Pre-Workshop Materials

Workshops 1 and 2

Case Background

Golden Monkey Mobile Hong Kong Company Limited

Overview

Golden Monkey Mobile Hong Kong Company Limited ('GMHK') is a wholly-owned subsidiary of China Golden Monkey Mobile Limited (HKEx:888) (NYSE: CGMM). This Hong Kong subsidiary, GMHK, began in 1996 and was the first PCS[1] (meaning Personal Communication Service) provider to launch services in Hong Kong under the brand "Monkey Magic Mobiles".

China Golden Monkey Mobile Limited (HKEx:888) (NYSE: CGMM) (the parent company) is listed on both the Hong Kong (HKEx) and New York Stock Exchanges (NYSE). It is also a Chinese-government state-owned enterprise and has one of the world's largest mobile phone subscriber bases. It is currently listed seventh in terms of market capitalisation on the HKEx.

GMHK is one of 33 wholly-owned subsidiaries of China Golden Monkey Mobile Limited, which is the largest mobile telecommunications provider in China and one of the largest telecommunications companies in the world. It has mobile networks in all 31 provinces, autonomous regions and directly-administered municipalities in Mainland China and in the Hong Kong SAR through these subsidiaries.

Its wholly-owned subsidiary, GMHK, is the market leader in the PCS market in Hong Kong and currently has 3.2 million mobile phone subscribers. GMHK provides a range of communication services including mobile voice, international direct dialling and roaming, and wireless data which is dependent on advanced technologies including WAP, GPRS and EDGE. This is all delivered through the well-established and respected Monkey Magic Mobiles brand. Capitalising on the strong support of its parent company, GMHK has launched a series of cross-border mobile services for customers travelling between Hong Kong and mainland China.

GMHK draws all research and development (R&D), new product, and a majority of its manufacturing from China Golden Monkey Mobile Limited which is based in mainland China. Not all manufacturing is operated through the parent company, with some specific manufacturing coming under GMHK for the Monkey Magic Mobiles brand.

GMHK's head office is based in Hong Kong as well as its various retail outlets. The retail outlets are managed through the Hong Kong head office. The Hong Kong head office also manages accounts, sales, marketing, human resources, corporate and administrative functions. GMHK runs one manufacturing site in mainland China which currently operates as a wholly-owned subsidiary of GMHK and which manufactures handsets specifically for Monkey Magic Mobiles.

GMHK has been a "Caring Company" since 2000 and has been a recognised merchant in Hong Kong under the "Quality Tourism Service" scheme since 2003.

Company structure and history

GMHK was one of the first entrants to the Hong Kong mobile phone industry and captured the majority of the mobile phone market when it launched Monkey Magic Mobiles in 1996. Since then it

[1] All acronyms and technical terms are listed in Appendix C - Glossary

has remained market leader and holds that position today (see the section on the *Domestic Market* for more information). It has been able to leverage its relationship to its parent company, China Golden Monkey Mobile Limited, to ensure it offers the best rates between Hong Kong and the mainland and to launch new products ahead of its competition.

The membership of the Board of Directors of its parent company, China Golden Monkey Mobile Limited, is outlined in Appendix A.

Senior management and key employees of GMHK are outlined in Appendix B.

GMHK has made acquisitions in the past to consolidate on its position as market leader in Hong Kong. It has acquired four start-up mobile phone providers from 1997 – 2005 and three of these are now fully incorporated under the GMHK business structure. They are all now part of the Monkey Magic Mobiles brand. The fourth was divested some years ago and has resulted in the company cash reserves.

In recent years the company has become acquisitive regarding OEM manufacturers. It has so far acquired one OEM manufacturer which is based in the Guangdong province in Mainland China, and which manufactures parts specifically for GMHK for Monkey Magic Mobiles. This manufacturer, Tiger Handsets Company Limited, was acquired in July 2008 and operates from the Shenzhen Hi-Tech Industrial Park, Guangdong province. It operates as a wholly-owned subsidiary of GMHK.

The company is currently considering a further acquisition of a second medium-sized manufacturer also from the Shenzhen Hi-Tech Industrial Park, Guangdong province. This company – Lucky Lion Handsets – currently produces mobile phone handsets for a variety of mobile phone brands across a number of companies. GMHK would be looking to make this acquisition to not only focus on the production of handsets for Monkey Magic Mobiles but also as a vehicle to begin producing and on-selling handsets for other subsidiaries of China Golden Monkey Mobiles. One of the considerations currently facing GMHK management is whether this acquisition fits into the overall business strategy and plans for new product and market development and, if it does so, how such an acquisition should be financed.

Company mission and values

The mission statement is as follows:

“Monkey Magic – placing the magic of mobile technology at your fingertips.”

Company values are as follows:

Value	Incorporates
Responsible	Safe products, responsible product development and R&D, social and corporate responsibility, environmental responsibility, fiscal responsibility, responsible staffing policies adhering to agreed national and international standards
Innovative	Leading the market in new products and innovations, being first with value-add mobile products, leveraging and improving upon existing mobile technologies, anticipating customer needs and wants
Value	Value for money products, price leader, value for shareholders, value for employees, value of contribution to local and global communications industry, right price, cost leadership
Entrepreneurial	Seizing opportunities in the market to increase existing market share, looking for new strategies to build markets and products, free-thinking and “big picture” management, considered risk-takers

Quality	Product safety, high quality product, low to no manufacturing and parts faults, quality provider of innovative mobile technologies, innovation is undertaken with the aim to produce safe, quality new product and systems, “perfect” products taken to market

Domestic market

Hong Kong has one of the most sophisticated telecoms markets world-wide and one of the highest penetrations of telephones, mobiles and the internet across the globe. It has a fixed-line density of 52% which is the highest in Asia. Hong Kong’s regulator is the Office of the Telecommunications Authority and it has played a major role in developing the telecoms sector in Hong Kong.

The mobile phone market reached saturation point in 2002, and going into 2011 the market continues to grow and there are now over 10 million phone subscribers in a population of 7 million people. In 2011 market penetration sits at over 170%. Growth is due to the fact that the main mobile providers (of which GMHK is one) continue to restructure and launch innovative products.

For the purposes of this case study, the number of mobile operators in Hong Kong is four. This has dropped down from 10 providers since 1996 due to the acquisitive nature of the leading mobile companies. Competition between the four providers is intense and tight and product innovation is essential to gain further penetration. This competition was further increased when mobile number portability was introduced in 1999. The market has also been well supported by the operators’ keenness to value-add to their mobile service offerings and value-add products are gaining market traction (see Products section for GMHK’s value-add services). The four providers (and their market share) are listed below:

- Monkey Magic Mobiles (through GMHK) has 32% of the mobile phone market
- Vodatele has 27% of the mobile phone market
- Tele Hong Kong has 23% of the mobile phone market
- Lifestyle Phones has 18% of the mobile phone market

GMHK is the only 100% Chinese mobile phone provider in the market due to the fact that the parent company is a Chinese-government state-owned enterprise. All other companies are publicly listed on various stock exchanges but all have some component of foreign ownership, including from major Australian and European telecommunications providers.

International market

GMHK only operates in the Hong Kong market through its successful Monkey Magic Mobiles brand.

Its parent company, China Golden Monkey Mobile Limited, has no plans to use GMHK to develop into the international market. The parent company has launched in two markets outside of China and Hong Kong – the Democratic Republic of Congo and the Republic of Zambia. It has established wholly-owned subsidiaries to enable market entry.

This international expansion is outside the interest of GMHK which can be classified as a one geographical market business.

Operating environment

Operating structure

GMHK holds two telecom licences issued by the Office of the Telecommunications Authority of Hong Kong. These are (1) a fixed carrier licence which covers cable-based external fixed service and (2) a service-based operator’s licence, which covers external telecommunications services, international value-add network services and mobile virtual network operator services.

GMHK offers its Monkey Magic mobile telecommunications services principally using the Global System for Mobile Communications, or GSM, standard. GSM is a pan-European mobile telephone system based on digital transmission and mobile telecommunications network architecture with roaming capabilities.

3G network

GMHK has been granted a WCDMA 3G licence and officially launched its 3G business service in Hong Kong on 1 September 2009. This 3G network operates off high speeds and has extensive international roaming coverage. All Monkey Magic mobile phones are now able to operate on the 3-network and migration of existing customers from the 2G to the 3G network is underway.

Relationships

The parent company, China Golden Monkey Mobile Limited, has an extremely close relationship with the Chinese government as it is a government-owned entity. Accordingly, in the past it was extremely close to the regulator and acted in a monopolistic manner. The opening up of telecommunications competition in the People's Republic of China has meant this close relationship is changing and the parent company has to operate in an open-market environment. However they still enjoy a close relationship with the government and regulators in the PRC but they are no longer able to rely on this moving forward.

The same situation applies for GMHK. As the only mobile phone provider with full Chinese government ownership it has enjoyed competitive advantage over the other operators due to a close working relationship with the Office of the Telecommunications Authority of Hong Kong. The regulator has indicated to GMHK that this close relationship will have to formally cease and it is likely that GMHK will no longer be able to use its close relationship with government officials to influence policy-making to its advantage.

Products

(**Note.** The product list below is a shortened one to that ordinarily offered by a "real-world" mobile phone company. For the purposes of the case study an abridged product offering list has been supplied.)

Product lines can be divided into two divisions – **voice business** and **value-add services**. Value-add services is further divided into **voice value-add services** and **data business.**

In summary, the voice business has remained relatively stable throughout 2010 with some small sales growth due to a greater concentration on the corporate user. Percentage of product revenues is unchanged from 2009 to 2010.

Management has concluded that existing voice business (represented by fees and handsets in the revenues) is coming to the end of the product life cycle in the highly sophisticated and competitive Hong Kong market. Future growth primarily sits with value-add services. Handset sales comprise only a small percentage of existing revenues but this **may** change if the proposed acquisition is approved and the strategy of on-selling to other subsidiaries in the group is adopted. This is only a secondary, long-term growth option behind growth in value-add services.

See the 2009 and 2010 revenues below:

	2010 (HK$ millions)	**2010 % of total revenue**	**2009 (HK$ millions)**	**2009 % of total revenue**
Operating revenue				
Fees	3,062	67%	2,789	68%
Value-add services	1,257	27%	1,084	26%
Handset sales	155	3%	153	4%
Other operating revenue	95	3%	101	2%
Total operating revenue	**4,569**	100%	**4,127**	100%

Voice business

Voice business is the business where customers make and receive calls with a mobile phone at any point in the coverage area of the Hong Kong mobile telecommunication network.

Services include local calls, domestic long distance calls, international long distance calls, intra-provincial roaming, inter-provincial roaming and international roaming. Revenues are made through the full range of Monkey Magic handsets and variety of mobile phone plans (contract and pre-paid). This is represented in the revenues by fees and handset sales.

In 2010, GMHK capitalised on the global recovery and further refined its sales for the voice business by taking on differentiated sales strategies, including a greater concentration on the corporate user at the expense of focusing on the saturated domestic/individual user. This resulted in a small increase in actual revenues in fees from HK$2,789 millions in 2009 to HK$3,062 millions in 2010, though percentage of overall revenues remained much the same. Note that handset sales remained relatively constant in both years.

Value-add services

There are two new business streams – voice value-add services and data businesses. These are both reflected in the revenues above as **value-add services**.

Voice value-add services mainly include caller identity display, caller restrictions, call waiting, call forwarding, call holding, voice mail, conference calls and others. These are all part of the existing revenues.

Data businesses mainly include short message services, or SMS, wireless application protocol, or WAP, Color Ring, multimedia messaging service, or MMS.

GMHK has followed the lead of the parent company and has placed a lot of emphasis on its value-add services business. This is now the major driving force of revenue growth for GMHK (and the company as a whole).

Revenue from the existing value-add services for GMHK increased from HK$1,084 millions in 2009 to HK$1,257 millions in 2010, contributing 26% and 27% respectively to overall operating revenue. Revenue from the value-add business is over a range of services within the product suite: key services such as Mobile Paper, Mobile Payment, and Mobile Reading were launched in 2009 and 2010 and rapidly grew. In addition, mobile internet-access data usage is also fast-growing and quickly becoming an important driver of future growth for the data component of the value-add business.

New value-add product development

GMHK is looking to add to its value-add product suite and is leveraging the R&D of its parent company to do so. The new products are extensions of its current value-add services and are:

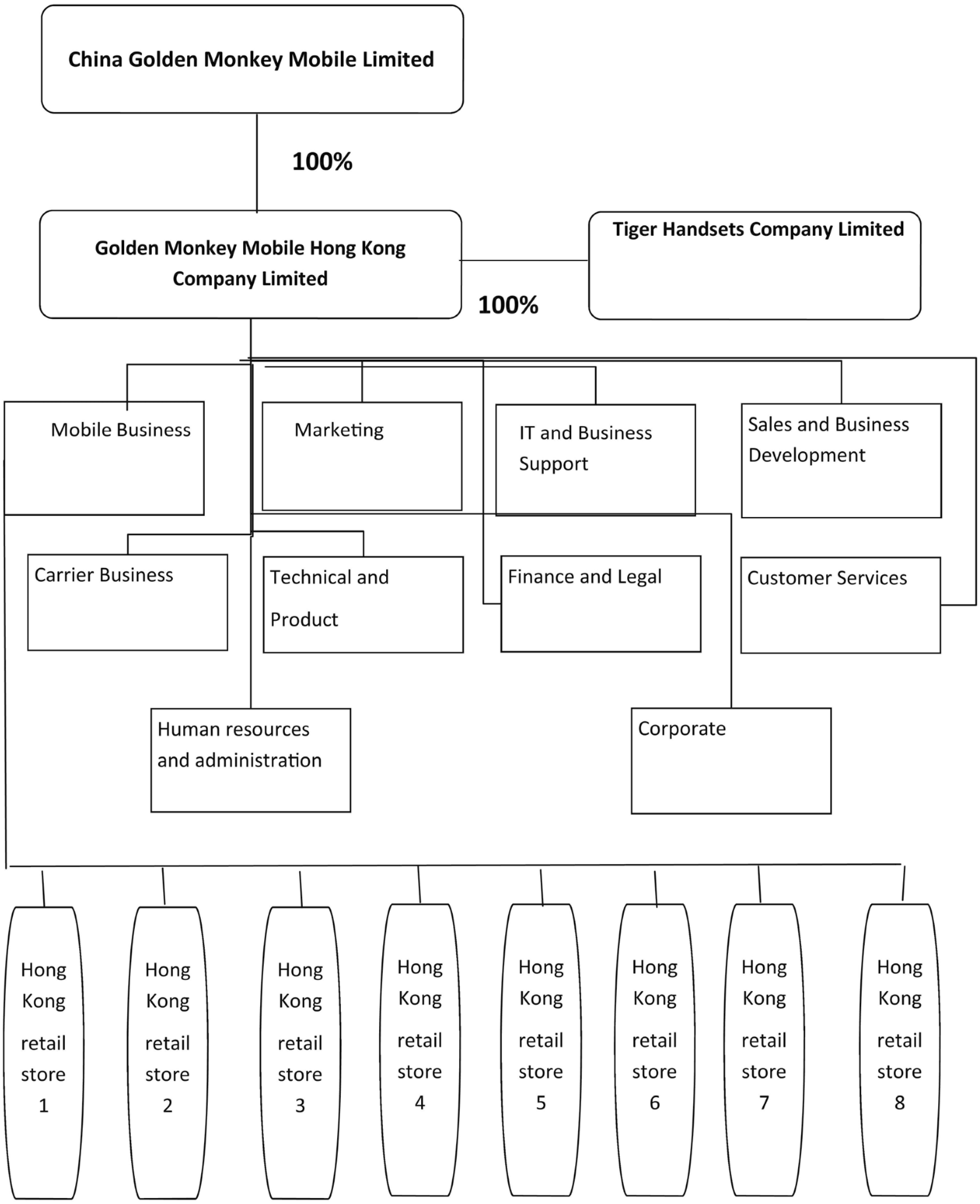
- *Mobile Gaming* – access to the widest range of gaming and betting over the mobile phone device. Two other providers have launched mobile gaming in 2010. GMHK is looking at partnerships with major online gambling sites and providers to provide the premium mobile gaming service.
- *Mobile TV* – all other providers have launched TV from the mobile device.
- *Mobile Filipino* – this product is directly for the Hong Kong Filipino community and is directly from the Philippines. Users can access ABS-CBN news, local events, movies, travel information and more local knowledge. No other provider is offering this in Hong Kong.

Operations

As stated previously, GMHK is a wholly-owned subsidiary of its parent company China Golden Monkey Mobile Limited. GMHK itself has made the following acquisitions and divestments since its inception in 1996:

- Four mobile phone providers from 1997 – 2005. Brands dissolved and fully subsumed into the GMHK business structure and Monkey Magic Mobiles brand. One phone provider was divested some years ago which explains the cash reserves currently held.
- One OEM since 2006. Tiger Handsets Company Limited is a wholly-owned subsidiary of GMHK and produces handsets for Monkey Magic Mobiles phones. To date, it has been used solely to supply the Monkey Magic brand as part of a cost leadership strategy. This is the entire extent of GMHK's manufacturing operations and operates from Shenzhen Hi-Tech Industrial Park, Guangdong province.

The current operating structure of GMHK is as follows:



The current operating structure has worked well since it was last revised in 2006. However, one major problem has been identified in the current costing structure. There is too much cost shifting between divisions and the internal transfer pricing is incorrect. This is hiding real costs of production and showing that costs are in fact, too high.

Handset sales

Mobile phone users change their handsets regularly, and customers are attracted by new handset designs. New designs are created regularly, and 'old' designs can become obsolete within less than one year. Sales of handsets from the stores are a comparatively small part of the company's total business. Many handsets are not sold, but are given away free to customers when they renew their annual subscription. The offer of a free handset with a current design is thought to attract many customers into renewing their subscription for a further twelve months. More than one half of the phones supplied by **Tiger Handsets** to the retail outlets are given free, as part of the subscription fee, to subscribers.

Handset sales in the company's retail outlets (in HK$ millions):

	2010	**2009**
Sales	155	153
Cost of sales	124	123
Profit	31	30

The cost of sales in these figures is the purchase price for the handsets paid by the retail outlets to the handset manufacturers. All handsets are supplied by the company's own subsidiary – Tiger Handsets.

Handset production and costs

Tiger Handsets has a production capacity of 80,000 handsets per month, and actual production during 2010 varied between 65,000 handsets and full capacity. The annual financial results for Tiger Handsets during 2010 are as follows:

(in HK$ millions)		**2010**
Sales		378
Direct costs of manufacture	(48)	
Manufacturing overhead costs	(120)	
Total manufacturing cost		(168)
		210
Administration and distribution costs		(168)
Profit		42

The transfer price for all handsets delivered to the retail outlets is manufacturing cost plus 125%.

Inventories of finished handsets are held at the distribution warehouse of Tiger Handsets and also in the retail outlets.

Research and development (R&D)

GMHK utilises the substantial, market-leading and well-financed research and development (R&D) department of its parent company, China Golden Monkey Mobile Limited. It has no intention to fund R&D itself.

Financial accounts for 2010 and 2009 for GMHK

Summarised financial accounts for 2010 and 2009

Golden Monkey Mobile Hong Kong Group

Consolidated income statements – Years to 31 December

Figures in HK$ millions

	2010	**2009**
Operating revenue		
Fees	3,062	2,789
Value-add services	1,257	1,084
Handset sales	155	153
Other operating revenue	95	101
	4,569	4,127
Operating expenses		
Leased lines	30	26
Interconnection	245	230
Depreciation	680	619
Personnel	293	252
Other operating expenses (see note 1)	1,562	1,322
	2,810	2,449
Profit from operations	1,759	1,678
Interest income	11	13
Financing costs	(21)	(22)
Profit before taxation	1,749	1,669
Taxation (tax rate in HK is 16.5%)	(289)	(275)
Profit after taxation	1,460	1,394
Number of shares (millions)	20	20
Earnings per share (HK$)	73.0	69.7

Golden Monkey Mobile Hong Kong Group

Consolidated statements of financial position as at 31 December

Figures in HK$ millions

	2010	2009
Current assets		
Inventories	74	56
Accounts receivable (see note 3)	94	69
Prepayments and other current assets	136	124
Deposits with banks	233	199
Cash and cash equivalents	118	110
	655	558
Non-current assets		
Property, plant and equipment	4,319	3,932
Construction in progress	451	340
Goodwill	238	238
Deferred tax assets	75	66
	5,083	4,576
Total assets	5,738	5,134
Equity and liabilities		
Current liabilities		
Accounts payable (see note 2)	760	695
Deferred revenue	356	327
Accrued expenses and other payables	683	568
Current taxation	92	112
	1,891	1,702
Non-current liabilities		
Interest-bearing borrowings	420	420
Deferred revenue	5	4
	425	424
Equity		
Share capital	200	200
Reserves	3,222	2,808
	3,422	3,008
Total equity and liabilities	5,738	5,134

Notes

1 ‘Other operating expenses’ in the income statements include costs of producing handsets. These totalled HK$336 million in 2010 (and HK$285 million in 2009).

2 ‘Accounts payable’ relate to expenditures on leased lines, interconnection charges and other operating costs.

3 Analysis of accounts receivable as at 31 December (in HK$ millions)

Accounts receivable	2010	2009
30 days or less	58	46
31 – 60 days	20	14
61 – 90 days	12	7
Over 90 days	4	2
	94	69

Appendix A – China Golden Monkey Mobile Board of Directors and Senior Management

Selection of the Board of Directors

Michael Yip, 55 – Executive director, Chairman and Chief Executive Officer

Michael Yip has been Chairman of the Board since 2002 and has been with the company for 20 years. He is hugely respected in the Chinese and global telecommunications industry. He has an economics degree from Oxford and a Masters of Business Administration (MBA) from London Business School.

Moses Wong, 46 – Executive director and Chief Operations Officer

Moses Wong has been an executive director since 2002 and is seen as the next Chairman of the Board. He joined the company straight after university and is an ambitious and extremely competent director and employee.

Steven Chai, 39 – Executive director

Steven Chai is the youngest member of the Board which he has been a director since 2008. He is a high-flyer in the telecommunications industry and holds an MBA from the Harvard Business School. He is a member of the audit committee.

Thomas Chan, 68 – Non-executive director

Appointed to the Board in 2001, Thomas Chan has no formal qualifications but has been an integral member of the Chinese telecommunications industry for over 40 years.

Katie Soon, 48 – Independent non-executive director

Appointed to the Board in 2005, Katie Soon is a CPA with approximately 25 years' experience. She is a member of the Taxation Committee of the Hong Kong Institute of CPAs. She is chair of the audit committee.

Kenneth Wong, 52 – Independent non-executive director

Kenneth Wong is a barrister and solicitor with over 25 years' experience. He worked in Hong Kong for over 15 years for a leading Hong Kong law firm. Kenneth Wong is a member of the audit committee.

Chief Financial Officer

David Chan, 44 CPA – Chief Financial Officer

David Chan is the group's CFO and as such is responsible for all corporate and group finance responsibilities. This is a demanding role and David has a reputation for being hard-working, committed and conservative.

Fund Manager (for case study)

Holly Lee, 28 – Fund Manager at ABC Funds Management

Holly Lee is the number one fund manager for ABC Funds Management based in Hong Kong. She has a Masters in economics from Oxford and is viewed as a rising star in the Hong Kong funds management industry. She is extremely talented and ambitious, and has a reputation for taking large risks to facilitate large returns.

Appendix B – Golden Monkey Mobile Hong Kong Senior Management

The senior management team of Golden Monkey Mobile Hong Kong includes:

Matthew Xu, 52 – Chief Executive Officer

Matthew Xu is the company's CEO and reports to the China Golden Monkey Mobile board. He has been in telecommunications since 1992 and with the company since 1997. He has no formal qualifications but is an astute and well-connected entrepreneur.

Penny Wong, 55 – CPA & Chief Financial Officer

Penny Wong is responsible for all accounting, IT, finance and administration for the GMHK subsidiary and must report to the group CFO. She has been with the company since 2008 and has previously worked in large accounting firms.

Jenny Wang, 48 – Sales and Marketing Manager

Jenny Wang is widely regarded as the best sales manager in telecommunications in Hong Kong and is now responsible for the sales and marketing of both voice and value-add business.

Alison Cheng, 36 – General Manager

Alison Cheng has worked for GMHK since it began operations in 1996. She is responsible for the overall operations of the Hong Kong head office and all retail subsidiaries.

Appendix C – Glossary of Terms

EDGE (Enhanced Data rates for GSM Evolution): Effectively the final stage in the evolution of the GSM standard, EDGE uses a new modulation schema to enable theoretical data speeds of up to 384kbit/s within the existing GSM spectrum. An alternative upgrade path towards 3G services for operators, such as those in the USA, without access to new spectrum. Also known as Enhanced GPRS (E-GPRS).

GPRS (General Packet Radio Service): A standardised part of GSM Phase 2+. GPRS represents the first implementation of packet switching within GSM, which is a circuit switched technology. GPRS offers theoretical data speeds of up to 115kbit/s using multislot techniques. GPRS is an essential precursor for 3G as it introduces the packet switched core required for UMTS.

GSM (Global System for Mobile Communications): GSM is a pan-European mobile telephone system based on digital transmission and mobile telecommunications network architecture with roaming capabilities.

MMS (Multimedia Messaging Service): an evolution of SMS, MMS goes beyond text messaging offering various kinds of multimedia content including images, audio and video clips.

OEM (Original Equipment Manufacturer): Company A manufactures products or components that are purchased by Company B and retailed under the purchasing company's (Company B's) brand name.

PCS (Personal Communication Service): The broad term for all mobile technologies and communication services.

SMS (Short Message Service): a text message service which enables users to send short messages (160 characters) to other users. A very popular service, particularly amongst young people, with 400 billion SMS messages sent worldwide in 2002.

WAP (Wireless Application Protocol): A de facto standard for enabling mobile phones to access the internet and advanced services. Users can access websites and pages which have been converted by the use of WML into stripped-down versions of the original more suitable for the limited display capabilities of mobile phones.

2G network: The second generation of digital mobile phone technologies including GSM, CDMA IS-95 and D-AMPS IS-136.

3G network: The third generation of mobile phone technologies covered by the ITU IMT-2000 family.

Glossary references: Terms in this glossary have been sourced from a variety of online glossaries including *http://www.gsmworld.com/newsroom/resources/numeric.htm* and wikipedia.org

Workshop 1 Session 2

Pre-workshop exercise 1 (Ethics)

Note. *This ethical scenario relates to GMHK's parent company, China Golden Monkey Mobile Limited only. The only impact it will have on GMHK directly is through loss of share price and brand reputational damage to the broader Golden Monkey Mobile brand.*

Ethical scenario

Today is Wednesday, 23 March 2011.

Steven Chai is an executive director of GMHK's parent company, China Golden Monkey Mobile Limited (CGMM). In late 2010 Steven, in his role as executive director of CGMM, commenced a **graft scheme** with the aim of pushing up CGMM's share price through investment funds. His motivations were to a) push up the company's share price for the overall gain of all investors and b) personal financial gain. Steven is working in conjunction with a fund manager at ABC Funds Management (Holly Lee) and one other, unnamed accomplice.

The details are as follows:

- In October 2010, Holly Lee, an up and coming fund manager at ABC Funds Management, purchased 10 million shares (belonging to Steven) of CGMM. She has allocated these stocks to various investment funds with the aim of holding them for six months.
- In January 2011, Steven placed an additional 3 million shares with Holly to glean further profits.
- As at March 2011, CGMM stock now appears to be favoured by institutional investors and has increased 9% since October 2010.
- All shares were sold one week ago and proceeds paid to Steven.
- On Friday 18 March (four working days ago), David Chan, as CFO of China Golden Monkey Mobiles became aware of the graft scheme for the first time. David is also a Hong Kong CPA. He **did not** immediately inform Michael Yip, Chairman of the Board.
- David Chan thought about the issue over the weekend and sought advice from his wife and father-in-law. On Tuesday 22 March (yesterday) he informed Michael Yip, Chairman of the Board.
- Two days ago (Monday 21 March), Steven took out HK$1.6 million to reward Holly Lee and the other co-conspirator for their part in the scheme. The money is due to change hands today. Holly is starting to have second thoughts about accepting the bribe money.
- David is re-evaluating his decision to not inform Michael of the scheme until Tuesday.
- Michael is re-evaluating his decision to sit on the information about the scheme overnight.
- David Chan and Michael Yip decide to inform SEHK today (Wednesday 23 March 2011) at 9.00 am.
- Patrick Field is an enforcement officer at the Stock Exchange of Hong Kong Limited (SEHK). He has HK$10,000 of shares in CGMM which are held in accordance with SEHK regulations for employees. David calls Patrick to inform him of the scheme and that the financial payment between the co-conspirators is due to occur today.

- Steven, Holly and the other conspirator do not know that David and Michael have become aware of the scheme.

Required

(a) Consider the key considerations in this scenario from the viewpoint of each one of the following persons:

1 David Chan, CFO of CGMM (and Hong Kong CPA)
2 Michael Yip, Chairman of the Board and CEO of CGMM (and Hong Kong CPA)
3 Holly Lee, fund manager of ABC Funds Management
4 Patrick Field, enforcement officer at the Stock Exchange of Hong Kong Limited – SEHK

(b) With reference to the HKICPA Code of Ethics, what are the ethical issues faced in this scenario?

(c) What do you consider to be the best solution or action to take to address the situation? You should use the American Accounting Association (AAA) Model as a guide for your analysis.

Workshop 1 Session 3

Pre-workshop exercise 2 (Executive Management)

Penny Wong, CFO, has asked you to attend a GMHK organisational business strategy planning session. In this session you will be asked to evaluate **four possible strategic options** and decide on the **appropriate strategy** to be taken by Penny and other GMHK management up to the Board of China Golden Monkey Mobile Limited. You understand that the following four persons of the finance team are keen on this agenda:

1 CEO – Matthew Xu
2 CFO – Penny Wong
3 Sales and Marketing Manager – Jenny Wang
4 General Manager – Alison Cheng

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

Required

(a) **Carry out a comprehensive market analysis of GMHK using Porter's five forces model, together with the sixth force – complementarity. Identify at least six points for each of six forces. Conclude whether the power of each force is high, medium or low.**

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

(b) **Complete an Ansoff product-market matrix of GMHK. In this matrix identify at least three points under each category. Use the conclusions from the market analysis you have prepared in part (a) to assist.**

Note: It is recognised that there may be many more than three possible items under each category, and that acceptable answers may vary in content.

(c) **Bring your completed Porter's five forces analysis and Ansoff product-market matrix 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)

You may wish to refer to the case study, which shows the typical annual expenditures in **Tiger Handsets**, the handset manufacturing subsidiary.

For the purpose of performance reporting, the manufacturing subsidiary (Tiger Handsets) and each of the retail outlets is treated as a profit centre. Handsets are transferred from Tiger Handsets to the retail outlets at **standard manufacturing cost** (expected manufacturing cost) **plus 125%**. The retail outlets then either give away the handsets as part of a subscription agreement, or sell them. Head Office has indicated that the retail outlets are expected to make **a return of at least 20%** on the transfer cost of handsets. Retail outlet managers are paid an annual bonus that is partly dependent on the volume of handsets that they sell.

There have been arguments between the managing director (MD) of Tiger Handsets and the managers of the retail outlets. The Tiger Handsets MD argues that some of the transfer prices for handsets are too low, and that he could sell both component parts and finished handsets to other mobile phone operators for a higher price, although he is not allowed to do so. The managers of the retail outlets complain that although demand is strong for some handset models, others are very difficult to sell because similar models are sold by rival producers at lower prices.

Penny Wong, CFO of GMHK, has asked you to investigate the situation. The company sells a fairly wide range of handset models, so she suggests that you focus on a small number of them. Her view is that the problem may have something to do with the use of transfer prices based on cost plus.

You have obtained the following information about typical monthly costs, production volumes and transfer prices for three models of handset produced in the manufacturing centre.

	Model A	Model B	Model C
Number of units produced and transferred	8,000	15,000	2,000
	HK$	HK$	HK$
Direct materials	134,400	120,000	52,000
Direct labour	153,600	240,000	64,000
Direct cost	288,000	360,000	116,000
Manufacturing overhead	720,000	900,000	290,000
Total manufacturing cost	**1,008,000**	**1,260,000**	**406,000**
Administration and distribution costs	1,008,000	1,260,000	406,000
Full cost	2,016,000	2,520,000	812,000
Expected manufacturing cost per unit	**126**	**84**	**203**

Manufacturing overheads are absorbed into the manufacturing cost at a rate of 250% of direct costs.

The managers of the retail outlets have reported that the transfer prices are too high for Models A and C, but they have not complained about the transfer price for Model B.

Penny Wong believes that the current costing system used by Tiger Handsets is unreliable, and that a better measure of the cost of manufacturing different models of handsets would be obtained using activity-based costing (ABC).

Your investigation suggests that for most manufacturing overheads (HK$ 5.6 million each month) there is no obvious cost driver other than direct costs of production. However, for manufacturing overhead costs totalling HK$ 2.4 million each month the number of batches produced is a suitable cost driver, and for inspection costs (included in manufacturing overheads) the most suitable cost driver is the number of units inspected, since all units are inspected individually. Inspection costs total HK$ 2 million each month.

Administration and distribution costs, which are HK$ 14 million each month and make up one half of the total costs of the manufacturing division, are absorbed at a rate of 100% of the manufacturing cost to obtain the full cost of production. However they are not used in the calculation of transfer prices.

Penny Wong has discussed the problems with the costing system and the transfer pricing system at a recent board meeting. She has suggested to her board colleagues that if the systems are changed this would reduce the arguments between the managing director of Tiger Handsets and the retail outlet managers, which are a matter of concern to the board. The board has asked for a special presentation from Penny Wong and her team.

Penny has asked you to assist with preparing the information for this presentation. She wants you to begin with an investigation of the current systems of costing and transfer pricing for the handsets made by Tiger Handsets.

Required

(a) Compare the expected profitability reported by Tiger Handsets for each of the three types of handset. The comparison should be based on gross and net profit per unit and profits as a percentage of the transfer price.

(b) Identify the weaknesses or limitations of the system of transfer pricing for handsets that is used within GMHK.

Workshop 2 Session 6

Pre-workshop exercise 4 (Treasury Operations)

The head of the company's treasury department is concerned about weaknesses in working capital management and cash flow management, and he has been looking at various ways in which these can be improved.

There are several reasons for his concern.

(1) Handset designs have a fairly short life, and new models of handset are introduced to the market regularly. It is therefore important to keep inventories as low as possible, without affecting sales of mobile phone services, in order to minimise the cost of writing off inventory that is out of date and difficult to sell.

(2) Most customers pay for their mobile phone services on a regular basis, in advance. However, some customers, especially business customers, are given credit. The head of the treasury department suspects that receivables management is inefficient because insufficient attention is being given to this aspect of operations.

(3) Suppliers to the company are complaining strongly about the amount of credit that the company is taking from them. The company is an important customer for many of these suppliers and as a consequence it has been able to buy goods and services on very favourable credit terms. As a result, a number of suppliers have gone out of business because of a shortage of cash, and there have been adverse reports about the company's late payments to suppliers in the media.

Required

(a) Using the financial statements for 2009 and 2010, calculate the average cash cycle (working capital cycle) for the company in each of these years and any other ratios that might help to assess the quality of working capital management. You should use the year-end figures in the statements of financial position for calculating all ratios.

(b) Comment on the cash cycle and other ratios you have calculated.

Workshop 2 Session 7

Pre-workshop exercise 5 (Corporate Finance)

The board of GMHK have been considering whether to make an offer to purchase **Lucky Lion Handsets**, the handset producer in Guangdong province. Although it is a medium-sized producer of handsets, it is bigger than **Tiger Handsets** in terms of production capacity and sales volume. By acquiring Lucky Lion, GMHK would be able to produce handsets initially for other mobile phone operators in the China Golden Monkey Mobile group and eventually for external mobile phone operators too. This should offer substantial opportunities for long-term growth within the communications industry.

There is some **disagreement** amongst the board members about whether Lucky Lion Handsets can be acquired for a suitable price. Lucky Lion is not a listed company, but the shares of similar listed handset producers and OEMs trade on HKSE at a fairly high price relative to earnings. The P E ratios of these similar companies are shown in the table below.

Company	P E ratio
1 Giant Giraffe Limited (GGL)	21.5
2 Hungry Hippopotamus Limited (HHL)	25.0
3 Zippy Zebra Limited (ZZL)	18.6

It has been an element in the capital expenditure policy of GMHK that all capital expenditure projects should pay back within seven years on a non-discounted basis, and a majority of board members see no reason to change this policy for the proposed acquisition of Lucky Lion.

GMHK has expressed its interest in acquiring Lucky Lion, and in response its owners have provided some indicative financial information about the company's expected profits in the current year, as follows.

	HK$m
Revenue	600
Cost of sales	(330)
Gross profit	**270**
Distribution costs	(120)
Administrative expenses	(110)
Net interest expense	(1)
Profit before tax	**39**
Taxation	(7)
Profit after tax	**32**

Lucky Lion has long-term borrowings of HK$ 100 million, and substantial cash and bank deposits. However the owners of the company have stated that if they agree to sell the company, they will withdraw all the cash in a special dividend payment before the sale occurs.

GMHK has estimated that if capital expenditure by Lucky Lion Handsets remains at about HK$ 60 million each year, which is equal to the annual charge for depreciation and amortisation, the company would be able to achieve growth of about 5% per year in sales and earnings for the foreseeable future.

At an initial board meeting of GMHK to discuss the possible acquisition of Lucky Lion Handsets, it is agreed that a suitable offer price that might be acceptable to the owners of the target company would have to be based on a PE ratio multiple. However, the board would also expect payback within seven years of making the acquisition.

Required

(a) **Suggest with reasons an offer price, based on a P E valuation, that might be acceptable to the owners of Lucky Lion.**

(b) **Suggest with reasons whether an acquisition at this price would pay back within seven years, and indicate the annual rate of growth in annual cash flows that might be needed for the investment to pay back within seven years.**

(c) **Recommend what the board of GMHK should do next, before deciding whether to make an offer for 100% of the equity shares of Lucky Lion Handsets.**