

MANAGEMENT CASE STUDY MARCH 2015 EXAM ANSWERS

Variant 5

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SECTION 1:

Part (a)

Economic climate

Future construction orders depend on the economic climate and the availability of credit for private sector expenditure. The market is very competitive and a number of companies are chasing the same contracts, causing downward pressure on prices. Although Bild can strive to remain competitive, the economic climate and availability of private sector finance are out with their control.

Reputation risk

Bild is very dependent on a good reputation in order to generate future revenue. In a competitive market clients will not select a builder with a poor reputation. Any problems with cost overruns, time overruns or poor build quality would lead to loss of future business with that client. Publicity given to such problems would also potentially lose revenue with future clients. Problems on site may not be within Bild's control.

Staffing risk

Bild is dependent on the recruitment and retention of good quality, highly motivated staff in order to generate revenue. This is linked to reputation risk, for example problems with staff motivation could lead to build quality issues, completing projects on time may require staff to work extensive overtime. A significant proportion of Bild's revenue comes from repeat business and retaining key staff who have a good relationship with clients will be important for revenue generation.

Financial facilities

Bild cannot generate future revenue unless they have sufficient financial facilities. Construction clients pay in stages but do not pay for work in advance; Bild must have the resources needed to finance work in progress. Bild Development makes a significant contribution to revenue and profit but also requires significant cash investment. Accurate cash flow forecasting is therefore necessary but may be difficult due to the complexity of the business and the level of uncertainty caused by issues outside Bild's control (e.g. weather, construction start dates, development sale dates)

Part (b)

Challenges associated with developing and implementing a management strategy

Hiring and retaining the right people

This is a challenge for the board, particularly given the cyclical nature of the construction industry. When the market is buoyant, there will be a shortage of skilled construction workers and managers. When the market is in decline, difficult decisions will have to be made about which staff to retain, and which to make redundant.

Strategic planning

The market is challenging and evolving, for example PPP opportunities may now be available to Bild. The board need to examine trends and innovations and evaluate how to differentiate themselves from competitors and how client behaviours are changing.

Succession planning

The board need to develop future managers with leadership and business skills. For example project managers may have solid technical knowledge and leadership skills, but may also need to understand the financial impact of their actions, and be able to forecast cash flows accurately. Developing and promoting the best managers will help build a culture of long term client relationships.

Organisational structure

Bild is a complex organisation. Offices are located throughout Ceeland, projects vary from small units to very large ones and the management skills needed for civil engineering, development and investment are different. The board need to build a sustainable organisation and minimise dysfunctional decision making.

Section 2

Part (a)

How can we ensure clear and effective communication between the executive and the non-executive directors?

Ensuring effective communication between exec and non-exec directors should be part of the role of the chairman. So the appointment of a strong chair, and making this part of his job description, should help.

It will be difficult for the non-execs to communicate effectively with executive directors if we do not have an induction program for executive and non-executive directors alike.

When the non-executive directors are appointed it should be clear what time commitment they are expected to give.

By ensuring the right people are appointed as non-executive directors who have useful experience, communication should be straightforward. By having diversity on the Board with the right mix of skills and experience this will facilitate good communication.

It is very important that all directors are given adequate information on Board proposals in a timely manner and of good quality. This is also part of the Chairman's role to ensure an agenda and information are communicated to the executive and non-executive directors. This is not simply a matter of making sure that reports are circulated in advance of board meetings. The information should be clear to all directors whatever their skills and expertise. The board needs information analysed in an insightful manner if it is to communicate effectively. The crucial relationship is that between the specialist directors, such as finance director, marketing director, chief executive and chairman. The finance director's duty is to give the board their own best judgement of Bild's financial position, but also to ensure that the financial information presented to the board has an appropriate level of detail and is understandable to directors who do not have an accounting qualification. This would apply to all discussions in any discipline: marketing, strategy, HR etc. This should help to facilitate the clarity and effectiveness of communication between directors.

Part (b)

There is a danger that executive directors see the role of non-executives as a "box ticking" exercise. A balanced board is a requirement but they may see no genuine benefit from the presence of non-execs. Since the training exercise for non-executives was a success, it may be worth carrying out similar training for executive directors so that they can better understand the role and benefits of the non-execs. This training could emphasise the benefits of the expertise that non-execs bring to Bild. It could be carried out regularly, perhaps annually, to ensure that directors are aware of the changing roles.

An induction package should be an essential part of the introduction of all new directors to the company. The Company Secretary or other senior officer should discuss many of the duties that the directors will be expected to perform, introduce them to all the people they will be working with and answer any questions the new director has.

In order to motivate the exec directors it may also be necessary for them to see for themselves the benefit of the non-execs. Telling them that there are benefits may not be enough. The improvements in communication set out above should assist – if the directors are communicating effectively the benefits of the non-execs should be readily apparent. Again, it is important that the non-execs have credibility with the exec directors, and therefore recruitment of individuals with appropriate experience, good business judgement and integrity is vital.

The non-execs themselves also have some responsibility here, as part of their role is to challenge the executive board and perhaps present views which are not held by the majority

of board members. Tact and diplomacy are important attributes for a non-exec. Again, the role of the chairman is important here; at the end of the day the board is just a committee and the chair has a responsibility to ensure that meetings are effective.

Section 3

Part (a)

The most obvious solution is to set transfer prices below the prices charged by third parties. However, while this may encourage divisional managers to borrow from other divisions, it is unlikely to be sufficient to solve the problem.

Equipment hire prices are likely to fluctuate considerably. They are also likely to vary widely from location to location. If there is little construction activity in a given area on a particular week, it is likely that any equipment required could be borrowed cheaply. It would therefore be necessary to either re-set transfer prices very frequently, or to require divisions to undercut any hire quote received from outwith the Bild group. The process of obtaining an external hire quotation, and then asking for an internal bid against it, could be too cumbersome.

It might be possible to set transfer prices very low, so as to just cover any incremental costs incurred by the lender. This would encourage managers to borrow internally but might make them less willing to lend. The incremental costs arising from hiring are likely to be low.

One way to encourage divisional managers to borrow equipment in house would be to make this part of a balanced scorecard appraisal.

Another method might be to make internal hire very easy. An internal database could be set up showing what surplus equipment is held at each location, making it a straightforward exercise for managers to find what they need.

Part (b)

It is worth noting that Bild will tend to hire large items of plant for prolonged periods. That means that the cost of each hire contract will be potentially substantial and so it would be worth investing time and effort in its control.

Bild Civil Engineering should establish a plant hire department that authorises all hire contracts costing more than, say, \$10,000. The department should be staffed by people with some understanding of the construction industry, so that they can understand the role of each item of equipment being hired.

Every request for authorisation should be accompanied by a document that identifies the contract, the location of the site and the nature of the work that must be undertaken. The plant hire department should be responsible for placing any orders for hire so that the regional subsidiaries do not simply hire from third parties as a matter of course.

The plant hire department should first check whether the item requested is in Bild's asset register. The asset register should contain a data field that makes it possible to search for, say, earth moving equipment. The asset register should indicate the location of the equipment and whether it is available for use or whether it is required for another contract. These would be further fields that would not normally be found on a typical asset register.

In deciding whether to use an asset belonging to a fellow division, the plant hire department should take account of the cost of transporting the asset to and from the site.

The plant hire department should estimate the cost of hiring the equipment commercially and should process an internal charge that is based on this market price whenever an asset is to be hired from a fellow division. That should ensure that both companies are willing to accept this arrangement because the owner is receiving a commercial rate and the hirer is not paying any more than would have been charged by a third party.

The plant hire department should also be analysing external hires to determine whether there are any assets that should be bought outright rather than hiring them. Having a central

record of hires will alert the company to the fact that certain items of equipment are hired so frequently that it would be cheaper to buy them instead.

Section 4

Part (a)

This scheme is unlikely to be successful.

Tax rates vary globally, and Ceeland's rate of 35% is relatively high. Many schemes exist where international companies seek to establish subsidiaries in the most advantageous tax locations. For example Starbucks sources its coffee from a wholesale trading subsidiary based in Switzerland which has a 12% tax rate on trading profits.

But Bild is not an international corporate; all its activities are based in Ceeland. Starbucks can argue that it makes economic sense to have one specialist coffee buying team to supply all Starbucks branches, wherever they are located in the world.. Bild cannot make a similar case for overseas sourcing of construction materials.

For the scheme to be successful, Bild procurement would have to buy construction materials at market prices and then sell them on to Bild at an inflated transfer price. This would lead to profits being located in Bild Procurement's low tax jurisdiction country.

The Ceeland tax authorities will challenge the arrangement unless Bild can demonstrate that the price paid to Bild Procurement is a fair market price. Indeed, with a tax rate of 35% the Ceeland tax authorities are likely to have considerable experience of investigating international tax avoidance schemes. Prices of construction materials are easily established and although Bild Procurement could probably justify an administration charge on top of market price, this is not going to be sufficient to shift profits to a lower tax jurisdiction. The promoters of the scheme are offering to have materials delivered to sites with no delay. The materials will therefore be sourced in Ceeland This, combined with the fact that Bild will pay prices set in \$, and not have a physical office, or staff based overseas, will make it impossible to argue that this is not an artificial transaction designed purely to avoid tax.

Part (b)

Bild is under pressure to cut costs in order to remain competitive. Tax paid is one of those costs. Reducing the effective tax rate should, in theory, make Bild more competitive.

There is, however, the danger of reputational damage from this move. This may not affect Bild's entire client base; some clients may wish to source construction as cheaply as possible and not be interested in the tax arrangements of the builder.

On the other hand, Bild also does business with the public sector in Ceeland. For example there may be new PPP opportunities for Bild to carry out work in partnership with the Ceeland Government. It is less likely that the government would be willing to enter into a partnership with a company which is deliberately setting out to exploit tax loopholes in order to avoid paying tax in Ceeland.

Other companies have suffered reputational damage and loss of revenue when such arrangements have been made public. For example in the UK, Starbucks and Amazon have been subject to extensive detrimental publicity. The construction industry in Ceeland is highly competitive and Bild is the third largest participant. It is therefore likely that Bild's competitors would quickly notice this action by Bild and would act to ensure that it was well-publicised.

If, as seems likely, the attempt to reduce tax in this way were to prove unsuccessful, Bild would face both a failed tax avoidance scheme (with associated costs) and negative publicity.