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PILOT PAPER – 2023-2027 SYLLABUS

SL4.5 Integrative Case Study

Strategic Level

ANSWER KEY

- a) **Provide a critical assessment of the current state of affairs of the company via:**
- i. A financial analysis to highlight the overall profitability, segmental profitability and liquidity of the company; (16 marks)

Sun, Sands and Hills Ltd

Financial Analysis

Indicator	Formula	2022	2021
Profitability			
Return on Equity %	Profit before tax/ Equity	0.53%	-0.55%
Return on capital employed %	Profit before tax/ Capital	0.35%	-0.35%
Gross Profit %	Gross Profit/ Sales	30%	35%
Operating Profit %	Operating Profit/ Sales	9.5%	9.9 %
Net Profit %	Profit before Tax/ Sales	0.68%	-0.85%
Liquidity			
Current ratio	Current Assets/ Current Liabilities	0.51	0.56
Acid test ratio	Liquid Assets/ Current Liabilities	0.40	0.46
Leverage/ Debt servicing			
Interest cover	Operating Profit/ Finance Costs	1.07	0.92

In search/ assessment of causal factors for the above observations:

Indicator	2022 over 2021
Sales	^ 25%
Cost of Sales	^ 35%
Gross Profit	^ 7%
Selling & Distribution	^ 17%
Administrative	∨ 5%
Operating Profit	^ 19%
Profit before Tax	^ 200%

Financial Analysis (cont.)

Segmental Analysis

	Change of Revenue (Rs. '000s) 2022 over 2021	Change of Gross Profit (Rs. '000s) 2022 over 2021	Gross Profit % 2022	Gross Profit % 2021
Company	^119,000	^178,500	30	35
Inbound/ Domestic	∨ 8,330	∨13,209	30	35
Outbound	^67,830	^16,137	31	35
Transport	^11,400	^773	36	43
Guest-houses	^47,600	^8,118	25	30

Possible inferences:

- 1) Overall profitability (Return on Equity and Return on Capital Employed) is exceedingly low (less than 1% and negative respectively) caused due to high finance (in the range of Rs. 50 million) costs. If not, they would be in the range of 6-8%)
- 2) Though revenue has gone up by 25%, cost of sales has gone up by 35% causing the gross profit to increase only by 7%. As a result, a dip in the GP% from 35% to 30% is observed in 2022 when compared with 2021. The same trend is observed in all the segments which calls for a review of costs.
- 3) Inbound/ domestic unit has recorded a drop in revenue as well as gross profit which is largely owing to the inefficiency of the Inbound sector driven by the liaison office.
- 4) The same trend is observed in operating profits and a wide dip in the net profit % (0.68% and -085%) with the latter caused owing to the payment of exorbitant finance costs.
- 5) The only positive aspect regarding managing costs seems to be the administrative costs (a drop of 5%) while selling and distribution costs have gone up by 17% in 2022 when compared with 2021.
- 6) The liquidity issue is evident by the exceedingly low current and acid test ratios.
- 7) The liquidity issue is further confirmed by the exceedingly low interest cover ratios.

Based on the above the major issues confronted by the organization are:

- The liquidity issue where the company finds it difficult to repay even the annual finance costs, leave alone the principal payments.
- Poor management of the inbound unit (the European segment).
- Ineffective management of costs all around.

- ii. An interpretation of the grid on market attractiveness and competitive position:
(04 marks)

(Total = 20 marks)

Market Attractiveness and Competitive Positions of different divisions of SSH

	Market attractiveness	Competitive position	Inference
Inbound- Foreign	H	L	Mismatch
Inbound-Domestic	L	H	Mismatch
Outbound	L	H	Mismatch
Transport	H	H	Matching
Guest-houses	H	H	Matching

Analysis of the grid [Comparison of market attractiveness (external factors) against Competitive position (internal factors/ resource allocation)] results in the Table given above.

According to the Table, compatibility exists only with respect to Transport and Guest-houses units. Concerning Inbound-Foreign unit resources allocation is lagging when compared to the market attractiveness while it's the opposite with respect to Inbound-Domestic and Outbound units. These are areas where action is required to be taken regarding resource allocation (such as further investments or divestments) and to be duly incorporated in strategy formulation.

- b) Justify the viability of the proposed debt-servicing plan under the stated assumptions: (15 marks)**

The company needs to pay attention to the importance of developing the inbound tourism segment (according to the analysis above, Market attractiveness is high while Competitive position is low) which is after all the core business of SSH. In compliance with information provided the debt-servicing plan can be presented as follows:

	Guest-houses	Transport
Current revenue	119 Rs. Mn.	. 60 Rs. Mn
Capacity utilization	70%	70%
Forecast utilization	90%	90%
Increased revenue	34 Rs. Mn.	17 Rs. Mn.

Gross Profit %	25%	36%
Increased Gross Profit	8.5 Rs. Mn.	6.0 Rs. Mn

Total increase in Gross Profit/ Cash-flow will be Rs. 15 Mn. Less increase in annual fixed costs of Rs. 4.5 Mn. i.e. approximately Rs. 10 Mn.

Currently (2022), the company's profitability is around Rs. 4 Mn. Therefore, the total increase in Gross Profit/ Cash flow amounts to Rs. 14 Million.

The annual capital instalment of a 7 year Rs. 400 Mn. loan (restructured) is Rs. 58 Million approximately.

Therefore, the gap to be bridged is Rs. 58 Million – Rs. 14 Million = Rs. 44 Mn per year. In order to generate this amount of Gross Profit the required increase of Revenue from other segments (Inbound-Foreign Travel and Outbound Travel) will be Rs. 146 Million. This should be possible by paying more attention to Inbound- Foreign Travel which has been the company's core-business which seems to be lagging at the moment, supplemented by Outbound Travel. In this exercise, attention was paid to payment of loan principal as the interest payments could be met out of the current revenues.

Thus, if the above plan is implemented with meticulous care the funds required to meet the interest and the payment of the principal could be found.

Note: The above computations were carried out using approximate Revenue and Cost figures which is how it should be looked at.

- c) Advise how the 'real' profitability (using Economic Value Added) of the company and its divisions could be measured based on the performance of 2022. Clearly state your assumptions and any further information requirements. (10 marks)**

How to ascertain the 'real profitability' of SSH and SBUs.

Company (SSH) level (05 marks)

Economic Value Added (EVA) can be used to measure the real profitability of the business
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Net Operating Profit After Tax (NOPAT) - Capital Charge (Total Equity- Non-Current Liabilities) x (WACC) Weighted Average Cost of Capital.

Based on Net Operating Profits for 2022:

Gross Profit	179 Rs. Mn.
Less: Recurrent/Operating Expenditure (Administration and Selling)	126 Rs. Mn
NOPAT [tax impact is ignored here]	53 Rs. Mn.

Less: Capital charge Rs. 12 Bn. x 20%	240 Rs. Mn
EVA	(187) Rs. Mn

Thus, the negative EVA is indicative of the overall deficit illustrated by the operations at SSH in a comparative sense.

SBU Level (05 marks)

The limited information that is available will not permit computation of the 'real' profitability of the different SBUs. In order for this to be ascertained the information required would be the dedicated costs for the different SBUs (salaries and other overheads that can be specifically identified) as well as the capital costs attributable to each. This could be achieved via a thorough Activity Based Costing (ABC) exercise carried out within the company. This line of computation will provide additional strength to the inferences arrived at through an analysis of Market strength and Competitive Position.

d) Critically comment on the possible impact of the following on the current status of the company:

- i. Absence of a General Manager;
- ii. The Finance unit;
- iii. The Human Relations unit; and
- iv. MIS unit. (10 marks)

It can be inferred that the above factors have had a considerable impact on the current status of the company. Their inclusion/ upgrading is greatly recommended as the following line of argument reveals.

Absence of a General Manager:

- The company was hitherto managed by the Chairman (NS) and the Managing Director (RK) who were experts in narrow fields of discipline, foreign travel and marketing respectively. They did not have a broad understanding of general management.
- Neither did they attempt to acquire general managerial skills through formal learning etc.
- Further, they did not have a balanced approach and grabbed opportunities as they came to their view.
- Presence of a General Manager would have enabled the identification of some of the issues (purchase of the corporate office funded through a loan).

- Thus, even in this late stage obtaining the services of a General Manager and positioning him/ her as the third in command (above functional managers) would be of benefit.

The Finance unit

- The Finance unit was confined to a part qualified accountant involved in stewardship accounting.
- Later preparation of final accounts was handed to an outside party.
- It is very likely that interpretation of final accounts, ratio analysis, cash flow management and techniques of Management Accounting were unheard of in the company.
- Although the company managed to continue unscathed for well-nigh 26 years the decision to move into its own premises through a colossal loan brought liquidity problems which would have been averted if they had a properly constituted Finance unit.
- It's unthinkable that a company as developed as SSH Ltd could have come this long with the little respect they paid to the Finance unit.
- Hence, it is imperative that they approach setting up a Finance unit without delay and further, build it up gradually in the context of the cash-strapped situation.

The Human Relations (HR) unit

- The HR unit was at an elementary level which consisted of an HR officer reporting to the Accountant.
- The functions of the HR officer were confined to recruiting personnel and maintaining their records.
- They did not have modern HR practices in place including systematic recruitment, training and development and implementing rewarding methods.
- It's likely that the Guest-houses unit was affected in particular owing to the absence of a sound HR unit. This is because no training and development of the staff was effected.
- Thus, upgrading of the HR unit is of immense importance.

MIS unit

- The company had a most rudimentary kind of MIS unit under the Manager Marketing.

- They were in possession of a system of very low sophistication with a few applications covering limited personnel.
- It seems that it was hardly used for control purposes.
- A big mismatch would have prevailed between the information needs and the supply.
- Perhaps the website ought to come within the main company. It's particularly in the context of poor performance of the liaison office in the Netherlands.
- It will be of immense relevance to examine the information need and upgrade the MIS system in a phased-out manner.

Thus, it's apparent that all four aspects have to be given serious thought and incorporated into evaluating associated costs and benefits.

- e) Identify five fundamental reasons, in addition to what was discussed in part (d) above, that would have driven the company (including matters arising from the liaison office) to its current status. Recommend strategies (corporate/ functional/ operational) for rectification of lapses observed. (25 marks)**

Major ground-level causes for the malady are:

- Continuing closed circuit mentality of the founder and friend.
- Absence of clear direction for the company and over-dependence on emergent strategies.
- Casual approach to setting up of the liaison office, loose relations and inefficiencies.
- Lack of professionals who could meet the heavy challenges of the day.
- Lapses in how the organization is structured with unclear/ unusual linkages.
- Lack of systems, procedures and controls, corporate as well as at the unit level.
- Dearth of financial discipline caused by lack of expertise in the area of management accounting and financial management.

Recommend strategies (corporate/ functional/ operational) for rectification of lapses:

The strategies presented are of a generic nature.

Corporate Level:

- Review activities of SSH at the corporate level and proceed to set up the Vision, Mission, Values and Objectives for which the assistance of a Management Consultant could be sought.

- Revisit the association with the liaison office and decide how it could be reconstituted for greater efficiency. Explore the possibility of having a stronger link with the company.
- Develop a strategic plan for the next 3-5 years.
- Review the organization structure in the light of the strategic plan and decide on the changes to be made.
- Decide on appointment of a few qualified and experienced for key positions including primarily a General Manager.

Functional Level:

- Reconstitute the units Finance, HR and MIS.
- Decide on functional level systems, procedures and controls.
- Decide on the appointments to be made in the light of the need and availability of funds.

Operational Level:

- Decide on functional level systems, procedures and controls.
- The development of the website within the MIS unit.

f) In light of the information given above and the suggested strategy imperatives recommend changes (with rationale) to be introduced to the organization chart. (10 marks)

Please include the proposed organizational structure.

- * The Manager Finance and the Managers (Operations, Hotels, Marketing and Transport) to form the Core management team.
- Managers HR and MIS constitute staff-level managers.
- The above structure emerges out of the deliberations given above.
- Any other logical structure including deviations to the above (with justification) will be acceptable.

Overall presentation and the covering letter

The covering letter given on the lines of the specimen will merit 05 marks, but adjusted on a pro-rata basis depending on the contents included.

Overall presentation of above average will merit 05 marks, but adjusted on a pro-rata basis depending on the deviations. (Total 10 marks)

(Grand Total 100 marks)

The Covering Letter

Amara de Silva
270, Thilaka Mawatha
Moratuwa

June 29, 2023

Mr. Nihil Simons
Chairman,
Sun, Sand, and Hills Ltd.,
Colombo 4.

Dear Mr. Simons,

Turning-around of SSH Ltd., Consulting Report

This report is the outcome of the consultancy assignment carried out by the undersigned for Sun, Sand and Hills Ltd. detailing ways and means of turning round the company from the unsatisfactory state it is confronted with.

The consultancy assignment was of four calendar month duration, from March 1, 2023 to June 30, 2023 with the first two months (March and April) allocated for collection of data and the next two months (May and June) for analysis and writing the report. The process involved visiting different locations including the liaison office in the Netherlands, conduct of in-depth interviews and synthesis and analysis of information. Further, Miss Ruwanthi Gamage was associated as the assistant consultant.

The report is organized in a logical sequence in order to ensure easy comprehension. It begins with the current state of the organization and associated reasons, followed by strategies and organizational changes to be effected. On receiving approval for the report the action plan will be presented.

The report is attached herewith for your perusal and necessary action. I shall be pleased to discuss and clarify any matters arising.

We thank you for the cooperation extended during the period of the consultancy.

Amara de Silva
June 28, 2023.
