THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

No. of pages: 07

Corporate Strategy and Contemporary Issues

KC5

DECEMBER 2015

Instructions to candidates

(1) **Time allowed:** Reading and planning - 20 minutes
Writing - 3 hours

(2) **Marks:** 80 marks

(3) The examination will be conducted as an open book examination.

(4) This question paper should be answered entirely in the **ENGLISH** language.

(5) Your answer must be submitted in the answer booklets provided at the Examination Hall.

(6) Any pre-prepared papers included in your answer WILL NOT be marked.

(7) After the instruction to stop writing at the end of the paper, you will be given five minutes to assemble your answer booklet/s.

Colombo Trading and Industries (CTIL) Group- Unseen Material

CTIL is a diversified organisation. As depicted in the organisation chart, each member company which constitutes several strategic business units (SBUs) is under the leadership of an executive director. Dealing in many products in an increasingly competitive environment results in busy schedules for the executive directors. The monthly extended board meeting is the gathering that paves the way for the group Chairman and the managing directors to understand important strategic and operational issues confronting the companies and SBUs within the group.

Given below are the descriptions of certain key issues, situations and problems that were subject to discussion at the September 2015 board meeting:

- **Interpretation of CTIL's performance by Adam and Bernard**

During the board meeting held in September 2015, draft management accounts of CTIL for the year ended 31 March 2015 were subject to detailed discussion. Adam and Bernard are two senior directors fresh from attending a senior management development programme in Singapore. Having done their financial analysis of the CTIL management accounts sent to them three days ago, prior to the meeting they made the following summary comment in the form of a joint statement:

"We seem to have done quite well. Despite intense competition and a growing market our sales have increased, profits have increased, assets have increased, and net profit has increased. Even one of the most important indicators in trading, the gross profit ratio and more importantly whilst keeping our expense ratios intact, the asset turnover ratio has also improved. Along with the increase in earnings per share we are sure in particular, our Chairman will be happy. Time to celebrate!"

- **Inventory controls implemented by Chohona (Finance Director)**

Adam informed at the meeting that he faced an embarrassing situation because he could not establish a letter of credit in time to import some urgent bearings required by an important, longstanding client due to the strict inventory controls in operation.

- **Compensation and rewards related issues**

Charlie, the Chairman, is the type of person who very well understands the importance, strengths and weaknesses of each key employee. However, he never believes in being dominated or showing his sentiments of appreciation, except during the year-end rewarding sessions where he personally hands over all senior managers the fixed amount of applicable bonus (that is dependent on the service and applicable profits of the employee's division), together with a special undisclosed component that represent his intuitive and subjective appreciation and recognition of an individual's contribution. This is a practice that is highly valued by the senior employees and Charlie believes it will create extra energy and excitement encouraging special and additional effort from his seniors.

As CTIL is a large organisation that has grown to the level of a major conglomerate in the country, Charlie regularly consults his influential colleagues from more established company settings for advice. He has been recently advised by them to resort to a somewhat formal rewarding system than paying discretionary undisclosed bonuses as practiced at present.

Xavior one of the joint managing directors, made a proposal to pay all managers of all the companies a profit share amounting to 10% of the respective company's 'profit after tax' which was to be allocated between the managers of the company on the basis of their total emoluments. This was to be in addition to their normal service and divisional profit based bonus that was charged to their divisional profit and loss statements.

Additionally, with the view to encourage those who have an impact on sales amidst emerging competitive pressures and benchmarking competitive practices, Xavior has also proposed all sales personnel to be paid a commission of 1% of the invoice value of the sales generated by them. Such rewards are to be paid monthly, instead of waiting till the year-end bonuses. Both the above proposals of rewarding employees recommended by the joint managing director are in addition to the annual existing bonus payment that is determined based on the stay of an individual within the group and the profitability of their respective divisions according to a predetermined scheme (subject to a maximum of two months of gross emoluments).

- **Certain strategic marketing issues confronting the Light Construction Equipment Division - Rammers**

Priyan, head of the Light Construction Equipment division was called for the meeting by Adam to explain some issues confronting Division 1 - Rammers. He informed at the meeting that the company's brand of rammers "Powerful" is facing increasingly tough competition from much cheaper Korean and Taiwanese brands that claim to be performing at equivalent levels in relation to 'noise levels' and 'vibrations felt by the operator'. However, Priyan admitted that the company's brand was still ranked higher amongst the dimensions such as 'compaction depth' and 'vibration frequency'.

At this point, the most senior sales manager was also called in for the meeting. He expressed his point of view that 'centrifugal force measured in tonnage' is a very important performance criteria from a buyers' perspective and the Korean competitive brand appears to be superior in this respect. He further pointed out the 'high price level' of the CSL brand even in comparison to equivalent Japanese brands that are also positioned as premium quality products at premium prices.

"Powerful" is a popular western product. Being one of the company's premier and longstanding brands, the Chairman is extremely fond of this product line. He was quite upset of the stiff competition facing the company, especially given the plans of the new government to construct two more highways in the country promising marketing opportunities for the company's light construction equipment range. This would be a key strategic strength to the company. With cheaper, yet technically powerful Asian brands making their inroads into the Sri Lankan market, the CTIL board realised the strategic marketing challenges that they will have to encounter in the future. They will no longer be able to rely on their past laurels where selling efforts mostly revolved around brand superiority. Carefully listening to these discussions the Chairman was conscious that no reference was made to several service offerings by his company as well as pricing related variables such as credit terms that CSL offers due to extensive supplier credits that he has personally negotiated. He felt that the situation warrants some high level strategic marketing expertise to inculcate a more organised marketing and selling approach in the companies.

- **Introduction of a new product at CSL and its feasibility**

Adam is an acknowledged individual with considerable contacts. He was always looking for growth in his divisions. Adam was also instrumental in establishing the Electrical Switchgear division, a quality product addition to the company's product portfolio that was perhaps not in line with the other major product categories within the group and required the establishment of a comprehensive dealer network. Adam is a hardworking marketing professional, and earned considerable respect from the Chairman and the rest of the directorate for this monumental achievement that has now turned out to be a profitable decision for the group as a whole. It is a prospective cash cow for the company in the long term.

At the board meeting Adam also put forward a proposal to locally produce a chemical which with further mixing and processing will provide a specialised 'road construction chemical' required for the two new highways that will be constructed. Always alert to developments in the macro environment, Adam had reliable information of the certainty of these two substantial projects, one of which is scheduled to commence immediately and be completed before the next parliamentary elections in 2020. Immediately thereafter, the second project will commence and be completed by 2025. With technical assistance, collaboration and advice from the company's overseas partner (a world renowned Dutch chemical company) it can be safely estimated that CSL will be able to secure all the orders of the 'road construction chemical' for these two projects (at the rate of 100,000 units per year for 10 years), that were imported during the previous highway construction. "As this is a product that will not have any noteworthy demand in the normal course of business, a new company needs not to be established. I can manage the manufacturing and supplying this chemical during the construction phrase of the two highways within a new temporary division under my supervision, with a few additional costs that will include the expenses of a specialist overseas chemist who will supervise the project with periodical visits to the country", commented Adam when forwarding his proposal. "This is also an excellent opportunity and an innovative avenue for us to circumvent direct competition from traditional equipment suppliers whilst earning an additional profit to the company. I will organise project finance at a rate that Chohona considers appropriate." He further said.

Financial data in relation to the new product proposal is as follows:

1. Projected asset investment:	
Working capital:	
- Cash	Rs. 15,000,000
- Receivables	Rs. 45,000,000
- Inventory including raw materials	Rs. 90,000,000
Fixed assets:	
- Mixing plant and equipment	Rs. 150,000,000
2. Cost data:	
Variable cost per unit	Rs. 900
Differential fixed cost per annum* (*Includes straight line depreciation on mixing plant and equipment)	Rs. 51,000,000
3. Unit price	Rs. 1,800
Assuming annual sales of 100,000 units.	

Fresh from his senior management development programme in Singapore that included a multi-disciplinary course curriculum with finance as a core-course module, Adam commented,

"When confronted with limitations of corporate funds, as a private company without access to capital markets, we should strive to make investment decisions for new products on the basis of Return On Investment (ROI) that will optimise scarce corporate level resources. The proposal I have forwarded will yield us a gross return (before tax) on assets amounting to 13%, which is well above our current equivalent figure for the group as a whole. Hence by undertaking this project, we will improve the wealth of the shareholders." Adam has also negotiated a separate package of funding to finance this project through his network of contacts in the financial sector.

- **SBU structure at CSL**

Creation of SBUs to facilitate the structuring of diverse business activities when embarking on diversification for growth was among the corporate level strategic management thought learnt during the recent management development experience. CSL executive director Adam wishes to revisit the appropriateness of the SBU structure of his company and recalled the discussions during the programme that revolved around the advantages of creating SBUs versus the resultant costs due to additional staff positions and overheads.

QUESTIONS

You have been appointed as the management consultant to advise Chairman Charlie, and was invited to participate in the September board meeting as an independent observer.

Required:

Prepare a memorandum to the attention of the Chairman containing answers to the questions mentioned below that revolve around the main issues that were subject to discussion at the meeting.

(Show your workings clearly by way of an appendix.)

Part A

(a) **Criticise** joint statement made by Adam and Bernard, by pointing out four critical observations that you will make in relation to the opinions expressed by the two directors.

Your answer may include findings from your analysis of the management accounts and other related information presented in the pre-seen. (You are <u>not</u> required to present a detailed analysis of the group's management accounts)

(12 marks)

(b) (i) **Evaluate** the controls that Chohona has adopted to control inventory of the divisions that are engaged in ex-stock sales, with particular reference to the "industrial bearings" division.

(4 marks)

(ii) **Recommend** two (02) improvements that you may consider appropriate for controlling inventory citing reasons for such recommendations.

(6 marks)

(Total: 22 marks)

Part B

(a) (i) **Evaluate** the sales incentive scheme as proposed by Xavior whereby 1% is to be paid to all sales personnel in respect of the sales generated by them. (2 marks)

(ii) **Propose** two (02) improvements that you may consider necessary to make the proposed scheme a more effective one. (4 marks)

(b) (i) **Evaluate** the profit sharing scheme proposed by Xavior for all managers of the group. (2 marks)

(ii) **Propose** two (02) recommendations that you consider in making the scheme more strategically relevant. (4 marks)

(c) **Propose** Priyan, Adam and marketing manager of the division Rammers of CSL, how they could analyse and better understand the specific problem faced by the company in marketing rammers as discussed at the board meeting.

The objective here is to guide them towards a methodical approach to understand and analyse the company's product offerings in relation to the competitor offerings. Illustrate your answer by developing a framework that will help the decision makers to arrive at a systematic understanding of the problem.

(10 marks)
(Total: 22 marks)

Part C

(a) (i) **Validate** the ROI computation that arrives at 13%, as presented by Adam for the proposed new product.

(4 marks)

(ii) In a multi–divisional firm such as CTIL, **discuss** the applicability and problems of using ROI as a method of controlling corporate resources.

(6 marks)

(iii) **Criticise** on the project evaluation methodology adopted by Adam to assess the financial viability of the project. (3 marks)

(iv) **Advise** with necessary calculations using an appropriate capital budgeting evaluation technique and conclude the rate of interest that Chohona needs to indicate to Adam as an appropriate rate of interest, to obtain funding to finance this project.

(Assume tax rate at 34% and ignore capital allowances)
(Hint: Compute IRR)

(13 marks)
(Total: 26 marks)

Part D

(a) (i) **Discuss** the dimensions that will define the scope, and influence the creation of SBUs, with particular reference to CSL's business activities.

(5 marks)

(ii) **Evaluate** the current organisation of CSL's SBU structure.
(Hint: look for overlaps in business scope amongst SBUs of CSL).

(5 marks)

(Total: 10 marks)
(Total for the paper: 80 marks)