THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC5 - Corporate Strategy and Contemporary Issues

December 2015

Questions

Part A

Memorandum

To : Chairman
From : Management Consultant
Date : 27/12/2015
Subject: Main issues /Recommendations.

(a) i) The amalgamated financials, contain results of all SBUs with varying patterns of profitability at different GPs hence for a more accurate interpretation of the performances of SBU's we may have to separately segment the financial performances of the each SUB.

ii) The Group's sales have grown by almost 5 percent and this indicates that in real terms the sales have not incurred when take into account inflation. The Group's sales comprise mostly imported items which are subject to exchange rate risk as the Sri Lankan rupee is currently depreciating. Hence when taking into account both inflation as well as rupee depreciation group sales may not have increased in real terms. This means in the growth market of construction equipment of the group's sales have not really increased, hence market share may have got adversely affected.

iii) Even though EPS, the most important indicator of corporate performance, has increased the return on assets an indicator of corporate efficiency which has marginally declined both at EBIT level (from 11.81% to 11.75%) and at PAT level (from 5.47% to 5.28%).

iv) It is also noted that one of the determinants of asset turnover is "stock turnover", is particularly important because stocks account for as much as 1/3rd of the total assets of CTIL. The average holding period of stocks in the current year has increased from 149 days in the year 2014 to 165 days in 2015 the year the CTIL's average holding period has exceeded a period of 5 months which is excessive in comparison to industry standards.

v) The company may have a material amount of slow moving stocks that may be concealed in increasing stock values.

vi) The average credit period has increased from 70 days in 2014 to 76 days in 2015

vii) The company is exposed to exchange risk as supplier credit represents nearly three months of purchases. This needs to be taken into account.

(b) (i) Pro-active controls practiced currently:

To control establishment of an L/C, i.e. making a confirmed, potential addition to inventories of a particular division's stocks, within a pre-determined standard, i.e. when a particular division is holding in excess of 10 items beyond the permitted stock holding period of 3 months for this purpose, L/Cs for that division will not be permitted.

Positive aspects of the control:

Pro-active, actual can be compared with a defined pre-determined standard.

Negative aspects of the control:

- Seems to be imposed by the Finance Director in a rather arbitrary manner without consulting the Divisional Heads who are closer to markets/customer needs. Hence it is not very market oriented action.
- A mere "10 items" as the control standard is arbitrary and may not be quite appropriate as the items may differ in value, i.e. some may be more expensive while others are less expensive; this is one of the biggest problems with the system adopted. Hence it's better to control through an overall value applicable to a division as opposed to a mere number of items because it is the total value of stocks over 90 days that will adversely affect the finances of the company.
- Stocks are being held to effect sales and the amount of inventories held need to take into account the potential sales as well as the industry standards.
- Does not take into account the needs of the market or market dynamics.
- All types of control systems must promote efficient internal business processes that are customer centric.
- Lack of flexibility and arbitrariness

(ii) Improvements that can be recommended, with particular reference to the Industrial Bearings division:

- When marketing 'Industrial bearings' the availability of ex-stock inventories with a minimum delay is important because of potential losses it can incur on the client organization. Hence different control standards must be established for different divisions such as industrial bearings. The control system can take into account the following factors;
- Higher gross profit ratio of the Bearings Division may allow for longer turn around periods for the 'Industrial Bearings' Division.
- Analyze the movement patterns of different items of inventory in relation to different client requirements.

- May be able to track the off take of different bearings by different clients also factoring the requirements of more important clients through perhaps an ABC system of inventory management by categorizing clients as A : most important, B: Important, C : routine customers. Thereafter, rationalize the ordering and holding of inventories by factoring variables that will help to maximize customer satisfaction or minimize customer dissatisfaction and minimize inventory costs.

- Take lead time into account.

- Develop a mechanism in consultation with the Finish supplier to obtain extremely important and urgent items on courier and carry out a cost benefit analysis with holding costs vs. courier costs for certain selected items that have been obtained through rigorous information analysis.

- All controls systems must be designed in an integrated manner and taking into account the needs of all functions and placing customer needs and wants at the centre of decision making.

- There must be adequate management co-ordination, particularly at the top level that will pro-actively avoid potentially damaging situations.

- Dealing with principals of international repute, the company and Adam can seek assistance from his foreign principal and more efficient computerized solutions adopted by them to efficiently manage and balance the task complex of customer needs with minimizing inventory.

Part B

(a)

i) Advantages:

- Directly linked to the sales effort and can act as a highly motivating factor.
- Based on sales value hence directly related to the sales value of a division and easily understood by all concerned
- Frequent rewarding on a monthly basis can be a powerful motivating factor compared to rewarding staff annually.

Disadvantages:

- Selling a few product categories may be difficult compared to other categories hence this scheme may not be equitable and may create dissatisfaction amongst sales personnel in those SBUs
- Not taking into account the taxes such as say VAT, NBT and hence rewarding needs to be based on net sales
- May encourage sales personnel to dump some items merely to collect the commission
- May drive sales personnel to take undue credit risks
- May ignore service aspects of client satisfaction at the expense of the sales quantity.

Proposed adjustments:

ii) Introduce following adjustments:

- Commissions payable after obtaining collections in regard to SBUs that deal in high value items

- Any commission payment to a sales person will be adjusted with a penalty for all outstanding sales effected by him according to a predetermined penalty structure say 0.25% for any outstanding over 60 days and 0.50% for any outstanding over 90 days and so on.

- There needs to be a penalty scheme for dealing with any eventual bad debts of sales effected by a particular sales person

- Commission payment needs to be computed after deducting all direct taxes.

- There has to be a mechanism to factor customer satisfaction levels of sales personnel such as attending to after sales and repair/service needs to be incorporated according to a formula within the incentive scheme.

(b)

(i) Advantages:

- Makes all managers conscious of profits, an important success factor for each company, thereby encouraging more cost conscious operational decisions can be a powerful motivating force when paid monthly.

Disadvantages:

- May resort to more '<u>short-term profit</u>' at the expense of 'long term strategic competitiveness' such as postponing strategic expenses such as brand building expenditure.
- Possibility to <u>manipulate accounting</u> profits through creative accounting practices.

(ii) Recommendations:

Recommendations to make the profit sharing scheme more strategically relevant:

- Basing the profit sharing on the company's profits; but it will be more appropriate and equitable to reward managers of a particular SBU on the basis of profits attributable to that SBU without taking the whole company's profits which is an amalgam of all SBU profits.

The scheme of profit sharing needs to extend beyond the financial perspective based on monthly profits only and may have to incorporate a more strategically relevant balanced set of measures:

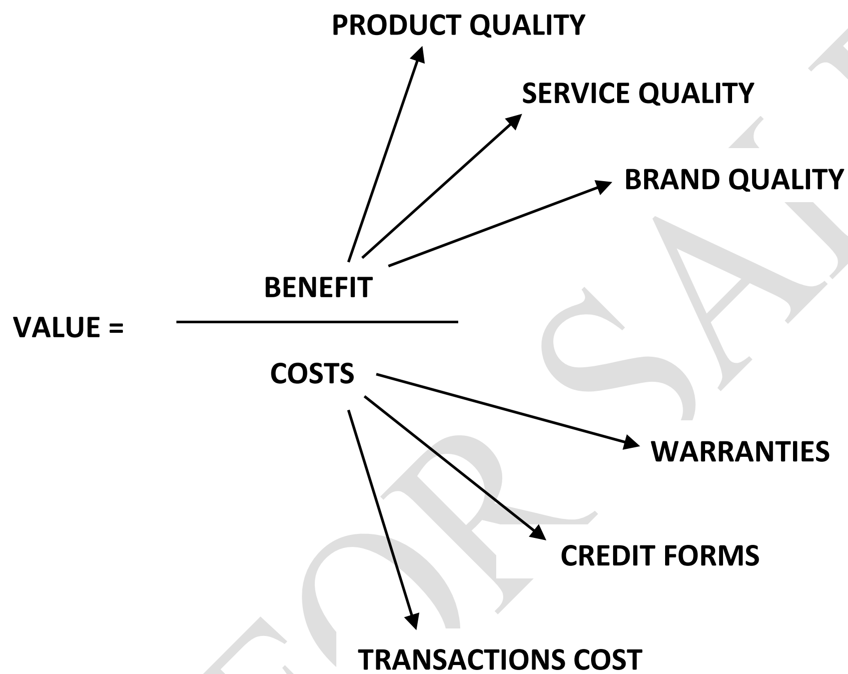
(a) Cash flow management in addition to purely profits and hence some weight on financial indicators such as inventory management and credit control efficiencies.

(b) Customer perspective: based on parameters such as customer satisfaction, customer loyalty, customer profitability, market share.

(c) Internal business process perspective: based and measured on perspectives such as customer lead time, availability of stocks, inventory management efficiencies, and service lead times.

(d) Learning and growth perspective: new product introductions, employee satisfaction, employee training on product benefits and the knowledge on products as well as knowledge on modern marketing management methods such as product positioning, competitive marketing strategy of the sales representatives and modern inventory management methods by personnel involved in managing inventories.

(c) The specific problem faced by CSL in regard to their brand of rammers, 'Powerful' is in relation to intense competitive pressure that revolves around 'customer value' because when purchasing industrial products the buyer behavior type displayed is 'rational and evaluated' hence understanding '<u>customer value' is important</u> as the purchase decision is based on 'customer in value' i.e. <u>perceived quality /perceived cost</u>. Therefore, the company must evaluate the relative value of benefits of their "Powerful" brand vs. main competitive brands, namely Korean and Taiwanese brands:



The following framework may be adopted that will help understand the problem:

The company must understand how it is performing on these important variables of the buying decision in comparison to the competitor

The most important customer value creation capability is through rationally <u>evaluated product benefits</u>. In this framework, we can show the product benefits with their assumed relative importance. Thereafter, how the company is performing relative to competition on each such value creating product benefits can be evaluated.

	Customer determined expectations / benefits	Relative Importance	Rating of the company	Competitors
				Korean Taiwanese Japanese
01	Noise Level	15	7	7
02	Vibrations felt by the operator	15	8	8
03	Compaction depth	20	7.5	6
04	Vibrations frequency	20	7	5.5
05	Centrifugal force	30 $\boxed{100}$	6	8

Similarly, the company needs to evaluate the service benefits such as On-time delivery/availability, Technical support and Response to problems and the relative importance of these in the customers' buying decision as well as the company's performance on these indicators in relation to the competition.

Similarly the company will have to evaluate Brand benefits such as
Innovative, European image, and Dependability
Thereafter comes the perceived cost of purchase that will include:
Purchase price, credit terms, transportation costs and warranties

Therefore when marketing industrial products that are purchased through a rationally evaluated decision framework, it is important to understand the customer value by carefully decomposing the constituting components of customer value. The sales force needs to be properly trained on such aspects so that they can approach their clients with a unique selling proposition in comparison to the current effort that mostly revolve around only brand superiority.

(Note to the Examiners: The students have to demonstrate their ability to advice the divisional marketing manager on how to solve the competitive situation that confronts the Rammers division as a result of Korean and Taiwanese brands attacking the CFL's premier brand in the industrial marketing situation that is based on rational evaluated buyer behavior and mere brand centric marketing will not assist in the selling effort. Hence the students need to lay out a framework such that is given that will incorporate all decision making variables. Here we are expecting the students to demonstrate some degree of creativity in solving a specific problem using their knowledge on marketing value creating)

Part C

i) Derivation of Adam's ROI computation:

			Rs.
Revenue	Rs. 1,800 * 100,000	=	180,000,000
Less: Variable Costs	Rs. 900* 100,000	=	90,000,000
Contribution			90,000,000
Less: differentiated costs			51,000,000
Profit before tax			39,000,000
Less: Tax 34%			13,260,000
Net returns			26,640,000
Total Investment			300,000,000
ROI = PBT/investment = 39,000,000/300,000,000		=	13%

ii) Applicability of using ROI

In any organization one of the most important factors that results in an increase in shareholder wealth is "profitability" that is, profit in relation to the resources deployed to earn such profits. In a multi divisional organization linking profits of different SBUs to their respective investment base is not straight forward. ROI is one of the methods of relating 'profits' to an SBUs investment base and has applicability because of its close relationship to the concept of corporate 'Return on Assets' and can be easily decomposed for further analysis [ROS *AT = ROI].

Problems of using ROI in CTIL to control it's SBUs

- May turn down profitable projects/products because of a high ROI hurdle rate
- May not invest in assets of long term strategic importance because that may affect short-term ROI
- Difficulty of separating value of common assets used by different SBUs within the CTIL corporate structure. For example to what extent the workshops are used by different SBUs benefitting from this expensive asset.

iii) Adam's assertion that the project's profitability based on pretax ROI is not a very conclusive or accurate measure of the projects true value creating capability as project feasibility based on ROI suffers from the serious drawback of not taking the time value of money' in to consideration. Therefore a financial evaluation based on a DCF based technique expresses a more accurate assessment of the projects financial feasibility.

Also it is relevant to pint out some important asset management ratios as applicable specifically to this project.

Average credit period – debtors turnover =180m/45m =4. Hence credit period = 90 days

Average residence period of stock- stock turnover = cost of goods sold /inventory=141m/90m= 1.57

Hence average stock holding period is 230 days approx.

Therefore the projects average stock holding and credit period account for nearly 310 days which may be considered quite excessive and hence is a cause of serious concern. Hence it appears that if these areas can be significantly improved, the projects profitability will substantially improve and hence it is necessary for Adam (A) to carefully explore how he can improve stocks and debtors management of the project.

iv) The proposed venture manufacturing a product with a limited life span of 10 years may be considered analogous to a project and hence it's true value creating capability may only be measured through using a 'discounted cash flow' technique.

Estimated life span 10 years

Accrued profit	39,000,000
+ depreciation	15,000,000
	54,000,000
54 Mn tax @ 34%	(18,360,000)
	35,640,000

Computation of IRR

Year	Cash flow (Rs)	D.F 10%	PV	DF 8%	PV
0	(300,000.000)	1	(300,000,000)	1	(300,000,000)
1 – 10	35,640,000	6.141	218,865,240	6.710	239,144,400
11	150,000,000	0.350	52,500,000	0.429	64,350,000
		NPV	(28,634,760)		3,494,400

$$IRR = 8\% + \frac{3,494,400}{32,129,160} \times 2\% = 8.22\%$$

Therefore if the company can obtain a source of funding the project at an effective rate below 8.2%, given other factors such as project risk, and working capital management are satisfactory the project is financially viable. Of course the sensitivity of the project can be checked with regard to some critical variables such as sales quantity

Part D

i) Dimensions

- A unique set of product markets –in a sense that no other SBU within the company structure competes for the same customers with similar products i.e. similarity of the customer needs

- A similarity of the personal characteristics or behavior patterns of the customers in the target market

- Technical compatibility –i.e. similar technical knowledge or technical complexity in selling the products within CSL's scope of products/customer needs

ii) As it stands currently, CSL is organized into four SBUs namely for marketing Rammers, Industrial bearings, Compressors and Electrical switchgear.

One of the fundamental desires to establish SBUs is the market-oriented desire to make the decisions closer to the needs of the target market. On this basis there is a rationale for establishing separate SBUs for Electrical switch gear belongs to the category of consumer durable where customers comprise of more retail, home owning, up-market segment and quite different to the other three product groups which are industrial goods.

Of the remaining three product groups Industrial bearings are required by manufacturing organizations and hence the requirements and buyer behavior may be different compared to "Rammers" and "Concrete mixers" which are both required by construction firms and there is some degree of technical compatibility. Hence there is a great possibility to have a single SBU to market both product groups.

This could bring about many economies in the form of:

- saving overheads of having only single Senior Manager instead of two as well as a number of sales reps in two divisions and other support staff and other office costs such as space for two divisions
- increasing sales rep productivity by selling both concrete mixers and rammers to the same customer; more convenient to the customers, hence greater customer satisfaction.
- saving of transport costs
- more scope for sales personnel to earn higher rewards and hence better employee satisfaction

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