KAPLAN FINANCIAL

HKICPA
Qualification Programme

Module B

Corporate Financing

KPMG

Mock Exam 2

Questions

Exam No:

HKICPA 2012

http://www.kaplanfinancial.com.hk

Professional Programme Module Examination	
Time allowed	**3 Hours**
Examination Assessment Allocation Section A – Case Questions Section B – Essay/Short Questions	 50 marks 50 marks
YOU SHOULD ANSWER ALL THE QUESTIONS IN THIS PAPER	

SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer ALL of the following questions which relates to the Case below. Marks will be awarded for logical argumentation and appropriate presentation of the answers.

CASE

Shinko Plc ("Shinko") is a manufacturer of mobile phones. The company was established in 2001 and was very successful for the next 9 years establishing a small chain of retail shops in Hong Kong. In 2010, the company's new products experienced reliability problems and competition from technologically superior products, causing sales fell by forty percent from 2008. This leads to substantial losses in both 2011 and 2012.

The company's managers are confident that the technical problems can be overcome, but this will require an investment of $2.25 million for new automated equipment and quality monitoring machinery. Shinko's bank, BXT Bank, is concerned about the company's recent performance, and a new debt or equity issue on the stock market is not possible. Without the new investment, Shinko is unlikely to be competitive, and might not survive in the next financial year. With the new investment, profits before interest and tax are forecasted to be at least $750,000 per year from 2013 for at least five years.

SHINKO PLC

SUMMARISED BALANCE SHEET AS AT 30 SEPTEMBER 2012

	$000
Non-current assets	
Land and buildings	1,500
Plant and machinery (net)	2,100
	3,600
Current assets	
Stocks	1,340
Debtors	1,090
Cash at bank and in hand	35
Total current assets	2,465
Creditors: amounts falling due within one year	
Overdraft	620
Other creditors	940
	1,560
Total assets less current liabilities	4,505
Creditors: amounts falling due after more than one year	
Term loan (from BXT Bank)	800
9% debenture 2025	500
8% convertible debenture 2014	1,000
10% loan stock 2016	500
	2,800

Capital and reserves

Called up share capital ($1 per value)	1,000
Share premium account	945
Revenue reserves	(240)
Total shareholders' funds	1,705
Total capital employed	4,505

Notes:

(i) The 9% straight debenture has first ranking security on the company's main factory building, the convertible debenture and term loan both have second ranking security on non-current assets. The loan stock and overdraft are unsecured.

(ii) The land and buildings are believed to have a realisable value 20% less than their net book value.

(iii) If the company ceased trading, stocks would be sold at 50% of their book value.

(iv) The new equipment would result in fifty staff being made redundant, with an immediate after tax cost of $500,000. If the company were to be liquidated, after tax redundancy payments would be $1 million. Redundancy payments may be assumed to rank after secured creditors and before unsecured creditors.

(v) Obsolete machinery with a net book value of $800,000 will be sold for $300,000 irrespective of whether or not the new investment takes place. The remaining of the plant and machinery could be disposed of at net book value. All disposal values are after tax.

(vi) The overdraft currently costs 10% per year and the bank term loan costs 12% per year.

(vii) The company's current share price is 23 cents, loan stock price is $78, straight debenture price is $90 and convertible debenture price is $94. All marketable debt has a par and redemption value of $100.

Shinko's finance director believes that a corporate restructuring could solve the company's problems, and has made the following proposals:

(i) Existing shareholders are to be offered 28 cents per share to redeem their shares, which would then be cancelled.

(ii) $1 million would be provided by a venture capital organisation in return for 700,000 new 25 cents par value ordinary shares.

(iii) The company's directors and employees would subscribe to 500,000 new 25 cents ordinary shares at a price of 150 cents per share.

(iv) The convertible debenture is to be replaced by new ordinary shares (par value 25 cents), with 60 ordinary shares for every $100 nominal value of convertible debenture.

(v) The term loan is to be renegotiated with the bank and the total amount of the loan increased to $2 million. This would have an expected interest charge of 13% per annum. Second ranking security on fixed assets would be offered on the overdraft.

(vi) All other long-term loans would remain unchanged.

Apart from the directors, none of the above parties have yet been consulted regarding the proposed restructuring. Following a restructuring, no corporate tax is expected to be paid for at least two years. The corporate tax rate is 33%.

The average price/earnings ratio in Shinko's industry is 12:1.

Required:

Question 1 **(40 Marks – approximately 72 minutes)**

Acting as a consultant to Shinko Plc, provide a report evaluating whether or not the suggested scheme of corporate restructuring is likely to be succeed.

Your report should contain:

(a) The restructuring principles and why the scheme is required

(4 marks)

(b) Does the scheme raise adequate finance

(5 marks)

(c) The capital repayment position of the creditors under immediate liquidation and post-restructuring scheme

(10 marks)

(d) An evaluation as to whether the new shares are fairly priced

(5 marks)

(e) An evaluation of the acceptability of the scheme to the parties and conclusion

(16 marks)

A full pro forma balance sheet is not required as part of your evaluation.

State clearly any assumptions that you make.

[Total: 40 marks]

Question 2 **(10 marks – approximately 18 minutes)**

List the main factors other than product reliability problems that can cause a business liquidity problems and ultimately insolvency.

(10 marks)

* * END OF SECTION A * *
(QUESTIONS)

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 3 (20 marks – approximately 36 minutes)

Bowland Carpets Ltd

Bowland Carpets Ltd ("Bowland Carpets") is a major manufacturer of carpets within HK. The company was taken over by its present parent company, Universal Carpet Inc., in 2002. Universal Carpet is a giant, vertically integrated carpet manufacturing and retailing business, based within the USA but with interests all over the world.

Bowland Carpets operates within HK in various market segments, including the high value contract and industrial carpeting area - hotels and office blocks etc. - and in the domestic (household) market. Within the latter the choice is reasonably wide, ranging from luxury carpets down to the cheaper products. Industrial and contract carpets contribute 25% of Bowland Carpets' total annual turnover which is currently $80 million. Up until 15 years ago the turnover of the company was growing at 8% per annum, but since 2006 sales have dropped by 5% per annum in real terms.

Bowland Carpets has traditionally been known as a producer of high quality carpets, but at competitive prices. It has a powerful brand name, and it has been able to protect this by producing the cheaper, lower quality products under a secondary brand name. It has also maintained a good relationship with the many carpet distributors throughout HK, particularly the mainstream retail organisations.

The recent decline in carpet sales, partly recession induced, has worried the US parent company. It has recognised that the increasing concentration within the Asian carpet manufacturing sector has led to aggressive competition within a low growth industry. It does not believe that overseas sales growth by Bowland Carpets is an attractive proposition as this would compete with other Universal Carpet companies. It does, however, consider that vertical integration into retailing (as already practised within the USA) is a serious option.

This would give the HK company increased control over its sales and reduce its exposure to competition. The president of the parent company has asked Jeremy Smiles, managing director of Bowland Carpets, to address this issue and provide guidance to the US board of directors. Funding does not appear to be a major issue at this time as the parent company has large cash reserves on its balance sheet.

Required:

(a) To what extent do Bowland Carpets current strengths help with the critical success factors required for the new proposed strategy into retailing?

(10 marks)

(b) In an external environmental analysis concerning the proposed strategy shift, what are likely to be the key external influences which could impact upon the Bowland Carpets decision?

(10 marks)

[Total: 20 marks]

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

Top Tots Plc (TT) is a well established manufacturer of consumer durables. The 'Glider', a hi-tech children's cot, is manufactured from material DMP. When it was released onto the market a year ago, it was the highest quality and strongest cot available. When it was launched, the recommended retail price was so low in relation to the excellent specification of the Glider that huge demand built up quickly. There is currently a 6 month waiting list for the product.

TT operates two divisions, division X which manufactures the material for the products and division Y which produces the completed products for sale.

Division X

The division produces two separate materials, material GDP and material DMP. Both materials take the same amount of labour time to produce a unit. Material GDP is sold to external customers only for $14 per unit. Division X incurs variable costs in producing this material of $9 per unit and fixed overheads amount to $1 per unit. The budgeted production and sales of material GDP for December is 2,700 units.

Material DMP is sold to division Y only. The transfer price that has been set for each unit is full cost + 10%. This material is available externally for $26 per unit but division Y has been told by management that they must buy the material from division X. Division X incurs variable costs of $20 per unit and fixed overheads of $8 per unit in producing material DMP.

Budgeted production and sales of material DMP for December is 2,000 units.

Division X has spare capacity.

Division Y

Division Y uses one unit of material DMP to manufacture one Glider. It incurs additional processing costs of $30 per Glider and anticipates that it will be produce and sell 2,000 Gliders in December for $60 each.

Required:

(a) **Using the forecasted information, calculate the December's profit for division X, division Y and TT.**

(5 marks)

(b) **Discuss the likely reaction of division X and division Y to the transfer price being set at full cost + 10%. Recommend, with reasons, a range for the transfer price of material DMP.**

(6 marks)

(c) **Assuming division X is now at full capacity, in terms of labour. Recommend, with reasons, a new range of transfer prices for material DMP.**

(3 marks)

(d) TT has recently developed a state of the art 'travel system' i.e. baby carriage for infant children. The travel system, named the 'Cruiser', is manufactured from a rare substance (CLO), which gives it superior strength and quality compared to any other travel system in the market. In view of the fact that the Cruiser weighs less than half of the weight of all currently available travel systems and is cutting edge in terms of style, the marketing director believes that it will give the company a considerable competitive advantage. The senior management committee is now in the process of putting together a pricing strategy.

Briefly explain what is meant by a market skimming pricing strategy and a penetration pricing strategy. Discuss the relative advantages and disadvantages of each approach for TT in the context of the Cruiser and recommend which approach should be used.

(6 marks)

[Total: 20 marks]

Question 5 **(10 marks – approximately 18 minutes)**

Diomed manufactures a single product with a production cost of $40 per unit which is sold to three customers. The details are:

Sales pattern:	Customer X	10,000 units per annum
	Customer Y	10,000 units per annum
	Customer Z	10,000 units per annum

All sales are made at $75 per unit.

Non-production overhead is:	$
Delivery	220,000
Quality inspection	200,000
Salesmen	80,000
After sales service	100,000

These non-production overheads are currently apportioned on the basis of a rate on the production cost.

The Managing Director is concerned about sales to Customer X, and is unhappy about the current cost allocation and has asked for an analysis of Customer Profitability (CPA) based upon Activity Based Costing methods. The following period activity volumes have been identified:

Customer	X	Y	Z
No. of deliveries	2,500	50	12
No. of inspections	10,000	500	0
No. of salesmen visits	200	24	6
After sales visits	200	100	50

Required:

Assess the three customers currently being served by using Customer Profitability Analysis and discuss your findings.

(10 marks)

* * END OF EXAMINATION PAPER * *
(QUESTIONS)

