



THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

TOP CA CASE STUDY EXAMINATION – MARCH 2015

**THE EXAMINATION QUESTIONS, INSTRUCTIONS AND ADDITIONAL
(IMPACT) INFORMATION**

Instructions to candidates

- (1) **Time allowed:** 4 hours
- (2) **Marks:** 100 marks
- (3) This question paper should be answered entirely in the **ENGLISH** language.
- (4) Your answer must be submitted in the answer booklets provided at the Examination Hall.
- (5) Any pre-prepared papers included in your answer **WILL NOT** be marked.
- (6) After the instruction to stop writing at the end of the paper, you will be given five minutes to assemble your answer booklet/s.

Sancloth (Private) Limited (SPL)

Sandra Gajanayake, CEO of SPL, is focusing on further network expansion and strengthening of different brands by increasing the company's business partners. On 24 November 2014, Sandra called a special board meeting to discuss SPL's future plans and strategies. At the board meeting she pointed out that SPL's products and services offered across the urban and semi-urban localities of greater Colombo and other central cities in Sri Lanka, have yielded significant growth in volumes. As a brand, Sancloth had gained greater affinities with a broader target market as a direct consequence of the expansion strategy. The branch network together with newly launched showroom stores now serves as an impetus for market expansion, whereby consumers who aspire to align with the brand Sancloth are motivated to do so, through greater accessibility and familiarity.

However, the strategy of expansion was not limited to only increasing the SPL store footprint. SPL continued to strengthen and expand its brand strategy, adding variation to the products offered and gaining access to different customer likings. This strategy is reflective of SPL's focus on enlarging its scope of operations with specialisation on key focal markets, not only as a differentiation strategy but also as a means to enhance the overall business viability and performance in the future. SPL's consistent quest to redefine the retail experience has been to test the boundaries, determine new norms and in fact continuously reconfigure the equation of retail experience. "How we shape our service offer is based primarily on business continuity; we should determine what needs to be done next by following a constant and relentless search for unique product ranges", Sandra further added at the meeting.

Sandra also emphasised the necessity of good governance practices for the sustainable growth of any business. She concentrated on the increase in volume of sales and the decrease in profit by 18%, from 2012/13 to 2013/14. Sandra is of the view that irregular purchasing may have caused the decrease in its profits while the volume of sales increased. Even though the internal audit function assists in monitoring the adherence to the systems and procedures and the improvement of the internal controls of the business, Sandra is of the opinion that the service of the external firm of accountants will also have to be obtained with a defined scope of work to review the

system adherence and to support the internal audit. Supporting her opinion, Sandra presented the information sent by Mr. Darmawardana relating to purchasing system observations (Annexure 02).

At the meeting, the finance controller Mr. Liyanage commented that the risk of the business may increase with the competition in the industry. He pointed out that the changes in macroeconomic factors such as inflation, limitation of tariffs such as GSP+, and currency depreciation had an immense impact on the growth of SPL. The increase in per capita income and tourist arrivals are catalysts for growth of the target market segment of SPL. But with the newly emerging brands, SPL has acquired a greater market share in the recent past. Therefore, the changes in the economic projections and performance should be closely monitored to understand the impact on the business. The products offered and communication of the value are tailored to recognise the change in customer needs and aspirations, and should be constantly reviewed.

He further explained that the ability to fund the business at a competitive rate is crucial. SPL should actively develop relationships with a multitude of lenders and potential other sources to broaden the funding options. The quality of service provided by employees and their work ethics and integrity are also important aspects to mitigate risks. Therefore he pointed out that the expansion strategy of SPL should be expedited to beat the competition in the market and asked the CEO about the discussion that took place at the previous meeting regarding the acquisition of or merger with Knitny Mills (Private) Limited (KML).

Accordingly, the CEO explained that the proposal is under consideration and Sanjaya, Senior Executive – Finance, has prepared the necessary information for the evaluation of the proposal, as per the report below.

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To: CEO (SPL)
From: Sanjaya, Senior Executive - Finance
Subject: Information regarding acquisition of KML

KML is one of the leading fabric mills in Sri Lanka which commenced its operations in 1992 with an initial investment of Rs. 40 million and a production capacity of 7,000 kg of knitted

fabric per week. Today, it has grown into a large organisation with investment (in setting up production facilities) in the Asian region of Rs. 2,300 million and production capacity up to 250,000 kg per week.

The employee base has increased from 40 to 1,100 with 175 of them being executives, and the annual turnover is in excess of Rs. 4,000 million. KML is located on a 34 acre site at Mahanel Estate in Horana and is one of the most diversified fabric mills with a capacity of 1,000 tons/month to knit, dye and finish all types of knitted fabrics such as cottons, cotton blends, polyester, polyester blends, viscose and micro modals. It also has the capability of in-house printing with color printing machines and fabric brushing machines.

Despite the decrease in revenue during 2013/14, KML showed a net loss reduction of 57% during that year, which is considerable growth for a textile manufacturing company. The company may not be able to achieve a significant growth in profit without having customer confidence, expected quality and on time delivery (OTD). This gives the indication that KML is continuously meeting customer expectations and requirements.

Increase in efficiency is evidenced by the decrease in cost of sales by 6% from 2012/13 to 2013/14. This may be due to increasing returns to scale, efficient utilisation of capacity and Right First Time (RFT) production. The idea behind RFT is that management wants all of the processes that make up the Just-in-Time (JIT) philosophy to be done correctly and efficiently so there are no delays in the production process. If RFT fails, production costs may automatically increase. The reasons for higher cost of sales may be due to underpricing, abnormal production loss and production inefficiencies.

As per my analysis the company has been continuously making a net loss. However, it seems like the company is trying to gain a sustainable development by better management practice. In 2012/13 the loss reduced by 45% compared to the previous year 2011/12, and for 2013/14 the reduction was 57% against the year 2012/13. This resulted in a 100% improvement in the company's bottom line over the two year period. Therefore I am highly positive about the future prospects of KML.

Further, I would like to furnish the following forecasted information prepared based on the financial statistics pertaining to KML.

Forecasted information of KML

	Rs. million						
	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Expected Net Operating Profit After Tax (NOPAT)	(224)	107	267	459	601	842	912
Depreciation	10	12	12	13	13	15	17
Increase in working capital requirement	24				5		

Applicable tax rate: 28%

Expected rate of return of shareholders in similar businesses: 28%

Average cost of debt of the company: 11%

I noted that the CEO of KML has disclosed in a business interview the bidding price range of Rs. 15 – Rs. 20 per share, justifying the bidding price by focusing on industry prospects. Further, I am positive about the possibility of fully financing the acquisition of the target company by a bank loan due to low interest rates prevailing in the economy.

Thank you.

Regards,

Sanjaya

Senior Executive - Finance

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However, the CEO of SPL is of the view that a merger with KML will generate more benefits than the acquisition of KML, and presented some analyses at the meeting. Further she stated, “Mergers and acquisitions play a significant role in the survival and vitalization of corporations today. They continue to be a major strategy for improving innovation, profitability, market share and share prices. Often, companies view the merger itself as the strategic end-game, rather than the main event. My experience and most of the industry research confirm that when mergers and acquisitions do work, the integration process seems to be holistic, fluid and well executed. How the corporate leadership focuses its energy as well as the timing and vision that drive employee engagement, impacts post-merger effectiveness. The single most important factor for post-merger success and long-term sustainability is the involvement and integration of employees from the start to create a common new identity around a shared vision.”

Further she mentioned a few statistics from the report provided by Sivian Consultancy (Private) Limited¹ at the meeting.

Present value of SPL = Rs. 5,712 million

Present value of merged firm (SPL+ KML) = Rs. 7,985 million

Accordingly, Sandra is positive about the financial implication of the merger but she is waiting to examine the qualitative impacts such as the effect on employees, environment, culture and especially the business identity created by her (Sandra). Moreover she reminded at the meeting of the origination of the company with hardships at the initial level and her dedication to uplift the business to the current position.

Further, one of the senior managers challenged these two business alternatives presented by Sanjaya and the CEO and commented that organic growth will generate more benefits than mergers and acquisitions. He pointed out that most of the mergers and acquisitions in practice did not achieve the expected success in the long run of the businesses.

After constructive comments, arguments and discussions at the meeting, the CEO appointed Mr. Liyanage, finance controller of SPL, to further analyse and evaluate the merger and acquisition proposals with recommendations, considering financial and non-financial information.

¹ Sivian Consultancy (Private) Limited is one of the leading valuation and consultancy firms in Sri Lanka.

Annexure 02

To: CEO (SPL)

Subject: Observations on the Purchasing System

From: Darmawardana

According to the formal appointment given by you to observe the purchasing system, I hereby present my observations.

- Objective of the purchasing department during the year 2013/14 was to continually source new products and expand the range of brands in order to create uniqueness and improved standards of the products offered. This objective was applied across all departments and contributed towards the overall growth of turnover.
- Purchasing documents were examined on a random sample basis, and we are in a position to conclude that the procurement process complies with all procurement requirements of the company. But we have noticed that a few purchase invoices in the name of Rialclothing (Private) Limited (RPL) were printed on SPL rough papers on which some company information was recorded.
- SPL made an effort during 2013/14 to strengthen the 200 plus network of local and overseas suppliers in order to bring the best and the latest in fashion to the consumers.
- It was noted that RPL, a major supplier of SPL located in Thailand, accounted for more than 75% of the total fabric purchases of the company in the last two years. Mr. Jayadeera was the head of the purchasing department during this period. Further it was noted that RPL was registered in 2012 in the name of Mrs. Jayadeera (Mr Jayadeera's wife). Currently she works as a consultant to Sancloth Apparel (Private) Limited.
- Further, it was observed that some prices of the material purchased from RPL were comparatively higher than the quotations sent by some other registered suppliers of the company. As evidence, we were able to find a few quotations when examining one of the purchase files for the month of November 2013.

Thank you.

Darmawardana

(Senior Internal Audit Manager)

Required:

1. Assume that you are Mr. Liyanage, the finance controller of SPL. You have been asked by the CEO to evaluate the two proposals regarding the acquisition of and merger with KML.

Prepare a report encompassing the above proposals to be submitted to the CEO.

Your report should include:

- An environmental analysis of the garment and textiles industry and KML, considering the impact of the proposed business strategies with reference to future trends in the sector. (20 marks)
 - Financial analysis and other factors which must be considered to decide whether to acquire or merge with KML. (40 marks)
 - Risk management strategies that should be adopted by the company to achieve a sustainable growth under each proposal. (10 marks)
 - Justification by prioritising the best option to be implemented, including the pros and cons of each proposal, in order to maximise shareholders' wealth. (15 marks)
2. Assume that you have been appointed as a forensic accountant to further examine the facts disclosed by Mr. Darmawardana regarding the procurement matters in the purchasing system.
Explain the issues relating to the purchasing system of SPL, their impact on the company and the ways by which they can be resolved. (15 marks)

(Total: 100 marks)