

SINGAPORE CA QUALIFICATION EXAMINER'S REPORT

MODULE: Business Value, Governance and Risk (BG)

EXAMINATION DATE: 9 June 2021

Section 1

General comments

The June 2021 BG examination consists of single case study with financial and industry data covering four questions across the syllabus, consistent with prior examinations.

The case is about a listed company which operates in the Singapore shipbuilding sector. The company is considering increasing its manufacturing capacity by acquiring a Japanese shipbuilder with large ship capacity. As a result of this, the Directors of Singapore Ship Build and Repair PLC (SSBR) are focused on a major refinancing decision to fund expansion, and also recognising the industry is changing due to sustainability concerns and climate change.

Risk and Governance learning outcomes are covered by Questions 1 and 4. Question 1 covers strategic, operational and acquisition risk assessment and Question 4 required Candidates to complete a corporate governance analysis of existing governance practices and recommendations for improved sustainability.

Financing and business valuation learning outcomes are covered by Questions 2 and 3. Question 2 requires Candidates to prepare a cash flow forecast and make refinancing decision whether or not to proceed with a 5 year convertible debenture which would potentially provide funds to expand by acquisition and lower the cost of finance. Question 3 required Candidates to determine a suitable price to acquire an shipbuilding company in Japan by demonstrating the application of free cash flow valuation techniques.

As with prior BG examinations, it was noted that overall Candidates' performance was better on the numerical elements of the examination than the discussion requirements, particularly where a specific impact on the company in the case was required. Again, important advice to future BG Candidates is to respond to each requirement explicitly in order to obtain all the available marks and to practice discursive questions, as requirements which assess understanding and application of the BG syllabus. Further analysis of Candidates' performance and advice for future Candidates is given below.

Section 2
Analysis of individual questions

Question 1

Question 1 focuses on the risk component of the syllabus and **1(a)** requires Candidates to identify and explain strategic, operational and acquisition risks, each relevant to SSBR's current shipbuilding operations. To earn the explanation mark for each risk, Candidates needed to explain the potential impact of each risk on SSBR's future performance, the effectiveness or efficiency of its operations, its long term reputation or need to effect strategic change. The quality of Candidates' responses was mixed. Many Candidates' responses could have been improved by:

1. Having full understanding on the difference between strategic, operational and acquisition risks.
2. Using evidence contained in the scenario to identify specific risk relevant to SSBR, rather than discussing generic risks which were less relevant; and
3. Explaining more on the potential downside (or upside) impact of each risk on SSBR.

Where Candidates were awarded marks for generic risks in some cases, however, the important advice to future Candidates is always use risk evidence from the case, where it is available. Common responses which failed to gain marks for explanation included the following:

- Not providing a specific explanation of stated risks, i.e., Candidates merely identified the risk only.
- Recommending measures to mitigate, eliminate or avoid risks instead of explaining them, as controls were not required.
- Mentioning generic risks without specifically linking these to SSBR.
- Stating general implications only, by using phrases like, "benefits may not be reaped", "negatively affect" and "this will impact SSBR's business".

Question **1(b)** requires Candidates to use expected value techniques to calculate the impact of loss from damage to a ship sent in for repair at SSBR dry docks, and then determine the expected financial impact on SSBR assuming 1 in 1000 ships sent in for repair incurred damage. For the most part, the numerical aspect of evaluating risk was well done. However, the ability to explain reservations concerning the methodology used or the data applied, was mixed. This was a straight forward requirement if concerns were raised about expected value as a method to predict a single loss, the source of probability data, assumptions limited to only three possible outcomes, and the fact that if a ship was damaged, the financial exposure was actually the loss incurred and not the expected value. Only a few Candidates scored full marks in this area.

Question 2

Question 2 is on financing a potential acquisition by issuing a five-year convertible debenture. **Part (a)** is a forecast cashflow comparison between issuing the new debenture and not. Generally, the forecast cashflow calculations were moderately

well done. However, many Candidates failed to forecast the impact on SSBR actual cash balance, which is what was needed to understand if the company could afford to repay its debts and also, have sufficient cash to fund a potential acquisition. Other common mistakes were Candidates not applying the forecast assumptions accurately given the scenario and adding back interest in determining the cashflow, as interest is a real cost and cashflow to SSBR.

Part (b) requires Candidates to critique the Directors forecast assumptions given in the case, which were either highly optimistic, or too simplistic for the real world. Whilst many Candidates correctly explained reservations about four of the assumptions stated in the case, some Candidates chose to comment on items not stated in the case. The advice to Candidates is use the evidence in the case to gain optimal marks.

Part (c) requires Candidates to comment on SSBR's capacity to meet debt repayments and fund a future acquisition. The quality of Candidate answers depended on their ability in **part (a)** to complete the cash flow forecast and determine the forecast cash carry forward balance once all debt had been repaid. Overall, this requirement was not well done, with many Candidates making general statements which either did not answer the requirement or were not supported by analysis.

Responses to the discussion marks in **part (d)** suggested a basic understanding of the key advantages and disadvantages of convertible debt finance was missing from many Candidates. Some Candidates thought a convertible bond was a bank loan or that the interest rate was negotiable. Sources of finance is an important BG syllabus area and questions which assess understanding the benefits and downsides of different types of finance should be anticipated by Candidates.

Question 3

Question 3 requires Candidates to prepare a risk adjusted discount rate and use it to complete a free cash flow valuation for a potential Japanese shipbuilding company to support an acquisition proposal, requested by SSBR Board, and consider the common post-acquisition problem of profit repatriation from another country.

Part (a) requires Candidates to determine the weighted average cost of capital, and this was reasonably well done by most Candidates. However, some Candidates failed to adjust a similar listed beta by de-gearing and re-gearing to SSBR's gearing level.

Part (b) requires the completion of a free cash flow valuation by applying the assumptions provided in the case. In general, Candidates were able to provide good calculations. Noted problems included failing to exclude depreciation as a non-cash item, inability to calculate the cash flow impact from a change in working capital and not applying the 25% reducing balance basis to calculate the tax allowance, instead, either chose to provide a straight line basis or omitted completely.

Part (c) is completed well as most Candidates were able to use the answers in the previous question part to provide the criteria and recommendation to either proceed with the acquisition or reject the offer. Most Candidates also provided a sensible action to be taken before proceeding with the acquisition.

Part (d) is a difficult requirement for most Candidates, as it required them to suggest solutions to overcome the problem of profit repatriation. The majority of Candidates were able to answer that the likely impact of the valuation of YSL will reduce with the delayed in profit repatriation due to the time value of money. However, few Candidates were able to correctly explain solutions which included transfer pricing, management charges, and the use of subsidiary loans. On the other hand, some Candidates incorrectly discussed the difficulty for SSBR to operate in a new country and failed to acknowledge that the acquisition of an existing company in Japan specifically addresses this.

Question 4

Part (a) requires Candidates to identify, explain and make recommendation to examples of non-compliance with the code of governance evidenced in the case. Most Candidates were proficient in explaining a relevant provision of code where SSBR was not currently compliant. Some Candidates failed to fully use all the evidence of non-compliance available in the scenario, such as lack of majority of NED's on the Board, lack of board performance evaluation and lack of regular audit committee meetings with the external auditors. The majority of Candidates simply stated the example of non-compliance but did not explain the specific problem that each provision or principle of the code is designed to address. For example, few Candidates explained that a lack of current investor information on the SSBR website prevents investors from making informed investment decisions. For future questions in the area of compliance with the code of corporate governance, Candidates are advised to explain the potential impact on non-compliance in addition to stating provisions or principles from the code.

For **Part (b)**, the majority of Candidates performed well and were able to explain the impact of the four sustainability challenges included in the scenario on SSBR and make appropriate and practical recommendations. For some Candidates, the recommendations provided were not specific or not practical, such as "use recycled materials". Here, we would expect a more detailed recommendation, such as, SSBR procurement to begin sourcing components from specialist suppliers of ship building components using recycled materials and evaluate the cost impact on existing margins. It was noted that a minority of Candidates failed to complete the exam due to time management issues, as they did not provide an answer to **part (d)**.