for the suppliers of building materials.

Prolonged periods of deferring projects can also create both a practical impetus to invest (in order to replace defective properties), as well as a political pressure to avoid alienating voters. Bild should study trends in government spending over time in order to establish whether the public sector is likely to feel pressured to enter into construction contracts in the short to medium term.

This answer does specifically address the variables to which particular attention should be paid in respect of the public sector. However the private sector discussion is more general and no specific variables are clearly mentioned.

Section 2

Profit recognition

The project comprises two elements. The simpler of the two is student accommodation. Bild should keep a separate record of the cost of building the accommodation and catering facilities. The revenues generated from the rental of accommodation and sale of food will be recorded on an ongoing basis. The cost of the property will be depreciated and other costs will be recognised as they are incurred.

The college itself will be potentially a little more complicated.

IAS 17 *Leases* would classify this arrangement as a finance lease. The risks and rewards associated with owning this property really lie with the government department. It would be ideal if Bild could determine the present value of the lease element of the contract. If the present value of the lease payments exceeds the construction cost then there will be a profit on the signature of the contract.

During the remainder of the contract, we will show the net investment in the lease as a current asset. As the lease payments are made, each payment will include an element of finance charge that we will recognise as income in our statement of profit or loss. This exercise will require us to determine an appropriate interest rate to apply to the future lease payments in order to determine the net investment in the lease and separate revenue from the repayment of the principal sum.

The service charge is a separate issue. IAS 18 *Revenue* sets out the treatment that we should follow. The future revenues should be fairly easy to determine, but we may have to allow for future costs. Presumably, certain costs such as non-routine refurbishment and renewals will occur from time to time. We will have to take care to ensure that we provide for any such future costs to ensure that we do not recognise excessive profit during periods when the college running costs are lower.

Challenges

The first issue will be in negotiating an acceptable price. The government will be under a certain amount of pressure to ensure that the contract demonstrates value for money, while Bild needs to ensure that all of the running costs will be recovered. Given Bild's inexperience, we may find it difficult to predict all future running costs and estimate them accurately. We have no real experience of property maintenance, which is very different from construction, and none of providing accommodation and catering services.

Bild will need to develop a host of new skills. We will need to employ staff who can manage the various support services that we are planning to offer, such as running the student accommodation. Bild may have to seek advice on the skills and qualifications required, otherwise we will employ potentially unsuitable staff.

We also have relatively little experience of employing staff at a remote location. Our site agents are about the only exception and they are professional people who need very little supervision. The local staff who will be engaged on this project will be providing a service and their behaviour may reflect badly on Bild.

Contract management may be an issue. There may be areas where our responsibilities overlap with those of the government. For example, health and safety could be a responsibility of both teaching and maintenance staff.

There could be adverse publicity from this arrangement. PFI schemes have been criticised in other countries and we may be accused of profiteering or of offering a sub-standard service.

Section 3

Balanced scorecard

The various headings will not necessarily be equally weighted.

Financial

Prosper – average payment made to each subcontractor – if Bild is paying its subcontractors well then they will prefer to do business with Bild

Customer

Customer partnership – Contracts awarded as a percentage of bids – if Bild targets subcontractors properly then fewer bids can be sought and each bidder will be motivated by having a realistic chance of success

Responsive supply – Number of new subcontractors added to preferred supplier list – if Bild has a range of potentially suitable subcontractors then there is less risk of individual subcontractors becoming overburdened with requests

Internal business

Design productivity – use of industry standard planning software – if Bild can encourage all subcontractors to use the same software packages then all parties will save time and inconvenience

Design productivity – time taken from seeking bids to starting work – if Bild can move quickly and award contracts then subcontractors will have a clearer understanding of whether they need to retain spare capacity

Learning and growth

Design partnership – extent of involvement of subcontractors in design work – if subcontractors can be more heavily involved in design work then there will be less scope for confusion and time to be wasted

Strategy

Our starting point should be to aim for win-win contracts so that both parties benefit. We appear to have lost ground to our competitors because subcontractors often prefer not to work for us when they have a choice.

It would be sensible to manage the relationship with subcontractors centrally so that Bild does not have two or more subsidiaries competing for the same subcontractor's services. Apart from damaging its credibility, Bild may be driving up the fees charged by subcontractors when they realise that Bild is struggling to find suppliers. A central office at Bild Civil Engineering could organise the process of seeking tenders so that the same subcontractor is never asked to undertake conflicting assignments.

Bild should consider more of a partnership arrangement with its subcontractors. It may be a false economy for Bild's construction managers to do all of the planning on complex projects. If the company makes greater use of the subcontractors' expertise then any additional fees paid to the subcontractor may be offset by savings from greater efficiency. The end result may be increased client satisfaction if Bild makes better use of the subcontractors' expertise.

Bild could even consider ceasing asking for bids from subcontractors. If Bild approached individual subcontractors with an offer of work then it would be possible to negotiate a mutually acceptable agreement that avoids wasting time on potentially unsuccessful bids. It is unlikely that a subcontractor would bid for work from Bild's competitors if a firm contract was on offer from Bild.

Section 4

Influence subcontractors

The most immediate approach would be to make subcontractors responsible for the safety of their own staff. Bild's contracts could make it clear that each subcontractor must compensate any employee who is injured.

It should be made clear that any breaches of site safety will be dealt with by reporting the subcontractor who is responsible to the authorities. Bild could make it clear that it will furnish investigators with any information and evidence concerning negligence or recklessness. Bild could also threaten to assist insurance companies investigating concerns about negligence, which could lead a careless subcontractor's insurance to be void.

Bild could offer subcontractors safety training at a reduced cost or even for free and support to ensure that all managers and supervisors are qualified to manage health and safety.

Bild could offer an incentive by maintaining a list of subcontractors who have good safety records. Subcontractors with poor safety records could be declared ineligible for future contracts. In extreme cases, safety breaches should be deemed grounds for the cancellation of existing contracts, without compensation.

Motivate and inspire employees

All construction workers should be required to wear appropriate safety gear such as work boots, helmets and high-visibility vests, when on site. Employees who are not fully equipped should be sent home without pay.

Bild should aim to raise awareness of safety by displaying signs and posters in recreational areas. The focus should be on the consequences of carelessness, such as death or serious injury. Stressing the risks to colleagues may help to create peer pressure if workers realise that their safety may be threatened by the recklessness of others.

Bild could reward safe operation by issuing small incentives, such as meal vouchers for use in the site canteen, to recognise and reward periods that have been accident free. This would be more about raising awareness in a positive manner than about the incentive in itself. Individuals who report safety problems should receive small cash rewards, again more in recognition than to create an economic incentive.

Driving performance

The site agent should be made personally responsible for overseeing the safety of all staff on the site. While subcontractors should remain responsible for their staff, the site agent should be required to explain why any serious accident occurred.

There should be formal accident registers so that injuries can be reported and any trends spotted. The site agent should be responsible for sending a summary to Bild Civil Engineering on a regular basis, along with a commentary on factors such as whether the accidents were avoidable.

There should be a clearly-defined threshold for reporting accidents, such as any incident that requires the attention of a first aider or the application of a dressing.

Detailed records should be maintained of preventative safety measures, such as maintaining safety guards or alarms. There should be a protocol for highlighting any routine maintenance that is overdue.

There should be regular safety audits. Inspectors could make unannounced visits to ensure that all relevant safety procedures are in evidence.