# MANAGEMENT CASE STUDY FEBRUARY 2018 EXAM ANSWERS

## Variant 5

### The February 2018 exam can be viewed at

https://connect.cimaglobal.com/resources/february-2018-management-case-study-exam-variant-number-5

***These answers have been provided by CIMA for information purposes only. The answers created are indicative of a response that could be given by a good candidate. They are not to be considered exhaustive, and other appropriate relevant responses would receive credit.***

***CIMA will not accept challenges to these answers on the basis of academic judgement.***

## Section 1

### Presenting change

Presenting the creation of the new HR Section as a source of competitive advantage would require Nortan's Board to be aware of any concerns raised by operating unit managers so that those concerns can be addressed in a sensitive manner. Such an acknowledgement will help to address the immediate sense of uncertainty associated with this change. The Board should make a point of requesting feedback from the operating unit managers on this proposal, if only so that they can take those into account in planning the change.

In terms of adding value, the operating units should be reminded that the new Section will free their managers from responsibility for the non-core activity of HR. Many of the responsibilities associated with HR are potentially time consuming and may be a distraction from the often go unrecognised and so managers may be encouraged by this development. Care will have to be taken to avoid patronising managers while making such remarks because they are also relinquishing some control.

It may be possible to use the efficiencies from centralising HR to free additional resources for operating units to apply to value creating activities. Some of the posts that were formerly occupied by HR staff within operating units might be left, but designated for some other purpose such as sales or some other function. Managers will perceive greater scope for adding value if there is a concession that could have a more direct impact on revenue generation. There will also have to be a clear plan for implementation because any disruption during the implementation phase would eliminate at least some of the gains being created and would undermine confidence in the new HR Section. Ongoing cases, such as staff appointments that are still in progress, will have to be concluded. Ideally, there will be a gradual closure of the local HR departments with sufficient staff left in place to handle ongoing commitments.

**Difficulties**

The most immediate difficulty with devising performance measures evaluating HR is that the function has several different objectives that could be in conflict. For example, the department is responsible for dealing with disciplinary matters, but an effective HR department might ensure that staff are managed in such a way that disciplinary action is unnecessary. There could be even more subtle issues arising from factors such as managing staff turnover. A satisfied and motivated workforce might have a low turnover rate, but that could lead to problems with limited opportunities for promotion or for recruiting fresh talent. Another difficulty is that Nortan is a global company and performance indicators could be affected by local factors. For example, a strong local economy may mean that it is difficult to retain employees because other companies are prepared to make attractive offers to recruit them. The converse is also true because HR could be credited with creating a settled workforce simply because there is little or no local competition for staff.

Measuring the effective performance of HR is complicated by the fact that there are confounding factors. For example, the management and supervision at operating units will have a more immediate impact on staff morale than the activities of HR. If problems are concealed from HR then it will be difficult to determine exactly how much responsibility HR bears.

Measurement will be further complicated by timing issues. For example, it may not become apparent that staff morale is poor until employees leave, by which time it is too late. Similarly, it may be difficult to tell whether a good choice was made in recruiting a new member of staff until they are in post and have signed contracts of employment. It may be difficult to evaluate HR’s performance in a relevant way that enables corrective action to be taken in good time.

## Section 2

### Negotiating strategy

A successful negotiation requires both sides to reach an agreement that both deem acceptable. That suggests that the first step would be for Nortan to be clear about both its own interests and those of the Dolrovian Government. Ideally, Nortan should identify a range of outcomes that have the potential to satisfy both sides, with a clear understanding of which would favour Nortan and which the government. The most effective strategy would then be to work towards an outcome that both sides would deem fair. Apart from the fact that both sides must benefit in order to reach an agreement, an unfair outcome will breed resentment and may threaten the stability of the ongoing relationship. It will also put the Dolrovian Government in a difficult political position.

Nortan has two main bargaining points in its favour. The first is that needs to create many data entry jobs and a much smaller number of managerial jobs for HR specialists. It would be possible to locate the IT centre and poorly paid jobs in Dolrovia and have the other jobs elsewhere. Nortan can apply subtle pressure by asking for concessions on the basis that the more support that is offered, the more jobs will be located in Dolrovia. The second point is the question of location if it does establish itself in Dolrovia. Presumably, it would be free to rent or buy any property on the market or even to custom-build a suitable building. Agreeing to buy the Dolrovian Government's building will undoubtedly benefit the Government politically because overspending on government contracts tends to attract a great deal of criticism from voters. Nortan might use this possibility as another way to extract concessions. Nortan should also consider its needs from the Government. The first is the opportunity to establish itself in the country without excessive government or regulatory interference. Countries can vary in terms of the extent to which they are open to foreign investment and Nortan should seek specific assurances that it will not face any discouragement from any branch of government. The second factor is money. It may be possible to negotiate grants or subsidies from the government in return for the creation of the jobs. Care should be taken not to be too greedy, though, because companies are often criticised for seeking unfair advantages from the host countries in which they do business.

### Risks and running costs

There are some obvious economic factors, most notably the exchange rate between the C$ and the D$. Depending on where the hardware and software were purchased, the depreciation and amortisation may be fixed in terms of C$ and may not change, but the other costs are potentially volatile. All of the costs listed, apart from depreciation and amortisation will require reimbursement from the Nortan Group and so any strengthening of the D$ could make all of these costs more expensive because they will be incurred locally in D$.

The significance of the currency risk could be estimated on the basis of past volatility. If these currencies have not moved significantly in the past against one another then there should be relatively little to fear. It should also be borne in mind that the rates could move in Nortan's favour and so the cost could fall. There could also be problems if Nortan's move to Dolrovia appears to be successful because other employers could follow. That could lead to increased competition for staff, which could increase the cost of salaries. Unless Nortan can maintain a clear lead on salaries, it may also have to endure additional costs to replace staff who have moved to competitors. There may also be inefficiencies in operations because of inexperienced staff having to take longer to resolve problems.

It would be difficult to quantify this risk, although it would be worth looking at the pool of potential employees. If there is high unemployment and a high level of education, then there may be plenty of qualified people to recruit as IT support staff and as HR support. There is more likely to be a problem with the HR professionals, but that may not be a problem unless any incoming company has a significant need of HR managers.

## Section 3

### Accounting treatment

Our starting point is to consider the classification rules set out in IAS 32 *Financial Instruments: Presentation*. These rules are necessary because it can be unclear whether financial instruments are to be treated as debt or equity. Preference shares must be studied carefully because some should be shown as debt and others as equity. This area can be confusing because companies often attempt to develop instruments that offer buyers the security of debt and yet can be accounted for as equity so that gearing is not affected.

The treatment of the preference shares will depend on the extent of any contractual obligation to the developer. If Nortan is obliged to deliver cash at some future date  then it is incurring a liability. If, for example, the preference shares are redeemable at the holder’s discretion then Nortan has an obligation to make a cash payment and so the shares would be classified as a liability. If redemption is at Nortan’s discretion, then there is no obligation and so there would be no liability. and if the directors can suspend the dividend payments then there would be no mandatory payments and the shares would be treated as equity.

The other major consideration is the initial measurement of these financial instruments. Assuming that the shares are to be classified as debt then they will have to be accounted for at their fair value. That is complicated by the fact that the shares are being issued for this specific purpose and so the fair value cannot be observed on the market. In the absence of a fair value for the shares themselves, we may assume that the fair value of the property that we will receive in return for the shares is a suitable initial measurement. Any issue costs will be deducted from the value of the instruments.

### Evaluation and implementation

Yes, it would be appropriate to prepare a formal project appraisal for this investment. The first reason is that we need to compare the potential cash inflows from establishing the HR Section in Dolrovia against alternatives. If we do not compare on the basis of meaningful and realistic project appraisals, then we could suffer an opportunity cost. Even if the property was being given to us free of charge, the fact that we will be entering into contracts and taking on employees means that we will be committing ourselves to making future payments and we need to understand the implications of that.

The second reason for requiring a formal project appraisal is that the fundamental purpose of such an exercise is to measure the impact on shareholders’ wealth. The preference shares that we plan to issue will have an effect on the shareholders’ future cash flows and so they have a cost. We need to establish the value of the shares that we will issue as well as the net savings associated with the more efficient HR arrangements.

The project sponsor is essentially responsible for the key decisions concerning the project and for providing oversight at the senior management level. Amber should be capable of fulfilling this role perfectly because she has been the driving force behind establishing the HR Section and has a clear vision for the project. She also has the necessary influence within the Nortan Group, both as leader of FOSSC and also in terms of her contact with the Nortan board.

There could be downsides to Amber accepting this role. She is keen to see this new HR Section develop and so she may be unwilling to compromise over resourcing decisions. Her involvement in this role could also make the managers at the operating units suspect that she is working to maximise the benefit of the new section for FOSSC. She could also be too busy in her existing role as head of operations at FOSSC to remain sufficiently informed about the project and its progress to act as an effective sponsor.

## Section 4

### Transfer pricing

The first challenge is that there are various governments who will take a keen interest in the transfer prices in order to ensure that there is no manipulation of tax bills. The Dolrovian Government will be unwilling to see Nortan Dolrovia pass the services on at cost because that will leave the company making zero profit and paying no tax. The operating units may face the opposite constraint, with host governments refusing to accept that the charges from Nortan Dolrovia are acceptable.

The usual response to this problem would be to ensure that all inter-company transfer prices are set at the arm's length market value of the services. Unfortunately, that might be difficult to do unless there are observable market prices for the wide range of HR services that Nortan Dolrovia will offer. It may be necessary to find a compromise by adding a margin to Nortan Dolrovia's prices that is acceptable to all.

Another significant problem will be the determination of what is actually being transferred and how it should be costed. At present, each operating unit has its own HR department and so HR costs are affected by local factors such as the complexity of employment law or the cultural issues associated with managing people. Operating unit managers will be demotivated if they feel that they are being charged more for the new HR service compared to running their own departments.

It should be possible to develop a cost-effective response to this concern. Firstly, if there are sufficient total savings from centralising HR in Nortan Dolrovia then it may be possible to average HR costs and still offer every operating unit some saving in comparison to makings its own arrangements. If that proves impossible then it may be possible to link charges to historical HR costs, with operating units that spent more in the past being charged a higher proportion of Nortan Dolrovia's billing. In principle, we might introduce a system of, say, hourly billings for HR professionals' time, but that would make arrangements more complex and would offset the likely cost savings for the Nortan Group as a whole.

### Shares and consolidation

The shares give the Dolrovian Government's nominee the ability to claim that it owns 60% of Nortan Dolrovia's issued equity. That permits the Government to claim that Nortan is not in breach of the rules set out for foreign ownership. The shares carry no voting rights, but the elected government will have a great deal of power over the activities of a foreign company located in its territory. The shares have no right to dividend either, but the company is subject to Dolrovia's tax law and so revenues can be extracted through taxation.

The shares offer alternatives to interfering through legislation. Having people on Nortan Dolrovia's board means that the Government will have access to internal board minutes and management reports. It will also be able to use the right to vote in the event of a breach of the law to deal with misbehaviour directly through control of the general meeting rather than having to rely on prosecutions and court action. The fact that the Government is investing practically nothing in the company means that it can afford to enforce these powers without necessarily losing anything.

In theory, the Nortan Group owns only 40% of Nortan Dolrovia, which would suggest that it has an associate rather than a subsidiary. Indeed, the fact that the other 60% of the company's ownership is in the hands of the bank means that it may not even be able to claim the significant influence necessary to account for this investment as an associate. The question that has to be decided is whether the differences in the shares means that the Nortan Group has control over Nortan Dolrovia. If it has then it will account for Nortan Dolrovia as a subsidiary.

The question of control hinges on the relevance of the voting rights that come into force on the Government shares in the event of a breach of company law. If it is easy for the Dolrovian Government to claim a breach in order to take control, then Nortan does not have a subsidiary. Equally, we need to be clear about the "very limited" voting rights enjoyed by the nominee directors. For example, if they have the power to block key decisions, even if they have no real power of their own, then they could make it impossible for the Nortan Group to exercise real control.