SINGAPORE CA QUALIFICATION EXAMINERS’ REPORT

MODULE: Business Value, Governance, and Risk (BG)

EXAMINATION DATE: 13 June 2017

Section 1
General comments

This examination consisted of a single case study with financial and industry data contained in appendices. Considering the specialist nature of the topics examined, the question paper was divided into two distinct sections of equal weight.

The company in question manufactured electronic components used in household appliances and was listed on the Singapore Exchange (SGX). The company had several wholly owned subsidiaries and two existing joint ventures (JV) located in China.

**Governance & Risk component – Questions 1 and 2 (50 marks)**

This section centred on a publicly listed company with an ineffective Audit Committee and a weak internal audit department and risk management processes. In addition, the company found itself in an ethical dilemma concerning falsified financial reporting in one of its China subsidiaries.

This section of the case study tested the Candidates’ understanding over the tone-at-the-top displayed by Board, the oversight role of the Audit Committee, and the effectiveness of the internal audit function, as well as the adequacy of the risk management framework and policies.

Overall, Candidates performed much better in answering Question 1 than Question 2. It is noted that more than 10% of Candidates did not complete all the question parts in Question 2. As can be seen from the comments below, there are a fair number of Candidates who failed to read the questions carefully.

**Business Value component – Questions 3 and 4 – (50 marks)**

This section centred on a 100% owned subsidiary in China and the offer of forming a new JV. Actual and projected financial data was provided as appendices to the main case, together with information on guidelines Chinese companies. As in previous examinations, some of the data points provided required professional judgment regarding appropriate adjustments prior to performing the required calculations. Future Candidates should note that this type of critical thinking and decision-making are a hallmark of the Business Value component of the BG examination.

Section 2
Analysis of individual questions
Question 1

Question 1 was divided into parts (a), (b) and (c) and focused on the oversight role of the Audit Committee (AC) over the internal audit (IA) function and the failure of IA to communicate directly with the AC on restrictions being placed by the Chief Executive Officer (CEO) in term of audit scope and annual audit plan approval.

Part (a) required Candidates to evaluate the effectiveness of the AC. Most Candidates generally well answered this part.

Part (b) focused on key risk indicators (KRIs) which were used by IA in performing its additional role of risk management. Part (b) (i) required Candidates to comment on the appropriateness of five KRIs being used. However, a fair number of Candidates responded by defining these KRIs instead of commenting on the appropriateness of each one. Part (b) (ii) required Candidates to identify three additional KRIs. Most Candidates were unable to do so. Candidates are reminded that they need to actively absorb what is happening around them in the workplace and when they visit clients, or even when shopping. Being cognisant of the processes that they observe and identifying potential gaps or areas for improved control will better equip them for answering this type of question and for spotting potential risks and red flags once qualified.

Part (c) required Candidates to identify four changes to enhance the effectiveness of IA. Most Candidates did well in this question part.

Question 2

This question was divided into (a), (b), (c), (d), and (e) focusing on the tone-at-the-top demonstrated by the Board in dealing with the ethical dilemma, and on steps needed to improve the risk management process. In general, Candidates did not answer the question parts relating to risk management very well, with more than 10% not answering Parts (d) and (e). Candidates are further reminded that studying for the Singapore CA Qualification is not module-specific nor solely technically based, but requires them to integrate their practical work experience and personal insights into their answers to demonstrate an elevate level of proficiency and understanding, as is required of a Chartered Accountant of Singapore.

Part (a) required Candidates to identify (i) one regulatory risk arising from the approach by a potential investor of unknown background and (ii) the steps needed to address this risk. A large number of Candidates either could not identify the risk or did not identify the correct risk. The case facts stated that little was known about the investor company or its shareholders (apart from the shareholders being cash-rich individuals that had recently made significant acquisitions), bringing into question the source of its funds and pointing to the potential for money laundering.

Part (b) required Candidates to critically evaluate the Board’s tone-at-the-top. Candidates were able to provide answers, but many Candidates failed to 'critically evaluate' the issues and provided short answers or bullet points. Hence, marks were lost. Candidates are
reminded that unless specifically asked for, bullet points should only be used in an answer as an absolute last resort if you are running out of time.

Part (c) required Candidates to recommend one action that the Board could take to deal with the ethical dilemma. Most Candidates answered this part poorly.

Part (d) asked for three immediate steps that the Board should take before it could express an opinion on internal controls for the year just ended. Many Candidates missed the word immediate and provided answers relating to long term measures, which were irrelevant to answering the question posed. Careful reading of each requirement is essential to maximise your marks.

Parts (c) and (d) related to actions which were more practical in nature and the working experience/exposure of the Candidates matters. However, even Candidates with limited working experience should have been able to draw on their general knowledge and prior studies to provide adequate answers for these two parts.

In contrast to Parts (c) and (d), Part (e) was a very straightforward question requiring Candidates to identify five areas that should be included in a risk management policy. The knowledge required to answer this part drew on the basic core foundation studies and general work/life experiences - an easy five marks. Candidates who were adequately prepared scored full marks for this question part. However, many Candidates either did not attempt this question or provided wrong answers.

Question 3

This question required valuation of the equity in the Hangzhou subsidiary of the case study company by discounting the free cash flow to equity.

Part (a) of the question required the calculation of free cash flow to equity (FCFE). Many Candidates appeared unfamiliar with FCFE though this is a standard business valuation concept. This may be because this specific valuation technique is not detailed in a step-by-step fashion in the Candidate Learning Pack (CLP). Candidates are reminded to go beyond the CLP in their preparation.

Part (b) of the question required computation of the unlevered cost of equity for the same subsidiary. Most Candidates could compute this correctly by applying the Capital Assets Pricing Model (CAPM) to the information on guideline companies given in the case.

Part (c) of the question required discounting the FCFE derived in Part (a) to obtain an equity value. Some Candidates incorrectly subtracted debt from this value, while some Candidates incorrectly discounted Free Cash Flow to the Firm rather than FCFE.
Question 4

This question drew on a typical evaluation of how business value can be increased and the importance of assessing the impact (positive and negative) of an acquisition or merger (in this case, a 50/50 JV) on the risk profile of the case study company.

Part (a) required computing three different measures of relative valuation. Most Candidates correctly applied Enterprise Value / Earnings before Interest, Tax, Depreciation, and Amortisation (EV/EBITDA), Price / Earnings (P/E), and dividend yield ratios to value the subsidiary company. Many Candidates also adjusted the numbers thus obtained by applying a discount for lack of marketability and/or a control premium. It was reasonable to consider these adjustments in this case, but the amounts of the adjustments were arbitrary and not justified by any information from the case or elsewhere. Candidates must justify their opinion and give the reasoning underpinning any assumptions they made.

Part (a) also required commenting on the appropriateness of these valuation estimates. Many Candidates provided generic comments giving general pros and cons of using the measures in any situation, but not focusing on the case. Good answers related directly to the case.

Part (b) considered a situation where a potential JV partner had been shown to have industry expertise and established distribution networks that the case study company was keen to exploit. The question part called for written discussion of the implications of this, with specific reference to how the valuation of the subsidiary in Hangzhou might be affected. For instance, the value of loss of independent control of the subsidiary versus the possible management expertise brought into the JV that could enhance cash flows. The relationship with the new JV partner could also lead to other mutually beneficial investment opportunities in the future. Since the JV would be run by the case study company and the new JV partner as equals, the appropriate cost of capital should reflect their respective costs of capital and cannot be computed solely based on the case study company’s cost of capital plus some mark-up.

Many Candidates failed to raise issues that would have an impact on the valuation, or to explain how the issues raised would affect a valuation. However, Candidates who could think about the situation presented strategically and operationally and related their opinions back to the facts of the case scored well.