

**1 Introduction**

The South African Multinational Paper Group Ltd ('SAMP' or 'the Group') is a producer and retailer of paper and pulp products. SAMP was founded in 1936 and listed on the Johannesburg Stock Exchange in 1937. SAMP's headquarters are based in Gauteng and it has pulping mills and paper production plants across KwaZulu-Natal and Mpumalanga.

SAMP has investments in various companies, including in Maastricht Mills B.V. ('Maastricht'), a subsidiary based in the Netherlands. Maastricht comprises 15% of SAMP's total assets. Firehouse Auditors Inc. ('Firehouse'), a large South African audit firm, has been the auditors of SAMP for the past eight years.

**2 SAMP product lines**

SAMP has the following product lines:

- **Graphic paper (GrP)** – GrP is used for printed communication purposes and includes two types of paper grade, namely coated paper and newsprint.
- **Speciality packaging paper (SPP)** – SPP is made from sustainably sourced wood, hay or hemp and is used for product packaging. The production of SPP emits lower carbon dioxide and uses approximately 40% less water than the production of GrPs.
- **Dissolving wood pulp (DWP)** – DWP has a wide range of uses, such as modifiers in lipsticks, washing machine tablets and fillers in fat-free yoghurt, and is also used to make viscose fibres for use in textiles (clothing). DWP is made from pulp from fast-growing trees.

**3 Industry information**

Due to a consumer shift toward digital media and advertising and environmentally friendly products, there has been a severe decline in the demand for GrP products in the paper and forestry products industry.

The demand for SPP products has increased sharply as consumers move to e-commerce and choose companies that use sustainably sourced carbon-neutral paper packaging.

The demand for DWP has increased significantly due to its wide applicability in various industries. DWP is easily available and sustainable, which is expected to further push the growth of the global DWP market.

This has created and increased the need to restructure production capacity away from GrP product lines in favour of SPP and DWP product lines.

#### 4 SAMP paper production and operational information

To produce its products, SAMP uses two main pulping processes:

- **Kraft pulping** – This process yields pulp for production of GrP and/or SPP. The pulp can be used to produce DWP if the woodchips used in kraft pulping are first steamed at high temperatures. This additional process does however result in increased consumption of timber in the production process.
- **Sulphite pulping** – This process yields pulp for the production of DWP.

Since incorporation, SAMP's focus has been the manufacture and sale of GrPs. The growth in demand for GrPs from the 1940s to 2010 saw SAMP increasing production of regular wood pulp by means of kraft pulping at its South African pulping mills. SAMP produces a small amount of DWP and SPP at certain pulping mills in KwaZulu-Natal.

Due to the decline in the demand for GrP over the last decade, SAMP's earnings have been declining steadily. This has led to lower cash reserves and increased debt levels, as gross and net profit margins continue to decline.

The reduced revenue growth and profit margins resulted in a significant decline in SAMP's share price. Accordingly, SAMP's shareholders are advocating for improved operating efficiency by disposing of the GrP operations to fund investment of more sustainable and profitable product lines and to reduce debt.

SAMP management is considering the following:

- The disposal of older, inefficient mills producing mainly GrP;
- Restructuring production capacity by converting machines that produce GrP to the production of SPP; and
- Converting kraft pulping mills to increase the production of DWP.

Management has established a task team to investigate these considerations, as well as other areas to improve earnings, such as cost savings and retrenchments. The task team is led by the new chief research and innovation officer, Charl Mondy.

The information below relates to the operations of SAMP for the financial year ended 31 December 2022 (FY2022), with related suggestions from the task team.

#### 4.1 Disposal of the investment in Maastricht

SAMP acquired 60 000 shares in Maastricht for EUR376 616. This acquisition was correctly recognised as a business combination on 1 January 2008 in terms of IFRS 3 *Business Combinations*.

Maastricht acquires kraft pulp from SAMP's South African mills, which it then converts into GrP at its pulping mill. Maastricht receives raw material when needed and does not hold inventory from SAMP on hand. The functional currency of Maastricht is the Euro.

Maastricht represents a separate geographical area of operations for SAMP.

On 1 January 2008, SAMP valued the land on which Maastricht's mill is situated at EUR200 000 more than the carrying amount at which it is reflected in the separate accounting records of

Maastricht. The carrying amounts of all the other assets and liabilities of Maastricht were equal to their fair values on this date.

On the recommendation of the task team, SAMP disposed of its total shareholding of 60 000 shares in Maastricht on 31 March 2022. This disposal did not comply with the criteria for classification as non-current assets held for sale until the date of disposal. The proceeds of the sale of the shares were received in cash as follows:

- EUR926 327 on 31 March 2022; and
- EUR611 921 on 31 March 2023.

Extracts of financial information relating to Maastricht is provided below:

<b>Maastricht</b>		
<b>Extract from the trial balance as at 31 December 2022</b>		
<b>Details</b>	<b>EUR</b>	<b>ZAR</b>
Ordinary share capital (shares of EUR1 each)*	100 000	1 037 000
Retained earnings		
At 1 January 2008	250 000	2 592 500
From 2 January 2008 to 31 December 2021	2 089 000	28 101 228
Revaluation surplus – arose on 1 January 2011 and relates to the land on which the mill is situated	450 000	?
Loss after tax for the year ended FY2022	(862 000)	?
The ZAR amounts have been correctly translated from EUR (functional currency) in accordance with IAS 21 <i>The Effects of Changes in Foreign Exchange Rates</i> for consolidation purposes.		

\* Unchanged for all periods under consideration.

<b>Maastricht</b>			
<b>Extract of the summarised statement of profit or loss and other comprehensive income for the year ended 31 December 2022</b>			
	<b>1 January 2022 – 31 March 2022</b>	<b>1 April 2022 – 31 December 2022</b>	<b>Total for FY2022</b>
	<b>EUR</b>	<b>EUR</b>	<b>EUR</b>
Revenue	275 000	825 000	1 100 000
Cost of sales	(325 750)	(977 250)	(1 303 000)
Expenses	(133 750)	(649 250)	(783 000)
Tax (expense)/income	(31 000)	155 000	124 000

The relevant exchange rates are as follows:

<b>Exchange rates</b>	<b>EUR1 : ZAR</b>
1 January 2008	10,370
1 January 2011	8,838
1 January 2021	17,802
31 December 2021	18,138
31 March 2022	16,193
31 December 2022	16,342
Average for the period	
1 January 2008 – 31 December 2010	9,456
1 January 2022 – 31 March 2022	16,495
1 April 2022 – 31 December 2022	16,533
1 January 2022 – 31 December 2022	16,795

#### 4.2 The SAMP Eastcreek coated paper production plant ('Eastcreek')

Eastcreek is situated in Mpumalanga and produces 23 000 metric tonnes of unique GrP per annum. Eastcreek is the only SAMP plant that produces this type of unique GrP and it represents a separate product line. Eastcreek receives kraft pulp from another SAMP subsidiary and produces the unique GrP.

Eastcreek's forecast net cash flows have declined significantly due to the reduced demand for GrP products. However, there is still a market for the unique coated GrP products that Eastcreek produces.

The task team recommended that Eastcreek be converted to produce SPP. At 31 December 2022, this recommendation had not yet been implemented.

Extracts of financial information relating to Eastcreek:

Eastcreek					
Description	Note	Date current assets were acquired / non-current assets first brought into use	Cost	Expected life at date brought into use	Carrying amount at 1 January 2022
			ZAR'000		ZAR'000
Land	1	1 January 2010	8 000	N/A	8 000
GrP paper factory building	2	1 May 2010	9 700	30 years	5 604
Fourdrinier machine	3	1 April 2016	7 000	Various	5 630
Paper coating machine	3	1 May 2016	3 310	10 years	1 434
Inventory	4	31 December 2022	1 580	N/A	N/A

Eastcreek Task team valuation report Extract at 31 December 2022			
Description	Value in use of current operations (pre-restructure)	Value in use if restructured to produce SPP	Fair value less costs to sell
	ZAR'000	ZAR'000	ZAR'000
Eastcreek coated paper production plant in total (land, GrP paper factory building, Fourdrinier machine, paper coating machine and inventory)	16 500	20 000	15 000

#### Note 1: Land

The land was initially acquired by SAMP for ZAR8 million with the intention of constructing the Eastcreek paper production plant. The task team contracted and appointed James Ngidi as its appraiser to determine the value of the land on 31 December 2022. James is an independent sworn appraiser with 12 years of experience and is registered with the South African Council for the Property Valuers Profession. He applied the International Valuation Standards, which came into effect on 1 January 2022.

James determined the fair value of the land to be ZAR6,8 million, based on its current use. Because the land is close to SAMP's other operations, it would be feasible to demolish the Eastcreek paper plant and use the land for a plantation of trees used to produce DWP. James determined that this would increase the production of DWP and increase the value of the land to ZAR7,7 million. The cost of converting the land will be negligible and there are no legal restrictions on this conversion. The land does not generate independent cash flows unless it is disposed of.

The cost of disposal of the land, including legal fees, will amount to ZAR200 000. The land will be sold once the factory building has been demolished, as the factory building has no use to other market participants.

## **Note 2: Factory building**

The factory building was constructed to meet very specific requirements related to housing the original Fourdrinier machine as well as a paper-coating machine. The building would have no other use to market participants. Therefore, should the machines be removed, the factory building would have to be demolished and sold for its scrap value. It is not possible to determine if the value in use is close to the factory building's fair value less costs to sell.

## **Note 3: Fourdrinier and paper-coating machines**

The Fourdrinier and paper-coating machines were replaced by new machines in 2016. These new machines were customised to be specifically housed in the factory building.

The Fourdrinier machine pushes wet pulp on a mesh belt through a series of rollers which dries the pulp. The Fourdrinier machine's mesh belt and rollers need to be replaced on a regular basis and have no residual value.

The mesh belt has a two-year useful life. The mesh belt currently being used was purchased and brought into use on 31 December 2021 for ZAR800 000 and was correctly accounted for.

The rollers currently being used were purchased and brought into use on 30 June 2021 for ZAR2,2 million and were correctly accounted for. The useful life of the rollers is five years.

The rest of the Fourdrinier machine has a useful life of 20 years and no residual value.

The dried flattened pulp is fed directly into the paper-coating machine. The paper-coating machine has no residual value.

The fair values of the Fourdrinier machine and paper-coating machine, as determined by quoted market prices, amounted to ZAR3,8 million and ZAR400 000 respectively on 31 December 2022. The costs of disposal of both machines are considered to be negligible. The value in use of both machines cannot be determined as neither produce cash flows that are independent of the factory building and each other.

## **Note 4: Inventory**

There were 2 000 metric tonnes of GrP inventory on hand at 31 December 2022. There were no raw materials or work-in-progress inventory on hand.

### **4.3 Restructuring: Management share incentive awards**

On 31 December 2021 SAMP granted options to its executives to acquire its shares. These options will mature on 31 December 2023 with a strike price equal to the SAMP share price at the grant date. Due to the declining share price, current market conditions, and the aftermath of Covid-19, these options are expected to remain out of the money until vesting. Accordingly, executives are demotivated as they feel their share options are worthless, and that they have little incentive to stay with the Group.

Charl, the chief research and innovation officer, proposed two alternatives for an incentive to be added to the executives' remuneration policy to try to retain them. Charl submitted the proposal directly to the shareholders for consideration at the upcoming annual general meeting (AGM).

#### Alternative 1

- A special cash bonus;
- A housing allowance, to be added to their monthly salaries; and
- A salary increase of 9%.

#### Alternative 2

- The issue of new share options to executives at a strike price lower than those of the existing share options.

Prior to the AGM, the majority of shareholders expressed reservations about both alternatives. They felt that this would defeat the purpose of the initial options agreed with the remuneration committee to align management and shareholder interests. They did not want to reward management for the poor performance and lack of insight into market trends in managing SAMP to date. Furthermore, these remuneration incentives would not necessarily act as an incentive to improve director performance – it would merely improve the executives' financial positions without clear performance-related targets. There would be no focus on company objectives such as implementing strategies to achieve carbon-neutral production facilities or lower its carbon dioxide footprint.

The shareholders noted that the Group was disposing of operations and considering retrenching staff and at the same time asking for additional rewards for executives. Furthermore, the shareholders themselves had suffered significant losses in investment value due to the decline in the SAMP share price. The net losses would also be worsened by approving these incentives.

## **5 Additional Information**

- The presentation currency of the Group is the ZAR.
- The financial year end for all companies in the Group is 31 December.
- The profits and cash flows of all the companies in the Group occurred evenly throughout the year, unless stated otherwise.
- The Group measures non-controlling interests at its proportionate share of the fair value of the net assets at acquisition date.
- The Group measures investments in subsidiaries in its separate financial statements at cost in terms of IAS 27 *Separate Financial Statements*.
- The Group measures land at a revalued amount and all items of property, plant and equipment at cost in terms of IAS 16 *Property, Plant and Equipment*.

- Depreciation is recognised on a straight-line basis over the useful life of the assets to their residual values.
- The Group presents a single statement of profit or loss and other comprehensive income.
- The Group presents the analysis of the results of a discontinued operation in the statement of profit or loss and other comprehensive income.
- The Group presents items of other comprehensive income net of related tax in the statement of profit or loss and other comprehensive income.
- The Group presents reclassification adjustments in the statement of profit or loss and other comprehensive income.
- The corporate tax rate for all South African companies in the Group is 28% and the capital gains inclusion rate is 80%. You may ignore changes and anticipated changes in the corporate tax rate in South Africa.
- The corporate tax rate of the Netherlands is 25,8% and capital gains are taxed at 0%. You may assume that other than the corporate tax rate, the tax legislation in the Netherlands is the same as that of South Africa.
- An appropriate pre-tax discount rate is 1,82% per annum (compounded annually) for all periods presented for amounts denominated in EUR.

**INITIAL TEST OF COMPETENCE, JUNE 2023**

**PROFESSIONAL PAPER 2**

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

<b>PAPER 2 PART I – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(a)	Present the information relating to Maastricht in the statement of profit or loss and other comprehensive income of the Group for FY2022. <ul style="list-style-type: none"> <li>• Ignore the tax consequences that the Group would incur on the disposal of Maastricht.</li> <li>• Ignore the attribution of amounts to the equity holders of the parent and the non-controlling interests.</li> <li>• Ignore note disclosures.</li> <li>• Ignore comparatives.</li> <li>• Round amounts to the nearest ZAR.</li> </ul>	34	
	<i>Communication skills – presentation</i>	1	35
(b)	Prepare the journal entries that account for the information provided in respect of Eastcreek in the financial records of SAMP for FY2022. <ul style="list-style-type: none"> <li>• Ignore all forms of tax.</li> <li>• Ignore dates of journal entries.</li> <li>• Ignore closing entries.</li> <li>• Round amounts to the nearest ZAR.</li> </ul>	22	
	<i>Communication skills – presentation</i>	1	23
<b>Total for part I</b>			<b>58</b>



**INITIAL TEST OF COMPETENCE, JUNE 2023**

**PROFESSIONAL PAPER 2**

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<b>PAPER 2 PART II – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(c)	Describe the substantive audit procedures that Firehouse should have performed on the disposal of the investment in Maastricht and the corresponding transactions in the separate financial statements of SAMP for FY2022.  <i>Communication skills – clarity of expression</i>	12  1	  13
(d)	Describe the substantive audit procedures that Firehouse should have performed on the fair value less cost to sell calculation of the land only for FY2022.  <i>Communication skills – clarity of expression</i>	7  1	  8
(e)	With reference to the information contained in section 4.3 – (i) critically evaluate the remuneration alternatives based on good performance evaluation principles; and (ii) discuss any business ethics and corporate governance concerns you may have.  <i>Communication skills – logical argument</i>	6 14  1	   21
<b>Total for part II</b>			<b>42</b>
<b>TOTAL FOR PAPER 2</b>			<b>100</b>