



The Institute of Chartered Accountants of Zimbabwe

QUALIFYING EXAMINATION

Part I Professional Paper 3

JANUARY 2011

TOTAL MARKS – 100
READING TIME – 30 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

100 marks

Experience Africa Holdings Ltd ('EA Holdings') is the holding company of a group of eco-tourism companies which provides world-class wildlife and outdoor experiences to discerning travellers. The group is committed to sustainable conservation and the empowerment of local communities. The group owns and operates safari lodges in Zimbabwe, Namibia and Botswana.

EA Holdings has three wholly-owned subsidiaries, which operate and manage the group's safari lodges in their respective countries, namely –

- Experience Africa Zim (Pvt) Ltd ('EA Zim'),
- Wildlife Botswana (Pvt) Ltd ('Wildlife Botswana'), and
- Wildlife Namibia (Pvt) Ltd ('Wildlife Namibia').

EA Holdings was founded 15 years ago by Dr Joe Player, an environmentalist and entrepreneur. His objective was to provide tourists with the opportunity to experience Africa's unique wildlife while promoting sustainable conservation of wilderness areas. EA Holdings listed on the Zimbabwe Stock Exchange (ZSE) in 2008. Immediately prior to listing, Dr Player retired as chief executive officer of the company and became the non-executive chairman of EA Holdings.

Shareholding and board of directors

The current shareholders of EA Holdings are as follows:

Player Family Trust	37%
Employee Staff Trust	5%
Unit trusts	8%
Public investment corporation	12%
General public	38%

The current directors of EA Holdings are as follows:

Dr Joe Player	Non-executive chairman
Ms Jane Player-Carter	Chief executive officer
Mr Sonny Ndlovu, CA(Z)	Financial director
Mr Thabiso Mleng	Operations director
Mr Jan Johnsen	Independent non-executive director
Mr Jim Jackson	Independent non-executive director
Ms Jayne Naidoo	Independent non-executive director

All executive directors have employment contracts (dealing with salaries, benefits and performance incentive payments). Non-executive directors receive directors' fees plus fees for attending meetings of the board of directors and its sub-committees. The Remuneration Committee is responsible for setting and monitoring the remuneration policies of the group and approving incentive schemes. The members of the Remuneration Committee are Mr Johnsen (chairman), Dr Player and Ms Naidoo. EA Holdings also has an Audit Committee consisting of Mr Jackson (chairman) and Ms Naidoo. A Risk Committee has also been established.

Auditors

Dlamini and Partners has been the auditors of EA Holdings and EA Zim for the past nine years. The engagement partner for the past six years, Bob Dlamini, is an experienced auditor of eco-tourism businesses.

Wildlife Botswana and Wildlife Namibia are audited by local audit firms in their respective countries. Independence-auditors was appointed as the auditor of Wildlife Botswana during October 2010.

The financial year end of the group is 31 October.

Information regarding EA Zim's operations

EA Zim offers 'all inclusive' travel packages to the upper end of the tourist market. Customer service is of paramount importance and the group strives to provide each guest with a unique and memorable experience. EA Zim owns numerous safari lodges in the Hwange National Park ('Hwange') in Zimbabwe. The company also owns a fleet of small aircraft to transport guests from Harare International Airport to the game reserve and back again.

EA Zim at present only offers six-night packages to guests and the standard all inclusive package includes the following:

- A return flight from Harare International Airport to Hwange in one of Experience Africa's aircraft;
- Six nights' accommodation at one of the safari lodges, including all meals and beverages;
- Daily game drives; and
- A hot-air balloon excursion.

The EA Zim safari lodges in Hwange can together accommodate a maximum of 150 six-night packages per month. For the past three years EA Zim's lodges have accommodated an average of 105 packages per month.

EA Zim bases its six-night package price on cost plus 20%, which at present amounts to \$1 838 excluding VAT. The current estimated cost of the package is as follows:

Cost of the all inclusive six-night package		
	Notes	\$
Accommodation	1	800
Food and beverages	2	300
Cleaning and other services	3	50
Game drives	4	90
Aircraft and flight costs	5	150
Hot-air balloon excursion	6	120
Electricity	7	22
Total cost		1 532

Notes

- 1 Accommodation represents the fixed costs of operating the lodges, excluding those costs mentioned below, and includes lodge maintenance costs, administration costs and municipal rates. These expenses are allocated to the six-night package based on normal occupancy levels of 70% for the lodges throughout the year.
- 2 Food and beverage costs represent the average cost of food and beverages consumed by each guest during a six-night stay.
- 3 Cleaning and other service expenses are the cost of employing staff to clean the lodges and service the rooms. Cleaning staff are able to clean and service the lodges if they operate at the normal 70% occupancy level. If the lodges are more than 70% full, cleaning staff work overtime at \$15 per hour. Cleaning staff spend an extra 30 minutes per day cleaning and servicing the lodges for each additional guest above the 70% occupancy level.
- 4 The cost of daily game drives comprises the salaries of game rangers, maintenance costs of vehicles and the cost of complimentary hampers provided for each guest. The complimentary hampers cost \$40 each and include a blanket for the game drives, a game viewing booklet and mini binoculars. Each guest receives one of these hampers during the course of their six-night stay at the lodge (they do not receive a hamper each time they go on a game drive). Game rangers are permanent employees of EA Zim.
- 5 The total cost of collecting guests from Harare International Airport, transferring them to the lodge, and returning them to Harare at the end of their stay amounts to \$15 750 per month. This cost is allocated to each package based on the number of guests per month at the 70% occupancy level. EA Zim has sufficient aircraft capacity to cope with a 100% occupancy level.

Some guests travel to EA Zim's safari lodges by road and at their own expense. These guests do not receive a reduction in the total package price. Mr Ndlovu, the financial director, believes that this is the correct treatment. In his opinion, 'the cost of running the fleet is mainly fixed and is incurred regardless of whether clients use the service or not'. Thus the cost of the air transport service is allocated to all packages sold. Market research has indicated that many guests find safari lodge packages which do not include air transport services in their prices, to be more affordable than the EA Zim package.
- 6 The hot-air balloon excursions offered to guests are outsourced to Eagle Eye Balloon Tours ('Eagle Eye') which operates from Hwange. Eagle Eye charges EA Zim a fee of \$120 per guest per hot-air balloon excursion. This fee is applicable for up to 105 guests in any particular month. If the monthly number of guests is higher, Eagle Eye has to rent extra hot-air balloons and charges an incremental fee of \$80 for each guest over 105 guests (i.e. \$80 plus the original \$120) to cover the increased costs. Eagle Eye has indicated that it could increase its capacity and reduce the fee to \$100 per guest if EA Zim could guarantee at least 140 guests per month.
- 7 Electricity costs vary according to occupancy levels. The total electricity cost per month at an occupancy level of 70% is \$2 310. Total electricity costs would amount to \$3 120 per month if the safari lodges operated at full capacity.

A new business venture for the Zimbabwe operation

The directors of EA Zim were satisfied with the company's results for the year ended 31 October 2010. The number of guests increased as a result of the FIFA 2010 Soccer World Cup in South Africa and it is hoped that many of these tourists will return to Zimbabwe in the future. At the National Tourism Board Conference entitled *Tourism 2010 and beyond*, Mr Sonny Ndlovu learnt that tour bus operators which offered bus tours around Zimbabwe to foreign guests during the World Cup had been highly successful. Sonny subsequently did some market research into a venture to utilise the monthly spare capacity at the Experience Africa safari lodges in Zimbabwe.

Sonny prepared the following business proposal which has been approved by the directors of EA Zim:

- EA Zim will enter into an agreement with Interstate Bus Tours (Pvt) Ltd ('Interstate'), a tour bus company wholly owned by Petunia Ndlovu, Sonny's wife. (Interstate is audited by Eric Eager, a sole practitioner.) Interstate will sell an all-inclusive package for \$1 700, consisting of three days and nights at the EA Zim Hwange safari lodges and four days and nights touring famous landmarks in and around Zimbabwe. The portion of the package that relates to the bus tour will include all meals, accommodation and sightseeing expenses. The three-night stay at the Hwange safari lodges will entitle guests to all the privileges of the standard six-night package, including the hot-air balloon excursion, daily game drives, food and beverages and all other lodge services. The existing game rangers and vehicles will be able to cope with the increased demand for daily game drives as most guests do not use this service every day. Over and above these normal privileges, EA Zim needs to provide entertainment on one evening per package. This would entail a cost of \$200 eight times per month. This package price does not include flights to and from Harare International Airport because Interstate will take responsibility for transporting guests.
- Market research indicates that there would be a demand for 120 such packages per month. Sonny was particularly thrilled with this proposal as it would solve the current problem of unutilised capacity at the Hwange safari lodges. The demand from Interstate is equivalent to 60 normal all inclusive six-night packages sold by EA Zim.
- Interstate will take responsibility for the booking, invoicing and general administration of the all-inclusive packages.
- Per the agreement, Interstate will pay EA Zim \$400 for each guest in terms of the three-night stay at EA Zim's Hwange safari lodges. Interstate has requested that EA Zim reserve a minimum number of 120 three-night packages at the Hwange safari lodges for their all-inclusive packages.
- Interstate will charge EA Zim a management fee of 5% for the three-night stay revenue for the booking, invoicing and administrative functions they perform.

The terms and conditions of the venture were unanimously approved at a directors' meeting on 15 September 2010 at which all the directors were present, for implementation in early 2011. The board of directors furthermore decided that the pricing of the standard six-night package should remain at \$1 838 per guest despite EA Zim's cost-plus pricing policy.

Interstate cost structure

In anticipation of the new business venture, Petunia is considering two options for delivering the four-day bus tour section of the package. The first option is for Interstate to deliver all the services themselves. The second option is to outsource the service to another tour bus operator, which will take responsibility for all aspects except booking, invoicing and general administration.

Petunia has prepared the following monthly revenue and cost-structure sheet:

	Notes	Option 1	Option 2
		\$	\$
Revenue (120 x \$1 700)		204 000	204 000
Experience Africa three-night package (120 x \$400)		(48 000)	(48 000)
5% management fee payable by EA Zim		2 400	2 400
Accommodation, meals and sightseeing expenses	1	(42 000)	–
Bus costs	2	(22 000)	–
General administration costs	3	(6 000)	(6 000)
Outsourced cost (120 x \$750)	4	–	(90 000)

Notes

- 1 Accommodation, meals and sightseeing expenses relate to the costs incurred during the four day and four night bus tours.
- 2 Bus costs include depreciation, the salary of the bus driver, insurance and diesel fuel costs.
- 3 General administration costs consist mainly of the recently appointed manager's salary. The manager will be responsible for the booking, invoicing and general administration of the bus tour packages.
- 4 Interstate would be able to outsource the four-day tour bus experience to Zimbabwe Tours at a cost of \$750 per guest. This price includes the bus service, accommodation and meals as well as sightseeing expenses.

Extract from the minutes of a meeting of the board of directors of EA Holdings

MINUTES OF THE BOARD MEETING
held on 15 December 2010

Present

Directors

Dr Joe Player
Ms Jane Player-Carter
Mr Sonny Ndlovu
Mr Thabiso Mleng
Mr Jan Johnsen
Mr Jim Jackson

Other attendees

Mr Jimmy Naicker
(company secretary)

Apologies

Ms Jayne Naidoo

Approval of the minutes of the previous meeting – 15 September 2010

The minutes of the meeting held on 15 September 2010 were approved subject to a few editorial corrections.

Election of board chairman

Dr Player expressed the desire to step down as chairman because he wants to spend more time with his wife and grandchildren. Dr Player will remain on the board as a non-executive director. He proposed that, in line with the company track record of success due to tight family control, his daughter, Jane Player-Carter, succeed him as chairman, while also remaining chief executive officer of the company.

After a short discussion by the board it resolved to appoint Ms Player-Carter as executive chairman. It was further resolved that no 'big fuss' would be made regarding the appointment, and that except for a ZSE announcement, no further publicity will be given to this matter.

Audit Committee feedback

Mr Jackson reported back on the recent Audit Committee meeting and raised a specific area of disagreement with the external auditors, namely that the external auditors are uncomfortable with the \$400 package fee to be paid by Interstate. They are of the opinion that it is below cost to EA Zim and that the transaction is not at arm's length.

Additional key business risks

Mr Ndlovu reported that the Risk Committee (which he chairs) has identified the following two additional key business risks facing the group, of which the board should be aware:

- **Regulation and compliance:** The risk that uncertainty surrounding new laws, regulations and compliance therewith is stalling business decision making and planning; and
- **Cost cutting:** Consumer price inflation and pressure from low-cost competitors can have a negative effect on the market share of the company.

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PROFESSIONAL PAPER 3

TO BE ANSWERED IN A SEPARATE BOOK	
PART A REQUIRED	Marks
(a) Discuss the following in terms of the Companies Act, Chapter 24:03: <ul style="list-style-type: none"> • Whether the consolidated annual financial statements of EA Holdings are required to be audited; and • Any matters to be considered with regard to the re-appointment of the current auditors of the company. 	3
(b) Discuss any ethical, corporate governance and statutory issues arising from EA Zim entering into a new business venture with Interstate as was presented to and approved by the board of directors of EA Holdings.	19
(c) Discuss whether the board of directors of EA Holdings complies with the <i>King Code of Governance Principles, 2009</i> (King III), regarding the appointment of Ms Player-Carter as chairman. Also discuss how Dlamini and Partners should respond to the appointment.	7
(d) Discuss the fraud risks and their potential impact on the audit report arising from the new business venture between Interstate and EA Zim.	7
Presentation marks: Arrangement and layout, clarity of explanation, logical argument and language usage.	2
TOTAL MARKS	38

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PROFESSIONAL PAPER 3

TO BE ANSWERED IN A SEPARATE BOOK		
PART B REQUIRED		Marks
(e)	Calculate the impact that entering into the agreement with Interstate will have on EA Zim's monthly operating profits.	18
(f)	Identify and outline the key factors that EA Zim should have considered prior to entering into the new business venture with Interstate.	18
(g)	Critically discuss the pricing strategies and policies adopted by EA Zim in pricing its standard six-night all inclusive package at the Hwange safari lodges.	10
(h)	Calculate the breakeven point, both in terms of revenue amount and number of guests, and the degree of operating leverage for each of the two cost structure options for delivering the four-day bus tour experience by Interstate. Based on the results of your calculations recommend, with reasons, which option is best for Interstate.	13
Presentation marks: Arrangement and layout, clarity of explanation, logical argument and language usage.		3
TOTAL MARKS		62