THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

27510 - TOP CA CASE STUDY EXAMINATION

MAY 2014

<u>Question 01</u>

Assuming that you are the CEO of Hamson Group,

1. **Draft an environmental analysis for Hamson Group considering the impact of proposed business strategies referring to future trends in hotel and Leisure sector.**

(18 marks)

- Candidates are expected to perform a PEST and SWOT analysis
- Referring to the Advance Information provided and as per their references, candidates are expected to come out with lucrative investment opportunities available in the hotel and leisure sector in Sri Lanka
- Candidates are expected to critically evaluate current trends in the hotel and leisure sector by doing an external environmental scan (Opportunities and Threats)
- Drawing from the answers provided in the above 3 questions, candidates are required to identify and report including the strategic priorities to explore and penetrate new business ventures related to hotel and leisure sector.

Students are required to describe the impact of different factors which affect the business environment using two environmental analysis models.
(Following points can be used as guidance for the expected answer)

01 PEST Analysis
Economic factors

- The industry is largely benefitted by rapid infrastructure development and transport facilities such as domestic highway network and air transport, supporting efficient tourist mobilization
- The development of domestic infrastructure facilities, strategic investments by global hotel chains, promotional campaigns, new tourist attractions and identified zones in the Northern and Eastern Provinces for tourism development activities, gave Sri Lanka a stronger stand in international promotions.
- Rising per capita income and higher disposable income of Sri Lankans
- Lower interest rates that promotes investments
- Tax benefits and exemptions allowed for leisure sector
- Rapid development of the hotel and leisure sector after war.
    - As example, Tourism sector passed the landmark of more than one million tourist arrivals in 2012 and 1.2 million in 2013, growing in line with the targets set for the sector.

    - Earnings from tourism exceeded US Dollar 1 billion, the highest amount recorded within a year, recording a growth of 25 per cent
- Tourism Development Zones in Kalpitiya, Kuchchaveli and Yala are being promoted for investment with a view to developing tourism on different themes. As an example, a hotel that came under the Kuchchaveli tourism development project was completed with an investment of Rs. 850 million adding luxury rooms
- Attraction of foreign investors for hotel sector
    - E.g. Shangri-La Asia Limited
- Sri Lanka Tourism Development Authority (SLTDA) together with the Urban Development Authority (UDA) continued its tourism zone identification process in the districts of Mulativu, Mannar and Jaffna in the Northern Province.
- Sudden economic down turn might create adverse impact on the industry

Political factors

- Government intervention to promote and nurture the hotel sector targeting of 2.5 million tourists and recording earnings of US dollars 2.75 billion from tourism by 2016 remained the main focus of the industry.
- Positive prospects in "Mahinda Chinthana" to promote and develop tourism sector in Sri Lanka facilitating the National Tourism Strategy introduced in 2011 to develop the tourism sector.
- Promotional activities conducted by the government in 25 trade and travel fairs worldwide with travel industry participation in direct market promotions that were held in the UK, China, Germany, India and the Netherlands and other countries.
- Regulations imposed by the government in respect of minimum room rates for each class of hotels.
- Impact of national tourisms strategy– with the steps taken by the policy makers towards restructuring and improving the sector.
- Launch of Sri Lanka travel and tourism club in collaboration with Ministry of Economic Development to develop tourism
- Stable political environment of the country.

Social factors

- Increasing trend of domestic tourism as a result of increasing living standard of people.
- Tendency of guest arrival from European countries
- Cultural changes due to expansion of the tourism industry
- Shortage of skilled labor in the industry restrict the fast development of hotel and leisure sector

- Anuradhapura is one of the cities identified by SLTDA and it is in the cultural triangle in Sri Lanka to promote tourism

Technological

- Higher rate of growth in technology reduces the cost of transactions. e.g online banking and payment systems
- Promotions of credit cards for hotel and leisure sector leads to develop domestic tourism
- Use of highly technological equipment reduce the overhead cost of hotels with more focus on customer neads
- Use of social media marketing reduces the promotional cost.

02 SWOT Analysis

Strengths

- Hamson Group (HG) is a large scale conglomerate established sixty years ago having a solid foundation in diversified businesses.
- Well established company with strong financial background
- Hands on experience in Hotel and leisure sector
- Diversified business that provide supporting services for the hotel and leisure sector such as Hamson healthcare and transport service

Weaknessess

- Since it is a family owned business, there may be governance issues that need to be considered
- High diversity in the group
- Lack of contingent plan for sensitivity of the industry
- Lack of skilled labor
- High fixed overhead

Opportunities

- Peaceful environment in the country helps to promote local and international tourism.
- Beautiful costal natural environment in the country
- Diversity of Weather Cnditions within a short distance in the country
- Lower cost of labor
- Low cost destination for foreigners due to exchange rate differences
- Development of expressway network over the country

Threats

- Inadequate transport network and tourism infrastructure
- Cultural and legal barriers to promote innovative games relating to hotel and leisure sector
- High competition locally and internationally
- High promotions for foreign tourism among Sri Lankans
- Internationally created negative image of the county (international human right concerns)
- Since the industry is highly sensitive to the present political environment, unexpected political developments/communal clashes can create a big impact to the sector

<u>Emerging trends in hotel and leisure sector</u>

- World tourism more focused on Eco tourism
- World class conferences held in Sri Lanka will promote national tourism for coming years
- International relationships improve the prospects in tourism
- Construction of express network over the country facilitates tourism

<u>Question 02</u>

Assuming that you are the CEO of Hamson Group,

2. **Prepare a report encompassing above proposals to submit to the next board meeting. Your report should include financial analysis of the viability of projects and other factors to be considered. Your answer must be justified through prioritizing the best option to be implemented and which will maximize the shareholders wealth.**

(65 marks)

- Candidates are required to support their arguments by providing accounting and financial analysis in order to consider and select a project which will justify the future prospects and strategic priories of Hamson Group for its sustainable development.

- Answer should be presented in the coporate report format and it should mainly include Executive summary, Introduction, Analysis, Conclusion and recommendations.

- Marks are allocated for the following areas

Reporting Format	= 5 marks
Rangiri hotel acquisition	=20 marks
Anuradhapura hotel project	=20 marks
Pros and cons of each options	=15 marks
Conclusion and recommendation	= 5 marks
Total	= **65 marks**

- Following information and calculations can be used to support your answer.

<u>Rangiri Hotel Ltd Acquisition Project</u>

Students are required to work out the valuation of the business based on the Dividend Growth Model approach and Forecasted Cash Flow technique.

Computation of Return on Equity

Year	**2013**	**2012**	**2011**	**2010**	**2009**
Profit for Ordinary Shareholders (Rs. '000)	231,815	227,385	180,849	208,199	157,910
Equity	1,167,939	1,144,758	956,220	842,286	709,039
ROE	19.8%	19.8%	18.9%	24.7%	22.2%
EPS	**5.15**	**5.05**	**5.05**	**5.78**	**4.39**
DPS	**4.636**	**1.263**	**1.859**	**2.082**	**1.75**
Payout ratio	90%	25%	37%	36%	40%
Retention ratio	10%	75%	63%	64%	60%
Growth	0.0198	0.1485	0.1191	0.1581	0.1332
Weights	1	0.4	0.16	0.06	0.03
Weighted growth rate	0.0198	0.0594	0.0191	0.0095	0.004
Average growth rate	11%				
Expected rate of return by shareholders in similar businesses	26%				
Price per share	= 4.64*(1.11)/ (0.26-0.11) **= Rs. 34.34**				

No: of shares	45,000,000				
Total value of shares (Rs. ‘000) as per Dividend Growth Model	154,530,000				
Book value per share	Rs. 25.95				
Total value of shares (Rs. ‘000) as per book value	1,167,939				

Forecasted cash flows for next five years (Rs. ‘000)

	2014	**2015**	**2016**	**2017**	**2018**
Net Operating Profit After Tax (NOPAT)	253,470	278,817	306,699	337,368	371,105
Add: Depreciation	55,000	60,000	60,000	70,000	70,000
Less: Increase in WC requirement	(25,750)			(5,800)	
Cash from operations	282,720	338,817	366,699	401,568	441,105
Cash flows are growing for the future periods					NCF/COC 1,917,847
Discount Rate (23%)	1	0.81	0.66	0.54	0.44
Present Value	282,720	274,441	242,021	216,846	1,037,939
Net Present Value	**2,053,967**				
Less: Debt	(179,786)				
	1,874,181				
Value per share	**41.65**				
Calculation of WACC for business valuation of Rangiri Ltd.					

Tax rate - 32%		Weights	
Average Cost of Debt	(17% X(1-.32)) 11.56%	20%	
Cost of equity	26%	80%	
WACC	**23%**		

Anuradhapura Hotel Project

Candidates are required to perform a comprehensive project appraisal relevant to the Anuradapura Hotel Project. They should justify the answer by:

- Applying the NPV decision criterion
- Applying other DCF criteria with strong justification (e.g. IRR)
- In addition to above, applying conventional investment decision criterion like Payback Period will also be accepted as supporting justification.

NPV Calculation for the Anuradhapura Hotel Project

Room type	**No: of rooms**	**2017**	**2018**	**2019**	**2020**	**2021**
Traditional	110	20,000	22,000	24,200	26,620	29,282
		475,200,000	522,720,000	574,992,000	632,491,200	695,740,320
Cottage/Double	10	30,000	33,000	36,300	39,930	43,923
		64,800,000	71,280,000	78,408,000	86,248,800	94,873,680
Cottage Single	10	25,000	27,500	30,250	33,275	36,603
		54,000,000	59,400,000	65,340,000	71,874,000	79,061,400
Family bungalows	20		60,000	66,000	72,600	79,860
			259,200,000	285,120,000	313,632,000	344,995,200
Room rental		594,000,000	912,600,000	1,003,860,000	1,104,246,000	1,214,670,600
Food		112,000,000	121,000,000	187,000,000	199,000,000	243,000,000
Total revenue		706,000,000	1,033,600,000	1,190,860,000	1,303,246,000	1,457,670,600
Operating expenses		523,000,000	610,000,000	742,000,000	787,000,000	825,000,000

Cash Flow Forecast for the Anuradapura Hotel Project

Rs. '000	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**TV**
Initial Investment	(1,337,187)	(931,458)	(274,000)					
Revenue			706,000	1,033,600	1,190,860	1,303,246	1,457,670	
Operating Expenses			(523,000)	(610,000)	(742,000)	(787,000)	(825,000)	
Net CF	**(1,337,187)**	**(931,458)**	**(91,000)**	**423,600**	**448,860**	**516,246**	**632,670**	
Discount Rate 23%	1	0.813	0.661	0.537	0.437	0.355	0.289	
	(1,337,187)	(757,275)	(60,151)	227,473	196,152	183,267	182,841	2,189,171
NPV	**824,292**							

Adjusted WACC for the construction of hotel project

Capital structure	Weights	Rate	WACC
14,517	0.72	0.26	0.1878
3,036	0.15	0.13	0.0196
2,543	0.13	0.16	0.0202
20,096	New WACCC		23%

Further students are required to briefly discuss about the qualitative characteristics (pros and cons) of each investment/business option.

Advantages and Disadvantages of Each Project

Rangiri Hotel Ltd Acquisition Project	**Advantages**	**Disadvantages**
	No additional hiring cost/labor cost	Higher bidding price offered by Rangiri Ltd.
	Minimum initial scope of work	Conflict of interest among new management and existing employees and existing governance issues in Rangiri Ltd.
	Lower consumption of time and human efforts	Threat of competitive bidders (price war)
	Capitalizing the existing reputation	Lack of information about the internal matters in Rangiri Ltd
	Acquiring assets lower that the market value	Difficulty of reaching a consensus to determine a true value (decision to stop at a certain bargaining range)
	Enjoying the existing customer base	Complexity involved in the due diligence process
	Healthy financial indicators of Rangiri Ltd.	.
	Synergistic benefits	
Anuradhapura Hotel Project	**Advantages**	**Disadvantages**
	Financial viability of the project because Positive NPV that maximizes shareholders wealth	Uncertainty about the future
	Acceptable to all stakeholders with the emergence of the booming tourism sector in Sri Lanka	Cash flow forecasts may not be realistic
	Consistent with the world environment protection initiatives (eco friendly, value-added services)	Changes in the political environment
	Shareholder wealth maximization	Cultural barriers due to project being located in the religious city and environmental issues

	Contributing to the development of the economy by the way of creating new employment opportunities and earning foreign exchange	Competition
	Locational advantage of world famous Anuradhapura city and heritage	High level of fixed cost
	Tax concessions and high rate of return on investment	Issues relating to project management and implementation
	Help to be the leader in the hotel industry	

Conclusion and Recommendation

Rangiri Hotel Ltd Acquisition Project	Value Per Share Book Value Per Share : Rs. 25.95 Dividend Growth Model : Rs. 34.34 Present Value method : Rs. 41.65 Bidding Price : Rs. 50 – Rs. 60 Since bidding price range is higher than the real value of a share, it is not recommended to acquire Rangiri Ltd., If the student accepts this option, he/she should strongly justify it with other qualitative facts.
Anuradapura Hotel Projectca	NPV = Rs. 824,292,000 Positive NPV suggests the financial viability of the project. Therefore, it is recommended to proceed with the construction of Anuradapura Hotel Project.

In addition to above, following business models should also be evaluated further.

- BPO Industry
- New venture in healath care sector
- New transportation network
- Readymade tailoring for tourists at the airport.

<u>Question No. 3</u>

Assuming that you are the CEO of Hamson Group,

3. Write a separate report to board of directors by emphasizing the importance, implementation procedures and its challenges on integrated reporting to Hamson Group.

(17 marks)

Integrated Reporting

To : CEO – Hamson Group

From: Senior Manager, Hamson Group

Integrated reporting outlines the organisation's social, environmental and economic risks and opportunities and how from a forward-looking and holistic perspective, they have been integrated into the core vision and strategy, over the short, medium and long term. Further, it sets out both financial and non-financial key performance indicators (KPIs) for material risks and opportunities, and demonstrates how performance against each KPI is managed to deliver value in the short to long term.

The aim of an integrated report is to allow stakeholders to gain a complete understanding of a company, its strategy and performance, and of how it is dealing with and has addressed sustainability challenges. The purpose of integrated reporting is to demonstrate the impacts of the organisation's environmental, social and governance matters on its financial performance, and vice versa and show how this flows from strategy and internal management processes. It should illustrate the extent to which the financial, social and environmental management systems of the organisation are creating and sustaining value over the short, medium and long term. For example, the application of integrated reporting could see Hamson group monitor the links between investment in customer service training for employees and the changes in customer and employee satisfaction and the return business that result from the business.

By enabling investors to assess the relative sustainability of Hamson Group over an extended time frame, integrated reporting can assist in focusing the financial system on longer-term value creation.

It is important to note that an integrated report is not achieved by merely merging the annual financial and sustainability reports. For most organisations adopting an integrated approach will involve a fundamental shift in Hamson Group model as they examine value creation through multiple dimensions.

Integrated reporting requires that organisations evolve their core mission and strategy to incorporate environmental, social and governance matters and correctly reflect their impacts on the company's financial performance, and vice versa (Jeyaretnam, T and Niblock-Siddle, K, 2010). The way companies do business and the goods and services they provide may be challenged. New opportunities, processes and markets may be explored.

Notably, integrated reporting is much more than a public report to stakeholders and it is not merely a merger of financial and non-financial reports. For most organisations, adopting an integrated approach will involve a fundamental shift in their business model as they examine value creation through multiple dimensions.

Integrated reporting requires that the key documents that drive Hamson Group activity, acknowledge and reflect the interdependencies between non-financial and financial performance. Embedding non-financials within company values and corporate strategy provides a signal to staff at all levels and to the company's external stakeholders that these matters lie at the heart of the Hamson Group's purpose and are thus to be reflected across operational strategies and policies, programmes and day-to-day operations.

Roadmap to integrated reporting

Integrated reporting necessitates a fundamental change in how Hamson Group is conducted and so requires robust and long-term planning.

Stage 1

- Ensure the organisation's processes for identifying and assessing material non-financial risks and opportunities are robust, timely and aligned with processes for managing financial business risks.
- Refresh Hamson Group's mission and purpose to encompass material non-financial concerns and reflect their interdependency with the financial standing of the company.
- Communicate the organisation's new, integrated mission and strategy to internal and external stakeholders.
- Commence development or refinement of non-financial KPIs and targets to reflect the importance of these matters to core business, and measure achievement of operational strategies as well as the core strategy.

  Integrate consideration of non-financial matters into core strategic planning activity.

Stage 2

- Refresh the core strategic plan to create an integrated strategy reflecting the organisation's revised vision and purpose.
- Revise, as necessary, existing operational strategies and policies for all financial and non-financial issues.
- Review the stakeholder engagement framework focusing on the need to deepen dialogue and increase transparency.

- Continue development or refinement of non-financial KPIs and targets and create action plans to deliver against them. Ideally, stakeholder engagement would facilitate this process.
- Review current internal data collection methods for KPIs and update or establish new systems as required.
- Issue a public report that reflects the organisation's emerging integration

Stage 3

- Seek external and internal stakeholder feedback on the previous year's report and the reported KPIs and targets.
- Gain external feedback on KPIs from investors, communities, customers and employees through the company website and other means.
- Improve stakeholder engagement through a higher level and greater number of disclosures.
- Review reporting against the applicable framework.

Stage 4

- Seek feedback on the previous year's report.
- Engage stakeholders online through a facility that allows them to provide feedback, ask questions and discuss issues.
- Develop a roadmap to secure third-party assurance for the report.
- Issue a public integrated report and continue to release financial and non-financial performance data throughout the year.

Implementation challenges

Integrated reporting is an evolving reporting mechanism. Early adopters of integrated reporting will be required to experiment with systems, data collection and public disclosures and identify how the interconnections between financial and non-financial performance are best understood and communicated.

1) Understanding and articulating linkages

Integrated reporting requires a detailed understanding of the complexity of the organisational value-creation process, including the relationships between financial and non-financial performance. Hamson Group's ability to articulate such linkages will depend on the extent to which its reporting procedures, knowledge management and data collection systems enable consideration of the relevant data. This will require expanding non-financial reporting systems to facilitate collection of data on all material matters and aligning them with or incorporating them into the company's financial data collection systems.

2) Quantifying performance

The metrics required for quantifying performance and demonstrating the linkages to financial performance are very different from traditional corporate performance measures. Integrated reporting will involve the development of a new language for measuring and articulating corporate performance, including an increasing use of environmental and social accounting frameworks.

3) Maintaining relevance to stakeholders

A key objective of integrated reporting is to provide an organisation's stakeholders with the information needed to make informed decisions. Therefore, it is critical to ensure that integrated reporting is relevant to each stakeholder group. This will require report content and stakeholder communications to be focused on those issues of greatest materiality. For many companies it may necessitate the release of specialist reports to meet stakeholders' needs and regulatory requirements.

4) Integrated risk management

Effective risk management ensures that a company is proactive in anticipating and managing its emerging risks and opportunities. Defining, prioritising and managing risks is not as straightforward as conventional risk management. Determining risk through application of financial thresholds is not sufficient. It requires a broader consideration of impacts and time frames, informed by transparent materiality-determination and prioritisation processes.

5) Challenges ahead

- Existing reporting procedures, knowledge management and data collection systems must expand to enable companies to articulate both the linkages between financial and non-financial performance and how they contribute to the value-creation process.

- A new language for measuring and articulating corporate performance, making use of environmental and social accounting frameworks, is required.

- The information needs of different stakeholder groups may necessitate the release of specialist reports to supplement the integrated report.

- Financial thresholds are not a sufficient test when assessing risks to non-financial areas. A broader consideration of impacts and time frames is required, informed by transparent materiality determination and prioritisation processes.

- Although standards for the assurance of financial and non-financial information currently differ, auditors of integrated reporting will need to assess all data in a consistent and cohesive manner.

- Auditors of integrated reporting will need the right skills and be versed in a broader range of performance fields to assess financial and non-financial information. Conversely, different auditors and different standards may be applied within a hybrid audit model to achieve the desired assurance outcomes.

Demonstrating to asset and fund managers that integrated reporting, with its holistic overview of company performance, will be of value in assessing other investments, will be critical in stimulating the uptake of this new form of reporting.

Conclusion and Recommendations

Traditional forms of public reporting, which include both financial and non-financial reports, do not disclose this link and typically focus on short-term and retrospective performance. They do not provide sufficient information to shareholders and other stakeholders to make informed decisions about the current and future company performance.

The concept of integrated reporting has arisen to address such deficiencies in current reporting regimes. The aim of integrated reporting is to acknowledge and demonstrate how an organisation is managing material financial and non-financial risks and the interdependencies between them. It is forward-looking, focused on short-term and long-term strategies as well as recent performance, and identifies how resources and governance structure will be deployed to create value.

Notably, integrated reporting is much more than a public reporting to stakeholders and it is not merely a merger of financial and non-financial reports. For most organisations, adopting an integrated approach will involve a fundamental shift in their business model as they examine value creation through multiple dimensions.

Therefore, it is recommended to implement integrated reporting system gradually to gain more competitive and sustainable growth in Hamson Group.

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They are not intended as “Model answers’, but rather as suggested solutions.

The answers have two fundamental purposes, namely:

1. to provide a detailed example of a suggested solution to an examination question; and

2. to assist students with their research into the subject and to further their understanding and appreciation of the subject.

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