



THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF SRI LANKA

**MULTIDISCIPLINARY CASE STUDY
PILOT PAPER**

Pupp 3040

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Advance Information

Cee line Fabrication Limited

List of exhibits

The following items are provided in the Advance Information

- (1) Background to the audit firm and your role
- (2) Permanent file extracts : Cee line Fabrications Limited (Cee line)
- (3) Extracts from business review and planning reports
- (4) Financial Statements for Cee line, prepared for management purposes by Bimal Wijesiri, Finance Director, for the years ended 31 December 20x1 and 20x2.
- (5) Forecasts for the years to 31 December 20x3 and 20x4, prepared in November 20x1 by Bimal Wijesiri.
- (6) A schedule of budgeted sales and cost of sales by quarter for the year ended 31 December 20x3 prepared by Bimal Wijesiri.
- (7) Budget for the year to 31 December 20x2, prepared in November 20x1 by Bimal Wijesiri.
- (8) Economic report on National Health Service and private hospital expansion.
- (9) Letter from Cee line's solicitors, Huludagoda, and Partners, concerning outstanding debt recovery and legal matters relating to the Anuradapura Factories.
- (10) 18 March 20x3 extracts of minutes from Cee line's board of 18 March 20x3.

Advance Information

authorization of payment before any cash is received. Terms of trade for payments follow contract details but the time period tends to be much longer and payment is subject to stringent quality control criteria being met on the whole contract.

The shares are currently held as follows:

Sumanadasa Perera 70,000 J. Silva 40,000 MB Cooray (nec Silva) 40,000; Kumara Rathnayake 20,000, Gunapala and Silvia Silva 15,000 each.

Advance Information

Exhibit 4

Prepared by Bimal Wijesiri, Finance Director, for management purposes, agreed with audited accounts.

CEE LINE FABRICATIONS LIMITED

Trading and profit and loss account for the year ended 31 December 20x2

	20x2	20x1
	Rs	Rs
Sales	5,919,598	5,232,439
Less:		
Direct labour (inc attributable overheads)	2,127,801	1,773,439
Materials	1,668,210	1,630,141
Change in stock	11,460	(13,601)
	3,807,471	3,389,979
Gross profit	2,112,127	1,842,460
Sundry income	29,784	27,853
Interest received	10,716	12,347
	2,152,627	1,882,660
Less Expenses		
Accountancy	41,358	34,081
Bad debts	17,542	15,569
Bank charges and interest	16,811	13,083
Carriage	44,685	39,537
Depreciation of:		
Leasehold improvements	39,318	26,410
Office equipment	6,170	4,550
Motor vehicles	136,723	136,723
Gain on disposal of fixed assets	-	(28,500)
Heat and light	14,174	16,157
HP interest	56,842	50,576
Insurance	242,426	236,296
Marketing costs	165,896	143,521
Motor expenses	72,874	79,875
Postage, stationery and advertising	31,749	35,165
Rent and rates	60,452	60,284
Salaries including directors' emoluments	247,980	184,812
Sundries	42,283	36,837
Telephone	15,727	12,818
	1,253,010	1,097,794
Net profit for the year	899,617	784,866
Corporate tax	(235,000)	(204,000)
Net profit after tax	664,617	580,866
Dividends	(200,000)	(200,000)
Retained profit	464,617	380,866
Retained profit brought forward	1,423,225	1,042,359
Balance carried forward	1,887,842	1,423,225

Advance Information

CEE LINE FABRICATIONS LIMITED

Notes to financial statements for the year ended 31 December 20x2

(1) ACCOUNTING POLICIES

(a) Depreciation

Depreciation is charged so as to write the cost of fixed assets off over their useful lives on the following bases –

Motor Vehicle	-	25% of cost
Plant and Equipment	-	16% of cost
Office Equipment	-	15% of cost
Leasehold Improvements	-	10% of cost

(b) Stock and Work in progress

Stock and work in progress are valued at the directors valuation, which approximates to the lower of cost and net realisable value.

(2) TANGIBLE FIXED ASSETS

	Motor Vehicles Rs	Plant & Equipment Rs	Office Equipment Rs	Leasehold Improvements Rs	Total Rs
Cost					
At 1 January 20x2	546,890	1,731,916	30,324	264,035	2,573,165
Additions	-	1,36,062	17,554	129,153	1,482,769
At 31 December 20x2	546,890	3,067,978	47,878	393,188	4,055,934
Depreciation					
At 1 January 20x2	273,445	1,083,794	28,322	153,510	1,539,071
Charge for the year	136,723	496,045	6,170	39,318	678,256
At 31 December 20x2	410,168	1,579,839	34,492	192,828	2,217,327
Net Book Value					
At 31 December 20x2	136,722	1,488,139	13,386	200,360	1,838,607
At 31 December 20x1	273,445	648,122	2,002	110,525	1,034,094

(3) CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	20x2 Rs	20x1 Rs
Value Added Tax	504,924	299,875
HP Creditor	468,429	382,966
Trade Creditors	822,011	782,294
Corporate tax	235,000	204,000
Dividends	200,000	200,000
Accruals	36,000	39,000
Other Creditor	33,421	39,188
	2,099,785	1,947,323

Advance Information

Exhibit 5

CEE LINE FABRICATIONS LIMITED

Trading and profit and loss account

Forecast to 31 December

	20x3 Total Rs	Year to 20x3 Colombo Rs	20x3 Kandy Rs	Year to 20x4 Total Rs	20x4 Colombo Rs	20x4 Kandy Rs
Sales – own work	6,400,000	2,600,000	3,800,000	7,000,000	2,900,000	4,100,000
Less:						
Direct Labour	2,230,000	1,004,000	1,226,000	2,489,000	1,114,000	1,375,000
Materials	1,920,000	816,000	1,104,000	2,036,000	911,000	1,125,000
Change in Stock	12,000	6,000	6,000	30,000	10,000	20,000
	4,162,000	1,826,000	2,336,000	2,455,000	2,035,000	2,520,000
Gross Profit	2,238,000	774,000	1,464,000	2,445,000	865,000	1,580,000
Gross Profit %	35	30	39	35	30	39
Accountancy	48,000	24,000	24,000	50,000	25,000	25,000
Bad Debts	10,000	5,000	5,000	14,000	7,000	7,000
Bank Charges and Interest	16,000	8,000	8,000	26,000	10,000	16,000
Carriage	38,000	10,000	28,000	40,000	12,000	28,000
Depreciation of:						
Leasehold Improvements	39,000	-	39,000	39,000	-	39,000
Office Equipment	6,000	6,000	-	6,000	6,000	-
Motor Vehicle	136,000	50,000	86,000	136,000	50,000	86,000
Heat and Light	13,600	6,000	7,600	15,000	7,000	8,000
HP Interest	52,000	12,000	40,000	52,000	12,000	40,000
Insurance	250,000	142,000	108,000	260,000	147,000	113,000
Salaries and Directors'						
Emoluments	220,000	100,000	120,000	250,000	115,000	135,000
Marketing Cost	189,000	108,000	81,000	205,000	115,000	90,000
Vehicle Expenses	62,000	30,000	32,000	67,000	32,000	35,000
Stationery and Advertising	38,000	10,000	28,000	42,000	13,000	29,000
Rent and Rates	60,000	24,000	36,000	64,000	26,000	38,000
Sundries	22,000	11,000	11,000	22,000	11,000	11,000
Telephone etc.	20,000	7,000	13,000	27,000	12,000	15,000
Total Expenses	1,219,600	553,000	666,600	1,315,000	600,000	715,000
Net Profit for Year	1,018,400	221,000	797,400	1,130,000	265,000	865,000
Net Profit%	16	9	21	16	9	21

Assumptions used in preparing budgets and forecasts:

- (1) Turnover is split between each of the business's factories either based on previous years turnover or on orders received or expected for the budgets/forecast period.
- (2) Direct Labour includes wages of the shop floor employees and the attributable, managers, administrative staff and Production Director including Employers' NIC, together with an overhead recovery rate to absorb all relevant overheads.
- (3) Included in overheads are depreciation of plant and machinery and rent and rates, light and heat, carriage inwards and clearing costs, apportioned to the factory floor.
- (4) The absorption rate is set so that actual costs equate to absorbed costs.
- (5) The Profit and Loss Account expenses are calculated as an uplift on the previous period's actual costs, plus any specific expenses information.

Advance Information

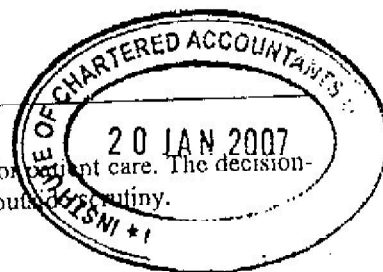
Exhibit 7

CEE LINE FABRICATIONS LIMITED

Budget year to 31 December 20x2 -- prepared November 20x1 by Bimal Wijesiri

	Total Rs	Colombo Rs	Kandy Rs
Sales – own work	5,900,000	2,400,000	3,500,000
Less:			
Direct Labour	2,110,000	918,500	1,191,500
Materials	1,690,000	751,500	938,500
Change in Stock	10,000	6,500	3,500
	3,810,000	1,676,500	2,133,500
Gross Profit	2,090,000	723,500	1,366,500
Gross Profits	35.42	30.15	39.04
Accountancy	40,000	20,000	20,000
Bad Debts	10,000	4,000	6,000
Bank Charges and Interest	14,000	7,000	7,000
Carriage	52,000	26,000	26,000
Depreciation of:			
Leasehold Improvements	40,000	15,000	25,000
Office Equipment	5,000	5,000	-
Motor Vehicles	136,000	50,000	86,000
Electricity	16,000	9,000	7,000
HP Interest	52,000	12,000	40,000
Insurance	240,000	123,000	117,000
Marketing Costs	160,000	90,000	70,000
Salaries and Directors' Emoluments	250,000	180,000	70,000
Vehicle Expenses	45,000	30,000	15,000
Postage, Stationery and Advertising	30,000	9,000	21,000
Rent and Rates	60,000	30,000	30,000
Sundries	20,000	10,000	10,000
Telephone	13,000	6,500	6,500
Total Expenses	1,183,000	626,500	556,500
Net Profit for Year	907,000	97,000	810,000
Net Profit %	15.37	4.04	23.14

Advance Information



Priorities will have to be established in order to provide a cohesive framework for patient care. The decision-making process will also have to be more transparent and vigorous to withstand outside scrutiny.

The patient's perspective

It is true to say that in previous years, the needs and requirements of the patient have not always been placed at the forefront of the decision making process. The market needs to bear in mind the patient's access to the system, the further information between patients, carers and other interested bodies, and the element of accountability to the public for decisions made.

Access to the healthcare system should be based on a level playing field. There are particular problems with people of a poor socio-economic status, people of ethnic origins, people who are already suffering ill-health or some other disability and people whose prior education has not equipped them with the information to realize that they have a role in their own medical outcome. In addition, elderly people, who now account for a larger proportion of the total Sri Lanka population than in previous years, can also suffer problems of access for similar reasons.

To combat this it is important that the flow of information should be effective and that information about the possible treatments available should be widely disseminated. Realistically, this may involve the use of languages other than English and some innovative ideas as to how information can be presented.

The provision of information should be co-ordinated by patient-focused bodies whose role would be to ensure consistent and effective communication at all levels.

Working to the healthcare industry

People working in the healthcare industry have various challenges to address. These are diverse, including under funding, rationing of treatment, the increased incidence of litigation and the increasing power exercised by patients and other external bodies. This has led to certain conflicts in terms of the desire to provide a high standard of quality of services within tight budgetary restraints and increasing demands from the general public.

In order to ensure that healthcare professionals remain in post, motivated and properly remunerated, properly co-ordinated policy needs to be implemented in order to reconcile these sometimes-contradictory objectives.

Healthcare funding

Sri Lanka spending on healthcare has consistently lagged behind compared with other developed countries. Since 1960 the Organisation for Economic Co-operation and Development countries have an average increased health spending per capita by 5.5% in real terms compared with only 3.6% in SRI LANKA. However, Sri Lanka healthcare market is not directly comparable to the rest of Asia because Sri Lanka has a much larger percentage of day care rather than long stay beds. Sri Lanka therefore has fewer beds per head of population than Asia.

In recent years the Sri Lanka has spent considerable sums trying to cure the problems caused by waiting lists. This has led to reduced expenditure on ward related equipment as the available funds are spent on operations and more advance diagnostic and monitoring equipment.

As a consequence the NHS has been left with insufficient capacity to provide the services that the public expect. Sri Lanka has too few hospital beds per head of population compared with most other health systems. The NHS lacks sufficient doctors, nurses and other skilled staff. One third of the buildings used by the NHS today were built before the NHS was even created. There is a backlog of maintenance in the NHS. The NHS has inadequate levels of modern equipment. IT investment has been too slow and too patchy.

In general, budgeting in the healthcare sector is performed on a fiscal year basis ie from 1 April to 31 March of the following year. Most hospitals operate a system whereby managers must commit to expenditure up to

Advance Information

Exhibit 9

HULUDAGODA & PARTNERS
Solicitors
14 King Street, Colombo 05,
Sri Lanka.

Cee line Fabrications Limited
Unit 34 Summer Trading Estate
Sri Lanka, Colombo.
10 March 20x3

Dear Sumanadasa and Kumara

Further to your letter of 2 March 20x3, I have pleasure in providing the following

- (1) Latest details on the collection of outstanding debts
- (2) Latest details concerning the lease on the Anuradapura factory
- (3) An analysis of our fees to date

Latest details on the collection of outstanding debts

At present we are dealing with four outstanding debts. Of these, judgement has been awarded in your favour for the debt from the General Hospital in Melrose. In this case you have been awarded Rs40,000 (exclusive of VAT) in respect of the book debt of Rs40,000 plus Rs4,500 in fees and interest. I am very pleased that this case has finally been settled as we have been working on it for over two years now.

In the cases of Empire Medical Centre and Whitehouse private Hospital, both under the control of Bruntwich Health Trust, we have written to each of these Kandy factory customers independently, asking for payment to be made. These cases are in their early stages. Although both have refused to pay for some months, they have only in the past three weeks given their full reasons-citing quality issues and penalty clauses. The total of these two debtors is Rs95,000 exclusive of VAT.

Finally, we have been trying to recover the old outstanding debt of Rs102,000 (exclusive of VAT) in relation to The New Medical Centre in Bombay. This debt relates to work done some time ago by the Colombo Factory. We have been engaged on a series of extensive and difficult telephone calls with both the hospital and a local firm of solicitors in India. At this time we do not expect to be able to recover this debt fully but Rs20,000 of the debt is covered under the Export Credit Guarantee Scheme so at least you will be able to recover that amount. We have started to prepare the necessary ECGS documents and we will be sending them to you shortly for approval and signature ahead on any claim.

Latest details concerning the lease on the Anuradapura Factory

We are close to completing our negotiations on the Anuradapura Factory and you should be able to take possession of the building in October 20x3 so that fitting out can start. We will be passing on to you the surveyor's fee of Rs7,000 for their report.

Analysis of our fees to date

At present our fees comprise Rs12,000 for negotiations with the landlord and finalizing the lease details in relation to the Anuradapura Factory and a further Rs3,400 in connections with the debt collection work.

Yours sincerely

Albert Huludagoda

Advance Information

Exhibit 10 A

Economic & Social Infrastructure. (Source - Central Bank Annual Report)

The health sector suffered from several major setbacks. As in the previous years, there were frequent labour disputes in the public sector health services, crippling the services and putting the general public into inconvenience. A major outbreak of Dengue Fever (DF) and Dengue Hemorrhagic Fever (DHF) infected more than 13,000 persons and claimed 73 lives. These illustrate the continuing difficulties in maintaining the heavy public funding of the government health care programmes provided to all without targeting. The deterioration in some aspects of public sector health services was to some extent, arrested by increased private sector investments mainly in curative health care. However, preventive care, mostly of a public good nature, suffered due to inadequate funding and other typical state sector inefficiencies, undermining Sri Lanka's historical achievements. Therefore, proper targeting could save funds for preventive health care thus elevating Sri Lanka's health performance. This is specially relevant since the private sector investors have a very minimal incentive in promoting preventive health care.

Under the health sector reforms, key recommendations Under the health sector reforms, key recommendations made by the Presidential Task Force (PTF) on Health in 1997 continued to be implemented on five fronts; improving at least one hospital in each district, expanding the services to areas of special needs, developing health promotional programmes, reforming the organizational structure including alternative financing mechanisms and promoting resource sharing with the private sector. Along these lines, the Ministry of Health developed a National Health Development Master Plan with the cooperation of JICA, in October 20x3. Under the programme of developing at least one hospital in each district, 34 hospitals in outstations have been identified for a phased development. To decentralise and develop mental health services, action has been taken to establish at least one mental rehabilitation centre in each district. In addition, 50 hospitals under the estate sector management have been identified for further development by the government. Of these, 22 hospitals have already been taken over by the government and are being improved.

As a tradable service, Sri Lanka's health services are gradually gaining competitiveness through increased investment by the private sector. The recent surge in private hospitals indicates the need for meeting demand for high quality health care when the public sector fails to provide the same. This is specially relevant to Sri Lanka's efforts at attracting tourists by providing the necessary infrastructure in niche areas such as health tourism. With the increasing participation of the private sector in the provision of healthcare, it is essential to develop a market based regulatory framework to ensure that quality and standards are maintained. It is apparent that the entry of the private sector into the provision of health care services has helped the country to prevent a general breakdown of the whole system. This was partly facilitated by releasing the vast amount of knowledge within the public sector health services for use by the private sector. Accordingly, the services of the specialists attached to the public sector health care system were formally made available to the private sector. Similarly, though not officially sanctioned, the services of technicians too were tapped by private sector institutions. This move can be described as a privatisation of inputs of a health care system and it has benefited all the stakeholders involved. It is now necessary to move a step further by permitting private medical schools under a strict standard setting framework of the government. Such private medical schools will help students following the biology stream to realise their goal of pursuing a medical education which the public sector is unable to satisfy at present due to resources constraints, liberalise the input market further and provide effective competition to public sector medical schools to upgrade quality, attain excellence and be the benchmark setter in medical education. The mostly expressed fear that the quality of the services would be compromised is totally unfounded, since all other inputs of the health care services such as buildings, equipment, vehicles and drugs are produced and supplied by the private sector.

Using the Advance Information

CEE LINE FABRICATIONS LIMITED

USING THE Advance Information

Note

The following analysis is not meant to be exhaustive. It represents the equivalent of a candidate's individual preparation. For the examination based on this case it would be the first step in the process, which should be followed by discussion of this case with similarly prepared candidates and their tutors or colleagues. That discussion would lead to further understanding and further case notes.

Not all of the preparation work shown here will become relevant to answering the case requirements but this work is an essential step in familiarization.

Familiarisation, analysis and awareness

The advance material in this illustrative case is slightly shorter than the real ACS examination cases but it provides enough of the appropriate information to allow the process of case familiarization, analysis and awareness to occur.

The process of familiarisation using the advance material, involves reading each exhibit carefully, and focusing on the key issues from each of these exhibits.

The analysis is the application of professional skills to the material presented – the analysis will involve both financial and non-financial factors.

The awareness is the setting of the case information in its wider context: business life cycle and business environment, as well as using personal professional and business awareness developed through practical work with clients.

Key facts noted from Advance Information concerning Cee line

Exhibit 1 - Background to audit firm (small/medium sized) and identification of position of candidate within the firm (graduate, working on a variety of clients).

Exhibit 2 - Background to Cee line

- Family owned limited company
- Sumanadasa Perera (founder) and Kumara Rathnayake (son-in-law) are the key directors
- Metal fabrication engineering and manufacturing business
- Operating for more than 20 years
- Two distinct, separate, aspects to the business
- Specialist engineering; Colombo factory; Sumanadasa Perera
- Health service supplier; Kandy factory, Kumara Rathnayake
- Successful business
- Health of one director (Sumanadasa Perera 59) a concern?

Exhibit 3 - Cee line's business review provides information on a number of important issues (not all reproduced here) such as:

- Planned expansion with commitment to new premises
- Looking for areas with better margin on sales
- New substantial contact already won
- Colombo factory large but dilapidated
- Company cash flow to provide finance for new factory
- Company has good track record on budgets/forecasts against actual (Ex7)

Using the Advance Information

Exhibit 10 A Economic & Social Infrastructure

- Major changes in the health sector
- Trends in the health sector in Sri Lanka
- Health Development Master Plan

Exhibit 10 B Economic Review of Sri Lanka

- Information about GDP of Sri Lanka.
- Changes of GDP in Sri Lanka

Exhibit 10 C Public Health Services

- Health sector information
- Government performance in health sector
- Private sector performance in health sector
- Health sector expenditure.

Missing information (Identified at this stage)

- 20x2 Trading and Profit and Loss Account split by factory
- Historic sales and cost of sales by quarter split for each factory
- Projections for 20x3 and 20x4 only show P/L figures
- Would like to see projected Balance sheet and Cash Flow Statement
- Economic review with details of demand for specific output from Colombo factory

Additional analysis (to be conducted as part of familiarisation work)

- Reconfiguration of financial information into one table
- Financial analysis (as far as possible)
- Cash flow statement (as far as possible)
- SWOT
- Porters five forces analysis? (not done).

Using the Advance Information

Cee line Ratio analysis

Financial analysis of actual results

Profitability ratios	20x1		20x2	
(1) Gross Profit %	$\frac{1,842}{5,232}$	35.2%	$\frac{2,112}{5,920}$	35.6%

A good consistent rate of gross profit. Stable over the two years.

Profitability ratios	20x1		20x2	
(2) Net Profit % (PBIT/Sales)	$\frac{785}{5,232}$	15.0%	$\frac{900}{5,920}$	15.2%

A good rate of net profit after charging significant costs such as:

	20x1	20x2
Marketing/sales %	2.7%	2.8%
Insurance/sales %	4.5%	4.1%

- Bad debts in both these years may be understated if the information from the solicitor is an indicator.
- Profit may be overstated.
- The profit on disposal may indicate that the depreciation policy is slightly heavy.
- Profit may be slightly understated

R.O.C.E

(3) PBIT	20x1		20x2	
S/Holders Funds & Long Term Loan	$\frac{849}{1,796}$	47.3%	$\frac{974}{2,631}$	37.0%

A very good return on capital employed.

(4) Profit After Tax	20x1		20x2	
S/Holders Funds & Long Term Loan	$\frac{581}{1,796}$	32.3%	$\frac{665}{2,631}$	25.3%

(5) Interest Cover	20x1		20x2	
PBIT	$\frac{849}{63}$	13.5 times	$\frac{974}{74}$	13.2 times
Interest Payable				

Very good cover for interest payable

(6) Dividend Cover	20x1		20x2	
	$\frac{580}{200}$	2.9 times	$\frac{665}{200}$	3.3 times

Dividend cover may be slightly low but not a matter for concern.

Liquidity ratios:

(7) Current Ratio	20x1		20x2	
	$\frac{2,709}{1,947}$	1.4 : 1	$\frac{2,802}{2,100}$	1.4 : 1
OR				
(8) Acid Test	20x1		20x2	
	$\frac{1,908}{1,947}$	0.98 : 1	$\frac{2,103}{2,100}$	1:1

Using the Advance Information

SWOT analysis

Strengths

- Well established business
- Experienced in engineering sector
- Good clients: range and size
- Reliable suppliers (?)
- Kandy factory very strong component of business
- New technology and knowledge workers in the company
- Ability to win new large profitable contracts
- Complimentary skills of directors

Weaknesses

- Some poor quality output (Colombo factory)
- Old fashioned management style
- Lack of real delegation – Colombo and overall
- No real corporate strategy
- Age, health and attitude of Sumanadasa Perera
- Some evidence of erratic selling (Bombay?)
- Bad debts experience significant – any others
- Evidence of poor control
- Potential loss of 20% of sales team
- Shareholders only members of immediate family
- Still seen as Sumanadasa Perera's business

Opportunities

- Continued government investment in NHS
- NHS a reliable, progressive and significant client
- Private hospitals set to re-equip and expand in near future
- Ageing Sri Lanka population therefore increase in demand for hospital services, beds
- Output from Cee line set to increase with new Kingsway factory
- Physical spare capacity

Threats

- New entrants from overseas
- Cheaper competitors
- Bargaining power of clients - especially NHS
- Strength, loyalty and quality of suppliers and their supplies.

Impact Information

List of exhibits

The following items were included in the Advance Information:

- (1) Background to audit firm
- (2) Background to the client company Cee line Fabrications Limited (Cee line)
- (3) Cee line's financial and business review extracts
- (4) Financial Statements for Cee line, prepared for management purposes, for the years ended 31 December 20x1 and 20x2.
- (5) Forecasts for the years to 31 December 20x3 and 20x4, prepared in November 20x1.
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- (9) Letter from Cee line's solicitors, Huludagoda, Constance and Partners, concerning outstanding debt recovery and legal matters relating to the Anuradapura Factories.
- (10) 18 March 20x3 extracts from Cee line's board minutes.
 - (10 A) Economic & Social Infrastructure
 - (10 B) Economic Review of Sri Lanka
 - (10 C) Public Health Services.

The following items are newly provided to candidates:

- (11) Memorandum from Mr Saman Wijerathna. (Partner in Gunarathna & Wijerathna, Chartered Accountants) to Sudath Perera giving instructions on the work to be done.
- (12) Letter from Mr. Kumara Rathnayake (Cee line Fabrications Limited) to Mr Saman Wijerathna requesting professional assistance and providing some background to the recent flood and claim.
- (13) Extract from Cee line's Business Interruption Insurance Contract.
- (14) Loss of Profit claim prepared by Cee line Fabrications Limited
- (15) Cee line Fabrications Limited Trading and profit and Loss Account for the 6 months ended 30 June 20x3.
- (16) Revised budget for Cee line for the year to 31 December 20x3.
- (17) Schedule of Actual Sales and Cost of Sales for Cee line by quarter from January 20x2 to March 20x3.
- (18) Report by Waruna Wasantha, Production Director of Cee line, re: Production planning for Cee line for the period of 31 December 20x3.
- (19) Report by Pubudu Jayasiri, Sales Director for Cee line, re: Consequences of the flood on company sales planning for the period to 31 December 20x3.
- (20) The appointment of the consultant by the board of directors.
- (21) The consultants report with options to re- establish the Kandy

Impact Information

Exhibit 12

CEE LINE FABRICATIONS LIMITED Metal Fabricators

Unit 34
Summer Trading Estate
Colombo
16 July 20x3

Mr Saman Wijerathna
Gunarathna & Wijerathna
Chartered Accountants
27 High Street
Colombo,
Sri Lanka.

Dear Mrs Wijerathna,

As you are aware, from our many previous conversations, we had a major flood on 31 March 20x3 when the River Mahaweli broke its banks and destroyed the Kandy factory of Cee line Fabrications Limited.

Cee line's business insurance covers the replacement cost of plant, stock and work in progress. These items have already been assessed and the claim agreed.

We are now currently seeking an interim payment under the "Business Interruption" heading in our insurance policy.

I am enclosing:

- (1) Extracts from our insurance contract re: Business Interruption (see Exhibit 13).
- (2) A summary of our loss of profits claim (see Exhibit 14), using the Gross Profit basis under section B.

I am also enclosing the following financial statements prepared on 4 July 20x3 which you may need to use in reviewing our claim.
- (3) The draft financial statements for the six months to 30 June 20x3 (see Exhibit 15) which reflect the trading which has occurred since the start of this financial year.
- (4) The revised budget for the year to 31 December 20x3 reflecting our current position (see Exhibit 16). The revised budget includes the draft half-year financial statements and appropriate projections to the 31 December 20x3 year-end.
- (5) A detailed break-down of actual sales and cost of sales for the past six quarters from 1 January 20x2 to 30 June 20x3 (see Exhibit 17).

I am also enclosing the reports made to the Board by the Production Director (see Exhibit 18) and the Sales Director (see Exhibit 19).

The consequences of the flood have required substantial overtime to be worked by administrative staff. Outside assistance was also needed from various agencies and legal advisors and have resulted in additional professional fees of about Rs 48,000 split roughly equally between accountancy and IT work, and legal fees. Not all of these invoices have yet been received. Also, we have just been notified, by letter of Rs 75,000 in penalties on one contract, due to late delivery caused by the flood – not yet adjusted for in the draft financial statements to 30 June 20x3. We have also written off some Rs 88,000 of debts generated from the Kandy factory sales.

Impact Information

Definitions

For the purpose of this insurance the following definitions apply.

Note: To the extent that the Insured is accountable to the tax authorities for Value Added Tax all items in this insurance shall be exclusive of such tax.

Turnover

The money paid or payable to the Insured for goods sold and delivered and for services rendered to customers in the course of the Business at the Premises.

Gross Profit

The amount by which the sum of the amount of the Turnover (less any discounts allowed) shall exceed cost of sales.

Note: In calculating the cost of sales the amounts of the opening and closing stock and work in progress shall be arrived at in accordance with recognized accounting methods.

Indemnity Period

The period beginning when the Damage occurs and ending when the results of the Business cease to be affected by the Damage but not exceeding twelve months.

Rate of Gross profit

The rate of Gross Profit earned on the Annual Turnover.

Annual Turnover

Turnover during the twelve months immediately before the date of the Damage.

Standard Turnover

The Turnover during that period in the twelve months immediately before the date of the Damage which corresponds to the length of the Indemnity Period.

For each of the above marked with an*, adjustments shall be made to provide for the trend of the Business which would have affected the Business had Damage not occurred, so that the adjusted figures shall represent the results which but for the Damage would have been obtained during the Indemnity Period.

Impact Information

Exhibit 15

CEE LINE FABRICATIONS LIMITED

Trading and profit and loss account for the six months ended 30 June 20x3

	Rs
Sales	2,112,750
Less:	
Direct labour (inc attributable overheads)	769,715
Materials	655,143
Change in stock	28,500
	<u>1,453,358</u>
Gross Profit	659,392
Sundry income	11,430
Interest received	<u>670,822</u>
Less: expenses	37,710
Accountancy	101,350
Bad debts	14,460
Bank Charges and Interest	31,460
Carriage	
Depreciation of:	19,659
Leasehold improvements	3,085
Office Equipment	68,362
Motor Vehicles	10,452
Electricity	31,020
IHP Interest	127,230
Insurance	35,630
Legal Fees	116,790
Salaries including Directors' Emoluments	129,538
Marketing Costs	35,630
Motor Expenses	20,400
Postage, Stationery and Advertising	26,248
Rent and Rates	14,730
Sundries	10,530
Telephone	<u>814,174</u>
Net (loss) for the period	<u><u>(143,352)</u></u>

Impact Information

Exhibit 17

CEE LINE FABRICATIONS LIMITED

Schedule of Actual Sales and Cost of Sales by quarter

Colombo

Year 20x2	Quarter 1 Rs000s	Quarter 2 Rs000s	Quarter 3 Rs000s	Quarter 4 Rs000s	Quarter 5 Rs000s
Sales	570	587	610	640	2,407
Cost of Sales	398	409	425	445	1,677
Gross Profit	172	178	185	195	730
GP%	30.2%	30.3%	30.3%	30.5%	30.3%
Year 20x3					
Sales	665	615	1,280		
Cost of Sales	465	490	955		
Gross Profit	200	125	325		
GP%	30.1%	20.3%	25.4%		
Kandy	Quarter 1 Rs000s	Quarter 2 Rs000s	Quarter 3 Rs000s	Quarter 4 Rs000s	Quarter 5 Rs000s
Year 20x2					
Sales	910	885	860	857	3,512
Cost of Sales	552	540	525	513	2,130
Gross Profit	358	345	335	344	1,382
GP%	39.3%	39.0%	39.0%	40.1%	39.4%
Year 20x3	Quarter 1 Rs000s	Quarter 2 Rs000s	Quarter 3 Rs000s	Quarter 4 Rs000s	Quarter 5 Rs000s
Sales	832	-	832		
Cost of Sales	499	-	499		
Gross Profit	333	-	333		
GP%	40%	0.0%	40%		
Total					
	Quarter 1 Rs000s	Quarter 2 Rs000s	Quarter 3 Rs000s	Quarter 4 Rs000s	Quarter 5 Rs000s
Sales	1,480	1,472	1,470	1,497	5,919
Cost of Sales	950	949	950	958	3,807
Gross Profit	530	523	520	539	2,112
GP%	35.8%	35.5%	35.4%	36.0%	35.7%
Year 20x3	Quarter 1 Rs000s	Quarter 2 Rs000s	Quarter 3 Rs000s		
Sales	1,497	615	2,112		
Cost of Sales	964	490	1,454		
Gross Profit	533	125	658		
GP%	35.6%	20.3%	31.2%		

Impact Information

Exhibit 19

To : Kumara Rathnayake/Sumanadasa Perera
From : Pubudu Jayasiri (Sales Director of Cee line Fabrications Limited)
Date : 3 July 20x3
Re : Sales planning for the period to 31 December 20x3

Following our recent conversation I have prepared the following note on the likely impact of the flood on sales from the Colombo and Kandy factories. My only reservation about the information below is that we have never been in this situation before and so all the figures are my best estimates. I have set out in the table below the sales which we achieved in quarters three and four working from the Colombo factory.

	Colombo Contracts Rs'000s	Kandy contracts Rs'000s	Total Rs'000s
Qtr2	390	235	615
Qu3	360	300	660
Qtr4	360	400	760

Before the flood, the sales forecasts for 20x3 and 20x4 looked very promising. The work that Malmi Jayalath. (Marketing Director) and I have done over the last 18 months was starting to pay dividends.

Sales of the Colombo product range have become increasingly solid due to the elimination of quality concerns. We should easily achieve the sales prediction shown above. The reduction in those sales against original budget reflects the switch of resources to ensure the completion of the penalty clause Kandy contracts.

The Kandy contract sales position is more problematic. We have had to spend a lot of time visiting out key clients to attempt to help them on-side during this time. In general our clients are willing to help us by waiting but they are pointing out the fact that there are a number of competing suppliers from abroad who are creating serious competition on price. Our counter argument is that our quality is much higher and our after sales service is much more effective. However, our sales from the Kandy contracts are well down on estimates/ The sales figure shown above are a realistic estimate of deliverable sales. If production can be increased we will be able to sell all that we can produce.

Our main competitors are as follows:

- DRT Engineering Ltd: This is an established business operating from a 5,000sqm-site in Dehiwala. The company has been our major Sri Lanka rival for many years. They have recently secured a major contract for the National Health Service, which we also bid for. We have already lost a couple of major contracts to them.
- Makeitquick Ltd: An up and coming company operating from an industrial site at Negombo. This company was a management buyout three years ago. Since then the company has had a rather chequered period. On a good day their product is second to none but their workmanship is variable and they have suffered because of this.
- The Indian Medical Engineering Company: Based in Indian, this competitor has the advantage of low labour rates and low material costs available in the Pacific rim countries. Their workmanship is of a relatively high standard, although we like to think that it is not as good as ours is. They have an excellent record of meeting their delivery times.

My best estimate of the length of time that it will take to pull the turnover round and to get us to the position which we would have been in, had the flood not occurred, would be 12 months for the Colombo contracts and 15 months for the Kandy contracts. Both these are periods of time from the time of the flood.

Overall the 20x3 sales have been hit hard by this flood, but the sales team have been working their way around the existing client base to reassure our customers that we will meet all existing orders as soon as possible.

Impact Information

Option 02 - Acquire the "CONSTRA" as a fully own subsidiary

Constra is a private company which is operating in Sri Lanka over the years as a competitor to the Cee line company. Constra is a family owned company. The shareholding of the Constra would be as follows.

Mr Malwaththa	50000
Mr Senake	50000
Mr Pathiraja	30000
Mr Nandana	20000

Profit & loss and Balance sheet extracts would be as follows.

Profit & Loss A/c for the ended 2003/12/31.

Revenue		3,000,000
Cost of Sales		1,550,000
Gross Profit		1,450,000
Selling & distribution	100,000	
Administration	200,000	
Other expenses	150,000	450,000
Operating Profit		1,000,000
-Finance cost		(100,000)
Profit before tax		900,000
Tax 35%		315,000
Profit after tax		585,000

Balance Sheet as at 2003/03/31

Assets	
Non-current Assets	3500,000
Current Assets	285,000
	3785,000
Equity	
Share capital	1500,000
Reserves	935,000
Non-current liabilities	
Bank loan (10%)(to be repaid in next 4 years)	800,000
Current liabilities	550,000
	3785,000

- The company's policy is to pay 25% of earnings as dividends.
- The last years dividends was as follows.

1999	95,000
2000	100,000
2001	135,000
2002	125,000
2003	146,250

- In the construction industry 17% return is expected

How to tackle the case

Cee line Fabrications Limited

How to tackle the case

Using the impact information and planning the answer

Overall

In the examination the benefit of good detailed understanding of the Advance Material will become apparent, but it will not necessarily drive the answer being requested.

In order to assimilate the Impact Information, and place the Advance Information in the context of the case requirements, a number of steps need to occur.

Steps

- (1) Read the requirements very carefully. In Cee line's case these are contained in the memo from the partner, Saman Wijerathna to Sudath Perera, but they also require reviewing in the context of the correspondence from the client.
 - A report is required for this client
 - Two key elements and
 - An executive summary
- (2) The remainder of the impact material should be skim read at speed to see what is available to help produce an answer and to allow a rough gauge of the complexity of the requirement.
 - There are 15 pages in total
 - After the letter from the client there are ten additional pages
 - Of these four pages are numerical schedules of varying complexity and two other have either diagrams or some numbers.

Assume all impact numerical schedules are important and will require more concentration to digest.
- (3) Re-read the requirements to ensure full understanding and to fix the requirements in mind for the detailed reducing to follow:
 - A review and report on an insurance "Business Interruption" claim
 - A full financial and operational review and report on the general business and strategic issues.
 - An executive summary.
- (4) Go through each new exhibit reading carefully against the exam requirements.
- (5) Highlight or note the information that may provide elements of the solution.
 - In Cee line's case every page of the impact information contains some relevant information.
 - For the highlighting see the detailed review to follow.
- (6) Consider carefully how the advance preparation may be of help in the solution.
 - Relevant to both requirements
 - For exact relevance see detailed review to follows.

How to tackle the case

- Identifies future cost of reversing changes.
- Useful document also includes the information that the business could physically operate from one site.

Exhibit 19 Report by Sales Director

- Identifies elimination of quality concerns at Colombo
- Lower Colombo sales than previous budget because of switch of resources.
- Identifies issue of competing suppliers
- Identifies own higher quality
- Identifies main competing suppliers
- Identifies main competitors 2 Sri Lanka and 1 Indian based
- Gives estimate of timescale of disruption
 - 12 months for Colombo from date of flood
 - 15 months for Kandy from date of floods
- Useful strategic document

Requirement 2 Overall review

From the above analysis, it would appear that a lot of the financial and operational review material will come from the previous analysis of the advance information (pages 116-122) topped up with information from Exhibits 15, 16, 17 for financial updates, and from Exhibits 18 and 19 for operational and SWOT updates.

Writing the answer

A suggested order of constructing and writing the answer might follow this pattern.

- (1) Write down the terms of reference to order thoughts and to get started.

Requirement 1

- (2) Perform the calculations for the insurance claim. Include these as appendices A,B etc.
- (3) Write any explanatory notes concerning the insurance calculation
- (4) Draw any conclusions

Requirement 2

- (5) Perform the calculations for the option evaluation Include these as appendices A,B etc.
- (6) Write merits & drawbacks in strategic points with rational criteria for evaluation.
- (7) Draw conclusion with the viable funding methods for the Cee-line

Requirement 3

- (8) Complete the financial analysis and commentary in the light of new financial information.
- (9) Pull together any more information on SWOT analysis for operational and strategic review.
- (10) Draw together any recommendations and conclusions

Finally

- (11) Write the Executive Summary:
 - Ensure that the executive summary is cross-referenced to the report.
 - Identify specific points for the executive summary in the report by clear noting eg (Note for executive summary).
 - Remember that the executive summary is for Cee line. Therefore it does not need to include background information they already know.
 - Not all of the information for the insurance claim needs to go in this executive summary.
 - Include conclusions and recommendations.

Note that although the executive summary is written as the last piece of work, it is placed in its appropriate place at the front of the report, just behind the terms of reference.

Illustrative answer

Report

Executive Summary

This executive summary refers to the report prepared on 18 July 20x3, by Gunarathna & Wijerathna, Chartered Accountants for Cee line Fabrications Limited, concerning the interim Business interruption insurance claim and overall financial and business review.

Interim Insurance Claim

The interim Business Interruption insurance claim covers a period of nine months to 31 December 20x3. The final claim should cover the twelve months to 31 March 20x4, the maximum period allowed under the insurance terms.

The total of this interim claim should be	Rs 1,132,000
This comprises Loss of Profits (see appendix A)	Rs 959,000
Other Expenses (see page 6)	Rs 173,000

A number of significant expenses have been excluded pending further clarification.

Bad debts – as not being caused by the flood	Rs 96,350
▪ Reconfiguration costs – due to lack of clarity of classification	Rs 50,000-80,000
▪ Professional fees legal fees not relevant to the flood	Rs 15,520

A number of significant expenses have been included but require further review.

These include the following

▪ Penalties considered to be a direct result of the flood	Rs 75,000
▪ Marketing costs increase assumed to be flood related	Rs 35,038
▪ Increased professional fees – balance to be confirmed as accurate	Rs 18,770

Conclusion

This interim claim of Rs 1,132,000 may need to be amended by further investigation. It will be the subject of detailed review within the final claim.

Option evaluation in order to re-establish the Kandy

In this report it has evaluated 3 options, which are available to re-establish the Kandy sales as follows,

- Option 01 - Re-build the Kandy at the same location with "BIG BUILD"
- Option 02 - Acquire the "CONSTRA" as a fully own subsidiary.
- Option 03 - Joint venture with the "METRO"

In the evaluation process, shareholder value maximization was the main decision criteria, having a 0.3 weighting which is the highest rank. Our evaluation is expanded to non-financial criteria as well. According to the report, the following were our non-financial criteria.

- Capital cost funding
- Control over the operations.
- Contribution to the growth prospective
- Retention of the customers.
- The Exit route availability

In order to have an integrated result from the evaluation process a score system was introduced for each option. According to results of the option evaluation it is recommended to acquire the "CONSTRA" as a fully own subsidiary because it will give a score amounting to 2.9. It will require an initial cash out flow of Rs 5,976,000. It is expected to be funded by a new share issue and loans.

Illustrative answer

Description of factory layout and personnel

The two factories, called the Colombo factory and Kandy factory, are used for different types of work. The Colombo factory is run by Mr. Sumanadasa Perera, the founder of the business and is used for high precision, specialist projects. The Kandy factory is run by Mr. Kumara Rathnayake and is used for larger jobs supplying the more demanding customers with frames for hospital equipment.

The Kandy factory was damaged in the flood on the 31 March 20x3. This factory will be unusable until Q1 of 20x4. Until this time the work of the Kandy factory will be carried out on the Colombo factory.

Review of general financial position and size.

	20x2	20x1	Increase
	Rs m	Rs m	Rs m
Turnover	5.9	5.2	0.7
Gross Profit	2.1	1.8	0.3
Net Profit	0.9	0.8	0.1
Net Assets	2.1	1.6	0.5

Generally the business is successful and profitable with a good order book. However as a result of the flood, the company made a loss of Rs 143,000 in the six months to 30 June 20x3. A revised budget prepared on 4 July indicates a loss for the year to 31 December 20x3 of Rs1.0 million, excluding any insurance proceeds.

At 31 December 20x2 the company had net current assets of Rs0.8 million and cash of Rs0.7 million. We have not been provided with a balance sheet at 30 June 20x3 nor a projected balance sheet to 31 December 20x3.

Market conditions

A large part of the company's business is with the NHS. There are indications from the Economic Report and general press information on government policy that there will be a significant increase in expenditure in NHS and Private Healthcare hospital equipment in the near future. Cee line is well placed to win a significant amount to this business.

Terms of insurance and relevant dates

The business interruption policy (Exhibit 13) has the following terms.

- (1) Loss of Gross Profit defined as rate of GP x (standard – actual turnover)
- (2) Increase in cost of sales – additional expenditure necessarily and reasonably incurred for sole purpose of limiting reduction in turnover.
- (3) Additional expenses – P&L expenses incurred for the purpose of limiting the reduction in turnover.
- (4) Definitions
 - Gross profit = Turnover – cost of sales (Stock + WIP valued per GAAP after provisions)
 - Indemnity period = date damage occurred to date results cease to be affected – not exceeding 12 months.
 - Rate of GP = GP earned on turnover during the 12 months immediately before date of damage (31 March 20x3)
 - Standard turnover = turnover during that period in the twelve months immediately before date of damage which corresponds to indemnity period.

Illustrative answer

The calculation should include a growth trend factor as identified by the budgets.

Calculation and Recommendation

Suggested GP calculations have been prepared and may be found in Appendices A & B

GP claim using the calculation from Appendix A – With Trend - Rs959,000.

Other Expenses

The claim, as prepared by Cee line, includes some expenses which the company has incurred rather than a justified list of the additional expenses relating to the flood.

These other expenses have been identified from the following

- (1) A comparison of actual expenses incurred for the 6 months ended 30 June 20x3 (exhibit 15) with 50% of the expected expenses as per the budget for the 12 months to 31 December 20x3 (Exhibit 5) to identify any unusual increases.

This is appropriate given the previous accuracy of budgets against actual – as per year to December 20x2 budget (Exhibit 7) in comparison with actual (Exhibit 4).

- (2) The letter written by Kumara Rathnayake (Exhibit 12) identifying additional expenses.

- (3) The memo from the Production Director (Exhibit 18) indicating removal costs.

- (4) The memo from the Sales Director (Exhibit 19) indicating the period of disruption.

Using (1) above a list of these significant other expenses, which may have been incurred to limit the reduction in turnover, could include:

(a)	Accountancy fees Rs(37,710 – 24,000)	-	Rs 13,710
(b)	Bad debts Rs(101,350 – 5,000)	-	Rs 96,350
(c)	Bank charges and interest Rs(14,460 – 8,000)	-	Rs 6,460
(d)	Carriage Rs(31,460 – 19,000)	-	Rs 12,460
(e)	Heat and light Rs(10,452 – 6,800)	-	Rs 3,652
(f)	HP interest Rs(31,020 – 26,000)	-	Rs 5,020
(g)	Insurance Rs(127,230 – 125,000)	-	Rs 2,230
(h)	Legal fees Rs(15,520 – 0)	-	Rs 15,520
(i)	Salaries Rs(116,790 – 110,000)	-	Rs 6,790
(j)	Marketing costs Rs(129,538 – 94,500)	-	Rs 35,038
Sub total			Rs 197,230

However each of these expenses need to be reviewed in the light of any general or specific price increase rendered by the supplier on services. Such as

(a)	Heat and light (say)	Rs 3,652
(b)	Insurance (say)	Rs 2,230

In addition some of these cost increases do not appear to relate specially to the flood damage, such as:

- (b) The bad debts increase may well have been the result
Of prior problems Rs 96,350
- (c) The majority of the legal fees appear to be the sum of costs
Identified in the letter from Huludagoda and Partners
(Exhibit 9). Rs 15,520

Excluding these specific expenses, pending further explanation, leaves:

Illustrative answer

Option 02 - Acquire the "CONSTRA" as a fully own subsidiary.

In order to consider whether to acquire Contra or not in stakeholders perspective, it is better to have a cash flow analysis and to calculate the net present value for the project. According to the calculations it will give a net present value of Rs 3,424,303 for the infinity it self. In the case of the annual equivalent value it gives Rs 411,080, which is the 2nd in option rank.

In the customers perspective, this option would be the best, because it will not require a transitional arrangement and it will have a good control with Ceeline as Constra would be a 100% subsidiary of Ceeline. The initial investment with the acquisition of the Constra is high with the high marketability of the shares with the growth of dividend. Although the auditors have emphasised about the going concern uncertainty citing liquidity problems with the Constra, it appears that they are have enough reserves to run business smoothly. Therefore the emphasis of matter by the auditor would not be a significant issue in the context of evaluating the option.

Option 03- Joint venture with the "METRO"

In order to consider whether the joint venture is a worthy option or not in stakeholders' perspectives, it is better to have the cash flow analysis and to calculate the net present value for the project. Joint venture agreement is favorable in the in the case of availability of the exit route but it can't expect any residual value at the end of the period. In the case of the Metro the auditors have given an adverse opinion for the recognition of the entity. However, if the investment outlay is proposed to happen at a single point in time (say year 1) without having the ability to bring in deferred cash inflows, it would not be significant in this context.

In the joint venture option there are two aspects

1. Joint venture agreement only for 5 years period
2. Continue with the joint venture after 5 year period.

01 Joint venture agreement only for 5 year operating period

With this arrangement Cee-line is supposed to enter into the joint venture agreement with Metro for the 5 year period only. In this option it will need a less amount of initial capital amounted to Rs. 1,000,000. Due to the specialization of duties there may be operational synergy. It will improve the ability to compete against the competitors. Similar to the option of rebuilding the Kandy, there is a transitional period which could result in unsatisfactory customer care and after sales service. The expected NPV of the option is 1,216,378

02 Continue with the joint venture after 5 years operating period.

If the joint venture is going to be continued after the 5 years operating period also it is assumed that they are in the business continually. The key element of this option is the additional cash investment with the implementation of the option. It will provide a greater flexibility to the Cee-line in arranging the funding method with them. This option which gives a highest annual equivalent NPV, which is amounted to the 437858 for the company.

Summary of the option evaluation.

Option	NPV	Time period	Cumulative discounting factor	Annual equivalent
Option 01 - Re-build the Kandy	1237713	15	6.973	177500
Option 02 - Acquire the "CONSTRA"	3424303	Infinity	8.33	411080
Option 03 - Acquire the "CONSTRA"	1216,378	5	4.11	295955
Option 03- Joint venture for infinity	3647,362	Infinity	8.33	437858

Illustrative answer

A financial and operational review of general business and strategic issues

Financial review

(1) Profitability

From a review of the financial information, Profit and Loss Account and Balance Sheet, to 31 December 20x2, it can be seen that Cee line is a company which is generating sale of nearly Rs6 million and that it has grown in sales terms at more than 10% in the year.

The company is generating good gross profits of around 35% per annum and stable net profits before tax of around 15%. These strong profits permit the payment of substantial dividends to the shareholders (100% of nominal value) and still allow significant earnings of some Rs464K in 20x2 to be retained (Rs380K in 20x1).

However it would appear from the solicitor's correspondence that there may be a significant issue of bad debts which would cause the 20x2 profits to be reduced by almost Rs200K.

The depreciation policy for Cee line is substantial and appears reasonably accurate with only small profits on disposal noted from the review.

The ROCE using PBIT is very strong at 37% (20x1 47%) and given the generous and tax efficient dividend policy is a positive element of this business.

(2) Liquidity

Although the profitability of the company is good a review of the liquidity of the business identifies some important issues.

The number of days sales in debtors is 110 days in 20x2 (104 days in 20x1). This is a huge time lag between making the sales and collecting money from debtors. Even for a company with significant trade with the public sector this indicates poor credit control. The figures are clearly being affected by the doubtful debts identified by the solicitor but this whole section needs to be tightened up to ensure efficient cash flow especially in the current difficult circumstances. (Note for Executive Summary).

The creditors payment period is extremely long at 180 days in 20x2 (175 days in 20x1). These figures could be heavily affected by seasonality - the quarter to December is the least busy and the business has almost certainly bought substantial amounts of inventory, which it has yet to pay for, before the first quarter of the new year which is its busiest time. But at nearly six months these time lags are certain to be testing the goodwill of suppliers. Their goodwill may be very important in the months to come. The only possible justification for this ratio is that the expenditure has been on fixed assets closer to the year end in 20x2 which may have distorted these figures. A similar issue would have to have occurred in 20x1 for this to be the case.

(Note for Executive Summary)

Stock turnover at 172 days (179 days in 20x1) is also extremely slow and indicates lax or complacent management as well as the potential for obsolete stock. (Note for Executive Summary).

It is recommended that the whole working capital management process be reviewed, strengthened and made for efficient, especially at this time of significant investment in new fixed assets that will cause a drain on cash resources during the current difficult circumstances. (Note for Executive Summary).

Illustrative answer

(3) Prices

Although there is no actual evidence that Cee line's current prices are out of line, it is apparent that cheaper competition exists. It may be possible to win the higher price argument on the grounds of a better quality product but only if that better quality product is being delivered. Management should remain constantly aware of this link and of the way in which their competitors are pricing equivalent products. **(Note for Executive Summary)**

(4) Markets

The market for the products that Cee line produces is very strong. Both NHS and private Healthcare are set to expand as a result of government policy and in line with the increasing ageing of the population. With the output from the new Kingsway factory coming on stream Cee line should be able to meet any increase in demand for its products. The challenge for Cee line is to maintain its share of that market in the light of the quality versus price debate.

Another matter is whether Cee line should be seeking out more export opportunities, or whether it should concentrate entirely on its domestic market. The experience of the sales to Bombay indicate that Cee line may have been naïve and less well informed concerning the best way of ensuring receipt of overseas debts. **(Note for Executive Summary)**

(5) Personnel (including Directors)

The senior personnel have contributed significantly to the past success of the business and it is apparent that personnel have been capable of adapting to new practices and technology such as CAD/CAM, which indicates a competent and adaptable workforce.

Currently a number of strategic personnel issues need to be addressed by Cee line. These include the identification of clear roles at Board level – particularly with regard to production planning and quality control where one person should have overall responsibility of this activity for the whole business. **(Note for Executive Summary)**

Alongside this clear role identification the company should also set in place, or reconfirm appropriate delegation of responsibilities throughout the organisation – particularly in relation to such matters as quality control and credit where it would appear that there is some laxity.

A system of succession management should be implemented to ensure that in the event of any sudden change for any senior personnel there is appropriate cover for their role. This is particularly important at Board level. **(Note for Executive Summary)**

The issue of staff retention should also be monitored. The fact that two members of the sales team representing some 20% of the sales force may leave at the same time could indicate a more widespread level of dissatisfaction amongst other workers. In a family based company the loyalty of the workforce is crucial but is sometimes not fully acknowledged.

Illustrative answer

Cee line Fabrication Limited

Appendix B

Calculation of the Loss of Profit

By Company

Loss in Kandy	Without trend	Rs000s	With Trend	Rs000s
Turnover in indemnity period	9m to 31/12/03 = 615 + 1420	2035	9m to 31/12/03 = 615 + 1420	2035
Turnover in standard period	9m to 31/03/03 = 14.70 + 1497 + 1497	4464	Budgeted T/O in standard T/O period 9m to 31/12/03 = 1570 + 1550 + 15.30	4650
Loss of turnover		- 2429		-2615
GP% on T/O in 12m to date of damage	12m to 31/03/03 = 523 + 520 + 539 533/1472 + 1470 + 1497 + 1497	35.6%	12 m to 31/03/03 = 523 + 520 + 539 + 533/1472 + 1470 + 1497 + 1497	35.6%
Loss of profit in Kandy		-864		-931

Illustrative answer

Option 02 Acquire the "CONSTRA" as a fully own subsidiary.

Year	0	1	2	3	4	5	6-- infinity
Initial investment ⁶	(1992,000)						
Cash profit ⁷		736500	793265	855769	924528	1000105	500000
Discount factor 12%	1	0.892	0.797	0.7117	0.6355	0.5674	4.725 ⁸
Discounted cash flows	(1992,000)	656,958	632,232	609050	587537	568026	2362,500

Net present value = 3424,303

⁶ Initial investment

MV of a share * No of shares = $13.28 * 150000 = 7304,000$

$$\text{MV of a share (In a divided growth situation)} = \frac{d_1}{K_e - g} = \frac{1.0627}{0.17 - 0.09} = 13.28$$

Growth rate = $5 (146,250 / 95000) - 1$
= 9%

⁷ cash profit in year 01 to 05

year	01	02	03	04	05
Operating profit	1090,000	1188,100	1295,029	1411,581	1538,623
- Tax	353,500	394,835	439260	487053	538518
Cash profit	736500	793265	855769	924528	1000105

Tax Computation.

year	01	02	03	04	05
Operating profit	1090,000	1188,100	1295,029	1411,581	1538,623
- Interest	80000	60000	40000	20000	0
Profit before Tax	1010,000	1128,100	1255029	1391,581	1538,623
Tax 35%	353,500	394,835	439260	487053	538518

⁸ Discount rate at infinity in year 5
(1/01.2) = 3.604

Illustrative answer

Year	0	1	2	3		5	6	7- Infinity
Initial investment in J/V	(1000,000)						(4000,000)	
Subcontracting income ¹¹		205,000						
Expected cash profit ¹²			396000	473000	616000	803000	1056000	1056000
Net cash flows	(1000,000)	205000	396000	473000	616000	803000	(2944000)	1056000
Discount factor 12%	1	0.892	0.797	0.7117	0.6355	0.5674	0.506	4.218 (8.33-4.11)
Discounted cash flows	(1000,000)	182860	315612	336634	391,468	455622	(1489664)	445,4830

Net present value 3647,362

11 Sub contracting revenue

Kandy budgeted sales 2004*0.05
(4100,000*0.05)

205,000

¹² Expected cash profit(in millions)

year	1	2	3	4	5	
High Growth 0.6	0.8	0.9	1.2	1.5	2.0	
Low Growth 0.4	0.6	0.8	1.0	1.4	1.8	
Expected profit	0.72	0.86	1.12	1.46	1.92	
Cee-line proportion(55%)	0.3960	0.473	0.616	0.803	1.056	

Illustrative answer

Option 03 Joint venture agreement only for 5 years operating period

Year	0	1	2	3		5	6
Initial investment in J/V	(1000,000)						
Subcontracting income ⁹		205,000					
Expected cash profit ¹⁰			396000	473000	616000	803000	1056000
Net cash flows	(1000,000)	205000	396000	473000	616000	803000	1056,000
Discount factor 12%	1	0.892	0.797	0.7117	0.6355	0.5674	0.506
Discounted cash flows	(1000,000)	182860	315612	336634	391,468	455622	534336

Net present value 1216378

Option 03 Continue with the joint venture after 5 years operating period.

9 Sub contracting revenue

Kandy budgeted sales 2004×0.05

$(4100,000 \times 0.05)$

205,000

¹⁰ Expected cash profit(in millions)

year	1	2	3	4	5	
High Growth 0.6	0.8	0.9	1.2	1.5	2.0	
Low Growth 0.4	0.6	0.8	1.0	1.4	1.8	
Expected profit	0.72	0.86	1.12	1.46	1.92	
Cee-line proportion(55%)	0.3960	0.473	0.616	0.803	1.056	

Illustrative answer

Appendix C

Calculation the NPV for each option.

Option 01 Re-build the Kandy at the same location with "BIG BUILD"

year	0	1	2-15
Initial cost ¹	(3500,000)		
Initial cost ²		(700,000)	
Subcontracting income ³		205,000	
Production capacity hire out income ⁴			86000
Cash profit from Re-build Kandy ⁵			710,000
Net cash flow	(3500,000)	(495,000)	796,000
Discount factor 12%	1	0.892	6.5066
Discounted cash flow	(3500,000)	(441,540)	5,179,253

Net present value of Re-building Kandy 1237713

¹ Initial cost at the 0 years.

Labour & material	3000,000
Professional fees	100,000
Variable production overheads	300,000
Other cost	100,000

² Initial cost year 1

Payment to the Contractors	500,000
Increase in the administration cost	200,000

³ Sub contracting revenue

Kandy budgeted sales 2004*0.05	
(4100,000*0.05)	205,000

⁴ Excess capacity hire-out income

Excess capacity *0.1 - 50000	
(4100,000/0.75*0.25*0.1)-50000	86,000

⁵ Estimated Cash profit from Re-build Kandy

Estimated profit	865,000
-/+ Non cash items	
increase in stocks	(20000)
Depreciation	125,000
+Interest	40,000
increase in the production overhead cost	(300,000)
Cash profit	710,000

Illustrative answer

Cee line Fabrication Limited

Appendix A

Calculation of the Loss of Profit

By Factory

Loss in Kandy	Without trend	Rs000s	With Trend	Rs000s
Turnover in indemnity period	9m to 31/12/03		9m to 31/12/03	
	= 235 + 700	935	= 235 + 700	935
Turnover in standard period	9m to 31/03/03		Budgeted T/O in standard T/O period 9m to 31/12/03	
	= 860 + 857 + 832	2549	= 970 + 920 + 860	2750
Loss of turnover		- 1614		1815
GP% on T/O in 12m to date of damage	12m to 31/03/03 = 345 + 335 + 344 + 333/885 + 860 + 857 + 832	39.50%	12 m to 31/03/03 = 345 + 335 + 344 + 333/885 + 860 + 857 + 832	39.50%
Loss of profit to Kandy		-638		-717
Loss in Colombo				
Turnover in Indemnity period	9m to 31/12/03 = 380 + 720	1100	9m to 31/12/03 = 380 + 720	1100
Turnover in Indemnity period	9m to 31/03/03 = 610 + 640 + 665	1915	Budgeted T/O in standard T/O period 9m to 31/12/03 = 600 + 630 + 670	1900
Loss on turnover		-815		-800
GP% on T/O in 12m To date of damage	12m to 31/03/03 = 178 + 185 + 195 + 200/587 + 610 + 640 = 665	30.30%	12m to 31/03/03 = 178 + 185 + 195 + 200/587 + 610 + 640 + 665	30.30%
Loss of profit in Colombo		- 247		- 242
Total loss		- 885		- 959

Amount claimed
(Note for executive summary)

Illustrative answer

(3) Most recent figures

The review of the accounts for the six months to 30 June shows a company that has been extremely badly hit by the flood of 31 March 20x3. Gross profit has dropped dramatically and there is now a net loss of Rs143,000.

No balance sheet has been provided as at 30 June 20x3 to enable any further comment on liquidity and to enable an assessment of how the cash has been moving through the business. Identifying the movement in, and the control of, cash is vital during a critical period such as this.

A detailed split of sales and cost of sales is provided between the two factories which shows that there is an underlying downward trend in sales of Kandy products against a small but steady increase in the Colombo factory sales. (Note for Executive Summary).

It is recommended that the sales and cost of sales from each factory be reviewed regularly as the company goes through a transition to ensure that best practice and control from each site are shared and updated. (Note for Executive Summary).

Other strategic issues

(1) Related party transactions.

In the director board of the company there are directors who are having inter-relationships with the families. Due to such relationships it could create issues with corporate governance and disclosures. Due to such 'close held- close controlled' issues it will make difficulties in raising new capital to the company.

(2) Organizational structure.

This is a family based company. Therefore it cannot expand the duties & responsibilities. Though Cee line is in an expanding business, it may be difficult to take charge of expansion opportunities with the same organizational structure.

Operational Review

(1) Production

There is evidence that the past production process at the Colombo factory had not been as efficient as it should have been. The introduction of new CAD/CAM processes has clearly been of great value. The question might be whether management's attention has been drawn to solving the Colombo problems allowing some slippage to occur at Kandy even before the flood.

One interesting fact of the flood has been the ability of the company to fit all its production equipment from both factories into the Colombo space. This raises the question of whether three factory sites are in fact needed in the future. Some further modernization of the Colombo factory may be an efficient way forward. Although it may not be possible to avoid the completion on the Kingsway lease, it may well be the case that the Kandy lease could be avoided. The overall lease position should be the subject of a careful management review. (Note for Executive Summary).

(2) Products

The increase in sales indicates that the products being sold by Cee line are in strong demand in the market place. The main concern is that of delivering a quality product to that market place. Evidence exists of the need to re-work goods and of disputes with clients involving the quality of products delivered. It would appear that a clear and consistent system for reviewing the quality of products should be established by the directors across all factory sites and best practice should be shared. (Note for Executive Summary).

Other strategic considerations in the option evaluation.

In evaluating the options considering only the financial perspectives is not suitable due to Cee-line having several stakeholders. Therefore the final decision should be based on the wide area of strategic issues as follows.

The following key variables will be considered as part of the appraisal and evaluation process. Each of the variables has been ranked on a scale of 1 to 4 (where 1 = worst and 4 = best) and weighted according to its relative importance. The resulting weighted scores can be considered in the option evaluation problem.

Option	Capital cost funding		Control over the operations.		Contribution to the growth prospective		Retention of the customers.		The Exit routs availability.		NPV of the option		Weighted Score
	Weight	Rank	Weigh	Rank	Weight	Rank	Weight	Rank	Weight	Rank	Weight	Rank	
Option 01 - Re-build the Kandy	0.20	2	0.1	4	0.15	3	0.1	2	0.15	1	0.3	1	1.9
Option 02 - Acquire the "CONSTRA"	0.20	1	0.1	3	0.15	4	0.1	3	0.15	4	0.3	3	2.9
Option 03- Joint venture only for 5year operation.	0.20	4	0.1	2	0.15	1	0.1	1	0.15	2	0.3	2	2.15
Option 03- Joint venture for infinity	0.20	3	0.1	1	0.15	2	0.1	1	0.15	1	0.3	4	2.45

According to the above analysis based on the six critical criterion and their relative ranking acquiring the "Constra" seems to be the best option. It is the best ranked option both on contribution to the growth perspective & the availability of the exit rout.

The available funding methods to acquire the "Constra"

According to the present market value of the Constra (13.28) it will require Rs 1999,000 for 100% acquisition in cash terms. The funding methods available for the Cee-line would be the insurance claim receivable, share issue & the bank loan. According to the insurance policy it is expected to be receive Rs 1132,000 in near future. Offering Cee- line shares to the Constra's shareholders would be another potential funding method. But Cee-line has to carefully consider the controlling power.

Long-term loan is viable because up to now Cee-line is strong in the gearing ratio which is amounted to 26%.

Illustrative answer

Revised expenses sub total	Rs 79,478
In addition there are a number of relevant expenses identified not yet included:	
(i) Penalties (Exhibit 12) – if due to failure to deliver on time Caused by disruption	Rs 75,000
(ii) Additional professional fees not included above (Exhibit 12) Rs48,000 - Rs13,710 - Rs15,520 =	Rs 18,770
Total additional expenses	Rs 173,368
(say)	Rs 173,000
=====	
Total Interim Business Interruption claim (GP plus expenses)	Rs1,132,000
=====	

(Note for executive summary)

Note :

The reconfiguration costs of Rs(50,000-80,000) identified by the production director (Exhibit 18) required further detailed review. These costs must already have been incurred but are not specifically identified and are presumed to be in cost of sales – direct labour. As such they are already part of the reduction in gross profit claim. Until there is more clarity concerning these costs, including the storage charges mentioned, this item has been excluded but should be kept under review until the final claim is submitted (Note for Executive Summary).

Tax implication of the insurance claim.

In the consideration of tax impact of the insurance claim it would have two impacts.

(1) Value Added Tax

According to the Value Added Tax Act No 14 of 20x2, insurance claim is to be considered as a supply of services.

Therefore "Cee line" need to collect VAT from the insurance company & VAT element needed to be repaid to Inland Revenue departments.

(2) Income tax computation.

The insurance claim realized under contract of insurance shall be deemed to be receipt from the trade, business, profession or vacation, if the sum so realized.

If the factory is going to be disposed it needs to calculate profit on disposal, which is taxable. The excess of Tax Written down Value to the insurance claim and the disposal value would be the profit on disposal.

Option evaluation in order to Re-establish the Kandy.

Option 01 - Re-build the Kandy at the same location with "BIG BUILD"

In order to consider whether the re-building Kandy is a worthy option or not in stakeholders perspective, it is better to have the cash flow analysis and to calculate the net present value for the project.

In that case it is better to understand the relevant and irrelevant cash flows. It is estimated that the cash flows from the rebuilding Kandy is expected to be for the 15 years.

Being on that assumption the relevant cash & present value calculations is given in the appendix C. According to the calculations it will give a net present value of Rs 1,237,713 for the 15 years period it self. In the case of the annual equivalent value, it gives Rs 177,500, which is the worst option. Re-building the Kandy would be a favorable in flexibility & controllability. In the case of protecting customers of Cee-line this would not be a good option because with in the transition period it can't ensure the quality dimensions of the product and customer services.

Illustrative answer

- (5) The relevant time periods are shown diagrammatically as follows:

31.03.02 30.06.02 31.12.02 31.03.03 30.06.03 31.12.03 31.03.04

(i) I ----- Annual turnover ----- I date of damage

(ii) I ----- Maximum Indemnity Period ----- I

(iii) I ----- Indemnity period ----- I

(iv) I -- Standard T/O period -- I

(v) I -- Alternative T/O period -- I

- (6) Adjustments may be made for the trend of the business so that figures represent the results which were predicted and would have been achieved but for the flood.

Comments on claim prepared by Cee line

A) Gross Profit Calculation

Turnover Period

The claim as prepared by Cee line (Exhibit 14) is based on the turnover of the Kandy factory for the 3 quarters to 31 December 20x2.

The business interruption policy appears to require the figures to be based on the quarters immediately preceding the date of damage – this would imply a claim using the 3 quarters to 31 March 20x3.

However, because of seasonality of trade, and in order to have comparability of periods, this point concerning the appropriate dates could be the subject of negotiation.

The flood damage had an effect on both factories and therefore it would be appropriate to consider the impact on the turnover of both factories: either separately if possible or else Cee line as a whole.

Reduction in turnover

The calculation as prepared is based on the entire turnover for the period.

The calculation should be based on the reduction between actual and expected turnover.

Gross Profit %

The claim as prepared by Cee line is based on the Gross Profit % for the Kandy factory for the 3 quarters to 31 December 20x2.

The Gross Profit % should be based on the GP % achieved during the 4 quarters to 31 March 20x3 rather than the 3 quarters to 31 December 20x2.

Given that there is an effect on both factories then it would be appropriate to look at the Gross Profit % achieved in each factory or else Cee line as a whole.

With Trends

The calculation as prepared does not show the impact of loss of potential trend of growth.

Illustrative answer

Financial and Operational Review

The financial review key points are:

- Highly profitable company with a solid dividend policy and history of good retained profits.
- There are current concerns over the potential bad debts position of around Rs200,000 which may increase
- There are variations in the profitability between two factories – these are now being adversely affected by the flood and require careful control.
- There are clear signs of poor working capital management and control.
 - Debtors collection period of 110 days is far too long and increases bad debt risk.
 - Creditors payment period of 180 days must be stretching the goodwill of creditors.
 - Stock turnover at 172 days looks like very poor inventory control

Conclusion

The company needs to be tighter on working capital and to control its cash management very carefully during this time of crisis and in the future.

The sales and cost of sales trends for each of the factories have varied in the past and must be monitored closely in the future.

The sales and cost of sales trends for each of the factories have varied in the past and must be monitored closely in the future to ensure complete and consistent control.

Operational review key points are:

- Production – space and lease commitments should be reviewed to eliminate any excess and to concentrate production in the more efficient location such as the Colombo factory.
- Products – consistent quality control must be established to eliminate job re-working and the risk of extended collection times, bad debts and penalties.
- Pricing – competition pricing must be closely monitored to avoid sudden loss of market to aggressive competitors.
- Markets – company should review its target market to ensure appropriate focus on nationalized and/or selected international markets.
- Personnel – there are signs of failures in the personnel management of the company. These could be addressed by:
 - Clarification of the role of each member of the Board
 - Identifying succession management from Board level down
 - Delegation of responsibilities for quality and credit control with review and action being made the responsibility of one member of the board.

Conclusion

Overall, the crisis caused by the flood has identified a number of immediate key operational issues, which must be addressed by senior management. It is essential that a comprehensive financial and operational review takes place as soon as possible using all the information available to the company.

Report on Interim Business Interruption Insurance Claim

Description of trade

Cee line Fabrications Limited is a well-established owner managed business, which manufactures equipment for the NHS and Private Healthcare sectors. The company operates from two industrial units at Cee line Colombo

Illustrative answer

Cee line Fabrications Limited

Illustrative answer

Terms of reference

We have been instructed by Cee line Fabrications Limited (Cee line) to conduct a review and prepare a report to the company on:

- (1) Cee line's calculations and interim claim to their insurance company concerning the business interruption caused by the flood on 31 March 20x3. This report is limited to Section B of the policy of insurance dealing with "Business Interruption" cover. The overall claim will be adjusted when the final claim is submitted. The policy of insurance does not specify the source documents to be used in calculating the claim.
- (2) A full financial and operational review of general business and strategic issues which, as a result of our work on the insurance claim and prior information, may become apparent.

In preparing our report we have had access to the following financial documents:

- Accounts for the two years ended 31 December 20x2 prepared for management purposes.
- Original forecasts for the years to December 20x3 and 20x4.
- Schedule of quarterly budgeted sales and cost of sales by factory for the year to December 20x3.
- Budget for the year to 31 December 20x2
- Trading and profit and loss account for the six months to 30 June 20x3
- Revised budget for the year to December 20x3
- Schedule of actual sales, cost of sales and gross profits split between the two factories Colombo and Kandy for the six quarters ending 30 June 20x3.
- Extracts from board minutes March 20x3

For the purposes of this report we have not carried out any specific audit or verification work on the information supplied.

The report has been prepared for the Board of Cee line Fabrications Limited and should not be divulged to third parties without our consent. In the event that the report is disclosed to third parties we accept no responsibility in respect of any matters contained within the report.

How to tackle the case

Highlighting of Impact Information against requirements

Requirement 1 – the insurance claim

Exhibit 13 Section B – Business Interruption (Gross Profit Basis)

- Essential document setting out the specific criteria for the claim based on
 - Reduction in turnover
 - Applying rate of gross profit (definition provided)
 - Shortfall in turnover during indemnity period against Standard Turnover (the 12 months before the date of damage with an adjustment for trend)
 - Increase in cost of sales
 - The additional expenditure necessarily and reasonably incurred to limit the fall in turnover
 - Additional Expenses
 - Incurred for the purpose of limiting the reduction in turnover
 - For example professional fees incurred.

Exhibit 14 Cee line's Calculation of Interim "Business Interruption" Claim

- Essential document setting out their claim
 - Based on Kandy only
 - Based on three quarters to December 20x2
 - Based on GP% achieved of 39%
 - Additional costs incurred
 - Professional fees
 - Bad debts
- Very simple calculation and claim – too simple

Exhibit 15 Actual Trading and profit and loss account for the six months to 30 June 20x3

- Useful document in similar format to advance information
 - Shows turnover
 - Shows gross profit
 - Shows detailed expenses – increases easy to identify
 - Shows significant net loss
- Essential document

Exhibit 16 Actual, first 6 months and Revised Budget second 6 months to 31 Dec 20x3

- Document contains a mixture of information actual and budget
 - Shows overall reduction in gross profit and net loss of Rs143,000
 - Shows split between Colombo and Kandy for all revenues and costs
- Important document for estimates and changes in specific costs

Exhibit 17 Schedule of Actual sales and Cost of Sales by Quarter from Jan 20x2 to June 20x3

- Schedule shows very important breakdown between the two factories
 - Shows the achievements at Kandy
 - Shows the impact of the flood on Colombo as well
- Essential document

Exhibit 18 Report by Production Director

- Provides the story of how the company has managed the flood
 - Identifies the issue of penalty clauses
 - Identifies the cost of moving the Kandy factory plant to Colombo
 - Identifies the timescale of disruption – to end of Quarter 3 in 20x3
 - Quarter 4 both lines should be operating at full production in Colombo factory

Impact Information

- By acquiring the "constra" company is expected that they can continue with the present level of sales in the Kandy branch.
- The growth rate is expected to be continuing in first 5 years & there after growth can't be expected but the it will remains the level of 50,000
- The auditors have emphasized their opinion on going concern on the fact that the company has a net current liability position.

Option 03- Joint venture with the "METRO"

Establishing the joint venture agreement would be another available option to continue with Kandy sales. According to the joint venture option Ceeline directors appointed a consultant in order to evaluate the potential joint venture arrangements. According to the consultants report , he has suggested 3 possible joint venture options and company has screened out 2 of them on the key criteria

"METRO" is the suitable joint venture agreement option for the Ceeline on the basis of the above criteria. According to the proposed joint venture agreement between the Ceeline Company and Metro, the following are the key elements.

- To invest 1 million rupees by Ceeline and 2 million by Metro with the profit sharing ratio of 55% and 45% respectively .
- Metro as a related building material producing company in Sri Lanka over the 15 years would like to operate in introductory and assembly stages of each and every hospital contracts.
- They were agreed to use the joint brand name called "Cee-Metro" for their production.
- Ceeline is in charge of the finishing part of each and every hospital contracts. After 5 years of operations they can decide whether to continue or not . If they are going to continue Ceeline has to invest additional Rs 4,000,000 for the continuation but there is no residual value at the end of the period.

The expected after tax cash profit of the joint venture operation would be as follows.

Rs Millions.						
	Probability	2004	2005	2006	2007	2008
Net After Tax Cash in profit.	High Growth 0.6	0.8	0.9	1.2	1.5	2.0
	Low Growth 0.4	0.6	0.8	1.0	1.4	1.8

Profit in year 2008 is expected to be continuing if the joint venture is continued. The company considers 12 % post tax rate as a suitable risk-adjusted discount rate for the evaluation. For the year 2003(the constructing period) they are ready to implement the transitional agreement as same as in the option 01

The recent most auditor's report of Metro stated that the financial statements do not give a true and fair view due to revenue recognition issues.

Impact Information

Exhibit 20

A consultant was appointed in order to identify the potential options available to for the Ceeline company after the destroy of the kandy factory. In the board meeting "TRUST CONSULTANTS" were appointed as the consultant s Trust Consultant were asked to identify the potential strategic & operational problems in the company And list out possible options available for the Cec- line company with view to maximize the shareholder value.

Exhibit 21 Report from "TRUST CONSULTANTS"

To :- Cee line - Board of directors

From:-Trust Consultants.

Date:- 2004 April 20

Re :- Options for Re- establishing the KANDY sales.

As your requisition in the board meeting we would like to submit our report including the potential options available for you .

In the evaluation we were highly considered the e following factors

1. Re-establish the KANDY sales with out any harm to the customer portfolio.
2. Continue with the present operations with a synergy in operational activities.
3. Contribute for the future growth prospective.

According to our professional view points possible options would be as follows .

Option 01 - Re-build the Kandy at the same location with "BIG BULID"

Option 02 - Acquire the "CONSTRA" as a fully own subsidiary.

Option 03- Joint venture with the "METRO"

Option 01 - Re-build the Kandy at the same location with "BIG BULID"

This would be the less risky option, but it will take about the one year to rebuild the Kandy again. With rebuilding of the Kandy it can fulfill the customer requirements properly with a greater flexibility. But the whole construction responsibility is with the Ceeline Company. Re-building the Kandy would improve the quality dimension .

The cost estimation for Re – building the Kandy

Labour & material	1000, 000
Professional fees	100,000
Variable production overheads	300, 000
Payment to the Contractors	500,000
Other cost	100,000
Increase in the administration cost	200,000
Absorption of the production OH	300,000

With the rebuilding of the Kandy it will have a excess capacity of 25% .The annual administration cost would be increased by Rs 300,000 due to the new building and the excess capacity level.

The excess capacity can hire-out in order to generate gross income to Ceeline 10% of the sales level. if it is hire out it will increase the annual administration cost by 50,000.

After rebuilding the kandy it is expected that they can continue with the budgeted sales level with same gross profit margins.

The transition period of rebuilding the Kandy .

In the year 2004 directors are willing to subcontract the forecasted sales level to the "ABC" company which is a subcontracting company . It is estimated that 5% of the net profit level on sales.

In further analysis about the contracting company it was identified that the "ABC" company is suffering from the financial problems as well . According to the subcontract agreement after one year a new agreement may be negotiable but neither company would have any commitment to continue.

Impact Information

Exhibit 18

To : Kumara Rathnayake/Sumanadasa Perera
From : Waruna Wasantha (Production Director of Cec line Fabrications Limited)
Date : 3 July 20x3
Re : : Production planning for the period to 31 December 20x3.

You have asked me to provide you with a summary of how the production has been organized in the Colombo factory during the year to date and how I plan to organize things for the remainder of the year. During Quarter 1 production in the Colombo factory consisted of normal Colombo type work.

From 1 April 20x3, following the flood, the Kandy factory contracts were dealt with in the Colombo factory. This was achieved by moving the machinery, which we managed to salvage from the Kandy factory into the spare space that we had at the north end of the Colombo factory (see plan below). The insurance claim for the plant and equipment lost in the flood was settled very quickly and we also spent Quarter 2 installing some of the new equipment in the Colombo factory. Some of the replacement equipment will not be needed until the Kandy factory is back in service again and this equipment will be paid for directly by the insurance company at the appropriate time. Throughout Quarter 3 we will continue to recognize the Colombo factory to install more of the Kandy factory machinery and ensure that we meet our production deadlines. This is necessary because some of the Kandy factory contracts carry substantial penalty clauses, which will be suffered if the contracts are not completed on time. Luckily, the new CAD/CAM machines, which were installed in the Colombo factory at the end of last year, can be adapted to do the work from the Kandy factory.

I remained concerned that we will not be able to meet all of the production deadlines. Not all of the Kandy contracts will need to be fulfilled immediately, as some contracts do not have penalties attached to them. However, as you know, we have missed some deadlines and we have already lost some of the contracts to overseas suppliers. The marketing department will need to get going on how to recover these Kandy customers in the future but it may be a forlorn hope after some of the conversation I have had recently.

Most Colombo contracts are penalty free, but we have some of the same penalty problems, although on a smaller scale, with a number of Colombo contracts. Additionally, although the vast majority of the Colombo customers are prepared to wait until January, some have gone elsewhere and we will need to work extra hard to get them back.

By the end of Quarter 3 it is anticipated that all the necessary transfers of production will have taken place and that Quarter 4 will have us working at full capacity in the Colombo Factory. At that time our production targets should match our expected sales.

Q1 Year 20x4 should see us back in the two separate factories, as before, as well as being able to utilize the new Anuradapura factory.

There are considerable costs involved in all this moving around. These include the removal of the usable plant from the Kandy Factory together with set up costs within the Colombo Factory, paying the workforce whilst the factory is reconfigured and storage of extra plant. The total bill is expected to be in the region of Rs 50-80,000.

A similar exercise will need to take place at the end of Q4 to enable the Kandy factory to be re-configured for the start of Q1 Year 20x4.

As was agreed, the Anuradapura factory project is being led by John Snow, who is an experienced engineer and project manager. He has managed to continue his set-up of the project without being affected by the flood.

All of this disruption is bound to have an effect on the labour overhead efficiency variance. At present the overhead recovery rate is 162% of direct labour cost. As we don't include premises insurance of my salary in this recovery rate these will therefore not affect the figures.

Despite all the problems caused by the flood I am confident that production will be back on target by early 20x4.

Impact Information

Exhibit 16

Cee line Fabrications Limited Revised Budget to 31 December 20x3

	12 Months Dec. 20x3 Total	6 Months Jun-03 (Actual) Total	Colombo	Kandy	6 Months Dec-03 (Budget) Total	Colombo	Kandy
Sales-own work	2,597,750	1,877,750	1,045,250	832,500	720,000	720,000	-
B work							
Completed in A	935,000	235,000	235,000	-	700,000	-	700,000
	3,532,750	2,112,750	1,280,250	832,500	1,420,000	720,000	700,000
Less:							
Direct Labour	2,056,715	812,715	565,143	247,572	1,244,000	564,000	680,000
Materials	1,038,145	612,143	384,090	228,053	426,000	216,000	210,000
Change in stock	43,500	28,500	5,000	23,500	15,000	5,000	10,000
	3,138,358	1,453,358	954,233	499,125	1,685,000	785,000	900,000
Gross Profit	394,392	659,392	326,017	333,375	-265,000	-65,000	-
Gross Profits	11.2%	31.2%	25.5%	40.0%	-18.7%	-9.0%	-28.6%
Interest received	11,430	11,430	11,430	-	-	-	-
Accountancy	62,210	37,710	24,000	13,710	24,500	11,000	13,500
Bad Debts	104,850	101,350	13,350	88,000	3,500	3,500	-
Bank Charges and Interest	32,460	14,460	7,000	7,460	18,000	9,000	9,000
Carriage	15,460	11,460	4,000	7,460	4,000	4,000	-
Depreciation of: Leasehold Improvements	19,659	19,659	-	19,659	-	-	-
Office Equipment	6,085	3,085	3,085	-	3,000	3,000	-
Motor Vehicles	136,724	68,362	25,000	43,362	68,362	25,000	43,362
Heat and Light	14,052	10,452	7,452	3,000	3,600	3,600	-
HP Interest	65,020	31,020	7,020	24,000	34,000	8,000	26,000
Insurance	252,230	127,230	67,230	60,000	125,000	65,000	60,000
Legal Fees	24,020	15,520	7,520	8,000	8,500	3,500	5,000
Salaries and Directors' Emoluments	332,790	166,790	94,790	72,000	166,000	94,000	72,000
Marketing Costs	187,538	99,538	58,538	41,000	88,000	48,000	40,000
Vehicle Expenses	51,630	35,630	21,000	14,630	16,000	16,000	-
Postage, Stationery and Advertising	29,400	20,400	9,000	11,400	9,000	9,000	-
Rent and Rates	39,248	26,248	13,124	13,124	13,000	13,000	-
Sundries	19,730	14,730	5,230	9,500	5,000	5,000	-
Telephone etc.	15,530	10,530	5,000	5,530	5,000	5,000	-
Total Expenses	1,408,636	814,174	372,339	441,835	594,462	325,600	268,862
Net Profit for the period	1,002,814	-143,352	-34,892	-108,460	-859,462	-390,600	-
Net Profit %	-28.4%	-6.8%	-3.6%	-13.0%	-60.5%	-54.3%	-67.0%

Comment: A successful business in terms of profitability. Could it do better?

Impact Information

Exhibit 14

Cee line Fabrications Limited

Claim for loss or profits due to business interruption caused by the flood on 31 March 20x3

			Rs 000's
Kandy turnover for the three quarters on 31 December 20x2 (885 + 860 + 857)	2,602		
Kandy Gross profit % for three quarters to 31 December 20x2	39%		
Therefore claim for loss of profit = $2,602 \times 39\%$			<u>1,015</u>
Additional costs incurred:			
Professional fees	45,520		
Bad Debts	88,000		
	<u>133,520</u>	ie	<u>135</u>
Total claim to date to			Rs1,150m

Impact Information

The specialist sale of the business at the Colombo factory has also suffered because the urgent outstanding Kandy factory contracts had to be dealt with in the Colombo factory in order to avoid significant penalties. To do this we moved the salvaged Kandy production line into the Colombo factory (see Exhibit 18). However by 31 December 20x3 we expect that the refurbishment of the Kandy factory will be completed and Sumanadasa will have the Colombo factory back exhaustively for his contract work from 1 January 20x4, we will also to take productive occupancy of the new Anuradapura factory.

The lease contract on the Kandy factory detailed that the lease would automatically be terminated in the event of destruction or loss of the building, other than as a result of the negligence of the tenants. There is no question of negligence and, consequently, Cee line Fabrications Limited are not responsible for any repairs to the factory building, and the lease payments have currently been suspended.

What we require from your firm is:

1. A complete review and written report on our calculations which will enable us to submit the appropriate interim claim to the insurance company. On the specific point about interim claims the "Business Interruption" insurance covers loss of Gross Profit and additional costs for a period of up to one year after any claimable incident.
2. A full financial and operational review and report on any other more general business and strategic issues which, as a result of your work, may become apparent to you.

Yours sincerely

Kumara Rathnayake

Exhibit 13

SECTION B - BUSINESS INTERRUPTION (GROSS PROFIT BASIS)

Underwriters will pay to the Insured in respect of each item in the Schedule the amount of loss resulting from such interruption or interference in accordance with the provisions contained therein.

Gross Profit Basis

This insurance is limited to loss of Gross Profit due to

- (a) A reduction in turnover

The amount produced by applying the Rate of Gross Profit to the value by which the Turnover during the Indemnity Period shall in consequence of the Damage fall short of the Standard Turnover and

- (b) An increase in cost of sales

The additional expenditure necessarily and reasonably incurred for the sole purpose of limiting the reduction in turnover in (a) above.

Additional Expenses

A claim under this item is limited to such further additional expenditure beyond that recoverable under part (b) above on Gross Profit as the Insured shall necessarily and reasonably incur during the Indemnity Period in consequence of the Damage for the purpose of limiting the reduction in Turnover. Examples of such additional expenditure would include professional fees incurred in preparing the claim.

Impact Information

exhibit 11

Memorandum

From : Saman Wijerathna
To : Sudath Perera
Date : 18 July 20x3
Re : Cee line Fabrications Limited

Yesterday I received a letter (see Exhibit 12) and attachments from Kumara Rathnayake of Cee line Fabrications Limited, the audit client you are familiar with, asking for our views on a number of business matters.

I would like you to prepare the first draft of the written response to their request on the following matters.

(1) Insurance Claim

They are requesting that we review and report on their "Business Interruption" insurance claim (see Exhibit 14), to ensure that it is in accordance with their insurance policy. You should therefore critically examine their "Business Interruption" claim and note any appropriate amendments. You will need to consider the following points.

- The amounts claimed must be in accordance with the terms of the policy (see Exhibit 13).
- It is not possible to claim for amounts relating to a degree of betterment.
- The claim should only cover the loss of profit and additional costs incurred directly as a result of the accident.
- It is not possible to claim for loss of future growth of the business.
- We should also consider, and report on, are any further items that could be claimed at this time concerning "Business Interruption" that have not been included in their calculations.
- Their insurance claim in relation to replacement of the damaged physical plant and stock has already been dealt with and need not concern us.

(2) Option to Re-establish the Kandy operations.

Directors have discussed the methods available to re-establish the Kandy and consultant has appointed in order to identify the potential options available for the Cee-line (exhibit 20). Now the report from the consultants has received with 3 potential options. You are required to evaluate the options in stakeholders' viewpoints in your report.

(3) Overall Business Review

This interruption to their business, caused by the flood has focused the Board's attention on the financial and operating position of the business. They would like us to provide.

- A full financial and operational review and report on any other more general business and strategic issues which become apparent to us in the course of this work and our previous knowledge of this client.

Please note:

- As is usual in this situation the tax aspects of insurance claims will be complicated and I would not expect you to have any knowledge of this area. I have arranged for the draft report to be passed to Malith Jayasingha. (tax partner) once we have finished out bit and he will deal with the tax implications before the report is submitted to Cee line.

- In the financial and operational review please try to be as constructive and professional as possible in your written report.

Please look at the attached documents and prepare your draft report including an executive summary so that we may review it together when I am back in the office on Friday.

Many thanks,

Saman

Impact Information

Cee line Fabrications Limited

Impact Information

Case study requirements

You are Sudath Perera, a senior working for Gunaratna & Wijerathna a firm of Chartered Accountants in Sri Lanka, Colombo.

One of the partners, Mr Saman Wijerathna, has recently had a letter (Exhibit 12) from Kumara Rathnayake, a director in the client company Cee line Fabrications Limited (Cee line), requesting professional assistance by way of and analytical review and commentary on an insurance claim. The claim is as a result of a flood on the night of 31 March 20x3, when the local river Mahaweli burst its banks resulting in substantial damage to the Cee line Fabrications Limited's Kandy factory.

Your firm is required to prepare a report for Cee line as requested in their letter dated 16 July 20x3.

Requirement

You are required to prepare a draft of this report as instructed by Saman Wijerathna in his memo dated 18 July 20x3 (Exhibit 11).

It is suggested that candidates allocate their time as follows:

Reading the paper	1 hour
Planning the answer and calculations	1 hour
Writing the answer	2 hours.

Using the Advance Information

These ratios seem fine but the detailed analysis will provide a better understanding.

Working Capital Management

(9) Debtors Collection Period	$\frac{1,484}{5,232}$	20x1 x 365 104 days	$\frac{1,776}{5,920}$	20x2 x 365 110 days
(10) Acid Test	$\frac{782}{1,630}$	x 365 175 days	$\frac{822}{1,668}$	x 365 180 days
(11) Stock Turnover	$\frac{801}{1,630}$	x 365 179 days	$\frac{789}{1,668}$	x 365 172 days

Comment

- (1) Year end at least busy quarter, quarter 1 is most busy which means stock and creditors are high
- (2) However none of the working capital ratios (debtors, creditors of stock turnover) is acceptable.
- (3) Clear signs of management complacency and/or lack of focus in a profitable business.

Ccc line – Suggested Cash Flow Statement 20x2

Net cash inflow from operating activities	1,477,399
Returns on investment and servicing of finance	(62,937)
Taxation	(204,000)
Capital Expenditure	(1,482,769)
Equity dividends paid	(200,000)
Financing (HPP Creditor)	370,819
Increase/(decrease) in cash in the period	(101,488)

Note 1 Reconciliation of operating [profit to net cash flow from ordinary operating activities

Operating profit (899,617 + 56,842 + 16,811 – 10,716)	962,554
Depreciation	678,256
Decrease in Stocks	11,460
Increase in Debtors	(296,333)
Increase in Creditors	121,462
	1,477,399

There has been a major investment in fixed assets, which is funded largely out of operating income with some increased Hire Purchase funding.

The company charges a substantial depreciation charge each year, which appears to be an accurate reflection of the wearing out process.

Using the Advance Information

Reconfiguration of Financial Information

Cee line Fabrications Limited

Trading and Profit and Loss Account

For the years to 31 December

	Actual 20x1	Actual 20x2	Budget 20x3 Total	20x3 Colombo	20x3 Kandy	Budget 20x4 Total	20x4 Colombo	20x4 Kandy
Sales-own work	5,232,439	5,919,598	6,400,000	2,600,000	3,800,000	7,000,000	2,900,000	4,100,000
Less:								
Direct Labour	1,773,429	2,127,801	2,230,000	1,004,000	1,226,000	2,489,000	1,114,000	1,375,000
Materials	1,630,141	1,668,210	1,920,000	816,000	1,104,000	2,036,000	911,000	1,125,000
Change in stock	(13,591)	11,460	12,000	6,000	6,000	30,000	10,000	20,000
	3,389,979	3,807,471	4,162,000	1,826,000	2,336,000	4,555,000	2,035,000	2,520,000
Gross Profit	1,842,460	2,112,127	2,238,000	774,000	1,464,000	2,445,000	865,000	1,580,000
Gross Profit %	35	36	35	30	39	35	30	39
Other Income	40,200	40,500	-	-	-	-	-	-
	1,882,660	2,152,627	2,238,000	774,000	1,464,000	2,445,000	865,000	1,580,000
Accountancy	34,081	41,358	48,000	24,000	24,000	50,000	25,000	25,000
Bad debts	15,569	17,542	10,000	5,000	5,000	14,000	7,000	7,000
Bank charges & interest	13,083	16,811	16,000	8,000	8,000	26,000	10,000	16,000
Carriage	39,537	44,685	38,000	10,000	28,000	40,000	12,000	28,000
Depreciation of:								
Leasehold	26,410	39,318	39,000	-	39,000	39,000	-	39,000
Improvement								
Office	4,550	6,170	6,000	6,000	-	6,000	6,000	-
Equipment								
Motor Vehicles	136,723	136,723	136,000	50,000	86,000	136,000	50,000	86,000
PP&E Disposal	(28,500)	-	-	-	-	-	-	-
Electricity	16,157	14,174	3,600	6,000	7,600	15,000	7,000	8,000
HP Interest	50,576	56,842	52,000	12,000	40,000	52,000	12,000	40,000
Insurance	236,296	242,426	250,000	142,000	108,000	260,000	147,000	113,000
Salaries	184,812	247,980	220,000	100,000	120,000	250,000	115,000	135,000
Marketing	143,521	165,896	189,000	108,000	81,000	205,000	115,000	90,000
Vehicle	79,875	72,874	62,000	30,000	32,000	67,000	32,000	35,000
Expenses								
Postage, etc	35,165	31,749	38,000	10,000	28,000	42,000	13,000	29,000
Rent & Rates	60,284	60,452	60,000	24,000	36,000	64,000	26,000	38,000
Sundries	36,837	42,283	22,000	11,000	11,000	22,000	11,000	11,000
Telephone	12,818	15,727	20,000	7,000	13,000	27,000	12,000	15,000
Total	1,097,794	1,253,010	1,219,600	553,000	666,600	1,315,000	600,000	715,000
Expenses								
Net Profit	784,866	899,617	1,018,400	221,000	797,400	1,130,000	265,000	865,000
for the year								
Net Profit %	15	15	16	9	21	16	9	21

Comment: A successful business in terms of profitability. Could it do better?

Using the Advance Information

- Exhibit 4 - Financial statements – prepared for management – for 20x2 shows:**
- Increase in sales, profits and retained earnings by more than 10% on 20x1
 - There was a large investment in plant and equipment in 20x2
 - Finance for P&E provided by internal funds and HP creditor
 - Steady good dividend
 - Good reserves showing prudent management over time.
 - Substantial depreciation charges
 - Statements not yet audited.
- Exhibit 5 - Growth expected to continue per forecasts – how realistic?**
- Basis for prediction of turnover
 - Direct labour includes overheads recovered on labour rate
 - Overheads list given but not amounts
 - Note 4 may be difficult for forecasts
 - Note 5 does not indicate any fresh thinking or analysis re costs
 - No projected balance sheet or cash flow statement.
- Exhibit 6 - Detailed split by factory of projected sales – potential revelry?**
- Breakdown shows quarter 1 (Jan-Mar) is busiest quarter for both factories
 - Kandy factory consistently higher GP% (39% versus 30%)
 - Kandy absolute GP almost double that of Colombo
- Exhibit 7 - Budget for the year to 31 December 20x2**
- Provides evidence when compared to actual of accuracy of forecasting
 - No budgeted balance sheet or cash flow forecast
 - Comprehensive list of expenses
 - Lower GP% in Colombo 30% versus 39% in Kandy
 - Very low net profit % in Colombo 4% versus 23% in Kandy
- Exhibit 8 - Extract from Economic Research Report on NHS and private (Dec 20x1)**
- Review of equipment provision, ward and theatre – currently inadequate
 - Sri Lanka economy strong, government policy expected to increase in health expenditure.
 - Sri Lanka expenditure on health lags behind Europe
 - Budgeting system causes final quarter (Jan-Mar) surge in expenditure
 - Average age of equipment is 10 years old
 - Life of equipment 10 -15 years (seems incompatible with average age)
 - 75% of hospitals expect to upgrade their ((all?) equipment in next 2-5 years.
- Exhibit 9 - Solicitors letter**
- Bad and doubtful debts – some significant issues (are these widespread?)
 - Some vagueness concerning debt recovery action
 - Anuradapura factory possession possible from October 20x3 (financing?)
 - Indication of slightly "cosy" relationship – things moving along slowly
- Exhibit 10 - Minutes from March Board Meeting**
- Identification of problems at Colombo factory
 - Sumanadasa Perera's illness recognized publicly
 - Potential loss of 20% of (experienced? Key?) sales team
 - Kandy factory operating at full stretch – (how will it meet further increase?)
 - Sumanadasa Perera's response indicates some complacency or lack of urgency

Exhibit 10 B

Economic Review of Sri Lanka. (Source Central Bank Annual Report)

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economy registered an annual growth of 5.4 per cent in the real Gross Domestic Product (GDP) in 20x4. The growth of over 5 per cent is a reflection of the economy's resilience to the many adverse shocks the country had to face during the year - the surge in international oil prices, a severe drought in the early part and the floods later on in the year and finally, the tsunami disaster. The growth was largely supported by the strong growth in exports, consumption and investment as well as the continuation of the ceasefire.

Healthy developments in the Services and Industry sectors contributed to economic growth in 20x4 while the Agriculture sector faced a setback due to adverse weather conditions. The Services sector grew by 7.6 per cent in 20x4 as reflected by the growth of wholesale and retail trade, hotels and restaurants, transport and communication, and financial, real estate and business services sub sectors, and contributed 77 per cent to the overall growth. Strong external and domestic demand helped the Industry sector to grow by 5.2 per cent, contributing 25.7 per cent to the overall growth.

The conduct of fiscal policy in 20x4 was a challenge in the face of internal and external shocks that were threatening to slowdown the economy. The government's overall fiscal deficit increased to 8.2 per cent of GDP compared with 8.0 per cent in 20x3. It is imperative to continue consolidating the progress made in achieving greater macroeconomic stability while taking actions to remove structural weaknesses inhibiting growth. In this connection, curbing monetary expansion and completing the fiscal consolidation process are essential to improve the country's macroeconomic stability.

Exhibit 10C

Public Health Services. (Source Central Bank Annual Report)

Health Services

Item	20x2	20x3	20x4 est
Government			
Hospitals (practicing Western medicine) (No.)	605	606	598
No. of beds	59,781	61,808	60,328
Central dispensaries (No.)	385	387	375
Total no. of doctors	7,459	8,342	8,749
Total no. of Assistant Medical Practitioners	1,295	1,289	1,276
Total no. of Ayurvedic physicians	16,455	16,799	17,038
Total no. of nurses	16,139	16,711	17,316
Total no. of attendants	6,955	6,880	6,696
Private			
Hospitals (practicing Western medicine) (No.)	n.a.	172	174
No. of beds	n.a.	8,500	8,650
Total health expenditure (Rs.bn)	24.9	27.5	34.4
Current expenditure (Rs.bn)	20.2	22.1	25.9
Capital expenditure (Rs.bn)	4.7	5.4	8.5

Advance Information

Exhibit 10

Minutes from Cee line Board Meeting 18 March 20x3 (extracts)

Agenda Items:

- (1) **Financial results 20x2 and forecasts 20x3 and 20x4 prepared by Bimal Wijesiri, Finance Director**

A detailed discussion of overall results with budget and plan (circulated ahead of meeting) was conducted.

- (2) **General review of progress by Kumara Rathnayake**

Since the end of December 20x2, we have been carrying out an analysis of the whole business. The original budgets for the two factories for the year ended 31 December 20x2, showed that the Colombo factory was due to make a low net profit. During our investigations we have discovered that although the Colombo Factory has the higher value specialist projects, it actually has a relatively low Gross Profit margin. The reasons for this low margin are twofold:

- (1) There are significant inefficiencies due to some work not meeting the customer specifications. This has led to a large amount of reworking at the company's expense.
- (2) Production planning has in the past been less detailed than necessary and this has led to production run inefficiencies.

These issues have been known in general terms for some time. We believe that they may well be resolved now that new Computer Aided Design and Computer Aided Manufacturing (CAD/CAM) equipment has been installed in the Colombo Factory in late 20x2.

As everyone knows Sumanadasa is not as fit as he once was. I have managed to persuade him that I should take a more active role in the planning within the Colombo Factory to allow him to concentrate on the engineering side of the Colombo work. We both believe that this will be in the best interests of the whole Cee line Fabrications Limited operations.

- (3) **Comments from Sales Director, Pubudu Jayasiri**

We are hitting our monthly sales target in line with budget. There have been no staff changes in the three months but we know that both Mike Denton and Sarah Miles are looking for other posts which would reduce the current sales team down to eight people.

- (4) **Comments from Production Director, Waruna Wasantha**

No significant problems to report. The new CAD/CAM equipment installed in the Colombo factory is proving a real benefit. The Kandy factory is operating at full stretch but is meeting production schedules. The planning for the new production facilities at Anuradapura is progressing steadily and as soon as we have access to that site we start the detailed production line design.

- (5) **Legal matters, comments by Sumanadasa Perera.**

My reading and review of the letter from Albert is that apart from the debt relating to The New Medical Centre in Bombay, everything else is under control.

Advance Information

their budgets or their budget for the following year will be reduced to the actual spend level of the previous year. This budgeting method often leads to significant expenditure in the January to March quarter.

The NHS plan places great emphasis on public consultation, which showed that the public wanted to see:

- More and better paid staff using new ways of working;
- Reduced waiting times and high quality care centred on patients;
- Improvements in local hospitals and surgeries.

The March 20x2 budget settlement means that the NHS will grow by 50% in cash terms and by 33% in real terms in just 5 years. This will fund extra investment in NHS facilities as follows:

- 3,000 extra beds in hospitals and intermediate care;
- Over 100 new hospitals by 2010 and 500 new one-stop primary care centers;
- Over 3,000 general practitioner (hereafter GP) premises modernized and 250 new scanners.
- Clean wards overseen by "modern matrons" and better hospital food;
- Modern IT systems in every hospital and GP surgery;
- 2,500 more consultants and 2,000 more GP's;
- 5,000 extra nurses and 1,500 extra therapists;
- 100 more medical school places;
- Childcare support for NHS staff with 100 on-site nurseries.

A questionnaire sent to both public and private hospitals dealt with all hospital capital expenditure and a summary of responses to each of the detailed areas is provided below:

Hospital beds and ancillary items

- The average age of hospital equipment is 10 years old
- The expected life of most hospital equipment is 10-15 years.
- 75% of hospitals expect to upgrade their equipment in the next 2-5 years to accommodate obsolescence, new health and safety requirements for staff and new technology.
- Current equipment is considered old fashioned by users.

Advance Information

Exhibit 8

Extract from an Economic Research Report on National Health Sector (hereafter NHS) and Private Hospital expansion by a third party research centre (report dated December 20x1).

This is a report concerning the predicted investment in equipment by the NHS and private hospital sectors for the period 1 April 20x2 to 31 March 20x5.

The main areas under consideration are:

- (1) Ward related equipment such as beds, tables, trolleys and other similar items
- (2) Theatre related equipment such as diagnostic and monitoring equipment

This report has been compiled using data obtained from the NHS Plan (which remains Crown copyright) and a detailed questionnaire completed by a number of private hospitals throughout the SRI LANKA. It also takes into account likely changes resulting from:

- (1) Changes in working practices
- (2) Health and safety requirements
- (3) The availability of improved equipment compared with that currently in use.

Economic outlook

Sri Lankan economy is currently in a relatively positive state. Inflation remains low and unemployment is also at a historically low level. Industrial output remains strong but the potential for exports remains mixed with the variation in the strength of Sri Lankan rupees against the US dollar being particularly important. Domestic demand is still sufficient to satisfy supply.

As a result of government policy there will be scope within public finances for a moderate increased investment in health. There will also be a related increase in investment through the private health sector. The government has recognized that the NHS cannot service completely the healthcare needs of Sri Lanka and recognizes the importance of a public/private partnership in the delivery of healthcare services. In the past the bed usage in the private sector was in the region of 50-60%, now it is in the order of 90-100%.

Healthcare values

Decisions over healthcare at all levels are made in the face of a mix of social, economic, technological and political factors. There are many competing demands and interests. The framework of values to underpin this process consists of:

- Equal care for equal need
- Full range of care and treatment
- Treatment not based on ability to pay

There is a question as to the extent to which these values have been realized over the years. It is not always possible to provide the full range of services for every patient. This has also resulted in rationing policies, definitions of what constitutes free healthcare and growth in the private provision of medical services. There will be further challenges due to the larger range of technological equipment, which is becoming available for patient use every day.

In assessing value for healthcare purposes, there are various parameters, which need to be looked at in evaluating how healthcare should be provided. In particular, it is necessary to consider what is relevant, accessible, acceptable and equitable, as far as the patient is concerned. There are also other factors, such as how efficient and effective the care can be and the competence of the provider.

Advance Information

Exhibit 6

CEE LINE FABRICATIONS LIMITED

Schedule of Budgeted Sales and Cost of Sales by quarter for the year ended 31. December 20x3.

Colombo		In Rs. '000's			
Year 20x3	Quarter 1 Rs	Quarter 2 Rs	Quarter 3 Rs	Quarter 4 Rs	Total Rs
Sales	700	600	630	670	2,600
Cost of sales	492	421	442	471	1,826
Gross Profit	208	179	188	199	774
GP%	30%	30%	30%	30%	30%
Kandy					
Year 20x3	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Total
Sales	1,050	970	920	860	3,800
Cost of sales	645	596	565	530	2,336
Gross Profit	405	374	355	330	1,464
GP%	39%	39%	39%	39%	39%
Total Year 20x3	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Total
Sales	1,750	1,570	1,550	1,530	6,400
Cost of Sales	1,137	1,017	1,007	1,001	4,162
Gross Profit	613	553	543	529	2,238
GP%	35%	35%	35%	35%	35%

Advance Information

(4) CREDITORS: AMOUNTS FALLING DUE WITHIN AFTER MORE THAN ONE YEAR

HP Creditor	543,335	172,516
	<u>=====</u>	<u>=====</u>

(5) CAPITAL

Share capital - Rs 1 ordinary shares fully paid	200,000	200,000
	<u>=====</u>	<u>=====</u>

(6) Reserves

Balance at 31 December	1, 887,842	1,423,225
	<u>=====</u>	<u>=====</u>

Advance Information

CEE LINE FABRICATIONS LIMITED

Internal Balance Sheet as at 31 December 20x2

	Notes 1 & 2	20x2 Rs	20x1 Rs
Tangible Fixed Assets			
Plant and Equipment		1,488,139	648,122
Office Equipment		13,386	2,002
Leasehold Land		200,360	110,525
Motor Vehicles		136,722	273,445
		<u>1,838,607</u>	<u>1,034,094</u>
Current Assets			
Stock and Work in progress	1	789,082	800,542
Trade Debtors		1,775,956	1,483,674
Prepayments		155,233	151,182
Cash at Bank and in Hand		172,084	273,572
		<u>2,892,355</u>	<u>2,708,970</u>
Creditors: amounts falling due within one year	3	(2,099,785)	(1,947,323)
Net Current Assets		<u>792,570</u>	<u>761,647</u>
Total Assets Less Current Liabilities		<u>2,631,177</u>	<u>1,795,741</u>
Creditors: amounts falling due after more than One year	4	(543,335)	(172,516)
		<u>2,087,842</u>	<u>1,623,225</u>
Capital Accounts			
Share Capital	5	200,000	200,000
Reserves	6	1,887,842	1,423,225
		<u>2,087,842</u>	<u>1,623,225</u>

Advance Information

Exhibit 3

Extracts from Business Review and Planning Report prepared by Bimal Wijesiri, Finance Director of Cee line, for presentation to the Board meeting 18 February 20x3

Overview

The Company has continued to trade profitably for the past year and has reported growth of more than 10% in sales in 20x2. The Financial Statements, prepared for internal management purposes, for the years ended 31 December 20x2 are included below and show excellent profits before and after tax with a high level of retention, all of which have increased by more than 10% over 20x1 (see Exhibit 4).

This reported growth in sales is forecast to continue in 20x3 and beyond. Both the forecast sales, and cost of sales for the year to December 20x3 and December 20x4 (see Exhibit 5), as prepared by the company in November 20x2, reflect these expectations. Currently we see no reason to change these forecasts.

A detailed breakdown of Budgeted Sales and Cost of Sales by quarter (see Exhibit 6) has been calculated from data constructed by the sales and marketing team working in close consultation with our clients.

The projected production requirements have been agreed with the production team and we have the capacity and resources to produce what is required to meet the expected sales forecast.

The track record of the company in predicting its financial future is robust. This can be seen by comparing the budget for the year ended 31 December 20x2, (see Exhibit 7), which was prepared in November 20x1, with the actual results for 31 December 20x2. We are confident that these forecasts for 20x3 and 20x4 are realistic predictions based on our current clients.

We also believe that the economic review (see Exhibit 8) indicates that the health service market will grow significantly over the short to medium term. As far as the Kandy side of our business is concerned we are placed to take on any new work which may arise from these growth expectations in general.

The company has also identified that we need to concentrate and expand into areas which provide a better margin on sales. On that basis and relying on our established reputation we tendered for, and won, a large new contract for Ripon Hospital at a gross profit rate of approximately 40%. This contract is due to commence delivery in January 20x4.

The Ripon contract required us to take on new factory premises. The Colombo factory, although large, is somewhat dilapidated and the new site we have identified at Anuradapura, would allow for overall future expansion of the business.

We have been in negotiations with the landlord of the Anuradapura industrial site since January of this year and the new factory is expected to be up and running by 1 January 20x4. The new factory will obviously involve considerable costs including the lease payments and other operating expenses but we should be able to manage these items from our normal cash flow.

Advance Information

Exhibit 1

Cee line Fabrications Limited

Background to the audit firm and your role

The firm of Gunarathna & Wijerathna, Chartered Accountants is located in Cee line, Colombo

It has a growing portfolio of regional clients, with the full spread of regular audit, accountancy and tax work, together with investigation reporting across the whole spectrum of business activity.

The office comprises six partners, all with a variety of professional experience before becoming partners in the firm. There are some thirty professional staff at all levels, and the same number of support staff.

You are Sudath Perera who joined Gunarathna & Wijerathna as an audit assistant in September 20x0. During your training you have worked with all six partners in different client projects. You are considered to be good with clients and to be versatile, capable and thorough in your work. You have frequently been asked to take on the more unusual client projects which require an application of analytical skills.

Exhibit 2

Permanent File (Extracts)

Cee line Fabrications Limited: Audit client since January 19x2.

Cee line Fabrications Limited (Cee line) is a long established (19w3) privately owned limited company. It operates as a metal fabrication engineering and manufacturing business and is owned and run by Sumanadasa Perera, the founder, and Kumara Rathnayake his son-in-law.

Cee line has two factories, the Colombo Factory and the Kandy Factory. The Colombo Factory under the direction of Sumanadasa Perera, carries out high precision specialist projects, which require metals such as stainless steel and titanium alloys, and advanced levels of technical skill. Sumanadasa Perera is a qualified engineer who built the current business over the past twenty years. He is married to June, has one daughter Mary and is 59 years old. He suffers from arthritis.

The Kandy Factory is used for larger jobs requiring less set up time and it utilizes a significant proportion of automated plant. During the past few years, it has been used wholly for large production runs of metal frames for hospital equipment, supplying fewer but more demanding customers in both the domestic and overseas markets. Kumara Rathnayake whose background is in sales and marketing looks after this side of the business. He is 35, married to Manel Silva, they have two children Sadun and Sindu. Kumara joined the business ten years ago in June 19x3.

Cee line has an extensive list of clients. These clients are divided into two main groups split along the lines of the output from the two factories. The Colombo factory clients tend to be established manufacturing companies engaged in the manufacture of a variety of white goods, and also include companies which are on-line with major manufacturers such as the motor trade. The terms of trade tend to follow a fairly standard commercial pattern, with any radical anomalies being the subject of personal negotiation with Sumanadasa Perera.

The Kandy clients are more health service based: both private and public sector. One of the noticeable factors in dealing with the large public sector clients is the long lead time between bidding for contract work, winning the order and the post-contract finalization of the specific contract details. There is also a long time period between starting to manufacture the goods, their delivery to the appropriate location and the eventual

