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**SINGAPORE CA QUALIFICATION EXAMINER'S REPORT**

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

**EXAMINATION DATE:** 8 June 2022

**Section 1**
**General comments**

The June 2022 BG examination consists of a single company case study with financial and industry data covering four questions across the BVGR syllabus, with each question covering particular syllabus areas, consistent with prior examinations.

The scenario company, Ace Ground Services Ltd (ACS) is a small, listed company on the Singapore Stock Exchange. ACS provides ground handling services in the aviation sector. 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 as a separate subsidiary (Ace Lounges Limited). The Board of ACS is considering the purchase of an aircraft inspection, maintenance and refueling company, AirFix, 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. It is also considering selling its struggling subsidiary, Ace Lounges Limited, to raise capital and rationalise its strategy.

Business valuation learning outcomes were covered by Questions 1 and 2. Question 1 required the valuation of Ace Lounges Limited using several valuation methods and comment on the suitability of each method.

Question 2 focused on the post-acquisition value of the new ACS-AirFix group, following the purchase of AirFix, the sale of Ace Lounges Limited and the impact on value from post-acquisition synergy. The post-acquisition value is then used to determine if the purchase represents good value for shareholders.

Risk and Governance learning outcomes were covered by Questions 3 and 4. Question 3 required Candidates to demonstrate their knowledge of the risk management process, and to evaluate several risks highlighted by the Operations Director. Question 3 also required Candidates to consider essential matters or due diligence which should be performed before ACS proceeded to make an offer for AirFix.

Question 4 required Candidates to consider governance related activities immediately after making an offer to purchase a company as well as provide recommendations to improve the effectiveness of director meetings and make governance related recommendations. Question 4 also required Candidates to evaluate the potential of the five candidates for the new group Non-Executive Director (NED) roles and in doing so comment on both ACS's approach and attitude to this process and the suitability and independence of each of the candidates for the role of NED which were included in the scenario.

Overall, the Candidates' performance has improved as compared to the past semesters. Contributing to this was a good overall performance of the valuation techniques central to business value in Question 1 and an improvement in written responses to the risk and governance elements in Question 3 and 4.

**Section 2**
**<u>Analysis of Individual questions</u>**

**Question 1**

**Part (a)** required Candidates to explain reasons which the ACS Directors may have for the disposal of Ace Lounges Limited. Generally, Candidates did quite well for this question. However, future Candidates are reminded to explain their reasons in more depth, instead of providing short sentences of five or six words which were not sufficient to fully explain a given reason.

**Part (b)** required Candidates to calculate the value of Ace Lounges Limited using the net asset, earnings, and dividend methods of valuation. This requirement was generally done well by most Candidates, but the most common error was with the net asset valuation and a failure to exclude the overdraft and loan which would remain with ACS, which was an explicit instruction included in the scenario.

**Part (c)** required Candidates to 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. Many Candidates understood that valuing a private company using the P/E ratio of a listed company would overvalue the entity due to growth assumptions and access to listed company advantages being embedded in the P/E ratio, which therefore required adjustment. Candidates who did not score well tended to miss this or limited their discussion to a single reason only.

**Part (d)** required Candidates to discuss one advantage and one disadvantage for each of the three methods of valuation required by the Directors of ACS. This was a straightforward requirement testing Candidates' knowledge of the differences between the methods. For most parts, Candidates performed well, but some Candidates less so due to the provision of overly brief sentences or repetitive statements. Some Candidates provided generic descriptions like 'easy to prepare', 'straightforward and easy to compute' or 'well understood by the public and easy to explain' rather than specifically explaining this within the context of valuing ACS.

**Part (e)** required Candidates to 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).** Here, Candidates needed to provide one well explained point which demonstrated the understanding of buyer synergy which majority of the Candidates were able to do.

**Question 2**

**Part (a)** required Candidates to determine an adjusted weighted average cost of capital (WACC) to evaluate the post-acquisition value of the combined ACS-AirFix group. Generally, this was well done by many Candidates although some Candidates applied incorrect debt and equity values of the new group to the regearing process, some Candidates were unable to apply the internal rate of return method to determine the cost of debt finance and some Candidates ignored the existing bank loan in the WACC calculation.

**Part (b)** required Candidates to compute a valuation of ACS shares immediately following the acquisition of AirFix Limited. This requirement was challenging as it required Candidates to add ACS, AirFix, synergies and remove ACE lounges before applying annual growth rates. Overall, Candidates' performance was mixed with very few Candidates achieving full marks. Common errors included:

- Valuing AirFix only, as opposed to valuing the ACS-AirFix Group.
- Including depreciation in cashflows and also including capital allowances.
- Failing to add back interest costs in converting profit to cashflow to value free cash flows (before interest).
- Not deducting the value of debt to determine the value of equity.

**Part (c)** required Candidates to evaluate if the acquisition price required by the shareholders of AirFix Limited was acceptable to the Board of ACS and its shareholders. Candidates were expected to quantify the increase in value due to the acquisition. Most Candidates failed to demonstrate the value difference between the acquisition price, and the uplift in group value due to the acquisition. Some Candidates provided only a narrative explanation without supporting this with numerical evidence. Overall, many did not do well for this question.

**Part (d)** required Candidates to explain one advantage and one disadvantage for the three types of finance (corporate debenture, bank loan and rights issue). Overall Candidate performance should have been better as this has been a commonly tested area. Common problems included providing an advantage only or a disadvantage only, repetition of points, stating facts about debt such as that debt must be repaid, without explaining this was an advantage or disadvantage, providing vague or generic answers which could be applied to any type of debt such as 'easily available' or 'need to pay interest'. Some Candidates stated that cost was 'cheaper' without referencing what they were comparing this to. Future Candidates are advised to focus on the specific nature of a requirement and provide focused answers in response.

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**Question 3**

**Part (a)** required Candidates to explain four stages of the risk management to the ACS Board of Directors (Risk Identification, Risk Evaluation, Risk Response and Risk Monitoring and Reporting). Generally, this was done well by most of the Candidates although some Candidates discussed risk evaluation and risk response together, thereby providing a confused answer. Some Candidates failed to make the link between risk response and implementing measures (TARA framework) to reduce the risk impact or likelihood. For reporting and monitoring, some Candidates focused on one aspect only, and many failed to mention the purpose of reporting to Senior Management and the Board so they could take reactive decisions based on the risk evidence reported.

**Part (b)** required Candidates to critically evaluate the comments made by the Operations Director and advise how each of the four operational risks discussed by the Operations Director could be managed. Whilst Candidates were generally able to correctly identify each risk and discuss the risk impact, many failed to confidently state that they disagreed with the Operational Directors' views and provide reasons for this. A small number of Candidates failed to provide responses to each of the four risks which resulted in limited marks being awarded to them. In terms of advice to manage risks, performance in this area was mixed with many failing to offer control strategies which responded directly to the risks identified. Instead, some Candidates provided vague suggestions irrelevant to the scenario or provided impractical suggestions. Looking forward, Candidates are advised to provide focused responses that are directed and connected to the scenario facts rather than to provide simplistic, vague, or generic answers.

**Part (c)** required Candidates to identify and explain four areas/matters of due diligence that the Board should be concerned with prior to finalising an offer for the acquisition of AirFix Limited. Overall, Candidates performance was less satisfactory than expected for this topic area. Examples of common errors made included focusing on corporate governance compliance rather than responding to the risk of paying too much for the acquisition, as well as repetition or too few points for the marks available.

**Question 4**

**Part (a)** required Candidates to advise the ACS Board of Directors on governance activities related to the acquisition of AirFix Limited which should be completed immediately following acceptance of the offer price made. Majority of the Candidates performed poorly for this question. Some Candidates' answers focused only on compliance with the corporate governance provisions which excluded practical good governance requirements such as documenting the decision in the Board meeting minutes and informing the Singapore Stock Exchange. A common misconception by Candidates was that, to purchase a non-listed company, a listed company requires a vote by shareholders at a general meeting to proceed, which is not the case. All Candidates are advised to consider what good governance means beyond compliance with the mandatory requirements of the corporate governance code.

**Part (b)** required Candidates to provide five recommendations to ensure good governance of ACS-AirFix Board of Director meetings. Some Candidates focused only on compliance with the corporate governance code, rather than provide sensible suggestions on how to improve the effectiveness of Board meetings so ACS is more likely to meet its strategic objectives with advice on how Directors should attend, prepare, and contribute to Director meetings. Some Candidates provided suggestions of good governance which were not relevant to the effectiveness of Board meetings.

**Part (c)** required Candidates to evaluate each of the five proposed Candidates for the roles of Independent, Non-Executive Directors to the Board of ACS-AirFix. In doing so, some Candidates focused on the shortlisted candidates and failed to provide any observations for the entire group of shortlisted candidates which would impact the effectiveness of the Board (lack of diversity, lack of gender balance, all older than 50). When evaluating each short-listed candidate from the scenario, some Candidates focused only on the independence of each candidate, which was well explained, but failed to explain their suitability to the role as a Non-Executive Director for the ACS-AirFix Group. On the whole, Candidates scored better explaining the independence aspect than suitability for the role.

**Part (d)** required Candidates to explain the role of the ACS Remuneration Committee and the potential consequences of the ACS Sales Director's suggestion to dissolve the Remuneration Committee. In general, most Candidates managed to explain the role of the Remuneration Committee but failed to address the potential consequences. However, the majority of available marks were for the consequences of having Directors effectively decide on their own level of remuneration. Whilst many Candidates were able to explain that this may lead to disproportionate levels of pay and explain that this was non-compliance with the code of governance, few Candidates considered the impact on shareholder wealth and the reaction of investors to the reason for non-compliance disclosed in the annual report under the comply or explain rule.