

Singapore CA Qualification Examination

8 June 2022

Business Value, Governance & Risk

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-ONE (21)** pages (including this instruction sheet). Each question may have **MULTIPLE** parts and **ALL** questions are examinable.
3. This is an open book examination. During the examination, you are allowed to use your laptop and any calculators that comply with the SAC's regulations. Please note that mobile phones, tablets, and all other electronic devices **MUST NOT** be used during the examination.
4. 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.
5. This examination paper is the property of the Singapore Accountancy Commission.

MODULE-SPECIFIC INSTRUCTIONS:

6. This case is hypothetical and has been written exclusively for the purpose of this examination. Names, characters, places and incidents used are imaginary or fictional. Any resemblance to actual events or locales or persons, living or dead, is entirely coincidental. This case is not to be cited without the permission of the Singapore Accountancy Commission.

IMPORTANT NOTICE:

If you are not feeling well, please do not press "Start Assessment". If you have started and leave during the exam, you would be deemed to have attempted the paper.

**e-Exam
Question
Number**

1

****VERY IMPORTANT NOTICE****

1. Your question paper is attached under the "**Resources**" tab found at the bottom right of **EACH** question.
2. You may also download the question paper that allows annotation throughout your exam in Question 1 of the e-Exam portal.
3. Please download the relevant required Appendices in Question 1 of the e-Exam portal.

Other important information:

4. You will be allowed to access your reference materials but **will not be allowed** to communicate with anyone either physically or through any electronic means.
5. You are **NOT ALLOWED** to access any websites during the exam.
6. You are **NOT ALLOWED** to print the question paper.
7. **Please take note that your screen will be monitored throughout the examination. If you are found to have accessed any websites, or if you cheat or attempt to cheat, you will be liable to severe disciplinary action.**

Should you encounter any issues during the exam, please call the following numbers:
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8. **You do not need fill in an answer for this question.**

Ace Ground Services Ltd

Ace Ground Services Ltd (“ACS”) is a small, listed company on the Singapore Stock Exchange which comprises the parent company and one subsidiary, Ace Lounges Limited. ACS provides ground handling services in the aviation sector from its base in Singapore close to Changi International Airport.

ACS was founded in 2002 and has grown from a small company which provided ticketing and baggage services at Changi airport, to growing a wide range of services which include facilitating the time-critical process of meeting, preparing and dispatching aircraft for take-off which is collectively known as “ramp services”. ACS also provides luggage handling and passenger services such as ticket desk, gate services and transfers between gates.

Currently, ACS operates ground handling services at two airports in Singapore, namely Changi and Seletar, and the company also operates its own “ACS” branded executive lounges at each airport. The business lounges operate as Ace Lounges Limited, which is a wholly owned subsidiary of ACS.

The Board of ACS is currently considering the purchase of an aircraft inspection, maintenance and refueling company as the ACS Board has decided these services will complement the current ground services offered by ACS. Maintenance and refueling are increasingly being requested by some airline clients, as they look to rationalise their supply chains and find single providers for all their ground services and aircraft turnaround services which are required prior to each flight. Aircraft maintenance and refueling services are highly regulated by global aviation regulators due to the potential loss of life from aircraft failures on the ground or in the air.

The Board of ACS has worked alongside AirFix Limited for many years, which provides inspection and aircraft maintenance services for the global airlines whilst on the ground at Changi and Seletar Airports. The Directors of ACS feel the acquisition of AirFix would widen the range of aircraft and airport services offered by ACS which can then be used as a basis to expand its services to airports in Malaysia and other countries in Southeast Asia.

Information for Ace Ground Services (ACS) Ltd

Group statement of profit or loss for the year ended 31 May 2022	S\$'000
Revenue	19,693.1
Raw materials and consumables	(9,633.7)
Staff costs	(4,934.1)
Depreciation amortisation and impairment	(434.8)
Company premises and utilities expense	(980.7)
Other costs	(2,033.9)
Finance costs	<u>(125.0)</u>
Profit before tax	1,550.9
Tax	<u>(263.7)</u>
Profit after tax	1,287.2
Dividend	<u>(321.8)</u>
Retained Profit	<u>965.4</u>

Note: The above statement includes results for ACS and Ace Lounges Limited.

Divestment of Ace Lounges Limited

The ACS Board has agreed that growth in the ACS ground handling services, aircraft maintenance and refueling services represents the optimal strategic future of the company. The Directors are observing increased competition from airport lounges operated by airlines and larger chains of international business lounge brands. Ace Lounges Limited's performance is disappointing due to ongoing staff turnover and service quality problems which are taking a disproportionate amount of the Directors' time. Therefore, the Directors of ACS have decided to sell Ace Lounges Limited.

The ACS Board has recently received an invitation from Skylounge Inc, a global provider of high-end airport lounges for business class customers, to discuss a potential purchase of Ace Lounges Limited.

Information for Ace Lounges Limited

Statement of profit or loss of Ace Lounges Limited for the year ended 31 May 2022	S\$'000
Revenue	1,323.6
Raw materials and consumables	(654.0)
Staff costs	(368.0)
Depreciation amortisation and impairment	(47.3)
Company premises and utilities expense	(150.5)
Other costs	(42.0)
Finance costs	<u>(7.5)</u>
Profit before tax	54.3
Tax	<u>(9.3)</u>
Profit after tax	45.0
Dividend	<u>(11.3)</u>
Retained Profit	<u>33.7</u>

Statement of financial position of Ace Lounges Limited as at 31 May 2022	S\$'000
Non-current assets – property, plant and equipment (See Note 1)	293.8
Inventories	32.8
Trade and other receivables	210.6
Cash and cash equivalents (Note 2)	<u>(15.1)</u>
Current assets	<u>228.3</u>
Total assets	<u>522.1</u>
Equity	
Share capital (one share of S\$1)	-
Retained earning	<u>238.1</u>
Total Equity	238.1
Liabilities	
Trade and other payables	134.0
Loans and borrowings (Note 2)	<u>50.0</u>
Current liabilities	184.0
Loans and borrowings (Note 2)	<u>100.0</u>
Total liabilities	<u>284.0</u>
Total Equity and Liabilities	<u>522.1</u>

Notes to the financial statements

Note 1: Property, plant and equipment	Furniture	Kitchen Equipment	IT Equipment	Total
Cost	S\$'000	S\$'000	S\$'000	S\$'000
At 1 June 2021	225.0	128.5	23.8	377.3
Additions	<u>15.0</u>	<u>5.6</u>	<u>4.1</u>	<u>24.7</u>
At 31 May 2022	240.0	134.1	27.9	402.0
Depreciation				
At 1 June 2021	(27.4)	(24.5)	(9.0)	(60.9)
Charge for the year	<u>(29.1)</u>	<u>(13.4)</u>	<u>(4.8)</u>	<u>(47.3)</u>
At 31 May 2022	(56.5)	(37.9)	(13.8)	(108.2)
Net Book Value				
At 31 May 2022	<u>183.5</u>	<u>96.2</u>	<u>14.1</u>	<u>293.8</u>
At 31 May 2021	<u>197.6</u>	<u>104.0</u>	<u>14.8</u>	<u>316.4</u>

Note 2: As part of the sales agreement, ACS will assume all the loans and borrowings of Ace Lounges Limited. For clarity, the overdraft and loan values attributed to Ace Lounges Limited will be retained by ACS on the sale of Ace Lounges Limited.

The Directors of ACS would like to urgently understand an indicative range of possible values for Ace Lounges Limited to discuss the potential divestment of its subsidiary at the next Board meeting. The ACS Board have requested the following valuations of Ace Lounges Limited for further discussions.

- (1) Net assets valuation at book value and also at realisable value.
- (2) Dividend valuation.
- (3) Earnings valuation based on 2022 profit after tax.

The following additional information has been provided by the Directors of the ACS on 15 June 2022 for the purpose of valuing Ace Lounges Limited.

Additional information for the valuation of Ace Lounges Limited

For the realisable net asset value, the ACS Directors have estimated the realisable value of each class of plant and equipment owned by Ace Lounges Limited as at 31 May 2022. In estimating the realisable value, the ACS Directors believe the value of the bespoke business lounge furniture and kitchen equipment have been over-depreciated so are worth more if they were sold on the open market.

<u>Class of Asset</u>	<u>Asset type</u>	<u>Realisable value as % of book value</u>
Property, plant and equipment	Furniture	150%
	Kitchen Equipment	125%
	IT Equipment	80%
Inventories		90%
Trade and other receivables		95%

For the dividend valuation, ACS Directors believe that future dividend growth will be 5% per annum and ACS shareholders require a minimum dividend return of 8% per annum.

For the earnings valuation, ACS Directors have advised to apply ACS's current price to earnings ratio adjusted downwards by 20% to the current post-tax earnings of Ace Lounges Limited.

Following the sale of Ace Lounges Limited, the Directors believe the ACS share price will remain unchanged as key major shareholders have recently signaled their approval in principle of this divestment strategy, so the ACS Board has the capacity to focus on strategic expansion of its airport ground services business.

Market Information for ACS and AirFix Limited quoted at the most recent close

	ACS	AirFix Limited
Number of shares	5,000,000	N/A
Current share price	S\$3.487 per share	N/A
Outstanding bank loans at 5.0% annual interest	S\$1,500,000	S\$500,000

ACS currently has a quoted equity beta of 1.715

**e-Exam
Question
Number**

Question 1 required:

- 2** **(a)** Explain **THREE** reasons which the Directors of ACS may have for disposing of Ace Lounges Limited.
- (3 marks)**
- 3** **(b)** Calculate the value of Ace Lounges Limited using the **THREE** methods of valuation required by the ACS Board.
- (10 marks)**
- 4** **(c)** Explain the ACS Directors' assumption to adjust ACS's current price to earnings ratio downwards by 20% when determining the earnings valuation of Ace Lounges Limited.
- (2 marks)**
- 5** **(d)** Discuss **ONE** advantage and **ONE** disadvantage for each of the three methods of valuation required by the Directors of ACS.
- (6 marks)**
- 6** **(e)** Explain why a potential purchaser of Ace Lounges Limited may be prepared to pay more for the company than the three valuations determined in part **(b)**.

(1 mark)

(Total: 22 marks)

Potential Acquisition of AirFix Limited

The Directors of AirFix Limited have indicated they may consider an offer from ACS to purchase 100% of AirFix Limited for S\$5 million. The acquisition of AirFix Limited would create a new group, ACS-AirFix.

The ACS Board of Directors would like to understand the estimated ACS-AirFix group value as at 1 June 2022 to determine if an acquisition price of S\$5 million will provide ACS shareholders with value for money.

The ACS Board has advised that a revised weighted average cost of capital (WACC) should be applied to the free cash flow value which incorporates the current combined debt and equity finance of the ACS-AirFix and include S\$5 million of new debt finance which will be required to purchase AirFix. For future free cash flow forecasting, the Directors have advised to assume that the divestment of Ace Lounges Limited has occurred. AirFix have provided their results for the year ended 31 May 2022 as follows:

Statement of profit or loss for the year ended 31 May 2022 for AirFix Limited

	S\$'000
Revenue	10,855.2
Raw materials and consumables	(6,691.0)
Staff costs	(3,334.2)
Depreciation amortisation and impairment	(820.2)
Company premises and utilities expense	(654.9)
Other costs	(1,244.2)
Finance costs	<u>(25.0)</u>
Loss before tax	(1,914.3)

The following additional information has been provided by the ACS Board of Directors to provide a free cash flow valuation of the combined ACS-AirFix group immediately post-acquisition.

Acquisition synergies

The following synergies are expected to be created by the management of ACS, following post-acquisition restructuring of the combined ACS-AirFix business.

Revenue synergy. The Directors of ACS believe that they can increase existing 2022 AirFix revenues by 7.5% in the first year, by cross-selling AirFix aircraft maintenance services to its existing ACS customers.

	% Increase on existing 2022 AirFix revenue
Revenue	7.5%

Cost synergy. The Directors of ACS believe they can significantly reduce existing 2022 AirFix costs in the year after acquisition following the adoption of ACS business practices and processes and achieving economies of scales by reducing overhead duplications in similar staff roles and property costs.

	% Reduction of 2022 AirFix costs
Raw materials, consumables used and subcontracts costs	5.0%
Staff costs	15.0%
Company premises and utilities expense	30.0%
Other costs	20.0%

The Directors have advised that the adjusted 2022 AirFix revenue and cost levels provide the base level on which new group strategic growth targets will apply for 2023 and onwards.

The Directors of ACS suggest that AirFix Limited’s adjusted 2022 revenue and cost are combined with ACS following the expected divestment of Ace Lounges Limited before the following strategic growth percentages are applied to forecast results for 2023 and onwards. The Directors also note that intercompany transactions between ACS and its subsidiary, Ace Lounges Limited, are negligible and should be ignored for the purpose of this appraisal.

Forecast free cash flows assumptions for three years from 2023 to 2025.

The valuation assumes the following annual growth targets for the entire new ACS-AirFix Group following the implementation of a new strategic expansion plan.

	2023-2025 (% per annum)
Combined ACS-AirFix revenue	3.0%
All costs, except finance costs	2.0%

The Directors have forecast the ACS-AirFix finance costs as follows, which take into account expected debt repayments.

	2023	2024	2025
	S\$'000	S\$'000	S\$'000
Finance costs	350.0	350.0	350.0

Capital expenditure is expected to be S\$500,000 in 2023 and will grow by 5% per annum until 2025.

For years from 2023 to 2025, additional working capital for each year is estimated to be 1% of forecast revenue for the same year.

Corporate tax is payable at 17% in the year it is incurred, and this rate is expected to continue. From 2023 to 2025, capital allowances on property, plant and equipment are expected to be available at an average of 10% per annum on a reducing balance

basis. For the purpose of estimating a new ACS-AirFix Group valuation, assume the tax written down value on ACS-AirFix assets at 1 June 2022 is S\$3,785,000.

Forecast free cash flows assumptions for 2026 and the years thereafter.

For simplicity, the Directors have assumed that 2025 forecast net free cash flows (defined as cashflows after interest, tax, capital expenditure and working capital) will grow by 2% per annum into perpetuity.

Financing of the acquisition of AirFix Limited.

The sale of Ace Lounges Limited is expected to raise at least S\$500,000 which will be used to provide short term liquidity to fund the new ACS-AirFix group during the immediate post-acquisition period. Therefore, acquisition finance of S\$5 million will be required to cover the full expected acquisition price. The Directors of ACS are considering a corporate debenture, a bank loan or a rights issue of new shares to existing shareholders to finance the acquisition of AirFix Limited.

For the purposes of estimating a new WACC and completing a free cash flow valuation of the combined ACS-AirFix group, the Directors have assumed a new corporate debenture will be issued to raise the required finance as this is the cheapest form of finance. However, no final decision on the source of finance to be used to purchase AirFix has been made.

One finance option identified by the Directors of ACS is the issue of a S\$5 million 5.5% corporate debenture on the day of the acquisition to finance the purchase of AirFix. This corporate debenture is expected to be issued at par value (where par equals 100) and will redeem in six years' time at a 5% premium above its par value.

The Directors have assumed that the divestment of Ace Lounges Limited will have no material impact on the quoted market information above so assuming no change for the purpose of the valuation of ACS-AirFix group.

The current yield on Singapore government debentures is 2.65% for all debenture maturities. The current market return on the Singapore equity market portfolio is 6.5%.

**e-Exam
Question
Number**

Question 2 required:

7

- (a)** Determine an adjusted weighted average cost of capital (WACC) to evaluate the post-acquisition value of the combined ACS-AirFix group.

Note: In doing so, assume the acquisition price of AirFix is S\$5 million and the ACS Board will issue a S\$5 million, 5.5% corporate debenture at par value on the day before the acquisition of AirFix to pay for it, which will redeem in six years' time at a 5% premium above its par value. Present your answer as a percentage to one decimal place.

(8 marks)

8

- (b)** Compute a valuation of ACS shares immediately following the acquisition of AirFix Limited. Use the free cash flow valuation method and the WACC determined in part **(a)** for your computation.

Note: In doing so, use year-end discounting and present your answer in S\$000's.

(14 marks)

**e-Exam
Question
Number**

Question 2 required:

9

- (c)** Evaluate if the acquisition price required by the shareholders of AirFix Limited is acceptable to the Board of ACS and its shareholders. **(2 marks)**

10

- (d)** Explain **ONE** advantage and **ONE** disadvantage for each of the following sources of finance which could be arranged to finance the purchase of AirFix Limited.
- i) Corporate debenture
 - ii) Bank loan
 - iii) Rights issue of new shares to existing shareholders

(6 marks)

(Total: 30 marks)

New ACS Risk Committee

The ACS Board has decided to set up a new risk committee with immediate effect. The committee will be tasked with implementing effective risk management at ACS and will be made of senior employees drawn from each ACS department.

The risk committee will follow a risk management framework which has been suggested by the external auditor as set out below. The ACS Board are unfamiliar with the specifics of the risk management framework and would like to understand how this will operate and have asked for an explanation of each of the stage.

1. Risk Identification
2. Risk Evaluation
3. Risk Response
4. Risk Monitoring and Reporting

The ACS Board is immediately concerned about the acquisition risk of paying too much for AirFix Limited and will ask the risk committee to advise on how this risk can be addressed before an offer is made for AirFix.

ACS Operations Director risk analysis

ACS's Operations Director has identified four specific operational risks which will arise resulting from the acquisition of AirFix and expanding into aircraft maintenance and refueling services. AirFix's existing Operations and Aviation Compliance Director is not expected to remain with the new ACS-AirFix group following the acquisition and takeover. The ACS Operations Director has emailed the board with an initial risk assessment of aircraft inspections and maintenance, staff turnover and refueling.

Extract from ACS Operations Director's email to the Board of Directors.

"Dear fellow Board members, I have identified four specific operational risks relating to aircraft maintenance following the acquisition of AirFix. I have included my risk assessment for further discussion when we next meet.

1. **Incomplete or inaccurate aircraft inspections and aircraft maintenance.** If we are short of time to turn around an aircraft for take-off, then we can just focus on the important parts of the inspection to avoid delay as the insignificant parts of the inspection can wait when there is more time. Also, I know there are many parts in an aircraft and many parts are not critical. Planes are designed to be safe with backup systems. Therefore, if an element of maintenance was not fully completed by our team, then it may not make a difference. To manage time and cost, we can focus on the major problems and repair or replace a minor part at the next time we service the aircraft.

2. **Staff Turnover: Loss of knowledge, experience, and skills.** Our maintenance engineers will learn on the job, so I presume we can recruit talented people from technical colleges, and they will soon learn what is required to maintain an aircraft from observing other experienced team members.

3. **Aircraft refueling accident.** Filling up an aircraft with fuel is not much different from filling up a car with petrol, it just requires a bigger nozzle. We do not need to be too concerned about it as the probability of a refueling accident is negligible as current refueling technology is so dependable that it is virtually impossible for a spillage to occur.

4. **Non-compliance with Aviation regulations related to aircraft maintenance and refueling.** With the expected departure of AirFix Limited's Operations and Compliance Director then it will fall on me, as ACS Operation's Director, to upskill in this area to ensure ACS-AirFix remains compliant with complex aviation law and regulations. However, the excellent AirFix maintenance and refueling team who will remain following the acquisition are currently supervised by an excellent Manager who understands aviation aircraft maintenance and refueling law and regulations and will support me as I train to become an expert in the area of aviation maintenance and refueling compliance. Therefore, I am very confident that ACS-AirFix compliance will be maintained in this critical area to ensure continuing operations.”

**e-Exam
Question
Number**

Question 3 required:

- 11** **(a)** Explain each of the following four stages of the risk management to the ACS Board of Directors.
- i) Risk Identification
 - ii) Risk Evaluation
 - iii) Risk Response
 - iv) Risk Monitoring and Reporting
- (4 marks)**
- 12** **(b)** For each aircraft maintenance and refueling risk identified by the ACS Operations Director in the email to the ACS Board of Directors:
- i) Critically evaluate the comments made by the Operations Director; and
- (8 marks)**
- ii) Advise how each operational risk exposure discussed by the Operations Director can be managed.
- (4 marks)**
- 13** **(c)** Apart from the areas identified by the Operations Director, identify and explain **FOUR** other areas/ matters of due diligence that the Board should be concerned with prior to finalising an offer for the acquisition of AirFix Limited.
- (8 marks)**
(Total: 24 marks)

ACS-AirFix Group Board Governance related matters

Following the acquisition of AirFix, the ACS Executive Board members have determined that two more Independent Non-Executive Directors (IDs) will be required to be appointed to the Board of ACS-AirFix Group to meet Singapore Corporate of Governance requirements in this area.

The ACS Executive Board has shortlisted a potential group of candidates for the roles of IDs from information supplied by a recruitment company which specialises in the board level vacancies.

The ACS CEO has decided that all existing AirFix Ltd Non-Executive Board members, should not be considered for any of the two ID positions and be excluded from the candidate shortlist.

The candidates shortlisted for the positions of IDs are as follows:

- Candidate 1** Male, 67 years old, retired as ACS Finance Director 5 years ago.
- Candidate 2** Male, 54 years old, is currently a Non-Executive Director for a retail company and is the brother of ACS's Sales and Marketing Director.
- Candidate 3** Male, 55 years old, also Non-Executive for an airline which is a large customer of ACS.
- Candidate 4** Male 58, previous CEO of a major logistics company who has never been a customer or supplier to ACS. This candidate currently has six other Non-Executive Directorships.
- Candidate 5** Male 68, was the ACS audit partner until his retirement earlier this year.

Over 90% of existing ACS Board members are male and 50 years old or above.

Finally, at the last ACS Board meeting, the Sales Director suggested that the ACS Remuneration Committee is dissolved to save money, with the Board of Directors taking on the responsibility to set the level of directors remuneration each year.

**e-Exam
Question
Number**

Question 4 required:

- 14** **(a)** Advise the ACS Board of Directors on **SIX** governance activities related to the acquisition of AirFix Limited which should be completed immediately following acceptance of the offer price made by ACS to purchase AirFix Limited.
(6 marks)
- 15** **(b)** Provide **FIVE** recommendations to ensure good governance of ACS-AirFix Board of Director meetings. Explain your rationale for each recommendation.
(5 marks)
- 16** **(c)** Evaluate each of the five proposed candidates for the roles of Independent, Non-Executive Directors to the Board of ACS-AirFix. Your evaluation should consider:
- i)** Overall observations for the group of shortlisted candidates. **(3 marks)**
 - ii)** The suitability and independence for each of the five candidates for the role of Independent, Non-Executive Directors. **(5 marks)**
- 17** **(d)** Explain the role of the ACS Remuneration Committee and the potential consequences of the Sales Director's suggestion to dissolve the remuneration committee.
(5 marks)
(Total: 24 marks)

END OF PAPER