Chartered Accountant SINGAPORE

SINGAPORE CA QUALIFICATION (PROFESSIONAL) EXAMINER'S REPORT

MODULE: Business Value, Governance and Risk (BG)

EXAMINATION DATE: 6 December 2023

General comments

The December 2023 BG examination consists of a single-company case study with financial and industry data covering four questions across the BVGR syllabus. Each question addresses particular syllabus areas, consistent with prior examinations.

Major Stays is a large, premium, private hotel chain that provides luxury short-break holiday destinations for city dwellers in Singapore and foreign travellers. It is favoured by guests with high levels of disposable income and has an excellent reputation among its guests.

Major Stays' strategy for growth aims to focus on improving its sustainability performance by focusing on environmental, social, and governance impacts. The aim is to attract environmentally conscious customers. The Board is relying on funds generated from current operations over the next three years, with an objective to generate S$100 million in cash by 31 December 2026 to fund its "Expansion for Growth" strategy and provide liquidity for ongoing operations. The Directors are concerned about current and future compliance with the existing loan and the ability to raise finance. Therefore, Major Stays' Board of Directors has requested a forecast of profit and a cash flow forecast for a three-year period starting from 1 January 2024.

Business valuation, capital structure, and working capital management learning outcomes, are covered by Questions 1 and 2.

Question 1 focuses on current and future compliance with the covenants in its existing fixed 4% bank loan of S$200 million and the evaluation of two additional finance options: (1) refinancing the existing bank loan and (2) a convertible loan note.

Question 2 focuses on the possibility for Major Stays to list its shares on the Singapore Stock Exchange (SGX) in the future to raise a substantial amount of new equity capital. This would enable the company to accelerate its growth and expand the number of hotels, either by building new ones, purchasing existing ones from competitors, or through the acquisition of a small hotel company. To assist, the Board has requested a range of equity valuations for Major Stays: (1) net assets valuation, (2) dividend valuation, (3) market approach using 31 December 2023 EBITDA and an average market earnings ratio, and (4) a free cash flow valuation. Question 2 also requires Candidates to explain the rationale for six SGX Main Board Listing Rules and determine if Major Stays is currently compliant with each rule.

Risk and Governance learning outcomes are covered by Questions 3 and 4.

Question 3 focuses on eight new sustainability objectives developed by the Board of Major Stays to improve its sustainability performance. The Risk Committee would now like to understand the aims of ERM further and how an organisation that implements its philosophy and approach to risk management can benefit.

Question 4 focuses on governance issues, including the situation where Major Stays' CEO also performs the roles of Chairperson of the Board that does not currently employ any Non-

Executive Directors, as well as other evidence of poor governance at the board level. Major Stays wishes to address weaknesses that are evident and provide recommendations to improve its procedures for managing customer complaints at the hotel chain.

As with prior BG examinations, it was noted that overall, Candidates performed better on the numerical elements of the examination than on the discussion requirements. Many Candidates failed to reference as well as use information and relevant facts from the case when providing written explanations to the requirements, which meant that Candidates were unable to score all the available marks they potentially could. Some Candidates' responses were also too brief, vague, or generic. This has contributed to the lower overall pass rate compared with previous sittings. Future Candidates are strongly encouraged to develop their written explanation skills by writing answers in full as part of their BG examination preparation, in addition to practicing numerical elements.

Question 1

Part (a) required Candidates to calculate loan covenants from the bank loan agreement between the bank and Major Stays and conclude on the results for 2 marks. Generally, most Candidates were able to compute the ratios, although some used the incorrect base to compute gearing. Some Candidates either interpreted the ratios incorrectly or did not provide conclusions on the results, although their computations were correct.

Part (b) required Candidates to discuss the impact on Major Stays should the loan covenant calculations fall below the threshold required in the loan agreement and advise how Major Stays should respond for 2 marks. While most candidates could identify the immediate impact of non-compliance with the loan covenants, some were unable to advise appropriately on how Major Stays could engage with its lender for further discussions to effectively manage the situation.

Part (c) required Candidates to prepare an annual cash flow forecast for the next three years, from 1 January 2024 to 31 December 2026, using the assumptions provided by Major Stays' Board of Directors for 11 marks. Most Candidates scored well in building up the P&L forecast, although some struggled with computing depreciation, and either omitted finance costs or failed to account for future loan repayments when calculating the annual interest charge. There were also a number of candidates who derived free cash flow and then computed equity valuation instead of setting out the annual cash flow forecasts and cash balances, which was required. Future Candidates are advised to carefully consider the requirements and respond to the task set. Some Candidates failed to apply cash brought forward to determine the annual cash flow forecast for each year.

Part (d) required Candidates to explain if Major Stays was forecasted to reach its cash target for investment at 31 December 2026 from the cash flow forecast and advise how Major Stays could implement changes to improve its forecast net cash flow for 2 marks and analyse forecast compliance with the three bank loan covenants for each of the years ending 31 December 2024, 2025, and 2026 for 3 marks. While most Candidates could state if Major Stays had achieved its cash target, some did not support their decision based on their earlier computations. Candidates also seemed to struggle with providing specific initiatives to improve the forecast net cash flow, with some responding with generic statements on increasing revenue or reducing costs. A number of Candidates either did not compute the forecast loan covenants or, where computed, failed to provide conclusions on whether the ratios were compliant for each year. Again, it is essential that Candidates carefully consider the requirement and respond to the task set.

Part (e) required Candidates to discuss the two finance options suggested for financing future expansion plans and conclude on the suitability of each option for the Board. The finance options were a bank loan for 3 marks and a convertible loan note for 4 marks. Candidates generally scored well in being able to state the benefits and considerations of each option. However, a number of candidates did not conclude by recommending whether each option was suitable for Major Stays. For written requirements, Candidates are strongly advised to always consider how the task relates to the subject of the scenario, in this case being Major Stays, an unlisted company that has experienced some covenant issues with its existing loan.

Overall, Candidates' performance was generally within expectations for Question 1 and this was the best-performed question of the entire paper. However, some Candidates could have scored better by avoiding basic numerical errors and providing more application-focused written responses using scenario information.

Question 2

Part (a) required Candidates to calculate the range of values for Major Stays as requested by the Board, using the assumptions provided by the CEO for 13 marks. Overall, Candidates' performance was less than anticipated, with some basic errors evident in a relatively straightforward series of equity valuations. For the net asset valuation, some Candidates failed to include all eligible assets and liabilities, including the brand valuation. In the Dividend Valuation Model, some Candidates applied the weighted average cost of capital instead of the cost of equity. For the Market valuation, most Candidates were able to derive the average and apply a 25% discount; however, most failed to deduct the debt value from enterprise value to determine the equity value. For the free cash flow to the firm valuation, some Candidates created their own numbers instead of using the data provided in the case, and many made errors in determining the Terminal Value. Again, many Candidates did not deduct the debt component from the enterprise value. Future Candidates are advised to practice the various valuation methods to avoid common pitfalls.

Part (b) required candidates to explain TWO reasons why EBITDA may be preferable to Profit after Tax for this company for 2 marks and explain TWO problems with applying an a market multiple of similar listed companies for 2 marks. Overall, Candidates' performance was weak, with vague, basic, or muddled responses that failed to focus on areas of difference, such as interest, tax, and capital expenditure, which would be eliminated by applying EBITDA. Again, this part was not well answered by most Candidates. Candidates were unable to articulate that it was practically impossible to have an identical company to use as a listed comparable and that subjective adjustments had to be made.

Part (c) required Candidates to explain FOUR specific adjustments to the free cash flow valuation in part (a) that could increase the value of Major Stays for 4 marks. This task required Candidates to link Major Stays' operations and its business valuation and provide practical suggestions on how the Board could increase revenue (i.e., increase room occupancy) or reduce costs (i.e., improve efficiency, renegotiate supply contracts) to uplift future profitability. Many Candidates simply provided spreadsheet changes, such as "increase growth rate", "reduce costs", or "reduce cost of finance", without suggesting how

Major Stays could achieve this. Part (c) was the most poorly performed subpart of this question.

Part (d) required Candidates to explain the rationale of the SIX SGX Listing Rules to the Board of Major Stays and advise if Major Stays is currently compliant with each listing rule for 6 marks. The six rules were provided in the case scenario, so it was a fairly simple task to assess whether Major Stays was currently compliant. Most candidates were only able to state either the rationale of each rule or the compliance (if any) and not both, which limited the marks they could score. For rationale, majority of Candidates' answers were short and failed to explain how each rule would protect the current and potential future shareholders of Major Stays should the company proceed with a listing.

Overall, the written responses for Question 2 were below the standard expected. This is also the worst performed question of this entire paper. Future Candidates are advised to consider the company, which is the focus of the case scenario provided, when responding to written requirements, as this will often yield responses that could be effectively applied in the real world.

Question 3

Part (a) required Candidates to quantify the financial exposure to Major Stays from a hotel employee or guest accident for one year and advise on the required level of annual accident insurance cover which Major Stays should obtain for 4 marks. Generally, most Candidates were able to quantify the expected value of one accident for one year. However, majority failed to provide the correct advice on the required level of annual accident insurance coverage. Most Candidates advised that the insurance cover should be the expected value of one accident for one year, which was incorrect. For insurance cover, the actual financial loss from one accident would not be the expected value. Thus, the required level to obtain was S$10 million, which provided coverage for the worst-case scenario for each accident.

Part (b) required Candidates to recommend ONE suitable key performance indicator that will improve its management and disclosure of ESG-related risks for each sustainability objective at Major Stays for 4 marks. Candidates were expected to provide a KPI that was measurable, actionable, and specific to Major Stays. Many Candidates provided a generic aim or irrelevant KPI which failed to link to Major Stays' sustainability objectives.

Overall, parts (a) and (b) were generally still performed well.
Part (c) required Candidates to advise how Major Stays could take specific actions at its hotels which will help the company meet its ESG objectives for 8 marks. The specific actions must be practical, realistic, and achievable by Major Stays. In general, most Candidates performed well in that they managed to articulate specific, practical, and scenario-based actions to meet sustainability targets. However, some Candidates provided brief, vague, or generic answers without linkage to Major Stays, which failed to score marks.

Part (d) required Candidates to discuss FOUR benefits of implementing an integrated risk management information system at Major Stays for inclusion in the Risk Committee's proposal to the Board to adopt ERM for 4 marks. Most Candidates provided the benefits of implementing a simple risk management framework instead of an integrated risk management information system. Also, the benefits needed to be relevant and specific to

Major Stays, with many responses being generic in nature. Descriptions of standard risk management benefits or procedures were not sufficient to earn full marks.

Part (e) required Candidates to discuss FOUR additional cost areas which would be incurred if Major Stays' risk management committee proceeded to implement an integrated risk management information system to improve its risk management practices for 4 marks. This was the weakest performing part of this question. Most Candidates provided brief, generic, or ordinary risk management costs, which were insufficient to gain full marks. Only a minority were able to provide well-explained, relevant costs which would be incurred only if Major Stays proceeded to implement an integrated risk management information system.

Overall, Candidates' performance was disappointing in fairly standard risk-focused questions, as Candidates often relied on generic statements or text from the open-book materials, without adjustment to the case scenario given in the question.

Question 4

Part (a) required Candidates to briefly explain the roles of a CEO and a Chairperson of the board and explain THREE benefits of separating these two roles for any large or listed company for 5 marks. Generally, Candidates answered this question well. Many could state the benefits of role separation but did not complete their answers with a clear explanation of these benefits. A few Candidates focused on the benefits without answering the first part of the question, and fewer did not provide answers for three benefits as required.

Part (b) required Candidates to explain FIVE weaknesses evident in Major Stays' current boardroom practices and behaviour for 5 marks. In response to this question, which was based on the fact pattern in the case, Candidates pointed out the weaknesses in the boardroom practice and elucidated the reasons thereof. Many Candidates merely stated the weaknesses without an explanation.

Part (c) required Candidates to recommend improvements that might create a more effective Board at Major Stays for each weakness identified in part (b) for 5 marks. Where answered, most Candidates were able to provide correct solutions for the identified weaknesses. However, some either failed to attempt this requirement or provided incomplete responses.

Part (d) required Candidates to advise the Board on FOUR consequences if managing customer complaints is not improved at Major Stays for 4 marks. Many Candidates were able to provide a good exposition of three to four consequences of poor customer complaint management as per the case. As before, some either failed to attempt this requirement or provided incomplete responses.

Part (e) required candidates to recommend and justify THREE governance or internal control measures aimed at ensuring customer complaints are appropriately dealt with at Major Stays for 3 marks. A significant number of Candidates provided correct responses to this question. However, some provided vague, short, or basic responses (e.g., document complaints on receipt), or irrelevant responses which failed to address the core problem of a lack of response to customer complaints at Major Stays. As before, some either failed to attempt this requirement or provided incomplete responses.

Overall, an improvement in the depth of written responses would enhance Candidates' performance on Question 4. There was evidence of time management issues, as a higher-than-expected volume of Candidates failed to provide responses to the subparts of Question 4.