SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer ALL of the following questions. Marks will be awarded for logical argumentation and appropriate presentation of the answers.

CASE

Boston Garment Limited (BGL), a listed company in Hong Kong, buys and sells sportswear for teenagers in bulk. It uses its own designer silk-screen machines to print specially designed patterns on the sportswear and sells them to a number of retail outlets in Hong Kong and mainland China. The appeal of the sportswear is largely dependent on the quality of the silk screen, such as the number of colours, use of glitter, and durability of the design. BGL wishes to be known for its trendsetting designs, and it wants its sportswear to be a "must have" for each and every teenager in Hong Kong and mainland China. The average price for the sportswear is HK$200, higher than the market average price of HK$150.

Operational details for the past five years

Description	2010	2009	2008	2007	2006
Bulk sportswear purchased (unit)	300,000	270,000	250,000	220,000	200,000
Number of sportswear spoiled (unit)	2,900	2,400	2,300	2,000	1,900
Operating margin	40%	38%	38%	37%	36%
Number of retail outlets	150	160	165	150	135
Number of design staff	10	7	7	6	5

At the end of each financial year, the management of BGL determines the quantity of sportswear to be purchased and sold for the coming year, and the amount of the advertising budget to be placed in teenage fashion magazines. The management also determines the number of design staff to support the business activities. The main tasks of the design staff are to develop an eye-catching concept with an easy printing concept in mind and fast delivery to retail and wholesale outlets. There is no direct relationship between the number of bulk sportswear purchased and the number of design staff and its associated costs. However, the success of BGL depends largely on the creativity of the design staff.

Although the business has been running quite well, the Managing Director, Mr. Dickson Chan, is of the view that a set of key performance indicators would be very helpful for him to guide and control the business to achieve the financial targets set by the Board. At a recent Management meeting, he has announced that he is going to implement balanced scorecard (BSC) in the company in order to achieve the financial goal as laid down by the Board. He asks the Financial Controller to consider the applicability of BSC to BGL.

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Forecast cash flow for the 4th quarter 2011

Cash control had never been a topic among the management team prior to the employment of the new Financial Controller, Mr. Sammy Lee, this year. Sammy is reviewing the cash flow situation in the last quarter of 2011. Based on the discussion with some colleagues, he gathered the following data to prepare the forecast cash flow for the 4th quarter 2011.

Cash Receipts and Payments Projection

In HK$	**Oct**	**Nov**	**Dec**
Cash receipts	4,900,000	5,000,000	5,100,000
Cash payments	4,850,000	4,950,000	4,700,000

He also found out that the cash balance for the current account with a bank was HK$100,000 on 1 Oct 2011, and a deposit bank account balance of HK$0. Also, the revolving credit facility has not yet been utilised. As a policy formulated by the Board recently, BGL must maintain a minimum cash balance in its current account of HK$500,000 for timely payment to suppliers and other parties. Any excess cash at the end of a month is to be invested in a deposit account to earn 2% per annum compounded monthly. Any cash shortages are covered by a withdrawal from the revolving credit facility of HK$350,000 at 5% per annum interest. Sammy expects all borrowing or deposit to occur at the beginning of the month and interest is paid or received at the beginning of the following month.

Ethical dilemma

BGL has been very successful over the last five years. It is now October 2011 and the Financial Controller, Sammy Lee (CPA) is assessing the forecast profit for the financial year ending 31 December 2011. It appears that the company will enjoy record profits attributable to very good business in the first nine months of 2011. However, Sammy is concerned about the prospects for the financial year 2012 which does not look promising, given the worsening inflation affecting teenagers' spending behaviour. He knows a drop in profits may reflect poorly on his performance for future promotion and his 2012 bonus according to the company-wide incentive scheme, for which the profit is capped for the bonus calculation. He is considering the possibility of making a number of accounting adjustments in the financial year 2011 which include deferring some sales revenue from 2011 and recognising it in 2012. This would have the effect of smoothing out the profits over 2011 and 2012.

Question 1 **(17 marks – approximately 31 minutes)**

Assume that you are the Managing Director, Mr. Dickson Chan, and you are going to write a memorandum to the Board to explain the following:

Required:

(a) **Identify with reasons what strategy BGL uses.** **(2 marks)**

(b) **Prepare a list of positives and negatives for the strategy adopted by BGL.**

(5 marks)

(c) **Why a balanced scorecard (BSC) is relevant or useful, with examples, to BGL and how it can be designed.**

(10 marks)

Question 2 **(21 marks – approximately 37 minutes)**

Assume that you are the Financial Controller, Mr. Sammy Lee, and you are asked by the Managing Director to provide the following information [i.e. (a)-(c)] to him.

Required:

(a) **Complete the cash forecast for each month of the 4th quarter 2011.** **(5 marks)**

(b) **BGL's cash position is very tight and the risks for defaulting accounts receivable keep increasing, suggest the measures that BGL could take to ensure that the cash forecast is achievable.**

(5 marks)

(c) **Refer to the relevant facts in the case. If the forecast cash collection was adversely affected, what type of financial risk would BGL now be exposed to and what would be the possible consequences and possible courses of actions to be taken by BGL?**

(5 marks)

(d) **Now assume that you are the independent director of BGL and you have carried out a working capital review of the company. Having listened to the cash flow forecast presentation by the Financial Controller, comment on the following for deliberation at the Board Meeting,**

Description	BGL	Industry
Sales growth between Jan 2011 and Sept 2011	30%	10%
Inventory turnover period	60 days	45 days
Accounts receivable settlement period	90 days	60 days
Accounts payable payment period	150 days	90 days

and also suggest, apart from tight control of accounts receivables, three possible ways of improving the finance and cash position of BGL.

(6 marks)

<u>Question 3</u> **(12 marks – approximately 22 minutes)**

Assume that you are the Financial Controller, Mr. Sammy Lee, and you wish to consider the ethical dilemma in light of HKICPA Code of Ethics and possible courses of action.

<u>Required:</u>

(a) **Identify with reasons which fundamental principles of the HKICPA Code of Ethics are relevant to this situation.**

(3 marks)

(b) **Outline three possible courses of action and explain which one you will recommend in the case of BGL.**

(6 marks)

(c) **How much damage is done to the Hong Kong stock market by providing misleading information to investors?**

(3 marks)

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End of Section A

SECTION B – ESSAY / SHORT QUESTIONS (Total: 50 marks)

Answer ALL of the following questions. Marks will be awarded for logical argumentation and appropriate presentation of the answers.

Question 4 **(20 marks – approximately 36 minutes)**

ABC is a high growth company in mainland China involved in solar energy. Under the current stage of development, cash flow from operations is still in a negative position. With the expected growth in business, the operating cash flow (OCF) is expected to turn positive in three years' time. The company plans to purchase capital equipment valued at US$55 million. After careful consideration of all the possible financing alternatives, the management decides to issue a 5 year USD non-redeemable zero coupon bond to finance this capital investment.

ABC's corporate finance advisor indicates that ABC will be able to raise the 5 year USD non-redeemable zero coupon bond at 9.5% in the US capital market, given the current liquidity and risk position of the company.

Required:

(a) **Explain why it is favourable for ABC to issue a zero coupon bond rather than a conventional bond.**

(3 marks)

(b) **How much will ABC need to repay at the end of the 5 years to redeem the bond at maturity? Ignore issue cost. If ABC forecasts to have only US$80 million cash to repay the bond at maturity, what is the implied (i.e. breakeven) interest rate p.a. that the company should target in raising this US$80 million bond?**

(2 marks)

(c) **Given the USD bond is non-redeemable and can only be repaid at maturity, name four financial risks that ABC will encounter from the issuance of the zero coupon bond.**

(4 marks)

(d) **Identify one approach to manage each of the risks identified in (c).** **(8 marks)**

(e) **What are the factors that investors in a zero coupon bond need to consider?**

(3 marks)

<u>Question 5</u> (20 marks – approximately 36 minutes)

Company P (P) offers to buy 100% of Company S (S). Total consideration will be settled by issuing new shares based on P's pre-acquisition share price stated below. Before the acquisition, the relevant financials are summarised below:

	P	S
Profit after tax (Earnings)	$50,000,000	$10,000,000
No. of shares outstanding	5,000,000	2,000,000
Share price before acquisition	$150	$60
EPS	$10	$5

The CEO believes that the main rationale for this acquisition is that the expected synergy effect of $5 million will result from a permanent cost reduction of $2 million and increased profit of $3 million due to enhanced market position enjoyed by the combined company. The CEO is also of the opinion that the enhanced market position is to be of strategic importance as the acquisition will make P the industry leader. Synergy is expected to materialise between 12 to 24 months after the deal is completed.

It is the policy of P to maintain or improve EPS after each acquisition, i.e. the projected EPS of the combined company cannot be lower than that of P prior to acquisition.

<u>Required:</u>

(a) **Assuming a no synergy position and the earnings of both companies remain unchanged before and after acquisition, what is the EPS of the combined company if P offers to buy all S's shares at $65 per share? Will this price be approved by P's Board based on an EPS maintenance strategy?**

(5 marks)

(b) **If the shareholders of S demand a selling price of $90, what will be the EPS of the combined company if P agrees to this price, assuming no synergy? Will P's Board approve it? State the reasons.**

(3 marks)

(c) **Assuming the $5 million synergy materialises as planned. What will be the maximum price P can offer and still maintain the post-acquisition EPS to the pre-acquisition level of $10 between 12 to 24 months after acquisition? All other aspects of the deal remain unchanged.**

(5 marks)

(d) **Assuming you are the CEO of P, how would you convince the Board to approve the acquisition price up to the amount calculated in (c)? Show all calculations and state all necessary assumptions.**

(4 marks)

(e) **If you were a member of P's Board, how would you assess the reliability of the $5 million expected synergy? Assume the maximum price calculated in (c) is offered, what is the impact on future EPS if this synergy is not achieved; and if it is achieved?**

(3 marks)

<u>Question 6</u> **(10 marks – approximately 18 minutes)**

XYZ, established 10 years ago, is a listed medium size real estate development company in Hong Kong. Its capital structure is made up of the following components:

- 10,000 bonds face value of $1,000;
- 2 million shares of 7% preference stocks with face value $100; and
- 5 million shares of common stocks.

Yield to maturity of bonds with similar characteristics is 7%.

The preference shares are selling for $60 a share. The common stock has a beta of 1.5 and sells for $50 a share.

Risk free rate is 3% and market return is 15%.

Tax rate is 16.5%.

<u>Required:</u>

(a) What is XYZ's weighted average cost of capital? (5 marks)

(b) XYZ is considering diversifying into the media business in mainland China and is considering a major investment proposal. The Board requires NPV as the quantitative evaluation tool and one of the Board members indicates that the firm's WACC can be used to discount the project cash flow to arrive at the NPV. Write a memo to the Board, in your capacity as the Finance Director of XYZ, to explain the appropriateness of this suggestion. State reasons to justify your answers.

(5 marks)

* * * END OF EXAMINATION PAPER * * *