INSTRUCTIONS TO CANDIDATES:

1. The time allowed for this examination paper is 3 hours 15 minutes.

2. This examination paper has FOUR (4) questions and comprises TWENTY (20) pages (including this instruction sheet, Appendix A and Appendix B). Each question may have MULTIPLE parts and ALL questions are examinable.

3. This is a restricted open book examination. You are allowed to have only the following materials with you at your exam location:
   - One A4-sized double-sided cheat sheet
   - One A4-sized double-sided blank scratch paper

4. During the examination, you are allowed to use your laptop and any calculators that comply with the SAC’s regulations. Please note that watches, mobile phones, tablets, and all other electronic devices MUST NOT be used during the examination and MUST NOT be within reach or sight or hearing from where you are seated to write the exam. Use of these devices, or, the sight or hearing of these devices, will be flagged as integrity breaches and investigated, unless it is for the purpose as stated under paragraph 6 below.

5. During the examination, videos of you and your computer screen will be recorded for the purpose of ensuring examination integrity and you have consented to these recordings.

6. Should you encounter any issues during the examination, please contact any of these four (4) hotlines for an invigilator to assist you. The hotlines will be operational from one hour before the scheduled start time of the examination to one hour after the scheduled end time of the examination.

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<th>Name of invigilator</th>
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7. This examination paper and all video recordings of this exam are the property of the Singapore Accountancy Commission.
MODULE-SPECIFIC INSTRUCTIONS:

8. Assume that all dollar amounts are in Singapore dollar (S$) unless otherwise stated.
Compulsory pre-exam steps to be recorded in video

Before you begin this exam, you are to perform a 360 degrees environment scan (via webcam), including a view of your table top, so that the location where you are taking the exam is being recorded in the video.

Next, show each side of your A4-sized double-sided cheat sheet to the webcam so that your cheat sheet is being recorded in the video.

Lastly, if you are using a calculator and a blank sheet of A4-sized scratch paper, show the calculator and both sides of the blank scratch paper to the webcam so that these items will be recorded in the video.

Should you encounter any issues during the examination, please contact any of these four (4) hotlines for an invigilator to assist you.

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Question 1 – (a), (b) and (c)

TG Co produces components for access control devices. One component, “SCANSECURE”, is an important part of facial recognition hardware used for quick and secure building access. TG Co aims to manufacture and supply SCANSECURE to producers of gate and door control equipment for wealthy individuals and corporate customers. SCANSECURE is expected to have a lifecycle of four years.

Production and sales are forecast as follows (in units per year):

| Year 1 | 70,000 |
| Year 2 | 106,000 |
| Year 3 | 150,000 |
| Year 4 | 72,000 |

The selling price per component (for the first year) will be $30 per unit, with variable cost (for the first year) of $12 per unit. Selling price is expected to inflate at a rate of 4% per year thereafter, rounded to the nearest cent each year, and variable costs at a rate of 7% per year, again rounded to the nearest cent each year.

TG Co incurs $750,000 of head office overheads annually.

Machinery will be required at the start of the project at a cost of $2 million.

Working capital of 7% of sales revenue will need to be in place at the start of each year of the project.

Corporate tax is payable at 17% on operating cash inflows, payable in the same year in which the operating cashflows are incurred. In addition, tax allowable depreciation can be claimed on a straight-line basis on the machinery. Its scrap value at the end of the project is expected to be zero. An after-tax nominal (or ‘money’) cost of capital of 10% is considered appropriate for appraising this project.
Question 1 required:

2 (a) Calculate the cashflows (including inflation) for sales revenue and variable costs for each of the 4 years of the project.

(6 marks)

3 (b) Calculate the Net Present Value of the project and recommend whether the project should be accepted or not. Limit discount factors to 3 decimal places.

Present your answers using the following format:

<Year>
Working 1 = S$ Answer
Working 2 = S$ Answer
Present value = S$ Answer
Total NPV of the project = S$ Answer

(15 marks)

4 (c) If inflation rates were to increase, how would this affect the overall NPV?

(4 marks)

(Total: 25 marks)
Question 2 – (a), (b) and (c)

Lucas Tan is the Head of Finance for Luminosity Co, a light bulb manufacturer. He is assembling investment plans for the coming period and has identified the following 5 potential projects:

<table>
<thead>
<tr>
<th>Project</th>
<th>Initial cost $'m</th>
<th>NPV $'m</th>
<th>Length of project (years)</th>
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<td>Project Alpha</td>
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<td>4</td>
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<td>Project Beta</td>
<td>30</td>
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<td>Project Epsilon</td>
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<td>-2</td>
<td>4</td>
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</table>

Lucas has been given a limited investment budget of $100 million to spend. None of the projects can be delayed. Luminosity Co has a cost of capital of 10%.
Question 2 required:

The projects are divisible. This means, for example, 30% of a project could be undertaken for 30% of the initial cost to yield 30% of the NPV. In addition, each project can only be undertaken a maximum of one time – i.e. Lucas could not choose to undertake a particular project 3 times over.

5 (a) Calculate and present the optimum combination of projects possible within the capital constrained budget that will maximise the NPV.  

(b) Assume now that the projects are repeatable and mutually exclusive.

i. Describe the approach Lucas should take to solving this problem.  

ii. By presenting supporting calculations, recommend which project(s) he should choose to invest in and the NPV of this investment decision? Refer to Appendix A for the tables for annuity factors.  

(7 marks)
Question 2 required:

Project Beta would be somewhat experimental for Luminosity Co, and Lucas is a little worried about this fact – it would be an investment in a new area. An alternative approach to investing in project Beta would be to acquire ‘Better Beta Co’, an established company that already makes a similar quantity of the components that project Beta would aim to supply.

(c) Discuss TWO potential advantages and TWO potential disadvantages of acquiring an existing business as opposed to investing in the project. Recommend with reasons which option would you recommend in this case.

(8 marks)

(Total: 25 marks)
Question 3 – (a) and (b)

Kallang Pharmaceutical Ltd (KPL) would like to calculate a cost of capital to appraise an investment in a new Centrifuge system that is used in research.

The following information relates to KPL:

<table>
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<tr>
<th>Description</th>
<th>Value</th>
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<tbody>
<tr>
<td>Number of ordinary shares</td>
<td>20 million</td>
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<tr>
<td>Size of retained earnings reserve</td>
<td>$28 million</td>
</tr>
<tr>
<td>Book value of 7% convertible debt</td>
<td>$29 million</td>
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<tr>
<td>Book value of 5% bank loan</td>
<td>$10 million</td>
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<tr>
<td>Market price per ordinary share (ex div)</td>
<td>$5.50</td>
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<tr>
<td>Market value of convertible bond</td>
<td>$107 per $100 nominal</td>
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<tr>
<td>Equity beta of KPL</td>
<td>1.4</td>
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<tr>
<td>Risk free rate of return</td>
<td>4.5%</td>
</tr>
<tr>
<td>Market rate of return</td>
<td>10.4%</td>
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</table>

The convertible debt has eight years left to run, at which point it can be redeemed at the investor’s option for $100 cash per $100 nominal or converted into 15 shares per $100 nominal. Share price is expected to grow at 6% per year for the foreseeable future.

KPL may need to raise more finance for the investment, in which case they are considering either debt or equity, but are unsure which is best. The industry average gearing level (calculated as debt / (debt + equity)) is 45% based on market values. The size of the investment and the amount of capital that would need to be raised would be relatively small.

Ignore taxation.
Question 3 required:

(a) Calculate the weighted average cost of capital for use in KPL’s investment appraisal. Refer to Appendix A for discount factors table and the IRR formula where appropriate. Present your answer to 2 decimal places. (17 marks)

(b) With reference to the capital structure of KPL, there are the Traditional View (‘trade-off theory’) and the Modigliani and Miller Theorem. Recommend and justify whether the project should be financed with debt or equity with reference to these two theories. (8 marks)

(Total: 25 marks)
Question 4 – (a), (b) and (c)

Reef Beach Supplies Ltd (RBSL) supplies leisure and safety equipment for use on beach holidays – ranging from beach sports equipment to inshore boating and water sports equipment.

A new Head of Finance, Tian Lim, has been appointed and she is looking to improve RBSL’s management of working capital.

RBSL has credit sales of $30 million a year. Standard terms of trade state that payment is required in 30 days, although many customers take longer to pay. Typically, 1% of credit sales are not recovered at all. Trade receivables currently stand at $4.1 million.

Tian is considering employing a debt factor to provide 2 services:

- With recourse debt factoring. This should save approximately 70% of the current bad debts, reduce receivables days to the 30-day standard term, and yield an administration cost saving of $75,000 a year. The factor would charge 1% of credit sales per year for this aspect of the service.
- Providing an advance of 80% of receivables at an interest rate of 7% per year.

RBSL finances its working capital using an overdraft at a cost of 5% per year.

Assume 365 days in a year.
Question 4 required:

10  (a) Calculate the net annual cost/saving of using the debt factor. Present answers to the nearest dollar.  
    (11 marks)

11  (b) Discuss THREE other factors that should be considered before making a decision of whether or not to employ a debt factor.  
    (6 marks)

Tian is also considering reducing the regular dividend payment to help improve liquidity.

12  (c) Discuss FOUR reasons how and why changing the regular dividend may affect share price.  
    (8 marks)
    (Total: 25 marks)

END OF PAPER
Appendix A

Standardised Common Content Reference Material

Financial Management

(For Jun 2020 Exam, last updated: 4 May 2020)

Important notes

1. This Standardised Common Content Reference Material (Reference Material) was first published on the SAC website on 4 May 2020.

2. The latest Reference Material will be incorporated into the examination question paper as an Appendix, and will be uploaded within your Exam in the e-exam software, Examplify.

RISK MANAGEMENT

- Identification
- Analysis (severity and probability)
- Prioritisation
- Treatment (Transfer, accept, reduce, avoid)
- Monitoring and review

Interest Rate Parity Formula

\[ F_n = S_0 \times \frac{(1 + i_a)^n}{(1 + i_b)^n} \]

- \( F_n \) = Forward exchange rate
- \( S_0 \) = Spot exchange rate
- \( i_a \) = Interest rate of country A (quote currency)
- \( i_b \) = Interest rate of country B (base currency)
- \( n \) = number of years ahead for which future exchange rate is being calculated

Purchasing Power Parity Formula

\[ S_n = S_0 \times \frac{(1 + \inf_a)^n}{(1 + \inf_b)^n} \]

- \( S_n \) = Forecast spot exchange rate
- \( S_0 \) = Spot exchange rate at \( T_0 \)
- \( \inf_a \) = Inflation rate of country A (quote currency)
- \( \inf_b \) = Inflation rate of country B (base currency)
- \( n \) = number of years ahead for which spot exchange rate is being estimated

THE FINANCING DECISION

Components of the cost of capital:

1. Equity
   - Dividend growth model
     \[ K_e = \frac{D_0 (1+g)}{P_0} + g \]
Where:
Ke = the cost of equity
D₀ = the current dividend per share
g = future anticipated annual growth rate in dividends per share
P₀ = the current ex-div share price

g can be estimated as
\[(D_r / D_e)^{(1/n)} - 1\]
Where:
Dᵣ = the latest dividend in a historical pattern
Dₑ = the earliest dividend in a historical pattern
n = the number of years between the earliest and the latest dividend in a sequence of historical dividends.

Or g = b x r
Where:
b = the proportion of earnings held back
r = the return on reinvested earnings

- **Capital asset pricing model**
  \[R_e = R_f + \beta (R_m - R_f)\]
  \[R_e = \text{cost of equity}\]
  \[R_f = \text{risk free rate}\]
  \[\beta = \text{beta coefficient}\]
  \[R_m = \text{market return}\]

2. **Bond**
   - Compute the value of bond using the sum of the present value of cash flows of the bond discounted at prevailing interest rate
   - Cost of a bond is the internal rate of return of the after tax cashflows associated with the bond (market price, interest and redemption proceeds)

3. **Bank loan**
   - After-tax cost of a bank loan = I% (1-t)
     Where:
     I% = the annual percentage rate payable on the loan
     t = the annual corporate tax rate

4. **Preference shares (redeemable and irredeemable)**
   - Yield of an irredeemable preference share = Dividend per year / market price
   - Yield of a redeemable preference share: Internal rate of return of the following cash flows:
     - T₀ – market value as an outflow
     - T₁₋n – preference dividends as an inflow
     - Tn – redemption proceeds
Weighted Average Cost of Capital (WACC)
WACC% = [(Ve/(Ve+Vd) x Ke) + [(Vd/(Ve+Vd) x Kd]
Where:
Ve = The market value of all ordinary shares
Vd = The market value of debt
Ke = Cost of Equity
Kd = After-tax Cost of Debt

THE INVESTMENT DECISION
The investment appraisal

- Net Present Value (NPV)

  Present value of an annuity

  \[\frac{1-(1+r)^{-n}}{r}\]

  Where:
  r = discount rate
  n = number of periods

  Present value
  \[PV = FV_n \div (1 + i)^n\]
  Where:
  PV = Present Value
  FV_n = Future value at end of period n
  i = Interest rate per period
  n = Number of periods

- Internal Rate of Return (estimated using linear interpolation)

  IRR is approximately \[A + \frac{(B-A) N_A}{(N_A - N_B)}\]

  Where:
  A = The lower discount rate chosen
  B = The higher discount rate chosen
  N_A = The net present value calculated at A%
  N_B = The net present value calculated at B%

- Accounting rate of return

  Accounting rate of return = Incremental accounting income ÷ Initial or average investment

  Where average investment = (initial investment + scrap value) / 2

- Payback period

  Payback period = Time to recover initial investment.
  If annual cashflows are constant then this equates to:
  Initial investment ÷ Net annual cash inflow
Capital rationing
- Divisible projects:
  - prioritise positive NPV projects using the formula: NPV / Initial investment
  - Start at the top and work down investing as you go.

Equivalent annual cost/value
- To find optimum asset replacement cycles or to choose between repeatable projects of different lengths: Rank using:
  
  Equivalent annual cost = NPV / Annuity factor

Business Valuation Techniques
- **Constant Growth Dividend Discount Model**
  
  \[ P_0 = \frac{D_0 (1+g)}{(K_e - g)} \]
  
  Where:
  - \( K_e \) = the cost of equity
  - \( D_0 \) = the current dividend per share
  - \( g \) = future anticipated annual growth rate in dividends per share
  - \( P_0 \) = the current ex-div share value of one share

- Cash Flow Methods
  The present value of future cash inflows as a result of acquiring the business.
  - Including synergies
  - Discounted at the cost of equity applicable to that business.

- **Price-Earnings (P/E) model (EPS)**
  
  \[ P_0 = \frac{P}{E} \times EPS \]
  
  Where:
  - \( P_0 \) = value of 1 ordinary share
  - \( P/E \) = an applicable price/earnings ratio (calculated as price per share / earnings per share)
  - \( EPS \) = earnings per share (being earnings available for distribution to ordinary shareholders / number of ordinary shares)

- Revised net asset value method for appraising investments and valuing ordinary shares:
  Book value of equity from the balance sheet (including reserves) adjusted if possible for market values.

WORKING CAPITAL MANAGEMENT

Working Capital Cycle (WCC)
The Working Capital Cycle for a business is the length of time it takes to convert net working capital (current assets less current liabilities) all into cash.

\[ WCC = \text{Inventory Days} + \text{Receivable Days} - \text{Payable Days} \]
Financial Ratios

- Current ratio = Current assets / Current liabilities
- Net working capital = Current assets - Current liabilities
- Return on total assets = Net income ÷ Average total assets
- Return on equity = Net income ÷ Average shareholders’ equity
- Receivables days = (Accounts Receivable balance ÷ annual credit sales) x 365
- Receivables turnover = (Annual credit sales ÷ Accounts Receivable balance) to give ‘times a year’
- Payables days = (Accounts Payable balance ÷ annual purchases or cost of sales) x 365
- Payables turnover = (Annual purchases or cost of sales/ Accounts payable balance) to give ‘times a year’
- Inventory days = (Inventory balance ÷ Cost of Sales) x 365
- Inventory turnover = (Cost of Sales ÷ inventory balance) to give ‘times a year’
- Gearing Ratio = Debt ÷ (Debt+Equity)
- Interest Coverage = EBIT ÷ Interest Expense
- Operating leverage ratio = (Sales - Variable Cost) ÷ (Sales – Variable Cost – Fixed Cost)
- Operating profit margin = EBIT ÷ Sales revenue
- Quick ratio = (Currents assets – Inventories) ÷ Current liabilities
### Present Value Tables

**Present value interest factor of an (ordinary) annuity of $1 per period at i% for n periods, PVIFA(i,n).**

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<th>2%</th>
<th>3%</th>
<th>4%</th>
<th>5%</th>
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### Appendix B – Common verbs used by the Examiners

<table>
<thead>
<tr>
<th>Verb</th>
<th>Description</th>
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<tbody>
<tr>
<td><strong>Calculate / Compute</strong></td>
<td>Do the number crunching and derive the correct answer. Make sure that you write down your workings and crosscheck your numbers.</td>
</tr>
<tr>
<td><strong>Describe</strong></td>
<td><strong>Describe</strong> requires you to provide the characteristics and features of an item or situation. For instance, “<strong>Describe</strong> the audit procedures to verify …” requires you to <strong>state</strong> the specific audit procedure/s that you would use without going into step-by-step <strong>detail</strong> of how to perform that procedure.</td>
</tr>
<tr>
<td><strong>Discuss</strong></td>
<td><strong>Discuss</strong> requires you to provide the ‘for’ and 'against' arguments, you cannot have a discussion without opposing views otherwise it would be just a conversation. If <strong>discuss</strong> is placed near the front of the instruction, then it requires you to provide an answer that is similar to <strong>explain</strong>, but addresses both the for and against arguments.</td>
</tr>
<tr>
<td><strong>Justify</strong></td>
<td>Whenever you see the word <strong>justify</strong> you must provide reasons for your answer, in other words, provide support for your argument or conclusion. If you fail to <strong>justify</strong> your answer, you will lose valuable marks.</td>
</tr>
<tr>
<td><strong>Recommend</strong></td>
<td>Make a statement about the most appropriate course of action. If there is more than one possible course of action, <strong>state</strong> which action you would choose and why (<strong>justify</strong> your choice). Your professional judgment and your ability to <strong>interpret</strong> the wider situation are critical to scoring well in these types of questions. Don’t forget to think about the future and the past, not just the present when making a <strong>recommendation</strong>.</td>
</tr>
</tbody>
</table>