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THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

27510 - TOP CA CASE STUDY EXAMINATION

DECEMBER 2013

Internal Memorandum

To: Monoj Ambani
From: Nimran Jayadesh
Date: 14 December 2013
Subject: Proposed merger – SBL and STF

Dear Sir,

Please find the draft report herewith for your attention.

I have analyzed each option based on the information available and a few assumptions made.

Hope to discuss the same with you this evening.

Best regards,
Nimran

Table of Contents

1. Executive Summary
2. Introduction
3. Evaluation of Recapitalization Proposals
4. Overall Implementation Plan
5. Analysis and Evaluation of Other Issues
6. Conclusion and Recommendations

NOT FOR SALE

1. Executive Summary

Meeting the minimum capital requirement and maintaining capital adequacy have become major issues for Serendib Bank Limited (SBL). Further to various discussions and meetings with the Treasury of Serendib Government (“Treasury”) and the Special Executive Committee (“SECo”), the following options are under evaluation:

- i. Issuing new shares through an IPO
- ii. Treasury injecting money
- iii. Merger with Serendib Trust Fund (STF)

Merger with STF has already been considered as the first priority by SECo. This option is further justified as the first priority by the detailed analysis in this report. Accordingly, the suggestion is to first consider the merger option and implement the same on or before 1 January 2014 (ref. Section 3.3). While satisfying the minimum capital requirement through the merger as a temporary solution, the merged entity should seek further funding from the Treasury (ref. Section 3.2). Finally, the merged entity may think of an IPO after two years. However, a strong balance sheet is mandatory to ensure the success of an IPO (ref. Section 3.1).

As discussed later in this report, there are operational/strategic issues in both the entities, which need to be resolved by way of a proper restructuring plan. Such issues are (but not limited to) the following:

- i. Accounting and financial reporting issues
- ii. Poor credit and recovery management team
- iii. Corporate governance issues
- iv. Taxation issues
- v. New legal status of merged entity
- vi. Repayment of MSDB depositors

Overall, as the first priority, SBL and STF are to merge and continue as a bank - with SBL in the micro finance sector. Further support from the Treasury is then to be requested for future capital requirements and expansion. Once a strong balance sheet position is created with a sound reporting environment and internal controls, SBL will go for an IPO within two to five years.

2. Introduction

SBL has been facing many difficulties during the last few years. Satisfying the minimum capital requirement as required by the Federal Bank of Serendib (FBS) and maintaining the same in the future has become a major issue for SBL. A special executive committee (SECo) has forwarded three options to overcome the set forth issues.

This report evaluates each proposal in detail with special attention to the merger option. The report also discusses alternative plans for implementation of the said proposals, and analyses and evaluates other issues faced by both SBL and STF.

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3. Evaluation of Recapitalization Proposals

3.1 Proposal I: Issuing new share capital by way of an IPO (Serendib Stock Exchange – SSE)

This proposal would bring the following advantages to SBL:

- SBL will meet the minimum required capital as stipulated by FBS and additional funds will be available for expansion in the future.
- Timely reporting of financial and operational information to comply with SSE regulations would bring publicity and help to attract a wider customer base.
- As a publicly owned bank, the overall valuation would increase due to factors such as access to liquid funds, enhanced reputation etc.
- Provide opportunities for unexploited markets.
- SBL will have greater ability to attract and retain highly qualified and talented staff by way of employee ownership plans such as Employee Stock Ownership Plan (ESOP).
- The existing credit rating will improve.

The proposal would also bring disadvantages such as:

- It will take considerable time to get ready for a successful IPO (at least two years)
- With a negative balance sheet, it is unlikely that the expected amount of capital can be raised through an IPO.
- SBL may lose the reputation it has already gained as a fully fledged government owned bank.
- Operating structure will be affected due to compliance requirements.
- Management will be more pressurized by shareholders to achieve higher profits to pay dividends.
- Additional responsibility to comply with SSE rules and regulations.
- Negative conditions prevailing in the economy and stock exchange would directly affect the value of the bank.
- The bank will have to pay a considerable amount as IPO expenses and underwriting fee.

Considering the above advantages and disadvantages, it is concluded that going for an IPO would not solve the problems of SBL with immediate effect. Therefore, this option cannot be considered as the first priority.

However, this can be considered later (ref. Sec. 4)

3.2 Proposal II: Treasury to infuse new funds to SBL

Advantages and disadvantages of this option are discussed below:

Advantages:

- Treasury has already agreed to fund by way of a “Letter of Comfort” and therefore SBL can demand funds from the Treasury. For this purpose, they can request FBS to send a letter to the Treasury indicating the non compliance with the minimum capital requirement.
- No change to ownership of SBL and it can continue as a wholly government owned bank.
- An extension time period can be arranged (on a case by case basis) with FBS to meet the required minimum capital if SBL can request the Treasury to negotiate with FBS.

Disadvantages:

- It has already been concluded that the possibility of cabinet approval for Treasury funds is remote.
- Even with approval, funds will be granted by way of alternative means and may not be liquid funds. If this would be the case, SBL will suffer in the future again.
- Government intervention (like what SBL has been facing since its inception) may limit the opportunities for SBL to expand.

According to the above situation, it is clear that this option will not be helpful in satisfying the immediate fund requirement of SBL to meet capital adequacy. The only key advantage is that there is a possibility to request a further extension period from FBS to comply with capital adequacy. As a temporary measure, SECo may advise the Treasury to send an official letter of request to FBS for such an extension. This would ultimately provide support for the implementation of the merger option which we will discuss in detail in next section of this report.

3.3 Proposal III - Merge with another government organization – STF

This proposal has already been concluded to be the first priority by SECo. The points discussed below further support this conclusion:

- Both SBL and STF operate in the same industry, the micro finance sector, therefore both physical and intangible resources can be shared after the merger.
- Strategic advantage is there for future expansion of SBL by using PO model (Partner of STF) instead of opening up branches for which the CAPEX is substantially high.
- This will help both organizations to strengthen their current position and establish themselves as a leading financial service provider in the country.
- SBL will be able to strengthen the micro finance business with the expertise and experience of the staff of STF.

- SBL can source low cost funds for future operations if there is a possibility of getting donor agencies (ADB, KFW etc.) to support the newly merged entity.
- The sound internal control structure of STF would bring synergetic advantages to SBL.
- With both entities being government owned, the decision making process for the merger implementation can be done within a relatively shorter period of time (it is assumed that all regulatory approvals can be arranged within a shorter period due to full government support).
- After the merger, the new entity can be structured with the required changes necessary for corporate governance such as Board balance, an integrated risk management committee, financial acumen, business expertise etc.
- STF's strong balance sheet position can help to meet the minimum capital requirement in the short run.
(*Assumption* – SBL's existing balance sheet will be restructured before the merger, and the development fund and long term liabilities to the government can be converted to components of stated capital. Once the merger takes place, the new entity will satisfy the minimum capital requirement)
- SBL has already obtained the banking license which is considered to be a high value intangible asset. After the merger, the new entity can operate its business in the banking sector while focusing on expansion in the micro finance sector.
- SBL has ongoing taxation issues/cases (ref. Sec 5). SECo can negotiate with regulatory authorities for waiver of such taxes or exemption from income tax and VAT. This can be done by using the exemptions/reduced tax rates already available for STF as a result of it being a non-for-profit organization.

However, the merger has the following limitations and SECo should consider all these matters prior to/during the implementation of this option:

- Is it possible to conclude the merger within two weeks of time and satisfy capital adequacy?
The question is whether the merger can be implemented within a short period of time (say two weeks). For this purpose, SECo should conclude the decision of the merger as soon as possible with relevant regulatory approval, and a request should be made to FBS for a further extension period (to satisfy capital adequacy) (preferably until the merger process is over).
- Regulatory compliance/approval needs to take place beforehand as a part of the merger:
 - i. Cabinet approval
 - ii. Donor agencies - consent for merger and additional requirements to follow up
 - iii. Relevant gazette notifications changes
 - iv. Objectives of the two entities: STF vs SBL (Articles of Association and Constitution to be considered in the new Articles of Association of the merged entity)
- Conflict of interest among employees/management of the two entities need to be addressed by way of a proper awareness programme.

- Possibility of restrictions on further funding to STF operations by international donor agencies in future. The merged entity should negotiate with such organizations and implement the micro finance model to satisfy the interest of donor agencies. A separate micro finance arm/unit can be established under the merged entity with a separate reporting structure.
- There may not be immediate cash inflow to SBL (within two weeks) and it will take some time to satisfy the minimum capital requirement (already discussed above).
- If the separate unit of micro finance would continue the same operating model as STF, then the profit margin would be relatively low and it would limit the growth of the new entity.
- Existing customers of SBL (mainly MSDB depositors) will not be happy with the merger, and the new entity should establish a separate operating model to ensure the payoff for MSDB depositors is within the stipulated time. The management of the merged entity has to restructure the recovery arm of MSDB assets. For this purpose, experienced staff of STF can be utilized.

4. Overall Implementation Plan

The deadline to meet the minimum capital requirement is 1 January 2014 and only half a month is available to implement the action plan.

As discussed with SECo and approved by HE the president of Serendib, immediate steps should be taken to merge with STF to satisfy the regulatory requirements. Therefore, within two weeks, Proposal III should be implemented. In this case, SBL may issue shares to Treasury. However, it is not practicable for the merger to take place within such a short period of time.

At the same time, SECo should follow up on the cabinet approval to allocate the deficit funds required to meet the capital adequacy. This may take time. However, an urgent request can be sent to H.E. president, copying to the cabinet, looking for the approval. Even if it gets delayed, it will be a benefit for the new entity (the merged entity) for its future expansion and thereby its sustainability.

Once the rush period is over (i.e. 1 January 2014 and after the merger has taken place), the management of the new entity may look in to Proposal I: the IPO option. For this purpose, creating a strong balance sheet position is a must. The management of the merged entity will be able to create a positive and strong financial position within a period of two to five years (say from 2016 to 2021). Assuming appropriate internal controls are in place, and corporate governance and other operating models are established to a satisfactory level, such an expectation is reasonable. Given this context, the new entity may go for an IPO within a period of two to five years after the merger and it will be successful. Furthermore, it will not be a big issue for the new organization to satisfy the commitment of MSDB liabilities in 2016 and donor liabilities of STF in 2021.

5. Analysis and Evaluation of Other Issues

5.1 Accounting and financial reporting issues

Both SBL and STF prepare financial statements on an annual basis, which consumes a lot of time. With the merger, the merged entity should have a proper accounting and financial system. Hence, it is required to invest in a new accounting system along with the IT facility. Furthermore, if SBL is going for an IPO, a comprehensive financial reporting system with real time transaction processing is considered an essential element. However, when implementing the new IT system, the cost /cash flow and timing will be critical factors to be considered.

5.2 Organizational structure issues

SBL's organizational structure is limited to operations, credit, HR and finance headed by senior managers. However for effective management, SBL should have the following committees:

- Audit committee
- Integrated risk management committee
- HR and remuneration committee
- Strategic issues committee
- Corporate governance and legal affairs committee

5.3 Weak credit management team at SBL

Competent staff who are capable of carrying out vigorous recovery measures should be recruited. It is better if SBL can recruit young, energetic, experienced people to the team with an aggressive recovery plan. The experienced staff of STF can also be utilized for this purpose.

5.4 Compliance with Listing rules

This can be viewed as a future problem if SBL goes for an IPO. The entity will have to adhere to Listing rules which will require more governance, effective risk management and internal controls.

5.5 SBL Board does not consist of qualified people

The Board should comprise of individuals from the financial profession with banking industry experience. Furthermore, individuals with human resource qualifications and experience will be helpful since a large number of employee issues will arise as a result of the merger. Individuals with IT knowledge should also be included on the Board for future developments. The existing Chairman is about to turn 70 years in the near future. This has to be considered when appointing the new Chairman after the merger. Can the same person continue to be the Chairman of merged entity? Is he qualified enough to be the Chairman? SECo should consider all these factors.

5.6 Brought forward tax losses of MSDB

It is noted that SBL has filed income tax returns after claiming the maximum possible tax losses of MSDB. However, as per the Inland Revenue Act of Serendib, it is evident that no loss can be deducted when there is a change of ownership. SBL and MSDB are considered to be two separate legal entities. There will be a possibility of receiving an assessment notice from the Inland Revenue Department (IRD). Proper provisions should be made in the accounts to overcome the issue. However, considering the benefit to the depositors as a result of the MSDB project by SBL to maintain the confidence of the general public on banks, the claiming of brought forward tax losses can be further negotiated with the relevant authorities (both the IRD and the Treasury). If the negotiation turns out to be positive with the merger process, relevant gazette notification can be passed including all the exemptions.

5.7 VAT on financial services not paid by MSDB

An assessment has been received by SBL on the VAT on financial services (FS) of MSDB. As per the Inland Revenue Act, a specified institution should pay VAT on financial services. A valid appeal should be made explaining the reason for non-payment of VAT on FS. The appeal can include an explanation such as – “Recovery of MSDB past due loans and advances cannot be considered to be a provision of financial services”. A valid appeal signed by the general manager of SBL has to be forward to the IRD within the stipulated time.

Furthermore, a provision should be made in the books of accounts of SBL.

In the future, once the merger takes place, SBL can look for an exception from the Act since the merger is with a trust fund. However, this may not be possible with the regulatory requirements.

5.8 Withholding Tax (WHT) on interest payable

As per the Inland Revenue Act, SBL will face the said issue on savings deposits from customers. SBL has to deduct the specified rate of WHT from qualified deposits and forward it to the IRD. Proper accounting systems should be available to adhere to the regulatory requirements. If SBL has not yet deducted WHT from deposits, this will create further burden to SBL due to non compliance.

STF will also face the same issue once they start deposit collection from the customers.

5.9 Legal status of the new entity

Since it has been decided to implement the merger option, its legal form should be verified with the relevant legal authorities. Until then, the new venture can be considered to be a continuation of SBL.

5.10 Repayment of MSDB depositors

Since the new entity is considered to be a continuation of SBL, a repayment scheme formulated by FBS should be processed according to the plan. MSDB depositors should be given an assurance notice indicating that all liabilities will be paid in the specified time period (i.e. by 31 December 2016). A press conference can be arranged to inform the depositors about the plan.

6 Conclusion and Recommendations

Based on the evaluation and analysis carried out on the options forwarded by SECo, the first priority has already been granted to merge with STF. The capital adequacy deficit should be met initially by restructuring the existing balance sheet and with the merger of STF. Further fund requirement from government Treasury can be requested as the second priority. Considering other factors, it is recommended that SBL should go for an IPO after the other two proposals are carried out. The timing of the IPO should be decided carefully after satisfying the minimum capital requirement.

The merged entity should continue as a bank under the SBL name, and SBL should focus more on the micro finance sector to get synergetic advantages from the merger.

This will help both SBL and STF to grow as one entity in the future, specially in the micro finance sector, which will ultimately ensure sustainability of the merged entity.

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