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Society of Certified Management Accountants of Sri Lanka

**Professional II Stage
September 2007 Examination**

Examination Date : 30th September 2007
Examination Time : 9.30 a. m.- 12.30 p.m.

No. of Pages : 09
No. of Questions: 01

Instructions to candidates:

1. Time allowed is **three (3) hours**.
2. Attached to the question are **Scenario I** given in advance and **Scenario II**
3. Answers should be entirely in **English language**.

<u>Subject</u>	<u>Subject Code</u>
Case Study	(CAS)

Question (100 Marks)

The Immortal Spice

You have been appointed as the Management Consultant by the Directors of the Immortal Spice Company (Pvt) Ltd

Prepare a report that prioritize the key issues facing the company and make appropriate recommendations.

The Immortal Spice

Scenario I

Sri Lankan Cinnamon

Cinnamon originating from Sri Lanka was always a commodity of much value and prestige. Sri Lankan cinnamon is special due to the unique soil structure in Sri Lanka. Sri Lanka has approximately a 70% market share globally. Cinnamon exports accounts for 50% of the annual spice exports, 17% of agricultural exports and 1% of total exports. Sri Lankan cinnamon has secured HS code globally, a big victory. Ceylon Cinnamon and Sri Lanka's affinity is so strong that the very botanical name of the spice - *Cinnamomum zeylanicum* is derived from the island's former name, Ceylon. The name *cinnamon* is correctly used to refer to Ceylon Cinnamon, also known as "true cinnamon"

There are three types of Cinnamon products:

1. Cinnamon Bark
2. Cinnamon Bark Oil
3. Cinnamon Leaf Oil

Cinnamon bark is the dried inner bark, stripped of its outer cork layer, which is peeled from thin stems and twigs of the cinnamon tree. Spices are processed, cleaned, graded and specially packaged. In consumer countries, they are cleaned and graded again. Odor of Cinnamon is aromatic and spicy, while its flavor may be hot and pungent. Powdered or rolled bark is blended with cardamom, cloves, lemon grass, pepper and other spices to make curries and side dishes in the region. It is also a component of Arab babarat, Moroccan rasel hanout, Tunisian galat dagga, Ethiopian berebere and French quatre epices. It's also used for biscuits, breads, confectioneries, chocolate, flavored coffee and tea, fruit preservatives, sauces, gherkin, pickles, sherbet, punch and mulled wine. Mexico, largest importer of Sri Lankan Cinnamon, boils the bark in water and uses the extract as a beverage similar to tea.

Waste from Cinnamon processing is used to manufacture bark oil, widely used in cookeries and confectioneries. It's also used for medical purposes such as stopping vomiting, stimulating the appetites of anorexics, or relieving flatulence, diarrhea, and hemorrhaging of the womb. Bark oil is one of the most powerful stimulants that can be manufactured. It is sometimes used as a cordial to treat cramps of the stomach, paralysis of the tongue or to deaden the nerve in a toothache. However, its principle use is as an aromatic to cover the disagreeable taste of other spices.

Cinnamon leaf oil produced from bark is used for aromatic liqueurs and cosmetics. World demand for cinnamon leaf oil has been around 120-150 tones per annum in recent years, met almost entirely by Sri Lanka. United States of America and Western Europe are the largest markets for cinnamon leaf oil. Imports into France and the UK have fallen in the last few years. Hong Kong is a significant importer although most of the oil is re-exported. The ready availability of eugenol from clove leaf oil has led to some loss in markets for cinnamon leaf oil. When eugenol from cinnamon leaf oil is processed further, the output iso-eugenol, possesses a more desirable aroma and flavour than the iso-eugenol derived from clove leaf oil. For most other purposes, however, the cheaper eugenol from clove leaf oil is preferred. Madagascar and the Seychelles have been intermittent suppliers of clove leaf oil on a very minor scale in the past. India produces very small amounts of clove leaf oil for domestic use.

All spices exported are in 3 forms. 1. Whole 2. Ground (powdered or fragmented) 3. Derivatives (e.g. oils). In Sri Lanka Cinnamon is predominantly grown in the Southern province. Main markets for Sri Lanka are Mexico, India, USA, Peru and Columbia. Some members of Sri Lankan spice industry have invested in superior distillation equipment, creating a general interest in the export of derivatives. Most Sri Lankan exporters sell spices through brokers or commission agents, who supply it to grinders or processors and subsequently sell it to the food manufacturing companies, food servicing companies and retailers.

The Sri Lanka Government has established a Cinnamon development fund for research and development, and has imposed a cess on the export of Cinnamon to finance this fund.

The Sri Lanka Spice Council, established in 2001 with the assistance of USAID, developed a cluster of growers, traders, distillers, governmental departments and ministries, to respond to the challenges facing the industry. They facilitate and implement competitive strategies.

University of Ruhuna recently developed an innovative machine to mechanise the rubbing process to reduce the involvement of labour and improve the quality of quills.

Nutritional effect

Cinnamon has unique medicinal properties. Throughout history, cinnamon has been linked to anti-clotting actions, anti-microbial activity, boosting brain function and aiding digestion. Perhaps cinnamon is most notable for its ability to reduce blood sugar, cholesterol and triglyceride levels in people with type 2 diabetes. A 2006 study published in the European Journal of Clinical Investigation found that cinnamon extract had a moderate effect on reducing fasting plasma glucose concentrations in type 2 diabetics. A large study published in Diabetes Care in 2003 reported that an intake of 1, 3, or 6 grams of cinnamon per day reduced serum glucose, triglyceride, LDL cholesterol, and total cholesterol in people with type 2 diabetes.

History

Mankind has been associated with Cinnamon since Egyptian era. Cinnamon has been mentioned in several books of bible – for instance as an ingredient in Mose’s anointing oils. Ancient Rome mourners burnt cinnamon in funeral pyres. It was a status symbol for Europe’s elite. The Book of Exodus of 1500 BC gives us a traditional application for anointing preparations. The gentle and subtle flavour of cinnamon causes those who know its story to call it the ‘Immortal spice’. Over the years, its popularity drew traders to monopolize the market. Merchants in Venice were monopolizing the trade for centuries, delivered by Arab merchants who closely guarded the secret of sourcing cinnamon. Some scholars speculate that upper crust of Europe’s society consumed large quantities of cinnamon in Middle Ages to cover up the taste of meat which began spoiling during the winter. It was a symbol of wealth. Cinnamon was reported to cure various ailments including coughs and indigestion during the middle ages.

The Sri Lankan Cinnamon industry began during the Portuguese period. The members of ‘Salagama’ caste were largely involved in the industry. They peeled the bark of young shoots of the cinnamon plant in the raining season, when the bark was more pliable. During the peeling process they curled the bark into the ‘stick’ shape still associated with the spice today. In the late 15th century, the profits the Portuguese made from exporting the Cinnamon from Ceylon to Calicut in India, were ten fold. To protect the monopoly Portuguese enslaved the Sinhalese, sank Arab dhows and hanged the agents of European competitors. Once more valuable than gold, Cinnamon was the cause of trade wars among the Portuguese, Dutch, French and English, who fought for the control of cinnamon trade in Sri Lanka

Risk Factors

One of the major problems faced by this industry is transportation of the Cinnamon. There is a risk of breakage, contamination with other spices and food items and exposed to humidity and moisture. Transport temperature has to be in the range of 150 C⁰ to 190 C⁰ and the cinnamon must be kept in a dry area.

Cinnamon peelers, many of whom live in the coastal areas, were seriously affected by Tsunami. In the Galle district alone, 136 acres of Cinnamon cultivation was damaged. Most of the workers are now unemployed, and the businessmen are not in a position to restart their business due to financial difficulties and loss of equipments.

Lack of marketing skills has been identified as another major problem which forces the small scale businesses to sell their produce at lower prices to the agents. Inadequate financial support has compelled many businesses to close down their operations. Use of poor technology and inadequate training affects the quality and increases the cost of production. Lack of International quality certification (ISO) is also a barrier for Sri Lankan Cinnamon traders to market their produce globally.

Sri Lanka is far behind other countries in the export of value-added spices. There is increasing demand for Organic Spices and Sri Lanka is lagging behind other countries in growing organic produce.

Apart from improvements in distillation practice, the greatest advances in productivity and quality will come from breeding programmes aimed at producing superior germplasm for planting. Some progress has already been made in identifying mother plants which give high yields of oil and high cinnamaldehyde and eugenol contents in the bark and leaves. This work needs to be continued.

Competition

Currently Sri Lanka controls 70% of global demand followed by Indonesia and Madagascar. Indonesia produces Cinnamon *Burmannii* rather than Cinnamon *zeylencium*. Indonesian Cinnamon quills are thicker and less delicate in nature but the taste is almost indistinguishable from the best grades of Sri Lanka, cinnamon. In Indonesia, Cinnamon and Coffee crops are inter-cropped to provide a sustainable agricultural approach in the forest margins of Sumatra, Indonesia.

Immortal Spice

Southern Spices was established in 1940 by the late Edmund Halagama. After his death, it was taken over by his three sons Sarath, Kumar and Ravi. In 1998, it was converted to a limited liability company and the name was changed to 'The Immortal Spice Company (Private) Limited'.

Their main line of business is exporting Cinnamon to Mexico, the UK and India. They have a few regular importers from these countries, with whom they have developed a long standing relationship. They purchase cinnamon from approximately fifty suppliers from the Galle district. The cinnamon is transported to their factory at Ekala, where it is cleaned, processed and packaged.

Sarath has a degree in Agriculture from University of Peradeniya and he heads production. Kumar, employed in the UK for five years as a marketing manager for a leading FMCG, has returned back to Sri Lanka to take over the marketing side of his family business. Ravi manages the Finance, HR and the logistics. Immortal Spice has 100 employees at the Ekala factory. In 2004, they have developed their own brand 'Immortal'. Kumar is actively involved in designing innovative packaging for their products and promoting their brands overseas. Recently they started a small quality control and testing section within the factory to monitor and improve the quality. They also fund a research project at a State University, to develop innovative manufacturing processes and to automate some of the practices of their suppliers.

Vision

Vision of the company was to develop a strong global cinnamon brand and be the market leader in cinnamon exports. They strongly feel that for sustainable competitive advantage and better margins they need to have a powerful brand. Branding will be a key strength in the negotiation with their buyers and removal of a few intermediaries. They are also very concerned about the quality. Company has a policy of making the highest quality cinnamon in the world

Pricing

50% of their sales are generated from higher grade cinnamon which is sold at a premium price. Immortal's prices are 25% higher than its rivals. The directors are always in dispute on the pricing strategy. Kumar wants to reduce the prices by 10%. He feels the price reduction will increase the volume by 30%. Kumar is of the view that by reducing the price, the company can provide a better value for money to its customers, and penetrate new markets occupied by immortal's rivals. Ravi is against a price reduction as it will have an impact on profits and liquidity. Ravi is of the view that the company should continue with its premium pricing and utilize its additional margin for brand building, and penetrate to new markets through its powerful branding.

Product development

In the last board meeting, Sarath suggested to diversify into other spices for higher growth and better profits. He stated that the company is over reliant on cinnamon and by diversifying they can spread the risk. But two other directors are against this suggestion. They feel, diversification to other spices will dilute their focus on their core competency area and may lead to neglecting the current potential for growth in the Cinnamon trade.

Suppliers

Five of their major suppliers closed down their businesses after the Tsunami and have not restarted their operations. This has affected the supply of the cinnamon barks. These suppliers are well experienced and trained on this operation. They expect financial assistance from Immortal Spice. Sarath and Kumar are keen in financing some of their suppliers. But Ravi is against this move due to Immortal's tight liquidity situation. There have been several rounds of discussions on the issue of philanthropic responsibility of restoring the livelihood of the past suppliers compared to the option of buying spices from new suppliers.

One of the suppliers, Somapala Brothers, has offered to sell their 2 acre land at Rs.30,000 per perch to Immortal Spice. Part of their land has been affected by the Tsunami tidal waves and it may take two or three months to start cultivating the lands. Market prices of these lands are in the region of Rs.50,000 per perch.

E-commerce

Senaka is a close friend of Kumar and suggested developing a website to globally market the products. He runs his own IT company which specializes in web page development and web hosting services. They have successfully hosted 25 websites during the last two years. Cost of designing ranges from Rs.50,000 to Rs.500,000 depending on the extent of creativity needed, sophistication, and the services provided.

Extranet

Mexican Spices is a regular buyer of the company from Mexico with a 10% share of the total sales. They have requested Immortal Spice to get linked to their Extranet for online e-orders and better communication. The proposed extranet system needs better bandwidth and they have suggested moving to MPLS or IPLC technology. Sri Lanka Dialog and Sri Lanka Telecom offer this facility, but the connection fees and monthly rentals are reportedly very high.

Quality Management

Newly recruited Quality controller has suggested applying for ISO certification. The Board is seriously analyzing this option and all directors feel they should immediately start the ground work for the certification. A meeting was held with a consultancy firm. They have agreed to provide the ISO consultancy, to assist Immortal Spice with documentation, training and quality audit services. They are expecting a fee of Rs.700,000 for the total service package. Now the board is having second thoughts on pursuing ISO certification.

Bank Loans

Immortal Spice currently has the following loans at NDB Bank.

Facility	Outstanding Loans (in Rs. Millions)
Term Loan 1	20.0
Term Loan 2	10.0
Overdraft	5.3
Packing credit loan	8.2
Export bill purchasing	16.2

The above facilities are secured against the factory property and a valuable residential property of the directors.

Eight installments of Term Loan 1 have been defaulted and the total amount in arrears is Rs.5 Million. The bank recovery manager has warned that if the arrears are not settled within a month, the bank will be compelled to take legal action to recover their dues. This loan has been secured against the residential property owned by the directors. The directors have been advised by the lawyers that due to the recent changes in the Banking Act , the bank cannot undertake parate action on third party properties.

The financial statements of Immortal Spice are in the appendix.

Appendix 1

Profit and Loss account

	Year ended 31/12/05 (In Rs. Million)	Year ended 31/12/06 (In Rs. Million)
Turnover	400	450
Cost of production	(200)	(225)
Contribution	200	225
Labour cost	(40)	(43)
Depreciation	(25)	(27)
Marketing cost	(10)	(15)
Distribution cost	(40)	(50)
Interest	<u>(10)</u>	<u>(12)</u>
Profit before tax	75	78
Tax	<u>(22)</u>	<u>(23)</u>
Profit after tax	<u>53</u>	<u>55</u>

Appendix 2

Balance Sheet

	As at 31/12/05 (In Rs. Millions)	As at 31/12/06 (In Rs. Millions)
Fixed Assets	200	231
Current Assets:		
Stock	40	55
Debtors	35	45
Cash	15	5
Total	90	105
Total Assets	<u>290</u>	<u>336</u>
Share Capital	50	50
Retained Profit	147	202
Term loan 1	22	20
Term Loan 2	11	10
Current Liabilities:		
Accruals & creditors	40	30
Export financing facilities	17	20
Bank Overdraft	3	4
Total Liabilities	<u>93</u>	<u>84</u>

End of Scenario I

Scenario 2 – A continuation of Scenario 1

Spiceline

Immortal Spice was recently approached by a new customer from USA, who informed them that their regular supplier from Indonesia, Spiceline has gone bankrupt and they are keen in sourcing future cinnamon requirements from Immortal Spice.

Subsequently Sarath visited Spiceline in Indonesia and offered to take over their business at a price of USD 600,000. Based on his initial discussion with the directors of Spiceline he feels that the failure of the company is mainly due to mismanagement and Immortal Spice can easily turnaround the company within few months. They have incurred an average annual loss of USD 50,000 during the last three years. They have average sales of USD 700,000 per annum with a contribution of 10%. The industry is expected to grow at a rate of 10% p.a. and Sarath is confident that they can reduce their overheads by 30% if they take over Spiceline and increase the price and gross margin by 25% of the premium brands of Immortal Spice.

European Office

Kumar suggested to the board that Immortal Spice establish a regional office in the UK as a subsidiary to directly handle the European distribution. This will help them to get rid of the agents and directly be in touch with the food manufacturers and retailers. With the development and expansion of the European Union, there are more opportunities to penetrate into other European countries as well. For this operation they need to invest at least Euro 200,000. Sales revenue are expected to increase by 10% and the gross margin on new sales are expected to be 5% higher than normal sales.

Somapala Brothers

Somapala Brothers have now been approached by a rival company of Immortal Spice. The rival has offered a price of Rs 40,000 per perch for the entire parcel of land. The rival company has got to know recently that around 20% of the land of Somapala Brothers has been affected by Tsunami.

DFCC

Ravi has approached DFCC bank last month and started negotiation with them for a loan of Rs.50 Million to settle the arrears at NDB Bank and finance the planned expansion. He has agreed to offer a valuable ancestral property of the family as collateral. The other two directors are against this mortgage.

Quality

Since January 2007, they have started receiving complaints on quality. One of the regular customers in Mexico (Alberto Cinno plc) has already stopped buying due to the high level of moisture in the barks and poor packaging. Mexican Spice has already sent a letter complaining about the quality and is demanding a refund of 10% of the order value.

Trade Union

Recently 75% of the employees of the company have formed a Trade Union which is affiliated to the Inter Company Employees Union of the JVP. The President of the Branch union has sent a letter with a long list of demands which include a 40% salary hike, three months bonus etc. Management is very disturbed with this move and informed the employees that if they don't resign from the union, directors will close down the company and start a new factory in another region. This has aggravated the Union and they have informed management of their intent to a strike within a week.

Management Consultant

The Directors collectively agreed to appoint a Consultant to advise them on the current issues and opportunities and to provide advise on implementation of modern techniques like Benchmarking, Total Quality Management, Activity Based Management and the Balance Scorecard.

Cost of capital of the company is at 12%.

USD = Rs.110/-

Euro = Rs.150/-

End of Scenario II
End of Question Paper
