



The Institute of Chartered Accountants of Zimbabwe

QUALIFYING EXAMINATION

Part II Paper 1

NOVEMBER 2010

**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.
 - **Even if it is not explicitly required, you should show workings and cross-reference them to your answer.**
 - Marks are awarded for appropriate arrangement and layout, clarity of explanation, logical argument and clear and concise language.
- 4 Working papers must be handed in with scripts.

Disclaimer clause: All names of persons, places and business entities mentioned in this examination paper are fictitious and any resemblance to real persons, living or dead, places and business entities are purely coincidental.

NOTE: The questions in this paper reflect currencies and comparative figures in US dollars to make a meaningful comparison of financial performance possible, with no account being taken of the anomalies of converting previous Zimbabwean dollars to US dollars.

QUESTION 1

100 marks

Brainz (Pvt) Ltd

Brainz (Pvt) Ltd ('Brainz') was formed in 1991 by two young professionals, Steve Smith and Horatio Adams, with the aim of providing advice to companies in southern Africa on general economic and financial issues. Mr Smith and Mr Adams are the joint chief executive officers of Brainz.

Over the last 19 years Brainz has grown and changed significantly and now comprises a head office and three wholly-owned subsidiary companies. The group also has an investment in an associate company. The group offers a broad array of products and services. The shareholdings in and group structure of Brainz (Pvt) Ltd are set out in appendix A (separate handout).

For some time now the shareholders of Brainz have considered listing the group on the Zimbabwe Stock Exchange (ZSE). Although the economic downturn has delayed the potential listing, the directors of Brainz have been taking steps to improve the general state of corporate governance within the group.

Brainz has nine directors in total, of which five are executive directors. Four of the executive directors of Brainz serve as chairmen of the Brainz associate and subsidiary companies. The four non-executive directors are appointed by the Smith and Adams family trusts. Brainz pays market-related fees to all its directors.

The board of directors meets twice a year to approve the annual budgets and governance frameworks for the group companies, to consider reports from the audit committee (which is the only subcommittee of the board) and to decide on strategy.

All Brainz directors and all the directors of the subsidiary companies participate in a cash-settled phantom share option scheme. Tranches of phantom shares are notionally awarded to scheme participants every year, at a price based on a pre-determined discount to the prevailing ZSE average price-earnings (PE) ratio for the Services Sector. These phantom shares vest over a two-year period, after which the shares are revalued using the current average Services Sector PE ratio. Thereafter participants can elect to exercise the notional share options, in which case the company settles the difference between the initial valuation and the newly determined share price.

At present the tranches of share options granted on 1 January 2009 and 1 January 2010 are under water (that is, out of the money) and the board of directors of Brainz is concerned that this will have a negative impact on the directors of the group companies. Accordingly, the board is considering revising the initial allocation prices of the options by increasing the pre-determined discount factor.

The current chairman of the board, who is also the chairman of the audit committee, is retiring in December 2010. The board is considering paying a gratuity of \$5 million to the outgoing chairman in recognition for his work in providing superior strategic leadership during his tenure.

Brainz Services (Pvt) Ltd

Brainz Services (Pvt) Ltd ('Services') provides information technology, group reporting, internal audit, legal and treasury services to the Brainz group, as well as advice on funding, risk management and debt collection.

The internal audit function has a total staff of six and is led by the former chief executive officer of Brainz Learning (Pvt) Ltd, Nigel Herd. Internal audit staff visit each of the Brainz subsidiaries at least once a year and conduct compliance-based audits to ensure that the internal control systems are operating effectively. To maintain independence Mr Herd has direct access to the external group auditors and reports directly to the chairman of Brainz. Mr Herd is the only other member of the Brainz audit committee.

Brainz Advisory (Pvt) Ltd

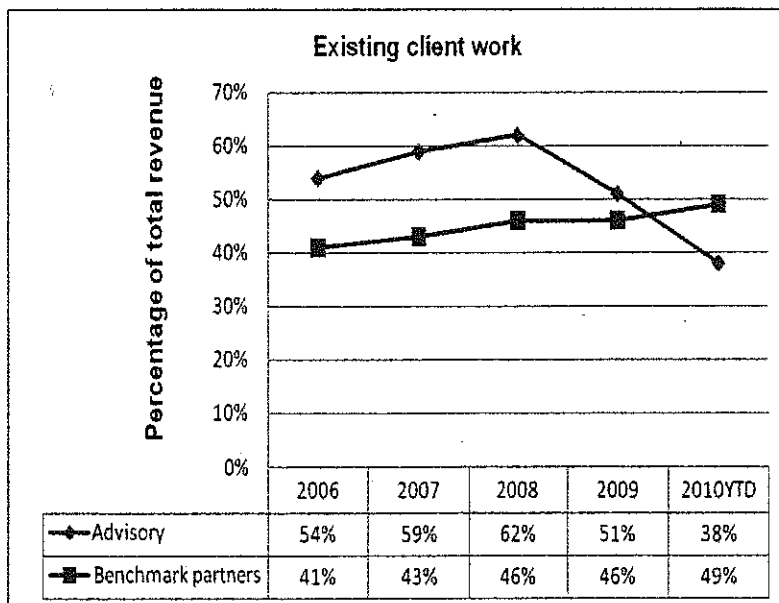
Brainz Advisory (Pvt) Ltd ('Advisory') forms the core of the Brainz group and provides a full range of economic and financial advisory services to clients in southern Africa.

Advisory currently employs 196 full-time consultants and a number of contract workers. Advisory works on a project basis and, depending on the nature of each particular assignment, sources a mix of own employees and contractors to undertake each project.

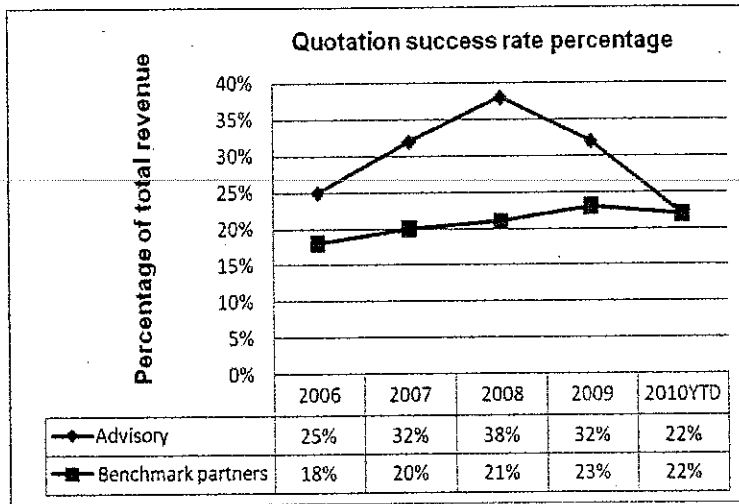
Advisory uses proprietary methodologies which are sourced from IQ International Inc. ('IQ'), an American research institute. IQ charges a fixed quarterly US dollar royalty for access to their methodologies.

Advisory benchmarks its marketing activities against a carefully selected group of benchmark partners who compete in the same market. The September 2010 Advisory management accounts reflect the following benchmarked marketing measures:

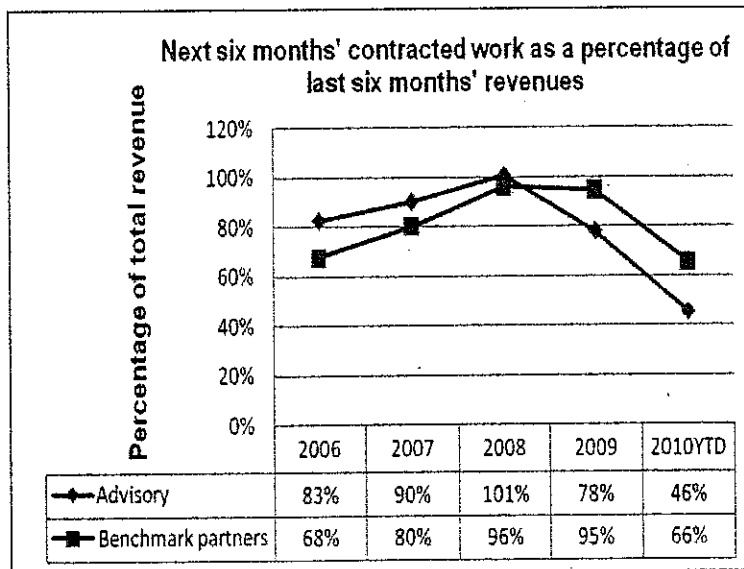
- (a) Percentage of total revenue sourced from existing clients (that is, clients for whom work has been undertaken previously):



(b) Success rate of total US dollar value of assignments quoted for:



(c) Total US dollar value of future contracted work for the next six months (work in the pipeline) at period end as a percentage of the past six months' revenue:



Advisory markets its services through the following channels:

- The Brainz executive directors who spend significant time networking and developing new contacts in order to source opportunities;
- Direct referrals from any third party, for which Advisory pays 2% of the quoted fee on project presentation to a potential client, and if successful, a further 2% at project inception; and

- Umfolozi (Pvt) Ltd ('Umfolozi'), which is wholly owned by three lawyers and tenders for public sector assignments in its own name. When a tender is awarded to Umfolozi, it immediately subcontracts the assignment to Advisory, which in turn pays Umfolozi 7,5% of the total quoted revenues for handing over the assignment.

Extracts from the audited 2008 and 2009 annual financial statements and related ratios, and from the latest forecast results and ratios for 2010 (based on the year to date (to September 2010) plus the forecast for the remaining three months), for Advisory are as follows:

BRAINZ ADVISORY (PVT) LTD				
	Notes	31 December	31 December	31 December
		2008	2009	2010
		Audited	Audited	Forecast
		\$'000	\$'000	\$'000
Key items from the statements of comprehensive income				
Gross revenue	1	1 005 000	1 250 000	814 450
Work in progress provisions and write-offs	2	(53 265)	(81 250)	(97 700)
Net revenue		951 735	1 168 750	716 750
Employment costs	3	(399 202)	(466 453)	(369 660)
Marketing costs	4	(48 240)	(68 750)	(48 650)
Royalties	5	(134 820)	(134 123)	(128 150)
Office rental	6	(36 160)	(40 861)	(46 173)
Administration costs	7	(80 400)	(88 750)	(94 960)
Interest charges	8	(28 024)	(33 567)	(25 270)
Sundry income	9	7 350	9 050	10 000
Profit before tax		232 239	345 296	13 887
Key items from the statements of financial position				
Work in progress (net of provisions and write-offs)		129 400	178 080	138 345
Trade receivables		79 850	109 590	87 023
Bank overdraft		107 890	135 000	65 000
Calculated ratios				
		Days	Days	Days
Days in work in progress	10	47	52	62
Days in receivables	10	29	32	39

Notes

- 1 Gross revenue represents estimated billings to clients which are debited to work in progress, including billing to group companies, based on monthly employee and contractor time sheets at an average standard charge-out rate per hour, which is determined annually in advance.

The 2010 standard charge-out rate and those used in the 2009 and 2008 years are as follows:

	2008	2009	2010
Charge-out rate per hour	\$1 800	\$2 100	\$2 400

- 2 Advisory makes a general provision of 3% of gross revenue against work in progress. If necessary additional amounts are written off at the point of final project invoicing to clients when work in progress is transferred to trade receivables.
- 3 Employment costs represent the cost to the company of its own employees as well as all amounts paid to contractors. In the last two years Advisory has aggressively followed a strategy of shifting its employment profile to more highly qualified professionals, and at present more than 90% of professional employees have at least a masters degree.

Relevant details of employment costs are as follows:

	31 December 2008	31 December 2009	31 December 2010
	Audited	Audited	Forecast
Weighted average number of full-time employees	191	205	196
	\$'000	\$'000	\$'000
Full-time employee costs to the company	143 250	170 150	240 430
Contractor costs	255 952	296 303	129 230
Total employment costs	399 202	466 453	369 660

- 4 Marketing costs consist mainly of payments made to third parties and to Umfolozi for client referrals.
- 5 This represents royalty payments to IQ.
- 6 With effect from 1 January 2007 Advisory entered into an eight-year lease agreement with Xtreme Properties Ltd for the provision of rental office space in all the major cities in which Advisory operates.
- 7 Office administration costs include all costs of the accounting, legal and human resource functions as well as intercompany charges from Services.
- 8 Interest is paid at the basic lending rate plus 3% on both the bank overdraft from MBR Bank and loans from shareholders. In 2009 MBR Bank became increasingly concerned about the extent of its exposure to Advisory, despite having a cession of trade receivables, and insisted that the overdraft facility be reduced to \$65 million by 30 September 2010.
- 9 Sundry income represents receipts from Brainz Learning (Pvt) Ltd for the provision of training material.
- 10 Ratios are based on gross revenue.

Brainz Learning (Pvt) Ltd

Brainz Learning (Pvt) Ltd ('Learning') offers a number of generic training courses in finance and economics. Learning has consistently yielded the highest return on equity of all the companies in the Brainz group.

Learning is run by a small group of people which provides leadership and handles all marketing and course administration activities. The copyright of each of the training courses vests in Advisory and Learning pays Advisory a fixed rate of 50% of all attendance fees for the use of the training materials. Learning has exclusive rights to all Advisory courses until 2018.

The presentation of training courses is outsourced to freelance lecturers who are contracted as and when needed. The frequency with which individual training courses are offered is determined by the response rates to the various marketing initiatives. Courses are presented in all major centres in Zimbabwe, South Africa, Botswana and Namibia at venues which are hired specifically for each course.

Training course evaluations indicate that Learning is one of the foremost training companies in southern Africa and that the calibre of the administration, training materials and teaching personnel is of the highest order.

Smile Inc.

Smile Inc. ('Smile') offers a member-based internet dating service. Members pay a monthly fee of US \$10 to Smile for access to the portal and to list their personal attributes, including photographs if they wish to do so. Smile also matches each member with potential partners using a patented mathematical algorithm that predicts compatibility based on 25 different variables.

Smile was incorporated in January 2008 and is registered in the Bahamas, a tax-free haven. The initial shareholders were the Smith Family Trust (45%), Adams Family Trust (45%) and Algiers Adams (10%). Algiers Adams is the managing director of Smile and is the son of Horatio Adams. Smile has to date spent US \$3 million on developing its business and marketing its site to potential members.

The Smile website is hosted by Services. The portal development activities have been outsourced to Whale Computing (Pvt) Ltd ('Whale'), which also owns the patented mathematical algorithm that Smile uses to match potential partners. Whale was wholly owned by Advisory until August 2010 when it sold 100% of the shares in issue to a third party. The sale of shares agreement provides for profit warranties for a three-year period. Advisory used the initial proceeds on the sale of shares in Whale of \$35 million to reduce its overdraft. If Whale achieves its profit targets, Advisory is set to receive a further \$30 million in three years' time.

Brainz acquired a 40% shareholding interest in Smile in December 2009 from the Smith Family Trust and the Adams Family Trust for an aggregate consideration of US \$12 million.

Brainz requested Algiers Adams to perform a valuation of Smile at 30 September 2010 with the intention of revaluing its investment in its financial statements for the year ending 31 December 2010.

Extracts from the valuation performed by Algiers Adams are set out below:

SMILE INC.					
INDICATIVE VALUATION AT 30 SEPTEMBER 2010					
	Notes	Year ending 30 September			Total
		2011	2012	2013	
Number of members	1	271 520	481 680	664 750	
		US \$'000	US \$'000	US \$'000	US \$'000
Membership fee revenue	1	32 582	57 802	79 770	
Advertising revenue	2	999	2 996	4 993	
Total revenue	3	33 581	60 798	84 763	
Operating expenses	4	(27 102)	(48 855)	(67 802)	
Earnings before interest, tax, depreciation and amortisation (EBITDA)	5	6 479	11 943	16 961	
EBITDA/total revenue		19,3%	19,6%	20,0%	
Discount factor	6	0,830	0,689	0,573	
		US \$'000	US \$'000	US \$'000	US \$'000
Discounted EBITDA		5 378	8 229	9 719	23 326
Terminal value	7				66 264
Valuation of 100% of Smile					89 590

Notes

- 1 Smile's internet dating service had 63 250 members at 30 September 2010. Smile expects membership numbers to increase to 271 520 in the 2011 financial year. Monthly membership fees are forecast to remain at US \$10 per month for the foreseeable future.
- 2 Smile signed up its first advertiser on the portal in September 2010 for an annual fee of US \$59 000. Given the expected increase in members over the next three years, Smile expects to derive significant revenue from selling advertising space on its website.
- 3 Smile incurred an operating loss of US \$17 000 for the year ended 30 September 2010. Algiers is convinced that Smile will exceed the profit projections, as membership numbers are increasing significantly on a month on month basis.
- 4 The forecast operating expenses are based on the assumption of a reduction in the following expenses:
 - A 20% reduction in the website hosting fees currently charged by Services. Smile currently pays a variable fee of US \$2 per member per month to Services. Algiers Adams assumed that there would be no annual increase in fees after the reduction has been negotiated; and

- A 20% reduction in royalties payable to Whale. Smile presently pays Whale a fixed annual fee of US \$5 million. Algiers Adams assumed that there would be no annual increase or decrease in the royalty fee payable from 2011 onwards.
- 5 Algiers has assumed that the annual EBITDA is equivalent to the free cash flow.
- 6 A weighted average cost of capital (WACC) of 20,4% has been used to discount future cash flows. WACC has been derived on the basis of the following:
- A target capital structure of 20% equity and 80% debt;
 - A cost of equity of 30%; and
 - A cost of debt of 18% per annum with no tax relief.
- 7 The terminal value has been estimated based on an annual growth in cash flows of 5% into perpetuity.

You may assume that the mathematical calculations of Algiers Adams to discount future cash flows and determine the terminal value are correct.

REQUIRED

		Marks
(a)	List areas, from the information provided and with reasons, in which Brainz does not comply with the <i>King Code of Governance Principles, 2009</i> (King III) requirements for corporate governance practices.	18
(b)	Review and discuss the marketing strategy and marketing performance of Advisory, based on the benchmarked marketing measures from 2006 to September 2010, as disclosed in the management accounts of Advisory.	12
(c)	Critically analyse and comment on the historical and forecast financial performance of Advisory from 2008 to 2010. Where appropriate, support your comments with relevant ratios and calculations.	30
(d)	Identify the reasons why Learning would have consistently yielded a high return on equity and comment on the sustainability of the business.	7
(e)	Identify and describe any possible conflicts of interest that may have or could arise from Brainz's investment in Smile.	8
(f)	Critically review and comment on the indicative valuation performed by Algiers Adams, by using the information included in Smile, at 30 September 2010. Where appropriate, support your comments with relevant ratios and calculations.	20
Presentation marks: Arrangement and layout, clarity of explanation, logical argument and language usage.		5