Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered
Workshop 1		
1. Introduction	• Presentation • Group discussion	
2. Ethics in business	• Case study • Group discussion	Ch. 1
3. Executive management	• Case study • Formal presentations	Ch. 2 & 3
4. Management reporting	• Case study • Formal presentations	Ch. 4, 5 & 6
Workshop 2		
5. Reboot	• Presentation • Group discussion	
6. Treasury operations	• Case study • Formal presentations	Ch. 7, 8, 10 & 11
7. Corporate finance	• Case study • Formal presentations	Ch. 12, 13, 14 & 17
8. Conclusion	• Presentation • Group discussion	

It is extremely important that you have studied the relevant chapters of the Learning Pack and completed the pre-workshop materials thoroughly prior to attending the workshops so that you can derive the maximum benefit from them. You should become familiar with the workshop materials as they will be raised for discussion throughout the workshops.

Please remember to bring a calculator with you to the Module B Workshops.

Pre-Workshop Materials

Workshops 1 and 2

Case Background

Overview

Fave Health and Beauty Limited ('Fave') has experienced exceptionally strong growth in the eighteen years since it was founded as a single beauty clinic in Hong Kong. It now has a listing on the Main Board of the Hong Kong Stock Exchange, and provides a range of health and beauty services. Its beauty clinics provide advanced treatments to clients, and the company also operates a number of spas, massage centres and slimming and fitness centres not only in Hong Kong, but also in Singapore and mainland China.

The business in Singapore was established nine years ago by means of a takeover of a local company, Perfect Beauty. The business in mainland China was established as a start-up business five years ago.

Two years ago, the company opened a chain of retail outlets selling beauty and skincare products, most of them sourced from France. These are advertised as 'scientifically proven, and with natural ingredients'. There has been very strong growth in retail sales during the past two years. In addition, the retail sales division is now the supplier of these products to the beauty centres, spas, massage centres and slimming and fitness centres, acting as the centralised purchaser of products for the entire group.

Market conditions

The market for health and beauty services is very fragmented and most of Fave's competitors are fairly small businesses that specialise and focus on niche segments of the overall market. In contrast, the board of Fave has set an objective of providing a wide range of health and beauty services and products to markets both inside and outside Hong Kong.

The company has also established a reputation for very high quality services, and its products and services are priced at the high end of the market range.

Until recently this did not seem to have any effect on sales, but in 2014, sales of slimming and fitness services declined significantly. Management believe that this decline is due to a combination of continuing global economic slowdown and an apparent change in consumer tastes. Strangely perhaps, individuals continue to demand beauty products but have lost interest in slimming and fitness. This decline is evident in Singapore as well as Hong Kong, but not in mainland China.

In contrast, sales of beauty and skincare products through Fave's retail outlets are expected to grow more strongly in the future. Many people who cannot afford expensive courses of treatment are doing 'the next best thing' and are buying luxury treatment products.

Whereas sales of products are targeted mainly at a mass market with discretionary spending capability, beauty treatments are in demand mainly with wealthy clients. As the numbers of wealthy families and professional women increases throughout South East Asia, demand has grown strongly and is expected to continue to grow. It seems inevitable that new competitors will seek to gain a foothold in this profitable market. The industry is already very competitive.

Because the market contains many competitors, staff turnover is quite high. Individuals move from one company to another, often in search of better remuneration, and the median length of employment for new staff is currently about three years. The company has introduced a bonus incentive scheme to retain its top beauticians and medical experts. In addition, the company plans to improve the technical abilities of its staff, and offers specialist training for staff, at the company's expense, in return for an undertaking to remain with the company for at least two full years after achieving a qualification in their area of expertise.

Services provided by Fave

Fave operates from a number of different locations and centres, some of which it owns and some of which are rented.

Fave's operations are organised into four operating divisions.

(1) **Beauty and facial**. The company has a number of beauty clinics, where treatments are provided exclusively to female clients. The company is able to provide advanced and complex treatments as well as simpler services. All clinics are equipped with cosmetic laser technology.

(2) **Spa and massage**. The company operate a number of exclusive spas, where clients are able to relax and also receive massage treatment and skin care treatment. Every spa is equipped with hydrotherapy jet baths.

(3) **Slimming and fitness centres**. Fitness centres also offer a range of slimming courses, yoga classes and dancing classes. Profit margins on this business are lower than for beauty clinics and spas.

(4) **Retail products**.

All centres are well-equipped, and the company regularly replaces existing equipment with up-to-date models. Equipment is purchased from the USA and Australia.

The company regards its high-quality equipment and facilities as a key marketing advantage. Recent advertising campaigns for its beauty clinics and spas have included slogans such as ‘Beauty transformation', ‘A beautiful experience' and ‘Relax in modern luxury'.

The company's beauty clinics provide treatments that range from simple to highly complex and advanced. Centres have their own operating theatres, with some beds for clients for overnight (or longer) stays, and they employ large numbers of medical and technical specialists. Most staff are employed within one centre, but some specialist surgeons (who are also employed full time) treat clients at several centres, in order to use their time efficiently and effectively.

Management believe that the high quality of Fave services, combined with strong brand recognition for Fave's beauty centres and spas, explains the full order book that the company enjoys. The company has already received bookings for courses of treatment that will last into 2016.

Albert Yip, the Chief Executive Officer (CEO), sometimes worries that the demand for beauty services will decline at some time in the future, just as the demand for slimming courses and fitness centres may have passed its peak. However Mandy Lam, the founder of the company who has now retired from the board, has sought to reassure him. ‘We are all living longer,' she told him, ‘and as long as we live, we shall want to feel young, healthy and beautiful.'

Locations

The company owns some properties, but about 75% of the space occupied and used by the company is rented. In total, the beauty clinics, spas and slimming and fitness centres covered 250,000 square feet of space in 2014, as follows.

	Square feet
Beauty and facial centres	166,000
Spas and massage centres	45,000
Slimming and fitness centres	24,000
Head office	15,000
	250,000

The board of directors

Since the founder of the company (Mandy Lam) retired three years ago, the board of directors has consisted of the chairman (Edward Chan), the CEO (Albert Yip), the chief finance officer (CFO, Cindy Kwok) and six independent non-executive directors. Albert Yip thinks that the board has too many non-executive directors.

Financial performance 2014

The company is profitable, but total profits fell in 2014 compared with the previous year. The decline is blamed largely on the poor performance of the slimming and fitness centres. Most directors on the board of directors are confident that profit growth can be restored, particularly if the company maintains its strategy of business expansion. Two directors argue, however, that the company should take measures to reduce costs before the company pursues any further growth targets.

Summary financial statements for Fave for the year to 31 December 2014 are shown in Appendix 1.

Management are very concerned about the big fall in customers and revenues at Fave's slimming and fitness centres during 2014. These centres operate under the brand name Slimfit. If the decline in revenue continues, management believe that they will have to consider the closure or sale of this part of the business. Until a few years ago, there was strong customer demand for slimming courses and fitness centres. Management do not really understand why demand has fallen so sharply, and some senior managers believe that demand will eventually recover. Others are not so sure that the business will ever recover.

Segmental performance for the company's four operating divisions is shown in Appendix 2.

Dividends, cash and treasury policy

Most sales by the company are paid for by cash or credit card. When customers sign up for a course of treatment, or for special beauty treatment, they are required to pay the full fee in advance for the entire course. As a result, the company receives some payments for treatments that they do not expect to be completed for over a year.

Cindy Kwok, the CFO of Fave, has agreed an arrangement with the major credit card issuers whereby the card issuers retain a substantial proportion of payments by credit card in special reserve accounts, and do not release the money to Fave until after the services paid for by credit card have actually been provided by Fave.

Cindy Kwok is proud of the fact that the company is ‘cash rich', so that after the first few years of its existence the company has never had to borrow money from a bank.

As a hedge against foreign exchange risk, Cindy makes sure that the company holds its cash in several currencies. Although half of its cash is held in HK dollars, the company also holds Singapore dollars, renminbi and some US dollars. Since the company sources most of its beauty and wellness products from France, Cindy is considering whether to open an account in euros too.

In view of the company's profitability and strong cash position, the board of directors has managed to combine a policy of fixed asset replacement (to keep its equipment and facilities up-to-date) and high dividend payouts. Edward Chan is a major shareholder in the company and strongly supports the high dividend payout policy.

The company has 50 million shares of HK$1 each in issue. The earnings per share for 2014 were $0.90. The company's share price is currently HK$12.20, down from $14.75 one year ago.

Future strategy

Albert Yip, the CEO of Fave, is arranging for the board of directors to undertake a strategic review of the company. He thinks that the board must assess conditions in the market for health and beauty treatment and products, and must be prepared to take initiatives to maintain the company's leading position in its markets.

He also thinks that it is now time for the company to consider the most appropriate strategy for taking the business forward in the next few years. His personal preference is for expanding the business into new areas, but he is also aware of the concerns of some board directors about the need to control rising costs.

A strategy study group has recently prepared a report for Albert in which four possible strategies are suggested as the key business strategy for Fave for 2015 and 2016. These four strategies are as follows.

Strategy 1. Open a new range of beauty clinics for men. Currently, Fave provides treatments exclusively for women, in the belief that women would not want to share treatment facilities with men. However, there may be strong hidden demand for beauty treatment from men that Fave could exploit by opening a new range of ‘Body Look' centres for men in Hong Kong.

Strategy 2. Continue with the development of the business outside Hong Kong. In addition to continuing with growth in Singapore and mainland China, the company should extend its operations to other countries in South East Asia, notably Malaysia and South Korea. To establish operations in these countries Fave should look for suitable acquisition targets.

Strategy 3. In view of the declining profitability of slimming and fitness centres, the company should sell or shut down these centres. Any cash from the sale of this business should be invested in expansion of the fast-growing retail sales operation in Hong Kong, Singapore and mainland China.

Strategy 4. Before adopting any new strategy for growth, the company should seek to reduce costs and improve profitability in its existing business, until the global economy shows signs of revival. If the company can achieve better profits and cash flows, it will be in a better position to select and finance growth opportunities in the future.

Appendix 1: Summary financial statements for the year to 31 December 2014

Financial statements for the year ended 31 December 2014

Fave Health and Beauty Limited

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2014

	2014 HK$ million	*2011* HK$ million
Sales revenue (note 1)	637	607
Cost of inventory sold	19	17
Employee benefit expenses	327	303
Occupancy costs (note 2)	102	102
Building management	13	13
Depreciation	26	25
Advertising and marketing	12	10
Bank charges	30	26
Other operating expenses	53	43
Total operating costs	582	539
Profit before tax and interest	55	68
Interest income	1	1
Profit before taxation	56	69
Income tax expense (note 3)	11	13
Profit after taxation	45	56

Notes.

1 At the moment, all retail sales outlets are located in Hong Kong and Singapore. Including retail sales, 83% of the company's revenue in 2014 came from Hong Kong, 4% from mainland China and 13% from Singapore.

2 Occupancy costs consist of rental costs and some operational costs associated with building occupation.

3 HK profit tax at 16.5%, foreign tax and deferred tax

Fave Health and Beauty Limited

SUMMARY STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER 2014

	2014		*2011*	
	HK$ million	HK$ million	HK$ million	HK$ million
Property, plant and equipment		216		203
Deposits (note 1)		32		35
		248		238
Current assets				
Inventory	11		10	
Receivables, deposits and prepayments (notes 1 and 2)	198		162	
Cash and bank (note 3)	410		390	
		619		562
		867		800
Equity and liabilities				
Share capital and reserves		240		249
Liabilities				
Trade payables and accruals	61		56	
Deferred revenue	554		483	
Taxation	12		12	
		627		551
		867		800

Notes.

1 Most sales are by credit card or for cash. When payments are by credit card, the credit card issuers retain deposits in reserve accounts to secure performance by Fave of services to customers for which customers have paid in advance. The deposits are released when the services to customers have been performed. Payments in advance by customers often cover a course of treatment or medication, which may last for over 12 months.

As at 31 December 2014, the receivables, deposits and prepayments were as follows:

	HK$ million
Trade receivables	26
Deposits with credit card companies	133
Prepayments of rent	71
	230

2 **Aged analysis of receivables at 31 December 2014**

	HK$ million
0 – 30 days	12
31 – 60 days	9
61 – 90 days	3
91 – 150 days	1
Over 150 days	1
	26

Most receivables are in HK dollars.

3 Fave has large amounts of cash on deposit. This is because the company takes payments in advance from individuals for courses and treatments. Because of the high demand for Fave's beauty treatments and spa centres, many individuals are willing to pay several months in advance, and sometimes over one year in advance, to make a booking.

Not all payments are in advance, however. The company accepts ‘last minute' bookings from clients, and allows up to 30 days credit, although some clients take longer to pay. To date, the company has not written off any receivables as non-collectable.

Cash is held in a number of different currencies. Company policy is to hold cash in different currencies partly to hedge exposures to foreign currency risk and partly to speculate by holding currencies that are expected to appreciate in value against the Hong Kong dollar. About 50% of cash is in HK dollars, 20% in Singapore dollars, 20% in renminbi and 5% in US dollars.

Fave Health and Beauty Limited

SUMMARY STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2014

	HK$ million	HK$ million
Profit before interest and tax		55
Depreciation	26	
Increase in inventory	(1)	
Increase in receivables, deposits and prepayments	(33)	
Increase in trade payables and accruals	5	
Increase in deferred revenue	71	
	68	
Interest received	1	
Tax paid	(11)	
		58
Net cash from operating activities		113
Net purchase of property, plant and equipment		(39)
Dividends paid		(54)
Increase in cash		20

Appendix 2: Segmental performance

The company is organised into four product and service divisions, regardless of geographical location.

	Beauty and facial HK$m	*Spa and massage* HK$m	*Slimming and fitness* HK$m	*Product sales* HK$m	*Total* HK$m
External sales	470	95	33	39	637
Transfers	–	–	–	18	18
Total sales	470	95	33	57	655
Transfers of materials	12	5	1	–	18
External cost of materials	–	–	–	19	19
Employee benefit expenses	239	33	12	10	294
Occupancy costs	61	22	8	5	96
Building management	7	3	1	1	12
Depreciation	10	6	5	1	22
Advertising and marketing	7	3	–	2	12
Other operating costs	35	5	2	2	44
Share of head office expenses	60	12	4	7	83
Total costs	431	89	33	47	600
Operating profit	39	6	0	10	55
Assets and liabilities at 31 December 2014					
Property, plant and equipment	127	56	15	7	205
Inventory	1	–	–	10	11
Receivables, deposits and prepayments	190	35	5	–	230
Trade payables and accruals	35	8	2	13	58
Deferred revenue	453	87	14	–	554
Note:					
Sales in 2013	425	97	51	34	607

Head office expenses 2014	HK$m
Employee benefit expenses	33
Occupancy costs	6
Building management	1
Depreciation	4
Bank charges	30
Other operating costs	9
	83

Note. The totals shown in this table do not correspond exactly to the figures in the summary statement of financial position because of assets or liabilities attributable to Head Office.

Workshop 1 Session 2

Pre-workshop exercise 1 (Ethics in Business)

Ethical scenario

Fave Health and Beauty Limited ('Fave') has a number of beauty clinics, where treatments are provided exclusively to female clients. The leading Hong Kong Beauty Clinic, Magic Spa, is always first to introduce new beauty and cosmetic treatments. It's specialities includes collagen, laser and Botox treatments, all of which have been very successful in the Hong Kong marketplace. It offers these services alongside more traditional beauty treatments such as facials.

Magic Spa has its own operating theatres, with some beds for clients for overnight (or longer) stays, and they employ large numbers of medical and technical specialists. Most staff are employed within one centre, but some specialist surgeons (who are also employed full time) treat clients at several centres, in order to use their time efficiently and effectively.

Magic Spa recently introduced a new treatment, relatively untested in the world beauty marketplace. The beauty treatment involves the withdrawal of the patient's blood, storage of the blood for a period of time and then a transfusion of the patient's blood back into their body. Its purpose is to reinvigorate and re-energise the patient and enable them to magically appear several years younger. This treatment has not been offered in Hong Kong, and has only been used as a beauty treatment in a handful of reputable salons world-wide. It is being clinically tested as a treatment in several cosmetic treatment laboratories around the world, including the Fave in-house laboratory titled Beauty Land Laboratory (BLL).

The head of medical research at BLL, Dr. Tommy Yeo, is the medical sign-off on all clinical trials. Dr. Yeo is a well-respected cosmetic surgeon and has been head of medical research for over 20 years. He is a member of various medical associations in Hong Kong and the Mainland. He is a well-respected member of the international cosmetic medical fraternity. He has been under great pressure since his second-in-command left the laboratory after falling ill over three months ago.

The new blood transfusion treatment underwent clinical trials over a six-month period. These trials only involved treatment on humans on two occasions. On the first occasion, the treatment went very smoothly. On the second trial, one of the patients fell ill with septic shock and required in-house treatment at the clinic. This was recorded as a 'one-off' reaction. All other patients responded well to treatment and did actually appear younger! Dr. Tommy Yeo signed off on the trials stating that the product was POSITIVE – READY FOR MARKET**;** but with a recommendation that three more human trials be conducted over a three-month period. The next day he went on a long-awaited, eight-week holiday to Europe.

During this time, the Head of New Product for beauty and cosmetics, contacts BLL for all the POSITIVE – READY FOR MARKET new treatments that can be offered to the marketplace. The blood transfusion treatment is on this list. The Head of New Product is very excited that this has received sign-off and puts the product into his six-month product plan to be presented to Albert Yip, the CEO.

Albert Yip receives the product plan and approves the blood transfusion for use in just one clinic as a trial – Magic Spa. He decides to wait to see how it goes before running it as a new product across all clinics (which will require Board approval). Albert Yip, relatively young and very ambitious, is keen to introduce innovative products and increase revenues using new product lines. He has been a Hong Kong CPA for 12 years.

Magic Spa runs the first treatment on four patients. There are two nurses and a medical doctor from BLL present. It all goes horribly wrong. Three of the four patients are rushed to hospital with severe septic shock. One patient, Patient X, develops an infection, *Mycobacterium abscessus*, and dies three days later. The other two patients are extremely ill but both recover after several weeks.

This is a public relations disaster for Fave. They quickly release media statements about the extent of testing and the positive results of the clinical trials, as well as promising a stop to all future treatments. The company does not release the negative result in the clinical trial, nor does it release the recommendation from Dr. Tommy Yeo that more clinical trials should be conducted. The media releases appear to contain the disaster and the damage to the reputation of Fave and to Magic Spa is limited.

Concurrently, a full internal review is launched into the affair and a complete report given to Albert Yip and the Chairman of the Board, Edward Chan. The Head of New Product is placed on performance monitoring and Dr. Yeo (who is now back at work) is asked to conduct an internal review of the operations of Beauty Land Lab. Albert Yip and Edward Chan now have the report and consider their next actions.

Linda Lee is an ambitious business analyst in her late twenties who has been working in the finance department of the Fave Head Office in Hong Kong for two years. She has been a Hong Kong CPA for five years. She has been asked by Cindy Kwok (CFO) to prepare figures showing the potential cost to the company of litigation and of reputational damage. In preparing her figures she is presented with the internal report which she is told is 'commercial-in-confidence'. Some weeks pass. Linda becomes concerned that the company is not planning to release all the information to the public. She takes a copy of the report.

Group discussion

In your group, you will be asked to consider this scenario from the viewpoint of **one** of the following persons:

(a) Mr. Albert Yip, CEO (and Hong Kong CPA)

(b) Mr. Edward Chan, Chairman and major shareholder

(c) Dr. Tommy Yeo, Head of Clinical Research of BLL

(d) Linda Lee, business analyst (and Hong Kong CPA)

In each individual group discussion, consider the following:

(a) Note down the key ethical considerations of your allocated person in the scenario

(b) With reference to the HKICPA Code of Ethics, what does the group consider to be the ethical issues faced in this scenario. This should be assessed from the perspective of the group's allocated person and as a CPA.

(c) Using the 3-step strategy to solve ethical dilemmas, what does the group consider to be the best solution or action to address the situation? This should be assessed from the perspective of the group's allocated person and as a CPA.

Workshop 1 Session 3

Pre-workshop exercise 2 (Executive Management)

Cindy Kwok, CFO of Fave, has asked you to attend a monthly management committee meeting. In this committee meeting you will be asked to evaluate **four possible strategic options** and decide on the **appropriate strategy** to be taken by Cindy and the other members of the management committee to take up to the Board.

They will certainly raise a lot of questions to you after your presentation to the management committee. You are very pleased to take on this opportunity to impress Cindy and the team.

Required

Carry out a comprehensive market analysis of the beauty, massage and slimming/fitness industries in which Fave operates using the Porter's five forces model. Conclude whether the power of each force is high, medium or low. Identify at least four points for each of five forces. In your analysis also consider the sixth force – complementarity and list at least four complementors.

Note. It is recognised that there may be many more than four possible items for each force, and that acceptable answers may vary in content.

Bring your completed Porter's five forces to the Workshop as a tool to assist you in evaluating the **strategic options** presented.

Workshop 1 Session 4

Pre-workshop exercise 3 (Management Reporting)

Albert Yip (CEO) and Cindy Kwok (CFO) have been discussing the performance of the four operating divisions.

Albert has expressed the view that the lack of profitability in the Slimming and Fitness division shows that the time will soon come when the division should be closed down. Cindy disagrees, arguing that the division provides substantial revenue for the company and contributes towards overall profits.

When Albert asks Cindy how much contribution does the division provide, Cindy admits that she does not know. The segmental performance reports do not provide the necessary information for this analysis. She is able to comment, however, that the division broke even in 2014 after charging HK$4 million in head office overhead charges, costs over which it had no control and for which the division was not responsible.

Albert wants to know whether there are some slimming and fitness centres that are profitable and some that make losses. He also wants to know whether some programmes are more profitable than others; for example, are slimming classes more profitable than yoga classes and dancing classes, and what about the profitability of the division's gymnastics centres?

They also discuss pricing. The company strategy has been to charge high prices as a sign of superior quality. The view has been that customers enjoy association with top quality services and will pay a high price for them. Albert takes the view that the deterioration in the performance of the Slimming and Fitness division in 2014 was the result of a big change in the market. He believes that customers no longer consider gymnastics to be a premium service and are becoming much more price-conscious. He is convinced that lower-priced competition and the change in customer attitudes has led to a fall in demand for Fave's slimming and fitness services, and that prices must be reduced in order to remain competitive and profitable.

Cindy disagrees. She says that it does not matter if sales demand is falling. The only consideration should be to ensure that sales prices are higher than costs.

Together, they look at the annual financial performance of one of the company's slimming and fitness centres in Hong Kong. These are summarised below.

	HK$'000
Sales:	
Slimming courses	1,200
Gym membership: annual subscriptions	2,050
Gym: occasional sales	340
Dancing classes	620
Yoga classes	890
Total revenue	5,100
Costs:	
Materials	150
Labour: trainers and class leaders	1,220
Labour: administration	635
Rental and building running expenses	1,400
Equipment depreciation	790
Marketing	40
Other operating costs	310
Share of head office costs	620
Total costs	5,165
Loss in 2014	(65)

Most of the costs of this centre are fixed costs. (Most of all the operating costs of the company are fixed costs.)

Required

Using the information in the case study and the supplementary information in this document, you are required to:

(a) **Analyse the financial performance of the Slimming and Fitness division in 2014.**

(b) **Explain the limitations of the cost and profit information in the segmental report and in the performance report for the individual slimming and fitness centre. Suggest ways in which the information about costs and profits could be improved, to provide information that has more value to management.**

(c) **Identify the merits and limitations of the current approach by the company to pricing its services to customers.**

Workshop 2 Session 6

Pre-workshop exercise 4 (Treasury Operations)

The company is making a review of its cash flows and working capital policies. Although the company is cash-rich, Cindy Kwok (CFO) is not satisfied that working capital has been well managed. The company is planning major investment next year in new equipment, and Cindy does not want to ask a bank for a loan to finance the purchases. She wants to finance all equipment purchases – possibly as much as HK$50 million during the year – out of cash flows and cash resources.

Her treasurer, Damon Lin, disagrees. He believes that for a company with a negative cash cycle, cash levels must be maintained at a high level.

He also believes that the company has excessive exposures to foreign exchange risk. These will increase next year when the company places orders for large purchases of equipment from Australia. Damon wants the company to hedge more of its exposures to currency risk, using either forward exchange contracts or currency options.

He wants to discuss a particular transaction with Cindy. The company is about to place an order for a quantity of equipment for its beauty clinics from a supplier in Australia. The equipment will be produced to Fave's specifications and will take six months to manufacture. Payment, in Australian dollars (AUD), will be required on delivery of the equipment.

The current spot exchange rate is HKD8.08 to AUD1. A bank is offering a six-month forward rate of HKD8.00 for the sale of Australian dollars to Fave. Damon has also established that if the company wanted to arrange a currency option to buy one million Australian dollars in six months' time at an exercise rate of HKD8.00, the cost would be HKD60,000.

Required

(a) **Using all relevant information in the case study, analyse the cash cycle of Fave to the extent that you consider this is possible.**

(b) **Giving your reasons, suggest whether the company will be able to pay HKD50 million for new equipment next year out of its cash resources and cash flows.**

(c) **List the advantages and disadvantages of using (a) a forward contract or (b) a currency option to hedge the exposure to foreign currency risk in the transaction that Damon Lin wishes to discuss with Cindy Kwok.**

Workshop 2 Session 7

Pre-workshop exercise 5 (Corporate Finance)

Cindy Kwok, the CFO of Fave, has asked her corporate finance management team to carry out an investment appraisal of a proposed purchase of beauty treatment equipment from Australia, costing HK$2 million.

The following estimates have been provided by Cindy Kwok for the investment appraisal exercise.

(1) The equipment is a single unit, and it has been estimated that clients will be charged HK$1,000 per hour for treatment using the equipment, at current price levels.

(2) There are no variable costs associated with using the machine, but additional fixed cash expenses of HK$120,000 per year will be incurred for each of the next four years, at current prices.

(3) The equipment is expected to have a useful life of four years, at the end of which it will be sold for HK$200,000 after allowing for inflationary increases in the residual value.

(4) It is estimated that the equipment will have revenue-earning capabilities in each year as follows:

Year	*Hours of use*
1	600
2	1,000
3	1,200
4	600

(5) The equipment will attract tax relief of HK$450,000 of cost in each year of use. You should assume that tax cash flows arise in the same year as the profits or tax allowances to which they relate.

(6) Taxation will be payable at a rate of 16.5%.

(7) It is expected that operating costs will rise by 5% per year because of inflation, and price rises will be 3% in each year.

(8) The company's cost of capital is 9%.

Required

(a) Calculate the net present value of a decision to purchase the equipment, using the estimates provided here.

(b) Perform sensitivity analysis on your calculations, and assess the effect on the net present value of the investment if:

(i) Revenue per hour from using the equipment is less than estimated or the number of revenue-earning hours each year is less than estimated

(ii) The additional operating costs are higher than estimated

(c) Recommend, on the basis of financial performance alone, either that the company should purchase the equipment or that it should not purchase the equipment.

Suggest how your recommendation might change if the company is considering the purchase of 10 such items of equipment over the next two year period.

(d) Cindy Kwok is known to favour the purchase of the equipment because she thinks that it is essential for Fave to remain equipped with fully up-to-date equipment. However the board may not agree to make any purchase unless the expected DCF return on investment exceeds the company's cost of capital.

Suggest the behavioural implications for the investment appraisal of Cindy's attitude towards the investment.