



## **MANAGEMENT CASE STUDY May 2018 EXAM ANSWERS**

### **Variant 1**

The May 2018 exam can be viewed at

<https://connect.cimaglobal.com/system/files/resource/MCS%20Variant%201%20Qs%20May%202018.pdf>

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### **Section 1**

#### **Resource-based view**

The resource-based view is suitable if Menta possesses the resources and competencies that it can use to generate competitive advantage. These resources should also be difficult for competitors to replicate, otherwise they would provide little or no real benefit to the company. If we can identify such resources and competencies, then it would offer an excellent framework for planning for growth because the board will be able to work on the basis of making best use of those resources

Menta has a significant competence in taking over smaller bus companies and in reorganising them to reduce operating costs. It has demonstrated that through a large number of successful acquisitions. That is a useful skill that will be difficult for others to develop because it requires experience of both the bus industry and of managing acquisitions and so there will be relatively few companies that can compete with Menta. Any companies that wish to copy Menta may make some costly mistakes before they develop Menta's competence in managing acquisitions and integrating them into their groups.

Menta appears to have reached saturation point with regard to making further acquisitions in its home country, so most future acquisitions are likely to be overseas. Bus services are an important issue for local governments and Menta has a reputation for undermining local competitors, thereby reducing choice in the market for local bus services. It may be that Menta's approach to doing business will be unacceptable to regulators and so ultimately unsuccessful in entering the new markets that the board may identify.

A large part of Menta's success in forcing its way into a dominant position in any new market is having the necessary financial strength to operate services at a low profit, or even at a loss initially. Menta has already run into a major competitor in the form of Dawlbus, whom it would not undercut in its home country. It may be that there are other large competitors who are well established in other countries that would have the ability to counter any attempt by Menta to force itself into their existing markets.

### **Evaluation of corporate acquisitions**

Evaluating acquisitions may be complicated because the takeover could have an impact on revenues. Bus companies derive a great deal of their revenue from government subsidies to operate public transport services and these are generally granted and managed at a local level. It may be difficult to determine the likely impact of the acquisition on future subsidy payments. That could complicate the evaluation of the acquisition pre-acquisition and could also make it difficult to determine whether local managers have failed if the subsidies are lost post-acquisition.

This problem could be best addressed by studying the terms on which any existing subsidies are paid in order to establish whether any change of ownership would trigger a review of the basis on which the grants are paid. If the payments are not conditional on the companies retaining their independence, then the subsidies should continue provided Menta does not attempt to withdraw any subsidised routes. The possibility that subsidies will not be renewed when they expire is a more complicated matter. Menta should evaluate the local companies on their management of the relationship with the government decision makers so that they are motivated to work towards an extension of any subsidy.

Managing costs could also be complicated because it may not always be realistic to reduce costs to the extent that has been possible in Menta's existing locations. For example, the workforce might resist any attempts to shed jobs or reduce wages. Any failure to manage costs could create pressures on costs elsewhere in the group if, for example, existing staff complain that their counterparts at newly-acquired subsidiaries are better paid than they are. Thus, the overall impact of an acquisition on group costs could be difficult to predict. Evaluating local management may also be

complicated because they will not necessarily have overall control of cost targets if those are set centrally in accordance with group policy

The problem of managing costs could be addressed by careful investigation of operating costs before the acquisition, with a view to identifying and understanding those areas where Menta would seek to create savings. The costs incurred by prospective acquisitions should be analysed to identify those that cannot readily be reduced, such as the cost of renting depots. Those costs will have to be sustained, even if they seem high compared to Menta's usual spending. The local management can then be given realistic and achievable targets for reductions on other costs, along with suggestions for their achievement. Menta's board should ensure that the local managers are adequately supported throughout this process

## Section 2

### Goodwill on Menta Delfin

The fair values of the identifiable net assets may be difficult to evaluate because of their nature and because of the fact that they are located in a foreign country. The bus depot has been built for a very specific purpose, which may make it difficult to put to any other use and so there will not be a readily observable market price. One solution would be to value the land on which the depot is situated, which will have a more generic and defensible market price. If the fair value of the land is significantly lower than the book value of the land and buildings, then it may be necessary to take that as the fair value of the depot as a whole.

Similarly, Menta will have to take care to establish whether there is an observable fair value for the fleet of buses. Different models may have very different values and there may not be an active market in used buses. Different countries may have different rules relating to the design and operation of buses and so it may be difficult for Menta to draw on its experience and knowledge of managing its own fleet. Menta might start by looking at the replacement cost of the buses with new vehicles. That would set an upper limit for the value, which could then be adjusted pro-rata for the age of the buses and their expected useful lives. While that would not be an accurate valuation, it would provide a reasonableness check

The value of the rights to operate those routes will be difficult to evaluate in the context of this acquisition. They could, potentially, have no value if the rights are foregone in the event of a takeover. This is clearly a matter that will have to be investigated in great detail as part of the acquisition process because Menta will not wish to acquire a bus company that does not have the required licence to operate. There is a further complication because the licences will only have value if Menta Delfin plans to continue with its existing routes. Menta will have to decide whether it will be necessary to seek new or revised licences in order to operate on a different set of routes that will be implemented as part of the reorganisation.

### Budgetary control issues

The most immediate issue is that Menta has taken control of Menta Delfin and so it has a right to determine the business plan and to set budgets accordingly. If Menta Delfin is allowed to refuse to accept the budget then Menta may undermine its own authority over its newly-acquired subsidiary. It would be a far more effective compromise for Menta to support and advise Menta Delfin through the transition process. It may be that the reluctance of Menta Delfin's management is due to a lack of understanding and so any support will help them to implement the budget effectively.

It is important that there is a mutual trust between Menta and the new Menta Delfin subsidiary. Part of that trust will be the recognition that the existing management team have prior experience of managing this company. That may require that Menta should show some respect when setting the budget and discussing its implementation. That process of communication should be helpful in enabling Menta to demonstrate its understanding of the industry and the logic behind its approach to establishing itself in a new market. If the local management of Menta Delfin can see that there is a proven logic underpinning the budget and that the budget is, in fact, realistic then they will be far better motivated.

Perhaps Menta should exercise just a little caution before finalising the budget in case the reluctance to accept it is due to some cultural or other factors that is specific to Essen. Menta has a successful system for acquiring and reorganising newly acquired bus companies, but it may not be aware of all of the implications of making those changes in other countries. Even if Menta intends to overrule any objections, it should take care to understand why the local management team has objected in case there is an unforeseen problem that has to be addressed. Menta will lose a great deal of credibility if it ignores Menta Delfin's objections and runs into difficulty because of that.

## Section 3

### TARA and self-insurance

The TARA framework requires that we consider the likelihood and significance of risks in order to evaluate how they will be dealt with. Menta has a large number of buses that operate on an almost constant basis, so the likelihood of an accident is relatively high. The consequence of an accident could be high because it could involve significant damage to property and could lead to serious injury or even loss of life. High likelihood and high consequence usually places activities in the “avoid” quadrant of the TARA matrix, but that would mean that Menta would have to withdraw from its core industry.

As an alternative, Menta could consider the risks associated with any given bus rather than for the fleet as a whole. When considering a single bus, the likelihood of an accident is, hopefully, relatively low. The consequence of any bus accident will always be high because of the number of passengers on board. Traditionally, low likelihood and high consequence risks are associated with transferring the risk, such as taking out an insurance policy with a third party. Transferring risk in this situation is such a commonplace practice that the City Council has built it into the evaluation criteria for accepting a bus company.

Menta could split the risk element into two. The first is the moral and reputational risk associated with causing injury and that risk cannot be transferred. The likelihood is relatively high, but the consequences will be relatively low provided Menta cannot be held responsible. That quadrant will be associated with the reduce quadrant, which is consistent with the idea that Menta should ensure that its drivers are well trained and that its buses are properly maintained. The second element is the financial cost of accidents. For any given bus, the likelihood of an accident is low and the financial costs is likely to be relatively small in comparison to Menta as a whole. That suggests that the “accept” quadrant is realistic because the cost of insuring a steady stream of accidents with a third party is likely to be more expensive than self-insuring.

### Negotiation

The first step is to learn as much as possible about the City Council’s attitude towards public transport and the constraints that affect it. This is an important aspect of preparation because Menta’s objective is to maximise the amount of subsidy received. The City Council may have a complicated set of objectives because of budget constraints, offset against a desire to be seen to be developing and encouraging public transport for the local community. The management team at Menta Delfin will have useful experience of dealing with the City Council and will be able to brief Menta .

Menta should then offer the City Council a detailed proposal, identifying the routes that it plans to offer and the subsidies that it would require to operate them. Ideally, Menta should present a bid that meets the City Council’s needs as well as its own. For example, it may be in Menta’s best interests to continue with some of the less profitable routes in order to avoid bad publicity for the City Council if the routes are withdrawn. If Menta offers a reasonable compromise then the City Council will find it easier to justify the granting of the subsidy to its local electorate.

There is likely to be a period of bargaining between Menta and the City Council and this phase will have to be managed carefully. Menta should focus on what it requires from the City Council and should classify any concessions that the City Council requests in terms of their significance. For example, it may be undesirable to offer a marginal route, but it would cost relatively little to do so and it might be worth doing if it enables Menta to agree a workable deal. As part of this negotiation, Menta should ensure that the City Council is aware of the factors that would make it impossible for Menta to do business, so that the negotiation can focus on the key issues.

## Section 4

### Project appraisal

Generally, project appraisal focuses on future cash flows. Exchanging one plot of land for another will not involve any cash flow and so it might be argued that it should be excluded from the project appraisal. The only capital cost that should be taken into account would be the cost of building the new depot on the site that will be provided by the City Council.

There could be an argument that exchanging a valuable plot of land for one that is less desirable will reduce shareholder wealth. That is significant because the whole point of project appraisal is to measure the impact of the project on shareholder wealth. We should, therefore, consider the relative values of the two pieces of land. We need to do this with the values now, and also consider future values but choosing the time frame is difficult. We should also consider the likelihood that we will have to sell our depot within the foreseeable future.

It could even be argued that the existing depot's value does reflect a potential cash flow. If Menta wished, it could sell the depot in order to realise the value of this prime site and could use some of the proceeds to build a replacement. That would yield a net cash inflow that is similar to the difference between the values of the plots of land involved in this discussion.

The only reason for relocating the depot is the desire to be eligible for the subsidy and so it must be taken into account in evaluating the project. We appear to be in a position where we are being asked to incur some building costs in return for an improved revenue stream and so the subsidy is part of the project. We should consider any other impacts on operating cash flows, such as greater efficiency from a new depot or additional fuel costs associated with operating from a less convenient location.

Before we make a final decision concerning the project we should, however, consider whether the subsidy really is dependent on the new depot. The fact that an influential member of the committee will oppose the subsidy may be an inconvenience, but there could be an appeal process if the application is rejected. It may also be difficult for the City Council to withhold the subsidy if Menta would resist by restricting its operations to profitable routes only and reducing the availability of public transport for sectors of the community.

### Related party

At first glance, there does appear to be a relationship between Menta and the City Council by virtue of the fact that the bus services that will operate in Delfin are almost a joint venture. The transaction involving land also appears to be set artificially, with no arm's length pricing of the assets that are being exchanged. That suggests that stakeholders ought to be informed of the basis on which the transfer was made.

Despite the artificial nature of the agreement, there is no reason to believe that Menta and the City Council are related parties in terms of IAS 24 *Related party disclosures*. There is no formal relationship that would fall within the terms of this standard, such as ownership of shares or other sources of influence. The fact that



the City Council could be viewed as a joint venture partner would be specifically from the definition of a related party

### **Conflicts with City Council**

The City Council has a complicated interest in the construction of the new depot. For example, local government normally has a duty to ensure that any new buildings are suited to the sites that they will occupy. It would normally be the Planning Department's duty to ensure that any new buildings satisfy their regulations, but in this case, it would appear that the Planning Department is keen to acquire Menta's existing site and so could be conflicted by a desire to persuade us to accept their proposal. Similarly, the Transport Department should have concerns about a proposal that will divert a great deal of additional bus traffic to another area if it would disrupt local traffic or create some other problems .

The proposal could raise objections from the department responsible for leisure because a recreational facility is being converted to commercial use. There may be objections from the local community, who will be affected by the development of this site. Local councillors could be concerned that they will lose votes in future council elections if local residents are unhappy and so they may intervene to block the proposal