June 2013 Examination

QP Module B – Corporate Financing

Deloitte - Final Mock Exam (4 June 2013)

Question Paper	
Time allowed	3 hours
This paper is divided into two sections	ALL questions are compulsory
<u>Section A</u>	Case study questions
<u>Section B</u>	Essay/Short questions

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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

No Snow Investment Limited (NSI), a company incorporated in Hong Kong with limited liability whose issued shares are listed on the Main Board of the Stock Exchange, is principally engaged in metals trading and investments in securities.

The Board of Directors of NSI is considering a "Proposed Acquisition" which represents an opportunity for NSI to diversify into a new business segment.

THE LETTER OF INTENT

The Board announces that on 28 May 2012, NSI entered into a legally binding Letter of Intent with an independent third party, pursuant to which NSI may acquire (subject to the Formal Agreement) from Thousand Queen Investment Limited (TQI) the entire 100% interest in Jiangxi Limited Company (JXL). JXL is principally engaged in ship building and repairs. Set out below is a summary of the terms of the Letter of Intent:

Subject matter

TQI currently owns 100% equity interests in JXL. Pursuant to the Letter of Intent, NSI may acquire from TQI the entire interest in JXL, a company established in Hong Kong in 2008. Based on the information provided by TQI, JXL is principally engaged in ship building and repairs.

Consideration

☆ Due Diligence

The basis of the consideration and purchase price are subject to, among other things, further negotiation and finalization and will be fixed upon completion of a Due Diligence Review. The total consideration shall be satisfied by a combination of (i) cash; (ii) Shares in NSI (HK) Limited, a listed company in Hong Kong (NSI holds a 40% interest in NSI (HK) Limited); and (iii) convertible bonds of NSI.

Pursuant to the terms of the Letter of Intent, the Proposed Acquisition is subject to the completion of the Due Diligence Review and the negotiation and finalization of the terms and conditions in relation thereof. **Accordingly, the Proposed Acquisition may or may not proceed.**

Subject to the terms and conditions of the Letter of Intent and upon completion of the Due Diligence Review, the parties to the Letter of Intent will enter into the Formal Agreement. Further announcement will be made by NSI when the Formal Agreement is being entered into by the parties to the Letter of Intent.

By Order of the Board
No Snow Investment Limited
Chan Tai Man
Chairman
Hong Kong, 28 May 2012

FEASIBILITY STUDY

NSI is considering the investment. A feasibility study has indicated that the new investment has a 70% chance of success and a 30% chance of fairness. Cash inflows are forecast as follows:

Year	**Successful** **\$ million**	**Fair** **\$ million**	
1	60	50	
2	62	50	
3	65	50	
4 and thereafter (∞)	70	50	constant CF to ∞

The expected capital investment is \$800 million. NSI's cost of capital is 8% per annum.

$\Sigma PV = \frac{An\ CF}{r}$

FINANCIAL STATEMENTS OF JXL

The summarised financial statements of JXL for the years ended 31 December 2011 and 31 December 2010 respectively are as follows:

JXL
Income statement for the year ended 31 December 2011 and 2010

	2011 **\$ million**	**2010** **\$ million**
Sales revenue	3,000	2,500
Cost of sales → OS + Purchase = CS for 2010	2,100	1,700
Gross profit	900	800
Operating expenses	750	605
Operating profit	150	195
Interest charges	50	45
Profit before tax	100	150
Tax	20	30
Profit after tax /Earnings	80	120

Statement of Financial Position as at 31 December 2011 and 2010

	2011	**2010**
	$ million	**$ million**
Non-current assets		
Property, plant and equipment	1,250	1,100
Current assets		
Inventory	140	130
Trade receivable	160	150
Bank/cash	50	50
	1,600	1,430
Equity		
Ordinary share capital	130	130
Share premium	330	330
Retained profits	310	230
	770	690
Non-current liabilities		
Long term loans	600	550
Current liabilities		
Trade payables	230	190
	1,600	1,430

Additional information is given as follows:

Opening bal for 2010

1. All sales were on a credit basis.
2. The inventory value, accounts receivable, accounts payable and capital employed (equity plus non-current liabilities) as at 31 December 2009 were $150 million, $300 million, $180 million and $1,000 million respectively. The purchase for the year ended 31 December 2010 was $1,800 million.

<u>Question 1</u> (25 marks – approximately 45 minutes)

Required:

Assume that you are the Accounting Manager of NSI:

(a) based on the expected net present value of the new investment, advise NSI whether to invest in JXL; (13 marks)

(b) briefly comment on the profitability, liquidity and management efficiency of JXL using the relevant financial ratios (up to three ratios in each aspect); (12 marks)
[Total: 25 marks]

One of the investment where NSI possessed a majority shareholding; B-Group, a company that listed on the Stock Exchange of Hong Kong, together with its subsidiaries are structured under two major divisions;

1. Logistics divisions
2. Retail divisions

The retail division is mainly headed by Greater China Supermarket Limited ("GCS"). GCS and its subsidiaries are one of the first retail chain operators in the PRC. The group has over 15 years' experience in operating retail chains in the PRC and, since 1998, has been the largest retail chain operator in the PRC in terms of turnover.

As at 31 December 2012, the retail division had a total of 100 mega-malls, 1,500 supermarkets and 2,000 convenience stores located in 15 provinces in the PRC.

The division's mega-malls have operating areas ranging from 5,000 square meters (sq. m.) to 25,000 sq. m., usually located in less convenient areas. These mega-malls aim to cater for a broad range of customers' one-stop shopping needs, offering a broad range of products. GCS aims at maintaining competitive pricing on all its mega-mall products.

Compared to the mega-malls, the division's supermarkets are smaller and mainly located in densely populated residential areas to cater for customers' daily necessities. Goods are priced in terms of their categories and product mix, allowing for highly competitive pricing for promotional products.

The division's stores target customers who need fast, convenient and 24-hour shopping services. The stores are much smaller and offer a selective range of products that are priced to have a higher gross profit margin compared to the mega-malls and supermarkets.

The division has actively expanded its business through franchising. The franchisees purchase goods from the group and are required to follow the group's operational policies and guidelines. The franchisees are wholly responsible for the performance of the franchised outlets.

GCS sees its business as having three different strategic units, the Mega-malls Unit, the Supermarkets Unit and the Stores Unit.

At the operational level, however, the retail division's outlets are divided geographically into hubs. The managers of these hubs are wholly responsible for the performance of the mega-malls, supermarkets and stores in their designated regions or provinces. Decisions on opening new outlets and closing down existing ones are made after negotiations between the hub managers and the heads of each strategic unit. Other operational decisions such as the level of inventory, the product mix and the extent of promotional discounts are made at the operational unit level.

Selected financial and operating information about the group's three strategic units are as follows:

	Mega-malls		Supermarkets		Stores	
	2012	**2011**	**2012**	**2011**	**2012**	**2011**
Number of outlets						
- directly owned	100	50	600	500	1,300	1,200
- franchised	-	-	900	800	700	500
Revenue (HK$'m)	7,154	4,717	5,643	4,953	1,470	1,120
% to total	50%	44%	40%	46%	10%	10%
Gross profit (HK$'m)	569	410	797	741	236	200
Gross profit margin (%)	7.95	8.69	14.12	14.96	16.05	17.86
Other income** (HK$'m)	613	331	484	361	136	128
Total profit margin (%)	16.52	15.71	22.70	22.25	25.31	29.29
Operating profit (HK$'m)	54	75	194	158	32	25
Operating profit margin (%)	0.75	1.59	3.44	3.19	2.18	2.23

** Mainly income from suppliers for display and promotion in the outlets of the group.

Selected management information about the GCS's largest hub, the Shanghai Hub, and one of the hub's directly owned supermarkets, SH-SM, for the year ended 31 December 2012 are as follows:

	Shanghai Hub 2012 HK$'000	**SH-SM 2012 HK$'000**
Revenue	4,285,000	3,762
Cost of sales	(3,850,000)	(3,231)
Gross profit	435,000	531
Other income – display and promotion	529,000	807
Distribution and selling costs	(818,000)	(1,110)
Administrative costs	(63,000)	(59)
Operating profit	83,000	169
Segment assets:		
- non-current assets	432,000	946
- current assets	871,000	1,247
Segment liabilities – current liabilities	932,000	1,550

<u>**Question 2**</u> **(12 marks – approximately 22 minutes)**

<u>**Required:**</u>

(a) **Identify the strategy at the business unit level adopted by the Stores Unit, the Mega-malls Unit and the Supermarkets Unit of the GCS.**

(7 marks)

(b) **Identify and evaluate the strategy adopted by the GCS at the corporate level.**

(5 marks)

[Total: 12 marks]

Question 3 (13 marks – approximately 23 minutes)

Required:

(a) Determine the type of responsibility centre that the Shanghai Hub should be classified as. Determine and calculate the financial measures you consider most appropriate to Shanghai Hub.

(6 marks)

(b) Determine the type of responsibility centre that the supermarket SH-SM should be classified as. Identify three possible financial measures that are appropriate in measuring performance and calculate the measures for the supermarket SH-SM's 2012 performance. Determine the financial measure you consider most appropriate to measure the performance of the manager of the supermarket SH-SM.

(7 marks)
[Total: 13 marks]

* * * END OF SECTION A * * *
(QUESTIONS)

SECTION B - ESSAY 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 (21 marks – approximately 38 minutes)

Three years ago Boluje Co built a factory in Hong Kong costing HK$3.2 million. To finance the construction of the factory, Boluje Co issued peso-denominated bonds in a foreign country whose currency is the peso. Interest rates at the time in the foreign country were historically low. The foreign bond issue raised 16 million pesos and the exchange rate at the time was 5.00 pesos/$.

Each foreign bond has a par value of 500 pesos and pays interest in pesos at the end of each year of 6.1%. The bonds will be redeemed in five years' time at par. The current cost of debt of peso-denominated bonds of similar risk is 7%.

In addition to domestic sales, Boluje Co exports goods to the foreign country and receives payment for export sales in pesos. Approximately 40% of production is exported to the foreign country.

The spot exchange rate is 6.00 pesos/$ and the 12-month forward exchange rate is 6.07 pesos/$. Taxation may be ignored in all calculation parts of this question.

Required:

(a) **Briefly explain the reasons why a company may choose to finance a new investment by an issue of debt finance.**

(7 marks)

(b) **Calculate the current total market value (in pesos) of the foreign bonds used to finance the building of the new factory.**

(4 marks)

(c) **Assume that Boluje Co has no surplus cash at the present time:**
Explain and illustrate how a forward market hedge could protect Boluje Co against exchange rate risk in relation to the dollar cost of the interest payment to be made in one year's time on its foreign bonds.

(3 marks)

(d) **Describe other methods, including derivatives, that Boluje Co could use to hedge against exchange rate risk.**

(7 marks)

[Total: 21 marks]

Question 5 (16 marks – approximately 29 minutes)

YV Co is a listed company in the Hong Kong stock market selling computer software. Its profit before interest and tax has fallen from $5 million to $1 million in the last year and its current financial position is as follows:

	$000	$000
Non-current assets		
Property, plant and equipment	3,000	
Intangible assets	8,500	11,500
Current assets		
Inventory	4,100	
Trade receivables	11,100	15,200
Total assets		26,700
Current liabilities		
Trade payables	5,200	
Overdraft	4,500	9,700
Equity		
Ordinary shares	10,000	
Reserves	7,000	17,000
		26,700

YV Co has been advised by its bank that the current overdraft limit of $4.5 million will be reduced to $500,000 in two months' time. The finance director of YV Co has been unable to find another bank willing to offer alternative overdraft facilities and is planning to issue bonds on the stock market in order to finance the reduction of the overdraft. The bonds with expected yield of 10.14% per year would be issued at their par value of $100 per bond and would pay interest of 9% per year, payable at the end of each year. The bonds would be redeemable at a 17% premium to their par value after 10 years. The finance director hopes to raise $4 million from the bond issue.

The ordinary shares of YV Co have a par value of $1.00 per share and a current market value of $4.10 per share. The cost of equity of YV Co is 12% per year and the current interest rate on the overdraft is 5% per year. Taxation is at an annual rate of 30%.

Other financial information:
Average gearing of sector (debt/equity, market value basis): 10%
Average interest coverage ratio of sector: 8 times

Required:

(a) **Calculate and comment on the effect of the bond issue on the weighted average cost of capital of YV Co, clearly stating any assumptions that you make.**
(4 marks)

(b) **Evaluate the proposal to use the bond issue to finance the reduction in the overdraft and discuss alternative sources of finance that could be considered by YV Co, given its current financial position.**
(12 marks)
[Total: 16 marks]

Question 6 **(13 marks – approximately 23 minutes)**

Budgeting may be viewed as a relevant technique in facilitating the assessment of business performance from initial planning to actual results. It will be necessary, however, to consider how to overcome factors that may limit its effectiveness.

Required:

(a) **Highlight THREE advantages that may be claimed for the use of activity based budgeting rather than a traditional incremental budgeting system.**
(6 marks)

(b) **Suggest FOUR reasons why advocates of a 'Beyond Budgeting' philosophy may not regard a major annual budget preparation exercise as an effective use of resources.**
(7 marks)

[Total: 13 marks]

* * * END OF EXAMINATION PAPER * * *
(QUESTIONS)

EXAMINATION REGULATIONS – HKICPA QP

1. You should take your staff card to the examination venue. The staff card must be placed on the desk at every examination for checking. In the absence of your staff card, please place on the desk your Hong Kong Identity Card or passport for identification purpose.

2. The examination is an open book examination. All answers must be presented in English.

    - A candidate is permitted to take into the examination room his/her own notes or reference books, rulers, pencils, pens, erasers and/ or correction fluid, geometrical instruments, slide-rules, logarithm tables and charting templates.

    - A candidate is permitted to use only noiseless and cordless calculators. Computers or any size or models are not allowed. Electronic dictionaries are not allowed.

3. Personal belongings must be left under your table. FTMS will not under any circumstances accept responsibility for loss, theft or damage to articles deposited in the examination venue.

4. The duration of the examination is 3 hours. Please ensure that you arrive 15 minutes before the examination starts. The Examination Supervisor will not allow you to enter the examination venue after the first 30 minutes of the examination.

5. You are not allowed to leave the examination venue for the whole examination.

6. Before the examination begins, please complete the following details on the front of your script booklet: **your name, staff code (if any), HKICPA registration no. and seat number.** Please also ensure that you include the above details on any continuation script booklet which may be given to you during the examination and note that no extra time is allowed for this at the end of the examination.

7. You must check the front cover of the question paper to ensure that you have been issued with the correct paper. You are required to **use the appropriate script booklet** to answer each section of examination paper, **i.e. Case on the script booklet for Case and Essay/Short Questions on the script booklet for Essay/Short Questions.** Failure to do so may render your examination script invalid.

8. Every desk in the examination hall will be numbered and it is essential that you sit at the correct desk for each examination. Failure to do so may render your examination script invalid. Candidates are not permitted to begin to write their answers on the script booklet until instructed to do so by the Examination Supervisor.

9. Candidates are required to write legibly in black / blue ball pen or ink. Do not use pencil. Candidates must stop writing immediately once the end of examination is announced and are not permitted to leave your desk until authorised to do so by the Examination Supervisor.

10. Candidates must not behave in a manner likely to distract other candidates. Please submit your completed script booklets, question paper and any unused stationery to the Invigilator / Examination Supervisor at the end of the examination. No item of stationery should be removed from the examination venue.