QUESTON 1 **100 marks**

DMG (Pty) Ltd ('DMG') was founded in 2017 as a low alcohol craft gin distilling business. The abbreviation DMG refers to the founding shareholders' desire to drink more gin. DMG produces gin which has an alcohol content of less than 0,5% by volume. Low alcohol gin appeals to health-conscious individuals who like the taste of gin without the side effects of consuming alcohol. Ms Nicola Gonoobs and Mr Anthony Poshnose are the two founding shareholders of DMG. Nicola is a prominent attorney in Johannesburg and Anthony is a retired professional golfer. The directors of DMG comprise Nicola (Chief Executive Officer), Anthony (Chief Operations Officer) and Mr Harry Solo (Chief Financial Officer).

The gin production process can be summarised as follows:

- Gin is produced using highly concentrated ethanol and adding juniper berries and other plant ingredients (DMG's secret recipe).
- Gin is distilled in DMG's copper stills by heating the concentrated ethanol and plant ingredients and then adding water to reduce the alcohol content.
- DMG next uses a patented process to reduce the alcohol content of its gin to below 0,5% alcohol by volume.
- The low alcohol gin is then bottled into 750ml bottles and labelled.

Each batch of gin takes eight hours of production time and DMG aims to produce 300 litres of gin per batch. DMG's current production capacity is 2 200 hours per annum.

Financial department and external auditors

DMG has a financial team of three people headed by Harry Solo. Harry is a qualified CA(SA) who joined the DMG team two years after completing his training contract. MediumSize Inc. ('MedSize') is the appointed Registered Auditor of DMG. The audit partner is Ms Katherine Birtwistle and the engagement team that services the DMG audit, consists of four members, namely three trainee accountants – Ms Nthabiseng Mbali, Mr Brian Hawkes and Ms Diana Jenkins – and an audit manager, Mr Sifiso Ndlovu.

Performance budget

DMG's financial year end is 31 December and it has recently prepared the following performance budget for the year ending 31 December 2019 (FY2019):

Performance budget for FY2019	**Notes**	**R**
Revenue	1	7 960 000
Raw material costs	2	(1 592 000)
Other direct production costs	3	(1 114 400)
Indirect production overheads	4	(1 470 000)
Gross profit		3 783 600
Advertising and promotional expenditure	5	(1 750 000)
Sales commission	6	(796 000)
Distribution costs	7	(220 000)
Administration costs		(450 000)
Earnings before interest and taxation (EBIT)		567 600

Notes

1 DMG is budgeting to produce and sell 40 000 bottles of gin in FY2019 at an average price of R199 per bottle.
2 Raw material costs comprise mainly ethanol, water, juniper berries and other plant ingredients.
3 Other direct production costs include electricity, direct labour costs and packaging expenses.
4 Indirect production overheads comprise premises rental, depreciation of equipment and supervisory salaries.
5 DMG is forecasting to spend R1 750 000 on advertising on social media and promotional activities. DMG is a business in its early stages of development and advertising and promotional activities are important for creating awareness of its unique product.
6 DMG outsources its sales function to an independent third party, LiquorForAfrica (Pty) Ltd ('L4A'). L4A has a crew of sales representatives which sells a range of brands of various producers to the liquor retail, restaurant and hotel industries. DMG pays L4A a 10% sales commission.
7 Distribution costs comprise the courier charges incurred by DMG to move products from its warehouse to its customers.

Yuppiedrinks

DMG has been in discussions with Yuppiedrinks ('YupD') to sell its gin through YupD's website, called Yuppiedrinks.com. Yuppiedrinks.com is a leading kitchen and homeware online retailer in South Africa stocking over 8 000 products. YupD estimates that it could sell 60 000 bottles of DMG's gin annually. DMG is confident that this will not have a negative effect on its budgeted sales volumes through L4A.

YupD proposes the following key terms and conditions for an agreement with DMG:

- Yuppiedrinks.com will offer DMG gin at R189 per bottle. This price will be re-negotiated annually;
- DMG will be responsible for fulfilling all orders placed via Yuppiedrinks.com. At no stage will YupD carry any DMG gin inventory risk;
- DMG will pay YupD a 20% commission on the sales price for each bottle of DMG gin sold by YupD;
- DMG will pay YupD R500 000 annually towards advertising expenditure that YupD will incur in promoting and advertising the DMG gin; and
- DMG will pay a monthly subscription fee of R15 000 to YupD for having its product included in the Yuppiedrinks.com catalogue.

DMG expects that it will be able to produce products for YupD at the same cost per unit for raw materials and other direct production costs that it has budgeted for FY2019. However, DMG expects that it will incur additional indirect production overheads of R935 000 and an additional R300 000 in fixed distribution costs if it produces and sells 60 000 bottles of gin via Yuppiedrinks.com.

DMG recently held a cocktail evening to promote its product, to which it invited YupD representatives as well as the MedSize audit team. Diana, the trainee accountant, realised that she had studied with Ms Prianka Anand, a representative of YupD, and the two of them started chatting about the potential agreement between DMG and YupD. Diana asked Prianka a couple of questions regarding the impact of the potential arrangement with DMG, including how the price of bottles would be determined, and what she thinks the potential profit impact on DMG would be. Diana was excited about the potential agreement, and shared her knowledge based on her work on the audit team. She hoped that it would help DMG to secure the agreement.

Retention of the master distiller

Mr Matty Williams is DMG's master distiller (or chief alchemist as he likes to refer to himself). He travels around the country to host gin tastings and provide free samples to potential customers. He created the unique gin recipe that DMG uses and is well known in the industry. Since joining DMG, Matty has been working on a month-to-month basis with no formal contract in place. Matty is an essential member of the business and DMG's business would be under threat if he left the company or joined a competitor. Accordingly, the shareholders and directors of DMG would like to incentivise him to stay on at DMG. Nicola and Anthony discussed the issue with MedSize, who in turn discussed it with their consulting division.

MedSize made the following recommendation:

- DMG offers Matty a three-year service agreement;
- DMG enters into a restraint of trade agreement with Matty, to the effect that he may not join a competitor in South Africa for a three-year period after leaving DMG;
- Matty is offered the option of acquiring a 10% shareholding in DMG for a total nominal consideration of R10 through the issue of new shares in DMG. The option can only be exercised in three years' time, provided that he is still employed at DMG at that stage and he performs in terms of key performance indicators (KPIs); and
- The suggested KPIs for Matty over the next three years is based mainly on production targets, such as the distillation of a minimum of 200 000 of the 750ml bottles of DMG gin over the three-year period, and that these bottles must satisfy appropriate quality standards.

Miniature bottles

DMG is considering extending its product range to miniature bottles (with a 50ml content each) of its trademark gin. The target market for the miniature bottles will be airlines, hotels and selected retail liquor outlets. YupD would possibly also be interested in selling these miniature bottles to their customers.

DMG expects the annual demand for its miniature bottles to be 150 000 units. The company will need to purchase another copper still to distill the gin for the planned 150 000 miniature bottles and also invest in packaging equipment to automate the bottling and labelling of the miniature bottles. The total purchase price of the equipment (copper still and packaging equipment) is forecast to be R250 000 and both are expected to have ten-year useful lives.

At the most recent meeting of the Board of Directors a decision was taken to use PackFast (Pty) Ltd ('PackFast') to provide the packaging materials for the miniature bottles. PackFast is a family business that has established itself as a leader of packaging supplies and packaging consumables in Johannesburg. Harry owns 10% of the equity interest of PackFast and the remaining shares are held by his sister, Ms Sally Solo, who is also the CEO of PackFast. DMG negotiated a significant discount on the contract price with PackFast. Harry felt strongly that this was the right service provider for the job, and therefore cast his vote in favour of this contract when it was voted upon at the most recent Board meeting.

The production and distribution costs per miniature bottle in FY2019 are estimated to be as follows:

Production and distribution costs per miniature bottle in FY2019	**R**
Raw material costs	2,80
Other direct production costs	3,20
Distribution costs	0,50

DMG forecasts that it will incur additional indirect production overheads, excluding depreciation of equipment, of R275 000 if it pursues the strategy of producing and selling 150 000 miniature bottles in FY2019.

Future strategic directions

Nicola and Anthony have big plans for DMG and feel the next strategic direction should be to enter the Southern African Development Community (SADC) market. They engaged MedSize to evaluate which of these countries would provide the best entry into this market. MedSize recommended that DMG should start its expansion in Mauritius. Other recommendations, ranked after Mauritius but in the top four, include Botswana, Tanzania and Seychelles. Mauritius was recommended because of the low corporate maximum tax rate of 15% and higher gross domestic product per capita than South Africa, even though the country has a population of only 2,5% of the South African population of 56,5 million.

There is an emerging low alcohol gin market in Mauritius, but at present there are only four market suppliers whose sales total R60 million per annum. DMG's gin is of a higher quality than that being distilled by these four suppliers.

DMG is likely to achieve a market share of 25% over three years from the date of entry: starting at 10% in the first year, increasing to 20% in the second year and stabilising at 25% in the third year. DMG is considering the following two alternatives for entry into Mauritius.

Option A: A joint venture with a local supplier

DMG could form a joint venture with a local supplier of low alcohol gin in Mauritius. DMG identified Hornet (Pty) Ltd ('Hornet') as a suitable potential partner. Hornet is a local producer of wine made from Mauritian lychees and does not have expertise in the distillation of gin. However, it is considered to be the best partner because it is situated close to Port Louis, the Mauritian capital city, and has suitable premises that are underutilised at present. It currently operates at 40% capacity, which means that the remaining 60% could be used to distil DMG gin. The premises have a current market value of R6,25 million. DMG proposes that it supplies the gin distilling expertise and working capital funding and Hornet the factory premises and capital expenditure funding. DMG and Hornet will share profits in the ratio of 60 : 40.

A working capital investment of R8 million would be required from DMG at the beginning of the first year of operations and thereafter the joint venture should be able to fund its own operations. It is estimated that the earnings before interest, depreciation and amortisation from the joint venture would approximate 16% of sales. The total purchase price of the equipment (copper still and packaging equipment), to be paid by Hornet, is forecast to be R4 250 000 and both are expected to have ten-year useful lives.

Hornet will source local employees to manage the operations of the joint venture. DMG will send two managers currently working alongside Matty to ensure a consistent quality of the gin. Matty would also be required to travel around Mauritius to host gin tastings and provide free samples. The Hornet premises are accessible by a major road and public transport and can be easily reached by employees from local areas. The labour force in Mauritius has strong bargaining power and the number of strikes reached an all-time high in 2017 because of low wage rates. The Mauritian government is working on legislation for the introduction of minimum wages.

Option B: Partnering with a Mauritian distributor

The second option would be to expand DMG’s existing operations in South Africa and export its gin to Mauritius by partnering with a Mauritian distributor. Greys Ltd (‘Greys’) has been identified as the most suitable distribution partner, as it is currently the leading distribution and importation company in Mauritius. Greys has over 73 years’ experience in the distribution of spirits, wines, cosmetics, food and pharmaceuticals to every corner of Mauritius, and its customers range from small boutiques to hypermarkets. Greys also produces its own products, which range from dark spirits such as blended, spiced and flavoured rums to white spirits such as cane spirit, white rum, vodka, wine and gin.

Greys is already supplying its products to Europe and South Africa and are in negotiations with various other countries, which are keen to import spirits at highly competitive prices. DMG sees this as a great partnership opportunity that will be mutually beneficial because DMG can also distribute some of Greys’s spirits and wines in South Africa. The idea is to distribute the same quantity of Greys spirits and wines in the South African market as the quantity of DMG gin that Greys would distribute on behalf of DMG in Mauritius. No sales commission or distribution costs would be payable to each other in terms of this arrangement. DMG’s expansion costs for partnering with Greys are estimated to be R5 million.

INITIAL TEST OF COMPETENCE, JANUARY 2019

PROFESSIONAL PAPER 2

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

QUESTION 1 PART I – REQUIRED		**Marks Sub-total**	**Marks Total**
(a)	Calculate the estimated impact on DMG's budgeted EBIT and profitability margins in FY2019 if 60 000 of the 750ml bottles of DMG gin are sold through Yuppiedrinks.com.	11	11
(b)	Describe the key factors DMG needs to consider in pursuing the supply arrangement with YupD.	17	
	Communication skills – appropriate style	*1*	18
(c)	Critically discuss the recommendation made by MedSize to retain Matty from both his perspective and the perspective of DMG.	15	
	Communication skills – logical argument	*1*	16
(d)	Describe the key considerations, supported by calculations, DMG should take into account in determining an appropriate selling price per miniature bottle in FY2019.	8	
	Communication skills – clarity of expression	*1*	9
Total for part I			**54**

INITIAL TEST OF COMPETENCE, JANUARY 2019

PROFESSIONAL PAPER 2

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

QUESTION 1 PART II – REQUIRED		**Marks**	
		Sub-total	**Total**
(e)	Discuss the pitfalls and merits of each strategic option with regard to DMG entering the Mauritian market, supported with reasons and calculations. State which of the two alternatives you would recommend for DMG.	20	
	Communication skills – logical argument	*1*	21
(f)	Discuss, with regard to the most recent DMG Board meeting – (i) any concerns you have, with reference to the *Companies Act*, Act 71 of 2008, and the SAICA Code of Professional Conduct; and	9	
	(ii) the aspects that should be considered by the audit team with regard to the decisions that were taken in terms of the *Auditing Profession Act,* Act 26 of 2005.	10	
	Communication skills – clarity of expression	*1*	20
(g)	Discuss, with reference to the SAICA Code of Professional Conduct, any concerns you may have in relation to the audit team's attendance and conduct at the cocktail evening held by DMG.	5	5
Total for part II			**46**
TOTAL FOR THE QUESTION			**100**