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THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

**KC5 - Corporate Strategy and Contemporary
Issues**

December 2019

XYZ Group

INTERNAL MEMO.

FROM: HEAD OF FINANCE

TO: CEO;

Subject: Refer. Email/QB Valuations and other concerns

Summary

I would like to provide the following insights related to your concerns on QB value, RO plant , IRD assessment and other matters;

- I. As per your request, I have done the required calculations to arrive at a value range of QB Bangladesh. Accordingly, value derived for QB would range from BDT 12 million to 25 Million. Further, I managed to collect more information related to the countries you are keen on and did country profile analyses for same. (details will follow in the next section)
- II. Regarding the RO CAPEX investment, my working on cost benefit analysis shows that the project is not financially viable, due to incremental costs. However, what is more important in this case are the nonfinancial aspects. Giving due consideration to nonfinancial concerns, the project is viable, and one can proceed further subject to limitations discussed in this report. **(more detail as given in sub para 2 below)**
- III. If the projected sales for next year would be USD 125 Million, we need to get ready for an additional short term facility to approximately USD 3 million, which means our short term facility exposure would reach up to USD 37 million, including funds to be blocked for LC period as well.

The simple calculation related to the facility gap is given in a separate annexure.;

When it comes to facility restructuring, I have a few options in my mind.

- Discuss with all the bankers to reduce short term rates. I'm sure there is a high chance for rate reductions by the Bank A, given the declining trend in LIBOR during last few months.
 - Consider the possibility of re-structuring the exposure limit with each bank
 - Consider optimization when utilizing existing facilities with a view to reduce finance cost. In this case, priority in utilization should be given to the lowest rate offering banks.
 - Negotiate to enhance the existing short term facilities from Bank D and E given the lowest rate offered already. If the rate can be lowered further by one of Bank D or E (may be both), the facility can be restructured to match the expected facility gap.
- IV. I drafted a letter to the Commissioner of IRD as given in annexure I separately. I also spoke to our tax consultant (can mention any audit firm name or tax expert name as assumption) regarding the letter, because we need to send a formal appeal to cancel this tax assessment. As we need to comply with the deadline, I will attend to finalising the appeal with our tax consultant as soon as possible.

- V. Since BOI approval has not been received for the proposed new factory (lingerie manufacturing plant), I did not do any working pertaining to this at the moment.
- VI. I have identified a few areas which need improvements, with regard to operations, supply chain, HR & compliance, Risk & control and many other business functions in particular,
- a) Supply chain: there is concern related to the **planning in this area**. As there is a significant amount of inventory already held in stock, order planning with an agreed time line, is a must to manage optimum levels of inventory. Proper coordination with the planning team, merchandizing team, operation team and finance team is also important. Proper inventory control, with close monitoring is required to maintain optimum levels of inventory, so that both holding and ordering cost can be minimised.
 - b) Need to hire a Procurement Head or Manager and set up a Central Procurement Department as early as possible. This will save cost in many ways.
 - c) Risk management/Internal control/cost saving project:
 Foreign currency risk management by negotiating with bank for forward contract.
 Internal control over procurement, inventory management,
 Optimising Bank facility utilization and reducing finance cost
 Fixed asset control in factories
 Control over machine rent (significant cost)
 Optimising transport cost and food bill by optimising transport routes
 Security and investigations cost reductions/(optimization of security budget)
 Information and system security risk and control
 Control over commercial operations (cost savings in import /export expenses),
 special control over airfreight charges
 Chemicals of cadre to inventory management and related compliance
 Carder management/subcontract negotiation
 Order filling for Capacity maintenance, to manage direct labour cost and other overhead charges
 Procurement decisions on high value CAPEX project
 Seconds sale revenue management and control over local sale of seconds i.e. damaged garments

Section I:

Investing in QB and value parameters

With the limited financial information available, I have arrived at the following value range as the potential value of QB –Bangladesh. I have made assumptions where necessary. Valuation was done by using two different valuation methods;

1. NET ASSETS METHOD – value is arrived at based on the expected market value of assets and market value of liabilities.

Assuming that there are no significant changes to the Company's assets and liabilities during 2019 (except for any impact from the profit for FY2019), are used to derive estimated. The net asset value as of 31st December 2018 and average expected EBITDA for 2019, Net asset value of the company as of 31st December 2019;

	Value in BDT
Net assets as of 31st December 2018	22,469,718
EBITDA Expected for 2019	3,118,628
Net Finance Cost-estimated	(127,000)
Net assets as of 31st December 2019	<u>25,461,346</u>

Note: Please note that the above adjusted net asset value is arrived at based on limited information available.

Candidates may use simple net asset value calculation as per theory (Asset –liabilities). As the financial information given is limited to December 31 2018, they may calculate Net asset as of 2018 and may suggest an assumption for December 31, 2019.

E.g. **there would be no significant changes in the values of company's assets or liabilities except any adjustments required to incorporate earnings for the year 2019.**

2. CAPITALIZED EARNINGS METHOD

This is a valuation method; perhaps the most generally accepted method that involves capitalizing future maintainable earnings, by the application of a suitable capitalization rate or multiple.

I have used QB's past six years earnings to estimate average future earnings (i.e. EBITA). Accordingly, average earnings expected in future, per annum, would be around BDT 3.1 million. I have also assumed a capitalization multiple of 4, which is considered to be reasonable, in the given context.

Therefore, the value of QB under this method is estimated to be BDT12.4 Million.

Further, assuming a discount rate of 19% and a 4% average growth rate, the value of QB is estimated at USD 20.7 million. The average growth rate is based on Bangladesh economic data.

Value Range:

Accordingly, the value range under the capitalization method would range from BDT 12 Million to BDT 20.7 Million.

Limitations of Capitalised Earnings Method

- Considering accounting profits rather than cash flows
- Assuming that the past performance trends will continue for the foreseeable future.
- Difficulty in estimating the discount rate and the growth rate accurately

Country Profile Analysis related to Bangladesh, Vietnam and Cambodia are given in a separate annexure

Other concerns

- Better option for growth by having access to global markets
- Avoiding current risk of over dependency on a unique set of products with same set of customers

- Diversification is available
- Option for back word integration(link) in the supply chain of apparel industry and chance to access expertise in fabric printing
- Mitigating country risk in Sri Lanka by investing in BD
- US-China trade war; Harness the benefit from opportunities available in BD or (Vietnam/Cambodia) with shifting Chinese garment industries (or orders from international buyers) to neighboring countries
- More plus factors to consider for investment in BD as against Vietnam or Cambodia
- However, the wage increase in BD's apparel sector during 2019 is a major negative concern. Also the high lead time in BD as against Vietnam or Cambodia (120 days vs. 60 days)

Section II:

Proposed Capital Investment –RO Plant

- Water recycling plant is viable from non-financial perspective.
- Based on available data, I have presented a simple cost benefit analysis. It shows that the project is not financially viable, given the incremental cost. Details of computation are given in the annexure.
- Included in non-financial factors;
 - ✓ Savings of 60% water through recycling, helps reduce water consumption and is environment friendly.
 - ✓ Regulatory authorities such as BOI would encourage this kind of CAPEX project because the project itself encourages sustainable development concerns in today's context
 - ✓ These kinds of projects can be used in sustainability reporting, to promote the image of the company
 - ✓ However, the question remains as to how the initial investment for the project is to be financed. We need to keep in mind that we cannot use short term facilities to finance long term CAPEX. Also, it is obvious that we do not have internal saved reserves to inject in this. The only option available is to approach a financial institution to finance the project. We can discuss with local banks to get a four to five-year term loan for this purpose. We can also approach IFC or any local agency of International funding organization. My view is that we can attract low cost financing from local banks or government/international funding organizations because this kind of project comes under 'sustainable development' schemes in banks' funding lines, which would attracts lower interest rates, as well.

Section III:

Letter to Inland Revenue Department

Having perused IRD correspondence regarding the assessment, I have drafted a letter to the commissioner. The letter is attached here with a separate annexure. As I informed above, I had a discussion with our Tax consultant – Mr..... .. and he agreed to review the letter for technical concerns, if any. I may be able to finalise the same next week, and can arrange to forward the same to reach the commissioner.

Further, I would like to share my concerns related to tax filling and compliance by XYZ.

- ✓ It seems that the executive who is responsible for maintaining tax correspondence files, have not maintained them properly for YA2015/16. Since the audit has already been done, we may be able to get photocopies of invoices and supporting documents related to the asset' acquisitions for which claims of capital allowances have been made. As this has already been discussed in the letter to IRD, we may get the chance to submit the supporting documents within a reasonable period of time.

Annexure I

Country Profile Comparison:

(sources of information: BDApparelNews Desk ..etc.)

I have done a detailed study about investing in Bangladesh's (BD) Apparel industry. Using the many sources available, I have summarize below the reasons supporting investment in BD's apparel sector.

- **Bangladesh is the second largest sourcing hub of apparel worldwide**, standing next to giant China, with over 6.3 percent of global market share.
- The country's apparel manufacturers and exporters firmly believe they will be able to deliver on the optimistic target of turning it into a \$50 billion industry by 2021
- Policymakers are banking heavily on the apparel sector in the country's transformation and graduation into a middle-income economy by 2021.
- Capitalizing on the ongoing US-China trade war, in a short span of time, Bangladesh's competitors are rapidly taking over a greater share of the US RMG market,
- Bangladesh government highly encourages foreign investment in the apparel sector – especially in the Economic Zones, and say it is ready to extend its full support to protect such investment.
- The minimum wage is around USD 68 per person which is reasonably low compared with other countries with a 160 Mn plus population, and employment in the industry around 4 million
(but need to consider recent pay hick as required by government policy;
- 24 apparel factories have been forced to shut down in Bangladesh due to losses since the implementation of a new pay structure for workers back in January 2019)

However, following are major negative factors when compared with Vietnam and Cambodia

- Bangladesh is the second largest exporter of apparel globally, but it mostly produces basic items, while its competitors, including Vietnam, Turkey, and Cambodia, have diversified and are currently manufacturing high end products
- Longer lead times are a major reason for the slower growth, compared with other countries.

Further plus factors to invest in BD can be summarized in the table below.

QUICK RETURN, PROTECTION:	100% foreign equity investment allowed, specially in Free zones with minimum 10 years of 100% tax holiday ROI is average 4.-6 years
AMPLE OPPORTUNITY, INCENTIVES	100 economic zones by 2030, tax concessions/duty free on raw material imports
BIG INTERNAL, EXTERNAL MARKET	Global apparel market of USD 650 billion by 2020. So big potential Currently exports to more than 130 countries
CHEAP AND ABUNDANT LABOUR	Minimum wage is around USD 68 per person which is reasonably low compared with other countries 160Mn plus population and employment in the industry around 4 million (need to consider recent pay hike due to government policy)
More focus on standardization	
STRONG BACKWARD BUILDING FORWARD LINKAGE	Around 1,430 textile mills are in operation. Capacity of yarn production is 2100million kg per year. and fabric production is 2800 million meters In its denim industry, the country is reliant on fabric import. (so Can use XYZ supplier link in future expansion in case for denim)
DUTY ADVANTAGES IN EXPORT	EU countries are importing 90% of garments from Bangladesh. Buyers are planning to increase sourcing of their goods from Bangladesh, which is classified as a Least Developed Country (LDC) and as such enjoys duty free access to EU market
Top Export Hot Spot Up to 2023	The statistics of McKinsey Apparel CPO Survey 2017, stated that Bangladesh will be among the top hot spots over the next 5 years, in terms of garments exports.

Further information from sources below related to country analysis:

Sector Profile		
No of industry	Bangladesh	Vietnam
	4560 garments and around 1500 textiles	6000 garments and textiles
Garments worker wage (USD per month)	68 to 100	122 to 176
Employment in industry	Around 4 millions	Around 2 millions

Lead time.

- Lead time is another key factor that buyers are concerned about as the garments industry is becoming more fast fashion-oriented. Although the shipping time to the EU and USA are quite similar, Vietnam can end up with a quicker lead time, as they are self-sufficient in textiles.
- On the other hand, Bangladesh is still dependent on imported cotton, yarn and fabrics (specially woven) which adds to its lead time. The average lead time from Bangladesh to EU and USA ranges from 90 to 120 days whereas from Vietnam it is 50 to 60 days which clearly puts Vietnam ahead.

Sustainability Issues

Besides, all these statistics, the drive for sustainability is becoming a major concern for the export industry, due to the recent emphasis on sustainable practices by different stakeholders globally. After some major accidents, Bangladesh improved significantly in the last five years and is now the leading Green manufacturing Industry in the world.

Vietnam doesn't have many green factories like Bangladesh & Vietnam CO2 emission are 2.29 tons per capita whereas Bangladesh emission are 0.59 tons per capita according to a report in 2017.

Annexure II

Cost benefit analysis of RO plant investment

Current operating cost Vs future operating cost with RO plant

Current cost of water per day

	<u>m3</u>		<u>Per m3</u>	<u>Cost per day</u>
Raw water	2600	Rs.	72.00	Rs. 187,200.00
	2080	Rs.	13.00	Rs. 27,040.00
				<u>Rs. 214,240.00</u>

With RO plant cost per day

Raw water	1400	72	100,800.00
Effluent	1120	13	14,560.00
RO plant operating cost	1200	86.84	104,208.00
			<u>219,568.00</u>
Incremental Cost of RS. Per day			<u>5,328.00</u>

Assumptions:

It is assumed that recycling limited only 1200 liters maximum. So the current raw water consumption would reduced to 1400 (2600-1200) liters

Current water requirement of 2600 liters will be consumed as follows:

Raw water : 1400

Re-cycle water 1200 at anytime which has the cost of RO plant operating

Annexure III

Working Capital Facility GAP for projected sales USD 125 Mn

	Days	Value -USD
Projected Sales	365	125,000,000.00
Average debtor days: 70 days	70	23,972,602.74
Average Inventory period: 63 days	63	21,575,342.47
		<u>45,547,945.21</u>
Average creditors period: 44 days	44	<u>(15,068,493.15)</u>
Net Working Capital required without LC		30,479,452.05
Average LC period is 21 days	21	7,191,780.82
Total Facility Required including LC		<u>37,671,232.88</u>
Existing Facility		<u>34,300,000.00</u>
Facility Gap		<u>3,371,232.88</u>

Note: the above facility gap is arrived at by considering both creditors' period and LC period for Fabric (RM). As the given information in the question paper is limited related to creditors days and LC period, candidates are required to make assumptions as follows;

- i. LC period is related to fabric and other related imports and simply taking the total average LC requirement based on annual sales is not possible because the cost of the exact LC value cannot be estimated without relevant information such as fabric cost as a % of sales value etc.
- ii. Creditors days is related to other suppliers and overhead related payments etc.

(However, marks can be given if the facility gap is calculated without LC period also.)

Annexure IV

Draft Letter to IRD

Date:

The commissioner
Unit 6 B (L.T.U)
Department of IR
Colombo

Dear Sir

TIN :

Income Tax Y/A: 2015/16

Appeal Against Income Tax Assessment No:

With reference to the aforementioned Notice of Assessment, we wish to appeal against this assessments.

The basis of our appeal is as follows;

1. The financial year 2015 was a bad period of XYZ Group's performance. Both our XYZ Apparels Pvt Limited and XYZ Trading Pvt Ltd made losses due to not receiving adequate orders from our buyers Internationally.
2. The said loss as reported in the above mentioned tax return was based on audited financial statements. Those audited financial statements are accurate and free from material misstatements and are fully compliant with required laws and regulatory frame work.
3. 99% of the business of our group is comprised of the operations of XYZ Apparels Pvt Ltd and XYZ Trading Pvt Ltd
4. XYZ Apparels Pvt Ltd is the parent company and XYZ Trading Pvt Ltd is the subsidiary. XYZ Apparels manufactures garments on behalf of XYZ Trading. XYZ Trading receive orders from international buyers and subcontract the same to XYZ Apparels, keeping a reasonable margin and exporting the finished garments. Both companies pay taxes at a lower rate being registered BOI ventures.
5. Our Group is fully compliant with vendor procedure manual and documentation requirements for US customs, related to imports under the first sale rule. A separate independent audit on our first sale compliance is required by an independent international auditor on behalf of our US buyers. As required by US customs first sale rule, we need to make sure that the transactions between factory operations and trading operations (called vendor Vs Factory relationship) have satisfied the following conditions;
 - ✓ Bona fide sale
 - ✓ The goods must be clearly destined for US
 - ✓ The price paid for the goods must be made at arm's length
6. The cost of sales of XYZ Apparels mainly comprises fixed expenses such as wages and salaries. Hence, a slight drop in revenue will result in a negative GP.
7. Your computation deriving a net profit based on a profit markup ratio, is baseless, as our entire group made losses during that year.
8. However, we are agreeable to the interest expense that pertains to the Directors/shareholders loan being charged at 28%.

9. Regarding the non-availability of proper evidence relating to fixed assets purchases claimed as capital allowance, please give us some times to provide the supporting documents in support of same.

Therefore, considering the above facts, please be good enough to cancel and recall the aforesaid Notice of Assignment.

Your kind corporation in this regard would be highly appreciated.

Thank you!

Yours Faithfully

Head of Finance
XYZ Apparels

Assumptions used in drafting the letter:

- Company has not filled its tax return for Y/A2015/2016 on or before due date. That is the reason for the late assessment during 2019 which is almost after the time bar for YA2015/2016
- In this context, it is assumed that there is no proper tax planning and compliance function in the company, and that they need tax expert ...



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