

## **MANAGEMENT CASE STUDY MARCH 2015 EXAM ANSWERS**

### **Variant 4**

**<https://connect.cimaglobal.com/resources/management-case-study-exam/march-2015-management-level-case-study-exam---bild-variant-number-4>**

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#### **SECTION 1:**

**Evaluate the impact of the risks associated with each of the three proposed responses to the possible change in the law.**

##### **Option 1:**

Carry out speculative development now

##### **Risk:**

This would tie up cash, possibly for several years. If an end user or purchaser cannot be found, potential losses could be very large.

##### **Evaluation:**

Bild's staff should be able to assess which parcels of land are most suitable for immediate development.

##### **Option 2:**

Sell to another developer now

##### **Risk:**

Sale would be at a discount to book value showing a loss on disposal. This might not be well perceived given that Bild is expected to have expertise in this area. If another developer can make a profit by developing the land then Bild should be able to.

##### **Evaluation:**

This would depend on how great a discount on book value would be needed, and also how likely is it that a speculative development would succeed.

##### **Option 3:**

Hold the land and await any changes

##### **Risk:**

There could be significant diminution in value of the land; again this could adversely affect the market image of Bild.

##### **Evaluation:**

This option does not require any immediate investment of cash. It is possible that there will not be a change in legislation, in which case this may be the best option.

There are two main ways in which Bild could reduce the overall risk:

Firstly, they have the benefit of skilled and experienced staff who are qualified to advise on the best course of action for each parcel of land. Staff should be asked to carry out a review of the land held and make recommendations.

Secondly Bild do not have to carry out the same course of action on all parcels of land – they could, based on skill and experience, select which land should be developed now, which sold and which held for the next few years. Speculative development would tie up cash. This could be funded or part funded by the sale of some land to other developers.

### **How applicable would sensitivity analysis and scenario planning be in this situation?**

Sensitivity analysis could be appropriate, for example to measure the impact on land prices of changes in key variables. The construction industry is volatile and affected by changes in the overall economy.

But since the key issue here is a change in the law which will either happen or not, sensitivity analysis may be of limited practical use.

Scenario planning is used by organisations to support making flexible long term strategic plans. This may be a more appropriate technique here Bild could identify a number of potential scenarios and analyse their implications. Best and worst cases could be examined.

Considering the implications of these could support the choices Bild must make. Scenario planning will help to focus on areas of uncertainty and strategic alternatives.

### **Evaluate the logic of Bild holding such parcels of land, ignoring the legal issues that may arise. Does holding land form part of a sensible strategy for our company?**

There are a number of reasons why a company such as Bild holds parcels of land on a speculative basis:

Some land may be bought for strategic reasons, to prevent a competitor buying it or because Bild is buying up smaller parcels of land in order to assemble a larger site.

To a certain extent Bild's development performance depends on their ability to spot opportunities to carry out developments at a profit. An opportunistic strategy may be appropriate and may include the speculative purchase of land.

Bild has highly trained and experienced professional staff who may be able to identify land which is under-priced in the market.

Land may also be held in order to secure future workload. If Bild has land available we may be able to carry out work when we have resources available, rather than having to wait until new sites are found.

On the other hand, care should be taken that land is not bought without good reason. Holding land ties up cash although it can be used to secure borrowings. Particularly given the regional structure of Bild, managers may wish to build up land holdings in their geographical area in order to attempt to secure future workload at the expense of other areas even if this is not in the best interests of the group as a whole.

## Section 2

### **Analyses our gearing position, and the impact of the potential change, with respect to the nature of our business and its overall position.**

Many construction companies, including Constructmore our closest competitor, have minimal gearing levels but Bild has been able to support much higher than average borrowing due to the land and property held by the development and investment subsidiaries. This has enabled us to offer greater security to lenders.

The change in accounting rules will mean that we have to change our accounting policies. We will have to restate the previous year's financial statements. What was previously classified as commitment will now be disclosed as a liability.

A key factor limiting the acceptable level of gearing for a construction company is the availability of cash flow to service debt, even during downturns. Our cash flows, assets and liabilities have not changed.

### **Suggests an approach that might be taken to negotiating a change to the loan conditions with the bank so that our technical default might be overlooked.**

We will have to enter into negotiations with our bank. Bild is unlikely to be the only company affected by this change in accounting regulation and the bank may well have a policy for how to deal with the impact of the change.

Our key negotiation point is that nothing has changed. Last year the bank was happy with our level of debt. The level of risk has not changed.

We may need legal advice and need to look carefully at the terms of the covenant. Ideally we would like it reworded to exclude leases on construction equipment. After the proposed changes these will be disclosed separately in a note to the accounts so this will be an easy adjustment for the bank to monitor.

We would prefer the covenant to be reworded rather than the breach of covenant to be overlooked on this occasion. Overlooking would be fine this time but could give us a problem when we come to take out new leases to renew equipment.

If the bank tries to demand immediate repayment and seize assets we may have a strong legal case to fight this. Our assets and liabilities have not changed and the bank would not be acting reasonably if they demanded repayment because of a change in accounting policy imposed on us.

### Section 3

#### **How should we ensure that the new Corporate Compliance Department's role is properly understood?**

The new department must have a formal document setting out its powers. It must be clear that these are real powers and that their findings are acted on. The department should be able to check that its ideas are enforced. The department should be staffed properly with some senior staff members in order to highlight the importance of the new department. The Board must back this approach and be seen to support the department's findings. A chain of command should be set up so that findings are reported to the correct person who is sufficiently senior to ensure compliance.

The company could have a news board where issues such as recent large fines to companies are highlighted. There have been many cases of non-compliance where the bribery rules throughout the world have been breached. The fines have been huge and would demonstrate the importance of the issues. Highlighting these events may encourage other departments and the Board to take compliance seriously.

The new department will be located at head office but they may need to communicate with staff based in regional offices. It may be necessary to consider the most effective means of communication, including online meetings. This will be more efficient than convening meetings at head office.

Efficient communication requires the ability to deliver a clear message with brevity. Messages should be appropriately structured as this will help the recipients to understand and retain the information.

Communication of the new department's findings will not be a single, one off event. The new department should ask for, and listen to feedback. This will help prevent misunderstandings.

Compliance can be used as a performance indicator. This would help to demonstrate its importance.

Changes to rules and regulations may not seem like an interesting topic to managers and directors. The new department should explain clearly why the changes are important to ensure that the importance of their communications is recognised.

The new department should emphasise that non-compliance can result in court cases for the company. This can also damage the company's reputation.

#### **What are the change management issues associated with the creation of this new department and, on a slightly different note, how can we motivate the board to make best use of the department's output?"**

The formation of the new department will create "people issues" with new leaders created, skills and capabilities developed and jobs changed.

Change is unsettling and the leadership of the board is important. If the CEO does not appear to consider the new department to be of value to Bild, others will follow his example. In order to motivate the board to make full use of the department's output it is important that the CEO is behind it.

The business case for the new department may have to be made, with specific examples of changes to rules and regulations which have affected Bild. This may have to be communicated through the business.

Effective and efficient communication from the new department is important and will help to convince the board of their value.

In order to motivate the board to make use of the new department, it may be necessary to make it clear that its creation was not a criticism of the board's ability to keep abreast of changes. As the new department begins work the board should be able to see its value. The market is increasingly technically complex and the board may see that the new department has the necessary skill to assess challenging changes and add value to the company. There is also an argument to be made that it is more efficient for a specialist department to assess changes and communicate them to the board, rather than each director having to carry out their own independent research. This should leave the directors more time to carry out other tasks.

## Section 4

### **To what extent are Bild's published financial statements affected by estimates and what problems are likely to arise in arriving at estimates in our industry?**

Accounting estimates are made when there is no precise means of measurement. Estimates are based on judgement and specialised knowledge derived from past experience. All published financial statements include estimated figures.

Estimated figures usually include:

Provisions, such as for the outcome of legal cases. The actual cost will not be known until the case is settled.

Value of assets such as land and buildings. The actual value will be what a willing buyer would be prepared to pay. This will not be determined until the asset is sold.

Depreciation charges. These require a number of estimates including the useful life of the asset, which will not be known with certainty until the end of the life of the asset.

The financial statements of a construction and development company like Bild may be more dependent on estimates than those of companies in some other industries. Assets such as land and buildings form a major part of the balance sheet value. These are valued annually by the directors, and every five years by professional valuers. The directors have the professional skills needed to carry out the valuation, but may also be under pressure to inflate the value of the assets.

Any uncertainty regarding the value of the assets will also have an impact on the depreciation charges.

Construction revenue is also dependent on estimates, such as the degree of completion of a project. These estimates will be reviewed and confirmed by professional advisors such as quantity surveyors. Nevertheless there will be less certainty regarding the appropriate level of revenue and profit earned than in other industries where this is known with more certainty.

### **How might Bild's internal management reports used for planning and control be dependent upon estimates and should we aim to restrict reports to factual information that can be determined objectively?**

The uncertainties regarding elements of the published financial statements will also affect internal management reports. Also we will have the added difficulty of preparing forecasts.

A key risk for Bild is that we will be unable to earn revenue in future if we lack financial resources. Managing cash flow is therefore of great importance, and this requires accurate cash flow forecasts.

Forecasting cash flow for Bild Investment should be reasonably straightforward, but estimating when sales proceeds will be received for the disposal of development projects may be extremely difficult. Cash inflows and outflows for construction work will also be difficult to estimate, for example work may proceed more rapidly in good weather and slowly when the weather is poor.

If we were to restrict our management reports to factual information only it would not be possible to use cash flow forecasts.

A key control measure for construction projects is forecast cost to completion, as well as rate of progress. Again, this must be an estimate prepared by the project manager with the

assistance of appropriate professional advisors. This cannot be totally factual or objective and will depend on the judgement of Bild's staff and their advisors.

Bild can ensure that estimates are prepared by appropriately qualified and experienced staff, and that they are supported by professional advisors as needed however it would not be possible to prepare the cost control and cash flow reports needed for management without the use of estimates.