No. of pages: 10

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

COMMON PRE-SEEN

(KC1 TO KC4)

JUNE 2019

Colombo Beverage and Confectionery (Pvt) Ltd

Introduction

Colombo Beverage and Confectionery (Pvt) Ltd (CBC) was established in 1985 as a manufacturer of carbonated soft drinks and frozen confectionery, initially for the Sri Lankan market. Currently its products are marketed locally as well as internationally. Harain Fernando (who holds a bachelor's degree in food technology from the University of Peradeniya) and his good friends and fellow university batchmates Jacky Ellawela and Yamuna Ediriweera, were the initial three shareholders of the company. At inception the three of them contributed equally to the initial equity capital of Rs. 150 million, issued at Rs. 100 per share. CBC's factory is located in Kaduwela, in the vicinity of the Kelaniya river, on an 8-acre land owned by the company.

In the domestic market CBC currently has a market share of 35% for carbonated soft drinks and a market share of 48% for frozen confectionery. All the products produced by the company are branded under the trademark "Sporty". The two main products produced under the brand name are soft drinks and ice cream. CBC offers 10 flavours of soft drinks and 20 flavours of ice cream to its consumers.

CBC has two main strategic business units (SBUs). One is its retailing arm and the other its manufacturing arm. Both units are separate profit centers established under two directors Jacky and Yamuna respectively. Due to high demand CBC expanded the factory in 2005 by incurring capital expenditure of Rs. 450 million and increasing the working capital by Rs. 75 million. The extra capital was funded by the three existing shareholders, as well as two new shareholders. The two new shareholders were a foreign investor David Scott (a British citizen who holds 36% of the total stated capital of the company), and Kamal Fernando (a Sri Lankan citizen and family friend of Jacky's, who holds 8%). The three existing shareholders Harain, Jacky and Yamuna hold 25%, 20% and 11% respectively, and have agreed to maintain this proportion of ownership in the future as well. CBC also negotiated a borrowing facility with the bank for additional working capital requirements in order to import raw materials and obtain the local purchases necessary for manufacturing its products.

CBC has implemented a continuous improvement system for its products and processes and also empowers its employees to stay at the forefront of its business sectors. The company attempts not only to provide a product, but also to deliver pleasure and nutrition through its exciting and superior products. During 2015, CBC obtained another Rs. 175 million as equity capital by way of a rights issue to fund product developments and other research activities. However, the shareholding structure did not change due to the rights issue. The company is keen on building strong relationships with its stakeholders, driven by the openness and trust it has maintained and its commitment towards all of them.

The revenue of the retail segment drastically improved year-on-year (YOY) compared to the revenue of the manufacturing segment. The higher growth in the retail arm created an opportunity to expand the company's activities to outstation areas of the North, East and some parts of the Uva province. However, the manufacturing segment contributed towards a higher proportion of the bottom line of the company.

Supply chain management

Accessibility to CBC's products was enhanced through a well-spread network of 170 distributors of soft drinks and frozen confectionery, and 25 retail outlets situated in the main cities that were negotiated on a long-term lease.

CBC always strives to obtain high quality raw materials. This is achieved through stringent quality controls and good practices stipulated in the quality control policy of the company. Furthermore, the company actively engages in the improvement of its suppliers who are key stakeholders of the company. Since CBC has implemented the continuous improvement system, it keeps improving its recipes, thereby providing more options for consumers who prefer healthier drinks with low sugar. Thus it can be observed that CBC drives a more value-based culture that covers a number of stakeholders. The company has also built very strong relationships with local suppliers including dairy farmers. CBC's annual budget allocates a significant amount of money for CSR programmes in order to develop livelihoods, build community infrastructure, reduce the carbon footprint, and look after the health of farmers by providing health care services regularly. Since 2015, the retail outlets of CBC aim to empower and support local charities and small entrepreneurs by providing a platform to sell their products.

Strategic thinking

CBC adheres to and follows the enterprise risk management framework that enables a robust process for creating value for all its stakeholders. The company considers the risk management process to be an integral part of its strategic decision making process. The strategic decision making committee is chaired by the chief executive officer (CEO) Heshana Fernando, who is the eldest son of Harain Fernando. Heshana emphasised the importance of risk management and incurred a large sum of money to maintain the quality of the products and improve the mechanism for risk management in the company, in order to mitigate all the possible risks.

However the chairman, Harain Fernando, was not happy with the above approach. He always mentioned that although the company should take all the necessary steps to avoid and mitigate risks, the company cannot spend such a large sum of money just to avoid all the possible risk factors. He was also of the view that they should identify and assess the risks before incurring costs to mitigate them. Harain pointed out at a recent meeting held on the risk management process that they should revisit their policy on the risk management framework and prepare an appropriate policy framework considering the large costs incurred by the company annually.

The chairman has strong political relationships with some ministers of the present government and has won a few government tenders to supply soft drinks and frozen confectionery for functions organised by government departments.

The Sporty brand currently competes successfully with several rival local and international brands and the company has appointed two brand ambassadors to promote their products. Recently, under frozen confectionery, CBC has also introduced two sugar-free ice creams (vanilla and chocolate).

Further, CBC is currently pursuing export opportunities in international markets such as the Maldives and Bangladesh, and has also just started exporting a few orders of its natural ginger-based Sporty Ginger Beer (SGB) to the European and North American markets.

However, tightening monetary conditions and maximum prices imposed on some essential goods have negatively impacted the gross margins of the company.

At a recent board meeting David Scott (director) pointed out that the brand value was not accounted for under intangible assets. He requested to record it in the financial statements for the year ended 31 March 2019, as there was a significant value created through growing business and demand.

The finance director Nihal Silva, instructed his subordinate Lakmalee Perera, an assistant accountant who had just completed the Business Level examinations of CA Sri Lanka, to prepare forecasted income statements and statements of financial position as at 31 March for the next five financial years starting from 2019/20 by considering the following.

(i) Inflation YOY

	2019/20	**2020/21**	**2021/22**	**2022/23**	**2023/24**
Inflation rate	5.0%	5.5%	6.0%	6.5%	7.0%

All expenses including cost of sales will be affected by this inflation.

(ii) Capital expenditure and working capital requirement.

	2019/20	**2020/21**	**2021/22**	**2022/23**	**2023/24**
Capital expenditure (Rs. million)	425	175	-	-	-
Changes in working capital requirement (Rs. million)	125	110	75	52	42

(iii) Exchange rate (annual average)

	2005	**2019**
LKR/GBP	175.35	229.55

Performance

The financial year under review (2018/19) was a challenging one for CBC, with developments in the macroeconomic front and government policy having a significant impact on performance. Moderate economic growth and the increased prices of food led to a contraction in the FMCG sector. Meanwhile, the government imposed an excise duty based on the quantum of added sugar contained in beverages with effect from 9 November 2017. The tax amounted to 50 cents per gram of added sugar and resulted in a sudden escalation of costs. Despite these challenges, the company should continue to place strategic emphasis on further development of the product portfolio and drive process and manufacturing efficiencies to support long-term growth.

The finance director, who is a fellow member of CA Sri Lanka, pointed out that although CBC had a higher revenue in 2018/19 compared to 2017/18, the gross margin had reduced to 12% from 14% in 2017/18. He pointed out that the cost of production had gone up during 2018/19 due to the increase in prices of diesel, furnace oil and other expenses. In addition, the increase in duties and levies on imports and the depreciation of the rupee further resulted in an increase in the cost of production. The newly enforced tax on added sugar will also have a direct negative impact on the profitability and revenue growth of the company. It will discourage the production of sweet drinks and food, as well as the consumption of such products by society.

In 2018/19, CBC replaced a few old machines with automated ones. This created a situation where a voluntary retirement scheme had to be enforced on unskilled labour who had worked for more than 15 years. Further, the company made plans to expand its outlets in the North and East starting from January 2019. The required capital expenditure and initial working capital for both purposes were funded by the bank as a long-term loan. The company presently enjoys concessionary rates from the bank (long-term loans at 8% per annum, short-term loans at 11% per annum, and an overdraft facility of Rs. 900 million at 15% per annum).

Nihal had a serious discussion with the chairman recently about CBC's overseas operations, especially the sales outlet situated in the Maldives to promote the Sporty brand among foreign tourists there. He suggested to close this outlet due to the continuous losses incurred from inception. He also mentioned that 60% of the total revenue generated in the Maldives in fact came from the agency network situated in different islands of the Maldives. However the chairman had a different viewpoint on the sales outlet and said that it was not a cost and can be brought under research and development since this outlet was used to promote the Sporty brand globally. The chairman instructed to change the company's accounting policy accordingly from 2018/19.

David is currently not happy with the present economic conditions and requested to find an exit strategy, since the value of his investment deteriorated daily due to the rupee depreciation. He wishes to exit from the company taking back his investment at the appropriate time. However, Harain pointed out that they should first go for an initial public offering (IPO) and generate new equity of Rs. 500 million to automate the factory and increase capacity. Once CBC is listed on the Colombo Stock Exchange, David can sell his shares to the public and exit from CBC taking a good price, as at that time the company's net worth would be much higher than when David initially invested in the company at par value.

However David claims that it is impossible to predict now that just after the IPO the market price of a share will in fact increase. Therefore he suggests that CBC purchases his shares at the fair value of the company. He also strongly opposes the current dividend policy and requested to consider a 100% dividend payout until he sells his shares or the company buys back the shares, since CBC has sufficient retained earnings and cash flows to pay dividends without an issue. He also stated that all the local directors have reimbursed their personal expenses such as school fees for children, vehicle rentals, overseas trip expenses and other drawings as allowances, in addition to the dividend payment, but he only receives the amount declared as dividend annually.

David also disagreed with the revalued value of the land and buildings of CBC obtained for the purpose of showing it in the financial statements as at 31 March 2019. This was because the board of directors of the company considered the approximate market value without obtaining the fair value from a professional valuer.

The finance director mentioned that CBC has liquid financial assets that generate only 8% – 11% of annual revenue and suggested to buy back all of David's shares immediately. He claimed the company's financial position will improve as a result, and this will help to get a higher price at the IPO.

A&B Associates is the external auditor of CBC. Henry Dissanayake, the son-in-law of the main partner of A&B Associates, was recently recruited by CBC as the marketing manager. He will be in charge of exports and the local distribution network.

The chairman of CBC received a letter from the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) requesting the relevant documentation pertaining to the fair value of property, plant and equipment, and inventories shown in the statement of financial position as at 31 March 2018. The board of directors requested A&B Associates to study this and prepare an appropriate reply to SLAASMB justifying the values shown in the financial statements as an additional assignment.

The internal audit team carried out a physical verification of stocks in retail outlets as at 31 May 2019. They found out that despite having a strict internal control system and tight quality control procedures there were a few items of soft drinks and frozen confectionery that were not moving for the last six months, but were considered as part of stock as at 31 March 2019. The finance director was not happy with the remarks made by the internal audit team and mentioned that there was no need for any adjustments to the financial statements as at 31 March 2019, since the company's external auditor had already observed the physical verification of stocks as at 31 March 2019 and was satisfied with the stock value.

The risk management committee headed by Nihal reported to the board that CBC has not repaired its plant that purifies the wastewater released into the river since the end of 2017. He submitted a budget of Rs. 45 million after obtaining a quotation from a reputed firm for the entire repair six months ago, but it was still not taken up by the board. He pointed this out at a recent board meeting, but the CEO questioned why they should be in a hurry to spend such a lot of money at this moment to purify wastewater. Nihal was not happy with the CEO's approach to the matter and mentioned that it was their duty to protect the environment from any pollution. In fact, a protest was also recently organised by a group of environmentalists against CBC, requesting them to stop releasing wastewater into the river. However, the protest was not successful due to poor participation.

Lakmalee had a discussion with the company's external auditor, who also provides tax consultations, regarding an assessment received by the company for the year of assessment 2016/17 from the Inland Revenue Department.

The finance director extracted the following information relating to a company similar to CBC.

- Debt-to-equity ratio: 2:3
- Beta value per ASPI: 0.89
- Market rate of return: 16%
- Risk-free rate: 11%

Board of directors of CBC

Chairman	Harain Fernando
Managing director/CEO	Heshana Fernando
Director	Jacky Ellawela
Director	Yamuna Ediriweera
Director	David Scott
Director	Kamal Fernando
Director	Nihal Silva

The financial information of CBC is given in Annexure 1.

Annexure 1

Colombo Beverage and Confectionery (Pvt) Ltd

Income statement	**Unaudited**	**Audited**
For the year ended 31 March	**2019**	**2018**
	Rs. '000	**Rs. '000**
Revenue	48,952,450	39,618,680
Cost of sales	(43,078,156)	(34,072,072)
Gross profit	**5,874,294**	**5,546,608**
Other operating income	1,548,412	1,448,168
Selling and distribution expenses	(1,677,315)	(1,293,012)
Administrative expenses	(1,416,604)	(1,215,312)
Other operating expenses	(759,841)	(741,862)
Operating profit before interest and tax	**3,568,946**	**3,744,590**
Finance cost	(227,792)	(108,546)
Finance income	104,917	125,616
Changes in fair value of investment property	21,360	85,638
Profit before tax	**3,467,431**	**3,847,298**
Tax expense	(889,817)	(1,225,280)
Profit for the year	**2,577,614**	**2,622,018**
Other comprehensive income		
Actuarial gain/(loss) on employee benefits	18,562	(46,025)
Revaluation of land and buildings	252,250	-
Tax on other comprehensive income	(125,256)	(7,686)
Other comprehensive income for the year, net of tax	**145,556**	**(53,711)**
Total comprehensive income for the year	**2,723,170**	**2,568,307**
Earnings per share (Rs.)	303.25	308.47
Dividend per share (Rs.)	175	175

Colombo Beverage and Confectionery (Pvt) Ltd

Statement of financial position	Unaudited	Audited
As at 31 March	**2019**	**2018**
	Rs. '000	**Rs. '000**
Assets		
Non-current assets		
Property, plant and equipment	8,296,034	8,092,886
Lease rental paid in advance	157,263	164,703
Investment property	218,402	197,042
Intangible assets	153,852	154,256
Non-current financial assets	251,264	160,253
Other non-current assets	876,365	667,229
	9,953,180	**9,436,369**
Current assets		
Inventories	3,892,670	3,564,063
Trade and other receivables	2,335,629	1,627,914
Other current assets	1,706,375	755,368
Short-term investments	1,023,276	715,660
Cash and cash equivalents	652,073	303,236
	9,610,023	**6,966,241**
Total assets	**19,563,203**	**16,402,610**
Equity and liabilities		
Stated capital	850,000	850,000
Revaluation reserve	402,250	150,000
Retained earnings	8,843,982	7,860,562
Total equity	**10,096,232**	**8,860,562**
Non-current liabilities		
Interest bearing loans and borrowings	750,525	159,525
Deferred tax liabilities	1,134,306	982,308
Employee benefit liabilities	361,866	571,353
Other non-current liabilities	176,921	183,465
	2,423,618	**1,896,651**
Current liabilities		
Trade and other payables	4,512,688	3,238,077
Income tax liabilities	197,504	542,130
Interest bearing loans and borrowings	400,000	152,667
Other current liabilities	1,108,161	1,185,919
Bank overdraft	825,000	526,604
	7,043,353	**5,645,397**
Total equity and liabilities	**19,563,203**	**16,402,610**

Five years at a glance	Unaudited	Audited			
Years ended/as at 31 March	**2019**	**2018**	**2017**	**2016**	**2015**
	Rs. '000				
Trading results					
Gross revenue	48,952,450	39,618,680	32,632,551	25,958,590	22,330,083
Gross profit	5,874,294	5,546,608	5,873,859	4,672,546	4,019,415
Operating profit before interest and tax	3,568,946	3,744,590	3,589,581	2,595,859	2,233,008
Profit before tax	3,467,431	3,847,298	3,465,577	2,725,652	2,121,358
Tax expense	(889,817)	(1,225,280)	(970,362)	(708,670)	(551,553)
Profit after tax	2,577,614	2,622,018	2,495,215	2,016,982	1,569,805
Assets, equity and liabilities					
Property, plant & equipment	8,296,034	8,092,886	7,354,945	6,676,533	6,258,120
Investment property	218,402	197,042	111,404	94,457	85,482
Other non-current assets	1,438,744	1,146,441	943,258	927,311	1,108,526
Net current assets	2,566,670	1,320,844	906,782	471,249	201,234
	12,519,850	**10,757,213**	**9,316,389**	**8,169,550**	**7,653,362**
Long-term loans	(750,525)	(159,525)	(112,520)	(159,258)	(185,337)
Other non-current liabilities	(1,673,093)	(1,737,126)	(1,424,114)	(1,156,003)	(1,067,966)
Net assets	**10,096,232**	**8,860,562**	**7,779,755**	**6,854,289**	**6,400,059**
Represented by:					
Stated capital	850,000	850,000	850,000	850,000	850,000
Revaluation reserve	402,250	150,000	150,000	150,000	150,000
Retained earnings	8,843,982	7,860,562	6,779,755	5,854,289	5,400,059
Shareholders' funds	**10,096,232**	**8,860,562**	**7,779,755**	**6,854,289**	**6,400,059**

	2019	**2014**	**2011**	**2006**	**2005**
Exchange rate (LKR/USD)	181.25	110.78	89.38	93.38	97.25