

MANAGEMENT CASE STUDY MARCH 2015 EXAM ANSWERS

Variant 3

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SECTION 1:

Planning and control issues

The most immediate issue is that this is a completely new venture for Bild. The company's experience and expertise are in construction. Bild will have to seek professional advice from someone who can advise on this area.

Planning and control will be complicated by the fact that it will be difficult to know what the norms are for this hospital because it has not been built yet. It may be possible to obtain budgets and financial records for other hospitals, but they will not necessarily be directly comparable. Those norms could also be subject to change over the ten year contract. For example, an outbreak of an infectious disease could require Bild to clean and disinfect the hospital to a far higher standard, and at a much greater cost.

The fact that this is a hospital means that Bild will have to ensure that it meets or exceeds all of its contractual obligations. For example, poor hygiene could injure patients or lead to the suspension of clinical services. Bild will need to ensure that it meets or exceeds all relevant standards in a changing environment in which it has no direct experience.

Controlling staff or even subcontractors may prove difficult because declining standards of service quality may not be obvious. It may be difficult to identify causes of poor hygiene or poor quality catering without an exhaustive investigation. Bild's reputation could be at stake because of this. The danger is that if Bild is unable to ensure that its service charges are sufficient to provide an adequate service then lower-level managers and supervisors will respond to any budget shortfalls by cutting back on service.

Deciding whether to bid

In the short term, Bild must decide whether it has sufficient capacity to prepare a credible bid document. Even if outside help is being sought, Bild's board will have to ensure that the advice is being sought from credible and reliable sources and even that may be a distraction from other matters.

The building project is worth considering on its own. Bild will be in a position to build the hospital and will, hopefully, earn a profit in doing so. The financial arrangements will, however, be less attractive because the client will not make any lump sum payment for the

work. Bild will have to fund the construction and will then recover that cost by charging an annual leasing fee. Bild will have to ensure that the financial return from what is, in effect, a long-term loan to City Health Board will be acceptable.

Bild will have to consider how this project will affect its financial position. It will almost certainly be necessary to borrow or even seek additional equity to finance the building work over the life of the arrangement. If Bild is unwilling or unable to do so then there is little point in bidding.

Bild will have to consider whether it can overcome its inexperience in managing this type of project. It could, for example, make a joint bid with a service company that could offer its expertise on the running of the hospital. Bild will have to ensure that it has the ability to actually run the hospital once it has been built.

Finally, Bild will have to consider the likelihood of winning the bid. If it is likely to be bidding against more experienced suppliers in this market then it could find itself being undercut on price because the competition will have a better understanding of their own cost structures and will be able to tolerate a slimmer margin. Even if price is not the issue, the competition could mean that the time and effort tied up in preparing the bid will be wasted because another company is likely to be the winner.

Section 2

Key accounting ratios

It is assumed that Bild Partnerships will constitute a significant part of the Bild Group, otherwise any impact on the group's accounting ratios would be minimal. That is a fairly realistic assumption because Bild will have to invest heavily in each project that Bild Partnerships undertakes and so it will almost certainly amount to a fair percentage of the group.

The return on capital employed is likely to decline significantly. That is almost inevitable because Bild's construction activities require very little in the way of assets. Bild appears to generate a significant contribution from a small asset base because most of the plant is hired or supplied by the subcontractors. A PPP arrangement would require Bild to invest heavily in property, which means that capital employed will increase in a potentially disproportionate manner even if the project is profitable. That problem may be offset to some extent by the manner in which the lease is classified. If Bild classifies the lease as a finance lease then it may deem the property to have been "sold" to the client and so it may not remain in Bild's statement of financial position as an asset. The assumptions made by Bild's analysts suggest that this will not be the case.

The ongoing provision of services will generate profits, potentially reducing the volatility in Bild's reported earnings. The construction industry may go through periods of boom and bust due to changing economic indicators. No matter what happens to the economy, Bild's PPP clients will have to honour their contracts. As public sector entities, they are effectively backed by the government and so there should be no concerns about their viability. Bild Partnerships will generate a steady revenue figure and will report earnings that are reasonable in response to that.

No matter whether Bild carries these PPP assets in its own statement of financial position, it will have to borrow heavily in order to fund them. Bild's gearing ratio will almost certainly increase.

Strategic direction

Bild would not necessarily have to stop anything that it currently does in order to become a player in PPP, but there will be some changes in emphasis, even at the strategic level.

Firstly, Bild presently has a mixture of private sector and public sector clients. It may be necessary for Bild to offer full PPP services in order to retain some, or even all, of its public sector clients. PPP is essentially a new funding mechanism for public sector entities that is becoming increasingly popular in many countries. Suppliers who do not offer PPP may find themselves struggling to win new business in the public sector. Thus, PPP is potentially necessary even in order to retain revenue streams at the strategic level.

Bild will have to take a much longer term view of its contracts. At present, the focus is on winning the building contract and then completing the construction work on time and under budget. PPP will require Bild to think ahead to the operation and management of the facility once it has been completed, perhaps for many years depending on the term of the initial contract and the likelihood of renewal. That may require Bild to consider whether it should make its own investment in projects. For example, over-specifying the build quality may reduce the long-term costs of maintenance or even of cleaning the property.

The nature of quality will change because Bild will have to be able to create a high quality building and then offer to manage its operation to a high standard. Bild will have to study the factors that determine quality in different public sector entities. For example, hygiene will always be important but acceptable standards are likely to be lower in, say, a school than in a hospital.

Bild may have to develop greater financial expertise in order to assist public sector clients. The fact that City Health Board, for example, is looking for a single supplier may suggest that it is keen to have a degree of latitude in designing contracts. It may assist with the accounting to have one supplier who could, for the sake of argument, offset an overcharge for the lease of the property against a discount on the facility charges with the overall intention of assisting with the accounting issues arising from public sector budgets. It may be that understanding such financial imperatives will become a strategic matter for all companies in the construction industry.

Section 3

Staff motivation

The employees will face a significant change in culture, moving from a public sector entity to the private sector.

It is quite common for this type of arrangement to lead to an overall reduction in staff levels. The service company that takes over the service has a clear financial incentive to reduce staffing levels to the minimum necessary to achieve an acceptable standard of service. In the short term, all staff will be unsettled by the threat of potential redundancy and that will continue until they are certain that their jobs are safe. During the interim period staff will be keen to promote their value to the organisation, which could lead to conflict between colleagues who believe that they are competing for the same job. Staff may be asked to apply for their own jobs and be faced with a sense that their past service is not being adequately taken into account.

In the longer term, staff may continue to feel that their jobs are at risk because Bild will be motivated by the desire to reduce costs and increase profit. Increasing costs elsewhere on the contract or changes that enable staffing levels to be reduced without impairing service would threaten staff.

The possibility that staff may be reemployed on poorer terms and conditions will also be demotivating. Most of these jobs will be relatively poorly paid in any case and so a decrease in pay will affect staff quite badly. Their basic living costs and also the cost of getting to and from work and paying for childcare will not be affected and so their disposable incomes will suffer. Thus, any decrease will be quite visible.

The move to the private sector will also affect the employees' sense of identification with the entity for which they work. Cleaners and catering staff may have felt a sense of pride in working directly for a school or hospital. That sense of connection to a worthwhile social endeavour will be tainted by the fact that they are now working directly for a profit-making business.

Communication

The first priority is to ensure that staff are given as much information as possible by Bild. It is almost certain that there will have to be a period of investigation and deliberation and so the first communication may be that staff will have to await an announcement concerning their futures. In that case, Bild should set itself a realistic deadline and tell staff when they can expect to be informed about Bild's plans for their jobs.

Ideally, there should be an opportunity to speak directly to staff. It may be possible to hold a meeting in a cafeteria at which a member of Bild's management can speak to the staff. Ideally, Bild should aim to provide a constant flow of information to reduce the natural tendency for employees to worry about rumours and gossip.

Bild should take care to keep the press informed about developments in the case of a high profile contract because unfounded press comment will create greater tension and uncertainty. Bild should be careful not to release information to the press until it has been announced to the employees, who will resent the fact that their futures are in the balance and they have to read about it in the newspapers.

Bild should aim to be honest in communicating with staff and to avoid patronising them. Aiming to justify reductions by the use of jargon such as "downsizing" or "rightsizing" will simply anger the people whose jobs are being lost or whose wages are being reduced. In the same vein, it may be unhelpful to tell staff who are being made redundant that their departure is for the good of the company. That will hardly be a former employee's concern.

Once matters have settled down, it may be helpful to ensure that remaining staff are given as much information as possible about future plans and about their job security.

Communication should be a two-way process. There may be scope for employees to suggest alternatives that could be viable for Bild's consideration. For example, many employees may prefer job-sharing and a reduction in hours and pay rather than redundancy and the complete loss of a job.

If candidates assumed that the Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE) apply then their answers may be modified, but the same basic concerns would arise. TUPE would not prevent the possibility of redundancies.

Section 4

Bild will have to ensure that the synergies that this arrangement creates are maximised so that both parties are encouraged to support one another. Bild can now offer proven expertise in construction and (through Servcom) in the provision of infrastructure.

This arrangement requires trust on both sides. For example, either party may wish to collaborate with other partners. Care will have to be taken not to threaten the partnership in doing so. Bild cannot be seen to use other service companies unless there is a very good reason for doing so.

Servcom may wish to work with other construction companies in addition to Bild because Bild will not necessarily win sufficient PPP contracts to create adequate growth for Servcom. That may lead to potential conflicts of interest. Servcom cannot, say, support another construction company's bid for a contract unless Bild has no interest in bidding itself.

Bild should take care to ensure that Servcom maintains its standards. If the two companies collaborate on a number of ventures then Bild's reputation will become tied up with that of Servcom and any complaints will affect both businesses.

Bild will also have to ensure that Servcom does not feel let down by poor workmanship. If Servcom struggles to maintain a property because Bild has cut corners in construction then Servcom will be put in a very difficult position with regard to reporting problems to the client and will resent being asked to cover for Bild.

The link between the two companies is strong, but not binding. Neither can take too much for granted. Bild's shareholding and seat on Servcom's board gives it influence, but that will be insufficient in itself to ensure the quality of Servcom's service.

Bild will enjoy very little of the profit from service work. It will receive 20% of the dividends paid by Servcom and so it will benefit to some extent, but it will also receive 20% of the dividends generated from other contracts that were not supplied by Bild. It may be necessary to negotiate a financial arrangement in the form of a commission so that Bild has a more direct incentive to employ Servcom.

Related party

Servcom will be an associate as defined in IAS 28 because Bild has significant influence.. Also, by definition, under IAS 24 any associate is a related party.

The fact that there is a relationship between the two parties will have to be disclosed. Even in the absence of the requirements of IAS 24, the shareholders have a right to know that there is a potentially significant relationship that may result in transactions that are not negotiated at arm's length.

The transactions between Servcom and Bild have the potential to be material if this arrangement proves successful. In the event that they are, Bild's shareholders have a right to know whether transactions with Servcom are being priced artificially. Bild will have to consider whether any commission that it receives from Servcom is set on the basis that would apply to an arm's length transaction. That may be a difficult question because such details will not generally be public knowledge and Servcom may be unable to give details about its arrangements with other construction companies as a basis for comparison because of commercial sensitivity.

Bild should disclose the amounts of any transactions with Servcom. Any outstanding balances will have to be disclosed, along with the terms and conditions related to them.

Bild will have to take care to meet its reporting obligations, which may be inconvenient if that information could also be of value to competitors.