

**QUESTION 1**

**100 marks**

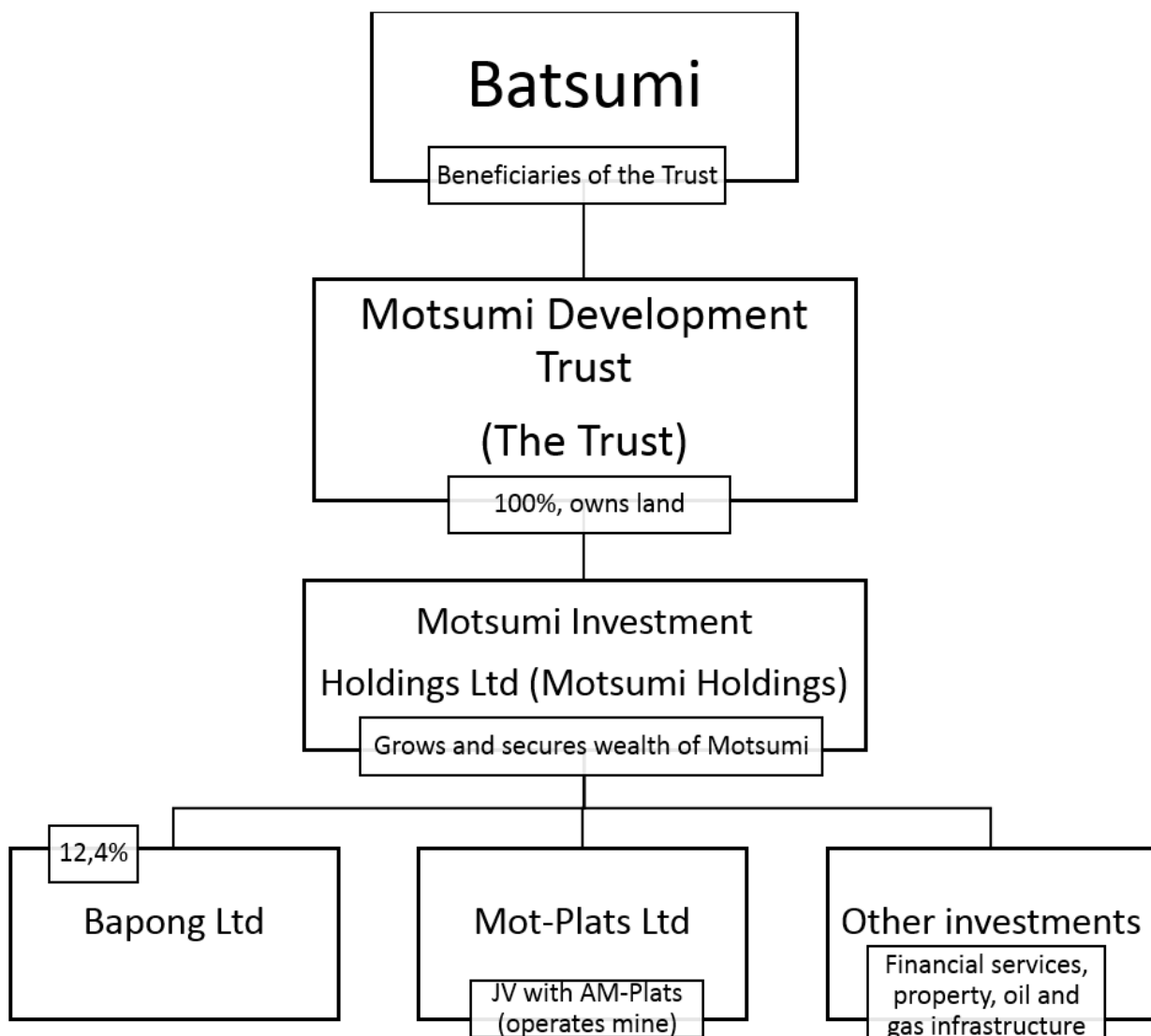
The Batsumi nation is a Setswana-speaking group of people who own and inhabit a 1 400km<sup>2</sup> area in South Africa. The land was acquired by the Motsumi Development Trust ('the Trust') through the pooling of the community's resources on behalf of and for the benefit of the Batsumi nation.

In 1924 part of the reef containing the world's largest platinum group metals deposit was discovered on the land owned by the Trust. Mining rights were issued to companies that are mining platinum group metals (PGMs) from the reef in exchange for royalties payable to the Trust.

The Trust established a wholly-owned subsidiary, Motsumi Investment Holdings Ltd ('Motsumi Holdings'), to grow and secure the wealth of the Batsumi nation. The Trust is responsible for providing Motsumi Holdings with its investment mandate and strategy, as well as its dividend policy. Motsumi Holdings entered into various arrangements to build up a diverse portfolio, including the following:

- 1 An agreement with Bapong Ltd ('Bapong'), a large listed platinum mining company, was entered into to obtain a 12,4% equity stake in Bapong.
- 2 An agreement with AM-Plats Ltd was entered into to form a joint venture, Mot-Plats Ltd ('Mot-Plats'), to operate a platinum mine to extract the minerals on the land owned by the Trust. This joint venture was listed on the Johannesburg Stock Exchange in 2010.
- 3 Acquisition of a variety of other investments (e.g. in the financial services, property and oil and gas infrastructure sectors).

The diagram below illustrates the different portfolio holdings:



You are a junior financial manager at Motsumi Holdings. You prepared the following summary, which sets out all the assets of Motsumi Holdings:

<b>Motsumi Holdings investment portfolio composition as at 31 December 2018</b>				
	<b>Beta factor</b>	<b>2018</b>	<b>Y-o-Y % change<sup>1</sup></b>	<b>2017</b>
		<b>R million</b>		<b>R million</b>
<b>1 Market value of listed investments</b>		<b>32 155</b>		<b>29 467</b>
<b>Resources</b>				
Bapong	1,7803	1 499	- 24,1%	1 975
Mot-Plats	0,8857	2 837	- 21,4%	3 608
<b>Financial services</b>				
Rand Corporate Bank Holdings	0,8850	16 765	19,2%	14 061
Rand Corporate Insurance Holdings	0,9143	10 229	15,3%	8 870
<b>Property</b>				
Propvest	0,3197	825	- 13,4%	953
<b>2 Directors' valuation of unlisted investments</b>		<b>1 538</b>		<b>1 655</b>
Mining and Oil & Gas Services SA (Pty) Ltd		1 538	- 7,1%	1 655
<b>3 Cash</b>		<b>138</b>	<b>- 13,8%</b>	<b>160</b>
<b>Gross asset value</b>		<b>33 831</b>		<b>31 282</b>

<sup>1</sup> The year-on-year % (Y-o-Y %) change represents the change in the market value or directors' valuation of the assets in the portfolio. Motsumi Holdings did not increase or decrease its shareholding percentages in the underlying investments during the financial year ended 31 December 2018 (FY2018). Apart from its investment in Mining and Oil & Gas Services SA (Pty) Ltd ('MoG SA'), Motsumi Holdings does not control any of its investee companies.

The following is a brief overview of each of the investee companies in the Motsumi Holdings portfolio:

<b>Investee</b>	<b>Overview</b>
Bapong	Bapong is one of the world's leading platinum and associated PGMs mining companies, producing approximately 25% of the global PGMs.
Mot-Plats	Mot-Plats is a listed black-controlled shallow depth platinum mining company operating in the North West Province.
Rand Corporate Bank Holdings Ltd	An investment company with a 33,9% stake in a large, leading South African banking group.
Rand Corporate Insurance Holdings Ltd	An investment company that owns a portfolio of investments in a number of South Africa's premier insurance companies.
Propvest Ltd	A leading South African real estate company, which owns property assets in South Africa, Mauritius and Europe.
MoG SA	Motsumi Holdings owns a 51% stake in MoG SA, which operates in the oil and gas infrastructure sector of South Africa, other African countries and the Middle East. MoG SA owns and operates fuel and gas pipelines as well as fuel storage depots.  MoG SA has a target debt to enterprise value ratio of 50% and an effective tax rate of 28%. Motsumi Holdings's corporate finance advisers recently estimated that MoG SA's ungeared beta coefficient is 0,7833.

## Funding of the Motsumi Holdings portfolio

The fair value of the debt used to fund the Motsumi Holdings portfolio as at 31 December 2018 is R8 370 million and comprises the following:

- 1 Debentures: The 5 000 debentures were issued at the beginning of January 2017 at their nominal value of R1 million each. The debentures are to be redeemed at nominal value on 31 December 2021, at which time similar debt will be acquired to replace the debentures being redeemed. The debentures pay interest semi-annually at a fixed annual nominal rate of 9,5%. Should a five-year term debenture be issued now, the market would expect to earn an annual return of 9%, payable semi-annually, on the instrument.
- 2 Medium-term loans obtained from local banks: The interest rates applicable to these loans average a nominal interest rate of 9,25% per annum.

## Market data as at 31 December 2018

Prime overdraft lending rate	10,00%
Three-month JIBAR <sup>2</sup>	6,92%
6,75% R208 government bond (redemption 2021)	7,91% yield
10,5% R186 government bond (redemption 2026)	8,93% yield

<sup>2</sup> *Johannesburg Interbank Agreed Rate.*

The equity market risk premium is 6%.

## Investment opportunities

The Investment Committee of Motsumi Holdings is currently considering two potential investment opportunities.

### **Opportunity 1: Equity raising campaign to be launched by Bapong**

Bapong announced by means of a SENS announcement on 11 January 2019 that the company intends raising approximately R4,36 billion by means of a rights issue. The proceeds from the rights issue will be used to settle certain debt facilities. On 11 January 2019 the opening share price of the Bapong shares was R35,69 per share, but the share price dropped to R34,20 after the announcement of the rights issue. The following is an extract from the circular sent to the Bapong shareholders:

<b>Bapong Ltd</b> <b>Extract from circular on rights issue</b>	
<b>Terms</b>	
9.1	Existing shareholders will be entitled to take up one share for every five existing shares held in Bapong at a subscription price of R30,34 per share.
9.2	The rights issue closes on 31 March 2019.

The following information, as measured on 31 December annually, has been distributed to the members of the Motsumi Holdings Investment Committee:

<b>Indicator</b>	<b>2018</b>	<b>2017</b>	<b>2016</b>	<b>2015</b>	<b>2014</b>
Bapong ordinary shares in issue (million)	718,55	718,55	607,08	607,05	606,91
Bapong closing share price (per share)	ZAR35,99	ZAR47,40	ZAR62,77	ZAR111,94	ZAR96,35
Platinum price (per ounce)	USD886,50	USD905,70	USD891,50	USD1 210,90	USD1 375,20

Bapong had a rights issue during FY2017 during which approximately R5,5 billion was raised. Bapong has not declared or paid a dividend to shareholders since 2014.

### **Opportunity 2: Acquisition of a stake in Ezempilo (Pty) Ltd**

The Chief Executive Officer (CEO) of Ezempilo (Pty) Ltd ('Ezempilo'), Ms Nonni Khumalo, recently approached the Investment Committee of Motsumi Holdings. She is aware of the Batsumi nation's commitment to community development, and believes that Motsumi Holdings could be an important business partner by investing in Ezempilo's expansion into Mozambique.

#### **Background information on Ezempilo**

Nonni has two passions in life: exercise and children. She combined these passions when she established Nonni's Gym in Umlazi 15 years ago. The gymnasium ('gym') offered exercise classes to children and unemployed adults in the community with the main goal being to keep these individuals occupied in a healthy manner. Nonni's Gym soon became very popular. Nonni started to charge a small membership fee to those gym users who could afford it, which enabled her to expand the gym and buy additional equipment. Nonni gradually replicated this concept in other areas and by 2013 she was the sole shareholder of Ezempilo, a company that owned 12 gyms in KwaZulu-Natal. Ezempilo has a 31 December financial year end. The gyms no longer have a free membership option.

#### **Share sale agreement**

In 2014 Migos Capital ('Migos'), a private equity firm, saw the enormous potential of the Nonni's Gym concept and purchased all the Ezempilo issued shares from Nonni. As part of the sale agreement Nonni had to continue as Ezempilo's CEO for at least five years, with the option of extending her employment contract thereafter.

#### **Current developments**

Since 2014 Ezempilo has grown its membership base and the company currently operates 20 gyms across South Africa. Ezempilo decided to extend its chain of gyms to Mozambique during the latter part of 2018 to cater for the local communities as well as foreign visitors to that country. By the end of November 2018 Ezempilo had opened three gyms in the Mozambican tourist centres of Xai-Xai, Inhambane and Maputo.

Shortly after the three gyms were opened in Mozambique, Migos announced its intention to sell off its interest in Ezempilo, which is why Nonni is engaging with the Investment Committee of Motsumi Holdings. She has approached Motsumi Holdings to determine if it would be interested in participating in the buyout of 100% of the shares in Ezempilo. Nonni has limited funds to invest to purchase an interest in Ezempilo.

She proposed the following transaction structure to Motsumi Holdings:

- A new company (Newco) would be formed to acquire a 100% interest in Ezempilo from Migos for R45 million;
- Motsumi Holdings would advance an interest-bearing loan of R30 million to Newco to enable it to fund the acquisition of shares in Ezempilo. The terms of the loan would need to be negotiated; and
- Nonni and Motsumi Holdings would subscribe for shares in Newco for a total subscription price of R15 million. Nonni would invest R9 million of her own funds to subscribe for 60% of the issued share capital of Newco. Motsumi Holdings would invest R6 million to subscribe for a 40% interest in Newco.

### **Revenue**

Revenue is generated from monthly and annual membership fees and Ezempilo's revenue increased by between 30% and 45% per annum during the last three financial years, being FY2015, FY2016 and FY2017. Nonni had promised an increase of at least 30% for FY2018.

Motsumi Holdings commissioned AB Consulting Services (Pty) Ltd ('AB Consult') to perform a due diligence investigation into Ezempilo as part of its evaluation of the investment opportunity. Motsumi Holdings specifically requested that AB Consult evaluate the revenue system, as it is concerned about the risk that Ezempilo may recognise fictitious memberships to inflate the revenue figure reported in its financial statements. An extract of the AB Consult report to the Investment Committee follows on pages 6–8.

### **Auditors**

Sharp Auditors Inc. ('Sharp'), a small audit firm situated in Umlazi, is the Registered Auditor of Ezempilo. Sharp consists of one partner, Mr Mcebisi Mkhize, who is a CA(SA) and Registered Auditor, and eight employees comprising an audit manager, four trainee accountants and three supporting staff members.

Sharp has been the auditor of Ezempilo since the company's incorporation. As a young man Mcebisi spent his free time at the original Nonni's Gym and became good friends with Nonni. Mcebisi always had a keen interest in information technology and he assisted Nonni with the computerisation of Ezempilo's membership information a few years ago.

Mcebisi was also involved in the initial selection and implementation of the current membership administration software package called *Wizard* and an accounting software application called *Amabhuku* that are used by Ezempilo. He was so impressed with these systems that he acquired the distribution licences for them. When a new gym is opened, Nonni always contacts him to install the systems.

To commemorate the opening of its 15th gym in June 2018, Nonni gave away 100 one-year membership packages (the most expensive packages) to persons who had contributed to the company's success. Sharp's staff members all received such complementary packages.

Mcebisi believes information technology is an integral part of the audit process and therefore Sharp uses the latest available audit software to perform data analytics and to assist with the performance of its audit procedures.

**Prepared by:** AB Consulting Services (Pty) Ltd

**Date:** 30 November 2018

**Entity name:** Ezempilo (Pty) Ltd

**Scope:** Revenue recognition

**1 Membership fees**

Revenue is generated from monthly and annual membership fees. All new members have to pay a once-off initiation fee. In 2018 this fee amounted to R1 620. Membership fees are not decreased on a pro rata basis if a new member should apply during the course of a month.

Ezempilo also has contracts with Wellness and Rewards Partners (Pty) Ltd ('W&R') a company that provides rewards to its members based on where they shop and the activities in which they engage. W&R members receive discounts on their membership fees.

Ezempilo has the following membership plans:

Plan	Details	2018 monthly fee (if paid on a monthly basis)	2018 annual fee (if paid on a once-off basis)	Discount for W&R member
White	Member visits only one specific gym	R198	R2 160	40%
Green	Member visits any of Ezempilo's gyms, but only between 08:00 and 16:00	R398	R4 380	50%
Black	Member visits any of Ezempilo's gyms during all opening hours (05:00 to 22:00)	R598	R6 360	60%

All members, including W&R members, are required to enter into an initial one-year membership contract. Thereafter the membership runs on a month-to-month basis, unless members pay the annual fee. Membership fees are payable in advance. The access of members who have not paid their membership fees by due date is suspended with immediate effect.

To cater for people from other communities who are on holiday, visiting family or travelling for work for a short period, Ezempilo also offers temporary daily and weekly access. The ad hoc temporary daily and weekly access fees for FY2018 were R50 and R200 respectively.

**2 The Wizard system**

Ezempilo has a standard contract that has to be completed and signed by all new and renewing members. The manager at each gym signs the contract after ensuring that all pertinent details have been completed and that the contract has been signed by the member.

Gym member details, new membership subscriptions and membership contract changes are captured on the *Wizard* system installed on personal computers at each of the gyms, and not on a central server. A unique electronic code is assigned to each gym's *Wizard* system and this code is recorded on all file headings that accompany data files generated by the *Wizard* system. Signed contracts are filed in fireproof safes at each of the gyms. Each gym issues receipts for membership fees paid by members and the details of the receipts are also captured on the *Wizard* system. The *Wizard* system generates a membership update transaction file containing all the new and amended membership information as well as receipts from members on a weekly basis.

The membership update transaction file is transmitted from each gym to the central computer at the company's Umlazi head office by means of a dedicated data network line. As soon as the *Wizard* system loaded onto the central computer receives this information, the membership database is automatically updated with the relevant data.

**Prepared by:** AB Consulting Services (Pty) Ltd

**Date:** 30 November 2018

**Entity name:** Ezempilo (Pty) Ltd

**Scope:** Revenue recognition

Daily and weekly access fee receipts are recorded on the *Wizard* system as cash sales and also sent to and uploaded on a weekly basis to the Umlazi head office and is then reflected in the revenue and receivables file.

### **3 Recording of transactions**

At the end of each month a revenue and receivables file is generated by the *Wizard* system. Nonni has edit access to the revenue and receivables file and after she has reviewed the file and made the changes she deems necessary, the revenue and receivables file is imported into the *Amabhuku* accounting application. The *Amabhuku* application uses the imported information to invoice the members with their monthly membership fees and to record payments of those fees received from members. It also posts the total of the current month's revenue column to the revenue general ledger account.

### **4 Revenue and receivables file: data structure**

An extract from the revenue and receivables file with a sample of members is provided on page 3 of 3 pages to this extract.

### **5 Findings**

Based on the system description and consideration of the revenue and receivables that took place during June 2018, there is a risk that there may be entries for fictitious members at the various gyms. We recommend that your auditors conduct an agreed-upon procedures engagement.

**Extract from due diligence report**

Page 3 of 3 pages

**Prepared by:** AB Consulting Services (Pty) Ltd**Date:** 30 November 2018**Entity name:** Ezempilo (Pty) Ltd**Scope:** Revenue recognition**Extract from revenue and receivables file for the month ended 30 June 2018**

Member number	Gym	Date joined	Type of membership	Opening balance: Amount out-standing	Current month's fee	Current month's receipts from members	Closing balance: Amount out-standing	W&R discount	Access expiry date
				R	R	R	R		
10185	Umlazi	01-06-13	Monthly: White	198	198	396	–		30-06-18
10203	Hluhluwe	01-07-13	Annual: Black	–	530	6 360	(5 830)		30-06-19
11247	Nongoma	01-01-15	Annual: Green	(2 555)	365	–	(2 190)		31-12-18
11251	Mkuze	01-01-15	Monthly: Black	598	598	598	598		30-06-18
11260	Umlazi	05-01-15	Monthly: White	198	198	–	396		30-06-18
12101	Mkuze	01-11-15	Monthly: Green	–	398	398	–		30-06-18
12109	Jozini	01-12-15	Monthly: Black	–	359	–	359	60%	30-06-18
12111	Mtubatuba	10-12-15	Monthly: Green	–	199	199	–	50%	30-06-18
13584	Mtubatuba	01-12-17	Monthly: Black	(675)	359	359	(675)	60%	30-11-18
13586	Mtunzini	01-12-17	Monthly: Black	–	598	598	–		30-11-18
13587	Umlazi	15-06-17	Ad hoc: Weekly	–	400	–	–		30-06-18
13588	Hluhluwe	18-12-17	Monthly: Black	598	598	598	598		17-12-18
13650	Umlazi	01-06-18	Monthly: White	–	198	198	–		31-05-19
13651	Mtunzi	01-06-18	Ad hoc: Weekly	–	400	400	–		14-06-18
13652	Mtubatuba	01-06-18	Monthly: White	–	215	1 620	(1 405)	50%	31-05-19
13653	Umlazi	10-06-18	Monthly: Black	–	598	598	–		09-06-19
13654	Jozini	15-06-18	Ad hoc: Weekly	–	400	400	–		29-06-18



**INITIAL TEST OF COMPETENCE, JANUARY 2019**

**PROFESSIONAL PAPER 1**

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

<b>QUESTION 1 PART I – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(a)	Discuss, with supporting calculations, the key matters that the Investment Committee of Motsumi Holdings should consider in its decision on whether or not it should participate in the proposed rights issue of Bapong.  <i>Communication skills – logical argument</i>	23  1	  24
(b)	Calculate the weighted average cost of capital of Motsumi Holdings as at 31 December 2018.  Hamada formula: $\beta_L = \beta_U [1 + (1 - t)(D/E)]$	17	17
(c)	Discuss the key matters Motsumi Holdings's Investment Committee should consider in evaluating whether it should invest in Ezempilo, based on Nonni's proposed transaction structuring.  <i>Communication skills – appropriate style</i>	16  1	  17
<b>Total for part I</b>			<b>58</b>

**INITIAL TEST OF COMPETENCE, JANUARY 2019**

**PROFESSIONAL PAPER 1**

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

<b>QUESTION 1 PART II – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(d)	With reference to the information in the extract from the due diligence report, and using a tabular format – (i) describe specific examples of how Nonni could manipulate the data in the revenue and receivables file for FY2018 in order to keep her promise of an increase in revenue of at least 30%; and (ii) for each example listed, describe the specific data CAAT procedures that could be performed on the revenue and receivables files to detect the manipulation.  <i>Communication skills – layout and structure</i>	11  11  1	23
(e)	Describe the agreed-upon procedures, other than data CAAT procedures, you would request the auditors to perform at each individual gym to identify any entries for fictitious members on the revenue and receivables file and to verify the accuracy of the different membership plans reflected in the revenue and receivables file.	6	6
(f)	Describe, with reference to the information contained in the scenario only, what aspects Mcebisi should consider before Sharp continues to act as Ezempilo’s auditor for FY2019.  <i>Communication skills – clarity of expression</i>	12  1	13
<b>Total for part II</b>			<b>42</b>
<b>TOTAL FOR THE QUESTION</b>			<b>100</b>