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Introduction

Module Aim and Structure

This module will enable you to handle ethical dilemmas and financial matters and appreciate the following four key financial roles which are common to commercial organisations.

- The executive management role to provide leadership and direction;
- The management reporting role to provide operational and financial information for decision making;
- The treasury operations role to manage cash flows both present and future and its related financial risks; and
- The corporate finance role to advise on the restructuring and expansion of business.

The module is structured in such a way that it can achieve the module aim. The structure provides the framework for grouping related topics together in a systematic way to facilitate your understanding of the relationship between different topics. This module structure also applies to both the Learning Pack and the module workshops to ensure a linkage between the module study materials and the workshop materials.

Overall Structure of Module B (Corporate Financing)



Workshop Structure and Format

In line with the module aim, the workshop is structured in a five-step approach as listed below.

- Ethics in business;
- Executive management;
- Management reporting;
- Treasury operations; and
- Corporate finance.

You will be working case exercises during the workshops. Through group work and discussion, you will appreciate how to apply commonly used ethical models in deciding on ethics issues, and various models in leading and managing an organisation.

Workshop Objectives

The workshops aim to enable you to understand:

- How to recognise situations where possible ethics issues arise and apply commonly used models in handling ethical dilemmas;
- How to apply various models in data gathering and analysing on an organisation's market environment and position, in order to evaluate and recommend strategic choices;
- How to apply various models in costing and performance measurement in order to evaluate the operational performance and make recommendations to address the issues;
- How to evaluate the liquidity and funding position of an organisation to identify financial risks and make recommendations to address the issues;
- How to apply various models in business valuation and recommend the best option for raising finance;
- The key elements of effective teamwork;
- The key elements in listening attentively and asking probing questions; and
- The consideration of different perspectives of a group before selecting feasible solutions or courses of action.

Development Indicators for Generic and Technical Competencies

The focus of the workshops is on formative development of skills, i.e. to train students to become future CPAs. A set of development indicators has been designed to encourage students to participate in the workshops and demonstrate the development of the intended learning objectives.

The purpose of the development indicators is to encourage you to:

- Prepare for the workshops;
- Actively participate and be engaged in the workshops; and
- Achieve the learning objectives by developing the technical and generic competencies.

It also allows the workshop facilitators to monitor the development of the students so that appropriate actions or counseling can be done.

As the learning objectives of each module are different, there will be different development indicators or criteria for different modules. There are core criteria, i.e. criteria that are common to all four modules, as well as some criteria which are specific to an individual module.

You are expected to demonstrate the following core criteria at each workshop:

- Be well prepared for the workshop by demonstrating reasonable level of knowledge of technical content (i.e. contribute to discussion by offering relevant facts or information);
- Be punctual (i.e. arrive at the workshop on time and do not leave early except with the approval of the Institute or workshop facilitators);
- Work well with team members and workshop facilitators (i.e. interact with them in a constructive manner);
- Proactive participation (i.e. show willingness to take up roles in group discussion and raise questions or express ideas/opinions appropriately); and
- Adhere to an ethical mindset and professional behaviour.

You are expected to demonstrate the development of the following specific criteria for Module B:

- Ability to identify and resolve business ethics issues;
- Reasonable understanding of the roles of executive management and management reporting, and the ability to apply key models;
- Reasonable understanding of the roles of treasury and corporate finance, and the ability to apply key models;
- Possess an enquiring mind;
- Ability to evaluate options and draw conclusion after considering all the pros and cons of each option; and
- Ability to structure your own presentation and to deliver clear presentation.

Passing Criteria for Workshops

A two-scale system of performance comprising 'yes for demonstrated' (i.e. 'green light') and 'no for not demonstrated' (i.e. 'red light') is set up for each development indicator. Students must achieve at least 70% of the available indicators obtaining 'green light' for satisfactory completion of workshops. In quantitative terms, a student will need to retake the two full-day workshops of a module if more than 4 out of the 16 development indicators for two workshops have been marked as 'no for not demonstrated' i.e. 'red light'.

Satisfactory completion of workshops is a prerequisite to sitting the module examination i.e. students who fail to complete the workshop satisfactorily are not allowed to take the relevant module examination. In order to complete the workshop satisfactorily, you are required to attend the two full-day workshops and demonstrate your successful accomplishment of the workshop objectives, via active participation.

Your Role and Responsibilities as a Workshop Student

You are expected to:

- Follow your study plan, study the Learning Pack chapters (and other reference materials where appropriate) in accordance with the workshop coverage and prepare well for the workshops;
- Read the case materials and complete the pre-workshop exercises, if any, prior to attending the workshops;
- Be proactive in discussion and participation in group activities during the workshops;
- Develop your technical and generic skills through active participation in group discussion and activities; and
- Observe relevant rules of the workshops (e.g. be punctual for workshops and follow the instructions of workshop facilitators).

Workshop Materials for Students

Prior to the workshops, you will be given:

- This introduction booklet, providing general information on the workshops in particular the topic coverage and the corresponding chapter list in the Learning Pack, which are listed under Workshop Outline and Learning Methodologies below;
- Pre-workshop cases background and exercises (if any); and
- The module Learning Pack.

During the workshops, you will be given:

- Additional case information; and
- Handouts (i.e. questions) for class work, which will be collected back at the end of each workshop.

Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered
Workshop 1		
1. Introduction	<ul style="list-style-type: none"> • Presentation • Group discussion 	
2. Ethics in business	<ul style="list-style-type: none"> • Case study • Group discussion 	Ch. 1
3. Executive management	<ul style="list-style-type: none"> • Case study • Formal presentations 	Ch. 2 & 3
4. Management reporting	<ul style="list-style-type: none"> • Case study • Formal presentations 	Ch. 4, 5 & 6
Workshop 2		
5. Reboot	<ul style="list-style-type: none"> • Presentation • Group discussion 	
6. Treasury operations	<ul style="list-style-type: none"> • Case study • Formal presentations 	Ch. 8, 10 & 11
7. Corporate finance	<ul style="list-style-type: none"> • Case study • Formal presentations 	Ch. 12, 13, 14 & 17
8. Conclusion	<ul style="list-style-type: none"> • Presentation • Group discussion 	

You are expected to have studied the relevant chapters of the Learning Pack and completed the pre-workshop materials thoroughly prior to attending the workshops. It is important for you to 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

Galaxy Health International Limited (Galaxy) is a pharmaceutical company, listed on the Hong Kong Stock Exchange (HKEx).

The company was established over 20 years ago by Vincent Hui and Carlton Tong, both of whom had previously started their careers with a major international pharmaceutical firm. The company has grown successfully since that time, and eventually obtained a Stock exchange listing five years ago.

Products

Galaxy manufactures a range of medicines and drugs which are sold worldwide. At the moment it has 55 products in its portfolio. These products are sold to markets that use Western medicine: at the moment the company does not manufacture products based on Chinese medicine.

Galaxy's products are sold mainly in Hong Kong and four of the world's five biggest geographical markets for pharmaceutical products: Japan, USA, Germany and France. (The fifth market is the People's Republic of China.) There are also some sales to Indonesia, Australia and to emerging market countries. Sales are priced in several currencies, according to the market: Hong Kong dollars, US dollars, euros and Australian dollars.

The products made and sold by Galaxy are divided into two broad product groups:

- Patented products: these are products that have been developed in-house by the Research and Development (R&D) department of Galaxy, and which are protected by patents for a finite period.
- Generic products: these are products that are not protected by patents and which are made and sold by competing pharmaceutical companies worldwide.

Patented products give Galaxy a monopoly in those countries where patent rights are recognised and applied. Patents protect companies that have carried out original research and development, and enable them to charge high prices (during the years when the patent protection applies) in order to recover their R&D costs.

Currently the company has 15 patented products in its product portfolio.

When products come out of patent protection, any company has the right to produce and sell competing 'generic' products. These consequently sell at much lower prices.

The pharmaceutical industry

The pharmaceutical market has increased globally by more than 100% since 2000 and continued to grow in spite of the worldwide recession triggered by the financial crisis from 2007. The fastest growth is occurring in emerging markets, although these are still much smaller in size than the established markets in the USA, Japan and elsewhere.

The industry has the prospect of many years of strong growth in the future, partly because of the ageing of the world's population, but also because of continuing advances in science. It is expected that many medical conditions, for which there are currently no treatments, will eventually be treatable with new drugs.

However for companies in the industry there are significant challenges.

- There is strict regulation over the development and sale of medicines and drugs. Pharmaceutical companies face difficulties in obtaining official approval and registration for new products. When products are brought to the market, there is then a risk of legal action by customers who make claims for alleged adverse effects of using the product.
- Manufacturers are under increasing pressure to keep prices down to a level that customers can afford. Government-run national health organisations complain about the prices they are expected to pay, and (under budget pressures) are increasingly using their strong purchasing power to demand price reductions. The fastest-growing companies in the market for generic drugs are those that can offer the best prices.
- R&D productivity is a concern for all companies that develop patented products. Productivity has been falling throughout the industry, due to:
 - The length of time taken to develop ever-more-complex new products;
 - The length of clinical trials;
 - The time required to obtain regulatory approval;
 - The high ‘failure rate’ of products under development which do not get through the pre-clinical development stage and clinical trials;
 - The risk that competitors develop a similar treatment which is better or first to market; and
 - The fact that the period for which patents are typically effective is shortening.

Companies also face the challenge of gaining acceptance in the market for new products after they have been launched. The profitability of drugs and medicines, as with all products, depends largely on sales volume.

The market for medicines and drugs is expected to grow substantially in future years, as larger numbers of the world’s population reach old age. In general, demand by individuals for medical products increases substantially after they have reached the age of about 60.

Even so competition in the pharmaceutical market is intense, especially for generic products. Many observers of the industry believe that as the market grows in size, competition will increase and customers will demand better value in terms of both price and product effectiveness. It therefore seems probable that there will be mergers and acquisitions throughout the industry within the next few years, as companies try to increase in size in order to achieve economies of scale and cost reductions.

Product development

The development of new products in the R&D department can be a long process. The early stages of development are known as the pre-clinical trial stage, when the drugs are developed but not yet tested on human patients. If the pre-clinical trials are successful, the development work goes on to more formal and regulated clinical trials, when the drugs are tested on humans and the results are monitored and assessed. If the clinical trials are successful, the company applies for formal registration of the drug by the relevant authorities in each market and on obtaining this, seeks patent protection. The new drug is then manufactured on a commercial scale and sold to the company’s target markets.

Successful development of new drugs and medicines calls for well-trained and well-educated scientists. Galaxy has been very fortunate in its ability to attract suitable graduates returning to Hong Kong after studying at leading universities in France, the UK and USA.

Galaxy has a good record of developing new drugs successfully. Even so, about 50% of new product ideas do not get as far as clinical trials and a further 30% fail clinical trials. This means that only about 20% of new product developments eventually reach the market.

When new products are launched commercially, their success is not certain. Some new products are enormously successful and generate large sales and profits. However, some new products do not attract sufficient customer demand and are withdrawn from the market after only a short time. One reason why products may not be a commercial success after they have been launched is that a rival company has produced an alternative product that customers prefer, perhaps because it is cheaper or has less harmful side-effects when used.

Production and sales

Galaxy has two production centres, one in Hong Kong and one in the USA. Each produces both patented products and generic products.

Direct materials account for about 70% of the cost of sales and direct labour for about 10%. One of the problems faced by all pharmaceutical companies is a shortage of direct material supplies. Globally, the demand for drugs and medicines appears to be increasing at a faster rate than the ability of manufacturers to produce them, with direct materials emerging as a key production factor.

The company employs a large sales force, with offices in all of its main markets. Sales to China and emerging markets are the responsibility of the sales team based in Hong Kong. Customers consist of government organisations with responsibilities for procurement of medical supplies, major independent hospitals and private clinics, and companies operating drug stores and pharmacies. The customer profile varies between Galaxy's different geographical markets.

The performance of Galaxy in 2014 and 2015 has been disappointing. A summary of financial results is given in Appendices 1 and 2. There has been a slow-down in the development of the company's product portfolio. During 2015, two of the company's high-performing patented products reached the end of patent protection: other generic product manufacturers have already begun to make and sell similar products and the market price of both products has fallen substantially.

During 2014, the company had difficulties with production and was operating near full capacity. As a result, it was unable to increase sales as much as it might otherwise have expected. There has been new investment in production facilities, but the benefits of increased capacity have not yet been achieved. The company expects sales to increase in 2016, after a revenue fall in 2015.

In recognition of the need to focus more on selling and marketing, in response to greater competition in the market, the company recruited and trained more sales and marketing staff during 2015.

Company vision and mission

Galaxy has recently launched a new corporate image which is tied into its significant investment in the sales and marketing division during 2015. In early 2016 Galaxy released its updated brand, vision and mission to the market.

Our vision

Transforming lives through easy access to innovative, high-quality and cost-effective health-care solutions.

Our mission

Our mission is to become a world-leader in the provision of high-quality and cost-effective health-care solutions. We aim to increase our supply of generic and patented products into key market areas while maintaining our commitment to scientific excellence and responsible drug development and delivery.

Our values

- Integrity: To be fair, honest and responsible in our dealings with stakeholders and the global community
- Excellence: To always strive for innovation, quality and scientific leadership in the development of new products

- **Transparent:** To ensure production, pricing and sales practices are sustainable, ethical, and open to public scrutiny

There are concerns in the sales and marketing division that the Board of directors and management of Galaxy are not incorporating the new vision and values into company decisions, and that Galaxy is not yet 'living by their values'.

Legal costs

Galaxy, like many other pharmaceutical companies, has faced increasing costs arising from legal action by customers and regulators, and also from actions to protect patent rights against 'pirate' manufacturers who produce copycat or counterfeit drugs without licence.

A large number of invoices are also challenged by customers, often claiming mis-selling of products by the company's sales representatives. The main reason for customer complaints is that products are less effective than Galaxy's sales representatives had led them to believe. Some complaints subsequently result in legal action by customers who are not satisfied with Galaxy's response to their complaints.

Financial performance

The company's financial performance during 2015 was disappointing, but senior management have attributed the problem to difficulties with production capacity during 2014 and the early part of 2015, and the expiry of patent protection for two of its successful products during 2015.

The company has pursued a policy since 2014 of increasing production capacity and spending more on R&D. Much of the expansion and business development has been financed by borrowing. The poor performance in 2015 has made the Board search for ways of reducing costs, and they are already in the process of making some redundancies throughout the company.

Ella Hui, daughter of the Chief Executive Officer (CEO) and the new Chief Finance Officer (CFO), has continued the policy of her predecessor of choosing to borrow from banks to finance business development rather than use the company's large cash deposits. She believes that the company's liquidity and gearing levels are not a threat to the company's financial position, and that the company's financial position will strengthen in the future when the company's business recovers and sales increase.

All the company's borrowings are from banks and are denominated in Hong Kong dollars or US dollars: the loans are mostly secured against assets of the company. There are unsecured overdraft facilities in all the company's traded currencies.

90% of the company's cash balances with its banks are held in Hong Kong dollars, with some deposits in US dollars, yen and euros.

The profitability of Galaxy in 2014 and 2015 are summarised in Appendices 1 and 2. Other financial information relating to Galaxy is given in Appendices 3 and 4.

Dividend policy and share price

There has been some disagreement between Board members about dividend policy. When Galaxy first listed on the HKEx, the company announced its intention that annual dividends would be maintained or increased each year.

Some Board members argued that dividend payments were too high, and prevented the company from reinvesting sufficient equity in the business. Dividend payments in 2015 were HK\$1,150,789,000 and in 2014 they were HK\$1,150,000,000. Dividends in 2015 were more than the retained profits for the year, and arguments about dividend policy among Board members led to the retirement of the former CFO, Mandy Chow, during 2015.

In the world's main stock markets, the shares of pharmaceutical companies are valued on average at a P/E multiple of 20, although high-growth pharmaceutical companies often trade on P/E

multiples of over 30. The current share price of Galaxy in 2016 is HK\$5.60. It has fallen from a peak price of HK\$15.25, that was reached during 2014.

The Board wants to restore the share price to its former high level and the decision to increase the dividend slightly for 2015 was influenced partly by a wish to protect the share price as much as possible, given the disappointing financial results for the year.

The Board of directors

Vincent Hui is the Chairman and CEO of the company and Carlton Tong is the Director responsible for R&D. The other executive directors are:

- Damon Tam, the Director of Operations.
- Ella Hui, the CFO. Ella is the daughter of Vincent Hui: she replaced Mandy Chow on the Board when Mandy retired in 2015.

In addition to the four executive directors, there are three independent non-executive directors.

Vincent Hui owns 30% of the shares in the company. Carlton Tong sold most of his shares when the company listed, but still owns 5%. The other executive directors own some shares but are not significant shareholders. Most of the company's shares are held by external investors, some of them holding between 2% and 5% of the company's equity. Vincent understands the need to maintain a continuing constructive dialogue with the company's shareholders, but he finds this difficult in cases where the investors are US-based investment funds and so geographically distant.

Appendix 1

Summary financial results for Galaxy Health International Limited (Galaxy)

Income statement for the year ended 31 December:

	2015	2014
	HK\$'000	HK\$'000
Revenue	12,855,940	14,172,145
Cost of sales	(3,278,396)	(3,402,767)
Gross profit	9,577,544	10,769,378
Distribution costs	(206,244)	(212,651)
R&D expense	(2,699,855)	(2,550,999)
Selling and general admin expenses	(5,103,209)	(4,984,797)
Other operating expenses	(445,802)	(491,438)
Operating profit	1,122,434	2,529,493
Net financial expense	(210,226)	(141,155)
Profit before tax	912,208	2,388,338
Taxation	(150,014)	(444,570)
	<u>762,194</u>	<u>1,943,768</u>

Included in the expenses for the year above are:

Amortisation and impairment of intangible non-current assets:	\$865,220,000
Depreciation of property, plant and equipment:	\$1,042,350,000

Galaxy Health International Limited (Galaxy)

Statement of financial position as at 31 December:

	2015 HK\$'000	2014 HK\$'000
<i>Non-current assets</i>		
Property, plant and equipment	7,170,639	6,733,021
Intangible assets	<u>4,223,143</u>	<u>3,351,077</u>
	<u>11,393,782</u>	<u>10,084,098</u>
<i>Current assets</i>		
Inventories	1,341,097	1,300,408
Trade and bills receivables	3,939,635	3,865,130
Other current assets	282,959	358,196
Bank balances and cash	<u>2,171,412</u>	<u>3,012,724</u>
	<u>7,735,103</u>	<u>8,536,458</u>
<i>Current liabilities</i>		
Trade payables	799,390	745,812
Other payables	583,796	537,261
Provisions	903,110	986,104
Tax liabilities	146,424	189,353
Bank borrowing	<u>718,000</u>	<u>474,500</u>
	<u>3,150,720</u>	<u>2,933,030</u>
Net current assets	<u>4,584,383</u>	<u>5,603,428</u>
Total assets less current liabilities	<u>15,978,165</u>	<u>15,687,526</u>
<i>Non-current liabilities</i>		
Borrowings	5,050,000	4,420,600
Provisions	1,090,250	1,140,000
Other non-current liabilities	<u>1,430,428</u>	<u>1,330,844</u>
	<u>7,570,678</u>	<u>6,891,444</u>
Total assets less total liabilities	<u>8,407,487</u>	<u>8,796,082</u>
<i>Capital and reserves</i>		
Share capital	500,000	500,000
Reserves	<u>7,907,487</u>	<u>8,296,082</u>
	<u>8,407,487</u>	<u>8,796,082</u>
Number of shares	2,500,000,000	2,500,000,000

Appendix 2

Analysis of sales and gross profit by product group

	<i>Patented products</i>	<i>Generic products</i>	<i>Total</i>
	HK\$'000	HK\$'000	HK\$'000
2015			
Revenue	8,356,400	4,499,540	12,855,940
Cost of sales	1,638,543	1,639,853	3,278,396
Gross profit	<u>6,717,857</u>	<u>2,859,687</u>	<u>9,577,544</u>
2014			
Revenue	9,762,231	4,409,914	14,172,145
Cost of sales	1,869,593	1,533,174	3,402,767
Gross profit	<u>7,892,638</u>	<u>2,876,740</u>	<u>10,769,378</u>

Appendix 3

Other financial information relating to Galaxy

Financial liabilities at 31 December 2015

	<i>Less than 1 year</i>	<i>1 – 2 years</i>	<i>2 – 5 years</i>	<i>More than 5 years</i>	<i>Total</i>
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000
Borrowings	718,000	3,396,000	1,051,000	603,000	5,768,000
Interest payable on borrowings	48,600	163,500	194,060	60,180	466,340
Trade payables	799,390	–	–	–	799,390
Other payables	583,796	–	–	–	583,796
Total	<u>2,149,786</u>	<u>3,559,500</u>	<u>1,245,060</u>	<u>663,180</u>	<u>7,617,526</u>

Analysis of borrowings, split between fixed rate and floating rate

Date	Fixed rate	Floating rate
31 December:		
2015	75%	25%
2014	70%	30%
2013	67%	33%

Appendix 4

Analysis of provisions at 31 December 2015

	HK\$'000
Severance	412,195
Environmental costs	130,350
Employee benefits	328,015
Patent litigation	194,300
Contractual disputes, claims and other provisions	928,500
	<u>1,993,360</u>

Provisions for environmental costs consist of provisions for investigation, remedy and maintenance activities in excess of normal ongoing R&D expenditure.

About 45% of provisions are due within the next 12 months.

Provisions for non-recoverable trade and bills receivable at 31 December 2015

	HK\$'000
Trade receivables	3,285,075
Bills receivable	821,500
	<u>4,106,575</u>
Less provision for impairment	(166,940)
	<u>3,939,635</u>
Individually impaired receivables for which provision has been made	417,350
Expected recoverable amount	(250,410)
Impairment provision made	<u>166,940</u>

Workshop 1 Session 2

Pre-workshop exercise 1 (Ethics in business)

Andy Smit is Galaxy's leading sales representative for the Western European market. He is currently negotiating a contract to supply a patented Galaxy product to the national health authority of Luxembourg (the *Caisse nationale de santé*). Luxembourg is a small European country situated between France and Germany. It has one of the most extensive state-supported national health services in the world. France and Germany are Galaxy's two major European markets.

The *Caisse nationale de santé* has its own strict ethical procurement policy. All suppliers must follow the Global Reporting Initiative (GRI) triple bottom line reporting procedures. This incorporates economic performance, environmental performance and social performance and must be both quantitative and qualitative. This includes:

- Economic – economic conditions of stakeholders and economic systems at all levels
- Social – engagement with community, philanthropic activity and the impact practices have on the social system in which it operates
- Environmental – sustainable practices, environmental initiatives and the impact practices have on the environment it operates in

The *Caisse nationale de santé* insists on specific disclosures for pharmaceutical companies. These are:

- Operation of clinical trials and human rights practices
- Sustainable practices for research and development
- Employee and contractor management, workplace and third party safety, fair contract terms and conditions
- Corporate governance and management following international best standards
- Disclosure of information – freely available and updated information on patent drugs, usage, clinical trials, results of trials
- Responsible and transparent sales practices – e.g. responsible promotion and selling of products
- Payments/bribery/inducements policy

The adoption of comprehensive CSR policies in the global pharmaceutical industry has been slow. Less than half of all companies make any CSR disclosure, and of those, the majority of the disclosures made were broad qualitative statements with no attempt at quantification. To add to this, in a sizable proportion of Hong Kong family-controlled companies, CSR and sustainability practices are not valued.

Galaxy makes a one-page CSR disclosure in its annual report. It is qualitative, not quantitative.

Vincent Hui, Chairman and CEO, 30% shareholder and one of the original owners, thinks that CSR is 'a waste of time'. He refuses to give it any priority in Galaxy and effectively overrules any major CSR initiatives. He recognises that Galaxy must follow the law in each jurisdiction, and international medical and research and development guidelines, but ensures that it does not do any more than these minimum requirements.

Andy Smit has had several conversations and emails with Ella Hui, Galaxy's CFO. He insists that Galaxy needs to prepare a comprehensive CSR report in accordance with the *Caisse nationale de santé* requirements.

Ella Hui is worried. She knows what her father thinks about CSR. More importantly, she knows there are a few practices in Galaxy which would counteract best practice. These are:

- Corporate governance – Vincent Hui is both Chairman of the Board and CEO. This contravenes best corporate governance requirements.
- Employee rights and welfare standards – Galaxy has been cost-cutting on safety checks at its Hong Kong production facility. It has also been very slow in implementing the new minimum wage rules in Hong Kong.
- Clinical trials – To cut costs, Galaxy has stopped auditing the treatment of its patients in clinical trials. It has standards in place, but they have not been audited (internally or externally) for two years.

Ella speaks to her father informally. He lets her know that 'CSR is a waste of time. We need to do the minimum to meet the law and still make money. We have never come up against such a restrictive ethical procurement policy before.'

After a discussion, Vincent and Ella come up with three options:

- (1) We ignore the request and pull out of the Luxembourg tender. It's a small market anyway.
- (2) We prepare the report as they request but just leave out any questionable practices or issues. That will fix the problem.
- (3) We take this opportunity to investigate questionable practices and take action. We implement a comprehensive CSR program in the company. We prepare a CSR report as requested and make this an annual occurrence. It's going to cost a lot – can we afford it at the moment?

Vincent and Ella Hui decide to ignore the request and pull out of the Luxembourg tender (Option 1). They do not tell Andy why, but he suspects it is because of the CSR reporting requirement. Andy is both angry and concerned by the decision.

Meanwhile, Sofia Muller from *Caisse nationale de santé* is very surprised that Galaxy pulls out of the tender. She also hears a rumour that Galaxy may be pulling out of the tender as it does not want to address the underlying CSR best practice issues outlined earlier.

Sofia arranges a meeting with Andy and reports her concerns. Sofia and Andy have struck up a good friendship, and she starts the meeting by inviting him out for dinner. Andy accepts the dinner invitation. Sofia then turns to business and tells Andy that she has heard rumours about Galaxy and has three options:

- (1) She can ignore the rumours, forget about the tender issue and keep her concern to herself. Galaxy will never get any contracts in Luxembourg when she is in charge.
- (2) She can discuss the rumours with her professional contacts in the French and German health services. Galaxy has significant contracts with these services.
- (3) She can formalise her concerns and make a report to the relevant medical and industry bodies.

Andy hears these three options and leaves the meeting. He is personally and professionally at conflict. His three options are as follows:

- (1) Ignore the meeting, don't tell anyone and consolidate his contracts in France and Germany.
- (2) Report back to Ella Hui about the meeting and highlight to her the importance of now acting on CSR and of addressing the underlying the best practice issues. He then feels he will have taken all the action he can.
- (3) Agree with Sofia, resign from Galaxy and join her in making a formal complaint to industry bodies.

Required

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

- Vincent Hui, Chairman and CEO of Galaxy and Hong Kong CPA
- Ella Hui, CFO and Board member of Galaxy and Hong Kong CPA
- Sofia Muller, Senior public servant in the *Caisse nationale de santé*, Luxembourg's national health authority
- Andy Smit, Senior sales representative for Galaxy Western Europe

In each individual group discussion, consider the following:

- (a) Note down the key considerations faced by 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 three-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.

The group should consider and make reference to the three options provided in relation to their allocated person.

Workshop 1 Session 3

Pre-workshop exercise 2 (Executive Management)

Ella Hui, CFO, has asked you to attend a monthly management committee meeting. In this committee meeting you will be provided with and asked to evaluate four possible strategic options for Galaxy, in order to decide on the appropriate strategy to be taken by Ella to the Board.

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

Required

Carry out a comprehensive market analysis of the global pharmaceutical industry in which Galaxy 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 the five forces. Also consider the sixth force, complementarity, and list at least four complementors.

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)

Vincent Hui had been expecting the financial performance of the company to improve in the final three months of 2015, and was surprised to learn from Ella Hui that there had been only a slight improvement during those months. He was angry that some external shareholders were dissatisfied with the company, even though dividends in 2015 were as high as in 2014 and dividend yield had risen. As far as he was aware gross profit margins were still high and profits would recover significantly when sales revenue improves. However, in spite of his vast experience in the pharmaceutical industry, he is not particularly good at analysing financial statements, and he has asked Ella to provide him with a brief analysis of profitability and financial returns in 2015.

Ella tells him that she has a number of concerns about financial performance, including sales mix, overheads and dividends. She is also worried about the future, and the implications for the company of stricter regulations introduced recently governing the testing and clearance of new drugs for commercial market launch. She tells Vincent that she thinks that the Board should monitor aspects of performance that will affect the company's long-term future, as well as showing concern for short-term profits and shareholder returns.

Vincent agrees that the new regulations are having an effect on the length of time that it takes to develop a new drug and obtain regulatory clearance for selling it commercially. Even so, he feels that Galaxy has a strong reputation as a producer of new drugs and medicines, and he is confident that business will improve substantially in 2016. His Board colleagues are expecting a 10% increase in revenue in 2016, but Vincent thinks that sales growth could be even higher.

Vincent tells Ella that he wants to discuss performance at a Board meeting that he has called, to be held tomorrow and would like Ella to make a presentation to the Board about financial performance in 2015 and also about expectations for the future. He agrees that some non-financial issues should be considered as well as profitability.

Required

On behalf of Ella Hui, please address the following issues.

- (a) The aspects of profitability and financial returns that you consider should be discussed by the Board. Where financial performance has been disappointing, suggest the most likely reasons.**
- (b) Identify two important areas of non-financial performance that you think the Board should monitor, in addition to financial performance. Recommend measures of performance that might be used for each of these areas.**
- (c) The Board is expecting an increase in sales of 10% in 2016, with minimal increases in costs and sales prices. Suggest what effect this is likely to have on profits in 2016.**

Your analysis should focus on profitability and return on investment. At this stage you are not required to analyse working capital or long-term capital structure.

Workshop 2 Session 5

Pre-workshop exercise 4 (Treasury Operations)

Vincent Hui believes that cash and cash flow are not a problem for his company. He knows that companies need to have sufficient cash or liquidity to survive, but he also knows that many pharmaceutical companies enjoy strong cash flows. He is also pleased that Galaxy has a large amount of cash and cash equivalents.

However he is concerned about the increase in borrowings by the company during 2015 and the fall in the size of the company's cash balances. Although the risk does not seem high, Vincent is worried about the possibility that unless the cash flow situation improves, the company may face a liquidity crisis at some time in the not-too-distant future.

He would like the company to increase its cash balances, because he thinks that the strongest companies all have substantial cash assets. Surplus cash can be invested in short-term investments, and the interest from these provide a useful addition to annual profits.

Vincent explains his concerns and views to Ella Hui. He tells her that he would like to see an analysis of the company's cash flows and liquidity position in 2015, and would like her to make suggestions about the measures to improve cash flows in the future.

He would also like her views about the minimum amount of surplus cash that Galaxy should seek to retain for investing in short-term investments to boost profits.

Required

- (a) **On the basis of the information available in Appendix 1 of the Case Study, prepare your best estimate of the cash flows of Galaxy during 2015.**
- (b) **Comment on the company's liquidity and cash flow position.**

You are not required to calculate or comment on the cash cycle/working capital cycle for the purpose of this exercise.

- (c) **Comment on Vincent's opinion that Galaxy should seek to maintain a minimum level of cash and cash equivalents.**

Workshop 2 Session 6

Pre-workshop exercise 5 (Corporate Finance)

Vincent Hui and CarltonTong have had a number of discussions with Teddy Lo, an academic at the University of Hong Kong. Teddy and a number of his academic colleagues have established a small company, Remind Pte Ltd (Remind), to exploit some important medical research they have been conducting. Teddy believes that his team have identified a method of treating memory loss in humans, and they are working on the development of a drug to assist with this treatment.

Teddy informs Vincent and Carlton that similar research is being conducted in other parts of the world, and he is concerned that without additional financial support his company may fall behind other companies in the search for a successful drug. If the company succeeds in developing a drug, its commercial potential will be enormous.

Teddy asks Vincent and Carlton whether Galaxy would be interested in acquiring Remind. He thinks it is worth HK\$150 million. Vincent and Teddy laugh at this suggestion. They reply that small start-up companies are high-risk ventures. Remind does not have any product to sell, and its new product for treating memory loss has not yet passed its clinical trials. It might never have a product that can be taken to market, and if this were to happen the company would have no value at all.

Teddy, Vincent and Carlton agree that it is very difficult to value a start-up company, and that if Remind is successful in developing its new product, its value would increase substantially.

In further discussions about the company, Teddy tells Vincent and Carlton that he would like to sell a stake in his company in order to realise a return on his investment. He thinks that he deserves a reward for all the work that he has put into the company.

Required

- (a) **How should Vincent and Carlton respond to the suggestion by Teddy that Galaxy should acquire his company?**
- (b) **What are the difficulties in valuing a company such as Remind?**
- (c) **Suppose that the Board of Galaxy agree to acquire 75% of the shares in Remind at a price of HK\$37.5 million. Would Galaxy be able to finance the acquisition by borrowing, or would it need to make an issue of shares to raise the capital required?**

