THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

# SUGGESTED SOLUTIONS



## KC5 - Corporate Strategy and Contemporary Issues

## June 2019

Business expansion strategies available to the company.

Responses should cover the points mentioned below, or any other well justified points.

- Increase market share - capture a bigger share of the current market (locally) with the products it already has, by engaging in aggressive marketing efforts.
- New markets - find new markets (locally and globally).
- Diversification - develop new products to sell to the current market and/or to new customers (related or unrelated diversification).
- Franchising.
- Strategic partnerships with other companies.

Determine ability of the Company to cope with the competition in the Japanese market, using an appropriate model or models.

Carry out a detailed analysis of the ability of the Company to compete, in terms of availability of resources and impact of coping with existing competition, when entering into the Japanese market, covering (yet not limited to) the following.

- Analysis of the Target Market in Japan
- Particular attention to cultural implications / e.g. communicating in the local language
- Analysis of differences in regulations and legislation, particularly relating to international trade, product quality, certifications and compliance requirements.

Important:

- Any other acceptable points, with proper analysis may be awarded marks.
- Students were expected to use an appropriate model or models (for example Porters Diamond Model, Porters five forces analysis, or any other model/analysis) to support their answer.

Financial feasibility of the project and qualitative/other factors to be considered. (State assumptions clearly, if any).

- Financial feasibility - See attached excel file
- Qualitative/other factors –

The financial feasibility had been carried out based on a 5 year forecast of financial and economic data. However there ought to have been changes in demand, inflation rates, growth rates, consumer preferences etc. Further, exchange rate fluctuations and the accuracy of /changes in forecasts, also need to be considered, in addition to the financial feasibility.

Issues related to the existing accounting and control systems should be highlighted, as well as shortcomings in other functional areas of the company, and strategies devised to overcome these issues.

**Issues**

- The Accounting and Control Functions appear to be at a basic level, and are limited to maintaining basic financial records/ financial statements, and detailed financial statements, which are not prepared as per accepted formats.
- A Strategic Plan or an Annual plan are not prepared.

- Monthly/Quarterly Budgetary Control and Variance Analysis Reports are not prepared and no Management Meetings had been held on a regular basis, to discuss past performance and future projections.
- Organizational performance is not regularly monitored using KPIs (for example although quality is claimed to be a priority, there is no indication of KPIs linked to quality being used).
- Adequate attention had not been paid to product costing, pricing strategies and inventory control.
- Product profitability analysis had not been carried out, relating to the different products of the company.
- Although ideas had been put forward for business expansion, there was no indication of any business feasibility studies being carried out, for each such idea.
- Screening of the competitiveness of the industry and competitor performance monitoring had not taken place.
- Lapses in working capital management were noted.
- Adequate attention had not been given to recruitment, selection, employee motivation and promotion.

**Strategies to overcome these issues**

- In light of the above issues, it is recommended that control systems be introduced, by revisiting the entire accounting and finance function in the company, and steps taken, to better manage working capital, through control of stocks, debtors and creditors.
  It is also recommended that existing employees be re-deployed, to ensure that the management accounting function in the firm is not neglected, and that timely and useful information is provided to support the internal decision making process.

<u>Sustainability concerns in relation to the environment, which should have been considered when entering into the Japanese market.</u>

- Japan is a country which places high importance on environmental protection. However in modern Japanese society a large amount of waste material was being produced and waste management was a critical issue. Therefore devising measures for waste disposal in an environmentally friendly manner, was critical.

- This would have significant implications when entering the Japanese market.
- E.g. before entering the Japanese market it would be necessary to be aware of the recycling policies and waste management regulations of the Japanese government, in addition to community concerns and public pressure, and consider how they will affect H&F products.

<u>Conclusion, clarity and language.</u>

The answer should be clearly presented with a brief conclusion.

| **Herbz & Fusionz project Evaluation** | | | | | | |
|---|---|---|---|---|---|---|
| | **2019** | **2020** | **2021** | **2022** | **2023** | **2024** |
| Number of bottles | | 1,000,000 | 1,100,000 | 1,210,000 | 1,331,000 | 1,464,100 |
| Price per bottle (¥) | | 50 | 53 | 55 | 58 | 61 |
| Revenue (¥) | | 50,000,000 | 58,300,000 | 66,550,000 | 77,198,000 | 89,310,100 |
| Exchange rate (LKR to ¥) | | 1.62 | 1.69 | 1.77 | 1.87 | 1.97 |
| Revenue (Rs.) | | 81,000,000 | 98,527,000 | 117,793,500 | 144,360,260 | 175,940,897 |
| Variable cost per bottle (Rs.) | | 30.00 | 32.00 | 34.00 | 36.00 | 38.00 |
| Total variable cost (Rs) | | (30,000,000) | (35,200,000) | (41,140,000) | (47,916,000) | (55,635,800) |
| Contribution (Rs.) | | 51,000,000 | 63,327,000 | 76,653,500 | 96,444,260 | 120,305,097 |
| Fixed cost | | (10,000,000) | (11,500,000) | (13,000,000) | (14,500,000) | (16,000,000) |
| **Earnings before interest & tax (EBIT)** | | **41,000,000** | **51,827,000** | **63,653,500** | **81,944,260** | **104,305,097** |
| Taxation (14%) | | (5,740,000) | (7,255,780) | (8,911,490) | (11,472,196) | (14,602,714) |
| **Profit after tax (PAT)** | | **35,260,000** | **44,571,220** | **54,742,010** | **70,472,064** | **89,702,383** |
| | | | | **(Rs.)** | | |
| Operating cash flows | | 35,260,000 | 44,571,220 | 54,742,010 | 70,472,064 | 89,702,383 |
| Initial investment | (100,000,000) | | | | | |
| Working capital investment | - | (5,000,000) | (5,000,000) | (5,000,000) | (5,000,000) | (5,000,000) |
| Net cash flows | (100,000,000) | 30,260,000 | 39,571,220 | 49,742,010 | 65,472,064 | 84,702,383 |
| WACC | | 17.30% | 17.30% | 17.30% | 17.30% | 17.30% |
| DCF factor at WACC | 1.0000 | 0.8525 | 0.7268 | 0.6196 | 0.5282 | 0.4503 |
| Present value of cash flows | (100,000,000) | 25,797,475 | 28,760,472 | 30,821,103 | 34,585,110 | 38,144,949 |
| **NPV for first five (05) years** | **58,109,109** | | | | | |
| **Discounted terminal value** | **274,783,000** | | | | | |
| **Total NPV** | **332,892,109** | | | | | |

**Working 1: Exchange rate calculation**

| Forecasted inflation rates | | | | | |
|---|---|---|---|---|---|
| | **2020** | **2021** | **2022** | **2023** | **2024** |
| Japan | 1.12% | 1.17% | 1.25% | 1.39% | 1.45% |
| Sri Lanka | 5.56% | 5.80% | 6.01% | 6.95% | 7.15% |
| Spot Exchange rate (Rs to Yen) | | | 1.55 | | |
| Purchasing power parity formula | | | | | |
| | **2020** | **2021** | **2022** | **2023** | **2024** |
| Exchange rate | 1.62 | 1.69 | 1.77 | 1.87 | 1.97 |

**Working 2: WACC**

| | |
|---|---|
| Debt weightage | 50% |
| Equity weightage | 50% |
| | |
| Cost of equity | |
| Beta | 1.20 |
| Risk free rate | 9% |
| Market risk premium | 10% |
| Cost of equity | 21.00% |
| | |
| Cost of debt | |
| Present SLIBOR | 11.81% |
| 4% Premium | 4% |
| Cost of Debt | 15.81% |
| Tax rate | 14% |
| Tax adjusted cost of debt | 13.60% |
| | |
| WACC | 17.30% |

**Working 3: Terminal value calculation**

| | |
|---|---|
| 5th Year net cash flow | 84,702,383 |
| Long run cash flow growth rate | 3% |
| 6th Year net cash flow | 87,243,455 |
| | |
| Terminal Value as at the end of year 5 | 610,166,628 |
| Year 5 DCF factor at the WACC of 17.30% | 0.4503 |
| Discounted terminal value | 274,783,000 |

**Other factors**

- <u>Reliability of  estimated inflation rates.</u>

  Considerable change in estimated rates would have an impact on the project as well as the NPV value.

- <u>Reliability of the financial forecast provided by Dilhan</u>.

  Accuracy of the figures given in the financial forecast are questionable.  If the figures are inaccurate, the project would yield negative results.  Therefore, it is important to validate the numbers used in the financial forecast, without merely relying on the financial and economic forecast given.

- <u>Terminal value calculation.</u>

  Terminal value calculation has been computed with the expectation that the cash flows will grow at 3 p.a. in perpetuity, which is an optimistic assumption.

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