

CA



THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

27510 - TOP CA CASE STUDY EXAMINATION

SEPTEMBER 2014

Please note that this document provides only a general expectation of the examiners. However, there may be variations in answers provided by the candidates with reasonable Justifications.

- (1) Describe which financial goal, in your opinion, Dilith seems to be primarily focused on.

In addition, explain whether you consider this goal to be the correct goal for SITS from the points of view of its stakeholders. Provide reasons for your answers.

(18 marks)

According to the information provided in both advanced information and impact information sections of the case study, Dilith seems to be primarily focused on profit maximization through minimization of major costs. As he over emphasizes on this he has throughout been reluctant to recruit required human talents for the growth of the company, i.e., whenever, other senior people highlighted the need of the recruitment of a few business analysts, he openly rejected this idea due to his concern about the high cost the company has to incur for these experts.

Though he thinks he is controlling the cost and thereby contributing to the profit, his over concern on this has itself become a constraint for profit growth. Therefore, there is a goal conflict within his thinking. Finally, his thinking is not contributing to the profit objectives of the company. He has been adamant in his thinking. As a result, in the recent past company revenues and profits started eroding. It has been reported that operating profits of the company have deteriorated during last two years; in 2012 and 2013 by 5.4% and 19.3% respectively.

Important: Students are supposed to quote from the information provided to prove their points.

Dilith's over emphasis on goal of profit maximization (through managing costs or reducing costs) cannot be justified from the point of view of other stakeholders such as clients, employees, board of directors, shareholders and lenders. His idiosyncratic (peculiar) behaviour or way of managing the company does not seem to be fitting to the overall organizational goal.

Modern literature on the theory of the firm and the finance theory suggest that the shareholder value maximization as the appropriate goal for the organization. Theoretically, this goal has been justified as an appropriate goal for a company as the goal of value maximization cannot be achieved without giving due consideration to other stakeholder interests. This has been discussed in stakeholder theory as well.

Two institutional investors who contributed to the share capital of the company through the private placement seem to be very unhappy regarding the progress of the company. Their intention has been to list the company on the stock exchange in order to realize a value for their investment. Their target is getting distant as Dilith has not understood the right goal for the firm and the strategy to achieve it.

Important: Candidates are required to explain the issue from the points of views of other constituencies of Stakeholders (e.g. lenders, employees) as well.

- (2) Explain the potential corporate governance issues and agency problems prevalent in SITS, with special reference to Dilith's management style.

(18 marks)

The answer should cover the following areas:

- Understanding of corporate governance
- Gradually evolved corporate governance issues within SITS
- Understanding of agency theory
- Dilith's management style is not in line with good corporate governance practice

Corporate governance is the system of rules, practices and processes by which a company is directed and controlled. Corporate governance essentially involves balancing the interests of the many stakeholders in a company - these include company shareholders, employees, customers, suppliers, financiers, government and the community. Since corporate governance also provides the framework for attaining a company's objectives, it encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure.

Naturally, with the growth of the company, the other stakeholders' involvement increases and the same can be observed in SITS as well. However, Dilith's management style which has been dominating right from the beginning of SITS has not given due consideration to the interests of the other stakeholders. In fact Dilith has failed to recognize evolving responsibilities towards increasingly important other stakeholders of the company with the growth.

According to the agency theory explanation, anybody who assumes the responsibilities of corporate management or controlling ownership becomes an agent of the entire shareholding community. Shareholders in general are the principal. Therefore, it is Dilith's responsibility to design a system so that all the layers of employees work for the company's overall goal. For this, it is very essential to create a goal congruent work environment. However, this is not visible within the company due to the peculiar management style followed by Dilith.

Dilith has a role conflict as a technical expert and as the CEO. He has not understood his priorities.

He has failed to assign responsibilities to others. Who is doing what is not clear. There seem to be no proper planning and delegation.

He has a problem of over confidence and underdelivery.

Being the chairman of the board and the CEO of the company Dilith controls the information and the agenda of the meetings. This is not a good corporate governance practice.(i.e. Duality is not there)

Dilith is not prepared to listen to others and always try to defend his stand. There seem to be less open discussions, both at the board level and the other operational levels.

Dilith's management style seems to be a part of his personality and upbringing. He has been his own person. He neither has a formal training in management nor proper experience achieved by working for another organization. He is not prepared to delegate as well.

Important: Candidates are expected to clarify their points, drawing from the information provided.

- (3) Assuming that you are the management consultant (Jayantha Welihinda) appointed to look into the issues at SITS, prepare a report to be submitted to the board of directors. Your report should cover, inter alia, an analysis of the problems faced by SITS and your recommendations (with justifications) to resolve them.

(Note: carrying out financial analysis may help you to understand some key issues faced by the company).

(64 marks)

The answer should consist of the followings:

- 1) A letter addressed to the Board of directors through the chairman
- 2) Report

The Report:

It is expected to provide a structured report covering:

Executive summary / Introduction

Should highlight major problems faced by the company currently as well as problems that may be faced in the near future, reasons for the problems (it should not be person-specific rather actions-specific) and major recommendations.

Analysis

Qualitative Analysis

Attention on the transformation process and mistakes (not taking appropriate action at the right time

Financial Analysis

Both time series comparisons and cross sectional comparisons are expected.

Candidates should recognize the fact that the financial analysis only help to identify the symptoms of the problems faced by the company and the seriousness of the problems

Time Series Analysis of Financial Performance

	Company		Change from 2012 to 2013
	2013	2012	
Current ratio	1.34	0.96	+0.38
Quick ratio	0.63	0.52	+0.11
Average collection period	121 days	75 days	+ 46 days
Total asset turnover	0.51	0.62	-0.11
Debt ratio	10.9%	10.2% *	+0.7
Time interest earned ratio (gross)	4.71 times	6.34 times	-1.63
Time interest earned ratio (net)	12.58 times	26.2 times	-13.62
Gross profit margin	45.3%	46.6%	-1.5%

Operating profit margin (before tax and net finance expenses)	26.4%	28.5%	-2.1%
Net profit margin	18.1%	27.44%	9.34%
Return on assets (ROA)	9.4%	13.1%	3.7%
Return on equity (ROE)	16.6%	24%	-7.4%
Earnings per share (EPS)	Rs. 5.32	Rs. 7.09	Rs.-1.77
Dividend per share (DPS)	Rs. 3.00	Rs.4.00	Rs. -1.00

Cross Sectional Analysis of Financial Performance

	Company	Industry average	Difference Company – Industry
	2013	2013	
Current ratio	1.34	1.42	-0.08
Quick ratio	0.63	0.98	-0.35
Average collection period	121 days	47 days	+ 74 days
Total asset turnover	0.51	1.56	-.1.05
Debt ratio	10.9%	21.5%	10.6%
Time interest earned ratio (gross)	4.33 times	9.3 times	-4.97times
Time interest earned ratio (net)	12.58 times	18.3 times	-5.71times
Gross profit margin	45.3%	54.2%	-8.9%
Operating profit margin (before tax and Net finance expenses)	26.4%	36.4%	-10.0%
Net profit margin	18.1%	34.5%	-16.4%
Return on assets (ROA)	9.4%	18.7%	-9.3%
Return on equity (ROE)	16.6%	32.3%	-15.7%

Using financial ratios, appropriate discussions are expected on **liquidity, leverage, profitability, asset utilization, shareholder consideration**. Further, the candidates have to discuss beyond what is reflected through financial ratios, i.e. though it shows an improvement in liquidity ratios, this is due to the delays in customer settlements and inventory build-up (work in progress). Further, candidates are expected to recognize that SITS is in critical juncture that SITS cannot move long without reforms.

Further, it was expected to explore the reasons for the symptoms identified through the financial analysis. There it was expected to come up with the whole lot of operational issues confronted by the firm (low productivity, quality issues, not meeting deadlines, customer dissatisfaction and payment delays, process related issues, employee issues etc.). Next, it was expected to come up with managerial issues that cause the operational issues (planning issues, organizational structure and division of work related issues, employee motivation related issues etc.) Finally, it was expected to identify the strategic causes that led to managerial issues (corporate goals and targets, stakeholder considerations, risk analysis, leadership, governance etc.) The analysis can be taken either bottom-up or top-down approach.

Recommendations

It is expected to proposed near-term, medium-term to long-term recommendations by the candidates.

Near term strategies should focus on immediate problems to be resolved with no or less financial commitment such as building project team and assigning work responsibilities, planning for clearing delayed work/projects, building relations with customers, recovery plans for delayed A/c receivables, strategies for strengthening working capital etc.

Medium-term strategies may include: withholding/reducing dividends, recruitment of required human talents, performance based reward system,

Long-term strategies may include: developing long-range plans including reviewing processes based on planning cycles, facilitate training opportunities for employees both technical and managerial (it is necessary to acquire managerial skills by senior staff including the CEO), strengthening the marketing programmes (overseas markets), strengthening the capital base of the company (listing), introducing risk management programmes, developing stakeholder relations.

Candidates are expected to be specific in their recommendations with appropriate justifications.

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They are not intended as "Model answers", but rather as suggested solutions.

The answers have two fundamental purposes, namely:

1. to provide a detailed example of a suggested solution to an examination question; and
2. to assist students with their research into the subject and to further their understanding and appreciation of the subject.

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