

IGNORE VALUE-ADDED TAX**Background**

The Sunnyside Food Group Ltd ('Sun Food') is a company listed on the Johannesburg Stock Exchange. The company operates several food franchises and owns various restaurants in South Africa. Its head office is in Johannesburg, where it was founded as a family business several decades ago. The Sun Food franchise brands are diverse (including pizza, seafood, and burger brands), which contributed to Sun Food's financial resilience during the lockdowns triggered by the Covid-19 pandemic.

Sun Food prepares annual financial statements in accordance with International Financial Reporting Standards (IFRS) and has a 31 December financial year end.

Sun Food derives its revenue from –

- the restaurants it owns; and
- franchise royalty fees from its franchise brands.

Sun Food restaurants focus on offering comfortable sit-down dining options.

Sun Food owns a portfolio of franchise brands that each comprises several individual franchises around the country. The franchises serve mostly takeaway meals with limited seating options.

The company has cash balances in excess of its operational requirements for the next two to three years. It is therefore considering two investment options.

Option 1: Dark kitchen and accompanying software application

Sun Food is exploring an investment in a 'dark kitchen', which is a kitchen that prepares food for delivery only. The dark kitchens are not open to the public for the collection of meals or in a sit-down format. These are also known as delivery kitchens or virtual kitchens and operate several brands from one large physical kitchen. Many dark kitchens have begun taking orders via their own software applications and delivery services. Customers are served only via delivery to their locations through delivery partners.

Dark kitchens became increasingly popular after the Covid-19 lockdown restrictions of the past few years. The management team at Sun Food is considering investing in a single dark kitchen that will house some of their existing takeaway brands.

Sun Food engaged a US-based hospitality consultancy firm, Consumer Concept Consultants ('CCC'), to research whether Sun Food should open a dark kitchen. CCC has expertise in launching new restaurant ventures and has assisted with the launch of several well-known, international dark kitchen projects. This market research was conducted during the fourth quarter of 2022, with CCC providing initial insights on the potential impact of a dark kitchen on Sun Food's operations. On 1 December 2022, CCC invoiced Sun Food USD500 000, payable on 31 December 2022, which is within CCC's normal credit terms. Sun Food settled the amount owing on the due date.

If Sun Food decides to go ahead with the dark kitchen project, CCC will create a customised software application ('app') for Sun Food. This app will provide a single platform from which customers would be able to access all takeaway brands that will be housed in the dark kitchen. Currently, all takeaway franchises in the Sun Food group accept orders from customers via popular food delivery apps operated by delivery partner companies outside the group.

The combination of several Sun Food brands into a single dark kitchen will allow customers to combine items from different franchise brand menus into a single order. Thus, there will be a saving on delivery time and costs for customers. This is expected to be a key benefit of the customised Sun Food app and dark kitchen project.

CCC is expected to develop and test the app in two separate phases. The app is expected to be completed on 31 December 2023, when the app and all rights attached to it will be transferred to Sun Food for its use only.

The following is an extract of the proposed contract terms for the app with CCC:

- The commencement date of development is 2 January 2023.
- The contract price is USD1,5 million.
- A 50% deposit of USD750 000 is payable on 2 January 2023. Sun Food is expected to make the payment on time.
- The balance of the contract price of USD750 000 is due on 31 December 2023. Sun Food expects to pay the outstanding amount on 31 December 2024.
- Interest is payable on any outstanding balances at 4% per annum, compounded annually.

The app is not considered to be a qualifying asset in terms of IAS 23 *Borrowing Costs*. The app will need to be upgraded after two years from the date that it is available for use, due to anticipated technological advances. At that point, Sun Food will evaluate the actual returns on the dark kitchen and decide whether to partner and add brands outside that of the Sun Food brand franchises. The useful life of the app for tax purposes will be two years from the date that the app is used to generate income. The tax cost will be equal to the total amount due (excluding interest) multiplied by the spot rate on the date of completion. The app will have no residual value.

If it decides on this option, Sun Food will launch its dark kitchen in January 2024 in Cape Town. Sun Food will close five franchises in Cape Town as soon as the dark kitchen project is launched. Two of these franchises are part of the Great Burger brand, and three are part of the Pizza Pronto brand.

The Great Burger and Pizza Pronto franchises have been struggling to meet profit targets in recent years. In terms of franchise agreements, the Great Burger and Pizza Pronto franchisees pay royalties of 18% of their revenue to Sun Food monthly in arrears on the last day of each calendar month. The franchisees benefit from Sun Food's negotiating power as Sun Food negotiates all rental agreements with landlords. The rental contracts are in the name of Sun Food. Sun Food therefore bears the rental charge for the franchises. These rental charges are accounted for in the royalty payment of 18% of revenue.

As per rental agreements, a rental of ZAR2,6 million would have been payable annually in advance in 2024 for each franchise that is to be closed. This rental would have escalated by 6% per annum each year thereafter. If the franchises are closed, Sun Food would have to pay a once-off, total termination penalty of ZAR3 million on 1 January 2024 for all five franchises. The penalty will be deductible for tax purposes.

Sun Food would be able to use the kitchen equipment and furniture from the closed franchises in the dark kitchen and staff members from these franchises would be re-assigned to the dark kitchen. Sun Food would incur rental costs for the new dark kitchen premises amounting to ZAR1 million per annum payable annually in arrears (escalating at 6% per annum).

The launch of the dark kitchen will impact projections for 2024 and 2025. The five Cape Town takeaway franchises are estimated to collectively generate ZAR18 million of revenue per year in 2024 and 2025, if the dark kitchen is not launched. If the dark kitchen is launched, only 80% of the estimated revenue will be generated in 2024 and 2025 from the dark kitchen. The anticipated loss in revenue (20%) may be ascribed to a loss of customers who prefer to order and collect their food in person.

However, revenue will be earned from new customers who prefer to order via the Sun Food app. Most of this revenue is expected to come from breakfast and lunch orders from people who work from home. In addition, revenue is also expected to increase as customers can choose items from both Great Burger and Pizza Pronto menus in a single order. Total additional revenue from new customers who prefer to order via the Sun Food app is estimated to amount to ZAR5,04 million in 2024 and ZAR5,58 million in 2025.

Option 2: EatWell

Despite the variety of fast food and sit-down brands in Sun Food’s portfolio, it does not have a brand that has an exclusively plant-based offering. Sun Food’s executives have identified a movement in customer preferences towards healthier food options, based on their analysis of product revenues from the company’s existing menus. Furthermore, information from food scientists shows that people are becoming more likely to develop food allergies. Due to these factors, smaller restaurants that offer a variety of plant-based meals are becoming more popular among customers. Plant-based foods are made entirely from plants and are free from all animal products.

EatWell Healthy Foods (Pty) Ltd (‘EatWell’) is a casual dining restaurant brand that provides plant-based meals to its customers. EatWell operates two sit-down restaurants in Cape Town. The company was founded by Cookie Baker in 2017. Its core values are to provide delicious meals that are healthy and environmentally friendly. Cookie, who has a majority shareholding in EatWell, is the product development director of the company, and she focuses on creating meals that use plant-based ingredients in a way that mimic foods that are traditionally meat-based, such as minced pork, and burger patties. EatWell also operates a kitchen in which it prepares a growing range of pre-packed, plant-based frozen meals for small supermarkets.

Sun Food’s management believes that EatWell’s unique product offering has great potential. They think that EatWell’s existing offering of frozen meals can be expanded by leveraging Sun Food’s distribution infrastructure. Further, Sun Food’s existing range of menus can be expanded to include more plant-based options. They are therefore considering acquiring a 30% stake in EatWell’s business for ZAR24 million. Payment will be made as follows:

Date	Payment
	ZAR’000
1 January 2023	16 000
1 January 2024	8 000
Total	24 000

EatWell's net assets amounted to ZAR76 million (having taken into consideration a deduction of ZAR25 million for all liabilities) on 31 December 2022. At that date, Sun Food considered the underlying assets and liabilities of EatWell to be fairly valued. The exception is a building used by EatWell for administration and production purposes with a carrying amount of ZAR16 million, which is considered to have a fair value of ZAR17,2 million. EatWell does not revalue its buildings.

EatWell and Sun Food agree that the building is expected to have a remaining useful life of ten years and a residual value of ZAR500 000. EatWell's profit after tax for the 2023 financial year (FY2023) is expected to be ZAR19,15 million. Should Sun Food acquire 30% of EatWell's ordinary shares on 1 January 2023, one of the conditions is that Sun Food will be entitled to appoint one of the four directors on EatWell's board of directors. Sun Food will have significant influence over EatWell.

At a recent meeting, senior executives of Sun Food further discussed the viability of EatWell and its acquisition. Many executives felt that the plant-based meal trend would pass and demand would disappear within a few years. Others believed that environmental concerns such as climate change would result in a growing demand for plant-based meals.

EatWell's current owners are concerned that Sun Food might after acquisition sell its shareholding to a party that does not support its core values. Therefore, the purchase agreement will include a clause that Sun Food must retain its stake in EatWell until at least 31 December 2025. Should Sun Food decide to sell at that point, the investment in EatWell must first be offered to the existing owners. The parties will calculate the equity value with reference to the enterprise value. The enterprise value will be calculated as earnings before interest, tax, depreciation, and amortisation (EBITDA) multiplied by 6.

Should the existing owners decide not to take up this option, the investment in EatWell can be sold on the open market.

The market value of debt in the company is expected to be ZAR9,8 million on 31 December 2025.

The following are extracts from EatWell's cash flow projections:

Cash flow statement: Extracts and projections	Notes	2022	2023	2024	2025
		Actual	Forecast	Forecast	Forecast
		ZAR'000	ZAR'000	ZAR'000	ZAR'000
Net cash inflow from operating activities	1, 2	18 500	19 610	20 983	23 081
Net cash outflow from investing activities		(10 160)	(10 770)	(11 523)	(12 676)
Net cash (outflow) / inflow from financing activities	3	(3 698)	1 745	1 867	2 054
Movement in cash and cash equivalents		4 642	10 585	11 327	12 459
Opening balance: Cash and cash equivalents		35 387	40 029	50 614	61 941
Closing balance: Cash and cash equivalents	4	40 029	50 614	61 941	74 400

Notes

- 1 According to the purchase agreement, EatWell will sell pre-packed meals to Sun Food at a gross profit margin of 10%, payable on delivery. This is a lower margin than EatWell's usual, market-related gross profit margin of 20%. EatWell's forecasts include the following cash amounts from Sun Food, at a 10% gross profit margin:

Projections from management accounts	2023	2024	2025
	Forecast	Forecast	Forecast
	ZAR'000	ZAR'000	ZAR'000
Revenue received from Sun Food for pre-packed meals	1 560	2 072	2 686

If Sun Food sells its stake in EatWell after 31 December 2025, any transactions between the companies will thereafter be subject to a market-related gross profit margin.

- 2 Excluding finance costs paid and tax paid, net cash inflow from operating activities approximates EBITDA. The following amounts were included in the estimations of net cash inflow from operating activities:

Amounts included in net cash inflow from operating activities	2022	2023	2024	2025
	Actual	Forecast	Forecast	Forecast
	ZAR'000	ZAR'000	ZAR'000	ZAR'000
Finance costs paid	686	784	882	922
Tax paid	3 700	3 925	4 121	4 928

- 3 EatWell's dividend policy is to pay its shareholders a dividend of 40% of its actual cash inflows from operating activities. The dividend is declared and paid on 31 December each year. It expects this policy to continue into the foreseeable future. Dividends paid are included in the cash flows from financing activities line item.
- 4 It is estimated that a cash balance of ZAR25 million is required for operations from 1 January 2023 to 31 December 2025.

Additional information

- 1 An appropriate pre-tax discount rate of 12% per annum (compounded annually) is applicable for all periods presented, for transactions denominated in South African rand.
- 2 Sun Food accounts for intangible assets on the cost model in accordance with IAS 38 *Intangible Assets*.
- 3 Sun Food's policy is to disclose cash flows from dividends paid as a financing activity, and cash flows from dividends received as an investing activity.
- 4 A corporate tax rate of 27% is applicable for all periods, unless stated otherwise.
- 5 The following actual and forecast exchange rates are applicable:

USD : ZAR exchange rates	USD1 : ZAR
1 December 2022	16,300
31 December 2022	16,450
2 January 2023	16,800
31 December 2023	17,250
31 December 2024	17,850
Averages	
1 December 2022 – 31 December 2022	16,220
1 January 2023 – 30 June 2023	16,630
1 July 2023 – 31 December 2023	17,020
1 January 2024 – 31 December 2024	17,550

The Sun Food executives asked the Sun Food accountant, Hugh Green, to provide forecast management accounts for Sun Food for FY2023. The only transactions accounted for that relate to EatWell, are included in the notes below:

Extract from forecast management accounts for the year ended 31 December 2023	Notes	2023
		ZAR'000
Revenue for the year		(2 360 000)
Net profit before tax	1	(294 380)
Taxation expense		103 754
Deferred tax liability as at 31 December		(52 340)
Inventory as at 31 December	2	86 750

Notes

- 1 Net profit before tax includes the dividend received from EatWell on 31 December 2023, in terms of the dividend policy.
- 2 This inventory balance includes inventory purchased from EatWell amounting to ZAR135 000.

INITIAL TEST OF COMPETENCE, JUNE 2023

PROFESSIONAL PAPER 1

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

PAPER 1 PART I – REQUIRED		Marks	
		Sub-total	Total
(a)	calculate the internal rate of return (IRR) for option 1: Dark kitchen and accompanying software application. <ul style="list-style-type: none"> • For calculation purposes, assume that today's date is 31 December 2022. • Limit your analysis to the period up to 31 December 2025. • Provide brief reasons for omissions/exclusions from your calculations. • Round all workings and answers to the nearest whole number. <i>Communication skills – clarity of expression</i>	19	
(b)	Calculate the IRR for option 2: EatWell. <ul style="list-style-type: none"> • For calculation purposes, assume that today's date is 31 December 2022. • Assume that Sun Food sells its stake on 31 December 2025. • Round all workings and answers to the nearest whole number. 	19	19
(c)	Provide a recommendation on the best investment option for Sun Food, taking into consideration your calculations in parts (a) and (b), as well as any relevant strategic factors. <ul style="list-style-type: none"> • Do not perform any further calculations. <i>Communication skills – logical argument</i>	19	
Total for part I			59

INITIAL TEST OF COMPETENCE, JUNE 2023

PROFESSIONAL PAPER 1

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

PAPER 1 PART II – REQUIRED		Marks	
		Sub-total	Total
For requireds (d) and (e), assume that Sun Food decides to go ahead with the dark kitchen and the accompanying software app, and that all forecast amounts have been achieved.			
(d)	<p>Discuss how the app created by CCC should initially be recognised and measured by Sun Food in terms of IFRS.</p> <ul style="list-style-type: none"> Round all amounts to the nearest ZAR'000. <p><i>Communication skills – appropriate style</i></p>	10 1	11
(e)	<p>Prepare the journal entries to record the contract entered into with CCC to develop the app, in the accounting records of Sun Food for FY2023 and FY2024.</p> <ul style="list-style-type: none"> Round all amounts to the nearest ZAR'000. All amounts are material. Do not provide journal narrations. Ignore closing entries. Ignore all tax consequences. 	10	10
For required (f), assume that Sun Food elects to invest in EatWell and that all forecast amounts are achieved.			
(f)	<p>Prepare an extract of the following statements of the Sun Food group as at 31 December 2023, in so far as the information allows:</p> <ul style="list-style-type: none"> Statement of profit or loss for the year; Statement of financial position; and Statement of cash flows, for the cash flows from investing activities only. <ul style="list-style-type: none"> Round all amounts to the nearest ZAR'000. All amounts are material. Do not provide notes to the financial statements and accounting policies. Do not provide comparative figures. <p><i>Communication skills – presentation</i></p>	19 1	20
Total for part II			41
TOTAL FOR PAPER 1			100