EXAMINATION 3
FINANCE AND MANAGEMENT CASE STUDY EXAMINATION NOVEMBER 2004
THE REPUBLIC OF BEARBADOS
TUTORIAL GUIDE

1 General Comments

(a) It is important that candidates answer all the questions as set.

(b) Where illustrative figures or information are asked for in a question, or their use is implied in the data, then they must be shown in the candidate's answer.

(c) Evasion of the terms of the question on the grounds that the situation depicted in the Case Study is unlikely to have arisen or occurred, or is improbable in concept, should be penalised.

(d) Working papers submitted with answers should be scrutinised and used to test the candidates' line of argument in unfinished work and as a guide to the method by which the candidates have utilised their acquired knowledge to deal with the various aspects of the case study.

(e) Detailed calculations are set out in the appropriate attached appendices. It must be emphasised that these are not 'model answer' figures but are based upon what are judged to be the 'best' assumptions made in answering the question. Candidates should not therefore be judged on whether they got the figures 'right', but on how they reached their figures and how reasonable are their assumptions and arguments.

2 Synopsis of Case

The case is set in Bearbados, an independent republic and a member of the Federated Stagnesia Alliance. There is no Bearbadian equivalent of local government and all public services are provided by Government Departments. A cabinet system is in place, with each Government Department led by a Minister of cabinet rank, who is supported by civil servants, headed by a Permanent Secretary. The case primarily concerns the Bearbadian Department for Local Resourcing (DLR), with responsibility for local services such as education, welfare, housing, property and environmental services, and, more specifically, the DLR's insurance arrangements.

At present, each Department is responsible for its own insurance arrangements and these are arranged with external insurers on a ground-up cover basis. A recent report by the Barbadian Audit Executive has been highly critical of these arrangements as being uncoordinated, lacking overall direction and failing to foster a risk management (RM) approach. As a result the Barbadian Treasury has issued an action plan to Departments, which includes guidance on the renewal of insurance contracts, the financing of reasonable excesses in-house as well as the creation of Internal Insurance Funds (IIF) by departments to fund these and RM programmes.

The DLR is the first Department to go to tender since the issue of the Treasury guidance and the candidate, who plays the role of Projects Officer in the DLR's Central Support Division, is required to organize the tender process and evaluate the three tenders received, both in terms of costs (actual and discounted) and quality factors. The latter involves an appraisal of the financial standing of the companies and consideration of other non-financial factors. Against a background of mixed attitudes, the candidate also has to produce notes assessing the DLR's current shortcomings in its RM approach, as well as proposals for the establishment of a formal RM strategy and criteria for the assessment of RM projects. The candidate's final task relates to the creation of the IIF through the establishment of income budgets for internal premiums and charges and the quantification of the costs involved on claims, claims handling and RM. There is also a requirement to test the sensitivity of the implications of the pricing proposals in respect of the SLA charges for claims handling through a Cost Volume Profit (CVP) exercise.

The case material also affords candidates full opportunity to demonstrate their understanding of the case material, as well as their technical, statistical and management skills, and their ability to communicate relevant information clearly and tactfully.

3. Question 1

Aims

(a) To test candidates' understanding of the case material and particularly the issues raised by Tess Coe's parliamentary question to the Secretary of State for Local Resourcing;
(b) To test candidates' ability under severe time pressure to recognize, analyse and comment appropriately upon the issues raised in the parliamentary question;
(c) To test candidates' skills in organizing and presenting such information in a clear, concise and tactful draft briefing note for the Under-Secretary (Central Support).

Assessment

(a) Comment upon the HMV policy, together with an explanation of the new arrangements for insurance, the reasons for the approach adopted and the implications of this for the overall insurance budget. (7 marks – A 7)

- A note that under the HMV policy –
  - There is no requirement to externalise commercial undertakings, nor even to advertise externally; (i)
  - Government Departments are merely required to benchmark their costs against external providers, as a measure of their competitiveness; (i)
  - There are even exclusions to this process, where it is deemed beneficial for specific reasons to retain services in-house. (i)
- Acceptance that all insurance polices currently provide "ground-up" cover (there are no excesses) and that all are operated through DFS Group. (v),3,5
- A note that the current contract with the DFS Group terminates on 31 March 2005. (v),3
- Comment that the DLR's insurances are not being brought "largely in-house" -
  - Only relatively small policy excesses are being brought in-house; 3,10
  - Claims handling on these excesses is also being brought in-house; 3,4,10
  - Together these amount to about 43% of the overall insurance spend in 2004/05; 9
  - The balance will remain with external insurers and is being tendered. 3,10
- A note that the driving force for the proposed changes was a report from the independent Bearbadian Audit Executive (BAE), which was supported by the multi-party Representatives Audit Committee (RAC) and accepted by the Government. (iii),1,2
- An explanation of the BAE's recommendations re the creation of Internal Insurance Funds (IIFs) to take the smaller, more numerous claims in-house, the settling of such claims in-house and the need to focus Departments on risk management. 2
- An explanation of the reasons behind these recommendations -
  - The increasing "claim culture" in Bearbados; 2,13
  - The increasing cost of insurance and the number of claims being made; 2,11,19
  - Concerns over the quality of claims handling, particularly on smaller claims; 2
  - The lack of any incentive to focus on risk management and claims avoidance; 2,4,11
  - External insurers are keen to divest themselves of small claims as they are inefficient and expensive to handle.. 8
- In terms of risk exposure, an explanation that –
  - All major risks will still be covered through external insurers; 9
  - Internal claims will be limited to £1.5 million through a stop-loss agreement. 10,11
- Comment that there will be no increase in the insurance quantum in 2005/06 other than for inflation. 4
- Acknowledgement that additional staff will be required as a result of the changes, but that this is cost-effective. 4,13

NOTE For suggested calculations see Appendix 1A, but note comments in 1(e) above

(b) Rebuttal of the points made re the treatment of specialist policies and an explanation of the tendering procedures currently being undertaken. (3 marks – A 3)

- A statement that no insurance contracts have yet been awarded to DFS for the period commencing 1 April 2005. 3
- Comment that the vast majority of the Department's current insurance arrangements from 1 April 2005 have, in fact, been put out to tender. 3,7,10
- The only exceptions to this were –
  - The policy excesses to be dealt with through the newly created IIF; 3,10
  - Claims handling on these excesses; 3,10
- A note that the tendering exercise is being carried out in accordance with FSA Procurement Regulations –
  - Tender Notice published in the Stagnatia Appendix of Government Advertisements (SAGA) under the open route; (ii),3,7,10
  - Adherence to the required FSA deadlines and timetables; 3,10
  - Ultimately notice of appointment in SAGA. 10
- Comment that these arrangements are in accordance with both the Government's policy on competition and the FSA Procurement Regulations. 10

(c) Comment upon the ARM and provision of evidence to support the increase in insurance costs, together with an explanation of the budget increase figures quoted for the Ministry of Environmental Services (ES) and the revised budgetary arrangements being implemented for 2005/06 and following years. (8 marks – C 4, A 4)

- Comment that the ARM is a broadly based consumer index and merely the average of a basket of goods and services. (ii)
- A note that some of the items in the basket might well have reduced in price over the year, whilst others will be significantly higher than the average.
- A comment that insurance is one area widely acknowledged as increasing in cost well above average inflation. 5,8,11
- On the basis of the indications provided by the DFS Group, confirmed by Riskless, Prophet & Prosper and the 2004/05 base figures, calculation of the inflationary increases expected on the policies.
- A note that at 14.97%, this is very much in line with the 15% agreed internally.
- Comment that the figures quoted are comparing -
  - The 2004/05 budget apportionment to ES calculated using the statistical insurance bases on which the current insurer calculates its premiums; 6
  - The average annual cost of claims by ES for the previous three years. 19
- Agreement that this comparison does produce an increase percentage of about 38%
- A statement showing the same figures for the other Ministries within the Department and for the Department overall. 26
- Comment that, whilst for ES the cost of claims met exceeds the budget allocated, the other Ministries reflect the reverse situation.
- A note that, in overall terms, the costs of claims is below the premiums paid and the budget allocated.
- Comment that there is no overall switch of resources and therefore no adverse impact on front-line services. 4,7
- Acknowledgement that the arrangements for 2005/06 are being revised to ensure that that budgets more closely reflect actual claims experience and to provide an incentive for risk management initiatives. 13,19

NOTE For suggested calculations see Appendix 1B, but note comments in 1(e) above

(d) Presentation, format, tact and general readability. (2 marks – P 2)

APPENDIX 1A

QUESTION 1

PAGE

1. Break-down of Insurance Quantum 2004/05

	£		£	
Total Quantum			3,000,000	6,9
Less				
Excesses Value	900,000			9
Claims Handling Value	400,000	43.3%	1,300,000	9
Continuing External Insurance		56.7%	1,700,000	

APPENDIX 1B

QUESTION 1

PAGE

1. Insurance Inflation 2005/06

	Rate	Base £	Inflation £	Updated £	
Updating of 2004/05 Base					
Liability	15%	1,210,000	181,500	1,391,500	6,8
Property	12%	1,130,000	135,600	1,265,600	6,8
Motor	20%	660,000	132,000	792,000	6,8
		3,000,000	449,100	3,449,100	
Inflation rate overall			14.97%		

2. Claims Comparison

	Educ & Welfare £	Environ Services £	Housing & Prop £	General £	Total £	
Allocation 2004/05	1,160,000	820,000	860,000	160,000	3,000,000	26
Claims Experience (annual - average last 3 years)	870,000	1,130,000	770,000	80,000	2,850,000	26
Effect	-25%	+38%	-9%	-50%	-5%	

Marks Allocation

Insurance Inflation – 2 marks
Claims Comparison – 2 marks

4. Question 2

Aims

(a) To test candidates' ability to analyse and evaluate a considerable volume of financial information relating to a tendering exercise;

(b) To test their ability to analyse the bids received for insurance on the basis of a 3-year or potentially 5-year contract and evaluate the consequential cash flows;

(c) To test their ability to critically appraise the financial standing of the three companies submitting tenders;

(d) To test candidates' ability to consider relevant non-financial issues in the context of the financial appraisal work carried out on the tenders and the tendering companies;

(e) To test their competence in drawing reasoned conclusions and making recommendations as regards the preferred provider;

(f) To test candidates' ability to produce a well-structured report for the Under-Secretary (Central Support) for presentation at the next DLR Executive Board.

Assessment

(a) Brief background to the tender decision, process, criteria and submissions received. (3 marks – A 3)

- ❑ A note that insurance arrangements are currently organized by each Government Department separately; (iv),1,2
- ❑ A Statement that the DLR's present insurance contract terminates on 31 March 2005 and it was agreed not to extend (roll-over) this contract; . (v),3
- ❑ A note that, in accordance with the Government guidelines and its plans to ultimately centralise this function sometime after 31 March 2008 -
  - The DLR's insurance arrangements were put out to open advertisement through SAGA, in accordance with FSA Procurement Regulations; 3,7,10
  - The contract period is from 1 April 2005 to 31 March 2008, with the provision for the contract to be rolled over for a further two years to 31 March 2010; 1,3,10
  - The tender papers detailing the DLR's requirements on the various risks to be insured specified -
    - Various statistics relating to the size of the DLR; 10
    - Claims history for the last three years; 10
    - The level of excesses that would be funded internally through the creation of an Internal Insurance Fund; 10
    - The DLR's intention to deal with all claims handling on amounts falling within the excesses; 10
    - The DLR's intention to establish a risk management function. 10
- ❑ A note that the tender notice specified that the contract would be awarded on the basis of –
  - Most economically advantageous (price); 10
  - Company strength, quality and experience. 10
- ❑ A comment that five tenders were received, but that two of these were rejected as they did not comply with the requirements advertised; 19
- ❑ A note of the three valid bids –
  - Dax Financial Services Group (DFS), the current provider;
  - Essenpea Municipal Insurance Inc (EMI);
  - Hang Seng Banking Company (HSBC).

Page

(b) Calculation of the cost and present value of each of the bids received over the initial three-year period and the extended five-year period, and an evaluation of the results achieved. (10 marks – C 8, A 2)

- □ A note that DFS has produced differential rates on some risks for each of the first three years, whereas the rates quoted by EMI and HSBC are fixed. 21,23,25
- □ A note that both EMI and HSBC are offering discounts on base premiums charged; 23,25
- □ Comment that the HSBC discount is conditional upon "introduction of a strong risk management regime and a satisfactory first two years claims experience". 24
- □ For DFS, calculation of the base costs for the first three years by multiplying the base for each risk by the rate tendered for each year. 21
- □ For EMI and HSBC, calculation of the base costs for the first year by multiplying the base for each risk by the rate tendered for that year. 23,25
- □ A statement setting out for each year of the main three-year contract and each of the two potential rollover years –
  - a note of the base costs calculated;
  - the application of any discounts offered;
  - calculation of the net position for each of the tenders for each year;
  - calculation of the net three-year and five-year costs for each tender;
  - the application of discount factors at 4% to the resultant annual net costs for each of the five years; (ii),15
  - calculation of the NPV three-year and five-year costs for each tender.
- □ A summary statement setting out the net cost and NPV costs for each of the tenders on a three-year and a five-year basis.
- □ A critical appraisal of the result, noting that –
  - Over three years, EMI is by far the cheapest of the three tenders, but is significantly more expensive than its competitors in year four and five;
  - HSBC is more expensive than EMI over the first three years, but on the basis of the ongoing discounts, the cheapest provider over the five-year period;
  - DFS is the most expensive provider over three years, but more competitive over five years – lower than EMI on an actual cost basis, but more expensive in terms of NPV.
- □ A note that, according to the Treasury, the period required will "almost certainly" be five years. 1
- □ Overall, the figures are much closer on a five-year basis, with about £85,000 (£17,000 per annum) covering all three tenders on a NPV basis.
- □ A comment that such a difference is relatively minor in the context of the overall tender annual cost and much therefore depends upon other tender appraisal criteria.

<u>**NOTE**</u> For suggested points see Appendix 2A, but note comments in 1(c) above.

(c) An analysis and critical appraisal of the financial information available on the three companies tendering for the contract and a note of what further information would be useful in evaluating the overall standing of the companies. (8 marks – C 2, A 6)

- Comment that the financial information available on the companies is not comprehensive and any evaluation is therefore relatively limited.
- Explanation of the main ratios/measures available and their relevance –
  - Growth Analysis
    - Sales (turnover) growth percentage – how fast is the company growing?
    - Profit growth – is pre-tax profit growing in line with sales?
  - Operating Ratios
    - Pre-tax profit to sales – are margins growing or reducing?
    - Pre-tax profit to capital employed (CE) – is the return on CE reasonable?
    - Debtors to sales – how efficient is income collection?
  - Financial Ratios
    - Debt to capital employed - How dependent is the company on non-equity?
    - Debt to equity gearing – How much of the company's income is geared to servicing non-equity capital (more sensitive measure)?
    - Current assets to current liabilities – What is the state of the company's short-term financial position and liquidity?
  - Investment Ratios
    - Pre-tax profit to shares in issue – What are the company's earnings per share?
    - Share price to earnings per share (PE) – What is the value of a share in the company as measured by its current earnings?
- Calculation of the investment ratios and a critical appraisal of all the financial data available.
- Comments on DFS -
  - A well-established company with a steadily growing turnover and increasing margins;
  - A steady debtors profile and a strong/improving current ratio;
  - Gearing ratios that are comparatively low and reducing;
  - Strong and improving earnings per share;
  - An increasing share price reflecting the company's stability and steady growth potential;
  - A steady and reasonable PE ratio.
- Comments on EMI -
  - A mid-sized company in the sector expanding its sales rapidly;
  - However, this is at the expense of its margins and its pre-tax profit ratios have decline significantly;
  - The expansion appears to be being funded through increased gearing and the current ratio has also declined;
  - Earnings per share are still positive and reasonable, but these have declined as profitability has declined;
  - The share price has declined, but the PE remains comparatively high, possibly reflecting the market's view of its growth potential.
- Comments on HSBC -
  - A new company trying to establish a market share;
  - Comparatively low sales, but increasing rapidly;
  - Barely profitable to date, after losses in its previous three years;
  - A worsening current ratio and a significant gearing increase as the company grows;
  - A comparatively low, but upward trending share price and modest PE ratio.