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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ZIMBABWE

Initial Test of Competence
Professional Paper 2

JUNE 2014

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.

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. Where necessary, an effective tax rate of 25,75% should be used

QUESTION 1 **40 marks**

Ignore any value-added tax (VAT)

Alpha Pharmaceutical Holdings Ltd ('Alpha') is registered in Zimbabwe and quoted on the Zimbabwe Stock Exchange. The Alpha group is a leading supplier of branded and generic pharmaceutical products in Africa through major investments in three subsidiaries in the pharmaceutical industry. It has an established market presence in South Africa through two subsidiaries, namely Omega Pharmaceuticals (Pty) Ltd ('Omega') and Delta Pharmaceuticals (Pty) Ltd ('Delta'). Alpha also has a third subsidiary, Alpha Pharmaceuticals (Pvt) Ltd ('APM'), which is registered in Zimbabwe. APM distributes pharmaceutical products throughout Zimbabwe and, from the beginning of 2012, also exported products to Omega and to Delta.

1 APM

On 1 July 2010 APM granted 500 share options to each of the 15 members of the executive committee of APM. These options entitle each of these members to one share in Alpha when exercised. The options are subject to the following conditions:

- The share options vest on 30 June 2013, provided that the employee is still employed within the Alpha group at that date.
- Vested but unexercised share options may be exercised on or before the earlier of 1 July 2016 or the date on which an employee resigns. If they are not exercised by the earlier of these dates, the options will lapse.
- The strike price associated with these options amounted to $15 per option.

The following information relates to the share option scheme:

	Actual number of employees still employed at relevant date	**Estimated number of employees expected to be employed at vesting date**	**Fair value* of share option**	**Alpha share price (closing price)**
1 July 2010	15	13	$10,00	$26,00
31 December 2010	15	13	$11,00	$30,00
31 December 2011	13	13	$12,00	$31,00
31 December 2012	12	11	$10,00	$29,00
27 February 2013	12	11	$9,00	$25,00
30 June 2013	12	n/a	$12,00	$28,00
31 August 2013	12	n/a	$12,50	$28,50
15 September 2013	12	n/a	$12,75	$28,75
31 December 2013	11	n/a	$13,00	$29,00

* The fair value was determined using an options pricing model.

2 000 share options were exercised by 31 December 2013 and APM settled all amounts owing to the employees on each exercise date.

2 Executive share option transactions

Amongst the 15 members participating in the share option scheme were Messrs Smith, Jones and Sibanda and Mrs Moyo.

- Messrs Smith, Jones and Sibanda all exercised their options on 30 June 2013.
  - Mr Smith, who is 58 years of age and who hoped to retire at the end of the 2013 year, sold his options in July 2013 for $14 000.
  - Mr Sibanda, who is 53 years of age, also sold his shares on 31 August 2013 for $14 250.
  - Mr Jones had not sold his shares by the 2013 year end.
- Mrs Moyo, who is 48 years of age, exercised her right to acquire the 500 shares on 31 August 2013. She sold 200 of the shares towards the end of December 2013 for $28,75 per share.
- One executive left the employ of APM towards the end of 2013 and forfeited his right to participate in the share option scheme.
- The remaining executives had not exercised their options to acquire the shares by the 2013 year end.

3 Other information

Consumer price indices that may be relevant were as follows:

July 2010	0,95%
June 2013	1,84%
July 2013	1,25%
August 2013	1,28%
September 2013	0,86%

All entities in the Alpha group –

- present annual financial statements in accordance with International Financial Reporting Standards (IFRS);
- have a 31 December financial year end; and
- apply consistent group accounting policies.

QUESTION 2 **60 marks**

OPM (Pvt) Ltd ('OPM') is a private equity company that invests in established small to medium unlisted companies that have growth potential, within the agricultural and industrial sectors.

Due to the higher risk associated with private equity investments, the directors target a return from OPM's investments of an average of five percentage points above the return on the Zimbabwe Stock Exchange's Top 10 index in the medium to longer term. OPM has just over $200 million invested at present, with individual investments ranging in size from $5 million to $15 million.

Prior to making a new investment, OPM performs a thorough due diligence investigation of the target firm. Investment terms are stipulated to ensure success. These include incentives for operating managers of the target firm, a retention period for senior management and representation on the board of the target firm by OPM executives.

In addition to senior management and the board of directors, OPM has the following staff complement:

- Deal initiators – employees responsible for sourcing new private equity investments (target firms) and presenting findings to senior management. Deal initiators also negotiate with the target firm, based on a mandate from senior management that has been approved by the board of directors. The remuneration packages of all deal initiators have a performance element that is linked to the value created by their investments.
- Back office staff – employees responsible for undertaking due diligence investigations and valuing investments for financial reporting and performance management purposes. This is undertaken for both potential new investments and existing OPM investments. It is done independently of the deal initiators, whose performance is based on the value created by investments.
- Accountants and administrative assistants – employees responsible for compiling monthly management accounts, financial statements and other matters related to administration.
- Cleaning and security staff.

Back office division and investment oversight committee

The firms in which OPM has invested submit compulsory management and financial reports. When deemed necessary, back office staff undertake surprise visits to these firms. These provide valuable information that assists with the monitoring of investments.

Quarterly valuations are performed by the back office team and submitted to the Investment Oversight Committee of the board of directors. This Committee considers the assumptions used, assesses the accuracy of the data used and approves the final valuations. The Investment Oversight Committee comprises the following four members:

- Mr Brian Heynes, CA(Z) – Finance Director and Chairman of the Investment Oversight Committee. He has 15 years' work experience within the financial services industry and has held these two positions at OPM for the past three years.
- Mr Edward Sithole – Chief Executive Officer and Chairman of the board. He has recently been appointed to these positions after working for many years at a leading international mining group as Managing Director of their Zimbabwean operations.
- Ms Brenda Koopman, CA(Z) – a senior deal initiator who was co-opted onto the Committee during the 2013 financial year ('FY2013') after the resignation of a senior

board member who was also a member of this Committee. She is the best qualified private equity finance professional at OPM and is the wife of Mr Henry Koopman, who manages OPM's Back Office Division.

- Prof. Melanie Naicker – independent non-executive director, who sits on the boards of two other listed companies. She has a PhD in strategy and has been employed with the specific aim of providing OPM with strategic insights with respect to their investment decisions.

Investment in Crescent Chickens (Pvt) Ltd

In June 2014 Mr Henry Koopman tasked back office staff with performing the work necessary to value all of OPM's investments at the end of OPM's most recent financial year on 31 May 2014. Mr Koopman reviews all valuations before submission to the Investment Oversight Committee and his performance and remuneration are linked to the accuracy of the valuations as assessed by the Investment Oversight Committee.

Details collected by a back office staff member relating to one of OPM's investments, namely Crescent Chickens (Pvt) Ltd ('CC'), are presented in appendices A and B. The valuation of CC has not yet been completed as the staff member responsible for valuing the company has been booked off sick for an extended period. However, the deadline for submission of all of OPM's investment valuations by the Back Office Division to the Investment Oversight Committee was Monday, 30 June 2014.

Appendix A: Information relating to the valuation of CC

Company background

CC is a poultry producer operating within Zimbabwe and was established in 1978. The company's operations are predominantly located in the Mashonaland Central Province, and through various brands it provides quality, affordable poultry products to customers throughout the country. The customer base of CC mainly comprises major food retailers as well as companies operating in the food services industry (such as fast food outlets).

CC is regarded as a mid-tier poultry producer with approximately a 2% market share in Zimbabwe, delivering an estimated 350 000 chickens per week to its customers.

Acquisition by OPM

OPM acquired a controlling stake in CC on 1 June 2010. Prior to this date the majority shareholders of CC were the management team members who had founded the company. The management team, all of whom are close to retirement, sold the majority of their shares to OPM in order to diversify their personal wealth prior to retirement. The terms of the acquisition required that the management team remain in the employ of the company until the end of FY2014.

OPM paid $6,5 million for 60% of the equity shares of CC in issue – the purchase price was based on a price-earnings ratio of 8,0 applied to net profit after taxation for the year ended 31 May 2010. Subsequent to the acquisition, OPM streamlined and aggressively expanded CC's operations by means of debt finance, as CC has historically had a very low gearing ratio.

Industry and company update (as at 14 June 2014)

The poultry industry has experienced significant pressures in recent years, mainly as a result of rising input costs and the inability to pass the cost increases on to customers. Selling prices have been constrained as a result of a flood of cheap chicken imports, which resulted in local poultry producers being price takers at the mercy of the large retail chains. In addition, the poultry industry remains fragmented, with no single supplier or group of suppliers dominating the market. This has placed additional downward pressure on operating margins.

In line with the industry, CC has struggled to remain profitable and reported losses in recent years. However, it has managed to report a profit for its FY2014.

Extracts from the draft financial statements for FY2014 as well as a projection of expected results for the next three financial years are presented in appendix B, together with selected supporting information which may be pertinent for the purposes of valuing CC. The forecast has been prepared by CC's financial manager, who included the following comment when submitting the information to OPM's back office:

> *'OPM has increased the financial leverage of CC to an exceptionally high level; hence my forecast has included a constant dividend policy (dividend cover of four times earnings) with excess cash being used to decrease debt levels in future years rather than reward shareholders. In addition to reducing CC's excessive gearing, the implementation of a constant dividend policy will provide shareholders with greater certainty regarding future distributions.'*

Taking into consideration future economic projections and the state of the poultry industry, CC's sustainable nominal growth rate beyond FY2017 is expected to be 6% per annum, largely due to its smaller size. The Zimbabwean long-term nominal economic growth rate is forecast to be 8% per annum.

Surprise visits during the year

Two surprise visits were made to CC's head office and operations by a team of back office staff members during the past two years. The following pertinent information was noted:

22 September 2013 surprise visit

- A new packaging process was installed during August 2013 which gives CC the edge over competitors, as no other chicken producer has a similar packaging process. This process guarantees what CC describes as a 'fresher for longer' product.
- A new operations manager was appointed on 1 September 2013 after the unexpected resignation of the previous operations manager, who had worked for the company for 23 years. In his resignation letter the former operations manager stated that his resignation was due to stressful working conditions and a breakdown in relations between the operations and finance divisions.
- Overall employee morale appeared lower than on previous visits.

13 June 2014 surprise visit

- No significant business process changes had occurred since the surprise visit in September 2013 – all production processes, including the new packaging process, appeared to be operating well.
- The operations manager who had been appointed on 1 September 2013 tendered his letter of resignation during May 2014 and will be leaving the employ of the company on 30 June 2014. CC has not yet found a suitable replacement and has no suitably qualified internal staff members who would be able to fill the position.
- Employee morale remains on the low side but seems to have improved since the last surprise visit.

Other information

The following market information has been gathered to assist with the valuation of CC:

- The current yield on a recognised long-term government bond is 7,8% per annum, while short-term government treasury bills are yielding 4,9% per annum.
- The market overdraft rate is presently 8,5% per annum.
- The average historic market risk premium for the Zimbabwean equity market is 5,5% per annum.
- Current information applicable to listed poultry producers and the wider agricultural sector is presented below:

Variable	**Average value of all listed poultry producers**	**Average agricultural sector value**
Levered beta	1,58	1,31
Unlevered beta	1,26	1,02
Debt-equity ratio	35%	40%
Earnings before interest, taxation, depreciation and amortisation (EBITDA) multiple	5,5	6,7

Mr Henry Koopman believes the most appropriate way to lever and unlever betas is to use the following Hamada formula:

$B_U = B_L / [1 + (1 - T)(D/E)]$

Where:	B_U	=	Unlevered beta
	B_L	=	Levered beta
	T	=	Taxation rate
	D	=	Market value of debt
	E	=	Market value of equity

Appendix B: Financial information relating to CC

CRESCENT CHICKENS (PVT) LTD
STATEMENTS OF COMPREHENSIVE INCOME
FOR THE YEARS ENDING 31 MAY

	Notes	Actual	Forecast	Forecast	Forecast
		2014	2015	2016	2017
		$'000	$'000	$'000	$'000
Revenue		50 316	51 322	52 348	53 918
Operating expenses	1	(45 081)	(45 985)	(46 904)	(48 311)
Depreciation		(2 534)	(2 628)	(2 694)	(2 748)
Operating profit		2 701	2 709	2 750	2 859
Interest income	2	62	58	41	42
Interest expense	3	(735)	(689)	(513)	(460)
Earnings before tax		2 028	2 078	2 278	2 441
Income tax		(568)	(582)	(638)	(683)
Net income		1 460	1 496	1 640	1 758
Retained income at beginning of year		15 936	17 031	18 153	19 383
Ordinary dividends declared		(365)	(374)	(410)	(440)
Retained income at end of year		17 031	18 153	19 383	20 701

CRESCENT CHICKENS (PVT) LTD STATEMENTS OF FINANCIAL POSITION AS AT 31 MAY					
	Notes	**Actual**	**Forecast**	**Forecast**	**Forecast**
		2014	**2015**	**2016**	**2017**
		$'000	**$'000**	**$'000**	**$'000**
ASSETS					
Non-current assets		**17 568**	**17 963**	**18 322**	**18 871**
Property, plant and equipment	5	17 518	17 963	18 322	18 871
Deferred taxation	4	50	–	–	–
Current assets		**10 387**	**10 008**	**10 469**	**10 676**
Inventories		1 428	1 283	1 570	1 618
Biological assets	6	3 577	3 593	3 664	3 774
Trade and other receivables	7	3 930	4 106	4 188	4 313
Cash and cash equivalents	2	1 452	1 026	1 047	971
Total assets		**27 955**	**27 971**	**28 791**	**29 547**
EQUITY AND LIABILITIES					
Ordinary share capital	8	1 200	1 200	1 200	1 200
Retained earnings		17 031	18 153	19 383	20 701
Non-current liabilities		**5 250**	**3 859**	**3 500**	**2 998**
Interest-bearing borrowings	3	5 250	3 500	3 134	2 621
Deferred taxation	4	–	359	366	377
Current liabilities		**4 474**	**4 759**	**4 708**	**4 648**
Current portion of interest-bearing borrowings	3	1 017	1 167	1 044	874
Trade and other payables		2 994	3 079	3 141	3 235
Provisions		463	513	523	539
Total equity and liabilities		**27 955**	**27 971**	**28 791**	**29 547**

Notes

1 The operating expenses for FY2014 include remuneration paid to the management team that founded CC and who were required to remain in the employ of the company until the end of FY2014. Their remuneration was approximately $250 000 less in aggregate during 2014 than the amount a similar management team would have been paid at market rates. This has been taken into account in the forecast figures.

2 Interest income comprises interest on CC's cash balances. Cash and cash equivalents reflect operating cash requirements.

3 Interest on long-term borrowings is payable at a variable rate linked to market overdraft rates. The interest rate payable is set at 250 basis points (2,5%) above market overdraft rates.

OPM's target long-term debt-equity ratio for CC is 25% and is based on market values, although the forecast which was prepared by the financial manager did not incorporate this.

4 CC had an unutilised assessed tax loss of $1 258 000 on 31 May 2014. This has correctly been accounted for and the benefit thereof was fully recognised in accordance with IAS 12, *Income Taxes,* resulting in a net deferred tax asset balance in the 2014 statement of financial position.

5 CC accounts for all property, plant and equipment in accordance with the cost model of IAS 16, *Property, Plant and Equipment*. Property, plant and equipment are reflected at a book value close to the assets' market value, except for the items specified below:

- Land and buildings acquired on 1 June 1990 at a cost of $380 000 now have a market value of $3 million. The property is used for operations and had a book and tax value of $200 000 on 31 May 2014. The fair value of the property was $1 250 000 on 1 October 2001.
- Equipment with a book value of $1 560 000 has an estimated market value of approximately $400 000.

6 Biological assets comprise chicken breeding stock and broilers (chickens specifically bred for meat production). These assets are measured at cost less accumulated depreciation and any accumulated impairment losses. Their book value is believed to approximate their market value.

7 When the financial manager submitted the financial information to OPM's back office he indicated that a major customer had filed for bankruptcy on 12 June 2014. The customer comprised 4% of the outstanding trade and other receivables balance at 31 May 2014, after 50% had been provided for in the form of an inclusion in CC's provision for bad debts at year end due to a poor settlement history and long overdue invoices. Initial indications are that CC will receive no compensation in respect of the amount owed.

8 Ordinary share capital comprises 1 500 000 shares in issue. The shares are held as follows:

Shareholder	**Number of shares held**	**Percentage shareholding**
OPM	900 000	60%
Management team (founders)	450 000	30%
Employees	105 000	7%
Ms Lauren Heynes (wife of Mr Brian Heynes – the Finance Director of OPM)	45 000	3%

The transferability of CC's ordinary shares is restricted in terms of a 'right of first refusal' clause in the shareholders' agreement in terms of which shareholders are required to offer any shares they intend to sell to other shareholders before such shares may be offered to third parties.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ZIMBABWE

INITIAL TEST OF COMPETENCE, JUNE 2014

PROFESSIONAL PAPER 2

The required section of this question consists of two parts. Answer each part in the correct answer book.

SA

PART I OF QUESTION 1 – REQUIRED		**Marks** Sub-total	**Marks** Total
(a)	With reference to the Alpha share option scheme granted to the executive committee of APM, discuss, with supporting calculations, the amounts that should be recognised in profit before taxation for the financial year ended 31 December 2013 of –		
	(i) APM; and	13	
	(ii) the Alpha group.	6	
	Communication skills – clarity of expression	*1*	20
Total for part I			**20**

Continued

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ZIMBABWE

INITIAL TEST OF COMPETENCE, JUNE 2014

PROFESSIONAL PAPER 2

The required section of this question consists of two parts. Answer each part in the correct answer book.

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PART II OF QUESTION 1 – REQUIRED		Marks Sub-total	Marks Total
(a)	Provide a detailed explanation of how share options are taxed.	5	5
(b)	Calculate any tax benefit accruing to Messrs Smith, Jones and Sibanda arising from the exercise of their options.	6	6
(c)	Calculate any tax benefit accruing to Mrs Moyo arising from the exercise of her options.	3	3
(d)	Calculate any capital gains tax liability for – (i) Mr Smith, and (ii) Mr Sibanda.	 4 2	6
Total for part II			**20**
TOTAL FOR THE QUESTION			**40**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ZIMBABWE

INITIAL TEST OF COMPETENCE, JUNE 2014

PROFESSIONAL PAPER 2

QUESTION 2 – REQUIRED		Marks	
		Sub-total	**Total**
(a)	Identify and describe the conflicts of interest that arise from the composition of the Investment Oversight Committee of OPM.	10	
	Communication skills – logical argument	*1*	11
(b)	Perform valuations of OPM's equity interest in CC at 31 May 2014, using the following valuation techniques: • Free cash flow method, • Earnings-based method; and • Net asset value method. Show all workings and set out the key assumptions you have used in each method.	41	41
(c)	Based on the results of your valuation workings in part (b) above, make a recommendation, with reasons, to the Investment Oversight Committee regarding the appropriate value of the investment in CC as at 31 May 2014.	7	
	Communication skills – logical argument	*1*	8
Total			**60**