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Chartered Accountant SINGAPORE

Singapore CA Qualification Examination

22 December 2020

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 **EIGHTEEN (18)** 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 watches, 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 and all video recordings of this examination are 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.

Examplify Question Number	Pre-exam instructions
1	**Instructions on Question Paper and Appendices, if any:**

i. Download the document(s) via this link – https://bit.ly/38mMMZd

ii. These file(s) is/are to remain on your desktop throughout the entire exam.

iii. Printing of the Question Paper is only allowed at the start of the exam and via a printer located in the same room.

iv. If you are unable to download the document(s) via the link provided above or if you have been provided with incorrect file(s) for the exam, please contact SAC at

(a) 6325 0515;

(b) 6325 0535; or

(c) 6325 0529.

v. If you need to go for toilet breaks, please mention "toilet break" to the webcam.

Company Background Information

Singapore Prestigious Dining Limited (SPDL) is a medium-sized private company which operates in the Singapore restaurant sector. The company was incorporated in Singapore in 2007 and currently operates a chain of twenty-five popular restaurants throughout Singapore under the Singapore Heritage Club brand. It enjoys a high brand recognition in Singapore with affluent, fashionable and professional customers.

Singapore Heritage Club restaurants have built a reputation for serving authentic and quality Singaporean dining fare aimed at the higher end of the restaurant market. The restaurants are also often a destination for family celebrations and business dinners. Each of the Singapore Heritage Club restaurant sites is large with a seating capacity of at least 200 coupled with additional private dining rooms and events spaces.

SPDL is headed by Ken Koh, who created the restaurant brand in 2007 and acts as SPDL's CEO and Chairman. Given the success of the restaurant brand in Singapore, Mr Ken Koh is now considering listing SPDL on the Singapore Exchange (SGX) to raise capital from new equity investors. The new capital will be used for expansion purposes with new Singapore Heritage Club restaurants initially planned for Singapore and Malaysia, with further long-term expansion planned for the rest of South East Asia and Australia.

The Board of Directors of SPDL has the following strategic aims:

- Provide a memorable and unique dining experience which encapsulates Singaporean history, heritage and culture;
- Ensure that an excellent dining experience is consistently provided across all restaurant sites; and
- Expand the number of Singapore Heritage Club restaurants to become the leading restaurant brand in South East Asia.

Question 1 – (a) and (b)

Restaurant operations

Each restaurant has its own manager. Historically, restaurant manager attrition is low and many of the twenty-five restaurant managers have been with SPDL for over five years. Each restaurant manager is given considerable autonomy to operate their assigned restaurant and to decide on the menu, food pricing, staff recruitment and training, staffing levels and raw ingredient orders which are then purchased centrally by SPDL's head office function.

Each restaurant offers the standard Singapore Heritage Club choice of meals as a base menu supplemented by daily menu specials determined by the lead chef at each restaurant. Additionally, each restaurant is decorated differently, which provides a unique feel to each restaurant, encouraging its customers to visit many of its restaurants to sample different menu choices and enjoy a different dining environment. This strategy has increased return customers who regularly visit different restaurants.

Each restaurant uses tablet technology to record customer orders and each order joins a queue which is displayed in the restaurant kitchen. Restaurant servers must ask the customer to confirm their choices before the order is submitted to the kitchen through the ordering system. Once meals are served, the confirmed order is used to prepare the bill at the end of the meal. All restaurant servers are allowed to amend or cancel any order on the system as customers may add additional items or cancel their orders prior to payment.

Each restaurant manager must control costs by balancing staff levels with customer demand by preparing a weekly staff schedule. The restaurant manager must also minimise raw ingredients wastage, for example, by promoting daily specials and managing raw ingredients order frequency and quantities. Kitchen and waiting staff work a minimum number of hours set by the restaurant manager with overtime work as and when required. Overtime is common as periods of high demand at each restaurant are not always predictable and often staff cover is frequently required for absent kitchen or waiting staff members. Each restaurant manager verbally agrees on overtime with each employee in advance, as and when it is needed. Once the overtime has been worked, the relevant employee will add a record of the overtime worked to the weekly overtime sheet which is kept at the cash register at each restaurant. The overtime sheet is then approved by the restaurant manager at the end of the week and submitted to the head office for payment.

Raw ingredients and beverage supply orders are completed weekly by the restaurant manager and submitted to a centralised purchasing department for order processing. Supplies are delivered directly to each restaurant by suppliers. Deliveries can be signed for by any employee when the deliveries are made to restaurants. As SPDL has been using trusted suppliers for many years, deliveries are only checked for quality and quantity on a sample basis.

Raw ingredients are stored in chilled cabinets which are accessible by all employees to ensure supplies can be obtained as needed without delay.

Each restaurant has its own set of methods to manage raw ingredients inventory, in order to minimise raw ingredients wastage and ensure raw ingredients used in meal preparation is within the "use by" dates printed on labels. It is the responsibility of each restaurant manager to ensure compliance with all Singapore food safety, hygiene and worker related regulations. As all restaurants have passed the official food regulation compliance inspections to date, there were no specific training provided by SPDL to restaurant managers in the area of food regulation.

Head office control

SPDL's head office is responsible for strategic planning, financial management and legal matters. It also provides marketing support for each restaurant and purchases all raw ingredients and beverages through central purchasing arrangements.

The head office operates financial control activities. A weekly profit statement showing the performance of the restaurant is prepared by head office for a weekly discussion with each restaurant manager by the Operations Director. The report includes a comparison against the budget for that restaurant and a comparison with the average results for all restaurants. The report contains information such as restaurant income, gross and operating profits and spending per customer. SPDL defines gross profit as sales less the cost of raw ingredients and beverages and restaurant staff wages. Each restaurant is expected to achieve a minimum 35% gross profit margin.

The last six months have been particularly busy for SPDL with the opening of two new restaurants and preparations for a possible listing on the SGX which has prevented the Operations Director, Christopher May, from discussing individual restaurant performance with each restaurant manager. The current overall gross profit margin for the company is 41%. However, there are currently two restaurants which are failing to meet the minimum gross profit margin of 35%.

Market research and customer feedback

A market research consultancy is engaged to carry out quarterly customer satisfaction and brand recognition surveys. A customer satisfaction report is submitted each quarter to SPDL's Board of Directors. However, there has been insufficient time to discuss the quarterly reports at recent SPDL Board meetings. The Operations Director, Christopher May, recently reviewed the latest customer satisfaction and brand awareness survey from September 2019 and was surprised by some negative customer comments expressing dissatisfaction with the service and food quality at some of SPDL's restaurant sites.

Restaurant promotion

Each restaurant manager actively uses social media to promote their restaurant and also uses traditional advertising on billboards, on public transport and in local magazines.

Examplify Question Number	**Question 1 required:**
2	**(a)** Identify **SEVEN** risks which SPDL restaurant operations are exposed to. For each risk: **(i)** explain the risk identified; **(ii)** evaluate the expected **likelihood** as high or low and explain your assessment; and **(iii)** evaluate the expected **impact** as high or low and explain your assessment. **Note**: Your answer should contain no more than seven risks. **(21 marks)**
3	**(b)** Describe **ONE** specific risk control response for each risk identified in part **(a)**. **Note**: Your answer should contain no more than seven risk control responses. **(7 marks)** **(Total: 28 marks)**

Question 2 – (a), (b) and (c)

The Directors have identified ten restaurants where the restaurant kitchen needs to upgrade its existing refrigeration equipment. The Directors have been researching possible replacement solutions and have identified a Taiwan based manufacturer and supplier of high-quality kitchen equipment which has offered the following purchase options:

Option 1: Lease

Each refrigeration unit can be leased for four years at an annual fixed cost of NT$213,000 payable annually in arrears. The manufacturer will include delivery from Taiwan to each of SPDL's restaurants, refrigeration unit installation, all repairs and maintenance services for the entire term of the four years leasing agreement.

Option 2: Purchase

One new refrigeration unit can be purchased in Taiwan for NT$765,000 and is expected to have a disposal value of NT$125,000 at the end of four years when the unit is expected to be replaced. The purchase cost includes all delivery and installation costs and each refrigeration unit is guaranteed for all breakdown and repairs by the manufacturer in the first year of use. After the first year, SPDL will be responsible for all repair, service and maintenance costs, which the Directors have forecast to be S$925 per annum (at current prices), with an inflation of 2% per annum for the remaining useful economic life for each refrigeration unit.

The current exchange rate between the Taiwan dollar and the Singapore dollar is NT$21.75 per S$1. The interest rate in Singapore is currently 4.5% per annum and the interest rate in Taiwan is 2.2% per annum.

The Directors are unsure whether it would be beneficial for the company to buy or lease the new kitchen equipment.

The Directors have assumed that SPDL can claim capital allowances on a 25% reducing balance basis. As the company is profitable, it expects to pay tax on profits at the annual corporate tax rate of 17%. For simplicity, the Directors assume tax is payable in the period it arises.

The Directors have forecasted the company's cashflow and have confirmed there is insufficient available cash to fund the outright purchase of the new kitchen equipment. SPDL has an existing bank loan on which it pays interest at after-tax rate of 6.0% per annum, which under the Directors' advice, is to be used in analysing the lease and purchase option.

If the purchase decision is chosen, then SPDL will need to arrange additional financing. The Directors have not yet approached the company's bank to arrange additional loan financing, and are also considering offering a corporate bond to investors.

Examplify Question Number	**Question 2 required:**
4	**(a)** Prepare an analysis to determine whether it is financially beneficial to purchase or lease the required ten new refrigeration units. **Note:** Present calculations for the ten refrigeration units and explain any assumptions made. **(16 marks)**
5	**(b)** Discuss **FIVE** potential benefits to the company of lease financing over the purchase of new refrigeration units. **(5 marks)**
6	**(c)** If SPDL decides to purchase the new refrigeration units and to use debt finance to fund the purchase, discuss one advantage and one disadvantage of: **(i)** obtaining a bank loan; and **(ii)** issuing a corporate bond. **(4 marks)** **(Total: 25 marks)**

Question 3 – (a), (b), (c) and (d)

The Directors of SPDL believe the high-end and well recognised Singapore Heritage Club brand has international growth potential. Many of the restaurants are often referenced by social media influencers in Singapore. The restaurants are desirable destinations for family celebrations and other social events. The Directors want to leverage on this brand recognition and value to expand the brand further with new restaurants in Singapore and Malaysia in the short term. In the longer term, SPDL plans to open new restaurants in other parts of South East Asia and Australia and to refresh existing restaurant interiors and branding.

The Directors would like to attract new equity investors and raise new equity capital to fund expansion by listing 10 million shares on the SGX. However, the Directors need help in calculating SPDL's value to determine a suitable issue price.

To evaluate a possible listing on the SGX, the Directors of SPDL would like to assess the company's valuation using four valuation methods, as follows:

1) **Free cash flow valuation** at 30 September 2020 values based on forecast revenue and costs by applying expected growth rates estimated by the Directors.

2) **Net assets valuation** at 30 September 2020 values:
    - A new asset valuation which excludes the Directors' estimate for the value of the Singapore Heritage Club brand; and
    - A new asset valuation which includes the Directors estimate for value of the Singapore Heritage Club brand.

3) **Dividend valuation method** using the 30 September 2020 dividend.

4) **Earnings valuation** by applying market multiples to 30 September 2020 profit after tax.

Below is summary data extracted from SPDL's management accounts for the year to 30 September 2020:

Statement of Profit or Loss
For the year ended 30 September 2020

	S$ '000
Revenue	10,374
Cost of sales	(6,088)
Gross margin	**4,286**
Overheads (including loan interest)	(3,795)
Operating profit	**491**
Corporate tax at 17%	(83)
Net profit	**408**
Dividend	(204)
Retained earnings	**204**

Statement of Financial Position
As at 30 September 2020

	S$ '000
Assets	
Property, plant and equipment	7,544
Inventory	680
Cash	533
Total Assets	**8,757**
Equity	
Share capital	100
Retained earnings	3,180
Total Equity	**3,280**
Liabilities	
Current liabilities	2,477
Loans (7.4% gross interest per annum)	3,000
Total Liabilities	**5,477**
Total Liabilities and Equity	**8,757**

A similar restaurant chain listed on the SGX has a quoted equity beta of 1.96 and is financed by 1/3 debt and 2/3 equity. The current risk-free rate of return in Singapore has been estimated by the Directors to be 4.5% and the equity market risk premium is also 4.5%.

The Directors of SPDL have supplied the following assumptions to be used when calculating the valuations.

1) Annual growth is assumed to be as follows:
   - *Revenue* – 2% per annum for years 1 to 2 and 4% for years 3 to 4.
   - *Cost of sales* – 2% per annum for years 1 to 2 and 3% for years 3 to 4.
   - *Overheads, including interest* – an overall increase of 2% per annum for years 1 to 4.
   - *Net free cash flows* – growth is expected to be 5% per annum for year 5 and each year thereafter on the basis of a successful listing on the SGX and planned expansion in Malaysia and other countries in South East Asia.

2) Working capital comprises only of raw ingredients and beverage inventories at each restaurant. No increase in working capital is required as the business grows because all inventory increases will be funded by credit terms offered by suppliers.

3) Current asset depreciation levels are a good indicator of annual capital expenditure. Therefore, to keep free cash flow valuation simple, no adjustment is required for annual capital expenditure and depreciation.

4) The Singapore Heritage Club brand is estimated to be S$2 million. This non-current intangible brand value is not recognised on the company's Statement of Financial Position.

5) Over the past 12 months, the average P/E ratio in the hospitality sector on various stock exchanges in Asia has been 12.5. The Directors recognise that SPDL is currently a small company compared to other public companies. However, the Directors believe SPDL has growth potential which will be attractive to new equity

investors. Therefore, the Directors suggest the following adjustments to be made to the quoted average P/E ratio in the hospitality sector when used to value SPDL.

- P/E ratio adjustment as currently not a listed company - less 20%
- P/E ratio adjustment as small relative to listed companies - less 15%
- P/E ratio adjustment for growth potential – plus 25%

6) Once SPDL is listed on the SGX, investors are expected to require a return of 11%, on average, and 11% should be used as the discount rate when calculating the free cash flow valuation.

7) A required return of 15.47% should be used when calculating the dividend valuation.

8) The current level of dividends is expected to increase by 5% per annum indefinitely and the Directors are keen to pledge this as a minimum dividend level in a listing prospectus to attract future potential investors.

9) The corporate tax has been payable at 17% per annum and this rate is expected to continue for the foreseeable future.

Examplify Question Number	**Question 3 required:**
7	**(a)** Calculate SPDL's current weighted average cost of capital using CAPM. **(5 marks)**
8	**(b)** Prepare the **FOUR** methods of valuation for the shares of SPDL as requested by the Directors. Prepare all valuations as at 30 September 2020 and use year-end discount factors, where applicable, presenting your answers to the nearest thousand Singapore dollars. **(12 marks)**
9	**(c)** Comment on the suitability of **SIX** of the assumptions made by the Directors of SPDL which were used to determine the valuations in part **(b)**. **(6 marks)**
10	**(d)** Recommend (with justification) a suitable issue price to list SPDL shares on the Singapore Exchange. **(2 marks)** **(Total: 25 marks)**

Question 4 – (a), (b) and (c)

SPDL has a small Board of Directors comprising three Executive Directors and two Non-Executive Directors, as follows:

Name	Description
Ken Koh (age 59)	The Chairman and Chief Executive Officer (CEO) of SPDL
Nicholas Nguyen (age 56)	Finance Director of SPDL
Christopher May (age 50)	Operations Director of SPDL
David Jeyaretnam (age 50)	Non-Executive Director (NED), who is the owner of Singapore Fresh Fish Limited, a key supplier to SPDL.
David Lim (age 51)	Non-Executive Director (NED), who was SPDL's previous Operations Director.

The Executive Directors are involved in the day-to-day management of the business and deal directly with restaurant managers on a day to day basis. The CEO and Chairman, Ken Koh, believes that only those who have worked for the company or who are associated with the company have the relevant knowledge and experience to successfully run the business. The Board has never undergone a performance assessment or evaluation of its effectiveness. Mr Koh believes there are no issues with the Board performance and effectiveness as SPDL has been successful in the past and is forecast to grow in the future. Currently, the two Non-Executive Directors form the Audit Committee.

At the last Directors meeting, Mr Koh acknowledged the company has limited knowledge of the requirements of the 2018 Singapore Code of Corporate Governance. He further commented that he does not fully understand the purpose of corporate governance and why SPDL will need to comply with all its requirements after the company is listed.

The Finance Director, Nicholas Nguyen, responded to Mr Koh that full compliance with the 2018 Singapore Code of Corporate Governance will be required by the market should SPDL proceed with the proposed listing on the SGX. Nicholas also explained that the market would expect SPDL to demonstrate the tenets of accountability, transparency and sustainability in its application of corporate governance principles and provisions.

Examplify Question Number	Question 4 required:
11	**(a)** Explain and discuss the importance of the **THREE** tenets of corporate governance, namely, accountability, transparency and sustainability, as set out in the 2018 Singapore Code of Corporate Governance. **(6 marks)**
12	**(b)** Explain the 'comply or explain' rule in the 2018 Singapore Code of Corporate Governance to the Board and the impact of this rule on SPDL after the company has listed on the Singapore Exchange. **(4 marks)**
13	**(c)** Discuss **SIX** changes which are required to the composition and performance of SPDL's Board of Directors in order to comply with the 2018 Singapore Code of Corporate Governance. For each change, you are expected to: **(i)** Identify the relevant principle or provision and explain why SPDL is currently not compliant with the 2018 Singapore Code of Corporate Governance. **(6 marks)**

Examplify Question Number	
	Question 4 required:
13 (cont.)	**(ii)** Recommend what action SPDL must take to become compliant with the 2018 Singapore Code of Corporate Governance. **Note**: Base your answer only on the information presented in the scenario. **(6 marks)** **(Total: 22 marks)**

END OF PAPER