FINANCE MARKING GUIDE
SABLETEL

In the Finance Role, the candidate would be expected to assess the financial position of SableTel to see what its current position is first (so recast f/s, do ratio analysis, assess budget/cash flows). This then allows them to assess the option of doing an IPO and the purchase offer, which requires candidates to use various valuation techniques.

The candidate is also asked to look at the Wireless Technology project (on the basis that they might not do the IPO or take the purchase offer) i.e. essentially looking at the option of continuing to run SableTel as is and seeing how much Star Nova would need to contribute/and whether it is worth continuing)

(Note: Solutions have been created for illustration purposes only. The Board of Examiners will determine the actual number of opportunities and define the expectations that will be part of the assessment to ensure the four roles are equated.)

CORE Financial Reporting-Depth
(will be broken down into multiple assessment opportunities by the BOE)

The candidate discusses the significant accounting issues related to the 2014 financial statements.
The candidate demonstrates competence in Financial Reporting.

Note: all CPA candidates are expected to achieve the same level of competence for Core Financial Reporting regardless of the role they choose. For purposes of illustration, the same information appears in each of the four Elective role solutions. However, it is possible that in a real case, that the ranking of the issues and the "slant" put on the discussion would be tailored to the role being assumed.

CPA	CPA Competency Statement	Core
1.1.1	Evaluates financial reporting needs	A
1.2.1	Develops or evaluates appropriate accounting policies and procedures	A
1.3.1	Prepares financial statements	A

In order to be able to assess the IPO and the $46,000,000 offer for SableTel, first we need to fix the financial statements. I have identified several accounting issues with respect to the 2014 financial statements of SableTel. Where possible I have estimated the misstatement and I have then adjusted the financial statements as presented to better reflect the actual financial condition and financial results of SableTel for its 2014 fiscal year. This will allow for a better assessment of Sable Tel's current worth.

Issue #1- Inventory – obsolescence provision

Guidance for accounting for inventory can be found in IAS 2 - Inventories

Inventory at SableTel consists of routers and modems that SableTel sells to its customers. Total inventory at August 31, 2014 had a book value of $3,219,431. The continuity of the inventory for the 2014 fiscal year can be presented as follows:

Inventory – Opening	$	883,318
Purchases – Discounted Product		2,500,000
Purchases – Other (Regular)		515,972
Cost of Sales – Routers and Modems		(679,859)
Inventory – Closing	$	3,219,431

The inventory level at year end would appear to be extremely high and may require write-down. The main reason for the substantial increase in inventory relates to the $2,500,000 of inventory which was purchased in September 2013. Given that the inventory tends to have a short life (typically 12 months), it is not clear why SableTel would purchase such a large quantity of inventory as its annual sales do not justify such a large purchase. It is now twelve months after this discounted product was purchased and therefore it is likely that much of this inventory can no longer be sold.

Sales of routers and modems for the 2014 fiscal year totaled $1,675,759. The costs associated with these sales totaled $679,859. Assuming similar sales in future years, SableTel has inventory on hand at August 31, 2014 which represents 4.74 years of sales ($3,219,431/$679,859). Given that these items have a short life (typically 12 months), a portion of the inventory is likely obsolete and requires write down. Further details would need to be gathered regarding the specific inventory items to determine an accurate obsolescence provision, but as an initial estimate, we could assume that items representing sales greater than one year will likely require a write down. Therefore the estimated obsolescence provision is $2,539,572 ($3,219,431 - $679,859). Therefore SableTel should reduce its inventory balance on the financial statements by $2,539,572 and increase its cost of sales by a similar amount (see the adjusted financial statements below).

Issue #2- Deferred Research and Development Costs

Guidance for research and development costs can be found in IAS 38 – Intangible Assets

Deferred research and development costs represents costs associated with the Wireless Technology Project from 2013 and 2014 that have been capitalized. The amounts have been capitalized as management has “declared its intention to carry this project to market”. However, this is only one of the criteria that must be met in order for research and development costs to be capitalized.

IAS 38 paragraph 57 states:

“An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.

(b) its intention to complete the intangible asset and use or sell it.

(c) its ability to use or sell the intangible asset.

(d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development."

SableTel clearly does not meet all of the criteria for recognition as an intangible asset.

The first criterion requires that the technical feasibility be assured. However, Dan has indicated that SableTel is currently awaiting a third party feasibility study for this project. Therefore it is unlikely that this criterion has been met at year end.

The second criterion requires an intention to complete the intangible asset. Management has indicated that they intend to complete the Wireless Technology Project so this criterion is likely met.

The next criterion requires SableTel to prove that it will use or sell the intangible asset. We can assume that this criterion is met and the Industry Canada grant may provide further evidence supporting this criterion as Industry Canada wants to use the technology (indicating that SableTel may be able to sell the technology as well.)

The fourth criterion requires management to demonstrate how the asset will generate probable future economic benefits. SableTel will utilize the wireless technology internally, presumably to decrease costs and increase margins. Therefore SableTel likely meets this criterion as the technology is supposed to increase margins by 5% across all of its product lines. This would provide substantial benefits (5% of $65 million is $3.25 million on an annual basis). SableTel would need to provide some evidence to support this assertion. This may be available once the third party feasibility assessment has been completed.

The fifth criterion requires adequate technical, financial and other resources to complete the project. Dan has indicated that SableTel does not currently have the financial resources to finish this project and requires funding from StarNova to complete the project. Therefore this criterion is likely not met currently as StarNova has not committed itself to the funding. However, should SableTel be able to provide support that StarNova or some other source will fund the remainder of the project then this criterion may be supportable.

Finally, SableTel must be able to demonstrate that it can measure reliably the expenditures attributable to the project. It is not clear if SableTel can do this. Dan has indicated that accounting came up with the $22 million necessary to complete the project but he is not sure how they came up with this number. As well, SableTel would also need to demonstrate that it had the necessary systems in place to track the costs associated with this project reliably. Therefore this criterion may be met but more information is required.

Since all six criteria must be met in order to capitalize the costs and at least two of the criteria are likely not met, the costs cannot be capitalized and must be expensed. As a result SableTel should reduce the deferred research and development costs from $9,160,250 to Nil and increase administration expenses by the same amount (see the adjusted financial statements below).

Even if SableTel met all of the criteria for capitalization of the development costs, it would not be able to go back to 2013 and capitalize those research and development costs in 2014. IAS 38 paragraph 71 states "Expenditure on an intangible item that was initially recognised as an expense shall not be recognised as part of the cost of an intangible asset at a later date."

From a presentation standpoint I would also recommend that consideration be given to separating the research and development costs from the administration expenses on the face of the statement of comprehensive income as it is a significant amount and is likely of interest to users of the financial statements.

Issue #3- Industry Canada Grant

Guidance for government assistance can be found in IAS 20 – Accounting for government assistance and disclosure of government assistance.

There are two issues associated with the government grant. The first issue is whether SableTel has met the criteria for recognition of the government grant. IAS 20 paragraph 7 states:

"Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:

(a) the entity will comply with the conditions attaching to them; and

(b) the grants will be received."

SableTel has received the $2,750,000 so we can safely state that the second criterion has been met. However, it is not clear if the first criterion, related to satisfying all of the conditions attached to the grant has been met. There is some evidence that the conditions have not been met as SableTel must share its technology with Industry Canada (IC) and IC must formally approve the technology. However, I would need to gather further details relating to the grant in order to determine if the first criterion has been met and as a result if the amount can be recognized.

Assuming that the above two criteria have been met then the second issue regarding the government grant relates to its presentation. IAS 20 paragraph 24 states:

"Government grants related to assets, including non-monetary grants at fair value, shall be presented in the statement of financial position either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset."

This government grant relates to the Wireless Technology Project. This project was initially recorded as an intangible asset. If the Wireless Technology Project was still recorded as an asset then SableTel would need to reverse the amount recorded as revenue and record the amount as either deferred income or by deducting the amount from the carrying value of the Wireless Technology Project.

However, due to the adjustment proposed above (see Deferred Research and Development Costs), the Wireless Technology Project is now expensed as administration on the statement of comprehensive income. The presentation of grants related to income is discussed in IAS 20 paragraph 29 which states:

"Grants related to income are presented as part of profit or loss, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expense."

I would recommend that the amount be recorded as a reduction of the related expense as it is clearly attributable to these expenditures. Therefore, the amount should be removed from revenue and recorded as a reduction of the research and development expenses (administration expenses) on the statement of comprehensive income (see the adjusted financial statements below). Note that the adjustment will have no net effect on the profit (loss) of SableTel.

Issue #4- Impairment of Mobile Network

Guidance for the impairment of assets can be found in IAS 36 – Impairment of assets.

In August 2014, Hurricane Baylee damaged several of the communication towers associated with SableTel's mobile network disabling the entire network. In total 60 of the 340 towers were damaged. Each tower has a carrying value of $35,000.

SableTel must determine if the communication towers require a write down at year end.

IAS 36 paragraph 9 states:

"An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset."

Clearly there is an indication that the assets may be impaired as the towers have been damaged. Therefore SableTel should estimate the recoverable amount.

IAS 36 paragraph 18 states:
"This Standard defines recoverable amount as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use."

IAS 36 paragraph 22 states:
"Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs (see paragraphs 65–103), unless either:

(a) the asset's fair value less costs to sell is higher than its carrying amount; or
(b) the asset's value in use can be estimated to be close to its fair value less costs to sell and fair value less costs to sell can be determined."

It would appear from the facts of the case that the towers, as a whole, make up a cash-generating unit as the entire mobile network has been disabled by the damage to 60 of the towers. Therefore it may be necessary to estimate the recoverable amount for the entire mobile network (i.e. the 340 communication towers) and not just the 60 towers that have been damaged.

IAS 36 paragraphs 66 and 67 state:
Paragraph 66 – "If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit)."
Paragraph 67 – "The recoverable amount of an individual asset cannot be determined if:

(a) the asset's value in use cannot be estimated to be close to its fair value less costs to sell (for example, when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and

(b) the asset does not generate cash inflows that are largely independent of those from other assets.

In such cases, value in use and, therefore, recoverable amount, can be determined only for the asset's cash-generating unit."

As stated above, there are two possible ways to determine an assets (or group of assets) recoverable amount. The first is to determine the assets fair value less costs to sell. We do not have a lot of information to determine this amount but it is unlikely that SableTel could sell the damaged towers for any significant amount. As well there is no indication that SableTel could sell its entire mobile network but it is possible that another telecom company may want this network. The mobile network, in its current state has no value as the entire mobile network has been disabled. It is important to note that the value in use is generally determined by its estimated future cash flows in its *current condition*. IAS 36 paragraph 44 states:

"Future cash flows shall be estimated for the asset in its current condition. Estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from:

(a) a future restructuring to which an entity is not yet committed; or

(b) improving or enhancing the asset's performance."

SableTel has indicated that it is unclear if the mobile network can be fixed. It is also contemplating replacing the entire tower system with a new faster system. Therefore it is unclear what the recoverable amount of the towers, or the entire system (the cash-generating unit) is at year-end.

I believe that there is likely some impairment within the mobile network. Further information would need to be gathered to determine the exact amount of the impairment but as an estimate we could approximate that the recoverable amount of the 60 damaged towers is likely NIL. SableTel should therefore write-down the asset to this amount. The total for these six towers would be $2,100,000 (60 X $35,000) (see the adjusted financial statements below).

Note that it is possible that all 340 towers and the entire mobile system (the cash-generating unit) would need to be written down to NIL or the estimated recoverable amount (fair value less costs to sell) as the mobile network has no value in use based on its current condition. It is also not clear if the network can be fixed, or even if it can be fixed, if SableTel plans to repair the network. If the mobile network cannot be sold (i.e. the fair value less costs to sell is minimal) and SableTel does not plan to fix the network, then the entire network should be written down to NIL. At a minimum this amounts to $11,900,000 (340 towers X $35,000 per tower) for the towers and may need to be higher if there are additional capital assets associated with the mobile network. At this point I will assume that the 280 towers that were not damaged would not require a write-down as they may have a fair value in the open market or may be able to generate positive cash flows in the future.

The write-down should be recorded as an impairment loss as stated in IAS 36 paragraph 59:

> "If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss."

If there are any insurance proceeds that are likely to be received as a result of the damaged tower that would reduce the loss.

As well, given that SableTel is contemplating replacing the entire system, it would be prudent to analyze the estimated useful lives of the assets in question and/or the residual values.

Deferred Revenues (minor issue)

There are no deferred revenues on the face of the statement of financial position. Given the nature of the company, a telecommunications company, I would expect that certain of its revenues would be billed in advance (i.e. it is typical for companies in this industry to bill a month of service in advance and some also require substantial deposits). This should be investigated further. It is possible that this amount is buried in the Trade and other payables line item on the statement of financial position. It is also possible that these amounts have been incorrectly recorded as revenues. Further information would need to be gathered to determine any error that exists.

Issue # 5-CRTC Fee

I have recalculated the estimated misstatement in the 2013 and 2014 CRTC Fees.

This calculation is based on preliminary information.

Description of Input	2010 Calculation	2009 Calculation
Revenues from long-distance, local and mobile services (see Note 1 to the financial statements)	$ 56,857,395	$ 60,712,173
Less: Related Party Revenues (assume = $0)	0	0
Less: Qualifying Costs (see Note 2 to the financial statements)	(25,215,367)	(25,333,908)
Add: Fees paid to non-Canadian entities (see Note 2 to the financial statements)	897,500	788,000
Add: 200% of negative margin customers (assume that the finance database is correct and assume 2009 = $0)	2,260,000	0
Add: Related Party Costs (see Note 2 to the financial statements)	1,357,850	1,458,760
Fee Base	36,157,378	37,625,025
Contribution Rate	12%	12%
Preliminary Fee Calculation	4,338,885	4,515,003
Fee as Calculated	3,817,484	3,842,785
Adjustment Required	$ 521,401	$ 672,218

The total estimated misstatement is $1,193,619. Of this amount $672,218 relates to 2013 and $521,401 relates to 2014. The amount relating to 2013 ($672,218) is an accounting error and as such the amount should be added to accrued liabilities and should reduce the 2014 opening retained earnings. The amount for 2014 ($521,401) should be added to cost of sales (CRTC Fee) and be added to accrued liabilities at August 31, 2014 as this amount relates to the 2014 fiscal year.

Issue #6-Adjusted Financial Statements

The financial statements for 2014 will require adjustment due to the cumulative material effect of the misstatements noted above. The following schedule adjusts the financial statements:

Item Description	2014 Actual F/S's (unadjusted)	Required IFRS adjustments	JEs	2014 Actual F/S's (adjusted)
Current assets				
Cash	$ 351,018			$ 351,018
Accounts receivable	15,864,501			15,864,501
Inventory	3,219,431	(2,539,572)	**1**	679,859
Total Current Assets	19,434,950	(2,539,572)		16,895,378
Property, plant and equipment	62,532,502	(2,100,000)	**4**	60,432,502
Deferred taxes	35,629			35,629
Intangible assets	10,753,709	(9,160,250)	**2**	1,593,459
Total Assets	$ 92,756,790	(13,799,822)		$ 78,956,968
Current liabilities	$ 22,265,938	1,193,619	**5**	$ 23,459,557
Long-term debt	44,152,572			44,152,572
Total Liabilities	66,418,510	1,193,619		67,612,129
Total Shareholders' Equity	26,338,280	(14,993,441)	**(A),5**	11,344,839
Total Liabilities and Shareholders' Equity	$ 92,756,790	(13,799,822)		$ 78,956,968
Revenue	$ 65,072,224	(2,750,000)	**3**	$ 62,322,224
Cost of sales	30,714,869	3,060,973	**1,5**	33,775,842
Gross profit	34,357,355	(5,810,973)		28,546,382
Expenses:				
Selling and marketing	16,875,413			16,875,413
Administration	13,336,292	8,510,250	**2,3,4**	21,846,542
Interest expense	2,967,650			2,967,650
Total Expenses	33,179,355	8,510,250		41,689,605
Profit (loss)	$ 1,178,000	14,321,223	**(A)**	$ (13,143,223)

The adjusted financial statements present a much different financial picture for SableTel for its 2014 fiscal year..

Journal Entries (JEs) (Candidates are not expected to present these entries)

JE #	Account Description	Debit	Credit
1	Cost of sales (routers and modems)	$ 2,539,572	
1	Inventory		$ 2,539,572
	To set-up a provision for inventory obsolescence		
2	Administration (R&D expenses)	$ 9,160,250	
2	Intangible assets		$ 9,160,250
	To reverse expenditures associated with the Wireless Technology Project that were capitalized		
3	Revenue (Government Grant)	$ 2,750,000	
3	Administration (R&D expenses)		$ 2,750,000
	To reclassify the Industry Canada grant received during the year		
4	Administration (Impairment charge)	$ 2,100,000	
4	Property, plant and equipment (Mobile Network Towers)		$ 2,100,000
	To record an impairment charge on the mobile network towers		
5	Cost of sales (2014 CRTC Fee adjustment)	$ 521,401	
5	Retained earnings (opening – 2013 CRTC Fee adjustment)	672,218	
5	Current liabilities (accrued liabilities)		$ 1,193,619
	To record the estimated misstatement in the CRTC Fee for 2013 and 2014		

Finance
(will be broken down into multiple assessment opportunities by the BOE)

The candidate calculates financial ratios for 2013 and 2014 to determine the financial condition and operating performance of SableTel relative to its competitors and to assess likelihood of achieving budget.

The candidate demonstrates competence in Finance.

This indicator is similar to one in the Performance Management role, however, the context is different, and the degree of depth expected would be higher for those in the Finance Elective.

CPA		CPA Competency Statement	Core	Elective
5.1.1		Evaluates the entity's financial state	A	A

To determine the financial condition of SableTel at August 31, 2014, we can compare certain key ratios of SableTel with the industry ratios provided. Below is a comparison of the key ratios for 2014 followed by an explanation of the information that these financial ratios contain:

Financial Ratio	SableTel 2014 Actual (unadjusted)	SableTel 2014 Actual (adjusted)	SableTel 2013 Actual (unadjusted)	Industry Ratios (2014)
Profitability Ratios				
Return on Equity (1)	4.5%	(115.9%)	(5.1%)	9.6%
Margin Analysis				
Gross Margin % (2)	52.8%	45.8%	53.1%	52.2%
Selling, marketing and administration % (3)	46.4%	62.1%	50.6%	40.5%
Operating Profit % (4)	6.4%	(16.3%)	2.4%	11.7%
Turnover				
Accounts Receivable Turnover (5)	4.1x	3.9x	9.6x	6.7x
Short Term Liquidity				
Current Ratio (6)	0.9x	0.6x	1.0x	0.8x
Long Term Solvency				
Operating Profit/Interest Expense (7)	1.4x	(3.4x)	0.6x	8.1x
Growth Over Prior Year				
Revenue Growth (8)	(0.2%)	(4.4%)	Note 1	(2.6%)

Details of calculations (see numbers from financial statements):

(1) Return on Equity – Profit/Total Shareholders' Equity
(2) Gross Margin % – Gross Profit/Revenue
(3) Selling, Marketing and Administration % – (Sales, Marketing and Administration)/Revenue
(4) Operating Profit % – Operating Profit (before interest)/Revenue
(5) Accounts Receivable Turnover – Revenue/Accounts Receivable
(6) Current Ratio – Current Assets/Current Liabilities
(7) Operating Profit/Interest Expense – Operating Profit (before interest)/Interest Expense
(8) Revenue Growth – (2014 Revenue/2013 Revenue) -1

Note 1 –this ratio cannot be calculated.

The above ratio analysis indicates that SableTel is not performing as well as its peers, both from an operational (income statement) point of view and from a financial condition (statement of financial position) point of view. The analysis also indicates that SableTel's financial condition has deteriorated over the past year. This assessment is based on the following:

- Profitability Ratios – SableTel's return on equity ratio is below the industry average and after adjustments it is negative. This indicates that SableTel is not earning an adequate return for its shareholder (StarNova). StarNova has indicated that it typically expects all of its investments to earn a rate of return above the investee's weighted average cost of capital (WACC). SableTel is not earning a return that is anywhere close to this. As well, after the 2014 adjustments, SableTel's ratios have deteriorated significantly from 2013 due to the large loss in 2014.
- Margin Analysis – SableTel's margin analysis indicates that it is earning a gross margin which is slightly higher than its peers (before adjustments). This margin (before adjustments) is also similar to the prior year. However, its big problem appears to be its high SM&A percentage. This is causing SableTel to have a lower operating profit relative to the industry. SM&A expenses are 6% higher at SableTel then its peers (before adjustments) and after adjustments are almost 22% higher. This is one of the largest reasons for the poor financial results and we should investigate further why this is the case. Some of this will be due to the R&D at SableTel. Relative to the prior year, SableTel appears to have a better SM&A percentage before adjustments. However, this amount relates to the reversal of the R&D expenditures related to the Wireless Technology Project. Once these capitalized expenditures are reversed, the SM&A percentage is significantly higher in 2014 than in 2013.
- Turnover – SableTel is not "turning" its accounts receivable fast enough. This is particularly true with respect to its accounts receivable in 2014 which appear to be abnormally high at August 31, 2014. This has also resulted in a turnover that is considerably worse than the prior year. SableTel appears to be tying up a significant amount of cash in its accounts receivable. If SableTel were able to increase its accounts receivable turnover to the average turnover in the industry it would generate significant additional cash and therefore it would need to borrow less money from StarNova in order to meet the needs identified in its strategic plan. This low accounts receivable turnover may be an indication that SableTel has uncollectible accounts receivable. Further information would need to be obtained to assess the amount for reasonableness and to determine if additional write-offs are required.
- Short-Term Liquidity – SableTel appears to meet the industry norms with respect to its current ratio. This is in part due to the high accounts receivable balance at year end. The ratios are slightly worse than the prior year but all above the industry norms and are acceptable (before adjustments). After the adjustment to write-off a portion of the inventory at year end, the current ratio is worse than the industry average.
- Long Term Solvency – Its interest coverage ratio is worse than the industry average and has deteriorated further in 2014 meaning that it may have trouble meeting its interest payments in the future. This is very troubling and indicates that, without some form of financial assistance, SableTel may not be able to meet its financing obligations in the near future.
- Growth Ratios – The industry has contracted over the past year and SableTel has contracted with the industry. Sales at SableTel have decreased by more than the industry (after adjustments) indicating a loss of market share as well. Note that the 2012 actual sales

figures were not available. These growth ratios should be computed over several years and trends identified and compared with the industry.

Dan's comments and the ratios presented to the StarNova Executive Committee are at the very least not informative and may even be misleading. The three ratios provided to the Executive Committee in Dan's presentation all essentially report the same information. All compare the net income of SableTel relative to some other balance and therefore, since SableTel initially reported an increase in net income, appear to be better in 2014 than in 2013. However, none of the ratios presented explain anything to do with the financial condition of SableTel or how SableTel compares with its peers in the industry.

There are other ratios and indicators that may provide significantly enhanced information for the Executive Committee as well. For example, SableTel should monitor and track ratios such as the following which are all common indicators within the telecommunications industry:

- Churn Rate – new customers/customers lost
- Customer Mix - % of small customers vs. % of large customers
- Capex Intensity – total capex (i.e. capital expenditures)/total revenues

Budget Analysis

Finance
(will be broken down into multiple assessment opportunities by the BOE)

The candidate discusses the budget.
The candidate demonstrates competence in Finance.

CPA		CPA Competency Statement	Core	Elective
5.1.2		Develops or evaluates financial proposals and financing plans	B	A
3.2.2		Prepares, analyzes, or evaluates operational plans, budgets and forecasts	A	N/A

The analysis which follows takes the 2015 budget as presented by Dan Wilson on slide 7 in his presentation to the EC (Column 1 below) and makes reasonable adjustments to the financial statement line items (Column 2 below) and finally comes up with a revised or adjusted budget (Column 3 below). Note that in all cases I have made some assumptions and further information should be obtained and analyzed before this budget is finalized. As well the budget needs to be "married" with the other components of the strategic plan to ensure they are consistent.

All items are in thousands of dollars.

Item Description	SableTel 2015 Budget (unadjusted)	SableTel 2015 Budget adjustments	SableTel 2015 Budget (adjusted)
Revenue (see Note 1)	$ 75,400	$ (9,350)	$ 66,050
Cost of sales (see Note 2)	33,930	(2,226)	31,704
Gross profit (see Note 2)	41,470	(7,124)	34,346
SM&A and interest (see Note 3)	37,250	(750)	36,500
Profit (loss)	$ 4,220	$ (6,374)	$ (2,154)
Depreciation (given)	7,500		7,500
Capital Expenditures (given)	(32,000)		(32,000)
Cash Flow	$ (20,280)	$ (6,374)	$ (26,654)
Gross Margin	55%	N/A	52%

Assumptions and support for adjustments

Note 1 - Revenues

The forecast shows projected revenues increasing by 15.9% in 2015 (this is before we adjust the revenues for the government grant in 2014). In 2014 sales at SableTel decreased by 0.2% before adjustments and by 4.4% after adjusting for the Industry Canada grant received. As well, the average revenue increase within the industry is forecasted to be 1.5% for 2015. Therefore it seems unlikely that SableTel will increase sales by 15.9% over the next year. As well, SableTel has lost one of its long time sales staff (Mr. Oldmun) which may result in further customer losses. Further indications that sales may be lower in 2015 are that SableTel has lost two big customers in 2014 and the fact that its mobile network is currently disabled and likely not earning any revenues.

However, there are some factors that may mitigate decreased sales, including the implementation of the more flexible pricing policy that will likely increase the sales group's success. Also, the fact that many new sales people are to be hired and trained needs to be considered.

After considering all of the above, I have projected that SableTel will increase sales by 1.5% over the next year consistent with the forecast in the industry. This requires a decrease in the sales projected of $9,350,000.

We will have to monitor sales effectiveness closely over the next several months in order to determine if these projections need to be revised further as this 1.5% may not materialize under the current strategy.

Note 2 - Cost of sales and gross margin

It is difficult to predict what the gross margin and therefore the cost of sales will be over the next year. On the one hand, competition is increasing and the industry gross margin has been decreasing over the past two years. On the other hand, SableTel is developing new technology that may significantly increase its margin. However, the Wireless Technology project will not be ready until 2016 and therefore will not affect the margin in fiscal 2015.

I have estimated that the gross margin will be 52% in 2015. This margin is close to the industry average for 2014 and also approximates SableTel's gross margin in 2014 once the effect of the government grant is removed from the gross margin calculation. Note that SableTel's gross margin, after all accounting adjustments would actually be less than 46% but this includes a one-time charge for inventory obsolescence which is not expected to be repeated in the future.

It is also not clear what impact the "non-standard" pricing policy will have on SableTel. This has not been factored into my analysis but could have a substantial negative impact on the margin for 2015. However, it is expected that any lost margin would be made up through increased sales so the net effect may be minimal.

Note 3 - Expenses

SM&A and interest expenses in 2014 totaled $33,179,355 before any adjustments. This amount was artificially low due to the Wireless Technology Project expenditures that were capitalized. For 2014 a more normalized expense total would have been approximately $42 million ($33 million plus the 2013 and 2014 research and development expenditures that were incorrectly capitalized in 2014).

One big question that remains is whether the Wireless Technology Project will meet the criteria for capitalization in 2015. Assuming that it does then the expenses for 2015 should be about $36.5 million ($42 million in 2014 less $9 million in R&D expenses (the expenses would be capitalized in 2015) plus 2% for inflation, plus additional staff estimated at 31 new staff at about $60K per staff member plus the new bonus plan estimated at $1 million). Therefore, I have decreased the budgeted expenses to $36.5 million for the year ended August 31, 2015 based on this analysis.

If the Wireless Technology Project expenditures are not capitalized then the expenses would likely be closer to $60 million. Note that whether these expenses are capitalized or expensed will not have any effect on the cash flow for SableTel and on the amount of financing that SableTel requires.

Other Amounts

No other amounts have been considered in the budget from a cash flow perspective. For example, SableTel had a large amount of accounts receivable on its books at August 31, 2014. If it can turn these accounts receivable into cash in 2015 and reduce its accounts receivable balance to more acceptable levels, then the amount of financing required from StarNova may be

reduced. Other working capital changes have also not been figured into the cash flow analysis and could influence the amount of funding required.

Summary of Adjusted Budget and Capital Requirements

The revised cash flow projections show that there will be a need for additional capital above the amount budgeted. The amount of funding required for SableTel for its 2015 fiscal year is estimated to be almost $27 million. The projections should be extended beyond 2015 to ensure that 2016 and future years will provide adequate free cash flow to justify the expenditures on the Wireless Technology Project. This work needs to be performed no matter which source of additional funding is selected. (See estimated Cash flows below.)

Estimated NPV of future cash flows generated:

	2015adj	5%	no chg	2016	2017	2018	2019	2020	2021
rev	$66,050	$75,400	$75,400	$75,590	$82,708	$82,708	$82,708	$82,708	$82,708
cos	$31,704	$32,422	$36,192	$32,504	$35,564	$35,564	$35,564	$35,564	$35,564
margin	$34,346	$42,978	$39,208	$43,086	$47,143	$47,143	$47,143	$47,143	$47,143
	52%	57%	52%	57%	57%	57%	57%	57%	57%
SM&A	$36,500	$36,500	$36,500	$37,230	$37,975	$38,734	$39,509	$40,299	$41,105
Depr.	-$24,500	-$24,500	-$24,500	$7,500	$7,500	$7,500	$7,500	$7,500	$7,500
Tot expenses	-$61,000	-$61,000	-$61,000	-$29,730	-$30,475	-$31,234	-$32,009	-$32,799	-$33,605
SubTotal	-$26,654	-$18,022	-$21,792	$13,356	$16,669	$15,909	$15,135	$14,344	$13,538
projected Net income loss	-$2,154	$6,478	$2,708	$5,856	$9,169	$8,409	$7,635	$6,844	$6,038
depreciation	$7,500	$7,500	$7,500	$7,500	$7,500	$7,500	$7,500	$7,500	$7,500
cash flow	$5,346	$13,978	$10,208	$13,356	$16,669	$15,909	$15,135	$14,344	$13,538
recurring Capital exp.	$4,000	$4,000	$4,000	$4,000	$4,000	$4,000	$4,000	$4,000	$4,000
projected Cash Flow	$1,346	$9,978	$6,208	$9,356	$12,669	$11,909	$11,135	$10,344	$9,538
PV Factor			0.8696	0.7561	0.6575	0.5718	0.4972	0.4323	0.3759
project worth	PVCF		$5,398	$7,075	$8,330	$6,809	$5,536	$4,472	$3,586
	$41,206		1	2	3	4	5	6	7
			15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%

Is the Budget Likely to be Achieved (looking at finance perspective only)?

The adjusted 2015 budget indicates that the budget as set out by Dan is not achievable and SableTel will not be profitable in 2015. Significant changes will need to be made in order for SableTel to become profitable. SableTel should take immediate actions to either increase sales and/or to decrease expenses in order to become profitable. It cannot afford to wait for the benefits associated with the Wireless Technology Project which at this point in time are not proven.

Should StarNova continue to support SableTel and its Wireless Development Project then it must find a financing source to fund SableTel. Potential sources of funding that should be explored are StarNova, through funding from its other profitable operations, or external funding such as an issue of additional shares by StarNova, or debt financing based on the projected cash flows that will prove out the investment. As well, SableTel could generate additional cash flow by improving the collection cycle for its accounts receivable.

Finance
(will be broken down into multiple assessment opportunities by the BOE)

The candidate calculates the value of SableTel's shares in order to estimate the cash inflow from the projected initial public offering.

The candidate demonstrates competence in Finance.

CPA		CPA Competency Statement	Core	Elective
5.2.5		Evaluates the entity's cost of capital	B	A
5.4.2		Applies appropriate methods to estimate the value of a business	B	A

Required: In order to raise the money needed for the Wireless Technology Project, Star Nova is contemplating an initial public offering of SableTel's shares. According to the plan, the public would own 30 % of SableTel's voting and participating shares.

The business valuation performed will be from the new shareholders' perspective. I will determine the theoretical value new shareholders should be willing to pay for their 30 % stake in SableTel.

From their perspective, the relevant future cash flows to take into account are the "free cash flows to equity", i.e. the operating cash flows (after interests), less the annual required recurring capital investments. The relevant discount rate to be used is the cost of SableTel's equity financing, since the new shareholders bear more risk than the creditors, their required rate of return is therefore higher.

The following calculation shows the costs of each of SableTel's financing sources, along with the determination of its weighted average cost of capital:

Weighted average cost of capital

Source of funds

	Amount	Weight	Cost (note)	Weighted cost
Long term debt	53 352 572 $	66,95%	4,20%	2,81%
Common shares	26 338 280 $	33,05%	15,00%	4,96%
	79 690 852 $			**7,77%**

Note:

Long term debt: Since the interests totaled 2 967 650 $ in 2014 on a 53 352 572 $ debt balance, the rate is estimated at 5,6 %. Assuming a tax rate of 25 % (combined federal and provincial), the cost of long term debt would be 4,2 % (5,6 * 75 %). {candidates could calculate average debt rather than y/e}

Common shares: Using the CAPM, the cost is 1% + (1,75 * 8%) = 15 %

These calculations ignore the tax for the moment. Using the revised budgeted amounts presented above, I have estimated the following operating cash flows for 2015:

	Projected net income	- 2 154 000 $
Add:	Depreciation expense	7 500 000
	Projected cash flows from operations	**5 346 000 $**

Assuming a recurrent amount of 4 million $ of capital expenditures (SableTel's capital expenditures totaled 4 390 000 $ in 2014 excluding investments in the non-recurring Wireless Technology Project), the cash flows to equity are estimated to be a yearly amount of approximately 1.4 million $.

Since the required rate of return estimated for SableTel's shares is 15 % as calculated above, the market should normally be willing to pay 9.3 million $ (1.4 million / 15 %) for 100 % of SableTel's shares.

A 30 % stake would then be worth 2.8 million $.

This amount is very small, considering the large costs associated with an IPO (prospectus, legal fees, compliance requirements, etc.). Furthermore, the amount obtained is far from reaching the required amount of 22 million $ to fund the remaining costs of the project.

I strongly recommend not pursuing an IPO at this time.

Finance
(will be broken down into multiple assessment opportunities by the BOE)

The candidate evaluates SableTel as a going concern to determine if the offer made to Star Nova for the assets should be accepted.

The candidate demonstrates competence in Finance.

CPA		CPA Competency Statement	Core	Elective
5.6.1		Evaluates the purchase, expansion, or sale of a business	B	A
5.4.2		Applies appropriate methods to estimate the value of a business	B	A

To evaluate the assets, we will use two different approaches. First, we will calculate the value of the assets based on their capacity to generate future operational cash flows. In the second approach, we will capitalize an estimate of SableTel's normalized net income.

Method #1:

We will calculate the value of SableTel's assets by discounting the operational cash flows available to all shareholders. The projected EBITDA will be used to make this calculation, to which we will deduct the recurring capital expenditures required. The discount rate will be the weighted average cost of capital, since the purpose is to determine the value of the operating assets, regardless of the way they were financed.

Using the revised budgeted amounts presented in a different section of this report, I have estimated the following EBITDA for 2015:

	Projected net income	- 2 154 000 $
Add:	Interest expense	2 968 000
Add:	Depreciation expense	7 500 000
	Projected cash flows from operations	**8 314 000 $**

Assuming a recurrent amount of 4 million $ of capital expenditures (SableTel's capital expenditures totaled $4,390,000 in 2014 excluding investments in the non-recurring Wireless Technology Project), the cash flows to equity are estimated to be a yearly amount of approximately $4.3 million.

Since Sabletel's WACC is 7.77 % as calculated above, the market should normally be willing to pay $55.3 million ($4.3 million / 7.77 %) for 100 % of SableTel's assets. Since the sale does not include the office furniture, computers and related application software at its leased office space

at its head office, we should therefore subtract the estimated value of these assets from the value of $55.3 million obtained above.

Method #2:

We will calculate the value of SableTel's assets by capitalizing SableTel's normalized net income before interest. To estimate this normalized income, we will use the revised 2014 net income as a starting point (including all the accounting adjustments discussed above), and then remove all non-recurring items.

Revised net income for 2014	(13 143 223) $
One-time items, non-recurring:	
Expenses linked with the Wireless Technology Project	9 160 250 $
Impairment of towers due to hurricane	2 100 000 $
Write-down of obsolete inventory due to over-purchasing	2 539 572 $
Interest expense	2 967 650 $
Normalized net income	**3 624 249 $**

Using a capitalization rate of 7.77 % (SableTel's WACC), the value of its assets is 46.6 million $. Again, since the sale does not include the office furniture, computers and related application software at its leased office space at its head office, we should therefore subtract the estimated value of these assets from the value of 46.6 million dollars obtained above.

The price offered is a good starting point for the negotiation process. Since SableTel's main source of revenues (long distance) is on a downward trend, and that the business hasn't been generating the required rate of return for StarNova in the past years, I recommend selling SableTel's assets at a price slightly above the amount offered.

Finance
(will be broken down into multiple assessment opportunities by the BOE)

The candidate analyzes the Wireless Technology Project to determine if SableTel/StarNova should continue to fund this project.

The candidate demonstrates competence in Finance.

CPA		CPA Competency Statement	Core	Elective
5.1.1		Evaluates the entity's financial state	A	A
5.1.2		Develops or evaluates financial proposals and financing plans	B	A
5.6.1		Evaluates the purchase, expansion, or sale of a business	B	A

Dan's presentation to the EC included some details on the "Wireless Technology Project" which it would appear is forming a significant portion of SableTel's strategic plan for the future.

From a financial perspective we know the following:

- SableTel has spent a total of $9,160,250 in 2013 and 2014 on this project
- SableTel plans to spend an additional estimated $20 million in 2015 to fund the this project (and another $2 million likely in 2016)
- Once the project is complete, margins are expected to improve by 5% for all products and services

For the purposes of this analysis (i.e. whether SableTel should continue to fund the project) the costs that have already been incurred in 2013 and 2014 are irrelevant as they are sunk costs. Therefore the only relevant costs are the estimated $22 million to be incurred in 2015 and 2016.

The benefits will be an estimated increased margin of 5% on all products and services. Using estimated revenues of $65 million (revenues for both 2013 and 2014 were approximately $65 million and revenues in 2015 are expected to be approximately $66 million) then the increased margin on an annual basis would be $3,250,000.

Pursuing the project would also avoid having to reimburse Industry Canada's 2,750,000 $ grant. The net cost of continuing the project is therefore 19,250,000 $.

The following table shows the calculation of the net present value of the project. The discount rate used is Sabletel's WACC of 7.7 %, plus a risk premium of 3 % to account for the riskier nature of the project. The discount rate is therefore 10.7 %.

I have assumed that, considering the fast obsolescence of technology in the telecommunications industry, the annual cash flows caused by the project would last 5 years.

I could have tax affected my calculations, but I have not bothered because all of the cash inflows are taxable, and all of the tax outflows are deductible (assuming that the cost of 22 million $ qualifies as R&D expenditures). All investment tax credits that could be obtained would increase the NPV calculation.

Cash outflows:		
	Future outflows required	(22,000,000 $)
Minus:	Saved refund to Industry canada	2,750,000 $
	Net cash outflow	(19,250,000 $)
Cash inflows:		
	5 yearly cash inflows of 3 250 000 $ discounted at a 10,7 % rate	13,395,700 $
Net present value		**(5,854,300 $)**

Based on quantitative factors alone, the Wireless Technology Project should be abandoned.

There are also some additional qualitative factors which should be taken into consideration:

1. Technology – SableTel operates in an industry where technology changes quickly. Therefore the timeframe to recoup the costs associated with a project such as this needs to be relatively short. It is possible that SableTel has already committed to some significant expenditures associated with this project. If this is true then these amounts would need to be factored into the analysis (i.e. the sunk costs may increase and the $22 million of relevant costs may decrease leading to a higher NPV). [The EC should consider the strategic reasons for making the investment—if the shift to wireless is important to SableTel's future, that may be a sufficient reason on its own to proceed. I have been asked to consider the finance side only.]

2. The $22 million in costs is an estimate only and may increase or decrease as the project proceeds. This adds additional risk to the project from a financial assessment perspective.

3. As with all projects in the technology area, there would be substantial technological risks that the project would not lead to the desired outcomes. That is the technology is not proven and the project may not generate the expected 5% increase in margin for all products and services. However, the higher discount rate has taken this uncertainty into account.

4. In recent years, SableTel and the telecommunications industry in general has experienced decreasing sales. Decreasing sales would mean that the benefits of the project would continue to diminish over time.

   One final note is that SableTel is expecting an independent feasibility study to be completed on the project within the next 60 days. This may mitigate some of the qualitative risk factors noted above and provide better information for this analysis.

Recommendation

I recommend that SableTel and StarNova wait for the feasibility study which is expected within the next 60 days. Once that study is received, SableTel and StarNova should weigh all the costs, benefits and risks to determine if they should proceed with the project. From the preliminary information available I would not recommend proceeding with the project as the projected benefits and payback of over six years do not justify the significant risks involved.