MANAGEMENT CASE STUDY FEBRUARY 2018 EXAM ANSWERS

Variant 4

The February 2018 exam can be viewed at

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Section 1

Suitability of KPIs

The KPIs have the advantage of being readily quantifiable and objective, which makes it easier to prepare clear reports. The objectives are consistent with establishing whether Nortan's purchases are being recorded promptly and accurately. There are only three measures, which may be viewed as an advantage because there are fewer trade-offs between potentially conflicting targets.

The KPIs may suffer from ensuring completeness in their measurement, particularly with regard to % of processing errors. The danger is that errors may not always be discovered, in which case the measure will overstate performance. At best, errors are likely to be discovered afterwards when accounts are checked against suppliers' statements. That delay could make it more difficult to hold the perpetrator of the mistake accountable.

There could be problems with overall accountability. For example, if the operating units are struggling to submit scans within 24 hours then there could be bunching at FOSSC. That could threaten FOSSC's ability to meet its own 12-hour deadline if a large number of transactions arrive at once. That could encourage dysfunctional behaviour such as delaying some of those purchases so that later documents can be processed on time. The overdue invoices are late anyway and there may be little incentive for FOSSC to process them as quickly as possible.

A further concern is that we appear to be basing the performance measures on the total throughput of transactions at FOSSC. That ignores the fact that 75%

of incoming transactions are received in the form of electronic documents that are generally processed immediately and without any problems. It would be more appropriate to set relevant KPIs for the electronic inputs and to measure performance on the paper invoices as a separate exercise, using the number of paper invoices as the basis for calculating percentages.

Weak leadership?
Leadership is a matter of affecting and influencing the behaviour of others. It is essentially about having followers do what the leader wishes them to. The fact that FOSSC's management team is not choosing to assert itself in a forceful manner does not necessarily imply anything about the strength or weakness of its leadership. The crucial test is whether the Heads of Section are being encouraged to achieve FOSSC's mission. There are different styles of leadership and each has advantages and disadvantages that depend on the circumstances in which leadership is being offered.

FOSSC's senior management has clearly decided not to pursue an authoritarian style of leadership. That should not be mistaken for weakness because authoritarian leaders are at risk of appearing to lack trust in their subordinates. The critical factor that determines the strength of leadership is the extent to which FOSSC's senior managers are providing support and coordination If the Section Heads are being left to make their own decisions without clear guidance or support then they may become demotivated because they may feel that senior management do not care how they perform. If, however, there is a participative style of leadership in which senior management works with the Heads of Section then the outcome will hopefully be that FOSSC captures the benefits of the managers' initiative and creativity. It would appear that the senior management team has a Theory Y view of the Section Heads, assuming that they are essentially keen and motivated to do their jobs to the best of their ability. If that is the case then the senior management team should aim to harness that attitude with a view to encouraging managers to solve problems, while providing the necessary authority and resourcing in the process. If managers can be trusted to work towards achieving high standards then there is very little need to question them and seek clarification of performance reports. Ideally, the managers will have a much clearer understanding of the priorities and the areas where intervention is required. It could be argued that giving a motivated management team the scope to manage themselves without undue interference is a sign of strong leadership.

Section 2

WACC

The first question is the impact of this transaction on the cost of Nortan's equity. The cost of equity can be measured in many ways, including through the analysis of the link between share price and expectations of dividends. We can estimate the cost of equity by dividing dividends, which can be adjusted to reflect the impact of expected growth, by the present share price. Making a significant investment in FOSSC is likely to push Nortan's share price down because the shareholders will view this as a disproportionate increase in administrative costs that exceeds the steady growth in revenues from operating activities. If the directors aim to maintain Nortan's dividends then dividing the same numerator by a smaller denominator will give a higher cost of equity (k_e). Nortan's cost of debt may also be affected by this borrowing. At present, Nortan's debts are only C$1,500 million. The additional borrowing amounts to more than a 50% increase in debt, which could lead lenders to charge more on the fresh debt. The market value of existing debts may decrease because of the additional risk, which would also increase the cost of debt. The impact on debt may not be particularly significant because Nortan has a large asset base that could be used to secure debts and the total borrowings will only be a small proportion of that. It is also to be hoped that Nortan will have a clear business plan that can be used to show lenders how their loans will be paid off from the group's operating cash flows, which will further reduce any concerns.

WACC is, by definition, a weighted average. Debt is generally cheaper than equity and so increasing the proportion of debt in the financing should have the effect of reducing the weighted average. Offset against that, increasing gearing makes the return on equity more volatile and so WACC increases because of that. The net impact on WACC depends on the extent to which Nortan's borrowings are responsible and safe. Nortan has had a significant increase in long-term provisions, which could disrupt future cash flows and profits in the event that they lead to immediate liabilities and that could make the prospect of additional borrowing even more daunting.

Real options

The key is to build in flexibility at each stage of the project. Ideally, Nortan should design this project so that it can be scalable. Nortan should aim to plan the project so that additional capacity can be added as and when necessary and without undue cost. Equally Nortan should be able to minimise its commitment to incurring unnecessary operating costs should its needs turn out to be less than expected.

The choice of location could be a significant factor in creating flexibility. Nortan should find a site where there is sufficient capacity in the existing infrastructure so that capacity is always likely to be available. For example, the availability of suitably qualified staff and also of fast data connections will make it possible to add capacity without having to invest heavily in staff training or on creating bandwidth. It may be better to consider locations that have already attracted similar facilities, even though there will then be greater local demand and initial costs may be higher. The fact that there are already centres in place means that the necessary resources can be found and local suppliers will already have an incentive to maintain the facility.

Ideally, Nortan would also wish to have the ability to minimise its commitments, at least until it is certain that the associated costs are necessary. For example, building or buying a building that has scope for quick expansion will enable the running costs to be minimised in the short term, with capacity added whenever it is required. Similarly, employment contracts should allow for the possibility of downsizing without excessive cost in terms of redundancy or other payments. Nortan might even consider leaving scope for relocating the new centre's services back to the original site in case changes in technology will reduce the need for space for data processing and other services. Renting premises rather than buying may give greater flexibility with regard to closing the centre down. The technology in use in the new centre should also be compatible with that in the original site so that operations can be interchangeable.

Section 3

Accounting issues

The first issue is that we will need to determine the value of the Nortan shares that are exchanged for the EHDATA equity. The fact that Nortan will not take control for six months will complicate matters because we will have to be clear about when the exchange of shares actually takes place. If there is a delay between the announcement of the acquisition and the share exchange then there could be volatility in Nortan's share price and that could lead to problems such as a contingent element to the consideration or a renegotiation of the terms.

The fair value of the separable net assets being acquired will have to be determined. That could be complicated depending on Eastland's economy and the extent to which there are observable market prices for assets, particularly property. The other assets create their own problems because it may be that the IT equipment has little or no value, other than as scrap. Similarly, software may comprise generic programs such as operating systems and other packages such as word processors, but much of it could be specific to EHDATA's previous role and could be of no value to anyone.

The provision for damages will have to be valued. The legal claim appears to be against EHDATA rather than the Eastland Health Board and it may be difficult for EHDATA to deny any responsibility. Indeed, the fact that EHDATA is becoming part of the Nortan Group could mean that patients have a greater incentive to make claims against the company. Claims may be lodged over a period of many years because patients may not always be aware that they have been injured until time passes and a problem becomes apparent.

Given these issues, it is possible that a significant proportion of the purchase consideration will be for goodwill. That could raise further problems because of the question of impairment of that goodwill. For example, there could be a significant and unexpected loss of staff. There will be a lingering concern about the value of goodwill on acquisition for as long as this company remains part of the Nortan Group.

Change management

First of all, this will be a transformational change. EHDATA's staff are used to working for a public-sector entity that is based in their home country. Now they need to adapt to working for a foreign oil company. The staff may be sensitive to changes in the company's culture and be unsure about the impact of changing priorities. There will also be a difficult transitional period arising because of uncertainties about Nortan's plan for staffing and rewarding the staff.

This change will also constitute a sudden "big bang". EHDATA will be placed under new management on a specific date and will be given a new role. The staff should expect to be retrained and reassigned to new tasks with immediate effect. The need to service the remainder of the government contract before the change means that there will be little scope for easing into the new role.

Benchmarking would be a useful start for EHDATA because it would go some way to showing that Nortan's expectations are realistic. Providing inexperienced staff with realistic and achievable targets will motivate them to work through the inevitable learning curve. Nortan would have to make allowances for any differences in staffing levels, operating practices and the speed and efficiency of the equipment.

Benchmarking could also create some problems at the original FOSSC site. Presenting the work of the displaced staff at FOSSC as a benchmark might be interpreted as an acknowledgement that there was little reason to transfer the work elsewhere. There could also be further motivational problems if the FOSSC staff start to wonder whether the benchmarking exercise is a possible precursor to moving more work to the EHDATA site. FOSSC could lose staff who are concerned that their jobs are insecure or subject to an unwelcome change.

Section 4

Competitive advantage

In considering this question, we need to bear several factors in mind. The first is that Nortan is an oil company, which means that its product is essentially a generic commodity. Nortan is in competition with other oil companies, in an industry where external markets will set prices and there is little scope for the differentiation of the product that is being sold. FOSSC may be able to help the managers of the operating units to add value through cutting operating costs or through offering different ways to serve customer needs.

At present, feedback from the Nortan Group staff suggests that the individual managers are more concerned with their own data processing needs than with the management of data across the Group, which is understandable. It may be necessary to conduct a pilot study, perhaps seconding staff from FOSSC to catalogue and classify the data that is available and that might be of use. That could be paralleled by the operating unit managers developing a “wish list” of answers to questions that they believe hold them back.

FOSSC creates a much greater opportunity for data sets to be collated. Previously, each operating unit maintained its own separate records, which mean that it would be potentially more difficult to gather data from across the Group. Having a single data centre means that Nortan can ensure that all files are in a consistent format and that data can be analysed to look for patterns. There may be opportunities to apply Big Data techniques to evaluate data concerning the overall management of, say, filling stations to maximise revenues.

Exploiting this data would require active collaboration between operating unit managers and data management specialists at FOSSC. The operating units would have to identify the type of data that would be potentially interesting and FOSSC managers would have to evaluate the costs of doing so. This cooperation would have the added benefit of enhancing the mutual understanding between the operating units and FOSSC. It may be possible for such conversations to streamline data management and so reduce FOSSC’s operating costs, which would enhance the Group’s competitive position.

Risks of investing in software

The most immediate problem in evaluating this investment is that it will be difficult to tell how valuable the information that it produces will be. It is to be hoped that this information will generate additional revenues and reduce costs, but there is no guarantee and the benefits may not justify the costs. It may be that Nortan’s managers already had sufficient understanding of the business to be able to identify most of the worthwhile opportunities.

This project will require the software to be purchased at the outset, with little or no scope for reselling or returning it in the event that the project does not proceed to plan. Nortan will also have to employ additional analysts and other staff to operate this system and those costs will be fixed. There will be bad publicity if the system has to be scrapped and newly appointed staff made redundant.

It may be possible to mitigate these risks by commissioning a consulting firm to explore the data that might answer a number of specific questions. That would enable Nortan to test the feasibility of the analysis of data without incurring the overall cost of a new system. It would also enable the Group to better understand the possibilities that this new approach to processing and exploring data might have.

There could be motivational risks if the managers at the operating units become concerned that the data analysis conducted by FOSSC will undermine their authority. FOSSC's data managers will be keen to demonstrate that they have delivered benefits and there would be a possibility that operating units might feel that their involvement in decision making will be undervalued. This could lead to dysfunctional behaviour such as operating unit managers rejecting opportunities or withholding data.