

## QUESTION

100 marks

Simunye Mines Ltd ('Simunye') is a global precious metals mining group listed on the Zimbabwe Stock Exchange. The group mines a mix of metals that includes platinum group metals (PGMs) and gold, as well as related products. The head office is situated in Zimbabwe. Simunye owns and operates assets across Zimbabwe through various subsidiaries. It also has PGM operations in the United States of America (USA).

The group's financial year end is 30 June.

### 1 Group results for FY2020

Simunye has been affected by drops in commodity prices, leading to profit pressures and a declining share price. The group's directors have expressed concern about Simunye's liquidity, as cash could only be generated by raising external funding and by selling investments, rather than through internally generated cash flow.

Simunye incurred a net loss after impairments of ZWL2 521 million in the financial year ended 30 June 2020 (FY2020) (FY2019: ZWL4 433 million loss). The USA PGM operations accounted for almost half of the group's EBITDA in FY2020.

Despite a flat average gold price year-on-year, the impact of safety incidents (e.g. miners trapped underground during power outages) and prolonged strike action caused production from the gold operations to decrease by 7 034 kg. This resulted in EBITDA from the gold operations declining by 74% to ZWL1 362 million.

In view of the underperformance of the gold operations over the past couple of years, management is concerned about the continuous reliance on the PGM operations, with the gold business eroding value and placing pressure on the group's liquidity. Management is therefore considering entering into discussions with key trade unions to restructure the gold operations.

### 2 Financing activities

On 6 October 2019 Simunye had announced that it had refinanced its credit facility. The new facility was ZWL60 000 million, increasing from ZWL35 000 million. The new credit facility replaced the old credit facility, which would have matured on 23 February 2020. The debt covenants, however, were not amended in the refinancing terms. The debt covenants are as follows:

- A net debt to reported EBITDA ratio of 3.5 : 1 or less up to 30 June 2021 (thereafter the ratio has to be 2 : 1 or less), and
- An interest coverage ratio (reported EBITDA to net finance charges) of at least 2 : 1.

At 30 June 2020 Simunye's debt to EBITDA ratio was 2.5 : 1, the interest cover was 4.9 and the group borrowings amounted to ZWL33 769 million (FY2019: ZWL25 206 million and FY2018: ZWL7 221 million).

Simunye's dividend policy has historically been to pay out at least 25%, but up to 35%, of earnings to shareholders. The group did not declare or pay a dividend during the year under review.

### 3 Going concern assessment

The consolidated financial statements of Simunye have been prepared in accordance with International Financial Reporting Standards (IFRSs). The directors have indicated that they believe that the group has adequate resources to continue as a going concern for the foreseeable future.

In order to accommodate a potential breach in debt covenant ratios resulting from the impact of a strike in the gold operations, Simunye might have to request a temporary debt covenant amendment allowing for no debt covenant measurements for FY2021. However, no agreement has been reached yet.

#### Going concern forecasts for Simunye Motorised Services (Pvt) Ltd ('SMS')

The Simunye group amongst others includes SMS, a wholly-owned subsidiary that produces and supplies mining trucks and motorised equipment. SMS has not been performing well in the difficult trading conditions and recorded a loss before taxation in FY2020.

The forecasts for FY2021, FY2022 and FY2023 have been drafted by the financial manager for review by the directors, to assess whether SMS will have sufficient resources to continue operations for the next 12 to 36 months. Explanations and assumptions for the forecast are provided below, but it is uncertain whether these assumptions are complete and accurate. The financial manager also provided a summary of the forecast profitability and financial positions of SMS. All the castings in the information provided below are correct.

Profitability – SMS	Notes	Actual 2020 ZWL million	Forecast 2021 ZWL million	Forecast 2022 ZWL million	Forecast 2023 ZWL million
<b>Revenue</b>	a	11 302	12 206	13 426	15 038
Cost of sales		(9 775)	(10 436)	(11 345)	(12 481)
<b>Gross profit</b>		1 527	1 770	2 081	2 557
Foreign currency exchange gains	b	224	250	250	250
Other operating income	c	193	220	255	300
Operating expenses	d	(1 572)	(1 666)	(1 750)	(1 837)
<b>EBITDA</b>		372	574	836	1 270
Depreciation		(178)	(193)	(194)	(203)
Impairments		(65)	–	–	–
<b>Profit from operating activities</b>		129	381	642	1 067
Annual change in revenue	e	(13,2%)	8,0%	10,0%	12,0%
Gross profit margin	e	13,5%	14,5%	15,5%	17,0%
Annual change in operating expenses	e	7,7%	6,0%	5,0%	5,0%
EBITDA margin	e	3,3%	4,7%	6,2%	8,4%

Cash flow forecasts – SMS	Notes	Actual 2020 ZWL million	Forecast 2021 ZWL million	Forecast 2022 ZWL million	Forecast 2023 ZWL million
<b>Profit from operating activities</b>		129	381	642	1 067
Adjustments for:					
Depreciation		178	193	194	203
Impairments		65	–	–	–
Gain on disposal of property		(17)	(88)	–	–
Other non-cash items		(19)	3	7	6
Interest income		12	14	14	17
Finance charges		(335)	(358)	(338)	(300)
Taxation paid	f	(9)	(10)	(89)	(220)
<b>Working capital movements</b>					
Inventories		(282)	(147)	(212)	62
Trade and other receivables		(34)	(4)	64	(131)
Prepayments		(6)	(5)	(3)	(5)
Trade and other payables		(57)	145	317	389
Deferred income		65	35	41	55
<b>Cash generated by operations</b>		(310)	159	637	1 143
Purchase of plant and equipment	g	(198)	(220)	(250)	(280)
Disposal of plant and equipment	g	32	150	–	–
		(476)	89	387	863
Interest-bearing liabilities raised		535	179	–	–
Interest-bearing liabilities repaid		(275)	(5)	(250)	(500)
Bank overdraft		24	(198)	–	–
Dividends paid	h	–	–	(200)	(220)
<b>Net change in cash and cash equivalents</b>		(192)	65	(63)	143
Cash and cash equivalents at beginning of year		376	184	249	186
<b>Cash and cash equivalents at end of year</b>		184	249	186	329

Financial position – SMS	Notes	Actual 2020 ZWL million	Forecast 2021 ZWL million	Forecast 2022 ZWL million	Forecast 2023 ZWL million
Property, plant and equipment		1 329	1 294	1 350	1 427
Other non-current assets		578	578	578	578
Inventories	i	5 857	6 004	6 217	6 155
Trade and other receivables		1 396	1 400	1 336	1 468
Prepayments		48	52	55	60
Cash and cash equivalents		184	249	186	329
<b>Total assets</b>		9 392	9 577	9 722	10 017
Equity		3 651	3 676	3 706	4 050
Interest-bearing borrowings	j	3 326	3 500	3 250	2 750
Deferred income	k	380	415	456	511
Deferred taxation		46	46	46	46
Trade and other payables		1 713	1 858	2 176	2 565
Provisions		78	82	88	95
Bank overdraft		198	–	–	–
<b>Total equity and liabilities</b>		9 392	9 577	9 722	10 017

## Notes to the forecasts

- (a) SMS's main customers are in the mining and construction industries. Both these industries have suffered in recent times due to the impact of Covid-19, volatile commodity prices, rising direct labour costs, government policy uncertainty, etc. SMS expects that trading conditions will improve in FY2021 and revenue growth will improve to 12% in FY2023.
- (b) SMS imports a certain range of machinery for resale. The treasury division of SMS has been very successful in the past in predicting currency movements and has regularly made profits on trading in foreign currencies. Management expects this to continue for the foreseeable future.
- (c) SMS sells extended warranties (on terms exceeding 12 months) over most of its product range. Income from these warranties is recognised as other operating income. There are no other sources of other operating income.
- (d) Operating expenses are forecast to increase by 6% in FY2021 and thereafter by 5% per annum, the expected inflation rate in Zimbabwe.
- (e) These ratios have been correctly calculated.
- (f) SMS had a tax loss available for set off against future taxable income of ZWL120 million at 30 June 2020; this has been disregarded in the forecast cash flows to be conservative. Forecast taxation has been calculated as 28% of profit before taxation based on Zimra's expected rate of taxation from 2021 onwards.
- (g) SMS will keep investing in plant and machinery to ensure that its manufacturing operations remain globally competitive.
- (h) SMS expects to resume paying dividends in FY2022 as profitability improves.
- (i) SMS is placing intense focus on reducing and managing inventory levels given that this is a major asset by value on its statement of financial position. SMS expects to reduce inventory days to 180 (based on year-end balances) by FY2023.
- (j) Interest-bearing borrowings are secured by a pledge over inventory and trade and other receivables as well as a guarantee by Simunye. SMS is hoping that its bankers will continue to support its turnaround strategy and actions and it plans to reduce debt levels steadily over the next couple of years.
- (k) Deferred income relates mainly to the warranty income received in advance, recognised over the period of the warranties.

### 4 Valuation of SMS

The directors of Simunye are considering the sale of SMS to fund their core mining operations.

They have indicated that they would like to value SMS as at 30 June 2020 using the discounted cash flow method, based on the forecast information provided above. Relevant information for the valuation is as follows:

- Cost of equity of 20%;
- Target debt to equity ratio of 1 : 1;
- Average pre-tax cost of debt of 14%; and
- The expectation that free cash flows will grow by 5% per annum after FY2023.

Companies similar to SMS have recently been sold on a 4 x EBITDA multiple.

## 5 FY2020 audit of the Simunye group

KPW Auditors ('KPW') has been re-appointed as the auditors of the Simunye group and are busy with the FY2020 year-end audit.

The following audit workpapers have been prepared:

<b>Workpaper description</b>	<b>Reference</b>
System description: Payroll system for mine workers' weekly wages for all mining operations	J-102
Audit of salaries and wages: Operating effectiveness of weekly wage controls	L-106
Audit procedures: Extract of occupational healthcare obligation	D-103

<b>Client:</b> Simunye Mines Ltd	<b>Year end:</b> 30 June 2020	<b>J-102</b> <b>Page 1/2</b>
<b>Prepared by:</b> L Castillo	<b>Date:</b> 15 May 2020	
<b>Reviewed by:</b>	<b>Date:</b>	
<b>Subject:</b> System description: Payroll system for mine workers' weekly wages for all mining operations		

## Background

With Simunye employing more than 45 000 full-time employees, salaries and wages represent a large proportion of the group's annual expenditure. A combined audit approach was once again adopted to gather audit evidence about the salaries and wages class of transactions for FY2020. All general controls at Simunye have been tested and were found to be operating effectively.

During the audit planning phase, Simunye's weekly wages process was summarised as follows:

### System description

Simunye continues to make use of *MyPay*, an in-house developed software package developed to maintain all employee data, including mine workers' attendance and payroll records.

#### 1 Maintenance of mine workers master file

All master file amendments are recorded on pre-printed, pre-numbered masterfile amendment forms (MAFs). The human resources (HR) manager prepares and signs MAFs for capturing. These are authorised by the Financial Director, after a review of the supporting source documentation. Each MAF must be signed as proof of the review and authorisation. Thereafter, the MAFs are captured by members of the HR department on the *MyPay* system. The system is controlled by stringent access controls.

Each year the HR manager uses a board resolution passed by Simunye's Board with respect to wage percentage increases for each pay grade to prepare the necessary MAFs.

All master file amendments are automatically logged by *MyPay* in number sequence, and the amendment logs are appropriately reviewed and signed by the Financial Director, who also conducts sequence checks of MAF logs.

#### 2 Mine worker identification and time-keeping of hours worked

Biometric thumb print data, stored per employee on Simunye's electronic employee master file, are used at each mine shaft. Access to the recording of the biometric data on *MyPay* is restricted by means of appropriate logical access controls.

Due to the dangers inherent in the mining environment, there is only one access point for entry/exit for the mine workers at every shaft. When entering or exiting the mine shaft, a biometric device scans the mine worker's thumbprint before activating a turnstile. Only one mine worker may enter or exit at a time. Two security personnel are present at the access point of each shaft to observe unsuccessful attempts to gain entry to or exit from the access point and also to observe miners as they walk through an electronic x-ray scanning machine designed to identify theft of valuables upon exit.

All biometric data are linked to the time-keeping module of the *MyPay* system, which logs the date, time and details of the shaft where the scanning took place. The system automatically calculates the hours worked by each mine worker for each day.

<b>Client:</b> Simunye Mines Ltd	<b>Year end:</b> 30 June 2020	<b>J-102</b> <b>Page 2/2</b>
<b>Prepared by:</b> L Castillo	<b>Date:</b> 15 May 2020	
<b>Reviewed by:</b>	<b>Date:</b>	
<b>Subject:</b> System description: Payroll system for mine workers' weekly wages for all mining operations		

### 3 Review of mine workers' attendance and approval of hours logged

*MyPay* produces an 'entry and exit' log for each shaft on a weekly basis. This detailed access log is reviewed on a weekly basis by each shaft manager and they follow up on unexplained activities noted, in a timely manner. The log includes details of late arrivals, absent employees and unexplained exits from the mine shaft.

Every Friday, a 'total hours worked schedule' is generated from *MyPay*, reflecting normal and overtime hours per mine worker for the week. Each shaft manager approves the schedule by signing it after scrutinising –

- that there are data for all the employees;
- that any days missed correspond to the biometric logs generated by the access device; and
- any incorrect or unexpected hours recorded, such as low hours, hours per week exceeding 45 (which is the average for the mining industry) or high overtime hours logged.

With regard to overtime hours worked, each shaft manager confirms the validity by signing off on the hours that were authorised by him prior to being worked. He also follows up on unauthorised hours reflected – thus the hours for which pre-approved permission had not been obtained.

<b>Client:</b> Simunye Mines Ltd	<b>Year end:</b> 30 June 2020	<b>L-106</b> <b>Page 1/1</b>
<b>Prepared by:</b> O Hampton (1 <sup>st</sup> year trainee)	<b>Date:</b> 8 July 2020	
<b>Reviewed by:</b>	<b>Date:</b>	
<b>Subject:</b> Audit of salaries and wages: Operating effectiveness of weekly wage controls		
<b>Control area</b>	<b>Audit procedures to test operating effectiveness of key controls</b>	
Maintenance of mine workers master file	<ol style="list-style-type: none"> <li>1 For a sample of 15 MAFs – <ul style="list-style-type: none"> <li>• inspect for the signatures of the HR manager, as well as the date on which it was reviewed, as evidence that the check has been performed on a timely basis;</li> <li>• inspect for the signature of the Financial Director, as evidence of her review and approval;</li> <li>• if related to a pay increase, agree the information on the MAF to the minutes of the Simunye Board meeting at which the increase was approved; and</li> <li>• inspect that the details of the new pay increase on the MAFs correspond to the staff members' permanent file details as well as to their payslips.</li> </ul> </li> <li>2 Inspect the sequential numbering of the MAFs, run an exception report for missing numbers and follow up on it.</li> <li>3 Using data computer assisted audit techniques, extract a list of duplicate employees' names / ID numbers of mine workers at Simunye.</li> </ol>	
Mine worker identification and time-keeping of hours worked	<ol style="list-style-type: none"> <li>1 Observe that mine workers are able to gain access to the mine shaft only after their thumb print has been scanned by the scanning device, and <ul style="list-style-type: none"> <li>• observe that upon exit they are required to walk through an x-ray scanning machine; and</li> <li>• review the screen to confirm the machine is operational.</li> </ul> </li> <li>2 Observe security staff reviewing mine workers using the biometric access system upon both entry and exit and confirm by inspection that there is only one access point to a mine shaft.</li> <li>3 For selected mine workers being scanned in and out, record their details and follow these activities to the relevant 'entry and exit' logs to confirm correct recording thereof.</li> </ol>	
Review of mine workers' attendance and approval of hours logged	<ol style="list-style-type: none"> <li>1 Enquire of the shaft manager of a selected shaft, the process he follows to review the 'entry and exit' logs and to investigate unexplained activity.</li> <li>2 Inspect a random sample of logs for evidence of review by the shaft manager.</li> <li>3 For a sample of the 'total hours worked' schedule – <ul style="list-style-type: none"> <li>• inspect the schedule for evidence of unusual hours worked (such as normal hours &gt; 45 hours or high overtime) and verify the accuracy thereof;</li> <li>• trace hours worked for a sample of mine workers on the schedule to system-generated attendance reports to confirm the accuracy thereof; and</li> <li>• inspect the schedules for the signatures of the shaft manager as evidence of review.</li> </ul> </li> </ol>	



<b>Client:</b> Simunye Mines Ltd	<b>Year end:</b> 30 June 2020	<b>D-103</b> <b>Page 1/1</b>
<b>Prepared by:</b> L Castillo	<b>Date:</b> 14 June 2020	
<b>Reviewed by:</b>	<b>Date:</b>	
<b>Subject:</b> Audit procedures: Extract of occupational healthcare obligation		

## Background

Simunye was served with two class action lawsuits during FY2013 and FY2015 by attorneys representing mine workers who allegedly contracted lung diseases while employed by Simunye.

These class actions were disclosed as follows in Simunye's FY2019 audited annual financial statements:

### **Contingent liabilities**

*Currently, due to uncertainties regarding the pending claims against the group, no reliable estimate can be made of the potential outcome, nor the length of time until the matter is finalised.*

During the planning phase of the FY2020 audit, management informed the audit team that the obligation has now become probable and an estimate has been determined.

In determining the value of the obligation as computed by an actuarial expert, the following variables were taken into account:

- Expected outcome of the lawsuit;
- Expected value of the benefits awarded to the plaintiffs;
- Expected timing of the settlement; and
- Estimated number of employees exposed.

The discount rate is equal to the risk-free rate.

	<b>2020 ZWL million</b>
Occupational healthcare obligation	1 077,2
Interest charge	46,4
Change in estimate	29,7
Balance at year end	1 153,3

The following audit procedures have already been performed by the audit team:

- Cast and cross cast all schedules and calculations obtained from the client.
- Amounts have been agreed from the general ledger to the trial balance.
- A signed management representation letter has been obtained from the management of Simunye.
- All minutes of meetings have been inspected for discussions relevant to the contingent liability and the health care obligations.

**INITIAL TEST OF COMPETENCE, NOVEMBER 2020**

**PROFESSIONAL PAPER 2**

**This question consists of two parts. Answer each part in a separate answer book.**

<b>PART I – REQUIRED</b>		<b>Mark</b>	
		<b>Sub-total</b>	<b>Total</b>
(a)	Critically evaluate the cash flow forecasts of SMS prepared to assess the company's going concern ability.  <i>Communication skills – appropriate style</i>	14  1	  15
(b)	Perform a discounted cash flow valuation of Simunye's equity interest in SMS as at 30 June 2020.  <ul style="list-style-type: none"> <li>• Use the free cash flow to operations method.</li> <li>• Start your valuation with the 'Net change in cash and cash equivalents' line item.</li> <li>• Assume that the revenue, operating costs and working capital forecasts are reasonable.</li> <li>• Round your answer to the closes million dollars (ZWL).</li> </ul>	22	22
(c)	Describe the actions Simunye could take to address its high gearing levels.  <i>Communication skills – appropriate style</i>	8  1	  9
(d)	(i) Describe the business risks that Simunye is currently facing evident from the scenario; and (ii) Provide a mitigating strategy for each of the risks you described.  <i>Communication skills – layout and structure</i>	8  8  1	   17
<b>Total for part I</b>			<b>63</b>

**INITIAL TEST OF COMPETENCE, NOVEMBER 2020**

**PROFESSIONAL PAPER 2**

**This question consists of two parts. Answer each part in a separate answer book.**

You are a senior trainee on the team assigned to the audit of the 2020 annual financial statements of Simunye.			
<b>PART II – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(e)	Discuss the nature, timing and extent of the further audit procedures that the audit team should follow to obtain sufficient appropriate audit evidence about the appropriateness of the use of the going concern basis of accounting for the preparation of Simunye's 2020 annual financial statements.	10	10
(f)	Based on your review of workpapers J-102 and L-106 criticise the appropriateness and completeness of the proposed audit procedures listed in workpaper L-106.  <i>Communication skills – appropriate style</i>	15 1	16
(g)	Provide the additional substantive audit procedures that should be performed to obtain sufficient and appropriate evidence regarding the occupational health obligation for the 2020 consolidated annual financial statements of Simunye, with reference to workpaper D-103.  Do not include group audit procedures in terms of ISA 600 <i>Audits of Group Financial Statements (Including the Work of Component Auditors)</i> .  <i>Communication skills – appropriate style</i>	10 1	11
<b>Total for part II</b>			<b>37</b>
<b>TOTAL FOR THE QUESTION</b>			<b>100</b>