

SECTION A – CASE QUESTIONS (Total: 50 marks)

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

CASE

Protex Group Limited ("the Company") has been engaged in the production of patented medical masks with different specifications and standards in a sterilised and strictly controlled manufacturing factory located in mainland China for many years. The Company sells their masks to hospitals directly in Hong Kong and other Asian countries. The Company has a few special patents for producing medical masks that provide competitive advantages and differentiation from medical masks manufactured by other competitors. The manufacturing processes are fully automated and require limited labour and supervisors to manage the processes. The Company acquires all raw materials through long-term contracts with reputable and stable medical suppliers and keeps all medical masks in sterilised, secured and well-controlled warehouses owned by the Company in Hong Kong and mainland China.

The Hong Kong office has a sales team and a sales administration team led by an experienced regional sales director in Hong Kong to sell and to arrange shipping and delivery of the products locally and regionally. The Company also has a customer service team that is led by an experienced customer service director to provide customer services to cater for the needs of different hospitals in Hong Kong and Asian countries. The Company has established innovative and automatic manufacturing, operation and accounting systems to make sure all manufacturing and operating processes and activities comply with different medical standards and requirements. The Company also has a research and development team led by a group of medical practitioners to develop new patents and to design new medical masks for the market. This successful strategy helped the Company to list on the Hong Kong Stock Exchange ten years ago, and their innovative and patented masks have received numerous awards and prizes in the medical equipment and accessories industry. Mr Song, the Chief Executive Officer of the Company and a fellow member of the Hong Kong Institute of Certified Public Accountants, was recognised as a successful entrepreneur by the government due to his contributions and achievements in manufacturing innovative and high quality medical masks in the industry.

Due to an outbreak of an unknown pandemic, there has been a tremendous increase in the demand of medical masks. The Company has a lot of medical mask inventory in their warehouses. One medical mask distributor, who is a good friend of Mr Song, suggests the Company sell their medical masks at ten times the existing prices to consumers who are willing to pay more money to buy medical masks to safeguard their health. It is estimated that the profit of the Company would be, at least, triple if they agree to cooperate with the distributor. There are major arguments at the Board of Directors' meeting about this proposal. Some directors agree that the Company should increase the prices of medical masks as there has been strong demand, which could increase the profitability and share price of the Company immediately. Some directors argue that the Company should not increase the price significantly so that underprivileged consumers will also be able to buy their products to safeguard their health during the pandemic. Mr Song is struggling on how to make this decision.

The pandemic has also generated significant increase in the demand of medical protection suits in Hong Kong and other Asian markets. The Company is considering the production of medical protection suits in existing markets. Based on their successful history of producing medical masks, the Company is considering using their exclusive patents and innovative manufacturing processes to develop a new medical protection suits business. Before they implement the new product development plan, the Company wants to review and evaluate activities that have added value in the production of medical masks so that they can use them to produce the new medical protection suits. The regional sales director also suggests that the Company can consider acquiring a private medical protection suits manufacturing factory that produces patented and high quality medical protection suits in the Netherlands. These products can then be sold in Asian markets. Since this would be the first time the Company has acquired another company in an overseas country, the Board of Directors is not sure how to start and wishes to investigate this potential investment. They are not sure about the operations, management and other material facts of the factory in the Netherlands. Being a listed company, Mr Song is worried that the Company will have to comply with rules and regulations in Hong Kong and the Netherlands when the Company decides to make such a significant acquisition.

The Company is also planning an overseas manufacturing project, namely Project Adventure, to buy a new machine to produce medical accessories in an overseas country due to the increase in demand of medical accessories in this overseas country. The cost of the new machine is US\$1 million, and the useful life is eight years with no residual value. The Company will evenly depreciate the machine based on its useful life. The Company has the following estimates in real values:

Year	1	2	3	4
Sales (US\$)	1,000,000	1,350,000	1,500,000	1,500,000
Operating expenses (US\$)*	540,000	600,000	660,000	660,000

The business strategist of the Company estimates that the gross margin ratio of the project is 70% and the tax rate is 30%, which is applied to both operating profit and gain on disposal of non-current assets. Since this is a special overseas project, the business strategist has decided to use a special discount rate that is the sum of nominal interest rate and country risk premium to assess the financial feasibility of the project. The real interest rate is 8% and the annual inflation rate is 2% in this overseas country. The country risk premium is 6% in a prosperous economy and 10% in a poor economy. The chance of having a prosperous economy is 50%. If business does not do well, the Company may decide to dispose of the machine at the end of year 4 for US\$600,000, which is estimated before taking into account inflation. The Company has decided to use nominal values to conduct the financial feasibility of this project.

* Including regular repair and maintenance of the machine.

Question 1 (15 marks – approximately 27 minutes)

Acting as financial controller of the Company, prepare a memo to the Board of Directors to recommend the most suitable strategic model and explain how the Company can use it to review and evaluate the value adding activities in the production of medical masks and how it can contribute to manufacturing new medical protection suits.

Note: A maximum of 2 marks for communication skill and 2 marks for analytical skill will be awarded.

(15 marks)

Question 2 (10 marks – approximately 18 minutes)

Using an ethical model, describe and explain what Mr Song should consider in order to make a decision about whether the Company should sell medical masks to consumers at inflated prices.

(10 marks)

Question 3 (12 marks – approximately 22 minutes)

(a) Propose and explain the processes that the Company should conduct before the acquisition of the medical protection suits manufacturing factory in the Netherlands in order to mitigate the associated risks of the acquisition.

(8 marks)

(b) Recommend what external professionals should be involved and their duties in the above processes.

(4 marks)

Question 4 (13 marks – approximately 23 minutes)

Advise on the most appropriate method to assess the financial feasibility of Project Adventure and use nominal values to prepare the financial feasibility analysis (assuming Project Adventure is not doing well at the end of year 4) to support your recommendation to the Board of Directors of the Company.

(13 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/ calculation and appropriate presentation of the answers.

Question 5 (16 marks – approximately 29 minutes)

Monica Marketing Limited ("the Company") is a private company owned by a few shareholders. The business assists hosts in organising annual dinners, conferences and exhibitions. The peak season of the Company is in July and August when many exhibitions are held during the summer holiday. The Company will sign a contract after the design and details of an event are agreed upon with the hosting organisation, and then the Company will start preparing for venue setup, buying the decoration materials, renting equipment, i.e. audio and lighting, and executing the agreed upon plan.

The Company will pay temporary workers immediately once the event is finished. The sourcing of the decoration materials is quite ad-hoc and decentralised at this moment. The project managers will source by themselves in nearby areas and pay cash for such purchases, including delivery and installation costs. The Company has one supplier to provide rental of audio and lighting equipment, for which the Company gets a 30-day credit period. For some events which invite pop singers, the Company is required to pay a 50% deposit one month before the event and 50% on the date of the event. The salary of the full-time staff is paid within five days on the next month, and the office rent is paid in the first week of the current month. The Company will issue invoices at the end of each month to their customers for those events that were completed in that month, and the customers must pay within seven days upon receipt of the invoices. There is no overdue noted.

The Chief Financial Officer ("CFO") has identified that there are weaknesses in the Company's procurement process, and the CFO suggests that the Company should centralise the procurement of decoration materials as well as delivery and installation for better price negotiation and better working capital management. Below is the monthly budget of the Company:

	Actual June HK\$'000	Forecast July HK\$'000	Forecast August HK\$'000	Forecast September HK\$'000
Service fee income	650	3,150	6,500	930
Expenses				
Office rent	180	180	180	180
Salaries and MPF to full-time staff	240	270	270	270
Salaries to temporary workers	20	65	110	40
Performance fees of pop singers	30	450	750	110
Decoration materials costs	117	567	1,625	140
Delivery and installation costs	20	158	325	47
Rental of equipments	35	221	455	65
Total expenses	642	1,911	3,715	852
Profit before tax	8	1,239	2,785	78
Cash balances at the end of June	2,000			

Required:

- (a) (i) **Prepare the cash flow forecast for July and August of the Company showing the forecasted cash balances at the end of each month.** (5 marks)
- (ii) **At the beginning of August, the Company foresees there is a significant risk that all of the service fee forecasted to be received in August would be delayed to September. Based on the forecasted cash balance of July, advise how much funding is required to sustain August operation and what will be the difference on the funding requirement if the Company temporarily postpones the projects in August to October.** (5 marks)
- (b) **Advise the Company on how to enhance working capital.** (3 marks)
- (c) **The Company has more than HK\$3 million in retained earnings, and one of the shareholders of the Company challenges the Company to distribute at least HK\$1 million dividends to all shareholders and seek an external loan for working capital. Advise on whether the Company should follow the shareholder's suggestion.** (3 marks)

Question 6 (16 marks – approximately 29 minutes)

Ashley Industrial Limited is a Hong Kong listed company ("the Company") based in mainland China with business in manufacturing industrial products and selling their products in mainland China and other Asian countries. The strategy of the Company is to invest in the best research and development ("R&D") and in the latest equipment technology to provide the industry with the best quality products. The Company is required to invest heavily in non-current assets such as R&D and new factories and equipment, and the Company has significant external borrowings from a bank. One of the Company's priorities is to maintain sufficient liquidity. The management of the Company is very happy with last year's financial results, when their sales recorded a 7.8% growth despite the slowdown of the global and Chinese economies. The management was proud that the current ratio of the Company is able to keep steady and even slightly improved compared to last year; however the bank does not agree. The bank warned the Company that their liquidity risk is increasing and suggested that the Company should take appropriate measures to improve the situation or otherwise the bank may call back their loan to the Company. The management was shocked and decided to discuss this issue with the Chief Financial Officer ("CFO").

Extract of statement of financial position

	2021 HK\$'000	2020 HK\$'000
Non-current assets	29,751	18,976
Inventories	2,645	1,355
Accounts receivables	3,663	2,850
Prepayment	500	400
Cash and cash equivalents	4,598	4,199
Total current assets	11,406	8,804
Current liabilities	8,422	6,603
Non-current liabilities	9,354	6,125
Total liabilities	17,776	12,728
Net assets	23,381	15,052

Extract of statement of profit or loss

	2021 HK\$'000	2020 HK\$'000
Sales	17,258	16,014
Cost of goods sold	(11,875)	(10,139)
Gross profit	5,383	5,875

Required:

- (a) Calculate the current ratio of the Company and advise on whether the current ratio has been really improved.

Analyse the comments from the bank and the reason why the liquidity risk has been increased. Based on the financial information provided, justify your answer with one profitability ratio, one other liquidity ratio, and the following two productivity efficiency ratios:

- Inventories turnover days (based on the inventories ending balance); and
- Accounts receivables turnover days (based on the accounts receivables ending balance).

Explain further the potential implications to the Company.

Assume 365 days in a year.

(11 marks)

- (b) In addition to ratio analysis as one of the performance measures, advise on FIVE strategic control measures for the Company to improve their performance.

(5 marks)

Question 7 (18 marks – approximately 32 minutes)

Andes Corporation ("the Company") is a company based in Hong Kong and listed on the Main Board of the Hong Kong Stock Exchange. The Company manufactures sports shoes in mainland China and Indonesia and sells its products to Hong Kong, Mainland China, the US and Europe through distributors. The distributors have agreed with the Company to a payment term where the distributors can pay in the local currencies of the distributors (i.e. HKD, RMB, USD or EUR) with a 30 to 90 day credit period to the bank account of the Company in Hong Kong.

The Company has a newly established treasury department in Hong Kong, and Nicole, who has over 15 years of treasury experience, has just joined the Company as the treasurer, reporting to the Chief Financial Officer ("CFO"), to lead the treasury department. The Company does not have any treasury policies, and they have relied on a multinational bank for treasury management for more than 20 years. The Company placed a significant amount of their excess cash in structured deposits and futures contracts in Australian dollars. Nicole was told by the CFO that the structured deposits and futures contracts were recommended by the relationship manager who believed Australian dollars would be strong and could potentially provide good returns for the Company. Nicole is not aware of the Company using any other services provided by the bank.

Nicole also has noted that the expansion of the Company mainly relies on internal funding, such as retained earnings of the Company, which may slow down the growth of the Company. Currently, the Company does not have any external debt. To allow the Company to grow faster, Nicole believes the Company should start looking for debt financing. However, under the recent uncertain economic environment, the first round of debt offering from the market was not very attractive, as the investors had priced in a high credit risk for the Company, which makes Nicole hesitate to consider debt financing for the Company, even though Nicole is very confident in the strong financial position and good liquidity of the Company. Nicole is thinking to approach a credit rating agency to rate the debt they issued to provide more confidence to their bond investors.

Required:

- (a) **Explain the role of the treasury department regarding the banking relationship management and propose three suggestions on what bank solutions can be introduced to improve the treasury operation of the Company.** (4 marks)
- (b) **Advise on what Nicole should do to facilitate the credit rating exercise by the credit rating agency.** (4 marks)
- (c) **The Australian dollar fluctuated significantly last year, and the Company suffered a huge loss from the structured deposits and futures contracts which they entered into with the bank, but Nicole realised that the relationship manager is not registered as a licensed intermediary in the Securities and Futures Commission ("SFC"). Nicole is planning to raise a complaint. Advise on where the Company could file their complaint and explain the grounds.** (4 marks)

- (d) Advise on how the treasury department of the Company can contribute to corporate governance, especially in terms of risk governance. Focus your discussion on the areas of governance structure and control environment.
(6 marks)

* * * END OF EXAMINATION PAPER * * *

SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer 1

Memo

To: Board of Directors of Protex Group Limited
From: Financial Controller
Date: xx/xx/xxxx
Subject: Application of value chain analysis to review and evaluate (i) the value adding activities in mask production and (ii) the potential contribution to the manufacture of new medical production suits

The value chain analysis should be used to review and evaluate activities on whether they add value in the production of medical masks in the Company. The value chain analysis is divided into: (i) primary activities that are directly related to production, sales, marketing, delivery and service – namely inbound logistics, operations, outbound logistics, marketing and sales and after sales services; and (ii) support activities, including procurement, technology development, human resource management and firm infrastructure, which provide supporting functions to make sure primary activities are performed effectively and efficiently and add value to the manufacturing and selling of medical masks.

Inbound logistics activities include receiving, handling and storing raw materials for the manufacturing system. The long-term contracts with suppliers and well-controlled warehouses can ensure that there are sufficient raw materials stored for production. This can help the Company to store and secure raw materials to develop new medical protection suits.

Operations activities relate to the use of raw materials and direct labour to produce medical masks. Since the manufacturing processes of making medical masks are fully automated with limited manual operations, this can avoid manual mistakes in the production processes. The Company has successfully produced high quality medical masks for years, and this experience could be modified to produce new medical protection suits. Nevertheless, the Company may need to acquire new equipment to produce new medical protection suits.

Outbound logistics activities include storage of medical masks in the warehouse and the distribution of medical masks to hospitals in Hong Kong and other Asian markets. The Company has sterilised, secured and well-controlled warehouses to keep all medical masks before selling to customers. The Company also has an experienced sales administration team to arrange shipment and delivery to hospitals in Hong Kong and other Asian markets. These will all create value to the Company to store and distribute new medical protection suits.

Marketing and sales activities are related to advertising, promoting and selling medical masks to hospitals. The Company has an experienced sales team led by a regional sales director to take care of selling activities to hospitals. The success of the Company has proved that the sales activities are performed satisfactorily. These activities can also contribute to the marketing and selling of new medical protection suits to customers. However, a new sales team may need to be established to sell new medical protection suits.

After sales services activities include customer services for handling hospital complaints and for providing advice and guidance to use different medical masks in hospitals. The Company has established an experienced customer services team led by a customer service director who has been providing continuous support to hospitals. This function can also add value in providing customer services to new medical protection suits. A new customer services team may be needed to form and provide customer service to new medical protection suits.

Procurement activities relate to the purchase of raw materials and production equipment to make medical masks. The Company has an established long-term relationship with reputable and high quality raw materials suppliers that can add value to ensure continuous supply of raw materials to develop new medical protection suits. The Company may also need to find new raw materials suppliers to provide raw materials to make medical protection suits.

Technology development activities include product design and improvement in manufacturing processes. The Company has a research and development team to do research and provide new technology to make medical masks. The Company has certain patents to produce medical masks. Nevertheless, it is not sure whether the research and technology used to make medical masks could be applied to make new medical protection suits.

Human resource management activities include recruiting, training, developing and rewarding people in production, sales and customer service in the medical masks business. The Company has different experts and experienced personnel to produce and sell medical masks and to serve customers satisfactorily. The development of new medical protection suits can leverage these areas of expertise and set up new production, sales and customer services teams to develop, manufacture and sell new medical protection suits.

Firm infrastructure activities relate to planning, finance, quality control, internal control structure and processes to make medical masks. The Company has set up an automatic system to manufacture and sell medical masks to hospitals. The existing system can also provide support to the planning and control in the manufacturing of new medical protection suits.

Upon the implementation of above recommendations, the value chain activities can add value to the development, manufacturing and selling of new medical protection suits.

Answer 2

Mr Song has to determine the facts and related ethical issues. The facts are that there is a tremendous demand for medical masks due to the health hazard in the community, and consumers have to buy medical masks to protect their health. The ethical issue is whether the Company should increase the price to sell medical masks to consumers to earn higher profit and sacrifice corporate social responsibility to the community during the pandemic.

Mr Song has to identify the major principles, rules and values of the decision. He is struggling with integrity, which implies fair dealing and truthfulness and acting responsibly and honestly with consumers, and corporate social responsibility, which implies the Company should not take advantage of the health hazard situation by increasing the prices of medical masks to earn tremendous profit. Based on stakeholder's theory, the Company has to consider the various stakeholders' reactions, such as the government, consumers, suppliers and shareholders, when determining whether the Company has acted irresponsibly. The Company and Mr Song may also lose reputation and respect in the community.

Mr Song has to specify the alternative courses of action. The first option is to use cost plus the original profit margin method to set the selling price by taking into consideration the increase of raw material costs due to escalated demand in the market and benchmarking their new selling price to those of similar products in the market. The second option is to sell the medical masks at ten times the existing price to consumers and earn more profit to benefit the shareholders of the Company.

Mr Song needs to assess the positive and negative consequences for the above alternatives in relation to the short-term and long-term prospects of the Company. If Mr Song decides to use cost plus the original profit margin method to set selling prices to sell their medical masks, they will lose the opportunity to earn higher profit for the shareholders, who may be discontented in short-term, but the Company will earn respect and good reputation from consumers and the community and also can retain loyal consumers and shareholders to the Company in the long run. If Mr Song decides to increase the prices of medical masks by ten times the existing price, the Company can earn higher profit for the shareholders and the share price may increase in the short term. Nevertheless, the Company's share prices and prospects may be adversely affected for acting selfishly without considering social responsibilities to the community and consumers.

The final step is to balance the consequences against primary principles or values to select the alternative that best fits the long-term value creation of the Company. Based on the above analysis, it is suggested that Mr Song should not earn super profit but should adjust the selling price after hedging the possible raw materials and logistic price risks for selling the medical masks to consumers for the long-term benefit and sustainability of the Company. This can also balance the interests of the shareholders, and the increased price is still affordable and reasonable to the community. The Company can also attract socially responsible shareholders to invest in the long-term. Moreover, stakeholders may also respect the Company's decision, which can strengthen their relationships with the Company in the long run.

Answer 3(a)

Since this is the first time the Company has made an investment to acquire a medical protection suits manufacturing factory in the Netherlands, the Company should conduct an overseas due diligence before the acquisition, which should include aspects in relation to commercial, financial, legal and intellectual property matters.

Strategic due diligence should be conducted to include strategic analysis that is used to explore the opportunities and threats that the manufacturing factory is facing in manufacturing and selling medical protection suits in the Netherlands and their existing markets by using PEST analysis and Porter's five forces model. Moreover, strategic analysis should also assess the strengths and weaknesses of the manufacturing plant by using resource analysis and value chain analysis.

Operational due diligence should also be conducted to review the existing operations, such as operational facilities, manufacturing processes and operational risks, of the medical protection suits manufacturing factory in the Netherlands.

Financial due diligence should be performed to assess the financial position, including profitability, liquidity, gearing, taxation, contingencies and capital commitments of the manufacturing factory. Particularly, the Netherlands may use different accounting rules to value and measure intangible assets such as patents. These should be reviewed and evaluated because they may significantly affect the acquisition price of the manufacturing factory. The Company should also assess other financial risks, such as credit risk, in the Netherlands that may affect the financial performance of the manufacturing factory and thus should be taken into consideration when setting the acquisition price.

Legal due diligence should be conducted to understand the corporate legal structure and rights of the manufacturing factory in the Netherlands that are new to the Company. The Company should also look at the acquisition laws related to overseas acquisition of a manufacturing factory in the Netherlands to make sure the Company is complying with them during the acquisition.

Intellectual property due diligence should be conducted to investigate the nature and details of the patents and licence to manufacture medical protection suits that the manufacturing factory possesses. These patents and licence are valuable intangible assets in the acquisition, so the Company has to review and look at all patent documents and registration details diligently.

Taxation due diligence should be conducted to evaluate tax issues, such as withholding tax and transfer pricing, and the tax consequence of the acquisition of the medical protection suits manufacturing factory in the Netherlands.

Answer 3(b)

A Netherlands business strategist or consultant who is familiar with the medical protection suits manufacturing industry should be employed to conduct commercial due diligence with the Company's management team.

A Netherlands certified public accountant who is familiar with the financial reporting and risks of the Netherlands should be appointed to work with the finance team of the Company to conduct financial due diligence of the manufacturing factory.

A Netherlands tax specialist should be employed to advise on the most appropriate tax structure for the acquisition with regard to the existing group structure of Protex Group Limited.

A Netherlands lawyer who is familiar with local acquisition laws should be employed to work with a Hong Kong lawyer appointed by the Company to conduct legal due diligence.

A Netherlands intellectual property lawyer who is familiar with intellectual property laws should work with a Hong Kong intellectual property lawyer appointed by the Company to conduct intellectual property due diligence.

A Netherlands intellectual property valuation expert should also be appointed to assess the market value of intellectual property possessed by the manufacturing factory based on specific local business and industry information.

Answer 4

The most appropriate method to assess the financial feasibility of Project Adventure is the net present value method using nominal values based on the preference of the Company.

Year	0	1	2	3	4
	US\$	US\$	US\$	US\$	US\$
Investment	(1,000,000)				
Sales ^(Note 1)		1,020,000	1,404,000	1,590,000	1,620,000
Costs of sales (30%)		<u>(306,000)</u>	<u>(421,200)</u>	<u>(477,000)</u>	<u>(486,000)</u>
Gross profit		714,000	982,800	1,113,000	1,134,000
Operating expenses ^(Note 2)		(550,800)	(624,000)	(699,600)	(712,800)
Depreciation		<u>(125,000)</u>	<u>(125,000)</u>	<u>(125,000)</u>	<u>(125,000)</u>
Profit before tax		38,200	233,800	288,400	296,200
Tax (30%)		<u>(11,460)</u>	<u>(70,140)</u>	<u>(86,520)</u>	<u>(88,860)</u>
Profit after tax		26,740	163,660	201,880	207,340
Add: Depreciation		<u>125,000</u>	<u>125,000</u>	<u>125,000</u>	<u>125,000</u>
Net cash flow	(1,000,000)	151,740	288,660	326,880	332,340
Cash flow from disposal ^(Note 3)					<u>604,621</u>
	(1,000,000)	151,740	288,660	326,880	936,961
Discount factor ^(Note 4)	<u>1.00</u>	<u>0.85</u>	<u>0.72</u>	<u>0.61</u>	<u>0.52</u>
Net Present value	<u>(1,000,000)</u>	<u>128,979</u>	<u>207,835</u>	<u>199,397</u>	<u>487,220</u>

(Note 1)

Sales (real)	1,000,000	1,350,000	1,500,000	1,500,000
Inflation (2%)	<u>1.02</u>	<u>1.04</u>	<u>1.06</u>	<u>1.08</u>
	<u>1,020,000</u>	<u>1,404,000</u>	<u>1,590,000</u>	<u>1,620,000</u>

(Note 2)

Operating expenses (real)	540,000	600,000	660,000	660,000
Inflation (2%)	<u>1.02</u>	<u>1.04</u>	<u>1.06</u>	<u>1.08</u>
	<u>550,800</u>	<u>624,000</u>	<u>699,600</u>	<u>712,800</u>

(Note 3)

Proceeds in year 4 (nominal)	649,459	649,459
Less: Net book value of the assets	<u>(500,000)</u>	
Gain on disposal before tax	<u>149,459</u>	
Less: Tax on the disposal gain (30%)		<u>(44,838)</u>
Cash flow from disposal		<u>604,621</u>

(Note 4)

Risk premium	Probability	
Prosperous economy (6%)	50%	3%
Poor economy (10%)	50%	<u>5%</u>
		<u>8%</u>

Fisher equation:

$$\begin{aligned}\text{Nominal Interest rate} &= [(1 + 0.08)(1 + 0.02) - 1] \times 100\% \\ &= 10.16\% \approx 10\%\end{aligned}$$

Discount factor 18%

Since the net present value is US\$23,431 and positive, the Company should invest in Project Adventure.

* * * END OF SECTION A * * *

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

Answer 5(a)(i)

	Forecast July HK\$'000	Forecast August HK\$'000
Service fee receipts	650	3,150
Office rent	180	180
Salaries and MPF to full-time staff	240	270
Salaries to temporary workers	65	110
Performance fees of pop singers	600	430
Decoration materials costs	567	1,625
Delivery and installation costs	158	325
Rental of equipments	<u>35</u>	<u>221</u>
Total disbursement paid	<u>1,845</u>	<u>3,161</u>
Net cash outflow	(1,195)	(11)
Cash balances brought forward	<u>2,000</u>	<u>805</u>
Forecasted cash balances at the end of the month	805	794

Answer 5(a)(ii)

Working capital needed for August operation
HK\$3,161,000

Extra funding required to sustain August operation
HK\$3,161,000 – HK\$805,000
= HK\$2,356,000

Working capital required to sustain August operation if the Company postpones the projects in August (HK\$'000)

$180 + 270 + (110 \times 50\%) + 221$
= 726

HK\$805,000 is able to cover HK\$726,000, so no further funding is required.

Answer 5(b)

The Company can consider centralising the procurement of decoration materials, delivery and installation by consolidating their procurement into a few authorised suppliers and negotiating a credit term for their purchases. Besides better pricing, consolidating their procurement allows the Company to have a steadier and larger scale of purchase to negotiate for better terms with their suppliers. The Company can negotiate with its suppliers for an open account which issues a monthly statement instead of paying its suppliers immediately by cash.

As the customers seem to settle the invoices immediately without asking for longer credit terms, the Company shall issue the invoices to their customers immediately after the events instead of waiting till the end of the month. The current practice will impact the working capital of the Company, especially for those events that are completed at the beginning of the month, as the Company has to wait for almost one month before receiving the cash.

The Company can also negotiate with its customers to place a portion of the fees as deposits in advance before the event. Placing deposits is a very common practice which can enhance the liquidity of the Company.

Answer 5(c)

The dividend policy is a key part of the long-term financial strategy pursued by the management and is a major part of the Company's relationships with its shareholders. Retained earnings is an internal source of cheap funds for financing the growth of the Company as well as funding the working capital of the Company, whilst dividends, from the shareholders' point of view, are a source of income or return on investment.

The payment of dividends is a cash outflow from the Company. Once the dividend is paid, it cannot be recalled by the Company if it subsequently finds itself in an illiquid position. The Company therefore needs to ensure it has sufficient liquidity to pay declared dividends and also to meet its liquidity obligations required for continuing funding and investment decisions. Using external debts to finance working capital involves interests, which affects the profitability of the Company at the same time.

For a private company, the shareholders will compare the interest rate on loans borrowed by the Company with the opportunity cost of the fund, i.e. the investment returns of the fund to be distributed to them as dividends. However, if the Company consists of more than one shareholder, the opportunity cost of the fund could be different, so the preference would vary.

The Company is recommended to develop a long-term and consistent dividend policy which can balance the expectation of shareholders and the needs of the Company.

As the forecasted cash position is below HK\$1 million at the end of August, it is not recommended to borrow to fund the dividend payment. However, developing a banking relationship by having a bank loan facility may help the Company seek financing when management has an opportunity to grow the business.

Answer 6(a)

Current ratio

2021:	11,406 / 8,422	= 1.35
2020:	8,804 / 6,603	= 1.33

Yes, the current ratio remained steady and even slightly increased from 1.33 to 1.35.

Liquidity

Quick ratio

2021:	(4,598 + 3,663) / 8,422	= 0.98
2020:	(4,199 + 2,850) / 6,603	= 1.07

or

Current assets to total liabilities

2021:	11,406 / 17,776	= 0.64
2020:	8,804 / 12,728	= 0.69

or

Working capital to total assets

2021:	(11,406 – 8,422) / (11,406 + 29,751)	= 0.07
2020:	(8,804 – 6,603) / (8,804 + 18,976)	= 0.08

Profitability

Gross profit margin

2021:	5,383 / 17,258	= 31.19%
2020:	5,875 / 16,014	= 36.69%

Although the current ratio is improved slightly, the quick ratio/ current assets to total liabilities/ working capital to total assets is getting worse. This indicates the Company's short-term liquidity position is almost unable to meet its obligations.

The gross profit margin decreased by 5.5%, indicating the Company was under price pressure and might have reduced their selling price to sustain their sales growth. The cost of goods sold could also have increased, giving cause to the lower gross profit margin.

Inventories turnover days

2021:	2,645 / 11,875 x 365	= 81.30
2020:	1,355 / 10,139 x 365	= 48.78

Account receivables turnover days

2021:	3,663 / 17,258 x 365	= 77.47
2020:	2,850 / 16,014 x 365	= 64.96

The increase in inventories turnover days from 48.78 to 81.30 might indicate a significant increase in inventory and not enough sales growth year on year, and there is also a risk of declining demand for their products. This might also indicate that the Company was not managing its inventories properly, and there could be a potential increase in obsolete inventories.

Accounts receivables turnover days was also increased, which indicated customers were repaying the Company slower or that there might even be overdues. This indicates that customers' ability to pay has deteriorated and may need to consider the adequacy of the provision for doubtful debt.

Answer 6(b)

In addition to the financial measures adopted by the Company to measure performance, the Company shall also take measures to enforce their strategic control to improve performance. Strategic control helps the Company to revisit the assumptions underlying the current strategy during the implementation stage, continue to monitor and evaluate the strategic milestones, and take any necessary corrective actions. Strategic control represents the processes to monitor and control the execution of a strategic plan for assessing long-term issues.

- Has the strategy been implemented as planned?
Measure the success of the R&D, new patents and products launched.
- Are the assumptions about major trends and changes correct?
Compare the products and equipments with competitors in the markets.
Benchmark against the competitors.
- Are objectives and schedules being met?
Measure the actual timeline for new product launches and compare with their planned timeline.
- Are revenues, costs, and cash flows supported by the assumptions and matched with the projections?
Explain reasons and root cause for major deviations.
- Are any operational changes necessary? When managing inventories, will the just in time or bill to order model be used?

Other valid point

Answer 7(a)

Managing an organisation's banking relationships constitutes one of the key parts of the treasury department's responsibilities. Maintaining a mutually beneficial and transparent relationship between the organisation and the bank is a critical factor towards achieving access to various treasury functions such as providing funding, processing payments, arranging hedging, and liquidity management. Banking relationships are normally managed by the relationship manager of the bank who is assigned to the company, and they normally provide these varied services and advice through their in-house product specialist. Banks often provide informal advice to the treasury department.

In this case, since the Company is exposed to various currencies such as HKD, RMB, USD and EUR, the Company could request the bank to provide hedging advisory services with foreign exchange products such as forwards and options. As the Company is selling to their distributors with credit, one of the solutions to working capital management could be factoring (or forfaiting) which banks are active participants. Factoring (or forfaiting) is the discounted sale of a receivable. Banks provide important funding as well as reduce credit risk for the customer.

Since the Company does not have any debt financing, the Company can consider inviting the bank to provide debt issuance and related advisory services. The bank can either assist the Company in issuing commercial bonds or provide a bank loan to the Company to finance the project or the growth of the Company.

Answer 7(b)

A company that issues debt can elect to have its debt rated by a credit rating provider. Since Nicole believes the Company's financial results are positive, strong cooperation between the Company and the credit rating agency can provide a positive message to the Company's bond investors.

The treasurer as well as the treasury team will be the key contacts of the credit rating analysts. They need to respond to the information requests from the credit rating provider's review team. The credit rating would be assigned to a company based on the information provided.

Generally, the analysts will ascribe about 50% of the rating to the Company's business profile and future prospects and 50% to its current financial profile. The analyst team uses financial statements publicly available. The analyst team will also assess forecasts and budgets, operating performance, risks and risk management approaches and the competitive landscape in the market. The analysis sometimes will start from a questionnaire, several years of historical financial data, forecasts, a business overview, a background of the senior executives, and a snapshot of the competitive landscape. The ratings focus is on forecasting the Company's performance into the future, rather than considering past performance.

The credit rating agency sometimes may request the treasurer to conduct a presentation, or arrange an interview with the Company's senior management, to let the credit rating team to question specific areas or items of concerns to assess the Company's financial stability and the likelihood of achieving its strategic objectives.

Answer 7(c)

The Company can complain to the bank for misrepresenting that the structure products in Australian dollars is good for hedging the foreign currency exposure of the Company as the Company did not have any currency exposure in Australian dollars, so there is no necessity for the Company to hedge the Australian dollar.

The Company can also complain to the Hong Kong Monetary Authority ("HKMA"), as HKMA promotes the stability and integrity of the financial system, including the banking system, and helps to maintain Hong Kong's status as an international financial center. HKMA is also the regulator of the Banking Ordinance. In this case, the bank was making an inducement to buy a structured product by providing a misleading rationale, i.e. to place the structure deposits in Australian dollars for hedging purposes, which potentially violates the guidelines on business practices of authorised institutions published by HKMA. The Hong Kong Monetary Authority is the frontline regulator of these activities.

The Company can also complain to the Securities and Futures Commission ("SFC"). The SFC requires intermediaries who deal and advise in futures contracts to register with the SFC. As the relationship manager is not registered with the SFC, he has violated the Securities and Futures Ordinance in dealing and advising in futures contracts. Also, as the SFC reviews offering documents and features of structured investment products including structured deposits, the Company can complain if the functions of these two products were not properly disclosed when the bank was recommending these to the Company.

Answer 7(d)

The Company is recommended to implement a risk management control system including preventing, detecting, and mitigating potential risks in the following areas.

Governance structure

The Company shall develop a governance structure to provide oversight and accountability for actions. The Board of Directors provides overall oversight and directions for the Company, and the treasury can provide professional advice on financial risks to the CFO and Board of Directors. The treasury department can also assist the Company in setting up a Risk Management Committee and can be one of the members who specialises in financial risks and formulate objectives regarding financial risk management.

The Risk Management Committee can report directly to either the Board or Audit Committee.

Control Environment

A comprehensive control framework, from oversight and supervision to specific process controls, can help the Company to achieve its business objectives and to mitigate and deter unethical conduct.

The treasury department can help to develop standards, policies and procedures, and communicate properly to the relevant staff of the Company. Clear and documented roles and responsibilities throughout the Company are critical to ensuring employees perform their functions in accordance with management expectations. The treasury department can also review business processes, such as management reporting, process documentation, technology and systems controls, or approval requirements, and suggest controls which can prevent or limit the opportunity for fraud and other unethical behavior related to financial risks.

The treasury department can advise on payment approval process and control, the appropriate delegation of authority for payment, the credit terms approval process to customers, and the execution of the credit policy to customers, i.e. dealing with overdue or excess credit limits. The treasury department can also develop investment and hedging guidelines and policies.

* * * END OF EXAMINATION PAPER * * *



Qualification Programme Examination Panelists' Report

Module 12 – Business Finance (December 2021 Session)

(The main purpose of the following report is to summarise candidates' common weaknesses and make recommendations to help future candidates improve their performance in the examination.)

(I) Section A – Case Questions

General Comments

Overall performance in this section was fair. Candidates are reminded to read the case and question requirements carefully before they plan and write their answers. Candidates are advised to be familiar with specific applications of strategic models to review and evaluate business operations and business strategies. Moreover, candidates are recommended to consider and assess different alternatives, short term and long term impacts of ethical decisions practically in the case. Overseas business acquisition has been very common in the business environment so candidates should be more familiar with due diligence processes to address different aspects of overseas business acquisition. Candidates should consider more practical business issues and variables when they use net present value to conduct financial feasibility. Again, merely copying materials from the learning pack into answers without further explanations and applications should be avoided. Candidates are advised to look at the case carefully so that they know how to explain and apply their knowledge to answer the case questions. Candidates should also wisely manage their examination time so that they can complete all the examination questions.

Specific Comments

Question 1 – 15 marks

This question required candidates to prepare a memo to the Board of Directors to recommend the most suitable strategic model and to explain how the company could use it to review and evaluate the value adding activities in the production of medical masks and how it could contribute to manufacturing new medical protection suits. Value chain analysis should be used that includes primary activities, namely inbound, operation, outbound, marketing and sales, services, and secondary activities, namely procurement, technology, human resources and infrastructure, to review and evaluate the production of medical masks by referring to specific case information. Moreover, candidates were asked to decide whether these activities could contribute to manufacturing new medical protection suits. Around half of the candidates were able to use value chain analysis to answer this question, but many candidates were not able to evaluate outbound, operations, infrastructure and technology with case information specifically. Also, only half of the candidates were able to use value chain analysis to evaluate whether these activities could contribute to manufacturing new medical protection suits. Many candidates were not able to write a proper memo structure with



introduction, content and conclusion. Therefore, candidates are advised to practise how to write a proper memo format and structure. Moreover, candidates should understand and know how to use proper strategic models supported by case information to review and evaluate the operation and strategy of a business.

Question 2 – 10 marks

This question required candidates to use an ethical model to describe and explain what Mr. Song should consider to make a decision about whether the company should sell medical masks to consumers at inflated prices. Most candidates were able to apply the American Accounting Association ethical model and to apply correct case information to answer this question. Nevertheless, candidates have to polish further their analytical skills to consider alternatives, and the short term and long term consequences in ethical questions. Most candidates only considered two alternatives, namely keeping the existing price or increasing the price of the masks. Candidates did not consider alternatives like the possibility of adopting cost plus pricing to reflect the long term increase of production costs of the masks in the pandemic situation. Again, candidates are reminded not to copy materials from the learning pack and case information in their answers without explanation and analysis.

Question 3(a) – 8 marks

This question required candidates to propose and explain the processes that the company should conduct before the acquisition of the medical protection suits manufacturing factory in the Netherlands in order to mitigate the associated risks of the acquisition. Most candidates were not able to propose that the company should conduct overseas due diligence before the acquisition. A lot of answers did not propose and explain different types of due diligence that could be applied in this overseas business acquisition case. Also, most answers were too generic without further elaborations and application of case information. Candidates are suggested to be familiar with the application of different due diligences applying in overseas business acquisition.

Question 3(b) – 4 marks

This question required candidates to recommend what external professionals should be involved and their duties in this overseas acquisition. Most answers were generic without considering the use of specific overseas professionals in an overseas business acquisition setting. Most candidates were able to find overseas lawyers and tax specialists to address legal and tax issues in overseas business acquisitions but a lot of candidates were not able to address legal structure and valuation of intellectual property in this case. Candidate are recommended to be familiar with overseas business acquisitions so that they can recommend specific overseas professionals to address different issues in this case.



Question 4 – 13 marks

This question required candidates to use the most appropriate method to assess the financial feasibility of Project Adventure and use nominal values to prepare the financial feasibility analysis to provide recommendations to the Board of Directors. Most candidates were able to use the net present value method to assess the financial feasibility of the project. Nevertheless, some candidates did not use nominal values correctly to calculate sales and operating costs, and some candidates were not able to calculate tax effects on depreciation and cash flow from disposal correctly. Some candidates were not able to use the Fisher equation to calculate the discount rate correctly. Candidates are suggested to be familiar with the net present value calculation with different variables, such as inflation rate, interest rate, depreciation, disposal of assets, that are practical business issues to address in financial feasibility in business decision making. Moreover, candidates are advised to have better time management in the examination because nearly one third of candidates did not attempt this question.

(II) Section B – Essay/Short Questions

General Comments

The overall performance was below average. The candidates performed better in calculation, but badly in providing advice. The candidates' analytic skills were weak, and they were unable to provide specific advice to the background given in the questions.

Specific Comments

Question 5(a) – 10 marks

This question required candidates to prepare the cash flow forecast and advise the funding requirement to sustain their operation for a given scenario.

The performance of the candidates was good. The candidates generally understood the question and were able to prepare the cash flow forecast as required. However, many candidates were unable to convert the payment terms of some specific items to appropriate cash flow.

Only some of good candidates were able to advise the correct funding requirement to sustain their operation for a given scenario. Some candidates even did not attempt this part.



Question 5(b) – 3 marks

This question required candidates to advise the measures to enhance working capital.

The performance of the candidates was good. Most candidates suggested the measures to improve working capital on both accounts receivables and accounts payables, although the suggestion related to cash receipt was too generic. Most candidates were unable to identify the delay issuance of invoice.

Some candidates mentioned inventories management, but they did not refer to the background of the question that the company did not have any inventory, and some candidates suggested to delay payroll and office rental which is impractical. Candidates should develop a better commercial sense.

Question 5(c) – 3 marks

This question required candidates to advise on the dividend decision.

The performance of the candidates was fair. Some good candidates could point out the dividend policy is a long term financial strategy and should be consistent. Very few candidates were able to compare the interest rate of the loan as the opportunity cost for shareholders.

Quite a lot of the candidates mentioned the signalling effect of share price; however the company in the question is a private company, suggesting the candidates did not understand the background of the question well. In other words, they provided irrelevant arguments not applicable to the question. Some candidate even mentioned that the tax benefit on interests is irrelevant.

Question 6(a) – 11 marks

This question required candidates to perform ratio analysis and provide advice including explaining the potential implications.

The performance of the candidates was satisfactory. Most candidates were able to perform the ratio analysis correctly. However, most candidates were unable to obtain higher marks as they were unable to explain the potential implications properly. Many candidates did not provide any advice and explanation. Some candidates discussed irrelevant issues like the implication of the bank loan and long term financing.

Question 6(b) – 5 marks

This question required candidates to advise on the strategic control measures for the company to improve their performance.



The performance of the candidates was poor. Candidates were not familiar with strategic control measure. Many candidates provided their measure by using the measures of balanced scorecard approach. Some candidates just provided generic measures like discount to customer etc. and some candidates referred to liquidity risk which is irrelevant.

Many of candidates even did not attempt this question.

Question 7(a) – 4 marks

This question required candidates to explain the role of the treasury department regarding the banking relationship management and propose suggestions on what bank solution can be introduced to improve the treasury operation of the company.

The performance of the candidates was poor. Most of the candidates did not understand the question requirement. Only a few candidates were able to focus their discussion on the role of treasury department regarding the banking relationship management and make valid suggestions. Most of the candidates provided a generic function of the treasury department which is irrelevant without addressing the requirements of the question.

Question 7(b) – 4 marks

This question required candidates to advise how the treasurer should facilitate the credit rating exercise by the credit rating agency.

The performance of the candidates was poor. Only some good candidates were able to point out that the treasurer would be the key contact to the credit rating agency, and only very few candidates were able to further elaborate the information required to provide to credit rating agency.

Many candidates misunderstood the credit rating exercise as setting a credit limit to their creditors. Many candidates provided suggestions how to enhance the financials as well as the cash flow. Both observations show candidates failed to understand the question properly.

Question 7(c) – 4 marks

This question required candidates to advise the appropriate regulators that should be approached in order to complain about the mis-conduct case with explanation.

The performance of the candidates was poor. Many candidates just provided generic comments on the behaviour of the relationship manager as inappropriate. Only some candidates mentioned SFC but most of them were unable to elaborate further. Very few candidates could point out other relevant regulators such as HKMA, HKEX and FRC.



Question 7(d) – 6 marks

This question required candidates to advise on how the treasury department contributes to corporate government in terms of risk governance.

The performance of the candidates was poor. Most candidates provided overall company governance structure or discussed enterprise risk management which were irrelevant. Very few candidates were able to point out that the treasury department can support establishing the risk management committee.

(III) Conclusion and Recommendation

Overall, the performance of the candidates was fair. Candidates should learn how to apply their technical and practical knowledge, such as value chain analysis, the American Accounting Association ethical model and overseas due diligence to answer case questions. It is also expected that candidates should be able to calculate net present value with different practical business variables to assess financial feasibility correctly. Moreover, candidates should improve their time management skills in order to complete all questions in the examination and to avoid writing answers in point forms. Candidates should continue practicing using past examination papers to strengthen their analytical and writing skills, both of which are key components in Module 12 examinations.

The advice provided by candidates was too generic and did not apply to the case. Candidates should provide their advice specifically to the case by properly understanding the background of the questions instead of providing generic advice and copying irrelevant information from their reference materials.

Candidates are also suggested to develop their skills on providing advice and developing their business sense.