SINGAPORE CA QUALIFICATION EXAMINER’S REPORT

MODULE: Business Value, Governance and Risk (BG)

EXAMINATION DATE: 9 December 2019

Section 1
General comments
This examination consists of a single case study with information on the industry, company and financial data. Considering the nature of topics examined in this module, the question paper was divided into two sections of equal weight.

The case study involves two companies in the airline industry, one of which is an established full-service carrier while the other is a low-cost carrier. The scenario of the case is based on the full-service carrier making a takeover bid of the low-cost carrier. In this scenario, there are specific analyses to be conducted and implications to be considered pertaining to board, audit, stakeholder and risk matters as well as valuation, share pricing and capital cost issues.

Subsequently, the full-service carrier considered buying another listed airline financed by a share for share exchange. The directors required a valuation and evaluation of the impact of the share for share exchange on gearing and cost of finance relating to the acquisition of this target listed airline.

Governance & Risk component – Questions 1 and 2 (50 marks)
Question 1 covers a range of governance matters, particularly due diligence, compliance and audit. Question 2 covers risk analysis, particularly on risk identification and mitigation. Generally, Candidates fared rather similarly for Question 1 and Question 2

Business Value Component – Questions 3 and 4 (50 marks)
Question 3 tested Candidates on determining the estimated value SingWings. In addition, Candidates are required to determine and comment on the changes in the valuation due to changes in the valuation variables.

Question 4 required Candidates to calculate the percentage and value of holdings in the newly merged group for JetSky and SingWings shareholders and gearing and weighted average cost of capital of the new merged group.

Candidates performed better in Question 3 compared to Question 4.
## Section 2
### Analysis of individual questions

#### Question 1

The question is to determine the Candidates’ understanding of specific concepts and applications of corporate governance in the scenario of corporate restructuring, specifically in a corporate acquisition.

**Part (a)** deals with the range of issues in Board and due diligence.

For **Part (a)(i)**, the answer comprised of independence and expertise of the members in the task force. In general, most Candidates managed to address the independence issue. However, not all Candidates managed to address the task force members’ expertise issue.

- Mr Seah: Most Candidates managed to address his independence but did not elaborate on his expertise.
- Ms Bai: Most Candidates adequately addressed her independence and expertise.
- Mr Kumar: Most Candidates addressed his independence and expertise well. However, some Candidates misinterpreted that he is not independent due to his shareholdings.
- Ms Smith: Most Candidates managed to address her independence but did not elaborate on her business expertise.

Overall, Candidates performed well in this question sub-part. However, most Candidates did not consider Mr Seah and Ms Smith’s expertise which resulted in deduction of marks.

For **Part (a)(ii)**, Candidates were generally able to identify generic areas of essential due diligence, such as financial, human resource and corporate due diligence. Only a few Candidates managed to identify and elaborate on the legal due diligence. Even though most of the Candidates managed to identify the financial, human resource and corporate due diligence requirements, they did not elaborate on the specific procedures in details.

**Part (b)** deals with compliance issues by the acquiree in a takeover.

This question was not well-attempted by Candidates. Most of Candidates did not understand the key subsequent compliance proceedings that the Board is expected to take.

Most Candidates’ answers were related to essential due diligence procedures requirement instead of compliance proceedings. However, most Candidates managed to identify one of the key compliance proceedings, which is to make recommendation to shareholders.

**Part (c)** deals with stakeholder engagement by the acquiree in a takeover.
Generally, Candidates did well in this question. Most Candidates were able to identify at least three acceptable stakeholders.

The preamble in the question with regard to the labour-management tension drew attention and helped Candidates in the determination of the relevant stakeholders. As a result, their write-ups on stakeholders’ considerations centred on this theme of labour-management tension between management and pilots. This is despite that the question asked broadly for considerations “to ensure good governance and ethical practices in its annual report”.

There are primarily four stakeholders from a fairly large acceptable pool of shareholders. While Candidates generally were able to explain their answers around the scenario, Candidates often made the error of:

1. indicating associated stakeholders as two separate categories e.g. unions and employees;
2. splitting generic stakeholders’ constituents as two answers, e.g. employees, and pilots and crews;
3. providing answers specific to the scenarios provided but under different stakeholders, e.g. employees breach of government labour regulations as opposed to a broader possible breach of regulations pertaining to labour and airline etc.

In such situations, for associated categories mentioned in the answers, full credits were not allocated to the other associated stakeholders.

**Part (d)** deals with a specific aspect of corporate governance in a takeover scenario, namely the internal audit function.

Candidates did not perform well for this question.

Most Candidates could generically identify the need for the Audit Committee (AC) to assess the adequacy, effectiveness and resources of the Internal Audit (IA) services offered. Candidates could also identify the generic question of IA independence, i.e. the need and requirement to report directly to ACs as opposed to management.

Most Candidates were, however, unable to identify independence or awareness that if JetSky’s IA was involved in the audit of TropicsAir, there would be a need to discuss its reporting arrangements to JetSky’s AC. In addition, there is a need to address IA’s reviews around activities that may be common to both JetSky and TropicsAir, for example codeshare agreements and reporting on issues that may impact JetSky’s operations or financials.

Lastly, the question centred around Interested Party Transactions (IPT) as defined by Singapore Exchange (SGX) or Related Party Transactions (Accounting Standards) was not included in a majority of Candidates’ answers. Some Candidates can recognise the cost or value requirement that ACs should review
before engaging related parties, but no Candidates identified the need to report such transactions as IPTs annually.

The answers received do, on the whole, represent a gap between theoretical knowledge and practical experience of Candidates.

**Question 2**

This question tests the Candidates on the full array of risk assessment from the acquiree’s as well as the acquirer’s perspectives. For the acquiree, a dynamic extension was done for the Candidates to evaluate the risks after the takeover. For the acquirer, Candidates were expected to work out risk mitigation measures.

Candidates generally performed well and were able to state and elaborate on the risks as well as stipulate the changes or mitigation strategies. However, they lose credit due to the following reasons:

**General Issues**

- Some Candidates failed to read the instructions and provide response based on the scenario in the case study. Some Candidates gave incoherent and general answers.

- Some Candidates failed to read the question clearly and provided responses which do not address the question, such as highlighting possible risk that TropicsAir would face upon takeover instead of responding to the question to evaluate on risks that the company would face before being acquired.

- Responses should be clearly classified based on risk categories provided in the question. Some Candidates gave lengthy definitions of the risks, which were even longer than the actual answers. Such definitions, however, earned them no credit.

- Some Candidates managed to identify appropriate risk but lost marks due to failure to provide relevant elaboration or provide appropriate concluding statement to clearly state the risk which the entity may face.

- Candidates should state any assumptions which were made as part of the response provided and not make definitive conclusion on risk which an entity could face, where case facts on such certainty is not clear in the case study.

- Many Candidates added their own case facts, such as foreign exchange fluctuations, interest rate changes, loan covenant breaches etc.
Specific Issues

- Many Candidates were not sure what strategic risks are. Some Candidates thought that fluctuations in fuel prices is considered a strategic risk.

- Some Candidates assumed that a bigger company would have necessarily performed more hedging or have more experienced staff perform hedging. A small company might have an effective hedging team too.

- Some of the Candidates’ responses in Parts (c) and (d) were skewed heavily towards the labour issue. There were obviously other risks in the case facts but those risks were overlooked and excluded from their responses. Nevertheless, such responses were not penalized.

Responses in Parts (b) and (d) should relate to the preceding parts, i.e. Parts (a) and (c) respectively. However, a few Candidates treated these parts as independent and did not link their responses to the previous parts. Such responses earned them no credit.

Question 3

Part (a) required Candidates to provide a free cash flow valuation by first creating a profit forecast using stated growth assumptions and making necessary adjustments converting profit to cash flow. This part was generally well answered. Points of particular challenge for many Candidates was the computation of capital allowances and working capital requirements. Very few Candidates correctly deducted the value to debt to derive the value of equity.

Part (b) required a sensitivity analysis of the valuation in part (a) at a higher growth level and higher cost of finance. Whilst the computations were performed competently by most Candidates, few Candidates were able to evaluate the sensitivity analysis and articulate the commercial implications, such as higher growth being unrealistic for the industry or the significant impact on profitability and cash flow should the cost of finance increases.

Part (d) required an earnings valuation using an industry average price to earnings ratio and comment on why this approximate valuation differed from the free cash flow valuation in part (a) and quoted share price included in the scenario. Whilst the calculation was well done by most Candidates, few Candidates provided persuasive explanations of estimates, private company information, average ratios, and limitations of using historical earnings. This suggested that whilst computations can be produced by most Candidates, an understanding of the limits of what is being calculated is less well understood.

Overall, future Candidates are advised to ensure that they develop the ability to perform financial analysis as this is a critical skill, and understand the limitations of the various business valuation models applied in this exam, as these skills will be examined by future exam paper requirements.
Question 4

Part (a) required Candidates to evaluate the impact of a share for share exchange on control and gearing, and determine whether each party would benefit from the proposed three for two share for share exchange. Many Candidates found the requirement to compute a potential change in value and then use this analysis to explain why each group of shareholders would support the merger, or not, challenging.

Part (e) required the calculation of gearing and cost of finance for the newly formed group. Most Candidates failed to provide a gearing calculation despite using the data required in the cost of finance calculation suggesting a failure to follow the question requirements. The computation of cost of debt required the correct extraction of credit risk premium from information quoted in the question. Most Candidates attempted this aspect with a degree of success. Some Candidates failed to attempt the cost of finance calculations which suggested time management was a particular challenge for these Candidates.