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Examination Techniques Seminar on QP Module Examinations

Module B (June 2018 Session)

Date: 4 May 2018

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Agenda

1. Introduction
2. Preparation Tips
3. Examination Regulations
4. Examination Techniques
   - Markers' Sharing
5. Q & A Session

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Part 1: Introduction

Today's objective:

Finding ways to pass the Module Examination!

HKICPA QP Module Examinations

Examination Format:

- Section A – Case Questions (50%)
- Section B – Essay / Short Questions (50%)
- 3 hours duration for each Module
- All compulsory questions

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Part 2:
Preparation Tips

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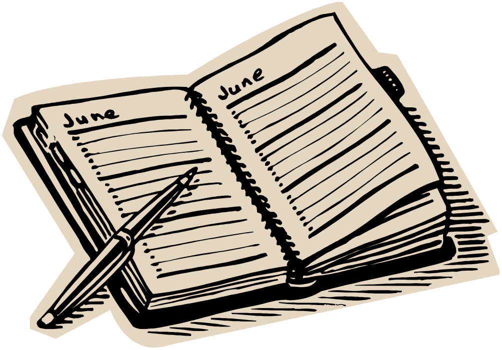
Commit to your Study Plan

Advantages:

- Schedule ahead
- Build long term memories ➔ maximize efficiency
- Avoid last minute work and minimize impact of unpredicted events…



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Prepare Critical File

How to prepare:

- Use different colour post-it for different standards / topics
- Organise materials by different standards / topics
- Understand theories behind each standards / topics
- Get familiar with this file

Advantages:

- Colour coding for standards / topics allows easy identification (same file used in examination – time saving!)
- Build up long term memories
- Avoid indexing without understanding

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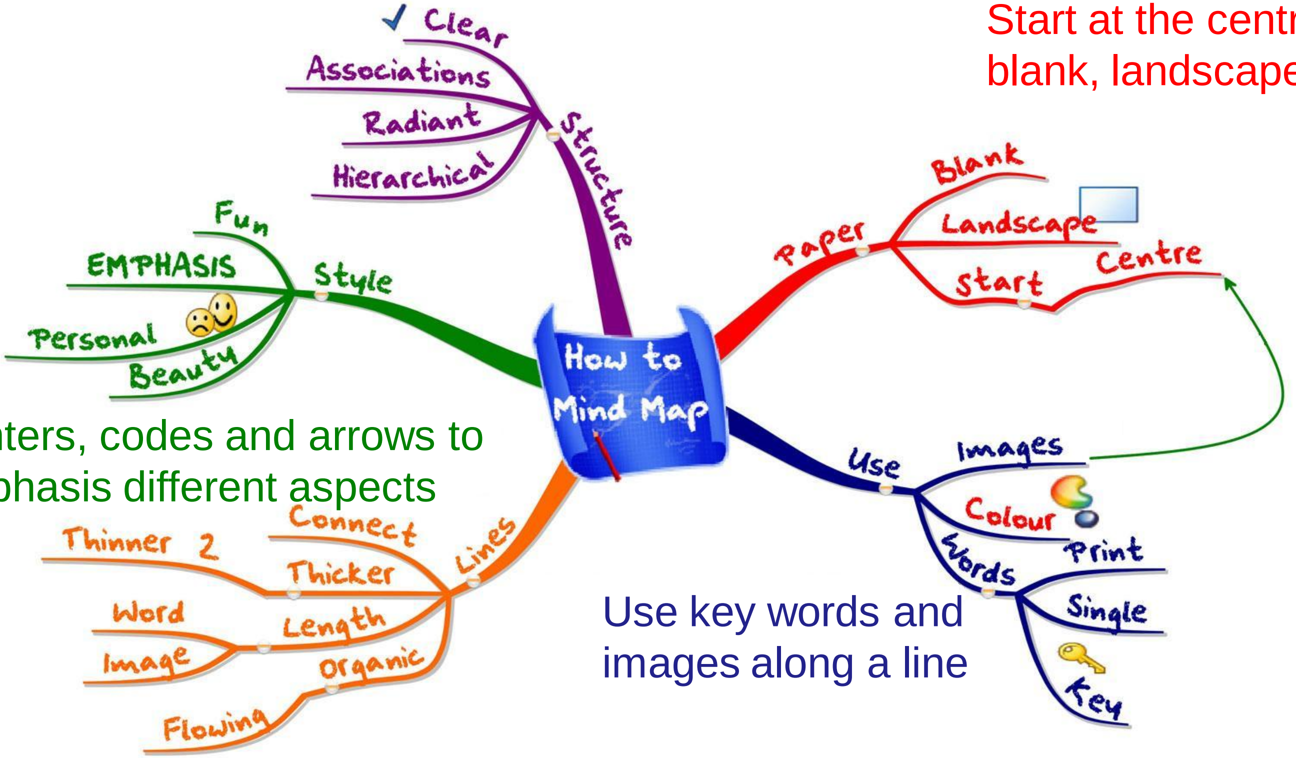
Mind Map

Radiate the ideas out from the central theme and main branches

Start at the centre of a blank, landscape paper

Use highlighters, codes and arrows to link and emphasis different aspects



Use key words and images along a line

Make the lines associate as clear as possible

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Other Preparation Tips

- Cover beyond LP
- Form Study Group with fellow students
- Visit QP Learning Centre
  - Past papers and Examiners' reports;
  - Special topics and/or Important notice; and
  - Module preparation seminar archives

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Part 3:
Examination Regulations

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Examination Regulations (highlights)

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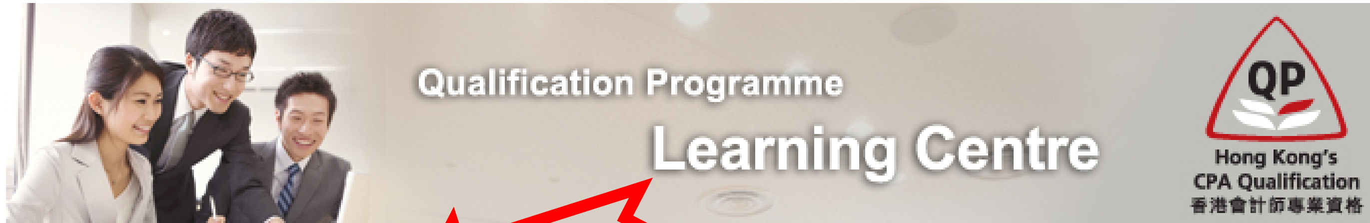
- Bring HKID card and Examination Attendance Docket ("EAD")
- Be aware of the **examination regulations** printed on the EAD which will be posted to students two weeks before the examination
- Arrive 45 minutes before the examination start
- Turn off your mobile phone or other electronic communication devices
- Don't write on the script booklet during the reading time (FE only)
- Don't write your name or personal information on anywhere of your script booklets
- Use blue or black ink pen
- Use appropriate script booklet to answer each section
- Stop writing immediately once the end of examination is announced

Failure to follow any of the examination regulations may result in marks penalty or even disqualification from the entire examination!



Examination guidelines

This video provides guidance on preparing for your upcoming examinations. Make sure you are familiar with these guidelines.

If you are unable to open the video by Internet Explorer, try opening it in a different browser (e.g. Chrome).

Examination assistance

Here are some study tips to help QP students to get through their examinations (please click here).

To help QP students prepare for the four module examinations, the Institute organizes a series of examination assistance functions for each examination session. For more details, please click here.

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Part 4:
Examination Techniques
- Markers' Sharing

Common Areas to Improve in QP Examinations.

A. Questions.

B. Answers.

C. Candidates.

A. Common areas to improve to handle questions:

1. Difficulty in identifying the specific question requirements.
2. Misinterpretation of the question requirements.

B. Common areas to improve to prepare answers:

1. Approach or structure of answers are disorganized.
2. Answers are either too long or too short.
3. Answers are wrong, irrelevant, or lack of practical consideration.
4. Answers are not linked to the case facts.
5. Answers are straightly copied from LP or reference materials.
6. Did not attempt all questions.

C. Common areas that candidates have to improve:

1. Inadequate or ineffective preparation.
2. Other commitments affecting examination preparation.
3. Not in a good form to perform on examination day.
4. Felt panicking or got nervous in the examination centre.
5. Poor time management.

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Section A
Case Questions

Panelists' Report

Section A – Conclusion and Recommendation

1. Candidates did well on computational questions.
2. Some calculation steps were not clearly shown.
3. Candidates were very weak in handling application, analytical and discussion types of questions.
4. Discussions were too short and answers were directly copied from Learning pack.
5. Answer format was inappropriate, such as memo formal.
6. Candidates were urged to improve their examination performance in the medium and long run.

Panelists' Report

Section A – Case Questions

General Comments

1. Performed well in Q3 to explain strategy plans and violation of ordinance.
2. Candidates showed a reasonable ability to handle computational problems.
3. Candidates felt difficult to handle analytical and qualitative types of questions.

Suggestions

1. Read and understand questions carefully to identify specific questions requirements and to avoid misinterpretations.
2. Need to understand and apply case information to tackle questions.

Question 1 **(16 marks – approximately 29 minutes)**

(a) If the cost of the processing operation is allocated on the basis of physical output measured by volume, calculate the total allocated cost (fixed plus variable) per bottle of premium orange juice in a normal month.

(3 marks)

(b) If the variable costs (including handling and bottling) of HKPOJL are allocated on the basis of physical output measured by volume, calculate the variable cost per bottle of premium orange juice in a normal month. Explain if the variable cost per bottle of premium juice should be used in pricing special orders for the premium juice.

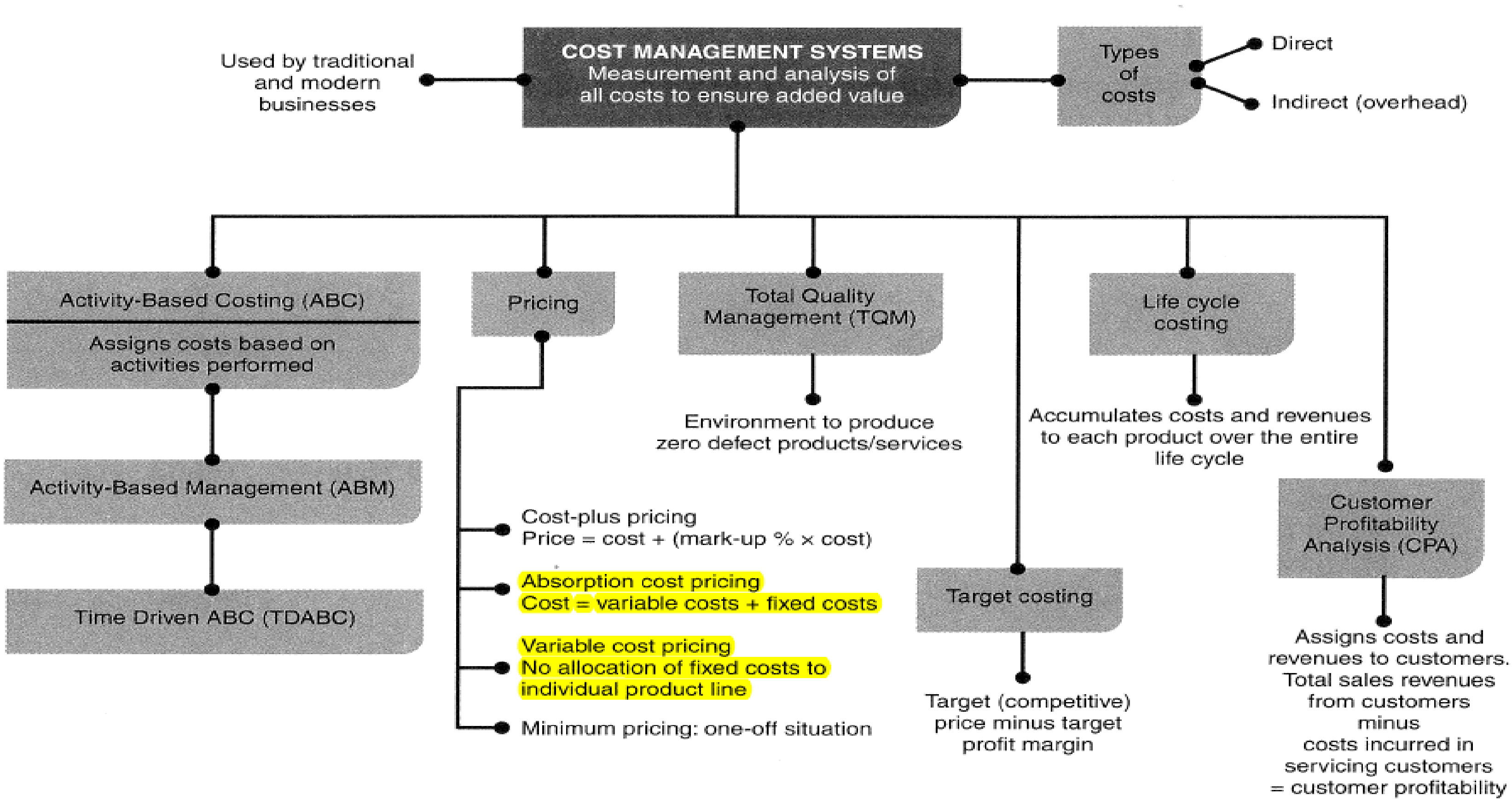
(6 marks)

(c) If the HK$140,000 in fixed costs for regular juice handling and bottling could be avoided, quantify the effect on the profits of HKPOJL in a normal month, assuming it discontinues the regular brand and treats all raw juice as premium grade.

(3 marks)

(d) List and explain two qualitative factors that could affect HKPOJL's decision to discontinue regular juice.

(4 marks)


COST MANAGEMENT SYSTEMS
Measurement and analysis of all costs to ensure added value
Used by traditional and modern businesses
Types of costs
Direct
Indirect (overhead)
Activity-Based Costing (ABC)
Assigns costs based on activities performed
Activity-Based Management (ABM)
Time Driven ABC (TDABC)
Pricing
Cost-plus pricing
Price = cost + (mark-up % × cost)
Absorption cost pricing
Cost = variable costs + fixed costs
Variable cost pricing
No allocation of fixed costs to individual product line
Minimum pricing: one-off situation
Total Quality Management (TQM)
Environment to produce zero defect products/services
Target costing
Target (competitive) price minus target profit margin
Life cycle costing
Accumulates costs and revenues to each product over the entire life cycle
Customer Profitability Analysis (CPA)
Assigns costs and revenues to customers. Total sales revenues from customers minus costs incurred in servicing customers = customer profitability

Case Information for 1(a), (b) and (c)

CASE

Hong Kong Premium Orange Juice Limited ("HKPOJL") has produced two categories of orange juice, serving the Hong Kong and China market since 2004. It was listed on the Growth Enterprise Board in 2013. The production process begins when a container acting as a large tank, a vat to be more specific, is loaded with oranges. The incremental cost of raw materials and processing one load is HK$2,500. Each load will produce 20 barrels of regular orange juice and 10 barrels of premium orange juice. The variable cost of carbonating and bottling the juice is HK$1,000 per barrel of regular juice and HK$2,000 per barrel of premium juice. 1,000 bottles of finished sparkling juice is produced from each barrel of raw juice. The fixed costs for a month is: HK$640,000 for the processing plant, HK$140,000 for handling and bottling regular juice, and HK$240,000 for handling and bottling premium juice. Regular juice sells at HK$4 per bottle and premium juice for HK$6 per bottle in the wholesale market. Normally, HKPOJL could process 100 loads and convert them into 2,000,000 bottles of regular juice and 1,000,000 bottles of premium juice in a month.

Selling prices and costs analysis for 1(a), 1(b) and 1(c)	Regular	Premium
Selling price per bottle	$4	$6
Variable cost per barrel	$1,000	$2,000
Numbers of barrels per load	20	10
Fixed costs	$140,000	$240,000
Process 100 loads and convert into bottles	2,000,000	1,000,000
Other Information: Incremental cost of raw materials and processing of one load	$2,500	
Fixed costs – processing plants	$640,000	

<u>Question 1</u> **(16 marks – approximately 29 minutes)**

(a) **If the cost of the processing operation is allocated on the basis of physical output measured by volume, calculate the total allocated cost (fixed plus variable) per bottle of premium orange juice in a normal month.**

(3 marks)

4.3 Absorption cost pricing formulae

Key term

The **absorption cost pricing formula** defines cost as being equal to all costs incurred in the production process, that is, variable costs plus fixed costs, both direct and allocated.

It is used by organisations because in the long run the price must cover all the costs and a normal profit margin.

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Selling prices and costs analysis for 1(a), 1(b) and 1(c)	Regular	Premium
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Answer 1(a)

According to the information of the case, the vat process cost has to be allocated with the amount
= HK$640,000 + HK$2,500 x 100
= HK$890,000

As the relative volume of premium orange juice is
= 1,000,000 / (1,000,000 + 2,000,000)
= 1 / 3

The allocated cost of vat process cost for premium juice is
= 1 / 3 x HK$890,000
= HK$296,667

Cost of handling and bottling premium juice
= HK$240,000 + HK$2,000 x 10 x 100
= HK$2,240,000

Total cost
= HK$296,667 + HK$2,240,000
= HK$2,536,667

Total cost per bottle
= HK$2,536,667 / 1,000,000
= HK$2.54

Panelists' Report

Question 1(a) – 3 marks

This question required candidates to compute the total allocated cost per bottle in a normal month. Most candidates did well. Some candidates seemed to misunderstand the question by providing irrelevant answers.

(b) If the variable costs (including handling and bottling) of HKPOJL are allocated on the basis of physical output measured by volume, calculate the variable cost per bottle of premium orange juice in a normal month. Explain if the variable cost per bottle of premium juice should be used in pricing special orders for the premium juice.

(6 marks)

4.5 Variable cost pricing formulae

Because of the criticisms of absorption cost pricing models, it may be preferable to utilise variable manufacturing costs or total variable costs for cost-plus pricing.

Key term

Variable cost pricing models remove the need for the allocation of fixed costs to individual product lines.

Selling prices and costs analysis for 1(a), 1(b) and 1(c)	Regular	Premium
Selling price per bottle	$4	$6
Variable cost per barrel	$1,000	$2,000
Numbers of barrels per load	20	10
Fixed costs	$140,000	$240,000
Process 100 loads and convert into bottles	2,000,000	1,000,000
Other Information: Incremental cost of raw materials and processing of one load	$2,500	
Fixed costs – processing plants	$640,000	

Answer 1(b)

Allocated variable cost for premium juice
= HK$2,500 x 100 x 1 / 3
= HK$83,333

Variable cost of handling and bottling
= HK$2,000 x 10 x 100
= HK$2,000,000

Total variable cost
= HK$83,333 + HK$2,000,000
= HK$2,083,333

Variable cost per bottle
= HK$2,083,000 / 1,000,000
= HK$2.08

In dealing with special orders for the premium juice which do not produce any regular juice simultaneously, the decision of HKPOJL would require incurring fixed and variable vat costs, and also the premium juice bottling variable cost. In this connection, special orders need to cover all of these costs.

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Panelists' Report

Question 1(b) – 6 marks

This question required candidates to calculate the variable cost per bottle and explain if the variable cost should be used in pricing special orders. Most candidates were able to get the first part correct but many did not attempt to provide an explanation.

(c) If the HK$140,000 in fixed costs for regular juice handling and bottling could be avoided, quantify the effect on the profits of HKPOJL in a normal month, assuming it discontinues the regular brand and treats all raw juice as premium grade.

(3 marks)

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Process 100 loads and convert into bottles	2,000,000	1,000,000
Other Information: Incremental cost of raw materials and processing of one load	$2,500	
Fixed costs – processing plants	$640,000	

Answer 1(c)

With the existing operation with production of 2 million bottles of regular juice and 1 million bottles of premium juice:

Profit
= HK$4 x 2,000,000 + HK$6 x 1,000,000 – (HK$640,000 + HK$2,500 x 100) – (HK$140,000 + HK$1,000 x 20 x 100) – (HK$240,000 + HK$2,000 x 10 x 100)
= HK$8,730,000

Assuming the discontinuation of regular juice, New profit
= HK$6 x 1,000,000 – (HK$640,000 + HK$2,500 x 100) – (HK$240,000 + HK$2,000 x 10 x 100)
= HK$2,870,000

Decline in profit if the regular juice is discontinued
= HK$8,730,000 – HK$2,870,000
= HK$5,860,000

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Panelists' Report

Question 1(c) – 3 marks

This question required candidates to quantify the effect on the profits if the firm discontinued the regular brand. Most candidates provided irrelevant answers or did not attempt the question.

(d) **List and explain two qualitative factors that could affect HKPOJL's decision to discontinue regular juice.**

(4 marks)

Proposed approach for Questions 1(d):

1.Recall the case materials again.

2.Understand the business and industry.

3. Provide answers based on (1) and (2) with business senses.

Answer 1(d)

Regular juice is discontinued if the total contribution margin does not cover the avoidable fixed costs, i.e. fixed costs that are eliminated if the regular juice is dropped.

Whether the demand function of different categories of juice are complimentary has to be considered.

Employee morale may be affected if some staff are to be laid off due to the discontinuation decision.

Panelists' Report

<u>Question 1(d) – 4 marks</u>

This question required candidates to list and explain qualitative factors to discontinue the regular juice. Most candidates did well in this part. Some tried to quantify the impact of the discontinuation decision.

Question 2 (20 marks – approximately 36 minutes)

(a) Determine the value of HKPOJL to GJL, assuming the new and optimistic growth rate could be achieved after acquisition. Is it a positive NPV project to proceed with the acquisition of HKPOJL all in cash, as suggested by Sandy? Support your answer with calculations.

(7 marks)

(b) Explain with calculations, if David's idea is a better alternative for the shareholders of GJL in terms of value creation.

(5 marks)

(c) Based on the results of the parts (a) and (b), should the acquisition go ahead? Explain what payment terms seem to make more sense to GJL. Identify two other factors in consideration to proceed with this acquisition.

(8 marks)

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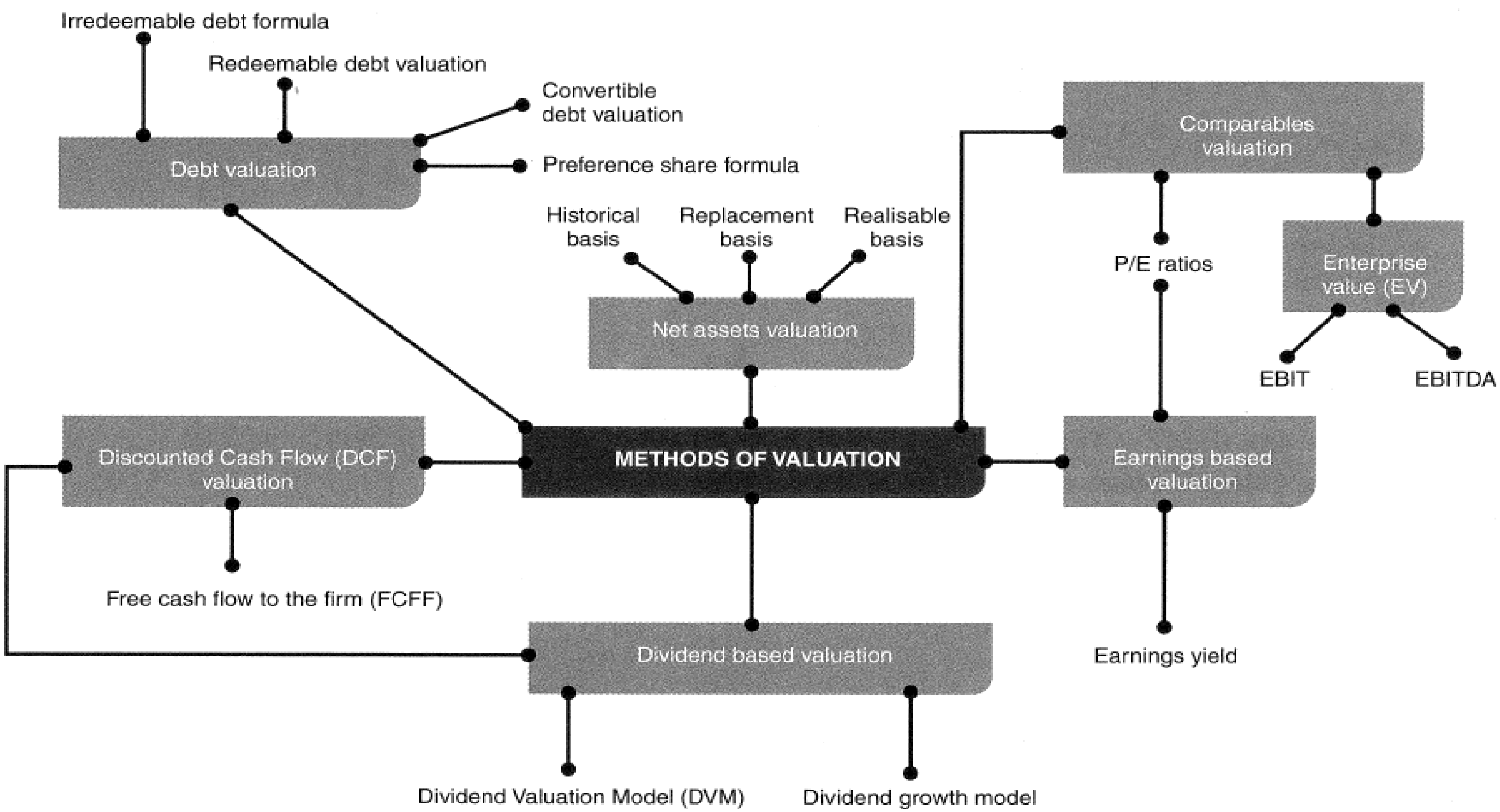

Case Information for 2(a)

Another juice company, Global Juice Limited ("GJL"), currently listed on the Main Board on the Hong Kong Stock Exchange, is interested to take over HKPOJL for the simple fact that GJL is mainly focused on apple juice processing. The CFO of GJL, Sandy Chiu, has the following information through due diligence work on the two firms:

	GJL	HKPOJL
Earnings	HK$420,000,000	HK$96,000,000
Dividends	HK$100,500,000	HK$47,000,000
Price/earnings ratio	14.5	10
Shares outstanding	150,000,000	75,000,000

Sandy is aware that the market believes the earnings and dividends of HKPOJL will likely grow at a stable rate of 4% per year as a standalone company. Nevertheless, the management team of GJL is betting that the acquisition of HKPOJL will enhance economies of scale and synergy between the two firms. As a result, the deal could push up the growth rate to 6% instead after the control change at HKPOJL.

Firms typically use net present value analysis when making acquisitions decisions. The analysis is mainly based on the terms of payment from the bidding firms. In terms of the payment terms, Sandy suggests using 100% cash at a HK$20 per share offering to the shareholders of HKPOJL. She thinks that a tender offer approach to gain control is sensible and simple for this deal. As she points out, the synergy creation will be larger than the premium GJL is going to pay.

Question 2 (20 marks – approximately 36 minutes)

(a) Determine the value of HKPOJL to GJL, assuming the new and optimistic growth rate could be achieved after acquisition. Is it a positive NPV project to proceed with the acquisition of HKPOJL all in cash, as suggested by Sandy? Support your answer with calculations.

(7 marks)

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5.1.1 Using FCFF

Since FCFF represents cash flows to all investors (debt and equity) in the firm, the discount rate used to compute the present value of future expected FCFF must be the "average" required return of these investors. The appropriate discount rate is the weighted average cost of capital (WACC).

There are a number of scenarios with regard to what cash flows might do in the future, giving rise to a number of variants as follows:

Where:
- V_0 is the present value of the firm
- $FCFF_t$ is the free cash flow to the firm in year t
- WACC is the weighted average cost of capital
- g is the growth rate in $FCFF_t$
- g* is the long-run growth rate in $FCFF_t$ in the two-stage growth model
- P_n is the present value of the price at which the share is expected to be sold at year n

The basic formula is:

$$V_0 = \frac{FCFF_1}{(1+WACC)^1} + \frac{FCFF_2}{(1+WACC)^2} + \ldots\ldots = \sum_{t=1}^{\infty} \frac{FCFF_t}{(1+WACC)^t}$$

If there is an assumption that cash flows grow at a constant rate (g) forever, this yields the constant growth model.

Where cash flows demonstrate this constant growth, the formula is:

$$V_0 = \frac{FCFF_0\,(1+g)}{WACC-g} = \frac{FCFF_1}{WACC-g}$$

Answer 2(a)

To find the value of HKPOJL to GJL, we need to find the share price with the new growth rate. We begin by finding the required return for shareholders of HKPOJL.

The earnings per share of HKPOJL
= HK$96,000,000 / 75,000,000
= HK$1.28 per share

The stock price per share
= 10 x HK$1.28
= HK$12.80

And the dividends per share
= HK$47,000,000 / 75,000,000
= HK$0.63

The current required return for HKPOJL's shareholders as a standalone firm before the deal, which incorporates the risk of the firm
= (HK$0.63 x 1.04 / HK$12.80) + 4%
= 9.09%

The price per share of HKPOJL with the new growth rate is:
= HK$0.63 x 1.06 / (9.09% – 6%)
= HK$21.49

The value of HKPOJL to GJL is the number of shares outstanding times the price per share under the new growth rate assumptions
= 75,000,000 x HK$21.49
= HK$1,611,428,571

Yes, it is a positive NPV project to proceed with the acquisition of HKPOJL.

The NPV of the acquisition is the value of HKPOJL to GJL minus the purchase price of the acquisition
= HK$1,611,428,571 – 75,000,000 x HK$20
= HK$111,428,571 which is >0.

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Panelists' Report

Question 2(a) – 7 marks

This question required candidates to determine the value of the target firm to GJL and analyse the NPV of the acquisition decision. The overall performance in this part was not satisfactory. Most candidates could not incorporate the new growth rate to determine the value. Also, many candidates were not able to apply the dividend growth model.

(b) Explain with calculations, if David's idea is a better alternative for the shareholders of GJL in terms of value creation.

(5 marks)

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Another juice company, Global Juice Limited ("GJL"), currently listed on the Main Board on the Hong Kong Stock Exchange, is interested to take over HKPOJL for the simple fact that GJL is mainly focused on apple juice processing. The CFO of GJL, Sandy Chiu, has the following information through due diligence work on the two firms:

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Price/earnings ratio	14.5	10
Shares outstanding	150,000,000	75,000,000

As a matter of fact, GJL has saved a large amount of cash in capital expenditure in the past three years, including investment in processing plants in Indonesia, India and Vietnam. However, the CEO, David Yao, is more inclined to offer 22,250,000 shares of GJL's new stock, rather than paying cash, to effect the payment to the shareholders of HKPOJL. His suggestion is different from the payment approach of Sandy. With the Hang Seng Index trading at a near record level at 30,000, David believes that GJL's stock could be overpriced. It could be a good time to acquire some quality assets by using the overpriced shares of GJL. Moreover, he is aware that negotiation with the management team of HKPOJL on a merger proposal would possibly reduce the premium required to be paid to the target's shareholders.

(b) Explain with calculations, if David's idea is a better alternative for the shareholders of GJL in terms of value creation.

(5 marks)

Answer 2(b)

The price of the stock in the merged firm would be the market value of the acquiring firm plus the value of the target to the acquirer, divided by the number of shares in the merged firm, so:
= (HK$420,000,000 x 14.5 + 1,611,428,571) / (150,000,000 + 22,250,000)
= HK$44.71

The NPV of the stock offer is the value of HKPOJL to GJL minus the purchase price offered to HKPOJL's shareholders. The purchase price offered to HKPOJL's shareholders is the stock price of the merged firm times the number of shares offered, so:
NPV = HK$1,611,428,571 – 22,250,000 x HK$44.71
= HK$616,631,071 > NPV of cash offer

Hence, David's idea is a better alternative in terms of value creation.

Panelists' Report

Question 2(b) – 5 marks

This question required candidates to explain the consequence of terms of payment in the acquisition. The performance was below expectations for this part. A lot of candidates could not work out the price of the stock after the deal.

(c) Based on the results of the parts (a) and (b), should the acquisition go ahead? Explain what payment terms seem to make more sense to GJL. Identify two other factors in consideration to proceed with this acquisition.

(8 marks)

Proposed approach for Question 2 (c):

The criteria that should be used to assess whether a target is appropriate will depend on the motive for the acquisition. The main criteria that are consistent with the underlying motives are :

1. Benefit for acquiring undervalued company
2. Diversification
3. Operating synergy
4. Tax savings
5. Increase the debt capacity
6. Disposal of cash slack
7. Access to cash resources
8. Control of the company
9. Access to key technology

Answer 2(c)

Yes, the acquisition should go ahead since the deal would create value to the shareholders of GJL.

GJL should offer shares to the shareholders of HKPOJL as terms of payment since the NPV under the stock deal is higher than the cash deal.

The attitude of HKPOJL's management team may increase the resistance to GJL.

The potential that another bidder may offer a higher bid to HKPOJL will affect the winning chance of GJL.

The willingness of the controlling shareholders of HKPOJL to sell will affect the completion probability.

Panelists' Report

Question 2(c) – 8 marks

This question required candidates to decide if the acquisition should go ahead and identify other factors in the decision. The performance was not satisfactory for this part. Most candidates were not able to state other factors to consider in the acquisition.

Question 3 (14 marks – approximately 25 minutes)

(a) From the perspective of GJL, explain whether a tender offer or negotiated merger is more appropriate.

(4 marks)

(b) Formulate a couple of defense strategy plans that HKPOJL could employ to turn down the offer from GJL.

(4 marks)

(c) Explain if there is any violation of any ordinance in Hong Kong by the banker, Jun Chen.

(6 marks)

Firms typically use net present value analysis when making acquisitions decisions. The analysis is mainly based on the terms of payment from the bidding firms. In terms of the payment terms, Sandy suggests using 100% cash at a HK$20 per share offering to the shareholders of HKPOJL. She thinks that a tender offer approach to gain control is sensible and simple for this deal. As she points out, the synergy creation will be larger than the premium GJL is going to pay.

As a matter of fact, GJL has saved a large amount of cash in capital expenditure in the past three years, including investment in processing plants in Indonesia, India and Vietnam. However, the CEO, David Yao, is more inclined to offer 22,250,000 shares of GJL's new stock, rather than paying cash, to effect the payment to the shareholders of HKPOJL. His suggestion is different from the payment approach of Sandy. With the Hang Seng Index trading at a near record level at 30,000, David believes that GJL's stock could be overpriced. It could be a good time to acquire some quality assets by using the overpriced shares of GJL. Moreover, he is aware that negotiation with the management team of HKPOJL on a merger proposal would possibly reduce the premium required to be paid to the target's shareholders.

Question 3 (14 marks – approximately 25 minutes)

(a) From the perspective of GJL, explain whether a tender offer or negotiated merger is more appropriate.

(4 marks)

Proposed approach for Q3(a):

1. Understand what is tender offer and negotiated merger.

2. Recall the case information.

3. Make a decision and justify your decision using the case information.

Answer 3(a)

A negotiated merger is more appropriate in this deal since it could involve the management team of HKPOJL, which is likely to enhance the integration of the two firms after the merger.

A lower takeover premium could result if the management team of HKPOJL is not negative to the proposal. It could save money for GJL.

If there is no rush to get the deal done quickly, a negotiated merger is recommended.

Panelists' Report

Question 3(a) – 4 marks

This question required candidates to explain whether a tender offer or negotiated merger was more appropriate. The performance was fair. Very few students could explain that a negotiated merger was likely to enhance the integration of the two firms after the deal. Only a few candidates mentioned that it could also result in a lower takeover premium.

(b) Formulate a couple of defense strategy plans that HKPOJL could employ to turn down the offer from GJL.

(4 marks)

11.1 Summary of defensive tactics

Tactic	Explanation
Golden parachute	Large compensation payments made to the top management of the target firm if their positions are eliminated due to hostile takeover. This may include cash or bonus payments, stock options or a combination of these.
Poison pill	This is an attempt to make a company unattractive normally by giving the right to existing shareholders to buy shares at a very low price. Poison pills have many variants.
White knights and white squires	This would involve inviting a firm that would rescue the target from the unwanted bidder. The white knight would act as a friendly counter-bidder. A white squire is similar to a white knight but the former does not take control of the target firm.
Crown jewels	The firm's most valuable assets may be the main reason that the firm became a takeover target in the first place. By selling these or entering into arrangements such as sale and leaseback, the firm is making itself less attractive as a target.
Pacman defence	This defence is carried out by mounting a counter-bid for the attacker. The Pacman defence is an aggressive rather than defensive tactic and will only work where the original acquirer is a public company with diverse shareholdings. This tactic also appears to suggest that the company's management are in favour of the acquisition but they disagree about which company should be in control.
Litigation or regulatory defence	The target company can challenge the acquisition by inviting an investigation by the regulatory authorities or though the courts. The target may be able to sue for a temporary order to stop the predator from buying any more of its shares.

Answer 3(b)

A poison pill plan could be used to allow existing shareholder to increase their shares upon an outside firm having achieved a certain level of shareholding. This could increase the difficulty and cost to GJL to obtain control of the HKPOJL.

HKPOJL could increase its borrowing to make it less attractive to GJL. Furthermore, a cash dividend could be paid out to shareholders to further reduce the cash level.

Golden parachute payments could be arranged for the existing management of HKPOJL if they are fired by GJL within one to two years after the control change happens at HKPOJL.

Panelists' Report

Question 3(b) – 4 marks

This question required candidates to formulate defence strategy plans for HKPOJL. The performance in this part was satisfactory. Some candidates explained common and popular defence strategies such as poison pill plans and golden parachute payments.

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(c) Explain if there is any violation of any ordinance in Hong Kong by the banker, Jun Chen.

(6 marks)

The story may not be quite that simple. If GJL's managers push for a stock-for-stock deal, this might tip off HKPOJL's managers that GJL is overpriced. As a result, HKPOJL's managers will ask for better terms than GJL could offer.

Given the high growth nature of the business in the Greater China region, analysts on the street tend to think that HKPOJL is underpriced in the financial market. The bankers working on behalf of GJL also indicate that there are some other firms interested to bid for HKPOJL at the moment. One banker, Jun Chen, is tipping off his old classmate on the potential offer to HKPOJL. His classmate then put HK$1 million on the stock. The classmate has made no promise to Jun that if there is any gain, Jun will receive any portion of that.

4 Insider dealing

Insider dealing is a category of "market misconduct" under the Securities and Futures Ordinance. The Ordinance has a dual regime for dealing with suspected cases of insider dealing that have been investigated by the Securities and Futures Commission – a civil regime and a criminal regime. The SFC may decide that a suspected case of insider dealing should be referred to:

- the Market Misconduct Tribunal, under the civil regime. The case is heard by the Tribunal, which has the power to:
  - prohibit the accused individual from taking part in the management of any listed company, and
  - require the individual to make a payment to the government for the profits obtained or losses avoided from insider dealing.
- the Secretary for Justice, under the criminal regime. Individuals found guilty of insider dealing may be imprisoned or required to pay a fine.

4.1 What is insider dealing?

Key term

Insider dealing occurs when an individual who is "connected" to a listed company has price-sensitive information about the company, and uses this information to deal in the company's shares (or advise someone else to deal in the shares) in order to make a profit or avoid a loss.

A "connected person" includes directors of the company and professional advisers. "Price-sensitive information" is information that the public does not yet know, but when the information becomes public knowledge it is likely to have an impact on the share price (so that the share price is likely to go up or down by a substantial amount).

An example of price-sensitive information is information about a merger or acquisition that is not yet public knowledge. Another example is the profit or loss of a listed company for a reporting period, prior to its announcement to the stock market.

Answer 3(c)

Under the Securities and Futures Ordinance in Hong Kong, insider dealing in relation to a listed firm takes place when a person who is contemplating or has contemplated making a take-over offer for that firm and who knows that the information that the offer is contemplated or is no longer contemplated is relevant information in relation to that firm, deals in the listed securities of that firm or their derivatives (or in the listed securities of a related corporation or their derivatives) or counsels or procures another person to deal in those listed securities or their derivatives, otherwise than for the purpose of such take-over. There is, therefore, an obvious violation by the banker, Jun Chen in this case.

Panelists' Report

Question 3(c) – 6 marks

This question required candidates to explain whether there was a violation of any ordinance by the banker. The performance was among the best part in Section A. Many candidates could identify the act as an insider dealing violation under the Security and Futures Ordinance ("SFO").

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Section B
Essay/Short Questions

Panelists' Report

Section B – Conclusion and Recommendation

1. Candidates should understand basic concepts in corporate finance that is essential for advanced career development.
2. Practise application type of questions.
3. Read the questions carefully and directly address the questions raised.
4. Write clearly.
5. Do not write irrelevant information or copy directly from the Learning Pack.

Panelists' Report

Section B – Essay/Short Questions

General Comments

1. This examination tested very fundamental and important subjects, such as cost of capital, bonds and general compliance issues of listed companies in Hong Kong.
2. They are essential to build and master advanced financial practices and to career development.

Suggestions

1. Candidates are encouraged to master these key concepts and practices.
2. Candidates should be able to handle calculations and essay type questions to present their ideas precisely, concisely and professionally.

Required:

(a) Calculate the current weighted average cost of capital of ABC Toys Limited.

(5 marks)

(b) Calculate the cost of capital that ABC Toys Limited should use as a discount rate for the NPV analysis of NewBus.

(8 marks)

(c) Advise the major limitations of the theories and principles used in calculating this discount rate.

(6 marks)

<u>Question 4</u> **(19 marks – approximately 34 minutes)**

ABC Toys Limited is a toy manufacturer listed on the Hong Kong Stock Exchange. Due to intense competition, the board of directors plans to diversify into a completely new industry in order to reduce the company's business risk. As a result, a project called NewBus is under consideration.

The company uses NPV to evaluate the financial viability of NewBus and is looking for a proper discount rate. Financing for this new venture will be from ABC's existing pool of funds.

ABC Toy Limited has a pre-tax cost of bond of 4%. The bond has a nominal value of HK$46.75 million and the last trading price was 107.14. Equity beta is 0.9. The debt is considered risk free. Market value of one ordinary share is HK$5.8. The number of outstanding shares is 20 million.

Risk free rate is 4% per year and average return on the market is 12% per year. Assume tax rate is 16.5%. Assume the debt is risk free.

The company has identified another listed company, Co2 Limited, which is in a similar business as the NewBus investment. Co2 Limited's equity beta is 1.1, has a equity market value of HK$75 million, and market value of debt is HK$25 million.

The investment in NewBus will not alter the current capital structure of ABC Toys Limited, which its board considers to be optimal.

Required:

(a) Calculate the current weighted average cost of capital of ABC Toys Limited.

(5 marks)

5.2 General formula for the WACC

A general formula for the WACC k_0 is as follows:

Formula to learn

$$WACC = k_e \frac{V_e}{V_e + V_d} + k_d(1 - t)\frac{V_d}{V_e + V_d}$$

Where:
- k_e is the cost of equity
- k_d is the cost of debt
- V_e is the market value of equity in the firm
- V_d is the market value of debt in the firm
- t is the rate of corporate tax

Answer 4(a)

ABC Toys Limited:	
Bond:	
Cost of debt - pretax, Kd	4.0%
Nominal value	46.75
Last trading price	HK$107.14
Equity:	
Equity beta	0.90
Number outstanding, M	20.00
Market value per share	HK$5.80
Risk free rate	4.0%
Average market return	12.0%
Tax rate, t	16.5%
Co2 Limited:	
Equity beta, βe	1.10
Equity market value, Ve, $M	75.00
Debt market value, Vd, $M	25.00

Current WACC

Cost of equity	11.2%	CAPM = 4+ 0.9 x (12 – 4)
After tax cost of debt	3.34%	Kd (1 - t)
Market value of equity, Ve	$116.00M	No of shares x price per share
Market value of debt, Vd	$50.09M	Nominal value x price quote
Total firm value, V	$166.09M	V= Vd + Ve
Equity weighting	69.8%	Ve / V
Debt weighting	30.2%	Vd / V
WACC*	8.83%	

*0.698 x 11.2 + 0.302 x 3.34

Panelists' Report

Question 4(a) – 5 marks

This question required candidates to calculate a company's weighted average cost of capital ("WACC") and was handled well by most candidates. Errors were found primarily in calculating: (1) the market values of debt; and (2) the after-tax cost of debt.

(b) Calculate the cost of capital that ABC Toys Limited should use as a discount rate for the NPV analysis of NewBus.

(8 marks)

3.7 The CAPM formula

Key term

The **capital asset pricing model** is a statement of the principles explained above. It can be stated as follows:

$$E(R_i) = R_f + \beta_i\,(E(R_m - R_f))$$

Where: $E(R_i)$ is the cost of equity capital
R_f is the risk-free rate of return
$E(R_m)$ is the return from the market as a whole
β_i is the beta factor of the individual security

Debt is often assumed to be risk-free and its beta (β_d) is then taken as zero, in which case the formula above reduces to the following form:

Formula to learn

$$\beta_a = \beta_e \times \frac{V_e}{V_e + V_d(1-T)} \text{ or, without tax, } \beta_a = \beta_e \times \frac{V_e}{V_e + V_d}$$

Answer 4(b)

Project cost of capital

βa, ungeared asset beta of Co2 Limited, Co2's capital structure	0.8605	βa = βe x Ve / [Ve + Vd (1 - t)]
βe, regeared asset beta, based on ABC Toys' capital structure	1.1707	βe = βa + (βa - βd) Vd (1 - t) / Ve = βa [Ve + Vd (1 - t)] / Ve, if βd = 0
Keg, cost of equity for Co2 Limited at ABC Toys' capital structure	13.37%	Keg = Rf + βe (Rm-Rf)
Project cost of capital	10.34%	0.698 x 13.37 + 0.302 x 4 x (1 - 0.165)

Alternative Method:

Ungeared asset beta of investment	0.8605	from above
Keu industry [Co2] ungeared	10.88%	Keu = Rf + βa (Rm - Rf)
Keg industry with ABC Toys' capital structure	13.37%	Keg = Keu + (Keu - Kd)Vd / Ve (1 - t)
Kadj = Keu (1 - tL)	10.34%	L = Vd / V

Panelists' Report

Question 4(b) – 8 marks

This question required candidates to establish a discount rate for use in NPV to assess the viability of an acquisition the target of which belongs to a different industry. Overall performance was poor indicating that candidates did not have sufficient knowledge of this topic. Most candidates were able to identify the ungeared beta of the new business but failed to re-gear this beta to ABC Toys Limited's capital structure. The main principles involved were (1) finding an ungeared beta of the industry to which the target belongs; (2) re-gearing this beta using the acquisition company's capital structure; (3) using this geared beta to evaluate the cost of equity; and (4) calculating the associated WACC. Another key concept in the WACC calculation is to use ABC Toys Limited's capital weights instead of using those of Co2.

(c) Advise the major limitations of the theories and principles used in calculating this discount rate.

(6 marks)

5.6 Limitations of using CAPM in investment decisions

The greatest practical problems with the use of the CAPM in capital investment decisions are as follows:

(a) It is hard to estimate returns on projects under different economic environments, market returns under different economic environments and the probabilities of the various environments.

(b) The CAPM is really just a single period model. Few investment projects last for one year only and to extend the use of the return estimated from the model to more than one time period would require both project performance relative to the market and the economic environment to be reasonably stable. In theory, it should be possible to apply the CAPM for each time period, therefore arriving at successive discount rates, one for each year of the project's life. In practice, this would exacerbate the estimation problems mentioned above and also make the discounting process much more cumbersome.

(c) It may be hard to determine the risk-free rate of return. Government securities are usually taken to be risk-free, but the return on these securities varies according to their term to maturity.

(d) Some experts have argued that betas calculated using complicated statistical techniques often overestimate high betas, and underestimate low betas, particularly for small companies.

Answer 4(c)

Major Limitations:

The methods used to calculate the cost of capital to evaluate NewBus's NPV is based on MM theory on un-gearing and re-gearing betas and CAPM. Major limitations include:

- Risk free rate and market return needed to be estimated and these data can vary for different time periods chosen (e.g. 3 years, 5 years or 10 years), leading to different results.
- It is difficult to find a proxy company with exactly the same business risk of NewBus from which to develop the appropriate beta. Such differences include, but are not limited to, debt structure, opportunity for growth, size and cost structure.
- Choosing one proxy company alone may provide biased results. Ideally, an industry average of peer group companies is preferred.
- An important assumption is risk free debt, which may not be true in practice, particularly when the D/E ratio is high. At high D/E ratio, the risk of insolvency becomes critical and will result in financial distress to the company.

This question assumes financing from ABC Toys. If financing is from other sources such as project finance, where funds raised may be based on a different capital structure than that of ABC Toys, the calculations need to be adjusted.

Panelists' Report

Question 4(c) – 6 marks

This question required candidates to demonstrate their understanding of the limitations of the Modigliani-Miller ("MM") and capital asset pricing model ("CAPM"). This question was quite well handled. Quite a few candidates were able to indicate most of the limitations. Some answers offered by a few candidates were too generic and as such did not score satisfactory marks. Two of the answers missed by a large number of candidates were: risk free assumption of debt and funding provided by ABC Toys Limited to justify using ABC Toys Limited's capital weights to calculate WACC in part (b).

Question 5 **(19 marks – approximately 34 minutes)**

A listed company Multifin Limited is planning long term financing using a bond. Two alternatives are considered - a straight Bond A or a convertible Bond B.

Bond A, with yield to maturity ("YTM") of 7.5% offers a coupon rate of 10% to be paid annually and matures in four years after issue at which time it will be redeemed at 105% of par value of HK$1,000. The YTM of a similar bond, Bond C, is also 7.5%. Bond C's coupon rate is 2% with 10 years to maturity.

Bond B also has a coupon rate of 10% and matures in four years. YTM is set at 7%. At maturity, one HK$1,000 par value bond can be converted to 20 ordinary shares. Current share price is HK$45. Bond holders will receive all coupon payments regardless of conversion or not.

Required:

(a) **Calculate the price of Bond A.**

(5 marks)

(b) **If management is very confident that the compound growth rate of the share price will be 5% per year for the next four years, calculate the price of Bond B and the conversion premium. Assume no transaction cost.**

(8 marks)

Financing	Straight bond A	Convertible bond B	Bond C
Yield of Maturity	7.5%	7%	7.5%
Coupon rate	10%	10%	2%
Year of Maturity	4	4	10
Redeem / Maturity	105% of par value of $1,000	$1,000 par value bond can be converted to 20 ordinary shares	
Current share price		$45	
Others	Coupon rate of 10% to be paid annually	Bond holders will receive all coupon payments regardless of conversion of not	

5.3.6 Convertible bonds

Key term

Convertible bonds are bonds that give the holder the right to convert to other securities, normally ordinary shares, at a pre-determined price/rate and time.

Conversion terms often vary over time. For example, the conversion terms of convertible bonds might be that on 1 April 2015, \$20 of bonds can be converted into one ordinary share, whereas on 1 April 2016, the conversion price will be \$22 of bonds for one ordinary share. Once converted, convertible securities cannot be converted back into the original fixed return security.

The current market value of ordinary shares into which a bond may be converted is known as the conversion value. The conversion value will be below the value of the bond at the date of issue, but will be expected to increase as the date for conversion approaches on the assumption that a company's shares ought to increase in market value over time.

Conversion value = Conversion ratio × Market price per share (ordinary shares)

Conversion premium = Current market value – Current conversion value

Answer 5(a)

YTM	7.5%	7.5%	7.5%	7.5%	7.5%
Year	1	2	3	4	4
Cash flow	HK$100	HK$100	HK$100	HK$100	HK$1,050
Discount factor	0.93	0.87	0.80	0.75	0.75
Present value	HK$93.02	HK$86.53	HK$80.50	HK$74.88	HK$786.24
Price of Bond A	HK$1,121.17				

Answer 5(b)

Share price in 4 years time	HK$54.70	HK$45 x (1+0.05)^4
Value of 20 shares at maturity	HK$1,093.96	

Since the 20 shares are worth more than HK$1,050, the redemption amount, the bonds will be converted.

YTM	7.0%	7.0%	7.0%	7.0%	7.0%
Year	1	2	3	4	4
Cash flow	HK$100	HK$100	HK$100	HK$100	HK$1,093.96
Discount factor	0.93	0.87	0.82	0.76	0.76
Present value	HK$93.46	HK$87.34	HK$81.63	HK$76.29	HK$834.57
Price of Bond B	HK$1,173.29				

Conversion premium = Bond price - current market price of 20 ordinary shares
= HK$1,173.29 - HK$45 x 20
= HK$273.29

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Panelists' Report

Question 5(a) – 5 marks

This question required candidates to calculate the price of a straight bond. It was a straightforward question and was handled well.

Question 5(b) – 8 marks

This question required candidates to calculate the price of a convertible bond. It was handled well. Most candidates were able to use the discounted cash-flow approach but a few missed using the value of the 20 shares as the terminal value, i.e. the value at maturity, and therefore did not obtain the correct figure. Also, it was noted the concept of conversion premium was not well mastered.

(c) A bond investor who needs a higher stable annual income does not plan to hold any bond until maturity. Advise the bond investor with explanations, as to whether he / she should invest in Bond A or Bond C.

(6 marks)

Proposed approach on 5(c):

1. Higher coupon rate provides higher annual income.

2. The term is shorter, the bond price is more stable due to higher certainty and less risk.

Financing	Straight bond A	Convertible bond B	Bond C
Yield of Maturity	7.5%	7%	7.5%
Coupon rate	10%	10%	2%
Year of Maturity	4	4	10
Redeem / Maturity	105% of par value of $1,000	$1,000 par value bond can be converted to 20 ordinary shares	
Current share price		$45	
Others	Coupon rate of 10% to be paid annually	Bond holders will receive all coupon payments regardless of conversion of not	

Answer 5(c)

The investor should choose Bond A instead of Bond C. Bond A offers a higher coupon, which provides higher annual income. Further, as Bond A's coupon rate is higher and the term is shorter, its price will be more stable than Bond C. As the investor may sell before maturity, the higher volatility of price (Bond C) carries higher risk. This is because if the investor sells before maturity, he/she may be subject to capital loss (even though gain is possible). As mentioned in the question, the investor needs higher stable income, therefore such volatility does not meet the investor's preference.

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Question 5(c) – 6 marks

This question required candidates to demonstrate their knowledge of bond price volatility to coupon rate. Given the investor in question preferred higher income and stable price (since the investor did not plan to hold the bond to maturity, a volatile bond would result in higher risks of capital loss upon disposal before maturity), Bond A should be recommended. This is because, higher coupon and shorter-term bonds are less volatile and therefore Bond A met both the investment objectives at lower risk than Bond C. Overall, performance was average.

Question 6 **(12 marks – approximately 22 minutes)**

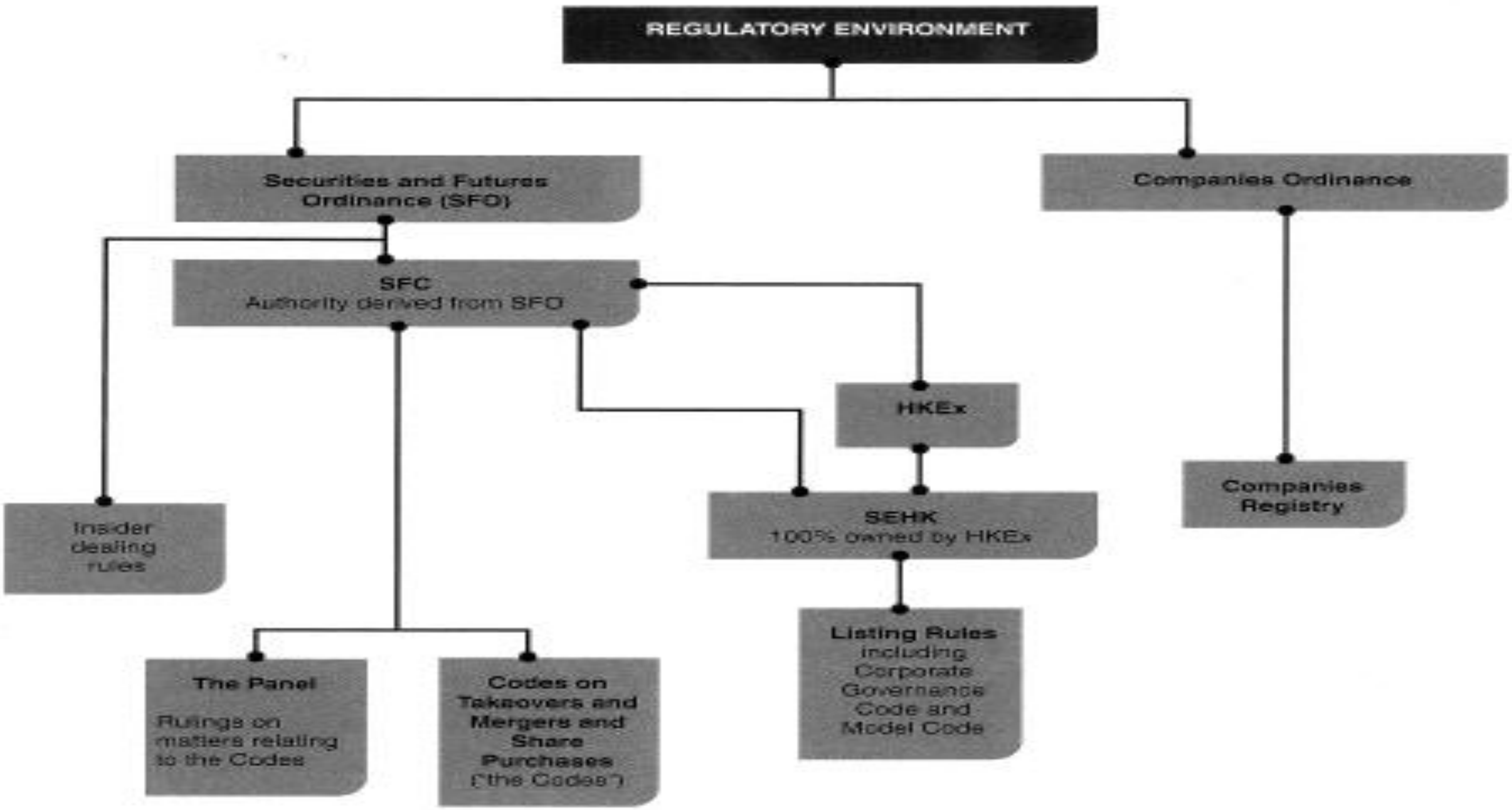
You are Toby Chan, the CFO who just started working for Tidyup Limited, a company recently listed on the Hong Kong Stock Exchange. The board of directors noticed that the company has committed the following non-compliance matters during the last financial year and asked you to evaluate the implications.

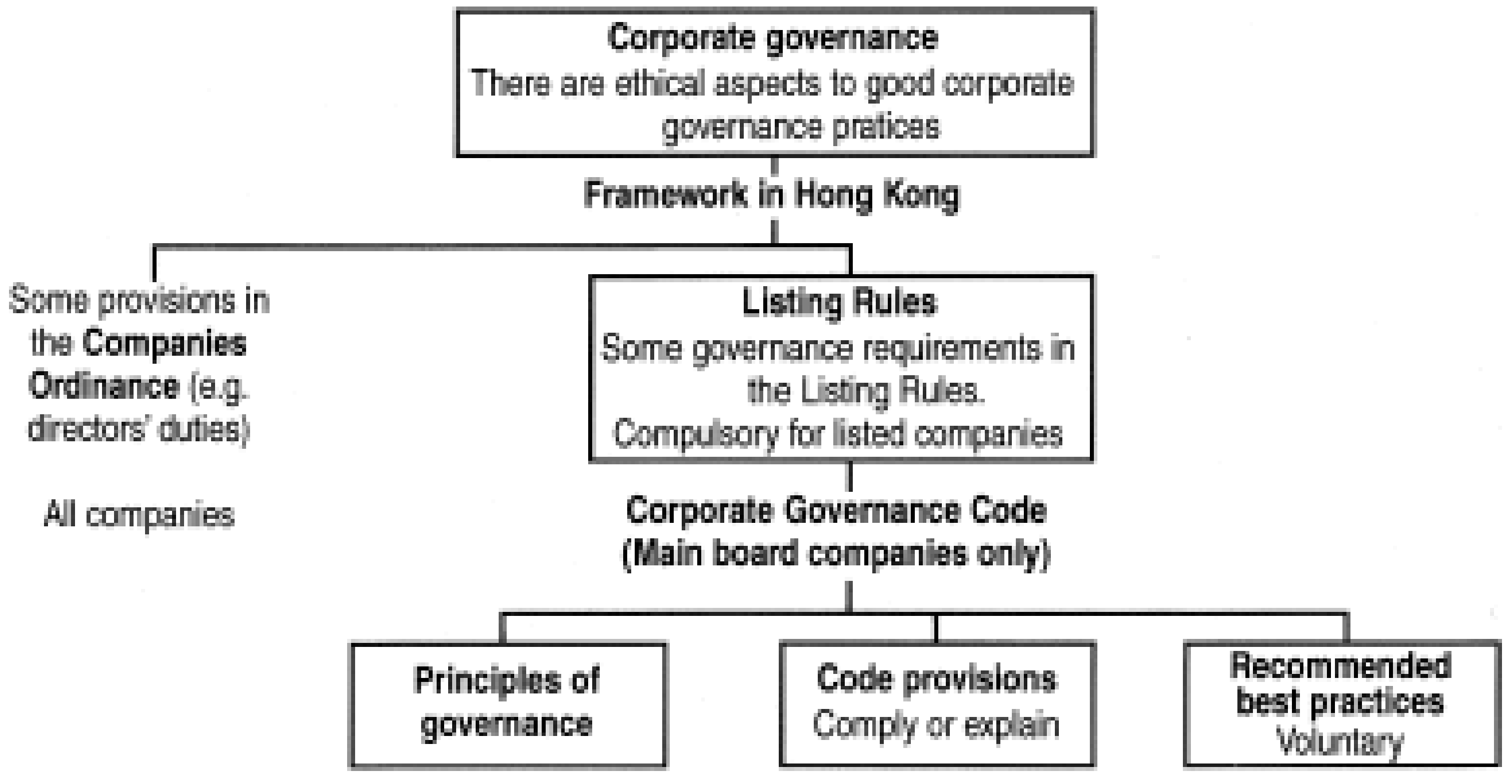
(a) No Corporate Governance report was issued for the last financial year;
(b) One of the directors bought shares within 40 days of the annual results announcement;
(c) CEO and chairman of the board are not separated and the company did not provide any explanation in the last annual report;
(d) Details of remuneration payable to members of senior management, on an individual and named basis were not disclosed in the last annual report.

Required:

Write a memo to the board of directors highlighting the rules or regulations violated and the regulatory consequences, if any, for each of the non-compliance matters identified. You are not required to quote the specific rules or regulations.

(12 marks)


REGULATORY ENVIRONMENT
Securities and Futures Ordinance (SFO)
Companies Ordinance
SFC
Authority derived from SFO
HKEx
Companies Registry
Insider dealing rules
SEHK
100% owned by HKEx
Listing Rules including Corporate Governance Code and Model Code
The Panel
Rulings on matters relating to the Codes
Codes on Takeovers and Mergers and Share Purchases ("the Codes")


Corporate governance
There are ethical aspects to good corporate governance pratices
Framework in Hong Kong
Some provisions in the Companies Ordinance (e.g. directors' duties)
All companies
Listing Rules
Some governance requirements in the Listing Rules.
Compulsory for listed companies
Corporate Governance Code (Main board companies only)
Principles of governance
Code provisions
Comply or explain
Recommended best practices
Voluntary

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Source of rule or guidance	Compulsory or voluntary for listed companies?
Listing Rules	Listing Rules are compulsory requirements
Corporate Governance Code – Appendix to the Listing Rules Code Contains:	
– Code provisions	Provisions should usually be applied (complied with). Any non-compliance must be explained in the annual report.
– Recommended Best Practices (RPBs)	RPBs are guidance only. Compliance is desirable but not compulsory. Non-compliance need not be explained in the annual report.

Aspects of governance covered by Listing Rules or CG Code	Examples of Rules, Code provisions
Directors	■ Separation of chairman and CEO ■ At least one-third of board to be independent non-executive directors
Remuneration	■ Companies must have a remuneration committee of the board with majority of independent NEDS
Accountability and audit	■ Auditors cannot be removed from office before AGM without shareholder approval in general meeting
Delegation by board	■ Directors may delegate authority but remain responsible ■ Directors **must** take an active interest in the company's affairs.
Communication with shareholders	■ Annual report should include discussion of company's business model (how it creates value) and its strategy for delivery of objectives

Insider dealing

Takeovers Code

Person with confidential price-sensitive information about a takeover must not deal in shares of the target company (until the bid is announced)

Model Code

– part of Listing Rules
– minimum standard of behaviour for directors: good practice for dealing in shares of their company

Insider dealing (an offence or misconduct) occurs when:

- a person *connected* with a listed company (such as director, employee, advisor substantial shareholder)
- had *relevant information* (which is not yet known to the public and is likely to affect the share price when made public)
- and deals in shares of the company or counsels/procures someone else to deal

An inside dealer can claim an exception to the rule as a defence, but has to prove his claim.

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Answer 6

To: Board of Directors
From: Toby Chan, CFO
Date: xxxxxxx
Subject: Non-compliance matters

Memo Format

Dear Board Members:

Regarding your query as to possible non compliance matters, please note that there are three categories of regulations involved: (1) The Securities and Futures Ordinances; (2) Listing rules; and (3) Corporate Governance Codes.

Each of the non-compliance issues is discussed below:

(a) No Corporate Governance Report was issued for the last financial year – There is a requirement in the listing rules to publish a corporate governance report annually and to include it in the annual report. Failing to do so is a violation of the rules and company and its directors may be subject to disciplinary action by the Hong Kong Stock Exchange.

(b) One of the directors bought shares within 40 days of the annual results announcement – this is a breach of the Model code in the listing rules banning directors to deal in shares within 60 days of the annual results announcement. Similar to (a), company and directors may be subject to disciplinary action.

However, in addition to breaching the Model code, if the relevant director was in possession of insider information, his / her act could possibly have breached the insider dealing provisions of Securities and Futures Ordinances ("SFO") as well. As such, the Securities and Futures Commission ("SFC") can consider referring the case to MTT (Market Misconduct Tribunal) for a civil regime and / or court under a criminal regime. The company should seek legal advice.

(c) The CEO and chairman of the board are not separated and the company did not provide any explanation in the last annual report - this is a breach of the code provisions of the corporate governance codes. Under the "Comply or Explain" regime, it is acceptable if the company provides an explanation that such an arrangement is better for the company due to its unique situation and the board considers it more suitable to have a combined role. If such an explanation is not provided, the violation may result in disciplinary action.

(d) Details of remuneration payable to members of senior management, on an individual and named basis were not disclosed in the last annual report – this is a non-compliance with the recommended best practice of the corporate governance codes. Not following recommended best practice will result in no adverse regulatory consequence but the code recommends, despite it not being required, that the company explains the reasons of non-disclosure in the Corporate Governance Report.

If you have further questions, please let me know.

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Panelists' Report

Question 6 – 12 marks

This question required candidates to demonstrate their understanding of the regulatory regime governing listed companies in Hong Kong as well as the consequences of non-compliance. The biggest performance issue observed was a lot of candidates did not address the "regulatory consequence" as required by the question and instead only stated the remedy and/or cause of non-compliance. Another area of weakness was the mixing up of impact from non-compliance with listing rules, laws, corporate governance codes and best practices. Performance was average. Only a few candidates did not use a memo format, as required.

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Summary of Examination Techniques

- Don't panic
- Manage your time (1.8 mins./mark)
- Attempt all questions and review your answers at last
- Read question requirements and identify the issues carefully
  - Highlight key words (e.g. Calculate / Advise / Propose etc…)
- Pay attention to specific format requirement (e.g. Memo)
- Give relevant answers
- Write clearly and check for careless mistakes
- Apply technical knowledge and don't copy from LP

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Part 5:
Q & A Session