MANAGEMENT CASE STUDY FEBRUARY 2018 EXAM ANSWERS

Variant 1

The February 2018 exam can be viewed at

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SECTION 1

BSC

The purpose of a balanced scorecard is to present a balanced view of performance, measured in terms of a variety of relevant performance measures. The criteria that have been selected are intended to offer a greater depth of understanding than a single criterion ever could. Reducing the scorecard to a simple pass/fail distinction on the basis of each criterion suggests that they are paying insufficient attention to FOSSC's overall performance.

One of the reasons for introducing a balanced scorecard is to reduce the risk of dysfunctional behaviour. The danger with skimming through the report and checking for red flags is managers may simply aim to exceed the 50% threshold set by FOSSC in order to avoid criticism. For example, appointments could be biased towards graduates, even if that means making dysfunctional appointments for the sake of numbers.

A naïve reading of the scorecard ignores the possibility that some of the responses could require urgent action. For example, the head of payroll has not yet submitted a detailed training plan. FOSSC has only five Sections and so the fact that one section is in breach could mean that there is a serious gap in the planning of training needs. The senior management team needs to comment

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on the late completion of this plan, even if it is merely to ensure that it is viewed as a priority to put this failure right.
One function of a balanced scorecard is to measure progress towards a mission or vision. If the scorecard reports are consistently positive then that may mean that FOSSC is getting close to its initial targets. Arguably, that is something that senior management ought to reflect upon because it may be desirable to set fresh targets if only to avoid boredom and complacency.

Role culture
There may be some evidence of HR's argument in the comments section of the balanced scorecard. For example, the lack of a training plan because of the recent appointment of a new head of section implies that the head of section was the only person capable of preparing this document. It should have been possible for other members of the payroll section's supervisory team to have drafted a training plan. The fact that this important task is viewed as the sole responsibility of the head of section confirms that there is a role culture. The fact that disagreement between section heads can lead to a stalemate in agreeing training needs is a further sign of a role culture rather than a task culture, otherwise some basis for progress would have been found or imposed. It could be argued that there is a need to focus on both the role and the task because neither can be considered in isolation. Each employee must be aware of his or her responsibilities and that will be set out in his or her contract of employment and job description. It will be confusing and demotivating to expect employees to accept responsibility for ensuring that every task is properly discharged because responsibilities will be unduly open-ended. Furthermore, there could be duplication of effort if more than one person attempts to resolve any given issue that arises.

The nature of FOSSC's role makes the need to ensure that all tasks are completed efficiently and effectively even more important. The operating units rely on FOSSC for support, but they may not be fully aware of progress in meeting targets or in dealing with anomalies. There could be serious disruption if the staff at FOSSC do not have an overview of the effective completion of each task because the focus is on individual performance and discharge of personal responsibilities. All staff at FOSSC need to have sufficient understanding of the service centre's role to at least understand any problems and report them to their supervisors so that action can be taken.

Section 2

Emergent approach
FOSSC's mission and basic strategy have been very clearly articulated. The only real strategic decisions that must be taken relate to the implementation in the form of identifying non-core activities that could be undertaken on behalf of operating units. The possibilities associated with offering new services will be affected by developments such as advances in technology and economic changes. For example, there provision of legal services may only have emerged as a possibility because of advances in communications that make it possible to draft and share contracts and also the availability of suitably qualified staff who can facilitate this service. It is undoubtedly possible to catalogue the various activities undertaken by Nortan Group operating units, but the realisation that one or more of those non-core activities might be offered by FOSSC will be a matter of responding to opportunities that arise.
Arguably, it could be more efficient to implement FOSSC's basic mission through a more coherent and deliberate strategy. There could, for example, be synergies associated with establishing more than one new service section at once because facilities might be shared and there could be economies of scale in, say, staff recruitment. It might be possible to do so by developing a list of the functions that are presently carried out by operating units and developing a checklist of the factors that will have to be aligned in order to make it possible to relocate them to a service centre. FOSSC could then track and study the projected availability of the resources required for each task so that a broad timetable might be developed.

It could be argued that an emergent strategy avoids the motivational issues associated with the planned relocation and centralisation of services. Nortan could lose staff if it develops a programme for the expansion of FOSSC, with associated job losses at the operating units. Knowing that a particular function will be relocated in the foreseeable future will encourage staff from that background to leave and will also make it difficult to employ well-qualified replacements. Furthermore, the emergent strategy avoids the difficult task of identifying in advance what technologies and other changes will be necessary to facilitate relocation.

Re-engineering

The most immediate challenge would arise from the diversity of the contracts that the members of the Nortan Group must complete. Nortan is a global group and there are many different legal systems around the world. Each contract will also have to allow for the nature of the agreement that is being negotiated.
A further challenge is that any corporation's contracts must be legally binding, but that is particularly true for Nortan. The actions of an oil company may be open to challenge and dispute, with many stakeholders who may wish to challenge the company's actions. The process must incorporate a thorough review to reflect the legal and commercial environments in which the contract will be enforced.

Re-engineering contracts may encourage a rethink of the approach to drafting contracts and the manner in which they will be enforced. For example, it would be possible to ask all parties to agree that every contract is to be enforced under Centarian law, which would undoubtedly benefit Nortan in many ways. The more standard terms that are introduced, the easier it will be to simplify negotiations on the basis that certain clauses are standard and must be included if an agreement is to be reached.

Re-engineering might also prompt a rethink of Nortan's approach to doing business. For example, supplier contracts may not allow for the latest legal precedents or the manner in which business is conducted in the oil industry. Developing a more efficient approach to negotiating and drafting contracts should, hopefully, prompt the development of better contracts that simplify the conduct of business.

Section 3

Technical and ethical issues

From a technical point of view, the basic question is whether the professional staff employed at FOSSC will have sufficient specific knowledge of each separate subsidiary to prepare a set of financial statements properly. For example, the estimated useful lives of plant and equipment could be affected by local climates and their estimated useful lives could be affected by local legal systems. That could lead to financial statements being prepared on the basis of estimates and assumptions that are potentially misleading.

The technical issues could be further complicated by a failure to understand the oil industry and its operations as a whole. Presumably, FOSSC will establish this new section at a single location and will recruit accountants locally. That could lead to the financial statements being prepared by qualified accountants who do not fully understand the business practices that could affect, say, the recognition of revenues or the capitalisation of costs.

From an ethical perspective, the financial statements of the separate subsidiaries will be prepared by accountants who are essentially independent of the management teams. The boards of the subsidiaries will not have the same ability to pressurise the accountants preparing their financial statements to indulge in creative or aggressive accounting. That should give Nortan's Board greater confidence in the consolidated financial statements that they prepare for the Group as a whole.

Conversely, centralising financial reporting could greater a greater pressure on Nortan's Board to manipulate the overall impression created by the Group financial statements. At present, the separate group members will prepare their own financial statements independently of the parent's board. These will be prepared in accordance with IFRS and also Nortan's specific accounting policies, but the parent will have limited scope for manipulating them. If the financial statements are drafted and consolidated by FOSSC then there could be greater scope for the Board to revisit the underlying financial statements with a view to enhancing the reported results.

Problems

The cash flows associated with this new venture will be difficult to predict with any certainty. First of all, the operating units will not necessarily release all of the accountants who were previously responsible for financial reporting. They may claim that they have other responsibilities and that the preparation of financial statements is a very small part of their overall duties. That could mean that there is an unexpected increase in Nortan's head count. It may also prove more difficult and expensive than expected to recruit the significant number of accountants who will be required to fill the newly-created jobs at FOSSC.

It will be necessary to create a suitable work space for this new Section, which may have to be equipped differently to FOSSC's existing Sections. It may be necessary to provide a more flexible workspace to allow meetings of teams and

workgroups. The Section may also require a very specific IT provision. These features may be difficult to cost.

The most immediate project management issues will be the need to manage the changeover from the existing system to the new one. Nortan will have to take great care to avoid disruption the process of publishing the financial statements because shareholders and lenders will expect the statements to be ready on time. It may be possible to schedule the switch to coincide with the preparation of the next set of financial statements, but that could lead to an unwelcome delay in implementation.

The project will also require a number of variables to be articulated. For example, the newly appointed professional staff will require a place to work. It may be difficult to appreciate their need of training until they are appointed and their knowledge can be evaluated. Ideally, there will be a formal handover from the outgoing staff to the new, but that might require complicated logistics in terms of timing and location.

Section 4

Accounting differences

The accounting choices are clearly significant because the profit for the year is more than W$200m higher when prepared by the subsidiary than when prepared by FOSSC, a difference of more than 40% of FOSSC's profit figure. FOSSC's cost of sales is significantly greater, presumably because of the recognition of provisions that the subsidiary board would not have recognised. FOSSC's recognition of the lease also means that cost of sales and finance charges are affected.

The statement of financial position is also affected by FOSSC's recognition of the two matters. Property, plant and equipment and non-current liabilities are both affected by the lease and current liabilities by the provision. The overall effect will be to reduce the subsidiaries return on equity and also return on capital employed. That could be a matter of some concern for the members of the subsidiary board because they may fear appearing to be rather less effective when evaluated on the basis of FOSSC's figures.

The subsidiary's gearing ratio will also be much higher under FOSSC's regime. It could be argued that there will be little impact on the subsidiary itself because its position as a member of the Nortan Group means that potential lenders will generally seek guarantees from the parent company. It is debatable whether the impact on gearing will make any difference to the management of the subsidiary, although the board may feel that it will undermine their credibility in the group, especially as the liability will be added to those in the consolidated financial statements.

The impact on payables is significant in terms of the percentage increase in current liabilities, but it would appear that the subsidiary will have a healthy current ratio in either case. Again, the subsidiary's position as a member of a large group will limit the impact of the recognition in terms of any dealings with stakeholders. There could be an issue, though, because of the position in the consolidated financial statements because the group does not appear to be particularly liquid according to last year's financial statements and adding W$52m of provisions to the group accounting will not be beneficial.

Accounting issues

Should investment centres prepare their own annual accounts?

If a subsidiary company is permitted to operate as an investment centre then the subsidiary board will be very conscious of the need to appear effective. Presumably, the subsidiary directors will be keen to report strong performance, particularly in terms of return on equity, in order to secure their jobs and be considered for promotion within the group. That raises a clear danger that their actions will be misrepresented through creative accounting or other manipulation through accounting choices or accounting estimates.

There is a counter-argument that such concerns will be addressed through the supervision by the parent company and also the scrutiny by the external

auditors. The parent has access to the subsidiary bookkeeping records and can study accounts that contain ‘high risk’ entries, such as lease payments or other costs that can be misclassified, such as debits to property, plant and equipment at cost. The external auditor will also review the basis on which the financial statements have been prepared.

Should Nortan revert?

There could be an argument that FOSSC has prepared the financial statements in a more independent and so in a more representative manner. Doing so has led to figures that are, arguably, a less attractive reflection of the subsidiary. We should, however, investigate further to determine whether FOSSC’s figures are truly a better application of the accounting rules. It may be that the accountants at FOSSC have simply been more cautious because they have nothing to lose if they understate profits and nothing to gain if they overstate.

Nortan’s Board should also consider the motivational issues of restricting subsidiaries’ ability to prepare financial statements. Insisting that we report a weaker set of figures could demotivate the subsidiary board and could deter responsible risk taking. Managers may become less inclined to use their discretion if they cannot protect their reputations though accounting choices that enhance the impression created by their annual report.