MANAGEMENT CASE STUDY FEBRUARY 2018 EXAM ANSWERS

Variant 3

The February 2018 exam can be viewed at

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Section 1

Dashboard

The most obvious impact is that operating units will see where their performance is ranked in comparison with the other entities in the Group. That might encourage managers to improve performance if they are below average. The knowledge that this information is being tracked and compared will encourage all managers to maintain or enhance their performance. Providing operating units with feedback could enable their managers to understand that there is a problem, in the hope that they can then do something about it. There is a danger that this feedback could ignore structural differences between operating units that would make it difficult to impose an effective benchmark. For example, if Region A is largely focussed on oil exploration then it may have to make purchases from a wider range of suppliers, many of whom will be supplying Nortan for the first time, and delays may be more likely. If we ignore such differences then the operating unit managers may be demotivated by the reports.

Operating unit managers may not be as motivated as Patience hopes because they may not care that their transactions cause the Purchase Section a little more inconvenience. The rankings are unlikely to attract any real attention unless they are backed by some form of encouragement or incentive. It may be possible to link the internal charge for processing invoices to the performance in the rankings.

It may not be wholly desirable for Patience to motivate management teams in this way. As things stand, the system is capable of processing purchases reasonably quickly and accurately. Giving every manager an incentive to focus more on processing purchase invoices may prove a distraction from the core business activities. There should be clear targets for the speed and accuracy of processing, but these should be consistent with Nortan's business model. FOSSC is supposed to be a partner that adds value by freeing operating units from such distractions and it may be in Nortan's best interests to permit things to carry on as at present

Cultural differences

Each operating unit will have at least two major sources of influence on its culture. The first is the national culture associated with the unit's location and the second will be the fact that it belongs to Nortan, which will have its own corporate culture. It would be unrealistic to expect employees to identify only with Nortan's corporate culture, with no regard for their own national cultures. Patience may have a point about national cultures having a role to play in establishing norms for factors such as attitudes toward authority or loyalty and those may have an impact on performance. It is certainly realistic to expect that national culture could influence the value that employees will place to submitting transactions on time and free from errors.

The danger in accepting that national culture should be a contributory factor to performance is that Nortan has a duty to manage the performance of its staff. Nortan's management has a right to expect all employees to conform to the company's culture provided they are not being asked to do anything that would be regarded as illegal or distasteful in their local community. Nortan's Board has a right to establish performance targets that apply to all operating units and those should be respected and adhered to regardless of national culture. National culture cannot be allowed to dictate, say, the need to check an invoice properly before submitting it to FOSSC.

Nortan's Board should set performance standards for the Group regardless of national cultures, but some allowance should be made for the manner in which those standards will be received and acted upon. It could, for example, be potentially demotivating to present targets in a manner that implies that Nortan does not respect its employees and their cultural norms. Staff could resent any implication that Nortan's values, which are likely to be tied to those of its home country, are the only ones that matter. Conversely, Nortan should also be wary of creating undue pressure for staff at operating units in countries that have a strong respect for authority in case they are put under undue pressure by the internalisation of demanding targets.

Section 2

Provisions

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* sets out three criteria for the recognition of provisions, including the fact that it is probable that there will be an outflow to settle an obligation and that the obligation can be estimated reliably. Both of these criteria require considerable judgement on the part of the preparer. Any two decision makers are likely to disagree over the interpretation of the word 'probable' and there is scope for disagreement over the evaluation of the reliability of an estimate. Each subsidiary will have its own accounts preparation team and that will undoubtedly lead to more optimistic accountants deciding that a potential provision should not be recognised, while more pessimistic colleagues may provide for a different obligation that is actually less likely to occur.

There is an associated problem arising from attitudes towards financial reporting. If a subsidiary is having a difficult year then its management team may be reluctant to recognise provisions in order to inflate profits. The fact that the circumstances leading to the need for a provision will not always be apparent to head office means that it may be difficult to discover this behaviour. It could even be difficult to penalise such behaviour because the subsequent need to recognise a liability after the year end has passed does not mean that the accounts were prepared incorrectly at the time.

The impact of the differences in judgement are likely to cancel to a large extent. Nortan is a huge group, with many subsidiaries. If some are a little too optimistic in their judgements while others are pessimistic then the 'average' will hopefully leave a realistic total for all provisions. Any error will lead to the misstatement of profit, with the direction of error being dependent on the overall deviation from the truth.

Creative accounting is more of a concern because it is likely to lead to the understatement of provisions and so there will be very little scope for compensation. That will lead to a net exclusion of provisions, which will lead to an overstatement of profits and also of net assets. The extent of that concern will depend on the number of subsidiaries who engage in that behaviour. There may also be a slight offset from subsidiaries that wish to smooth out profit trends by overstating provisions in good years in order to keep a steady increase.

Sensitivity

A standardised set of assumptions would eliminate the scope for subjectivity and also for the deliberate distortion of estimates and assumptions. At present, there is scope for otherwise identical projects to be evaluated differently because of differences in the attitudes of the management teams proposing them. There could be genuine differences of opinion about the economic and commercial inputs into project appraisals and that could lead to inconsistent

judgements by Nortan's Board over key projects proposed by different management teams.. There could also be dysfunctional elements associated with capital budgeting, if a manager does not have sufficient "strong" NPV projects to use up an annual budget then it may be tempting to take a less rigorous approach to sensitivity analysis.
The danger is that any sense of consistency could prove misleading because different projects will have different risk characteristics and so simply imposing a range of assumptions across the group will do nothing to enable Nortan's Board to make better decisions. Some variables may be far more volatile than the 5-10% variation suggested by operating units and others may be far less. Standardising assumptions costs Nortan the ability to tap the knowledge and experience of managers, who know their businesses and markets and can make informed judgements.

The suggested approach could be adapted and made more effective by offering operating unit managers more relevant assumptions to be used to "stress-test" their project appraisals. For example, Nortan's Board could ask for revised figures assuming, say, a 1% rise in interest rates or a 3% decrease in the market price for a barrel of oil. The operating unit's economists and other managers would have to estimate the implications of such a change and report the results. That would give Nortan's Board a much better insight into sensitivity, particularly because the inputs could be modified to ensure that they remain relevant.

An alternative approach to stating inputs into the sensitivity model would be to request reports on each project's sensitivity to key variables. For example, by how much would annual revenues have to decline for the NPV to reach zero? That would then permit Nortan's Board to consider the likelihood of different scenarios and so evaluate the risks for themselves, with far less scope for distortion by operating unit managers. There would also be far greater consistency in reporting because each management team will be working backwards to determine an estimate based on basic algebra .

Section 3

Re-engineering

The first step would be to avoid the loop from the originating operating unit to Nortan Head Office, which simply wastes time and effort. It may be possible to redesign the project appraisal document so that gaps and inconsistencies are more obvious. Doing so would also make the document more effective because there would be less of a temptation for operating unit staff to leave gaps rather than including information that might reduce the likelihood of the project being accepted.

It might enhance overall performance if the FOSSC Project Section became involved at an earlier stage, possibly assisting the operating unit in the creation of the appraisal. The Project Section would then be more familiar with the purpose of the project from the outset, which would improve the quality of the service that it could provide. It would also mean that the Project Section was more aware of ideas and proposals being originated across the Group, which could lead to ideas being shared.

The implementation phase appears to involve the Project Section in a reactive role, with updates being supplied by the operating unit. It may be possible for the project section to offer a greater degree of support, with designated project management specialists providing input on implementation and measuring progress. These specialists may be better equipped to identify problems that require intervention at an earlier stage. This would improve both communication and the efficiency of implementation.

The post-implementation audit will undoubtedly add value, but it seems to be the first time that FOSSC's Project Section conducts a detailed investigation of implementation. This reinforces the suggestion that the input should come during implementation rather than afterwards. That would mean that the post-implementation audit could be carried out with a light touch, pulling out broader issues identified during implementation.

Nortan Group mission

Any re-engineering exercise is consistent with the idea of reducing costs or enhancing revenues, which supports the idea of delivering shareholder value. Re-engineering is about looking at processes with a view to making them more efficient, so improving future cash flows. It implies an attitude that there should be a purpose to any activity and that the costs and benefits associated with that activity should be kept under review in order to work towards progress.

Focussing the Project Section more on improving oversight of project appraisal and implementation should increase the likelihood that Nortan invests consistently in positive NPV projects. Re-engineering the process of developing investment opportunities will deliver additional wealth to the shareholders and will reduce the risk of losses due to negative NPV. Over time, that greater consistency will be noticeable and perceptions of risk will diminish.

In considering this mission, the Project Section should be aware of the nature of the industry. An oil company will make large investments that are almost routine in nature. For example, exploring for oil involves making risky investments in a succession of projects, some of which will strike oil and some of which will not. Such “routine” projects may be best left to geologists and other specialists in the relevant operating units rather than interfering from the centre.

Care will also have to be taken in setting a balance between the objectives set out in the mission statement. It is, for example, difficult for an oil company to act in a wholly sustainable manner because oil is a finite resource. Any oil-related activity is also likely to create externalities and the risk of an environmental catastrophe. It may be that re-engineering the Project Section to take greater responsibility for those factors will lead to greater consistency in making trade-offs between shareholder wealth and environmental responsibility and sustainability.

Section 4

Share price

The share price is a function of future cash flows associated with holding shares. For example, the dividend growth model suggests that the share price can be measured in terms of expectations of future dividends. If the directors assume that the expanded Project Section will enable Nortan's dividends to grow more rapidly, then the share price should increase to reflect that prospective growth. If that assumption is logical and is shared by the capital markets then the share price ought to increase, despite the additional running costs and any cash tied up in the expansion.

The shareholders may not share the Board's optimism and so the share price rise may not materialise. First of all, Nortan cannot offer full details of its expectations because that could prove damaging for the Group. Competitors would be interested in any disclosures that enable them to predict the investments that Nortan plans to make and so the shareholders will generally be far less informed than the directors. The shareholders may also disagree with the directors' enthusiasm for any given project. Company directors may invest in order to appear active or to generate short-term publicity.

In theory the right issue will affect the share price in a very predictable manner. It effectively dilutes the share price in a manner that is clearly stated and understood. Rights issues will only succeed if the issue price is lower than the existing market price. The shareholders would not be prepared to pay more than the present market price to buy new shares from the company. The dilution effect will, therefore, involve a decrease to a point that is between the current price and the rights price, with the extent of the decrease determined by the relative weightings of the existing shares to the new.

In Nortan's case, the details of the rights issue have not yet been announced, which creates a degree of uncertainty. The market knows that the shares will be diluted, but it is unclear by how much. That suggests that the share price will decrease to reflect the market's best guess as to how the rights issue will be structured. The fall may be offset by the impact on any expected NPV associated with the new funds. If the proceeds of the rights issue are to be invested wisely then all shareholders will benefit and that will add upward pressure to the share price.

Authority

FOSSC's project managers will require sufficient authority to protect Nortan against any losses that they can foresee. At the very least, that must mean that their authorisation must be obtained before any project can proceed. While that is a rather negative approach, the Project Section does not initiate projects and so its only role in selection could be to reject unacceptable proposals. In the same vein, the Project Section may have the authority to recommend that failing projects be suspended so that no further sums are invested in them.

If the Projects Section is to be effective then it should have the authority to speak on behalf of the Board, so that operating unit managers take it seriously. If that seems excessive then managers who are concerned that a key project is being delayed or cancelled can always communicate with the Board. Ideally, any such disagreements should be settled through a discussion between the Project Section and the managers, with no need to exercise authority.

The operating units appear to be structured as investment centres, if only because they initiate their own project appraisals. The operating units should, therefore, be evaluated on some basis that recognises their ability to generate returns from investments, such as return on capital employed. It might be argued that the Project Section constrains their choice of projects, but these managers should still be evaluated on the basis of their ability to identify sound investments.

The fact that the operating units cannot invest in every project that they wish to does not mean that they are being hampered. If anything, their performance should be improved by the Project Section. They are less able to invest in weak projects that will offer a poor return and so the ones that are given authorisation should be capable of offering good returns. In any case, if the tension between operating units and the Project Section means that operating units are under greater pressure to find good projects then overall performance ought to improve.