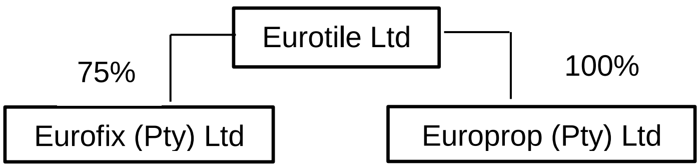
QUESTION **100 marks**

Assume a company tax rate of 28% for all periods.

1 Background on the companies in the Eurotile Ltd group

Eurotile Ltd ('Eurotile') was established in 1993 when the Kunene brothers became aware of the success of Giovanni Ravazzotti (the founder of Italtile, a company listed on the Johannesburg Stock Exchange (JSE)). The brothers, Paul and Saul Kunene, identified an opportunity in the market to import ceramic tiles from Eastern European countries like Bulgaria, Romania and Hungary.

The current group structure of the company is as follows:



Paul and Saul still own 26% and 25% respectively of the shares of Eurotile. The remainder of the shares in Eurotile is owned by a number of shareholders, none of whom individually owns more than a 10% equity stake.

In 2001, after the decline in the value of the rand against most major currencies, Eurotile decided to manufacture its own range of tiles. Through its diverse product offering, Eurotile is able to provide tiles to all levels of income earners.

At the height of the construction boom in 2010, Eurotile established Eurofix (Pty) Ltd ('Eurofix'). Eurofix manufactures tile adhesive. From the commencement of business there was a problem with the quality of the adhesive that Eurofix manufactured. This was only resolved when a 25% stake was sold to a chemical engineering company, namely Chemen (Pty) Ltd ('Chemen'), which made changes to the adhesive's formula. Eurotile still owns a 75% equity interest in Eurofix.

Currently the group has 17 stores throughout South Africa. The imported and manufactured tiles and tile adhesive are sold in these stores. All stores are leased from landlords. Eurotile also has an online store that sells tiles and related merchandise to wholesale and retail customers.

Europrop (Pty) Ltd ('Europrop'), a wholly-owned subsidiary of Eurotile, owns the title deeds of the factories and warehouses owned by the group. All manufacturing takes place near Vereeniging in Gauteng.

Audibi Inc., a firm of Chartered Accountants (SA) and Registered Auditors, has been the Registered Auditor of the companies in the Eurotile group for the last three years. The audits of the group companies for the financial year ended 30 June 2021 (FY2021) have a deadline for completion of 31 December 2021.

2 Segment information relating to the Eurotile group

The unaudited segment report for the FY2021 financial reporting period contains the following information:

SEGMENT INFORMATION								
	Revenue		Gross profit margin		Profit/(loss) before tax		Financing	
	R million		R million		R million		Target capital structure (debt to equity)	WACC*
	2021	2020	2021	2020	2021	2020		
Retail stores	583	571	116	109	32	25	40 : 60	16%
Properties					23	25	60 : 40	15%
Manufacturing: Tiles	299	298	79	78	48	46	50 : 50	17%
Manufacturing: Adhesive	104	102	20	23	(19)	(18)	50 : 50	18%

* Weighted average cost of capital.

3 Financial information relating to Eurofix

The management report for FY2021 contains the following information:

EUROFIX: MANAGEMENT REPORT INCOME STATEMENT FOR THE PERIOD ENDED 30 JUNE					
	Notes	Actual	Forecast		
		2021	2022	2023	2024
		R'000	R'000	R'000	R'000
Revenue	1	104 083	112 410	121 403	131 115
Cost of sales	2, 4	(83 990)	(90 700)	(97 950)	(105 790)
Gross profit		20 093	21 710	23 453	25 325
Administration and other operating expenditure	3, 4	(10 830)	(11 370)	(11 940)	(12 530)
Loss on sale of assets	5	(9 900)	–	–	–
Operating profit/(loss)		(637)	10 340	11 513	12 795
Finance cost		(19 690)	(20 670)	(21 700)	(22 790)
Investment income		460	460	460	460
Loss before taxation		(19 867)	(9 870)	(9 727)	(9 535)
Taxation	6	860	–	–	–
Loss for the year		(19 007)	(9 870)	(9 727)	(9 535)
Attributable to:					
Owners of the parent		(14 255)			
Non-controlling interests	7	(4 752)			

Notes to the income statement of Eurofix

1 Revenue is expected to grow by approximately 8% per annum during the next three years, in line with international trends. Covid-19 did not adversely impact the company's operations.

2 The company is considering replacing 200 of its 300 factory workers with robots in 2024, which will result in a wage cost saving of approximately R20 million per annum. The robots could be leased at an annual cost of R16,1 million (including VAT). This information has not been factored into the forecast as yet, as the board is only expected to deliberate on this transaction during its next meeting in a month's time. This initiative is an integral part of returning the company to profitability.

3 R2,4 million in annual rent is paid to Europrop for all financial years presented. Rent is paid annually in arrears within the group. The depreciation charge in relation to IFRS 16 *Leases* is R1,4 million for all periods presented and is included in administration and other operating expenditure. The finance charges are included in the finance cost line. A market-related rent for FY2021 would have been closer to R1,8 million (excluding VAT) per annum. The lease agreement is renewed on an annual basis and contains an inflation-based escalation clause. The lease has been correctly accounted for in terms of IFRS 16 and reported as part of property, plant and equipment in the balance sheet.

4 Depreciation charges (and equal wear and tear allowances) on various plant and equipment (excluding the depreciation stipulated in note 3 above) amount to the following:

	R'000
FY2022	12 586
FY2023	12 732
FY2024	14 843
FY2025	15 718

5 The company replaced part of a plant that has not been fully operational since the establishment of the company.

6 The company tax rate is 28%. FY2021 taxation relates to the movement in the deferred tax balance. Current and deferred tax movements have not been considered for the forecast periods.

7 The only other shareholder in Eurofix is the chemical engineering company, Chemen, which owns 25% of the company's equity. Chemen has expressed interest in the past in obtaining a larger shareholding in Eurofix.

8 When Audibi Inc. starts with the FY2021 year-end audit in October 2021, the board will provide it with the actual financial results for FY2021 and the forecast for FY2022, with the applicable relevant notes, in electronic format. This will constitute proof of the board's assessment of Eurofix's ability to continue as a going concern for the next 12 months. The board intends to inform the auditors that subordination agreements have been obtained for most of the shareholders' loans (see note (c) to the balance sheet below) which state that these shareholders will not have any claim on the assets or any repayment during the next 12 months after FY2021 unless all other debt has been settled. This is part of the board's intervention to address the going concern challenges of Eurofix.

9 All forecast figures were compiled after taking the potential restructuring into account, excluding the possible impact of the move to robots.

10 The VAT rate of 15% is expected to remain unchanged for the foreseeable future.

EUROFIX: MANAGEMENT REPORT BALANCE SHEET AS AT 30 JUNE			
	Notes	**2021**	**2020**
		R'000	**R'000**
Non-current assets		**154 737**	**137 582**
Property, plant and equipment	a	137 667	121 382
Goodwill		2 360	2 360
Intangible assets		5 580	5 570
Financial assets		5 820	5 820
Deferred tax		3 310	2 450
Current assets		**25 790**	**24 340**
Inventories	b	12 790	11 820
Trade and other receivables	b	11 160	11 510
Taxation receivable		1 770	930
Cash and cash equivalents		70	80
Total assets		**180 527**	**161 922**
Equity		**(65 187)**	**(44 870)**
Equity attributable to Eurotile		(48 890)	(33 653)
Non-controlling interest		(16 297)	(11 217)
Non-current liabilities		**212 804**	**184 442**
Long-term borrowings	c	200 000	170 620
Lease liability	e	12 804	13 822
Current liabilities		**32 910**	**22 350**
Short-term borrowings		9 380	6 030
Trade and other payables	b	9 190	7 350
Bank overdraft	d	14 340	8 970
Total equity and liabilities		**180 527**	**161 922**

Notes to the balance sheet of Eurofix

a) Capital expenditure of R2 million is planned in FY2022 and R5 million in FY2023. From FY2024 onwards, it is estimated that capital expenditure of R12,5 million per annum should be sufficient to sustain operations. These amounts have been appropriately adjusted for inflation.

b) It is estimated that net working capital will normalise at around 10% of the estimated revenue from FY2022 onwards.

c) Long-term borrowings for FY2021 include a R70 million bank loan that was obtained to finance the acquisition of plant and equipment of R70 million. The remainder of the long-term borrowings are shareholders' loans. These shareholders' loans bear interest at market-related variable interest rates and are proportional to shareholdings. The average interest rate before tax on all loans is 10%.

d) The bank overdraft facility is R15 million. The bank has already indicated that it expected Eurofix to reduce the current facility to at least R10 million within two years.

e) The lease liability has not yet been split into a current and non-current portion.

4 Decision regarding Eurofix

The profitability of Eurofix has been declining over the past few financial years and Eurotile's chief financial officer (CFO) had put the matter of Eurofix on the agenda for discussion during the most recent meeting of the board of directors.

The following two options are now being considered by the board:

- Restructuring Eurofix, by immediately selling non-core assets in Eurofix and restructuring its debt and equity. The sale of the non-core assets would provide an immediate cash inflow that would enable Eurofix to meet the bank's demands and reduce outflows in terms of interest payments. Creditors will also be approached for more favourable repayment terms. The reduction in the workforce (discussed under section 3) is a main aspect of ensuring a return to profitability; or
- Liquidating Eurofix.

The CFO was requested to obtain estimates regarding the potential liquidation of Eurofix and presented these to the board:

- Property, plant and equipment would realise R98 million, which is in line with the current book and tax value of the assets. The R98 million includes non-core assets which can be sold for R12 million.
- The financial asset (a non-core asset) is an investment in the cumulative preference shares of a company which is listed on the JSE. Eurofix has received a consistent dividend of R460 000 from these preference shares over the past few years. The investment was made at a time when the company had surplus cash resources and interest rates were low. The market-related return on similar preference shares is 8,5% per annum (nominal and pre-tax). The preference dividends are paid annually in arrears. The preference shares could be sold for market value less a once-off commission of 1% of the selling price.
- Inventory could be sold to the group's stores at a discount of 20% of net asset value.
- Eurofix would probably be able to collect 90% of the total value of all its trade receivables.
- During liquidation, an offer of 80c in the rand could be made to Eurofix's creditors (trade and other payables), which they would in all likelihood accept.
- All other debt (excluding shareholders' loans) will be settled in full. Shareholders' loans will be written off.
- Intangible assets are very specific to the operations of Eurofix and would have no resale value.
- The deferred tax asset will be written off and the taxation receivable will be collected.
- Liquidation costs would amount to 2% of the total gross asset values realised.

5 Qualitative information gathered on the Eurotile group

The group has in place an Enterprise Risk Management Framework, which is based on a combined assurance model comprising management, external auditors and internal audit.

5.1 Online stores and roll-out of technology

During the last financial year (FY2020) there was an increase in traffic at the group's online store. The records of the transactions for the online store are integrated with the group's financial accounting system. The group also rolled out free Wi-Fi access to customers at all its physical stores, which has been received positively by customers.

Eurotile's strive towards innovation is also evident from the implementation of smart scanners at checkout points at the warehouse and stores. These scanners should enable the simultaneous, once-off scanning of all items in a trolley when a customer walks through the scanner (it is therefore not necessary to scan each item individually). This is made possible by attaching inexpensive microchips to the packaging of each item sold. However, due to initial setup problems experienced with the implementation of the scanners, checkout times were longer than usual, which led to customer dissatisfaction.

Eurotile has also acquired computer software from an American IT group to analyse 'big data' with the aim of assisting it in predicting customer spending patterns. This should have enabled the company to optimise order quantities. Store managers unfortunately complained that reliance on the big data technology has led to out-of-stock instances of popular tiles, while on the other hand, stores had large quantities of slow-moving tiles in stock. Wholesale customers purchasing tiles and tile adhesive at the warehouse experienced the same frustrations.

5.2 Remaining competitive

While imports from Eastern Europe remain competitively priced, these suppliers are often not in touch with the latest global trends. A similar problem has been experienced with local manufacturers.

Eurotile's aim is to increase the variety of its manufactured products to enhance customer satisfaction, but it lacks funding to support research and development initiatives in this regard. An increasing number of customers is opting to use vinyl stickers that can be pasted on walls like wallpaper, instead of tiles; the stickers are cheaper than tiles and much easier to replace when remodelling.

5.3 Staff issues

There is a significant demand for well-trained staff in many South African manufacturing companies. Eurotile and Eurofix consequently experience a high staff turnover, especially among skilled employees who are lured away by competitors that offer better salary packages.

To make matters worse, the area in and around Vereeniging has been affected by numerous strikes and protests by local communities, some of which have turned violent. Eurotile's manufacturing and storage premises are situated in close proximity to the areas where a large number of these protest actions have taken place and, fearing for their safety, some staff members resigned.

Most of the remaining staff members cannot easily resign since they are the sole breadwinners of their families. The workers' union representing Eurofix's employees has expressed concern on various social media platforms about the safety of workers.

In addition, the social unrest affects the safety of wholesale customers who collect tiles and tile adhesive directly from the warehouses.

5.4 Consumer spending and demand

There have been reductions in consumer spending in the renovation and building market during the past few years, which has negatively affected the Eurotile group's revenue. Many competitors have reduced profit margins in order to survive. Customers are demanding increased accessibility to online stores, coupled with efficient on-site customer service.

5.5 Manufacturing process

Manufacturing of ceramic tiles by Eurotile produces large quantities of CO_2 emissions, which are viewed as a major contributor to global warming. The manufacturing of tile adhesive by Eurofix results in air and soil pollution due to the fine dust residue released during the manufacturing process. An increasing number of customers is becoming aware of the impact of manufacturing processes on the environment. Research recently conducted by the World Economic Forum revealed a substantial reduction of wastage and CO_2 emissions in factories which replaced their workers with robots, which are also more efficient.

5.6 Economic forecasts

The expected South African inflation rate for the foreseeable future is 4% per annum while the South African economy is expected to grow by a mere 1% per annum.

6 Factory leased from Europrop by Eurotile

Eurotile leases its factory building in Vereeniging from Europrop. Europrop has correctly classified the lease agreement with Eurotile as an operating lease in terms of IFRS 16.

In terms of the lease agreement, Europrop was required to customise the factory building to meet the specific needs of Eurotile. The lease agreement will continue until 30 June 2026, at which date the factory building and the land on which this factory is situated will be disposed of by Europrop at its estimated future value of R5,75 million (including VAT).

Eurotile paid annual rental in arrears of R2,76 million (including VAT) in cash on 30 June 2021. The rental is subject to an annual inflation-based escalation clause.

Europrop incurred annual operating expenditure of R1 104 000 (including VAT) to properly operate and maintain the factory building for use by Eurotile during FY2021. The operating expenditure incurred is also subject to an inflationary increase.

Both Eurotile and Europrop are registered Category C VAT vendors generating 100% taxable supplies. Europrop originally acquired the land and factory building on 1 June 2012, at a cost price of R5 million (excluding VAT). R4,5 million of the original cost price was attributable to the factory building and R500 000 was attributable to the land. As Eurotile uses the factory building in a process of manufacture, as defined in the *Income Tax Act,* Europrop qualifies for tax allowances on the building at 5% per annum on a straight-line basis in terms of section 13(1) of the Act.

It is the accounting policy of the Eurotile group to subsequently measure all investment properties using the fair value model in terms of IAS 40 *Investment Property.* The fair value of the factory building and land leased to Eurotile was R6 059 393 (excluding VAT) on 30 June 2020, after deducting the accrued lease income of R1 140 607 on that date. The fair value of the land and building is proportionately allocated in relation to the original cost price.

The group reviews its fair value estimate on a quarterly basis for significant changes. The process would also include a review of the discount rate, which includes significant unobservable inputs. The group obtains evidence from third parties on a semi-annual basis to support the reasonability of the fair value estimate.

The following journal entries, which are correct, have already been processed in the records of Europrop for FY2021 by the financial accountant:

	Dr	**Cr**
	R	**R**
Bank (SoFP)	2 760 000	
Accrued lease income (straight-line adjustment) (SoFP)	63 089	
Lease income (P/L)		2 463 089
VAT control account (SoFP)		360 000
Operating expenses (P/L)	960 000	
VAT control account (SoFP)	144 000	
Bank (SoFP)		1 104 000

At 30 June 2020, the correctly calculated balance of deferred tax relating to the investment property and lease agreement with Europrop amounted to R1 060 674 (credit).

INITIAL TEST OF COMPETENCE, SEPTEMBER 2021

PROFESSIONAL PAPER 2

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

<table>
<tr><th colspan="2" rowspan="2">PAPER 2 PART I – REQUIRED</th><th colspan="2">Marks</th></tr>
<tr><th>Sub-total</th><th>Total</th></tr>
<tr><td>(a)</td><td>Perform a free cash flow to firm valuation of Eurofix to estimate the value of Eurotile’s 75% shareholding in the subsidiary.

• Use earnings before interest and taxation (EBIT) as the starting point for the free cash flow valuation.</td><td>22</td><td>22</td></tr>
<tr><td>(b)</td><td>Prepare a memorandum to Chemen in which you describe the current business and financial risks facing Eurofix that may be used by the directors of Chemen to influence negotiations regarding a potential increase in its existing shareholding in Eurofix.

• Calculations are not required.

Communication skills – layout and structure</td><td>10

1</td><td>11</td></tr>
<tr><td>(c)</td><td>Make a recommendation to the board of Eurotile addressing the qualitative and quantitative factors relevant to the two options to either restructure or liquidate Eurofix, as described in section 4.

• Exclude considerations regarding a move to robots.
• Ignore all tax implications in your calculations.

Communication skills – logical argument</td><td>18

1</td><td>19</td></tr>
<tr><td colspan="2">Total for part I</td><td></td><td>52</td></tr>
</table>

INITIAL TEST OF COMPETENCE, SEPTEMBER 2021

PROFESSIONAL PAPER 2

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

PAPER 2 PART II – REQUIRED		**Marks**	
		Sub-total	**Total**
(d)	Discuss the key considerations that the directors of Eurofix should take into account when deciding whether to replace 200 employees with robots in FY2024. *Communication skills – appropriate style*	8 *1*	 9
(e)	Describe the substantive procedures that you expect Audibi Inc. to perform on the FY2022 forecast information and relevant applicable notes, to obtain audit evidence about Eurofix's ability to continue as a going concern for the 12 months after the end of FY2021. • Include information relating to the subordination agreements. • Assume that all amounts are material. • Do not provide substantive procedures to audit the FY2021 actual results. *Communication skills – clarity of expression*	14 *1*	 15
(f)	Prepare the additional journal entries to account for the investment property and the lease with Eurotile in the separate accounting records of Europrop for FY2021. • Assume that the appropriate pre-tax discount rate is 15%. • Include journal entries relating to deferred taxation. • Ignore journal entries relating to current taxation. • Round all amounts to the nearest rand. • Do not provide journal narrations.	15	15

Continued

INITIAL TEST OF COMPETENCE, SEPTEMBER 2021

PROFESSIONAL PAPER 2

PAPER 2 PART II – REQUIRED (continued)		**Marks**	
		Sub-total	**Total**
(g)	Disclose all relevant information relating to the fair value of the investment property leased to Eurotile as it would appear in the notes to the annual financial statements of Europrop for FY2021, to comply with the requirements of IFRS 13 *Fair Value Measurement* in respect of non-financial assets. • Comparative information and accounting policy notes are not required. • Where the available information is insufficient, provide examples and/or details of information that you would include to complete the required disclosure in terms of IFRS 13. *Communication skills – presentation*	8 *1*	9
Total for part II			**48**
TOTAL FOR THE QUESTION			**100**