

**Ignore value-added tax and dividend tax**

Oneity Ltd ('Oneity') is a South African based retail holding company listed on the Johannesburg Stock Exchange (JSE). The Oneity group has an extensive global footprint comprising 400 stores in 10 countries and specialises in retail sectors such as household appliances, furniture and fashion apparel.

Key information pertaining to all companies within the Oneity group:

- The Oneity group prepares its financial statements in accordance with International Financial Reporting Standards (IFRSs).
- The Oneity group early adopted IFRS 16 *Leases* for the financial year ended 28 February 2019 (FY2019).
- All companies have a 28 February year end.
- The presentation and functional currency of all companies is the South African rand.

**1 Governance structure**

Oneity's governance structure consists of the Board of Directors, assisted by four committees, namely the audit, remuneration, risk governance and nominations committees. Oneity's Board as at 28 February 2019 consisted of the following individuals:

Director	Notes	Position	Age	Years in position
Mr A Diddas	1.1; 1.2	Chairperson	57	12 years
Mr C Trainer	1.2; 1.3	Chief Executive Officer (CEO)	55	12 years
Mr D Jones CA(SA)	1.2	Chief Financial Officer (CFO) and Company Secretary	58	16 years
Mr HI Tech	1.2; 1.4	Chief Operations Officer (COO) and Chief Audit Executive (CAE)	55	11 years
Mr N Hike	1.2	Director Human Resources	56	11 years
Mr S Solomon	1.5	Non-executive director	60	13 years
Ms F Merell	1.6	Non-executive director	47	1 year
Mr A Sics	1.7	Non-executive director	62	15 years

**Notes**

- 1.1 Mr Diddas owns 15% of the equity interest in Oneity and was appointed as the Chairperson of the Board by all the members of the Board at the 1 June 2006 meeting. Mr Diddas served as CEO of Oneity until 1 March 2006. He has also served as the Chairperson of the Audit Committee of Oneity for a number of years.
- 1.2 Messrs Trainer and Diddas have been friends since their university years. They also form part of the so-called 'Ancient Lads' Club', a name they earned while at university, to which Messrs Jones, Tech and Hike also belong.
- 1.3 Mr Trainer was appointed to the position of CEO of Oneity on 1 March 2006 by Mr Diddas and he also served as a member of the Audit Committee of Oneity for a number of years. Mr Trainer declared to the Board on numerous occasions that he had no interest in any company other than Oneity. However, after the purchase of UB Appliances (see section 2) had been completed, it came to light that this was not the case.

- 1.4 Mr Tech plays a significant role in the day-to-day management of Oneity as COO and has also served as the CAE of Oneity for a number of years.
- 1.5 Mr Solomon is the CEO of one of Oneity's significant suppliers.
- 1.6 Ms Merell is an experienced designer who was responsible for overseeing and managing the fashion division of Oneity. She left the employ of Oneity on 1 March 2017 and joined one of the Oneity group's other subsidiaries as COO. She was appointed as non-executive director to the Board of Oneity on 1 March 2018 by all the members of the Board serving on this date.
- 1.7 Mr Sics serves on the boards of 12 other companies from various industry sectors, which the Board of Oneity believes makes him a valuable asset to the group of companies.

## 2 Acquisition of assets and liabilities of UB Appliances

On 8 November 2017 the Oneity Board unanimously decided to propose a take-over of UB Appliances ('UBA'), South Africa's biggest appliance retailer. This would further diversify the Oneity product offerings and leverage off several synergies that could be derived from Oneity's well-established supply chain. Oneity and UBA entered into a sale of business agreement on 19 December 2017.

Ownership of UBA was made up as follows prior to this take-over:

Shareholders	Shareholding
VestBid Ltd is a private equity firm with a diversified investment portfolio	30%
Mr Lace (COO of UBA) and Mr Trainer (CEO of Oneity), each held a 35% equity interest in UBA	70%
	100%

### ***Accounting for the acquisition of the assets and liabilities of UBA***

The purchase agreement stipulated that specified assets and liabilities of UBA were to be transferred to Oneity on 1 March 2018. Oneity therefore obtained control, as defined in IFRS 10 *Consolidated Financial Statements*, over these assets and liabilities on this date. The take-over also met the definition of acquiring a business, as defined in IFRS 3 *Business Combinations*.

The financial accountant of Oneity, on instruction of Mr Trainer, processed journal entry JNL:NR-458 for FY2019 to account for the acquisition of the specified assets and liabilities of UBA.

<b>JNL:NR-458</b>				
		<b>Notes</b>	<b>Dr.</b>	<b>Cr.</b>
<b>Account description</b>	<b>Financial statement</b>		<b>R'000</b>	<b>R'000</b>
Property, plant and equipment	SoFP	2.1	10 000	
Investment property	SoFP	2.2	6 550	
Intangible assets: Goodwill	SoFP	2.3	4 500	
Non-current assets held for sale	SoFP	2.4	7 500	
Inventory	SoFP	2.5	29 700	
Bank and cash (R14 800 000 – R325 000 – R900 000 – R5 500 000)	SoFP	2.6; 2.8; 2.9; 2.12	8 075	
Right-of-use asset	SoFP	2.7	1 650	
Intangible assets: Workforce (R3 500 000 + R5 500 000)	SoFP	2.8	9 000	
Share issue costs	P/L	2.9	900	
Intangible assets: Legal fees incurred	SoFP	2.12	325	
Gain on bargain purchase (balancing figure)	P/L		9 160	
Lease liability	SoFP	2.7		1 760
Share capital (300 000 x R253 (25 300 cents))	SoCE	2.9		75 900
Provision: Earn-out bonus	SoFP	2.10		3 100
Provision: Contingent payment	SoFP	2.11		5 000
Provision: Claim from customer	SoFP	2.13		1 600
<b>Acquisition of UBA</b>			<b>87 360*</b>	<b>87 360*</b>

\* The casting of the journal entry is correct.

- 2.1 UBA's property, plant and equipment consist of several buildings and equipment and a piece of owner-occupied land. All of these assets were considered to be fairly valued in terms of IFRS 3 at the acquisition date, except for the owner-occupied land. This land is currently held for industrial use as a site for one of UBA's factories. Similar sites have recently been developed into office buildings. On the acquisition date the land in question had no restrictions to prevent it from being developed into office buildings. The fair value of all UBA's property, plant and equipment amounted to R10 million (if the site were held for industrial use) and R12 million (if the site were developed into office buildings) on the acquisition date.
- 2.2 The investment property is an office building which was subject to a market-related lease agreement between Oneity and UBA. The lease came to an end on 28 February 2018. Oneity leased the building from UBA for office space and will continue to use it for this purpose. The carrying amount of this building in the separate financial statements of UBA on the acquisition date did not materially differ from its fair value.
- 2.3 The goodwill recognised is a result of a previous business combination between UBA and an unrelated third party a number of years ago. The goodwill has never been impaired.
- 2.4 The non-current assets held for sale consist of a factory building that was correctly classified as a non-current asset held for sale in terms of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. The estimated costs to sell are R250 000 and the fair value of the factory building was R7 500 000 on the acquisition date. Oneity intends to sell the building within 12 months.

- 2.5 The inventory balance is correctly reflected at the lower of cost and net realisable value in accordance with IAS 2 *Inventories* and this value approximates the fair value of the inventory on the acquisition date.
- 2.6 The bank and cash of UBA at the acquisition date was R14 800 000 (favourable balance).
- 2.7 The right-of-use asset and corresponding lease liability are a result of a lease agreement between UBA and an unrelated third party and the amounts reflected are based on the original contract. Per the lease agreement, UBA leases a number of specialised machines that are used in the supply chain process. The lease agreement does not qualify for the recognition exceptions stipulated in IFRS 16 par. 5. On the acquisition date, the remaining lease term amounted to four years and the correctly calculated present value of the remaining lease payments, as if this lease were a new lease on the acquisition date, amounted to R1 850 000. UBA's lease payments are higher than what market participants are currently paying. On the acquisition date, the fair value of this 'off-market' component amounted to R292 000.
- 2.8 The purchase agreement stipulates that UBA's key personnel and executives (an assembled workforce) would be employed by Oneity subsequent to the take-over. Mr Trainer valued this workforce at R3 500 000 on the acquisition date. Oneity was required to pay retrenchment packages of R5 500 000 in cash on 1 March 2018 to the employees not employed by Oneity after the take-over.
- 2.9 The purchase consideration was settled by Oneity with an immediate cash payment of R32 400 000 to UBA on 1 March 2018. In addition Oneity issued 300 000 ordinary shares on 8 March 2018. Oneity incurred share issue costs amounting to R900 000 on the issue date. Oneity's share price was as follows on the relevant dates:

Date	Quoted on the JSE
1 March 2018	25 200 cents per share
8 March 2018	25 300 cents per share

- 2.10 An earn-out bonus of R3 500 000 will be payable to Mr Lace on 28 February 2021 if he remains in the employ of Oneity until that date. If he resigns before that date, the bonus will be forfeited. The fair value of the earn-out bonus was reliably determined to be R3 100 000 on the acquisition date.
- 2.11 Cash payments of R2 500 000 each are payable to Messrs Lace and Trainer, in the event of Oneity's price-earnings multiple (PE ratio) exceeding 18 by 28 February 2021. The fair value of these further payments was reliably determined as being R4 600 000 in total on the acquisition date.
- 2.12 Oneity incurred legal fees amounting to R325 000 in drafting the purchase agreement, which was paid in cash on the acquisition date.
- 2.13 On the acquisition date, the following facts were identified from the draft separate financial statements of UBA for FY2018:
- UBA expensed an amount of R1 900 000 incurred with the development and registration of a patent for a specific appliance developed and manufactured by the company during FY2018 as it did not meet the requirements for recognition as an intangible asset per IAS 38 *Intangible Assets*. Oneity's management decided not to continue using the patent. A fair value could reliably be placed on the patent and amounted to R1 200 000 on the acquisition date.

- An amount of R1 800 000 was correctly disclosed as a contingent liability in terms of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The contingent liability is a result of a claim from a customer who was allegedly injured using an UBA appliance. The classification as a contingent liability was based on the fact that only a possible obligation, as defined in terms of IAS 37 par.10, existed at the end of FY2018. This conclusion was still applicable and correct at the acquisition date as none of the circumstances which resulted in the conclusion had changed. The fair value of this contingent liability was reliably determined to amount to R1 600 000 on the acquisition date.

### 3 Valuation of UBA

Oneity wanted to acquire all the assets and liabilities of UBA. Accordingly when the initial purchase offer was made to UBA, the Financial Manager of UBA performed a quick price-earnings (PE) valuation to determine whether the price offered was fair.

The valuation was performed by applying Oneity's PE ratio of 17,5 at the end of FY 2018 to UBA's FY2018 after tax earnings. The PE ratio was reduced for the fact that UBA is not an international company. The synergies expected from the take-over were taken into account.

Details of the valuation performed:

<b>PE valuation on 28 February 2018</b>	
	<b>R'000</b>
Profit after tax	5 164
Adjusted for after tax interest on shareholder loan	201
After tax synergies expected	1 200
Maintainable earnings	6 565
Value of 100% of enterprise value using 16,5 adjusted PE ratio	108 323
Less shareholder loan	(2 732)
Premium for majority share	10 559
Value of 100% equity	116 150

### 4 Free cash flow valuation

Following some concerns raised by the shareholders of UBA, the Board decided to investigate what the free cash flow valuation of UBA as at 28 February 2018 would have been. It decided that the starting point should be a draft statement of cash flows of UBA with projections of future cash flows up to FY2021. It is presented on the basis that UBA had not been acquired by Oneity, and had continued with its normal operations. All of these projections were done before any decision or consideration to sell UBA took place.

<b>UBA</b>					
<b>Abridged statement of cash flows for the year ended/ending</b>					
	Notes	FY2018	FY2019	FY2020	FY2021
		Actual	Forecast		
		R'000	R'000	R'000	R'000
<b>Cash generated by operations before working capital changes</b>	4.1	7 700	8 705	9 748	9 942
Changes in working capital					
Trade receivables		(476)	(442)	(478)	(516)
Inventory		(908)	(884)	(955)	(1 032)
Trade payables		340	663	716	774
<b>Net cash inflow from operating activities</b>		6 656	8 042	9 031	9 168
Net investment in property, plant and equipment	4.1	(2 320)	(2 400)	(15 700)	(3 000)
Proceeds from sale of fixed assets	4.1	10 000	7 500	0	0
Distribution to shareholders	4.2	(1 291)	(1 413)	0	(1 625)
Net increase/(decrease) in cash and cash equivalents		13 045	11 729	(6 669)	4 543
<b>Cash and cash equivalents at beginning of year</b>		1 755	14 800	26 529	19 860
<b>Cash and cash equivalents at end of year</b>	4.3	14 800	26 529	19 860	24 403

## Notes

4.1 The following items were included in the actual and projected earnings before interest and tax (EBIT) of UBA:

	Notes	FY2018	FY2019	FY2020	FY2021
		Actual	Forecast		
		R'000	R'000	R'000	R'000
Depreciation		(3 200)	(3 300)	(3 300)	(3 600)
Profit on sale of fixed asset	4.1.1	684	0	0	0
Sponsorship of Olympic team	4.1.2	0	0	0	(2 000)
Cost to sell factory building	4.1.1	0	(250)	0	0
Lease income: Investment property		720	785	855	932

4.1.1 The profit on the sale of a fixed asset relates to a warehouse that was sold at an amount of R10 million on 30 April 2017. UBA's management decided to use the R10 million proceeds from the sale of the warehouse in FY2018 to settle the purchase consideration of a replacement building, and not to use this amount for operating activities (the amount was included in UBA's cash and cash equivalents balance at the FY2018 year end). UBA will only acquire the replacement building in FY2020 at a cost of R13 million. UBA rented this replacement building as from 1 May 2017 on a month-to-month basis at a cost of R90 000 per month. In addition, there is a factory building that was classified as non-current assets held for sale on acquisition (see point 2.4 under section 2). The factory building is intended to be sold within 12 months (i.e. during FY2019). No other large capital expenditures apart from routine maintenance are expected in the near future.

4.1.2 The sponsorship of the Olympic team pertains to a decision that was taken during FY2018 to sponsor the South African athletes who would be attending the Olympic Games hosted by Japan in July 2020.

- 4.2 UBA usually distributes 25% of its after tax profits to the shareholders. However, the decision was taken not to distribute any profit in FY2020 because of the planned purchase of the replacement building.
- 4.3 Excess cash is deposited in a money market account which earns interest at 7% per annum. All interest income projected for FY2019 to FY2021 relates to the excess cash balances.
- 4.4 The following interest income and finance charges were included in the actual and forecast cash flows:

	<b>FY2018</b>	<b>FY2019</b>	<b>FY2020</b>	<b>FY2021</b>
	<b>Actual</b>	<b>Forecast</b>		
	<b>R'000</b>	<b>R'000</b>	<b>R'000</b>	<b>R'000</b>
Interest income	700	1 225	315	315
Finance costs	1 655	1 655	1 655	1 655

Before the take-over took place, UBA had expected an annual growth of 5% in free cash flows after FY2021. It was anticipated that this growth rate could be as high as 7% after the take-over as a result of an increased market share resulting from Oneity's well-established supply chains.

## 5 Additional information

- All items of property, plant and equipment are accounted for on the cost model in terms of IAS 16 *Property, Plant and Equipment*.
- All intangible assets are accounted for on the cost model in terms of IAS 38.
- All items of investment property are accounted for on the fair value model in terms of IAS 40 *Investment Property*.
- Oneity's weighted average cost of capital (WACC) is approximately 11,97%.
- UBA's WACC is approximately 12,93%. This was estimated by using the cost of equity of an international appliance retailer, Bafa Ltd, and adjusting the figure for risks specific to UBA and the fact that UBA is a private company.
- UBA's after-tax cost of debt is reasonably approximated in its WACC.
- UBA had a total of R15 million in interest-bearing debt at the end of FY2018.
- The corporate tax rate applicable to all companies is 28% and all capital gains are taxed at an effective rate of 22,4% for all financial years under consideration.





**INITIAL TEST OF COMPETENCE, JUNE 2019**

**PROFESSIONAL PAPER 3**

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

<b>PAPER 3 PART II REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(c)	Evaluate and comment on the PE valuation performed by the financial manager in determining the value of UBA.  Do not re-perform the calculations or the PE valuation.  <i>Communication skills – appropriate style</i>	11   1	   12
(d)	Use the free cash flow valuation method to estimate the equity value of UBA as at the end of FY2018 as if the acquisition by Oneity had not taken place.  Provide the key assumptions you used in performing your valuation.  <i>Communication skills – appropriate style</i>	21   1	   22
<b>Total for part II</b>			<b>34</b>
<b>TOTAL FOR THE QUESTION</b>			<b>100</b>