

**QUESTION 1****100 marks**

Brilliant Breeze Ltd ('Breeze') is a leader in the renewable energy industry in South Africa and has a financial year end of 30 September. Breeze is listed on the Alternative Stock Exchange (AltX). The company manufactures wind turbines in its Cape Town factory and also constructs and maintains wind farms for its industrial customers in South Africa. The company has been expanding rapidly in recent years, using mainly debt financing, and is currently highly geared. Breeze's target debt ratio is 60%.

<b>1 Kenyan project</b>
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Tornado Energy Ltd ('Tornado') is one of Breeze's largest South African customers, representing 20% of Breeze's revenue. Tornado decided to expand into other African countries, starting with Kenya, and contracted with Breeze to construct a new wind farm in Kenya. This was Breeze's first construction project outside South Africa. Rather than establishing an office in Kenya, Breeze serviced this project from South Africa by temporarily moving staff to Kenya as required.

The parties agreed that Breeze would construct the wind farm for Tornado, using wind turbines that it had manufactured. Once completed, Breeze would be responsible for maintaining the wind farm in terms of a five-year maintenance contract.

Breeze invoiced Tornado in South African rand (ZAR) and the cash receivable schedule for the contract was as follows:

<b>Cash receivable schedule of Kenyan wind farm project</b>		
	<b>Notes</b>	<b>ZAR million</b>
Upfront deposit, payable on 1 April 2020	1	16
Progress payment when the site is ready for construction	2	10
Guaranteed payment upon completion of construction	3	50
Bonus payment upon completion of construction	4	15
Total maintenance payments over the life of the contract	5	25
<b>Total</b>	<b>6</b>	<b>116</b>

**Notes**

- The upfront deposit covered the cash outlay of manufacturing the wind turbines and was refundable only if Breeze did not deliver the wind turbines to the site. Once they had been delivered to the site, Tornado obtained control over the wind turbines. The wind turbines were delivered to the site on 30 June 2020.
- The site was ready for construction on 31 May 2020.
- This payment would only have been legally due once construction was completed and the wind farm was connected to the electricity grid. Breeze met these conditions on 30 June 2021.
- The bonus would be received by Breeze if construction was completed before 30 September 2021. At the financial year ended 30 September 2020 (FY2020), Breeze was uncertain if this amount would be received as it had no experience with construction timelines in Kenya. The construction was completed on 30 June 2021 and the bonus was paid on this date.

- 5 The maintenance payments were payable in five equal instalments, to be paid annually in arrears. The first payment was due one year after the wind farm was connected to the electricity grid. If Tornado cancelled the contract during the maintenance period, Breeze would be entitled to a pro-rata payment for maintenance services rendered based on the time expired.
- 6 The contract required Tornado to source construction materials in Kenya. Materials with an invoice value of ZAR12 million (which equalled the fair value) were delivered by Tornado to the site on 31 May 2020. Breeze obtained control of the materials on the same date. As at 30 June 2021, Breeze had used 90% of these materials in the construction of the wind farm (FY2020: 0%). Breeze sold the remaining materials, which it was entitled to retain, for ZAR2 million in cash on 30 June 2021.
- 7 The timing of payments relating to the Kenyan project provided neither Tornado nor Breeze with a significant benefit of financing the transfer of goods or services.

Breeze correctly identified three performance obligations in the contract, namely the sale of the wind turbines, the construction of the wind farm, and the maintenance services. Breeze also sells each of these goods and services separately on a regular basis. Management determined that if it had entered into separate contracts, the prices would have been ZAR31 million for the wind turbines, ZAR77 million for the construction contract (including a performance bonus of ZAR15 million) and ZAR25 million for the maintenance services. Whenever a customer purchases wind turbines and construction services together, Breeze grants the customer a 5,3763% discount on the amount, excluding any performance bonuses.

For construction services, Breeze recognises revenue over time based on physical inspection of construction completed to date. On 30 September 2020, physical inspection indicated that construction was 30% complete.

Costs not evident from the above information, to be recognised in profit or loss for this project, were correctly determined to be as follows:

<b>Cost of sales schedule of Kenyan wind farm project</b>	
	<b>ZAR million</b>
1 April 2020 – 30 September 2020	45
1 October 2020 – 30 September 2021	47
<b>Total</b>	<b>92</b>

## **2 Opening of new African offices**

Following the success of the Kenyan project, management decided that Breeze should investigate an expansion into the rest of Africa. This expansion would be facilitated by establishing a permanent office in another African country. This would enable construction and maintenance services to be delivered to local customers in that country. The existing Cape Town factory would still manufacture all wind turbines.

To identify the country that the company should target first, management obtained the following publicly available data to enable it to compare various countries with South Africa:

<b>African expansion possibilities</b>					
	<b>Notes</b>	<b>South Africa</b>	<b>Kenya</b>	<b>Namibia</b>	<b>Morocco</b>
Flight distance from Cape Town to capital city		0	5 200	1 500	11 100
Main business language		English	English	English	French
Currency <sup>#</sup>	1	ZAR	KES	NAD	MAD
Gross domestic product (GDP) per capita (in ZAR)		89 292	25 998	80 178	47 026
Ten-year GDP growth per annum		1,6%	5,1%	3,3%	3,1%
Unemployment rate		27,0%	9,3%	23,1%	9,0%
Local skills score*	2	58,1	56,3	54,6	48,6
Ease of doing business score*	3	84	56	93	53
Liveability index score*	4	70,9	60,1	64,6	68,6
Environmental performance score*	5	60	86	69	65
Change in environmental score	6	+8,5	0,0	+9,1	+13,3
Renewable as % of total energy	7	17,2%	72,7%	26,5%	11,3%
Land area with appropriate wind speed	8	Yes	Yes	Yes	Yes
Breeze's current customers	9	Yes	Yes	No	No
Current central bank interest rate		3,5%	7,0%	3,8%	1,5%
Corporate taxation rate		28%	30%	31%	32%

# Currencies: KES = Kenyan shilling  
NAD = Namibian dollar  
MAD = Moroccan dirham

\* Higher scores are better.

### Notes

- 1 The NAD:ZAR exchange rate is fixed at 1:1.
- 2 The local skills score reflects the education and skills of the local population.
- 3 The ease of doing business score takes into consideration factors such as the regulatory environment and the availability of resources.
- 4 The liveability index score reflects the quality of life for ordinary citizens in a country.
- 5 The environmental performance score reflects how well this country compares to others with regard to environmental legislation and enforcement.
- 6 The change in the environmental score reflects how the environmental credentials of the country have changed over the past ten years.
- 7 The renewable energy percentage reflects how much of the total electricity consumed in the country comes from the use of renewable energy sources such as water, wind and solar power.
- 8 Suitable conditions for wind farms require areas with a regular wind speed of six metres per second or faster.

- 9 Breeze has no customers or indirect exposure in any other African countries, apart from the Tornado project in Kenya.

Management believes that Breeze will be welcomed in any country that it chooses to enter due to its strong environmental credentials and track record of creating job opportunities.

The construction of wind farms requires specialist supervision skills. Therefore, during the first year of operation of the permanent foreign office, construction supervisors will be temporarily transferred from Breeze's Cape Town office to that foreign office. The foreign office will be charged an hourly rate for these supervisors.

The following information relates to costs incurred by Breeze in respect of the supervisors and revenues generated by the supervisors:

- Each supervisor is paid a fixed salary of ZAR768 000 per annum. On average, each supervisor works 1 920 hours per annum. If a supervisor was required to work any additional hours (i.e. overtime), that supervisor would be paid ZAR600 per additional hour.
- It was estimated that the foreign office would require 500 hours of supervision during the first 12 months of operations. The supervisors are expected to have, in total, 350 unutilised normal working hours available during this 12-month period (before considering the Department of Environmental Affairs contract below).
- The South African government has offered Breeze a contract to provide specialist advice to its Department of Environmental Affairs regarding the effect of wind farm construction projects on the environment. Given their skills, the supervisors would be required to carry out the contract. The contract would run over the same time period as the first 12 months of a foreign office's operations. The government has offered to pay Breeze a rate of ZAR500 per hour for a total of 300 supervisor hours. The number of hours is non-negotiable.
- All costs relating to flights, accommodation and subsistence will be payable by the foreign office.

### 3 Long-term debt maturity

ZAR500 million of Breeze's long-term debt is maturing in early October 2022. Breeze does not expect to have sufficient cash available to repay this debt. The following sources of finance are therefore being considered:

- A ZAR500 million rights issue. The following market data is available:

Selected market data	
Yield on 364-day Treasury Bills	4,85%
Yield on R186 Government Bonds (matures 21 December 2026)	7,50%
Yield on R2032 Government Bonds (matures 31 March 2032)	9,75%
Market risk premium: South Africa	7,00%
Unlevered beta of Breeze	0,85
Current market price of Breeze shares	ZAR20 per share

Hamada formula:  $\text{Beta (levered)} = \text{Beta (unlevered)} \times [1 + \{(1 - T) \times (\text{debt} / \text{equity})\}]$

- A bank loan of ZAR500 million at a market-related fixed interest rate of 12% per annum. Interest is payable annually on 30 September. The capital portion of the loan will be repayable in five equal annual instalments commencing on 30 September 2023. The bank will require a first cession over Breeze's accounts receivable and inventory balances to cover the capital amount outstanding.
- A green corporate bond that will have a nominal value of ZAR550 million and an issue price of ZAR500 million. The coupon will be payable quarterly in arrears at the South African Reserve Bank repurchase rate (repo rate) of 3,75% plus 4,25%, equalling 8,00%. The first coupon will be payable on 31 December 2022. The bond will be redeemable at par on 30 September 2029.

Irrespective of the source, the finance will be raised on 1 October 2022.

The following extract from Breeze's budget is available to assist the management team with evaluating which source of finance Breeze should select:

<b>Extracts from the budgeted statements of financial position at 30 September:</b>				
	<b>Notes</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>
		<b>ZAR million</b>	<b>ZAR million</b>	<b>ZAR million</b>
Share capital (100 million ordinary shares)	1	500	500	500
Retained earnings		1 250	1 325	1 500
Shareholders' interest		1 750	1 825	2 000
Long-term debt	1, 2	3 250	3 250	3 250
		<b>5 000</b>	<b>5 075</b>	<b>5 250</b>
Property, plant and equipment		3 500	3 575	3 475
Current assets		2 000	2 125	2 155
Current liabilities		(500)	(625)	(380)
		<b>5 000</b>	<b>5 075</b>	<b>5 250</b>

### **Notes to the budget**

- 1 The budgeted amounts include the effects of the planned expansion into the rest of Africa. However, it does not include the raising of any new finance referred to above.
- 2 ZAR750 million of the long-term debt is from NatBank and matures in September 2029. The high debt ratio resulted in a breach of one of the loan covenants contained in the NatBank loan agreement. However, Breeze was able to successfully renegotiate the loan terms. The revised loan terms stipulate that the loan will become due and payable on 1 October 2024 if Breeze's debt ratio is not below or equal to the 60% target by 30 September 2024.

**INITIAL TEST OF COMPETENCE, JANUARY 2022**

**PROFESSIONAL PAPER 1**

**This paper consists of two parts. Please answer each part in a separate answer book.**

<b>PAPER 1 PART I – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(a)	<p>Prepare the journal entries (cash transactions included) of Breeze to account for the transactions and events in terms of International Financial Reporting Standards for the financial year ended 30 September 2020 and 30 September 2021 with reference to section 1.</p> <ul style="list-style-type: none"> <li>The Kenyan project meets all the requirements of a contract in terms of IFRS 15 <i>Revenue from Contracts with Customers</i>.</li> <li>Round amounts to the nearest ZAR.</li> <li>Indicate, for each leg of a journal entry, which component of the financial statements will be affected (for example: P/L, SFP, OCI, equity).</li> <li>Show all workings to support calculations, including revenue amounts.</li> <li>Ignore expected credit losses.</li> <li>Ignore all tax consequences.</li> </ul> <p><i>Communication skills – presentation</i></p>	30	
<b>Total for part I</b>		<b>1</b>	<b>31</b>

**INITIAL TEST OF COMPETENCE, JANUARY 2022**

**PROFESSIONAL PAPER 1**

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<b>PAPER 1 PART II – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(b)	Advise Breeze on which country would be best for expansion with reference to section 2. Also include any other factors that Breeze should consider when selecting one of these countries for expansion.  <i>Communication skills – logical argument; appropriate style</i>	20  2	  22
(c)	With reference to section 2 only – (i) calculate the minimum hourly rate that the foreign office should be charged for supervisors in the first year of operations (briefly motivate any amounts you exclude); and (ii) identify other key factors that could impact the minimum hourly rate for supervisors.	6  4	  10
(d)	Critically evaluate, with reference to section 3, the sources of finance being considered. Your evaluation should include – <ul style="list-style-type: none"> <li>• a comparison of the costs of finance and the impact of each source of finance on the target debt ratio for all budgeted periods (round all final answers to two decimals); <u>and</u></li> <li>• any other qualitative factors not dealt with.</li> </ul> <i>Communication skills – logical argument; layout and structure</i>	35  2	  37
<b>Total for part II</b>			<b>69</b>
<b>TOTAL FOR THE PAPER</b>			<b>100</b>