

## **CGMAX MANAGEMENT CASE STUDY MAY 2019 EXAM** **ANSWERS**

### **Variant 3**

#### **Section 1**

#### **Whether a luxury garden design and construction service adds to competitive advantage**

Jord is a differentiator, operating at the premium end of the prefabricated housing market and charging a high price. This strategy is clearly working well, as Jord is highly profitable and has a long customer waiting list. Competitive advantage currently arises from a very high-quality offering with exacting standards, excellent levels of customer service and a unique product offering that is sustainable and ethically sound.

Jord will have to undertake some discreet market research in order to establish whether a graded design service would enhance competitive advantage. If customers wish to be presented with a completed house, including a finished garden, then Jord may be able to further differentiate itself by adding this service. Those customers would prefer the greater simplicity of having the house and garden managed by a single entity. It may be, though, that many house buyers will be keen to find and brief a garden consultant who understands and shares their vision and so there may be little interest in any consultancy that Jord acquires.

There may be concerns that a garden consultant will not have the experience of the different climates and soil types that would be encountered because of the fact that Jord builds homes in different countries. It would certainly harm Jord's reputation if a customer's garden did not thrive because of the use of plants that were unsuited to local conditions.

There are no particular synergies between the house construction and the creation of the garden. It may be difficult for the customer to envisage what the garden design would look like until after the house had been built. It would also be inconvenient for the garden work to be undertaken during the house construction, because of the need for the housebuilders to access the site with cranes and other equipment. In some respects, Jord would be forced to operate housebuilding and garden design as two very separate businesses, even if they were providing both services to the same customers. There are some indications in the figures that suggest that, although the product offering appears to be conceptually an excellent fit, Garden Art may have the described potential to distract management time.

#### **Financial health of Garden Art**

It should be borne in mind that we have little direct interest in Garden Art's financial health as an independent entity because we ought to consider it as a potential subsidiary of the Jord Group. For example, Garden Art's revenue has fallen from 2017 to 2018. Following modest growth from 2016 to 2017 of 2%, sales fell by 17% from 2017 to 2018, to a level over E\$1 million lower than that achieved in 2016. This is a

potentially worrying sign because it could imply reputational problems associated with poor quality work, leading to declining sales. If that concern proves unfounded then it should be borne in mind that Jord's interest is in acquiring a consultancy that can service housebuilding clients. Declining revenues could imply the availability of resources, such as skilled labour and consultants, to start immediately on Jord's projects.

Operating profit margin is also disappointing, showing an organisation that is struggling to cover costs, with one year in the period making a loss. It may be that the cost base reflects high quality work and that could indicate that Jord will have to ensure that it can enhance Garden Art's revenues through obtaining commissions from housebuilding clients. It is clear that Garden Art's profits are sensitive to revenues. Garden Art's average salary seems very high, suggesting that it has skilled staff for whom there is a considerable market demand. That reinforces the need to generate revenues.

There is a similar argument with regard to wasted materials. It tends to imply a tendency towards achieving high quality, even if there is a financial cost. That will have to be considered before making an investment because curtailing waste could lead to impairment of the quality of work.

Garden Art's gearing is relatively high and rising. That is coupled with volatile cash flows, which is a dangerous combination. The fact that Garden Art will be part of the Jord Group means that it will receive greater support and may not be in any great danger. It will also motivate the present owners to consider whether they wish to bear the risks associated with continuing to operate independently. They may be motivated to accept a relatively low purchase price if Jord makes the offer to buy them out.

**Section 2**  
**Requirement - 1**  
**With regards to the acquisition**

In the accounts, the assets acquired will be brought into the statement of financial position using the exchange rate applicable at the date of the transaction. An amount of goodwill will probably be created, which is the difference between the amount paid

and the value of net assets acquired. There will be no foreign exchange gains or losses to deal with at that stage.

### **With regards to ongoing trading**

At each subsequent reporting period, Jord will translate the numbers for the subsidiary into Corvolan dollars, which will be the presentation currency for Jord. The translated numbers will then be consolidated in the group accounts.

The translation may create exchange rate differences that need to be dealt with in Jord accounts.

In terms of the statement of financial position, Garden Art balances will need to be translated at the reporting date. If the exchange rate has changed since the previous year end (and, going forward, from the last reporting date) the translated value of assets and liabilities will have changed giving rise to exchange gains or losses on translation which will be recognised within other comprehensive income, held in a separate reserve held within equity in the statement of financial position.

The Garden Art income statement will also need to be translated to Corvolan dollars at the reporting date but based on the average rate of exchange during the financial period.

The overall exchange difference (arising from retranslation of the prior year assets and liabilities, and from the difference between the comprehensive income at average and closing rate) will be recognised within other comprehensive income.

A further exchange difference then arises upon consolidation for goodwill, which will also be recognised at the closing rate, and is retranslated from opening to closing rate. However, we will need to ensure that any impairment is taken care of before translating the balance.

In our case, Jord is acquiring 100% of the subsidiary, so we won't have any non-controlling interests (NCI) to worry about. If there were any NCI's, then the exchange differences would have been split between Jord and the NCI's based on a pro rata basis.

### **TARA**

#### **Requirement 2 – What is TARA and how can we use it?**

TARA is a framework for classifying risks according to both their likelihood and impact. It can be argued that the combination of those two factors gives some insight into how best to manage any given risk.

In its simplest form TARA classifies both likelihood and impact on a two-point scale to give high and low for each. That can then be presented on a 2x2 matrix. Each cell then corresponds to one of four approaches that can be taken to managing risks. These are identified by their initials:

Transfer – usually associated with high impact, low likelihood  
Avoid – usually associated with high impact, high likelihood  
Reduce - usually associated with low impact, high likelihood  
Accept – usually associated with low impact, low probability

For example, the risk of legal problems is hopefully low impact, but the nature of our business involves contracts and so there could be a high probability. That risk might be reduced by hiring a local lawyer to advise.

If we assume that exchange rates are unlikely to be volatile then exchange differences are potentially high impact, but low probability. They could be transferred by hedging against currency movements on any receivables or payables in Ertovian dollars.

Cultural differences are unlikely to be significant enough to create problems because the two aspects of the business will operate independently, so they are low likelihood and low impact. That suggests they can be accepted.

The problems with trading performance are, potentially, high likelihood and high impact because of the current position. That risk would be best avoided by developing a new business model.

The risks associated with there being differences between the operations of Jord and Garden Art are potentially high impact and high likelihood. A mechanical application of TARA would suggest that they should be avoided, but the only way to do that would be to abandon the investment. Given that the decision to invest has been made, the most appropriate response would be to reduce the risk by, say, hiring a manager with the necessary expertise to supervise Garden Art's operations on Jord's behalf. The same could be said about customers not wanting to use Garden Art's service. It is probably high risk and high impact, but the risk might be reduced by promoting the service.

The financial problems associated with gearing are also high impact and high likelihood, but they might be accepted on the basis that Garden Art will become part of the Jord Group, and the group could support the company through any difficult periods.

### **Section 3**

The transfer pricing system we have set up seeks to move profit from Garden Art to Jord, in order to benefit from a better tax rate in Corvola than Ertovia. In theory, that would lead to the recognition of more profit in the country with the lower tax rate, which would benefit Jord as a whole. Such behaviour is, however, unlikely to be acceptable to the tax authorities in Ertovia. It is very likely that this approach would be

deemed unacceptable from a tax perspective. If Jord went ahead then it could lead to investigations and demands for additional tax payments in Ertovia.

There have been cases recently in which major multinational corporations have been accused of trying to artificially reduce their tax bills through manipulation of transfer prices. That has led to bad publicity for the companies concerned. The directors have been accused of unethical behaviour and so it has caused reputational damage as well as penalty payments.

There is nothing to prevent Jord from using this approach for internal management purposes, with adjustments to reported earnings to cancel the 10% reduction. That could, however, lead to behavioural consequences and Jord may want to assess whether the benefit gained by lowering the tax bill, particularly as Garden Art is currently barely profit making, are worth the potential issues that might be caused within the group.

Transfer pricing in this way may impact on the morale and motivations of staff at Garden Art. We know that they have some spare capacity and can still attract work at market value which at present is more beneficial to staff's revenue-based bonus system than performing the 10% discounted work for Jord.

We have already received complaints from Saffron Svoboda, including a letter written on behalf of the whole management team, stating their annoyance at the transfer pricing in place. In this instance it appears to have affected their results, reducing the self-esteem of the team and impacting the bonuses they can achieve. Whether the bonus system in place is appropriate is a matter for separate consideration but, certainly, this transfer pricing system has caused disgruntlement at the subsidiary.

The disgruntlement could lead to behaviours that cause problems at Jord. If Garden Art behave badly on Jord jobs reputation will be affected, and if they continue to fill their order book with external work, instead of prioritising Jord work, it could seriously affect the scheduling of jobs and reputation overall. Jord should be able to enforce upon Garden Art how they schedule Jord work in, but further steps to micro manage these people could be very badly received causing further problems.

It may be beneficial, at this point, to revisit the transfer pricing system to address the issues raised by Garden Art, perhaps as part of an exercise to look again at the whole working relationship between Jord and Garden Art. A dual pricing system where Garden Art records one price and Jord records another price may lead to some year-end adjustments in the accounts but could potentially keep both parties happy.

### **Managing conflict**

There are significant problems occurring relating to conflict between Jord and Garden Art. It appears that Jord have attempted to make a start on cost management at Garden Art and tried to impose Jord ways of working and scheduling, as well as the previously discussed transfer pricing system.

To some extent, Garden Art should be expected to come into line with Jord. They are 100% owned by Jord and, so, it is not unreasonable for Jord to require Garden Art to work in certain ways and follow the rules of operation of Jord as a company.

However, they don't want a 'riot' on their hands, so may wish to look for a way to resolve the conflict more collaboratively, rather than simply laying down rules about how things should work.

Good communication is always a good start point for such efforts. Explaining to the team at Garden Art why Jord works in the way it does, and why it is important for good performance, lays down the basis for discussions about why Jord would now like Garden Art to work in that way.

Jord may want to emphasise that, ultimately, higher profitability is likely to be beneficial to everyone at Garden Art and, although it may seem difficult to accept compromises and changes in the short-term, the long-term benefits may be quite positive for staff at Garden Art. Jord could even set up a bonus system for Garden Art staff based on group profitability. This could lead to more goal congruence across the organisation.

It would be worth Jord spending some time with the team at Garden Art, talking these matters through. This would also allow them to identify any members of staff at Garden Art who could assist with their efforts to tighten things up at Garden Art. Identifying people who will be a driving force for change, keeping the peace and working collaboratively, could be very useful to Jord allowing them to work from the inside to resolve conflicts and achieve improvements overall.

## **Section 4**

### **Business process re-engineering at Garden Art**

In principle, a business process reengineering (BPR) programme at Garden Art could provide an opportunity to identify and remove non-value adding activities. The fact

that the company has been reporting poor results is sufficient to suggest that it might aim to improve its approach to operations.

It would involve making significant changes to processes and procedures to improve operations at Garden Art. The advantages of implementing such a system at Garden Art is that it might lead to improvements in the performance at Garden Art. We know their results are far from ideal, particularly with regards to waste, and that there is likely to be room for significant gains if they use some of Jord's approach in order to drive out waste and improve efficiency.

The danger is that Jord does not understand how the process of meeting customer needs actually works. The timesheet demonstrates that some time is spent doing activities that are not budgeted for, but Jord may discover that some gardening contracts require additional inputs to tweak plans. Garden Art is working at the upper end of the market and it will be judged on results. Any interference by Jord could lead to false economies.

It may be, however that not all the activities on the timesheet are a waste of time. Although 'getting a feel for the garden' sounds vague, it may be an important step in the process of designing and constructing a garden. Regardless of the individual activities listed on the timesheet, a BPRE programme should help to identify other activities that may not be adding value that don't come to light given the level of granularity of the timesheet and stepping through the process should help with this.

There are, however, potential disadvantages to business process re-engineering, particularly in this scenario. It may be time consuming and difficult to implement if the staff at Garden Art are not on board. Although some compromises have been reached regarding old areas of conflict, this may aggravate old arguments leading to problems re-engineering processes effectively at this time.

### **Three appropriate performance measures to drive performance of garden construction workers**

At present, garden construction workers are given bonus based on revenue. This seems like an inappropriate performance measure for these staff members, as it is not an area they have much control of. There are areas they do control, such as the quality of the construction build and waste incurred in construction that would be far better areas to incentivise.

I would suggest the following three performance measures:

Time spent on construction vs budget – this will allow Garden Art and Jord to identify where more time is being spent on construction than was anticipated and find out the reasons why. If staff were given bonus based on this, they would work to keep time within budget. Care would need to be taken that quality wasn't compromised but, if the time budgeted is correct in the first place, this should not be an issue.

Wastage of materials in construction vs budget – this will allow Garden Art and Jord to identify more accurately where waste is occurring in the system. If staff are given bonus on this area, they will be motivated to reduce it, which will benefit the organisation as waste is currently too high.

Customer rating on quality of garden construction – this measure allows monitoring of the quality of the garden build work, ensuring it is commensurate with the quality of

house building. It is advantageous to incentivise builders to strive for quality, leading to a better product and customer service overall.

For the new performance measures to be embraced by staff we must ensure that any results set against a budgeted figure are compared to a budget that has been compiled in a fair way. It may be necessary to include workers in the budget setting process to ensure they buy in to the target so that debates about whether the budget is fair or not don't arise.

### **How changing the performance measurement system may affect the behaviour of workers**

Changing the performance measurement system is likely to cause some concern amongst the construction workers, simply because it will be different from the current system that they are already familiar with.

The motivation behind changing a performance measurement system is to get better performance out of the workers so, hopefully, if the changes are managed well, in the long term these changes will achieve that aim, with better worker behaviour occurring as a result.

More appropriate performance measurement systems are an important part of ensuring goal congruence across the organisation and need to ensure that workers are striving to improve things they can control rather than things they have no influence over.

Jord needs to be careful with these changes as recent history with Garden Art is not entirely positive and new performance measures may not be well received. Workers may be offended that their time, wastage and quality are being measured leading to further issues with motivation.

They may see it as a way for management to pay them less in bonus payments. It may take them a while to get used to the new system and, in that time, their bonus payments may suffer. A key difference in this system will be the fact that the bonus scheme will not just be based on revenue. Non-financial measures will be used as well. These may be harder for the staff to understand at first and they may be skeptical of them.

However, if the workers are involved in the discussions with regards to setting the performance measures and they have been given a good understanding of why the new system is being put in place and how it can be of benefit to themselves as well as the business, they are more likely to be accepting of it and work towards achieving the performance measures set. It will be important to ensure that an open and two-way communication process is in place.

I would recommend that these changes are made, but that the timing is carefully assessed to ensure it drives the optimal behavioural outcome in workers.