QUESTION 1 **100 marks**

SuperMega (Pty) Ltd ('SuperMega') is an entertainment company with a large presence throughout South Africa and some presence in other select African countries. The company focuses on providing digital satellite TV services to its client base, which consists of consumers and businesses across the economic value chain. The company was launched in 1995, and its entertainment offerings have expanded over time and include a wide variety of channels. The company has about five million subscribers of whom approximately four million reside in South Africa.

You are the financial manager who was in the process of finalising the annual financial statements for the year ended 30 June 2017 (FY2017) before they were authorised for issue on 8 August 2017.

Key information pertaining to SuperMega:

- SuperMega prepares its financial statements in accordance with International Financial Reporting Standards (IFRS).
- SuperMega has early adopted IFRS 9 *Financial Instruments.*

1 Competition Commission investigation and fine

In December 2016 SuperMega was notified by the Competition Commission of South Africa that it would be fined for anti-competitive behaviour. The matter relates to a November 2015 investigation which found that, through the Media Credit Agency (MCA), various media companies agreed to offer similar discounts and payment terms to advertising agencies that placed advertisements with MCA members. MCA members were offered a 20% discount for payments within 45 days of statement date, while non-members were offered 15%.

The Commission found that this practice restricted competition among competing companies as they did not independently determine an element of the price in the form of either settlement discounts or trade terms. The Commission concluded that this practice amounted to price fixing and a contravention of competition legislation.

After an internal legal review SuperMega decided to make a R50 million 'good faith payment' (an amount paid in advance to indicate the intention of settling a matter in a fair, open and honest manner) on 2 January 2017. This was meant to be used as a base for negotiations on the eventual fine payable.

Payment alternative 1

On 30 June 2017 the Competition Commission ruled that SuperMega had to pay a fine of R375 million in total. This had to be settled as follows:

- The good faith payment already made counts towards the total amount payable;
- An additional R50 million payable immediately;
- Five payments of R45 million per annum starting on 30 June 2018; and
- The balance of R50 million as a final payment on 30 June 2022.

Furthermore, to encourage more responsible behaviour and the development of smaller businesses, SuperMega was ordered to pay 0,5% of its average earnings before interest, tax, depreciation and amortisation (EBITDA) over the past five years (FY2012 to FY2016) to a business development charity on 1 July 2017. This amount will be managed by the Media Development and Diversity Agency and will be audited annually. SuperMega will not qualify for a tax deduction on the R375 million fine but will qualify for a tax deduction in full on the business development charity payment.

SuperMega's revenue and key profitability ratios over the past five years were as follows:

	FY2012	FY2013	FY2014	FY2015	FY2016
Revenue (Rm)	6 500	6 850	7 400	7 450	7 280
EBITDA margin	36%	35%	37%	36%	34,5%
Net profit margin	11%	9%	13%	12%	11%

Payment alternative 2

As an alternative, the Competition Commission will allow SuperMega to settle the fine by means of a single cash payment of R250 million. This amount would be in addition to the R50 million good faith payment. The company would have five days from 30 June 2017 to settle this amount. No payment to the business development charity would be required under this option.

Proposed funding options

The Chief Financial Officer of SuperMega, Honey Malone, has proposed the following alternatives to the Board for settling the amounts due to the Competition Commission:

1 Using operating cash flows to settle the liability;
2 Selling the company's head office building (valued at approximately R450 million), or alternatively entering into a sale and leaseback transaction with regard to the property;
3 Using short-term debt facilities; or
4 Raising additional funding by means of the issue of shares either to existing or to new external shareholders.

2 BPL broadcasting rights

On 1 July 2016 SuperMega acquired the broadcasting rights for soccer matches of the British Premier League (BPL) for R3 500 million. This agreement gives SuperMega sole broadcasting rights to all matches of the BPL across Southern Africa until 30 June 2021. SuperMega considered this to be a bargain purchase, given its initial forecast cash flow expectations. However, because of political instability, rising unemployment and slow economic growth, initial growth in subscriptions has been disappointing. SuperMega's management accordingly reduced the forecast cash flow expectations arising from the broadcasting rights on 30 June 2017 (see point 3.3 below).

The only journals processed in respect of broadcasting rights by SuperMega for FY2017 are as follows:

		Dr.	**Cr.**
		R million	**R million**
1/07/2016	Broadcasting right: BPL (SoFP)	3 500	
	Bank (SoFP)		3 500
	Purchase of BPL broadcasting rights (five years)		
2/01/2017	Broadcasting right: Good faith payment (SoFP)	50	
	Bank (SoFP)		50
	Good faith payment to Competition Commission		

3 Initial feasibility study

The initial analysis, which had been performed by Honey and which was used to justify the acquisition of the BPL broadcasting rights, was based on a financial feasibility analysis and marketing study conducted in early 2016. Her calculations are presented below (cash flows are before tax):

Financial year – June	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
3.1 Forecasts ignoring BPL deal						
SuperMega subscribers (million)		5,00	4,97	4,94	4,97	5,07
Market share		80%	78%	76%	75%	75%
Total market size (million)		6,25	6,38	6,50	6,63	6,77
Total annual advertising revenue (Rm)		3 400	3 488	3 660	3 864	3 930
Subscription revenue (Rm)		5 100	5 231	5 490	5 796	5 895
		8 500	8 719	9 150	9 660	9 825
Annual subscription revenue per subscriber (R)		1 020	1 053	1 111	1 166	1 163
Advertising revenue/total revenue		40%	40%	40%	40%	40%
Advertising revenue/subscription revenue		67%	67%	67%	67%	67%
3.2 Forecasts assuming BPL deal is signed						
SuperMega subscribers (million)		5,13	5,23	5,33	5,44	5,55
Market share		82%	82%	82%	82%	82%
Total market size (million)		6,25	6,38	6,50	6,63	6,77
Incremental advertising revenue (Rm)		225	487	789	995	1 076
Incremental subscription revenue (Rm)		338	730	1 184	1 493	1 614
		563	1 217	1 973	2 488	2 690
Broadcast rights cost (Rm)	(3 500)					
Net present value (Rm)	2 131					

Honey did note, although this was not communicated to the Board at the time the decision to acquire the BPL broadcasting rights was made, that she was unsure how the following factors should be incorporated into her analysis:

- SuperMega agreed on a marketing campaign to raise awareness of the new broadcasting rights acquired. This was projected to cost R75 million per year (over and above existing marketing spend).
- The cost of the initial feasibility study and marketing analysis of R5 million that was paid in FY2016.

Subsequent to the acquisition of the BPL broadcasting rights, the actual (for FY2017) and revised (for FY2018 to FY2021) market share, subscriber numbers and revenue were as follows:

Financial year – June	2016	2017	2018	2019	2020	2021
3.3 Revised forecasts						
SuperMega subscribers (million)		4,96	5,06	5,16	5,26	5,37
Market share		81%	81%	81%	81%	81%
Total market size (million)		6,13	6,25	6,37	6,50	6,63
Incremental advertising revenue (Rm)		(70)	168	445	623	673
Incremental subscription revenue (Rm)		(104)	252	667	934	1 010
		(174)	420	1 111	1 557	1 683

4 Market dominance action plan

In the light of the Competition Commission fine and recent interactions with industry bodies, the Board of Directors of SuperMega is concerned about its future responses to potential regulatory changes within its industry. This follows a period of particularly negative publicity on monopolies in South Africa and pricing to end users in view of the difficult macro-economic environment. The extract below from a prominent local newspaper by an activist consumer group highlights the negative publicity.

For the benefit of a few – Pay TV in South Africa

Despite complaints and outstanding legal actions, access to information and international content seems to remain the preserve of the few and the privileged. It is clear that SuperMega is the dominant market operator – and it obviously exercises significant control over the market.

Furthermore, it has abused its position, as is evidenced from the following:

1. ***Exclusivity of content:*** The nature of the exclusive contracts entered into between content rights providers and broadcasters means that SuperMega effectively has no competition when acquiring rights and hence is the sole owner of the rights.
2. ***National sporting events:*** SuperMega has exclusive rights to broadcast our national sporting team performances, including our athletes' performances at the Olympic Games and South African participation in Soccer World Cup events, limiting access by poorer households.
3. ***Subscription fees:*** To watch live sporting games consumers have to subscribe to SuperMega. Given the way content bundles are structured – regardless of needs and preferences – users either have to purchase a pricey bundle or forego access to the events completely.

The Board has consequently resolved that Honey prepare an action plan to address these concerns. She has identified the following key risks:

- Increased litigation due to potential market dominance concerns and customer complaints.
- Further Competition Commission investigations into SuperMega as a result of the increased concerns about its monopolistic position and ownership of key content.

- The risk that in future the broadcasting rights process will be subject to greater scrutiny by the regulatory body, with a more competitive bidding process being introduced.
- SuperMega may be forced to sell content to rival pay TV stations at a subsidised rate to increase competition in the sector.
- SuperMega may be forced to introduce a ‘free to air policy’ on national sporting events to grant access to households that cannot afford its services but should not be denied the right to watch national sporting events on international stages.
- Reputational damage to SuperMega from the on-going negative media publicity.

5 Medium-term note programme

To generate liquidity, the treasury executive of SuperMega decided to issue debentures in terms of SuperMega’s medium-term note programme. The following is an extract from the applicable pricing supplement:

Applicable pricing supplement – extract	
Issuer	SuperMega (Pty) Ltd
Nominal amount	R625 million (R1 million per debenture)
Type	Fixed rate convertible note
Coupon rate	4% fixed nominal rate per annum paid quarterly in arrears
Conversion option	At the option of the holder after five years (1 January 2022)
Conversion terms	10 000 SuperMega ordinary shares for every four debentures held. Debentures not converted will be redeemed at their nominal amount.
Issue date	1 January 2017
Maturity date	1 January 2022

On 1 January 2017 SuperMega issued 625 debentures at their fair value of R800 000 each by means of a private placement to South African companies, and incurred transaction costs of R5 million. On the same date the market interest rate of a similar instrument without the conversion option was a 12% fixed nominal rate per annum paid quarterly in arrears.

6 Additional information

- The corporate tax rate in South Africa is 28%.
- SuperMega’s weighted average cost of capital (WACC) is approximately 14%. The company’s after-tax cost of debt is reasonably approximated by its WACC.
- Shortly after issuance of the debentures, the South African Revenue Service issued a tax ruling with regard to the debentures, which stated the following:
  - All interest paid on the debentures (including the amortisation of any premium or discount) would be considered to be deductible for tax purposes;
  - A yield-to-maturity method, which is similar to the effective interest rate method employed in IFRS 9, should be used for this purpose; and
  - Any transaction costs incurred on the issuance would be deductible for tax purposes in the tax year in which these costs are incurred.
- Broadcasting rights acquired are deductible for tax purposes over a three-year period.
- Where applicable and unless otherwise evident, fair value less costs to sell equates to value in use.
- SuperMega measured all financial liabilities at amortised cost in terms of IFRS 9.
- All amounts are material.

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INITIAL TEST OF COMPETENCE, JUNE 2018
PROFESSIONAL PAPER 1

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

QUESTION 1 PART I – REQUIRED		**Marks**	
		Sub-total	**Total**
(a)	Calculate and conclude on which alternative for settling the Competition Commission fine is cheaper for SuperMega.	10	10
(b)	Identify and discuss the factors SuperMega should have considered in determining whether it should have selected alternative 1 or 2 to settle the Competition Commission fine.	8	
	Calculations are not required.		
	Communication skills – logical argument	*1*	9
(c)	Identify and discuss the disadvantages of each of the proposed funding options that Honey identified for settling the Competition Commission fine.	12	
	Communication skills – logical argument	*1*	13
(d)	Based on the updated information in point 3.3 of the initial feasibility study –		
	(i) estimate whether the BPL broadcasting deal would have been financially feasible and lucrative; and	8	
	(ii) identify any other factors that should be considered in evaluating the broadcasting deal.	7	
	Round all amounts to the nearest R million where applicable.		15
(e)	Identify and describe potential mitigating actions SuperMega could undertake to respond to the risks and issues raised under the market dominance action plan.	10	
	Communication skills – clarity of expression	*1*	11
Total for part I			**58**

INITIAL TEST OF COMPETENCE, JUNE 2018
PROFESSIONAL PAPER 1

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

QUESTION 1 PART II – REQUIRED		**Marks**	
		Sub-total	**Total**
(f)	Discuss under which classification SuperMega should present the following items in its statement of cash flows for FY2017:		
	(i) The good faith payment of R50 million;	2	
	(ii) The purchase of the BPL broadcasting rights; and	2	
	(iii) The issuance of the debentures.	2	
	Ignore comparatives.		
	Communication skills – clarity of expression	*1*	7
(g)	Prepare all journal entries required to account for the debentures issued by SuperMega on 1 January 2017 in the financial statements of SuperMega for FY2017.	19	
	• Include journal entries relating to current and/or deferred taxation. • Ignore closing journal entries. • Round all amounts to the nearest rand.		19
(h)	Prepare all adjusting journal entries required to correctly account for the BPL broadcasting rights in the financial statements of SuperMega for FY2017.	15	
	• Include journal entries relating to deferred taxation. • Ignore current taxation. • For financial reporting purposes assume a discount rate reflective of the risks associated with the broadcasting rights is 25% (before tax) and 20% (after tax). • Ignore closing journal entries. • Round all amounts to the nearest rand.		15
Communication skills for parts (g) and (h) – presentation			*1*
Total for part II			**42**
TOTAL FOR THE QUESTION			**100**