The Chartered Institute of Management Accountants

GATEWAY CASE STUDY May 2018 EXAM ANSWERS

Variant 5

The May 2018 exam can be viewed at

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Section 1

Internal reporting in terms of non-financial measures

There are two dimensions to this request. It is, potentially, demotivating for Menta Dorland to be reporting in C$ because a weakening of the D$ could disrupt trends in performance. For example, revenue could be increasing in terms of passenger numbers and D$, but that could be offset or even appear as a reduction when translated to C$. If budgets and targets are set in C$, then Menta Dorland could feel that it faces an almost impossible struggle if the D$ weakens and increases the business that it will have to do

The problem is that Menta Dorland is part of the Menta Group and the Central Eurozone management team needs to know how the company is performing in terms of C$. If the D$ is weakening, then that may raise questions about the overall profitability of the Central Eurozone. It is important for Menta's senior management to have an overall view of the performance of the group and of the contribution made by individual group members.

Non-financial measures could be a useful way to focus on the ability of the Menta Dorland management team in terms of factors that can drive success. For example, passenger numbers could be a relevant measure of performance because growth in passengers ought to benefit the company. There is, of course, a risk that this could lead to dysfunctional behaviour if Menta Dorland reduces fares in order to artificially increase the number of passengers carried.

Menta should consider evaluating all group members in terms of a combination of financial and non-financial measures that hold local managers accountable for maintaining revenues and maximising return. Targets can be set for factors such as customer satisfaction, which might give early warnings of problems such as a decline in profitability. Where financial performance figures are potentially misleading, local managers should be encouraged to explain the reasons for that, as Hugo has done in relation to the translation of D$ results to C$.

Losses on retranslation

Hugo makes a valid point in that the losses on the retranslation of goodwill are not taken to the statement of profit or loss and so they do not affect Menta's reported profits for the year. It could be argued that goodwill is held as a long-term asset and that its value can be expected to fluctuate over the years that the subsidiary is expected to remain part of the Menta Group. In that sense, taking currency movements through other comprehensive income does reduce the emphasis attached to them. Currency losses do, however, reduce shareholder wealth in the sense of reducing reported equity and so they can hardly be ignored.

It could be argued that goodwill on acquisition is not, in itself, a particularly important measure of financial position. It is essentially a balancing figure that has very little meaning as an asset, in and of itself. Adjusting that asset because of currency movements tells the shareholders very little about the underlying economic entity and its ability to generate wealth. That does not necessarily mean that the losses on retranslation can be ignored. Continuing gains or losses should serve as a warning to the shareholders that currencies have been moving in a particular direction over the years. That is an important economic indicator that could have wider significance in understanding the future prospects of the group.

Changes to equity will have an impact on accounting ratios that are based on capital employed, whether equity-based or total long-term finance. Debiting currency losses to Menta's translation reserve will not affect the numerator on return on equity or return on capital employed, but it will reduce the denominator. That will have the effect of making the group appear more efficient, because of an accounting adjustment. If shareholders are comparing returns from one year to the next, then they could be confused by currency movements and, in that sense, they cannot be ignored.

Section 2

National cultures

Norcandia's lower power distance means that its society is less tolerant of differences in power between individuals. For example, managers will interact differently with their subordinates, with less emphasis on seniority giving the right to impose decisions. Staff within Menta's new subsidiaries will be less willing to accept changes imposed by Menta Central Eurozone, just because of this new ownership. Menta will have to aim for a slightly more relaxed and inclusive management style than it has in its Centralia subsidiaries. That is likely to involve observing and continuing existing practices as far as possible.

Norcandia's higher uncertainty avoidance means that staff will feel less comfortable with risk, uncertainty and ambiguity. For example, managers will be less willing to work with rules that give significant discretion and latitude in their interpretation and application. Menta will have to ensure that managers and staff at the new subsidiaries are given sufficient clarity and structure concerning the manner in which they operate. Setting out broad principles for making operational decisions is likely to cause discomfort and make staff feel threatened.

Norcandia's feminine orientation values relationships and quality of life, whereas Centralia's masculine orientation focuses more on achievement and success. For example, managers may have a greater concern for staff welfare and development as objectives in themselves rather than as a means to achieve greater profit. Menta should be conscious of the fact that managers in Norcandia will tend to take a wider perspective of things when they are managing their companies. It will still be acceptable to ask them to seek profits and create wealth, but they may find themselves taking other factors into account, such as ecological and environmental issues.

Pricing

The biggest challenge arises from the fact that there are no comparable bus services against which to benchmark pricing. The local population has no experience of long-distance bus travel and so they may not be capable of offering any reliable response to market research. The country's population is relatively prosperous and so they may not necessarily need fares to be low, risking an opportunity cost if Menta sets the pricing too low

Menta does face competition from both rail and car and so it needs to be aware of the market. Menta will have to take care not to focus too heavily on competitive pricing, though, because rail travel is likely to appeal more to passengers who are interested in environmental performance. Bus travel will almost certainly be cheaper and more environmentally friendly than using a car, although driving offers greater flexibility.

In the first instance, it would probably be sensible to aim for a penetration pricing approach and make it clear that these are short-term, reduced prices. Hopefully, that will encourage travellers to try the bus as an alternative to train and car. Making it clear that this is a short-term offer will encourage passengers to take advantage while they can.

Once Menta has established its presence then it can start to increase its prices Hopefully a moderate increase will enable the company to estimate the price elasticity of demand for long-distance bus travel. Menta can then start to think in terms of the capacity and the associated costs that it wishes to commit to this service in the long term so that it can maximise its overall contribution.

Section 3

Porter's five forces

Menta might have evaluated the market using the five forces model, but it is debatable whether it would have obtained any useful insights that would have helped it in this case. The model draws upon a number of logical assumptions that are based on practical experience, but that does not mean that they always apply in every case At best, an analysis based on Porter would have justified the decision by basing it on a valid and well-established model.

The criteria relating to barriers to entry and the power of suppliers do not apply in this case. Menta has considerable experience of entering new markets and it has an established basis that relies on acquiring an existing market participant. Menta planned to bypass any barriers to entry using its well-proven method. Concerns about powerful suppliers simply do not apply, partly because Menta was acquiring established going concerns and partly because there is a free and open market in the assets and consumables required by bus companies

Menta would have considered the impact of rivalry amongst competitors and substitutes and would have disregarded both. Virtually all of Menta's subsidiaries operate in a competitive environment and Menta has devised strategies for winning market share. Bus services are essentially homogenous, which means that Menta could easily win or lose market shares depending on the strength or weakness of the competition. Menta's experience of winning a lead in most of the markets where it operates would have led to these forces being discounted.

Menta's venture has foundered on the basis of the power of customers, which the company is unlikely to have foreseen. Menta's customer base comprises the many individuals who travel by bus. Individually, they have no means of communicating or of reaching a conscious consensus over their preferences. It would be perfectly realistic for Menta to have expected passengers to have been motivated by the lower fares that it offered, as opposed to the emotional attachment to existing bus companies that has actually manifested itself.

Mitigating the risk of recurrence

The most obvious mitigation would be to conduct market research, such as that used retrospectively in Norcandia, to determine whether Menta would face consumer resistance. Customers may not necessarily behave in the manner that they say in response to a survey, but their responses will, hopefully, have some predictive value. Menta should engage local marketing consultants to design and administer the surveys in order to minimise the risk that the survey instrument will yield biased results.

Menta may have been slightly reckless in acquiring two subsidiaries at once in Norcandia and it should be less ambitious in future acquisitions. Each subsidiary serves a single town and so there is very little benefit to be had from acquiring two or more companies when entering a new country. The knowledge gained from acquiring a single company should make it easier to expand with further acquisitions later.

Menta could look at the experience of other foreign bus companies who have operated in a particular country. If they have succeeded in establishing themselves then there should be no reason for Menta to be concerned that it will face a repeat of the poor results in Norcandia. Menta need not necessarily enter the towns that are already being served by foreign companies.

Menta could reduce its exposure by buying controlling interests in foreign subsidiaries while retaining local investment. That would mitigate the financial risk because less would be invested in a particular company and so Menta would have less to lose. It would also reduce the extent to which the company is perceived as 'foreign'. In some cases, it may be worth leaving the company with its original branding.

Section 4

Transfer pricing for management advice

The idea of charging Menta Norcandia for management time and effort given by Menta Eastern International is perfectly legitimate. It is no different in principle from having group members compensate one another for intra-group transfers of any other resource, such as inventory. Realistically, the charges should reflect the cost to the subsidiary that provided the advice, which could include the opportunity cost of the time in terms of lost opportunities or efficiencies. As always, there should be an incentive for management advice to be offered and accepted and so transfer prices should not be so low, as to deter the provision or support or so high as to make it uneconomic to accept it.

Linking the transfer price to the success of the advice could lead to difficulties in terms of measuring the success of that advice. A group member that is in need of support may take suggestions from several sources and will attempt to provide its own solutions, so isolating the effects of the specific advice offered from one of those sources will be difficult. There will be a risk that a great deal of time and effort will be wasted on the subsequent evaluation of the management fee that is to be charged.

The group member offering the advice may also attempt to take credit for remedies that are either obvious or that are already under consideration by the recipient. Claiming credit for things that would have happened anyway might boost the fee, although it could also insult the recipient of that advice and deter further interaction between group members In the worst possible case, the author of the advice might not even add value by including further suggestions that might extend the ideas that the recipient had already.

The subsidiary in receipt of advice could defer the implementation of any good suggestions so that there is no immediate sign that it has benefitted. In some cases, it may not implement viable suggestions at all if the net benefit, after management charges, is insufficient. That would reduce or even eliminate the need to accept a management charge, but it would also delay the solution to any problem.

Finance and financial reporting

There is a danger that imposing a significant management charge will lead to a breakdown in relations between the finance and management teams of Menta Norcandia. The charge will have a material adverse effect on the subsidiary profits and the managers may resent finance. That could lead to problems in the future if these subsidiaries choose not to seek advice from the finance team because of fears of being unable to control any resulting management charge. It would always be preferable if any disputes could be settled amicably through negotiation.

The danger is that there is little point in having a finance function if it does not fulfil its purpose. If the subsidiaries are permitted to bully the finance team into ignoring this charge, then it will lose much of its authority. It could be argued that it is more important for the finance team to assert itself in this case and to make it clear to all subsidiaries that they cannot manipulate their financial performance.

The question of whether it would be a breach of accounting standards if no management charge is entered into the books is complicated. It is debatable whether Menta Norcandia has incurred an expense if there is unlikely to be an outflow of cash or other resources**.** In the absence of a clear agreement between Norcandia and Menta Eastern International, it could be argued that no transaction has occurred**.** In that case, there is no specific standard that would require an adjustment to be made**.**

From an ethical point of view, it would be a breach of the principle of objectivity if we overlook the need for an adjustment because of the possibility of reducing the tax liability if the charge is not processed**.** The subsidiaries in question are required to prepare financial statements that present fairly and so the lack of a specific accounting standard does not justify omitting the adjustment altogether**.** The principle of integrity requires us to be straightforward and honest and so we need to ensure that we reflect the performance of these companies correctly, even if the omission of this adjustment will probably go unnoticed by the tax authorities who will be affected**.**