MANAGEMENT CASE STUDY NOVEMBER 2015 EXAM ANSWERS

Variant 5

The November 2015 Exam can be viewed at

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Section 1

Cost of equity

The cost of equity is essentially the relationship between the returns generated on behalf of the shareholders and the share price. If the shareholders believe that the returns on offer are insufficient to justify the present share price then the share price will fall until equilibrium is restored. In the case of a quoted company, that process is observable because there is a market price that is constantly updated in line with perceptions of the risks and rewards of owning shares.

The fact that ABC is an unquoted company does not mean that equity is cost-free. It simply means that the parameters associated with measuring that cost are not observable. The shareholders will have their perceptions of the value of the company and of the returns that they anticipate and there will still be consequences of any perceived imbalance. If the shareholders are dissatisfied then they may consider selling their shares. That could make economic sense because there could be potential buyers who believe that they could manage the company more effectively and so they could be prepared to pay a margin over and above the price at which the shareholders would sell.

As a management team, our objective should be to maximise shareholder wealth. We will have failed to achieve that if it becomes economically viable for the shareholders to sell their shares to a third party. In the event that they do sell, there is a strong possibility that the new owners will replace the board and so there will be a personal cost to the directors.

There could be less extreme issues arising from a failure to offer the desired cost of equity. The shareholders may decide to signal their dissatisfaction through the annual general meeting. They could, for example, vote to reduce directors' remuneration, or they could vote one or more directors off of the board in protest.

Loss of Colette

It may be surprising that the shareholders are aware of Colette's contribution, but it is clear that she is a major strategic resource. The fact that she has created a niche for herself and exceeds her job specification means that it is difficult to be clear about her overall contribution. It is widely believed that her contacts in the industry mean that ABC has a large group of expert consultants available to cover virtually any assignment that is likely to be offered to the company. There is a danger that consultants are keen to work with Colette and may not necessarily be as loyal to ABC after she has retired. Even if that is not the case, potential clients may also feel that ABC will be less capable of staffing a major assignment.

Collette's contacts are also a source of revenue because she is well placed to hear rumours about prospective contracts. Her meeting report from the dinner indicates that people trust her enough to pass on rumours and to ask candidly for work. IT can be a sensitive area. Security considerations can make it risky to confide information and reputations can be harmed by disclosures about project overruns. It is unlikely that ABC has anyone else who could gather such information. Colette's contacts also make it easier for her to approach potential clients on an 'off the record' basis in order to exploit these insights.

Colette's overall role will be difficult to evaluate because her success means that business ticks over smoothly and her input is not particularly visible. Her role as a founding Board member means that she is likely to accept that she receives less credit than she probably deserves. It might be difficult to motivate other members of the management team to accept that responsibility because they may feel that their contribution is not valued. Colette's background in recruitment also seems to have demonstrated that she is a 'people person', which may also explain part of her motivation.

There could be some upside risks associated with Colette's departure. Her departure will give the opportunity for a fresh perspective on recruiting and retaining consultants. Colette has also been a little guilty of taking a wide interest in a number of different issues, which could have confused the lines of responsibility. Her departure may make the management structure a little more coherent.

Section 2

Nolan Consulting

Nolan would hold a total of 17.5% of ABC, which would not give them any specific power over the company's management. They have asked to appoint a board member in the event that they make the acquisition, but they have no particular right to demand that appointment. It may, however, be advisable for the current board to agree to this appointment. If the directors refuse then Nolan might lobby the other shareholders believing that ABC has something to hide. Once appointed, that board member would almost certainly give Nolan a significant degree of influence over ABC's management. They would also have an inside knowledge of the company's intentions, which could offer some influence in and of itself.

The fact that Nolan holds a significant block would give it an incentive to take an active role as a shareholder. Collectively, the founders will control only 25%+12.5% = 37.5% of the votes, with the other shareholders having the remaining 62.5%. It would not be particularly difficult for ABC to draw upon the support of a small block of other shareholders in order to outvote the board members in general meeting.

Owning 17.5% would also give Nolan influence through being able to buy or sell its shares. Other shareholders might be prepared to sell their shares if Nolan made it clear that it is in the market and it would be possible to work towards obtaining a controlling interest. If Andrew and Bippin cannot afford to buy Colette's holding then they would be incapable of bidding against Nolan for an even larger number of shares. Alternatively, Nolan could offer its own shares for sale to a third party who was interested in buying a controlling interest.

ABC's board may feel that Nolan would have limited scope for putting any of these threats into effect because the remaining small shareholders may be inclined to trust the leadership of the established board, given that it includes the remaining two founders.

Change accounting numbers

Realistically, there is very little that can be done to manipulate reported profit in the manner described.

As directors, ABC's board has a clear duty to prepare financial statements that inform the shareholders of ABC's performance and financial position. The board's duty is to all shareholders, including Nolan Consulting which has a 5% stake. This duty applies to all directors, not just to me as finance director and so Andrew would be in breach of the law, along with the other board members.

There are further ethical implications. Even though it does not necessarily apply to the board, the CIMA Code of Ethics for Professional Accountants sets out a relevant set of principles. Integrity and objectivity would both require honest financial reporting, regardless of the implications for the company and its board. Professional competence and due care would require that the financial statements should be prepared correctly and in accordance with any relevant rules and requirements. The fact that the email refers to making a change implies that the figures have a 'correct' version that will be replaced with a more favourable set of results in order to meet Andrew's needs.

The requirement to prepare the financial statements in accordance with IFRS means that ABC has very limited scope for inflating the reported earnings. The standards generally set out the policies that can be applied and so ABC has very little discretion over the accounting treatments that it employs. In the event that ABC could justify a change of policy then it would have to highlight the changes that have been made.

ABC's figures are externally audited by an independent accounting firm. The auditors will review factors such as accounting estimates and will ensure that the figures are realistic. The auditors would modify their audit report and draw attention to any material mis-statement.

Any buyer who overpaid Colette for her shares might demand compensation if it was later discovered that the share price had been inflated through distorted financial statements.

Section 3

Uncertainty

Resolving this dilemma requires an understanding of the potential costs and benefits and the relative likelihoods.

The most obvious starting point is the potential fee income that could be charged for such advice. We have a list of contacts who might be prepared to migrate if we encourage them. We appear to have a reasonably clear understanding of the number who would be prepared to engage us for this task.

The potential benefits of working with some early adopters will be more complex than simply generating a fee. Firstly, we will also develop experience and expertise in working with the new operating system. That could be critical in future bids for other work that we tender for because clients will undoubtedly be swayed by prior successes. Secondly, if we do not contact our clients with regard to a major event such as a new operating system and our competitors do, then we could lose established clients.

The downside risks will have to be considered in terms of the realistic worst case scenario. In the worst possible case, the software would be so badly flawed that clients suffered major system failures and ABC was liable for recovery. Historically, new operating systems cannot be guaranteed error free because some problems only come to light when they have been operating in real world conditions. However, Petaware's own testing, including beta testing using prospective users, should have ensured that the system is reasonably stable and operational and so the worst possible case is highly unlikely to arise. Furthermore, Petaware will aim to respond quickly to any flaws that are identified and patches will be issued as quickly as possible, so ABC's responsibility would be limited to ensuring that the patches were installed correctly.

The most likely downside will be that most of ABC's clients will decline the offer of support at this stage and so the marketing effort will be largely wasted. Even that may not be too serious if it creates a sense that we offer a proactive and supportive service to our clients.

Bippin

The fact that you are a founder and significant shareholder means that you have been given some latitude in deciding your own role within ABC. It is clear that you enjoy that role, but that does not mean that it is necessarily healthy for the company to pursue the latest trends.

As a director, your duty is to maximise the shareholders' wealth. The board should ensure that each director's role is geared towards achieving that objective.

From ABC's perspective, the key strategy is the sale of services. Anything that you do to ensure that ABC is successful is likely to be consistent with maximising shareholder wealth. The big question is whether your interest in the latest technology supports or undermines the company's mission. Board members should really have a strategic vision.

It could be argued that clients are looking for an efficient solution to their IT needs and that the latest technology will tend to carry a cost in terms of reliability. If you find yourself struggling to convince clients to use the latest technology because they are keen to implement tried and tested solutions then Andrew probably has a point. Even if you manage to persuade clients to use the very latest technology, it is important to consider whether we could have still sold the consultancy and made a profit from the sale of an existing solution.

The best way to determine the relevance of your interest is to analyse your engagement with the business as a whole and with clients in particular. If you can demonstrate that your interest in this technology has contributed to signing contracts or to completing projects then Andrew's arguments may not be valid. Even so, it may be that your role as a director has been overlooked in the process because there are more junior sales and consulting staff who should be providing clients with that support and advice.

Section 4

BSC

The key to interpreting the Balanced Scorecard is to take a balanced view overall. If all of the actual measures were amber or green then it might be argued that the targets are insufficiently challenging and so the fact that there are some reds is probably motivating, if nothing else.

The scorecard should form the basis for a discussion of overall performance. It should be made clear that the board has noted that there are a number of greens, which appear to signify that the department exceeds expectations. There are also a number of reds, which suggests that some more work needs to be done. The important thing is not to stress the reds to the extent that the head of department feels that any shortcomings will be used as an excuse for criticism.

Looking at the overall impact, I might be a little concerned at the distribution of reds, ambers and greens. The greens appear to be concentrated on areas that might be relatively easy to achieve and that might not always contribute hugely to success. For example, logging large amounts of time to training might enhance performance, but if the courses were badly selected then the training programme could degenerate to a box-ticking process. On the other hand, the monthly salary bill exceeds target by more than 20%, which is an expensive overspend. It will also be difficult to reduce salaries by that amount.

The report might be improved by requesting a commentary on how each of these measures is perceived. The head of department should indicate what response is appropriate in every case, perhaps stating what will be done to improve on the reds and explaining whether further work is appropriate for the ambers and greens. Constant reflection on the targets will ensure that the targets remain realistic and motivating, otherwise performance might simply slip.

Incentives

This would defeat the point of the Balanced Scorecard. The manager would effectively have a single score in the form of the net bonus. The whole point of a balanced scorecard is that every business has a host of objectives that are not necessarily closely related to one another.

It is possible for some areas of performance to be satisfactory while others are in need of improvement. A single measure of performance, such as profit, offsets the strengths and weaknesses and masks the need for improvement. The fact that profit is satisfactory does not mean that it could not be even better.

The proposed feedback loop might mean that the manager starts to become demotivated. A monthly penalty of K$20 for failing to get the salary bill under control might be preferable to the stress of actually addressing the problem. If the rewards and penalties are made more significant then there could be serious dysfunctional behaviour. For example, the department head might suppress reports of intrusions that threaten client data because a failure in that area could involve a serious financial penalty.

The weightings could also make the whole process demotivating because there will always be areas where improvement is required. It might be argued that the manager is responsible for working towards improvements, but it may be that not all of the factors are entirely within the manager’s personal control. A composite measure, whether in the form of a bonus or some other combination of the scores, might leave the manager feeling exposed because of the implication that the factors are all controllable at a departmental level. It may not, for example, be possible for the manager to be capable of keeping staff turnover down to less than one per month given that wages and other conditions will be set centrally.