



Institute of Certified Management Accountants of Sri Lanka
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May 2021 Examination

Apex Level
ICS – 501 Integrative Case Study
Scenario I

No. of Pages: 10

Scenario I

Forever Construction Company Ltd (FCL)

Company Background

Forever Construction Ltd (FCL) is a medium sized construction organization founded by an engineer Malaka, a civil engineering graduate from University of Moratuwa and a Quantity Surveyor, Nalinda a batch mate of Malaka. The company became operational in the year 2009 when they commenced business in the field of civil construction, being the profession of both founder shareholders. After qualifying in the mid-nineties from the University, both of them had their initial exposure in the construction industry at the State Engineering and Construction Corporation (SECC) which was the principal state sector organization primarily engaged in construction, while Malaka opted to stay in the country and build his career in the private sector after his initial stint at SECC, Nalinda pursued an overseas engagement in Saudi Arabia for an attractive remuneration with all facilities.

Both of them, even during their formative years in the profession since qualifying, shared the ambition and passion of having their own business one day. Despite been distantly apart when Nalinda was overseas, they were in constant contact designing their long-term mission of forming a construction firm in Sri Lanka. Having inherited wealth from his family, Malaka was ready to commence business when Nalinda returned from Saudi with his accumulation of savings from his overseas employment.

Forever Construction Ltd (FCL) was incorporated in 2008 and commenced their operations in 2009. Some pertinent information about the company in its initial years, up to current position, is given below:

FCL Internal Affairs

Strategic and Cultural:

- The shareholding was an equal spread between the two founding partners as well as being the only directors of the firm. The mission of the company has been agreed informally to be restricted to the area of Colombo district and confined to the construction of medium scale commercial buildings.

- After about three years in operation, it was agreed by the directors to earn maximum possible profit and invest in land and buildings. It was evident that by the year 2013 when FCL purchased the property that is located in a suburb which the company initially occupied on rent as its main office premises.
- The directors are firm believers of 'Cash Flow' as the driving force of a business. In the minds of the directors, cash flow simply means the ability by the Operations and Project implementation to obtain progress payments, as per the initially agreed terms of payment. Cash flow management is considered to be the best form of control and this philosophy is a belief and the directors also prefer the accounting division advocates this line of thinking. For example, FCL gives preference to construction projects with healthy cash flow, when deciding the priority of making payments in relation to purchases of raw materials for different projects.
- All payments to the financial institutions are considered as top priority, including loan repayments of the property loans.
- From the point of view of the shareholders, the company has enjoyed success continued for a decade by the year 2019 in terms of shareholder wealth when taking into account the totality of the market values of the company assets.

Having reached a turnover level of approximate Rs 200 Mn by 2012, within three years since commencement in the year 2009, the directors expressed that their commitment and ability to carry out and complete projects have enabled the company to reach a level of Rs 400mn in the year 2017. In the process they have developed a loyal client base with repeat business and some long standing, trustworthy technical staff were among the reasons cited by directors as further justification of FCL's success.

Marketing, Operations and Organizational structure:

- As professionals in the field of construction both directors prefer being fully engaged in the business. With a view to maximize their contribution to the business, the arrangement was for them to canvass business by both directors using their professional contacts. Each construction business opportunity successfully obtained by the company was termed as a 'project' and all projects for overall supervision were divided between the two directors depend on their respective canvassing successes.

- Relationship marketing was considered to be of utmost importance and the life blood of marketing success. From commencement to conclusion, each respective director will be personally in touch with the owners of the projects and attend to any trouble shooting.
- Each project was managed by a 'Site Engineer' who in turn reports to a 'Project Manager' and currently there are four project managers reporting to the two Directors. The company presently has eight projects in progress, out of which five are under Malaka.
- There is a contingent of 'Quantity Surveyors' at the head office that is considered a core team assisting the project managers in arriving at estimates, quotations, measuring the value of works done, project invoicing and follow up of retention money. Each quantity surveyor is allocated to a project from the stage of estimation and will be associated with that project until receipt of the final retention money. Their total expenses are included under 'administration expenses' in the financial statements that account for nearly 20% of such.

Financial, Accounting, HR and divisional Structure of the finance function:

- FCL assets, apart from the head office premises also include a property which has been acquired primarily for investment purpose in the year 2016. This is a property at Homagama that the company has earlier rented and utilized as a temporary shelter for accumulation of raw materials that represent the excesses at different construction sites.
- All major items of machinery, vehicles of the directors and transport vehicles are leased.
- Part of the initial capital was placed as fixed deposits with commercial banks and working capital was raised as overdrafts on the strength of such deposits along with the accumulated interest. This practice also continued whenever it was possible, especially during the years of prosperity, and after the declaration of dividends.
- A key aspect of financial policy agreed by the directors of FCL and shared with the accounting staff is that the company's 'direct' borrowings for projects such as company overdrafts will only be on the strength of fixed deposits held by the company. The fixed assets such as land and buildings can only be mortgaged to obtain loans for such assets at the point of purchase and also to obtain a range of bank guarantees. Such guarantees are an integral part of bank facilities and the working capital financing in any company engaged in the construction industry. A construction company's business model essentially requires several bank guarantees such as 'bid bonds', 'advance payment guarantees' and

'performance bonds'. All these three instruments are required to successfully obtain and complete a construction project.

- Further, as mentioned above, in a construction business, several guarantees of different varieties are outstanding at any point of time in the company's working capital cycle.
- The directors feel that once the loans are repaid and on retirement, they can enjoy the capital gains on properties, as well-earned rewards for their sacrifices and entrepreneurship.
- Hands on in the business, the two directors control both finance and the overall operations of their respective projects. The accountant reports directly to both directors, and she is assisted by three assistants. This team attends to all banking, payments, wages and salaries, including sub contractors' payments of construction sites, statutory payments such as VAT, EPF, ETF and company return etc, and the preparation of annual accounts and taxation related issues.
- Most of the HR functions such as issuing of appointment letters of performance assessments, monitoring and reward practices such as annual increments, if there are any, are attended by the directors. The payment of senior management salaries and related bank remittances, being confidential, is the responsibility of the accountant who has been with the company almost from its inception. She is considered to be very trustworthy, however, due to constant pressure of work she was not able to progress her studies beyond the intermediate level of a professional accounting body.
- The Accounting and project information are processed using a 'QuickBooks' computer package and one assistant of the accountant manages the data entry operation.
- FCL does not have a formal store operation system which carries inventories of even common construction materials. All materials for each project are ordered 'Just-in-time', as and when required from the FCL's network of suppliers from whom they can obtain credit up to a maximum of two months. All orders for materials have to be signed by the site engineer and are forwarded to the accounts department. After further scrutiny by the respective director, the date of payment of each invoice and the respective bank on which a cheque is to be issued are also decided by the director with the guidance of the accountant.

- Also, the company operates through a network of labor contractors who will give FCL a month's credit and by such arrangement has avoided dealing with own construction labour force.

Project Costing / Pricing Details

FCL's 'pricing' formula:

- All direct costs comprising materials and labor from sub-contractors are considered as 'Prime Cost' that could be reasonably estimated when preparing quotations as these are based on BOQs. Further on account of construction overheads that are difficult to be estimated at the point of submitting client quotations, 15 % of prime cost are accounted in the pricing formula. Accordingly,

Project Direct Cost = Prime cost + 15% of Prime Cost

Quoted price (without VAT) = Project Direct Cost + 40% of project direct Cost
(that includes the profit margin)

Final price is negotiated and agreed upon by the director in charge of each project.

Figure 01 : Property acquisition details

Property	Date of Acquisition	Purchase Price	Bank Loan	Terms of repayment	Market value as on 31st March 2021
Head Office	1 st April 2013	90 mn	80mn	Two-year grace period/ interest at 15% p.a., 15-year equated installments*	Approx.150mn
Yard Premises	1 st April 2016	45 mn	40mn	Two-year grace period / interest at 15% p.a., 15-year equated installments*	Approx. 60mn

**Interest only to be served in the first two years and loan repayments commence from the end of the third year, as equated annual installments.*

Concerns of the Directors of FCL

The first phase of Post Covid – 19 era caused lots of operational and financial issues and such problems prompted the directors of FCL calling advice from a financial consultant. During their initial discussions with the consultant- Mr. Dillon, the following concerns, problems and intentions were expressed:

- Not receiving sufficient financial information from the Finance section regarding the cost updates in relation to projects such as cumulative sub contractors' payments in relation to each sub-contractor, project wise. Such delays can adversely affect the project's cost controls.
- Delays in obtaining timely audited accounts that affect the directors in negotiating for projects. Submission of up-to date audited accounts are a compulsory requirement as per most projects' tender documents.
- The accountant has been indicating her intention to leave the company after nearly a decade of service at FCL. Given that the accounts division consists of new staff members altogether, apart from the accountant, how best the division can be structured and strengthened.
- Should there be a viable acquisition of a small construction company located outside the western province, an opportunity to be involved in as a construction partner in an apartment project, is among some of the growth prospects that FCL is currently pursuing.
- One of Nalinda's professional colleagues has advised him about the benefits of current project management softwares available in the market and their advantages. Accordingly, the directors are interested to know whether the company should invest in the project management and better information processing capabilities that could also be integrated with the company's accounting system.
- Not very happy with the fact that there are monies owing to directors, from the company, having operated for over a decade.

Impact of Covid-19 on the Construction industry

The year 2020 has impacted the construction industry from a number of perspectives, the availability and transportation of raw materials, workforce availability, adherence to Covid -19 protocols, and even the restricted and sporadic interruptions in working hours. Accordingly, the sector altogether had dismal performance in its GDP's growth performance.

Financial extracts of FCL

The company's last three-year financial extracts are given in **Appendix 1a & 1b**

-End of Scenario I-

Appendix 1-a

Forever Constructions (Pvt) Ltd (FCL)			
Income Statements for the years ended 31st March.			
	2019	2020	2021
	Rs 000's	Rs 000's	Rs 000's
Turnover	401,012	421,063	433,093
Cost of Sales			
Direct Costs			
Raw materials	144,364	151,583	155,913
Sub- contractors -Labor	100,253	117,898	121,266
Construction overheads	60,152	67,370	69,295
	304,769	336,851	346,474
Gross Profit	96,243	84,212	86,619
Operating costs			
Administration Expenses	60,152	46,317	47,640
Selling and Distribution	13,180	14,498	17,398
Finance Costs			
Net Finance costs	18	210	694
Property loan interest	17,100	16,300	15,900
Net Profit/Loss	5,793	6,887	4,987
Taxation	811	964	698
Profit after Tax	4,982	5,923	4,289
Note:			
1. Turnover and Direct Costs- both are without VAT.			
2. Net Finance Cost: Interest expenses excludes interest on property loans, less Interest Income.			

Appendix 1-b

Forever Constructions (Pvt) Ltd (FCL)			
Statement of Financial Position as at 31st March			
	2019	2020	2021
	Rs 000's	Rs 000's	Rs 000's
Fixed Assets			
Land and Buildings	170,000	190,000	210,000
Machinery and Equipment	30,132	35,294	40,387
Vehicles	15,034	20,012	18,087
	<u>215,166</u>	<u>245,306</u>	<u>268,474</u>
Current Assets			
Work in Progress (net of advances)	38,096	56,142	86,619
Debtors and Retention receivables	50,127	70,177	72,182
Fixed deposits	45,205	51,321	56,325
	<u>133,428</u>	<u>177,640</u>	<u>215,126</u>
	<u>348,594</u>	<u>422,946</u>	<u>483,600</u>
Current Liabilities			
Creditors- (Raw materials and Labor)	32,415	47,720	65,445
Creditors -Statutory	12,836	20,452	29,134
Creditors -Expenses	9,516	12,317	15,323
Loans from Directors	45,213	59,780	49,738
Bank Overdraft	46,125	58,314	70,210
	<u>146,105</u>	<u>198,583</u>	<u>229,850</u>
Long Term Loans	110,100	106,050	101,150
Reserves	42,389	68,313	102,600
Share Capital	50,000	50,000	50,000
	<u>202,489</u>	<u>224,363</u>	<u>253,750</u>
	<u>348,594</u>	<u>422,946</u>	<u>483,600</u>
Note:			
1. The year 2019 figures are re-grouped as per the audited accounts and 2020 and 2021 figures compiled out of draft accounts.			
2. Land and Buildings: Valuation.			
3. In this case situation, the market for land and buildings up to 2019, has only enjoyed very moderate growth.			
4. Machinery and equipment: Net Book Value.			
5. Vehicles: Net Book Value.			
6. Creditors: Only included raw materials and Labor contractors' payments			

ICS -May 2021 Examination- Marking Grid					
Evaluation		Weightage	Competency assessment (Marks)		
			High level of application	Middle level of application	Low level of application
Knowledge	Technical knowledge (On Management Accounting, Financial Accounting & Business Management.	30	24-30	8-23	1-7
Application	Application of practical solutions based on the knowledge and skills gained through synthesis, analysis and calculative practices.	20	16-20	6-15	1-5
Integration	Examine a problem/ issue in a holistic sense through drawing from diverse functional disciplines.	15	12-15	4-11	1-3
Prioritization	Demonstrate a rational, balanced outlook supported with evidence to unearth issues and rank them in the order of priority.	15	12-15	4-11	1-3
Decision	Present viable decisions and implementable recommendations.	10	8-10	4-7	1-3
Presentation	Ability to structure answer clearly and legibly in a most appropriate logical sequence. With recommendations and relevant references clearly.	10	8-10	4-7	1-3
TOTAL		100			

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