

SECTION A – CASE QUESTIONS (Total: 50 marks)

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

CASE

Wealth Management is a professional service for individuals that includes financial planning, estate planning and investment portfolio management. It can cover all parts of the financial life of a person. As people are getting more concerned about the quality of their retirement years, wealth management has been a booming business among insurance companies, independent financial advisors and banks even in the aftermath of the financial tsunami. Integrity and quality of service are important attributes to compete in this business.

ACC Bank has been established for more than 50 years. It offers a wide variety of banking services to its clients. One of its services is aimed at high net worth individuals in its Private Banking section. Mr. Cyril Chin is the Managing Director of the Section. He is 45 years old and has obtained a Masters Degree in Business Administration. He has worked in the Bank for more than 15 years. Mr. Gilbert Tong is the Personal Assistant of Mr. Chin. He has been working in the bank for more than 25 years since graduating from a secondary school. Mr. Tommy Chan is a qualified accountant. He joined the bank three years ago and he is the Chief Accountant of the bank.

Recently, Tommy attended a course on Activity Based Costing (ABC) run by the HKICPA. Having shared experiences with fellow members during the course, he believes that the Private Banking Section should implement an ABC System rather than continue operating under the traditional costing system, which has been used without much change since its inception 50 years ago. He is of the view that the current system does not provide useful information on cost management and reliable customer profitability analysis.

When Tommy was back in the office, he discussed with Cyril and Gilbert in order to promote the implementation of an ABC System in the Private Banking Section. Tommy met with strong resistance from Gilbert who said that there were a lot of difficulties in implementing the ABC System. However, Cyril was interested in this idea and asked Tommy to write a report for deliberation during the forthcoming Managers' Meeting. Also, he asked Tommy to make a detailed customer profitability analysis of its high net worth clients using the ABC System.

Having reviewed the current system, and discussed it with the relevant colleagues, Tommy noted that the clients of the Private Banking Section are classified and ranked into four customer groups based on the value of their individual liquid assets deposited with the Bank. Overheads were absorbed by each customer groups with reference to the man hours consumed. He prepared the following customer profitability statement.

Customer Profitability Statement

Customer Group	1	2	3	4	Total
Client's value (\$ Million)	5M<X<20M	20M<X<40M	40M<X<70M	70M<X<100M	
No. of clients	1,000	1,500	2,000	1,800	6,300
	(\$'000)	(\$'000)	(\$'000)	(\$'000)	(\$'000)
Total contribution	500	900	1,400	2,500	5,300
<u>Overheads(*)</u>					
Share of support costs	285	760	790	1,165	3,000
Share of fixed facility costs	100	160	240	500	1,000
Profit / (Loss)	115	(20)	370	835	1,300
Ranking by p/l	3	4	2	1	

(*) Using absorption method to allocate overhead costs for each customer group.

In order to convince the management to adopt the ABC System, Tommy has collated the following support costs based on major activities. His analysis revealed that these costs are variable in relation to certain drivers. The details of the analysis are shown below.

Activity Analysis of the Support Centres

Customer Group	1	2	3	4	Total
(1) No. of Telephone Enquiries	200,000	150,000	220,000	300,000	870,000
(2) No. of Statements Prepared	120,000	120,000	240,000	480,000	960,000
(3) No. of Client Meetings	60,000	100,000	110,000	200,000	470,000

Overhead Costs by Activity

Description	HK\$'000s
(1) Telephone Enquiries	1,000
(2) Statements Prepared	250
(3) Client Meetings	1,750
Total	3,000

Tommy then re-ranked each customer group on a "net contribution per client" basis. During the Managers' meeting, Cyril suggested that further investigation was needed for the low profitability (or losses) client groups. He is of the opinion that marketing and sales effort should be placed on the two most profitable client groups only. He made the following 2 proposals for Tommy to work on further:

Proposal A

Discontinue 2 groups out of 4 using the ranking of “net contribution per client”. As a result of this reorganisation, Cyril anticipates that there are three scenarios for each of the remaining two client groups.

The Second Most Profitable Group		The Most Profitable Group	
No. of Clients	Probability	No. of Clients	Probability
2,250	0.30	2,000	0.20
2,500	0.40	2,200	0.50
2,750	0.30	2,500	0.30

The facility costs are expected to increase by 10%.

Proposal B

Discontinue either one of the 2 less well performing client groups (i.e. keeping 3 client groups in operation). The facility costs are expected to increase by 8%. However, increments on client numbers, as well as related contribution margin for the two high performing groups mentioned above will be reduced by 75%.

Question 1 (20 marks – approximately 36 minutes)

Assume that you are Tommy, the Chief Accountant. Write a report for the coming Managers' Meeting and explain clearly the following questions:

- (a) Describe the nature of ABC and explain how it differs from the traditional costing System? (5 marks)
- (b) Outline the stages of implementing ABC System. (5 marks)
- (c) Discuss the difficulties which might be experienced when implementing ABC System. (5 marks)
- (d) How does ABC help to determine customer costs and how does customer profitability analysis assist cost management? (5 marks)

Question 2 (15 marks – approximately 27 minutes)

Prepare a customer profitability statement based on the ABC analysis and comment on your results.

(15 marks)

Question 3 (15 marks – appropriately 27 minutes)

Assume that only the two most profitable groups are certain to be kept for business, calculate the Net Benefit under Proposal A and Proposal B and evaluate the results.

(15 marks)

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End of Section A

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

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

Question 4 (20 marks – approximately 36 minutes)

VMC is a medium-sized exporter of pitaya (commonly known as dragon fruit) in Vietnam. The company purchases the pitaya from more than 100 pitaya farms in southern Vietnam. The pitaya is collected and processed centrally for export.

Over the years, VMC has been selling all the produce to the U.S. market through Fruit-Xpress, a U.S. importer of fresh and processed fruit. Fruit-Xpress resells the imported fruit to several chain stores and its own distribution networks in the U.S. Shown below is the information extracted from the financial statements of VMC and Fruit-Xpress:

	US\$'000s	
	VMC	Fruit-Xpress
Revenue	45,435	689,827
Cost of Goods Sold	41,753	492,807
Average Account Receivables	12,735	81,708
Average Inventory	4,567	50,108
Average Account Payables	1,546	149,878

The average cash conversion cycles for an exporter in Vietnam and importer in the US are 90 days and 20 days respectively.

Required:

- (a) Calculate the length of time in VMC's and Fruit-Xpress's cash conversion cycle. Assume 365 days in a year and round up to the nearest day in your calculation. (7 marks)
- (b) Comment on the performance of these two companies in managing their cash conversion cycles. Which company is weaker in this aspect? State your reasons. (6 marks)
- (c) Recommend the possible actions to the weaker company you identify in (b) to enhance cashflow performance. (5 marks)
- (d) Apart from liquidity risk, what other financial risks is VMC facing? (2 marks)

Question 5 (22 marks – approximately 40 minutes)

John is a young entrepreneur who owns two companies in Hong Kong. One of his companies is Glitters Company Ltd which manufactures high-end festival decorations. However, since the U.S. and U.K. entered the economic downturn, Glitters has been facing an increasingly difficult business environment as these two markets account for about three quarters of its annual sales. Glitter's funding shortfall by the end of the year will be HK\$574 million.

To keep Glitters afloat, John has decided to sell his other company, Goldsteron. This company is a distributor of artificial jewellery products. Although Goldsteron is still making a decent profit, John believes that the competition will be keen in a few years time when more competitors from mainland China enter this market. Through the introduction of a banker, he has started discussions with Adam who is interested in buying the Goldsteron business. After conducting preliminary due diligence, Adam has obtained the following financial information:

- The current annual sales are HK\$1,386 million, and growth rates for the next four years are estimated to be 12%, 11%, 10% and 9%. In Year 5 and thereafter, the growth rate will stabilise at 8%.
- The pre-tax profit margin is 13.5% and Adam expects that the margin can be maintained at this level in the future.
- Depreciation expenses are calculated as 11.5% of EBIT.
- The working capital requirements are about 20% of sales. At the end of June, the working capital stood at HK\$165 million.
- The additional capital expenditure requirements are estimated to be 10% of sales for Year 1 and Year 2, reducing to 6% in Year 3 and 4 and thereafter.
- The tax rate is 17%.
- Goldsteron's total external borrowing amounted to \$133.5 million.

Required:

- (a) Adam overheard from the market that John is in need of cash and thus Adam makes a conservative offer by applying a hurdle rate of 15.5% to calculate the enterprise value of Goldsteron. What is the price that Adam will offer if he is only prepared to pay only for the NPV of the equity value? (15 marks)
- (b) John wishes to maintain a minimum cash level of HK\$500 million after selling Goldsteron by the end of the year. Can this be achieved if he accepts Adam's offer? (2 marks)
- (c) If not, what is the hurdle rate that John should counter-offer Adam in order to achieve the minimum cash level of HK\$500 million? (5 marks)

Question 6 (8 marks – approximately 14 minutes)

Lending restrictions, such as “Rating triggers”, exist in some companies’ loan facilities or financing documentations. A rating trigger is a provision in the financing agreement that in case of a change in the borrower’s credit rating (usually a downgrade), it will trigger certain specific actions by the lenders, such as increasing the borrowing cost or accelerating the loan payment.

Required:

- (a) **Why do the lenders want to include lending restrictions in financing agreements?** (4 marks)
- (b) **What are the risks to the borrowers of accepting lending restrictions?** (4 marks)

* * * END OF EXAMINATION PAPER * * *