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

Scented candles are commonly used in high-class restaurants and hotels. Colours and fragrances are added to the wax to produce scented candles. Customers are willing to pay a premium for high quality products. Since Hong Kong has become more affluent, more and more middle class and upper class people are interested in buying these premium products for meditation purposes nowadays.

Mr. C.M. Cheung is the Managing Director of GOM Company Limited (GOM). The company mainly manufactures fancy scented candles for the Hong Kong market. The company was established by C.M.'s father in the 1960's. The factory premises are owner-occupied, with a floor area of about 10,000 square foot, and located in an old factory building in Chaiwan, Hong Kong. It has about 200 employees and is regarded as the market leader in the scented candle industry.

GOM has developed its own brand name (GOM) in the market. The company has been able to acquire a market share of 20% with an enviable profit margin of 15% due to good product design and superior product quality under the leadership of the chief product designer, Mr. Ivan Lee, who had helped the founder to start up and expand the business to its present scale. However, Mr. Lee will retire next year and the company has been looking for his successor for several months already.

During the past few years, the company deferred several expansion plans due to the inadequate resale value of the factory premises to purchase new factory premises on Hong Kong Island. Indeed, the supply of factory premises has become less and less due to the conversion of factory premises into residential property by some property developers. In addition, old plant and equipment could not be replaced by new ones due to floor loading and safety regulations imposed on the present premises, which has also inhibited the expansion plans.

In recent years, market share and the profit margins are shrinking as a result of increasing competition from the suppliers in China and South East Asia. Their products are much cheaper and more beautifully designed. However, some of them produce inferior products that are tainted with toxic chemicals.

HK$'000	2005	2006	2007	2008	2009	Industry
Sales	50,000	49,000	48,000	42,000	40,000	200,000
Net Profit Margin	30%	28%	25%	20%	15%	10%
Number of customers	1,000	1,050	1,000	900	850	5,000
(Key customers)	100	100	100	110	115	

Since the establishment of the company, the setting of the selling price has been based on the total cost plus approach using the standard costing method. Manufacturing overhead is adopted into cost unit by reference to the units produced. Mr. Cheung is worried about this approach as it may not be able to identify those products with a positive contribution, and is too rigid and prone to lead to wrong decisions in setting the selling price. In order to maintain the market share and profit margin, Mr. Cheung wants to hold a brainstorming meeting to discuss the alternatives on setting the selling price, especially the marginal cost plus method which he heard about during a recent seminar held at the Hong Kong Institute of Certified Public Accountants.

Of the many products produced, GOM–Fantasy is the best seller. In a recent management meeting, Mr. Cheung asked Mr. Tommy Lau, the Financial Controller, to compare the cost price in June with the budget in order to identify the areas for improvement.

Mr. Lau gathered the following budget data for the month of June 2010 as follows:

1.	Budgeted Sales and Production in June	100,000 units
2.	Selling price of GOM–Fantasy	HK$100/unit
3.	Direct Materials Costs per GOM–Fantasy	
	- Consumption of Component X	5 units
	- Purchase cost of Component X	HK$4/unit
	- Consumption of Component Y	4 units
	- Purchase cost of Component Y	HK$2/unit
4.	Direct Labour Costs per GOM–Fantasy	
	- Consumption of labour hours per unit	4 hours
	- Labour cost per hour	HK$10/hour
5.	Variable Factory Overheads	HK$4/unit

The actual data for June are as follows:

1.	Actual Sales and Production in June (opening and closing inventory were the same)	95,000 units
2.	Sales of GOM–Fantasy	HK$11,400,000
3.	Consumption of Component X	550,000 units
4.	Purchase costs of Component X	HK$2,310,000
5.	Consumption of Component Y	450,000 units
6.	Purchase costs of Component Y	HK$810,000
7.	Consumption of Labour Hours	360,000 hours
8.	Total Labour Costs	HK$4,320,000
9.	Variable Factory Overheads	HK$380,000

<u>Question 1</u> **(14 marks – approximately 25 minutes)**

Assume that you are Mr. Tommy Lau, the Financial Controller, perform a SWOT analysis in order to summarise the challenges and opportunities for Mr. Cheung to consider.

(14 marks)

<u>Question 2</u> **(10 marks – approximately 18 minutes)**

Prepare a memo to Mr. Cheung, Managing Director, to contrast the methods of total cost plus pricing with marginal cost plus pricing.

(10 marks)

<u>Question 3</u> **(19 marks – approximately 34 minutes)**

Calculate the budget contribution and actual contribution, and make a reconciliation of the contribution between budget and actual. You need to identify all the variances in this reconciliation statement.

(19 marks)

<u>Question 4</u> **(7 marks – approximately 13 minutes)**

Assume that the chief product designer, Mr. Ivan Lee, has discovered that GOM-Fantasy has been tainted with toxic chemicals. Prolonged exposure to these toxic materials will have a detrimental effect on health. Mr. Lee, who is retiring soon, is of the view that the company should not launch product recalls as it will cause financial and reputation damage to the company. Mr. Lee also intends to continue production until exhaustion of the tainted materials. What HKICPA Code of Ethics for professional accountants should be considered if you (i.e. Tommy) are being consulted on the decision for product recalls.

(7 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 5 (18 marks – approximately 32 minutes)

Grand Reily (GR) is a listed conglomerate with a market capitalisation of more than HK$120 billion. While its core business is in the retailing and entertainment industries, GR had a real-estate arm which invested in fifteen residential and commercial properties in China, Hong Kong, Korea and Singapore. This property portfolio contributed 12.5% of the underlying profit to the group last year.

Having benefited from the rally in the property markets across the Asia Pacific region, the values of these properties have appreciated more than 50% from GR's initial investment. Considering that the yield of the portfolio has shrunk to below 2.5%, GR was not without concern with regard to the over-heating of the property market and thus decided that it would be to the benefit of the company to retreat from this investment. After several months of negotiation, GR successfully sold the entire property portfolio last week to an Asian Property Fund at a price of HK$35 billion.

After this transaction, GR has repaid most of the outstanding debts but is still sitting with a cash balance of over HK$24.5 billion. As a result of this, the Chief Financial Officer (CFO) of GR is considering to change the dividing policy by substantially increasing the payout ratio for this year and distributing all the cash to the shareholders.

Required:

(a) You are the Finance Manager of GR and have been requested by the CFO to analyse the pros and cons of his idea regarding the dividend for this year.

(12 marks)

(b) Apart from the dividend, what is another common way of returning the money to the shareholders? In what situations will it be considered a more suitable alternative?

(6 marks)

<u>Question 6 (24 marks – approximately 44 minutes)</u>

Max is the newly hired treasurer of Lipport Company Ltd. (Lipport). Lipport relies heavily on external borrowing to fund its operations and several acquisitions made in the last five years. As at the end of last month, the total borrowing of Lipport amounted to HK$5.3 billion. However, thanks to the quantitative easing policy in all major countries after the global financial crisis, the borrowing costs of Lipport have declined significantly. While the views on when this monetary policy will end are still very diverse, Max believes that inflation is taking root in many countries and that once the monetary stimuli are withdrawn, market interest rates would spike up shortly. Therefore, he does not feel comfortable having this borrowing based on floating rates.

<u>Required:</u>

(a) After meeting a few banks, he has received proposals on making use of the following instruments to hedge the interest rate exposures:

- **interest rate caps**
- **interest rate swaps**
- **forward rate agreements**

(i) Briefly explain the key features of these three instruments. (6 marks)

(ii) Given Max's view on the interest rates, recommend <u>one</u> instrument and explain the advantages and disadvantages of using the instrument in hedging interest rate risk. (6 marks)

(b) When projecting the future interest rate trend, Max has consulted a leading economic analyst who has come up with the following projection:

	Year 1				Year 2			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
3-month HIBOR	0.15%	0.50%	1.05%	1.50%	2.00%	2.45%	3.00%	3.65%

Max has decided to cover the interest-rate exposure for the next two years with an interest-rate cap set at HIBOR of 1%. The most competitive market quote for the cap premium is 1.05% on the notional amount of the intended transaction. The premium is to be paid upfront. According to the latest forecast, Lipport's debt level will remain at HK$5.3 billion throughout the next two years and all of the loans are based on floating-rates refixing every quarter.

Assume that the actual market interest rates will be the same as the projection and that the borrowing margin is 1.1% on top of the HIBOR:

(i) What will be the total interest cost to Lipport for the next 2 years if all the borrowing is based on floating-rates? (5 marks)

(ii) What will be the total borrowing cost (interest cost plus hedging cost) for the next two years if the borrowing is covered by the interest rate cap? (5 marks)

(iii) Will the use of a cap bring any cost savings to Lipport? If so, how much will it be? (2 marks)

<u>Question 7 (8 marks – approximately 14 minutes)</u>

Grow Fast is a multi-national company with 24 group companies located in Europe and the US. Due to inter-company transactions, many of the group companies often make payments to each other by electronic fund transfers each month. Recently, the banks have raised the fee for each transfer by 20% to cover their increasing operating costs. The finance manager of Grow Fast, Tim Macoy, was asked by the CFO to review the costs related to these inter-company fund transfers. Tim has gathered the following data:

• Group companies required to make inter-company fund transfers	:	24
• Average number of transfers that each group company makes to every other firm per month	:	40
• Transaction fee charged by the banks for each fund transfer	:	HK$100

<u>Required:</u>

(a) How much does Grow Fast incur each month on making the inter-company fund transfers?

(3 marks)

(b) Explain a technique that Grow Fast can adopt to reduce the number of fund transfers between the group companies without the need for any change in the number of inter-company transactions?

(3 marks)

(c) What will the cost of fund transfers to Grow Fast be if it adopts the above technique?

(2 marks)

* * * END OF EXAMINATION PAPER * * *