



The Institute of Chartered Accountants of Zimbabwe

QUALIFYING EXAMINATION
Part II – Financial Management
Question 2
NOVEMBER 2008

TOTAL MARKS – 100
READING TIME – 20 minutes
WRITING TIME – 150 minutes

INSTRUCTIONS TO CANDIDATES

- 1 Enter your examination number on the front of the answer book. Your name must not appear anywhere.
- 2 You are reminded that answers may **NOT** be written in pencil.
- 3 The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and the required depth of the answer.
- 4 Answer the questions using –
 - appropriate arrangement and presentation;
 - clarity of explanation;
 - logical argument; and
 - clear and concise language.**Marks will be awarded for the above.**
- 5 Working papers must be handed in with scripts.

NOTE: The questions in this paper are not intended to reflect the reality of the Zimbabwean economy. Hence reference to exchange rates, interest rates, return on capital, etc., are to be taken at face value and there is an assumption that financial instruments such as foreign exchange contracts will be freely available. Normal tax rate of 30% may be assumed.

QUESTION 2

100 marks

World-wide Workers (Pvt) Ltd (WwW) was established in 1998 by Mr James W. Bend to provide outsourced labour broking services to the hospitality industry in Zimbabwe. The year end of the company is 30 September. Mr Bend had worked as a general manager at various leading European hotels before emigrating to Zimbabwe in 1997. Mr Bend recognised the need of hospitality groups such as hotels, conference venues and casinos, for staff sourced from competent third parties. Outsourcing the recruitment and administration of staff allows hospitality groups to focus on their core businesses.

Mr Bend has been the Chief Executive Officer of WwW since inception of the business. WwW grew rapidly over the period 1998 to 2003 and became a leading human resources provider to the Zimbabwean hospitality industry. Mr Bend sold a 70% shareholding in WwW to Barbarians Investments (Pvt) Ltd (Barbarians) in 2004. The shareholders of Barbarians are high net worth individuals who want to invest in high growth private companies with a view to exiting these investments via a listing on the Zimbabwe Stock Exchange (ZSE) or selling their interests to strategic buyers or private equity funds.

Introduction of a partner

iSiswe Ltd (iSiswe), an investment company wholly owned by prominent businesspersons, acquired a 26% shareholding interest in WwW in 2006. Mr Bend convinced Barbarians to sell a portion of their shareholding in WwW to facilitate the deal effective from 1 October 2006. The key terms of the transaction were as follows:

- Barbarians sold a 26% shareholding in WwW to iSiswe for \$10,5 million. For purposes of this sale transaction the value of WwW was determined to be a price-earnings multiple of 9,0 of the audited after tax profits of WwW for the year ended 30 September 2006.
- Barbarians extended a loan to iSiswe for 90% of the purchase consideration due, and iSiswe paid 10% of the purchase price up front.
- The loan from Barbarians to iSiswe is repayable over ten years with a final repayment date of 1 October 2016. The loan bears interest at the ruling prime overdraft lending rate with interest calculated and capitalised quarterly in arrears.
- After the transaction the shareholders of WwW were Barbarians 44%, iSiswe 26% and Mr Bend 30%. No share sales or transfers have taken place since October 2006.
- In terms of the shareholders' agreement of WwW the company's dividend policy is to declare and pay out 70% or more of the after-tax profits as dividends annually.
- iSiswe is required to utilise 90% of the dividend income received from WwW to pay the interest and capital outstanding on the loan from Barbarians until the loan has been repaid in full. Apart from this condition, there is no obligation on iSiswe to pay any amounts owing until 2016. iSiswe is obliged to repay all outstanding interest and capital amounts owing on 1 October 2016.
- In terms of the WwW shareholders' agreement –
 - Barbarians is entitled to appoint two non-executive directors;
 - iSiswe is entitled to appoint one non-executive director; and
 - Mr Bend is entitled to appoint two executive directors.

WwW's labour outsourcing service

WwW has 24-month service level agreements with the majority of its hospitality clients. WwW provides outsourced labour to its clients on a temporary or ongoing basis. The major benefits to clients are as follows:

- The clients incur no recruitment or training costs;
- WwW is responsible for payroll and human resources administration of outsourced labour;
- If clients are unhappy with the service of WwW individuals working for them, they can terminate this contract immediately without having to follow the normal human resources and disciplinary procedures;

- Clients only pay for hours worked, and are billed by WwW monthly in arrears; and
- Clients retain management control over labour on site.

The calibre of staff is critical in the labour outsourcing industry. WwW continually invests in training and development of staff to ensure they meet client requirements and further develop their skill sets. Training benefits both employees (professional development usually leads to higher income) and WwW, who can charge higher rates for more skilled staff.

WwW pays its employees every two weeks. WwW is able to charge higher than normal market rates for its employees because of the superior service levels and the high quality of contracted labour it provides.

Acquisition of Guards 4U (Pvt) Ltd

During 2007 Mr Bend was approached by a close family friend, Mr Julius Goldfinger, who owned a security company, Guards 4U (Pvt) Ltd (Guards 4U). Mr Goldfinger was emigrating to Australia and wished to sell the business. Mr Bend believed the acquisition of a security company would be a strategic fit for WwW and set about persuading the WwW board of directors to buy 100% of the shares in issue of Guards 4U on the basis that the acquisition would –

- allow WwW to diversify into a new market segment, thus reducing reliance on the hospitality industry;
- allow WwW to offer its hospitality clients outsourced security guards, a service which WwW does not currently provide;
- enable WwW to manage the business in a more robust fashion and achieve various revenue enhancing opportunities and cost savings. In particular, Mr Bend believed that WwW could achieve substantial administrative savings for Guards 4U by leveraging its investment in human resources systems; and
- fast track WwW's goal of listing on the ZSE – the acquisition of Guards 4U would add significant critical mass to the WwW group and a listing could possibly be achieved within the next 18 months.

The non-executive directors of WwW appointed by Barbarians and iSiswe raised various concerns regarding the potential acquisition of Guards 4U, including the following:

- The highly competitive nature of the security industry in Zimbabwe with no substantial barriers to entry;
- The nature of Guards 4U's business which differs from that of WwW: Guards 4U enters into contracts to provide security for commercial property owners and residential estates. WwW places outsourced labour and has no further day-to-day involvement in the management of employees;
- Guards 4U needs to invest in capital assets (motor vehicles and electronic equipment) in order to provide the required service to its clients. Guards 4U also needs to provide uniforms for guard personnel. In the hospitality industry, WwW's clients provide uniforms and corporate clothing at their cost to contracted WwW employees; and
- The potential impact that Mr Goldfinger's emigration to Australia could have on the business of Guards 4U. He has been the managing director of Guards 4U since the inception of the company.

Finally, the board of directors reluctantly agreed that WwW should pursue the acquisition of Guards 4U, backing Mr Bend's entrepreneurial skills and judgement to ensure that the acquisition would add value to WwW. Mr Bend was given the authority to negotiate the acquisition of Guards 4U, provided the business was acquired as a going concern as opposed to acquiring the shares in the company.

The major stumbling block in negotiations was Mr Goldfinger's reluctance to provide any profit warranties. Guards 4U had reported profit after tax of \$5 million for the year ended 30 June 2007 and Mr Goldfinger believed it would be prejudicial to his interests if he warranted future profits as he would not be in a position to control the operations of Guards 4U after having sold it.

The business of Guards 4U was acquired as a going concern with effect from 1 October 2007. The following assets and liabilities were included in the acquisition:

	\$'000
Fixed assets	11 420
Accounts receivable	8 904
Inventories (uniforms)	3 400
Trade creditors	1 850

The purchase price for the business of Guards 4U was \$40 million, payable as follows:

- \$10 million on 30 September 2007;
- Three equal annual instalments of \$10 million commencing on 1 October 2008; and
- The outstanding purchase consideration would bear interest at 2% below the prime overdraft lending rate, calculated and payable monthly in arrears.

After receipt of the first tranche of the purchase price, Mr Goldfinger paid a commission of 2% of the selling price to Mr Bend, as promised, for his efforts in concluding the deal between WwW and Guards 4U. Mr Goldfinger was immensely relieved that he could emigrate in the knowledge that his business was in safe hands and that he had sufficient capital to retire comfortably. Mr Bend did not disclose the \$800 000 commission he received from Mr Goldfinger to the WwW board of directors, as he believed the amount was immaterial and merely a goodwill gesture between friends.

Audited results of WwW for the year ended 30 September 2008

The abridged results for the year ended 30 September 2008, extracts from the annual financial statements and other relevant information are summarised below:

WORLD-WIDE WORKERS (PVT) LTD			
ABRIDGED INCOME STATEMENTS FOR THE YEAR ENDED 30 SEPTEMBER			
	Notes	2008 \$'000	2007 \$'000
Revenue	1	161 275	92 966
Cost of sales	2	(123 337)	(69 725)
Gross profit		37 938	23 241
Operating costs	3	(30 899)	(16 824)
Earnings before interest, tax, depreciation and amortisation (EBITDA)		7 039	6 417
Depreciation		(3 900)	(1 450)
Investment income		0	1 392
Finance costs		(5 400)	0
(Loss) / Profit before taxation		(2 261)	6 359

WORLD-WIDE WORKERS (PVT) LTD
ABRIDGED BALANCE SHEETS AT 30 SEPTEMBER

	Notes	2008	2007
		\$'000	\$'000
Non-current assets		31 446	5 800
Equipment and vehicles		13 320	5 800
Goodwill		18 126	–
Current assets		32 419	20 250
Inventories	4	6 350	–
Trade receivables		26 069	8 660
Cash and cash equivalents		–	11 590
TOTAL ASSETS		63 865	26 050
Equity			
Capital and reserves		20 420	22 681
Non-current liabilities			
Amounts due to Guards 4U		20 000	–
Current liabilities		23 445	3 369
Trade and other payables		4 055	1 719
Taxation		–	1 650
Amounts due to Guards 4U		10 000	–
Bank borrowings	5	9 390	–
TOTAL EQUITY AND LIABILITIES		63 865	26 050

Notes

- 1 Segmental performance of the Hospitality Division and the Security Division for the 2008 financial year:

	Hospitality Division	Security Division	Total
	\$'000	\$'000	\$'000
Revenue	103 594	57 681	161 275
Cost of sales	(79 840)	(43 497)	(123 337)
Wages	(70 839)	(34 798)	(105 637)
Motor vehicle expenses	–	(1 997)	(1 997)
Other costs of sales	(9 001)	(6 702)	(15 703)
Gross profit	23 754	14 184	37 938

The utilisation and billing of labour in the Hospitality Division during the 2008 and 2007 financial years are summarised below:

Hospitality Division		
	Year ended 30 September	
	2008	2007
Available labour hours, for billing to clients	1 196 000	1 177 600
Actual hours billed to clients	863 000	845 000
Utilisation (billed versus available hours)	72,2%	71,8%
Increase in average number of employees during year	1,56%	2,50%
Average hourly wage rate paid to employees	\$59,23	\$53,36

- 2 The Security Division performed below expectations during the 2008 financial year. There were widespread strikes by security workers during the year. After protracted negotiations with unions, WwW agreed to increase the wages of employees employed in the Security Division by 12% with effect from 1 April 2008.
- 3 Operating costs increased significantly in the 2008 financial year. Once off costs relating to the acquisition of Guards 4U and the integration of this business into WwW amounted to \$4 million. These costs included legal and advisory expenses of \$1,5 million and Information Technology (IT) system costs of \$2 million.

Operating costs for 2008 and 2007 can be summarised as follows:

	2008	2007
	\$'000	\$'000
Computer expenses	6 200	3 500
Head office costs	9 500	7 785
Legal and advisory expenses	4 500	2 100
Management bonus	2 049	650
Staff uniforms	6 150	—
Training costs	2 500	2 789
Total operating costs	30 899	16 824

WwW introduced an incentive scheme for its executive directors during 2006. The bonus is determined as 3% of the Zimbabwe dollar value growth in revenue in each financial year and is allocated on a discretionary basis by James Bend.

- 4 WwW imported uniforms for security staff from a supplier based in China. The Zimbabwean supplier they had used previously had increased prices by 20% in January 2008 and WwW decided to find an international source. The Chinese supplier's prices are on average 25% lower than the cheapest Zimbabwean supplier. However, they require large order quantities in order to ship to Zimbabwe.
- 5 Mr Bend negotiated an overdraft facility of \$15 million with WwW's commercial bankers in October 2007. The overdraft bears interest at the prime overdraft lending rate (currently 15,5% per annum).

REQUIRED

		Marks
(a)	Provide detailed comments on the company's trading and financial performance in 2008, based on your review and analysis of the income statements of World-wide Workers (Pvt) Ltd for the years ended 30 September 2007 and 2008 and related information. You should calculate relevant ratios and, where necessary, compare the performance of World-wide Workers (Pvt) Ltd in 2008 to that in 2007.	30
(b)	Calculate the following ratios for the 2007 and 2008 financial years: <ul style="list-style-type: none"> • Inventory turnover ratio • Average collection period ratios • Average payment period ratios • Debt equity ratios. 	7
(c)	Identify and describe possible ways in which World-wide Workers (Pvt) Ltd could improve its future cash flow and liquidity position. In your answer you should identify at least five possible initiatives/actions and outline how these may improve the future cash flow and liquidity of World-wide Workers (Pvt) Ltd.	15
(d)	Discuss and evaluate whether or not the shareholder value of World-wide Workers (Pvt) Ltd has been enhanced by the acquisition of the business of Guards 4U (Pvt) Ltd. In your answer you should include the impact of the acquisition in the 2008 financial year and the potential that the acquisition will enhance or destroy shareholder value in the long term.	9
(e)	With regard to the iSiswe Ltd transaction – <ol style="list-style-type: none"> (i) identify and outline any potential problems or issues with the agreed financing structure from the perspective of Barbarians Investments (Pvt) Ltd. Your answer should identify issues that have occurred as well as ongoing issues; and (ii) discuss what impact, if any, this financing structure has or could have on World-wide Workers (Pvt) Ltd as a company. 	9 3
(f)	Evaluate the management incentive scheme for the executive directors of World-wide Workers (Pvt) Ltd and identify with reasons the shortcomings, if any, of the scheme from the perspective of the company.	10
(g)	Discuss the actions and behaviour of Mr James W. Bend as a director and shareholder of World-wide Workers (Pvt) Ltd, and identify, with reasons, any behaviour or actions on his part which may have contravened good corporate governance practices and/or the Companies Act.	12
Presentation marks Arrangement and layout, clarity of explanation, logical argument and language usage.		5

