

Ignore value-added tax (VAT).

1 Background

FreschKart Supermarkets Ltd ('FreschKart') is a grocery, clothing and general merchandise retailer that operates over 2 500 stores across South Africa, Lesotho and Namibia. FreschKart was established in 1994 by Sipho Nxiweni when he purchased a small grocery retailer in Cape Town. Since then, FreschKart has grown to become one of the best-known brands in Southern Africa, mainly due to the wide range of quality goods it offers at affordable prices. Most of the products that FreschKart sells are purchased from local retailers, but the company also imports some of its products from countries in various parts of the world.

FreschKart has a 31 December financial year end and its functional and presentation currency is the South African rand. Its financial statements are authorised for issue three months after each year end. Appendix 1 contains an extract of FreschKart's financial statements. FreschKart believes in good corporate governance principles and strives to comply with the King IV Report on Corporate Governance. FreschKart is listed on the Johannesburg Stock Exchange.

FreschKart operates through multiple store formats under two distinct brands: the FreschKart Brand ('FKB') and the Cracker Brand ('CB').

- FKB stores target middle to high income households, which generally result in greater profit margins than CB stores. However, FKB stores have lower growth opportunities.
- CB stores generally cater to lower income households. These stores offer consumers affordable groceries and cheaper clothes and typically have lower profit margins but high-volume sales.

The food retail industry is subject to rigorous health and safety regulations and food safety standards, which require businesses like FreschKart to ensure the safety and well-being of its customers while maintaining a strong reputation. FreschKart ensures that all its franchise stores are in compliance with these standards by undertaking regular audits of its franchise stores.

Since listing in 2013, FreschKart's share price has been highly volatile due to several operational and financial matters. During the current year, FreschKart's share price has fallen by more than 10% to its current share price of R20,50. FreschKart's current asset beta (unlevered) is 0,45 and its current equity beta is 4,84 (levered).

FreschKart is highly geared and most of its debt is subject to a variable interest rate. Consequently, FreschKart is currently in discussions with its lenders about refinancing its debt. However, this process has not yet been finalised. Furthermore, FreschKart's historic overreliance on debt for funding operations has moved the entity outside its targeted debt to total firm value of 40%.

2 Operations of FreschKart South Africa ('FreschKart SA')

2.1 Overall performance

FreschKart's poor performance has mainly been driven by the performance of FreschKart SA over the past five years. This has been impacted by the declining economic growth rate in South Africa and it has also struggled to grow its market share in South Africa. The major factors are the highly competitive retail environment in the country and consumers who are becoming increasingly price sensitive due to increases in interest rates and high inflation. This has had a negative impact primarily on FKB stores. FreschKart SA currently accounts for 90% of FreschKart's total revenue.

For the financial year ended 31 December 2024 (FY2024), FreschKart SA's operations reported a considerable loss after its retail sales declined significantly. This was in part due to employee strikes in the industry for wage increases, resulting in the loss of operating capacity and stock-outs¹. FreschKart SA also had to increase prices of some imported goods due to the depreciation of the rand against the United States dollar (USD).

Another key reason for the poor performance of the company over the past five years has been the company's food ordering and delivery service application ('app'), GoFresch.

2.2 The GoFresch app ('GoFresch')

GoFresch was launched in 2009 as part of FreschKart SA's strategy to reach a wider consumer base in South Africa. At the time of its launch, FreschKart SA was the only grocery store in South Africa to offer a food ordering and delivery service.

GoFresch enables customers to order a maximum of 20 items from their closest FreschKart SA store. The items ordered are then selected, packed and delivered to the customers' chosen address within two days of an order being placed. GoFresch collects customer data, including their payment information and home addresses.

In the first few years of operating GoFresch, FreschKart SA was able to capture valuable market share away from its competitors. However, since 2021 competitor retailers have offered similar services to their customers at cheaper prices, as these retailers use third parties to deliver their orders. All FreschKart SA's deliveries are made by inhouse delivery teams (i.e., FreschKart SA makes its own deliveries).

As competitors are able to offer customers delivery within 60 minutes of an order being placed, FreschKart SA's customers have started to complain about the delay of FreschKart's delivery service and also that incorrect items are being delivered.

Furthermore, competitor apps allow customers to select alternative items when a preferred item is out of stock. Customers find these apps to be more user-friendly, which has allowed their competitors to attract a greater share of the online market. Consequently, FreschKart SA has seen its once innovative service being overtaken by that of its competitors. As at 31 December 2024, sales through GoFresch accounted for more than 20% of FreschKart SA's total sales.

¹ Stock-out is a situation where a company does not have enough of a specific product to sell to its customers.

2.3 FreschRewards customer loyalty programme

In response to increasing competition and changing consumer preferences, FreschKart SA, particularly its FKB stores, embarked on a strategic initiative to enhance customer loyalty through the implementation of a customer loyalty programme. On 1 December 2024, FreschKart SA launched the 'FreschRewards programme' at selected FKB stores. The FreschRewards programme is aimed at rewarding loyal FKB store customers for their purchases and encouraging repeat visits.

FreschKart SA integrated its loyalty programme across multiple channels, both in-store and via GoFresch. Customers earn points ('FreschRewards') every time they use their FreschRewards card at the till in-store or online (i.e., when buying via GoFresch). They can thus redeem loyalty points for discounts on future purchases.

FreschRewards members earn one point for every R2 spent, while every 100 points earn customers a discount of R1. FreschRewards can only be earned on goods purchased in-store or via GoFresch and not on delivery fees or FreschRewards redeemed.

During December 2024, the selected FKB stores offering the FreschRewards programme sold goods for the total cash amount (i.e., including delivery fees) of R5 million via GoFresch and in-store of R19 million. All the goods purchased via GoFresch were delivered by FreschKart's delivery service (FKB stores deliver goods at a fixed delivery fee of R35 per order). 20% of the 10 000 orders made during December 2024 via GoFresch were purchased with a FreschRewards card and earned FreschRewards. One order requires one delivery.

FreschKart SA correctly estimated that 75% of these FreschRewards would be redeemed. By 31 December 2024, 250 000 FreschRewards earned during December 2024 were redeemed on in-store purchases. These customers only paid R100 000 cash for these goods.

FreschKart correctly determined that sales made via GoFresch to non-FreschRewards members consist of two performance obligations: (i) sale of goods and (ii) delivery services. Sales made to FreschRewards members have a third additional performance obligation, namely (iii) material right – FreschRewards.

FreschKart is uncertain how the FreschRewards programme will influence its revenue recognition and recognised the following in this regard for sales made via GoFresch:

Account descriptions and calculations	Dr.	Cr.
Bank (SoFP)	5 000 000	
Revenue: Delivery fees (P/L) C1: (10 000) orders x R35 per order		350 000
Revenue: Sale of goods (P/L) C2: R5 million – R350 000		4 650 000
Bank (SoFP)	100 000	
Revenue: Sale of goods (P/L)		100 000

3 Debt refinancing

The FreschKart board is considering refinancing some of its existing loans to help ease FreschKart's current cash flow constraints. Some of FreschKart's loans worth a total of R4,3 billion are due to expire on 30 September 2025.

FreschKart would like to refinance the full balance of these loans before they become due, as the company does not have sufficient cash flow to repay the outstanding balance of these loans. Most of these loans were originally taken out years ago when the company was able to negotiate favourable terms. The current average interest rate on these loans is 10,75%.

One of the directors at the board meeting suggested that FreschKart consider settling a portion of the loans using a rights issue. This would help FreschKart to raise additional equity finance, which would in turn help it to recapitalise its balance sheet. The director suggested that FreschKart could offer one share for every four shares held at a price of R17,20 per share.

The board agreed that FreschKart would need to reduce its current debt levels as it had experienced increases in debt servicing costs over the past five years. FreschKart has already breached one of its covenants when the company's total liabilities exceeded its total assets by more than 75% and the company is close to breaching another debt covenant, should its interest-bearing debt rise beyond 90% of total assets.

However, the directors ultimately voted against the rights issue for two reasons.

First, the rights issue would possibly have a negative effect on FreschKart's current share price and could have a further dilutive effect on shareholder value. FreschKart's share price has historically been between R20 and R36 per share, which is the board of directors' target share range in order to protect company value. This is based on the following share tracker information:

Indicator	2023	2022	2021	2020
Shares in issue (million)	1 000	1 000	1 000	1 000
Closing share price (per share)	R24	R25	R28	R36

Second, since FreschKart had an unsuccessful rights issue in 2018 where only R230 million of the envisioned R350 million was raised, the market may react negatively and shareholders are unlikely to support another rights issue. This would probably drive up the cost of any alternative recapitalisation efforts in the future. FreschKart's total shares in issue as at 31 December 2024 remain at one billion.

While no rights issue would be undertaken at that time, the board agreed to revisit the matter during FY2025 to help FreschKart to recapitalise its balance sheet. For the time being, the loans would be refinanced using new debt.

Given FreschKart's already high debt balance, only one bank was willing to provide refinancing for the FreschKart loans. Bank Finance Ltd offered FreschKart a single new loan to cover the full refinancing. The terms for the Bank Finance Ltd loan are as follows:

Principal amount	R4,3 billion
Nominal interest rate	19% p.a. fixed
Loan advance date	1 July 2025
Term	3 years
Upfront issuance cost	3%

Interest on the loan is to be calculated and paid quarterly in arrears. The principal amount is to be repaid in three equal annual instalments, with the first repayment due on 30 June 2026. FreschKart is to pay the upfront issuance cost on the loan advance date. This cost is calculated based on the principal amount received.

4 Impairment of South African operations

In view of FreschKart SA's poor performance, FreschKart's management considered it appropriate to carry out an impairment test on the Sandton store, FreschKart's worst performing store, at the end of FY2024.

The following lists the affected assets of FreschKart's Sandton store, as at 31 December 2024:

	R'000
Land	2 250
Buildings	3 860
Furniture and fittings	9 500
Intangible assets	200
Financial assets	2 150
Inventory	10 300
Total	28 260

Additional information on the impairment

- 1 The carrying amounts of property, plant and equipment and the intangible assets have been calculated correctly in accordance with IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* respectively, at cost. Inventory is reflected correctly in accordance with IAS 2 *Inventories* at the lower of cost or net realisable value. The carrying amount of financial assets (bonds) are reflected accurately at amortised cost in accordance with IFRS 9 *Financial Instruments*.
- 2 Goodwill of R120 000 attributable to the acquisition of the FreschKart Sandton store is included in intangible assets.
- 3 The FreschKart Sandton store was correctly identified as a cash-generating unit as defined in IAS 36 *Impairment of Assets*.
- 4 The recoverable amount for the FreschKart Sandton cash-generating unit is R24 million.

5 FreschKart SA's eco-friendly strategy

Given the last few years of poor performance, FreschKart's new chief executive officer (CEO) believed that FreschKart SA needed to re-strategise its operations and focus on profitability. He believed that FreschKart SA needed to reposition itself as an eco-friendly retailer², as consumers are becoming more conscious of how companies' operations affect the environment. Competitors have pursued this strategy and, although FreschKart SA has no experience in this area, the CEO believed that FreschKart SA would be successful. He believed that this strategy would perfectly align with one of FreschKart's core values of promoting green energy. To give effect to this new strategy, the CEO put together a presentation to the board of directors of several areas of the business that would need to be adjusted to implement the strategy.

This strategy was implemented effective from 1 December 2024 and consists of the following:

5.1 Customer packaging

² An eco-friendly retailer is a retailer that focuses on reducing environmental waste in every section of its business.

FreschKart SA is phasing out the use of plastic bags at till points to package customer goods at all its stores. Thus, all FKB and CB stores are packaging customer goods in FreschKart branded cotton bags. The new bags are being sold to customers for R5 per bag as opposed to the traditional plastic bags, which were sold at R1,60 per bag.

5.2 Recycling centres

All FKB stores greater than 2 500 m² (approximately 60% of all stores) have drop-off recycling bins outside the stores. The recyclable goods are being delivered to various recycling retailers in the area once a month.

5.3 Marketing

All FKB and CB stores are now marketing themselves as only selling goods that are environmentally safe. Goods that are not environmentally safe and that are sold under existing contractual agreements (see section 7 below on the Cisty Ltd ('Cisty') contract), are being sold to non-related grocery retailers, such as Pay and Choose Ltd ('Pay and Choose'), at the cost of the goods (for FKB and CB stores) less 10%. The decision to sell these products at a loss to Pay and Choose was because FreschKart struggled to find a suitable buyer before the implementation date of the strategy and the significant penalties payable for early termination of these contracts before the contract end date.

5.4 Green energy

All FreschKart SA stores are investing more in solar panels and sustainable water harvesting techniques (such as boreholes). This will help to reduce FreschKart's carbon emissions, consistent with commitments made on climate change. At the time of deciding on this strategy, these measures had already been introduced in some of the company's warehouses and distribution centres.

5.5 Reporting

FreschKart will publish a list of its environmental commitments in its 2025 annual report (sustainability report section). The commitments will be updated every year to include any new commitments or remove any commitments which the company believes it will be unable to achieve.

6 Acquisition of solar panels

In its endeavour to fulfil one of the company's core values of promoting green energy, FreschKart SA ordered 10 000 advanced solar panels for its distribution warehouses and selected stores from a supplier based in China. The order was placed on 1 February 2024. These solar panels are expected to surpass the normal lifespan of 20–30 years of locally sourced solar panels, and last up to 40 years. FreschKart's management agreed with this estimate.

The total purchase price was USD1,3 million. A 50% deposit of the purchase price was paid on 1 March 2024 when the solar panels were loaded onto the ship in Shanghai, China. This is also the date control of the solar panels transferred to FreschKart SA. The balance was paid on the arrival of the solar panels in Durban, on 22 March 2024. FreschKart incurred and paid total shipping costs of R1,1 million and non-refundable import (customs) duties of R2,6 million.

The solar panels were –

- 1 transported to the distribution warehouses and selected stores at a total cash cost of R750 000;
- 2 installed at a total cash cost of R1,2 million; and
- 3 tested for effective operation at a total cash cost of R200 000.

All solar panels were installed and certified as working as intended on 1 May 2024. This milestone was publicised at a celebratory event at a cash cost of R143 750. On 1 May 2024, management estimated that the solar panels have a 20% residual value of their total cost. The solar panels are depreciated on a straight-line basis.

The following exchange rates were obtained from a reputable financial institution:

	USD 1 = ZAR
1 February 2024	18,59
1 March 2024	18,79
22 March 2024	19,60
1 May 2024	18,86

7 Cisty contract

Cisty manufactures and sells laundry detergents. Cisty had negotiated a contract with FKB stores to supply Cisty laundry detergent exclusively in all FKB stores for a period of three years. The contract comes to an end on 30 November 2025.

Laundry detergents contain heavy metals, phosphates and other toxic chemicals. When washed through waterways and into the rivers, these harmful additives can be poisonous to fish and affect the quality of the water.

As a result of FreschKart's new commitment to only sell goods that are environmentally safe, it had to reconsider the contract with Cisty. FKB stores stopped selling Cisty laundry detergent units in their stores from 1 December 2024. From this date onward, it sold all its Cisty detergent units to Pay and Choose at cost less 10%. While initially a beneficial partnership, the contract has now become onerous as a result of FreschKart's new strategy.

The contract stipulates that each FKB store must purchase a minimum of 10 000 Cisty detergent units each month, regardless of actual demand or sales performance. The contract includes a clause allowing Cisty to increase the prices of Cisty detergent annually, on 1 December, linked to the consumer price index (CPI) on that date. The cost price per Cisty detergent on 1 December 2022 was fixed at R90 per detergent unit for the 12 months ended 30 November 2023. The CPI was 5,3% and 5,7% on 1 December 2023 and 1 December 2024 respectively.

FKB stores face substantial penalties if they fail to meet the volume commitments or breach any other terms of the contract. These penalties include a fine of R1,5 million and potential legal action, putting additional pressure on these stores to comply with the onerous terms, even if it means sacrificing profits.

8 Leave pay provision

The leave policy applicable to the FKB store managers on 31 December 2023 (FY2023) stipulated the following:

- Each store manager is entitled to 30 days' leave in an annual leave cycle;

- There is no limit to the number of unused leave days that can be accrued in an annual leave cycle;
- Unused leave days can be carried forward and taken or be paid out in subsequent years;
- Leave days not yet taken by the date store managers resign or retire will be paid out at a daily gross salary rate at the time they resign or retire; and
- Accrued leave days expected to be taken before a store manager resigns or retires, will accrue at a cost-to-company rate.

In view of FreschKart's poor financial results, and to improve its debt levels, FreschKart changed some terms of the FY2023 leave policy for FY2024 and future years to no longer allow accumulated leave days to be paid out, i.e., the terms were changed from vesting to non-vesting. The number of leave days granted to the store managers remained unchanged and they were still allowed to accumulate their leave to use in future periods.

A store manager earns on average a basic gross salary of R800 000 per annum. No salary increases were forecast for FY2024. FreschKart contributes a further R80 000 per annum in company contributions to a store manager. These company contributions are expected to remain the same for FY2025.

Each store has one manager. On 31 December 2023, each store manager (on average) had accrued 40 leave days. At that date, it was expected that (on average) each store manager would use 20% of these accrued leave days before they retire or resign. During FY2024 each store manager (on average) took 45 days' leave.

On 31 December 2024, it was expected that (on average) each store manager would only be able to use 60% of their accrued leave days before they retire or resign.

FreschKart's annual leave cycle coincides with its financial year. Leave days are taken on a first-in-first-out basis. There are 260 working days in a financial year.

Appendix 1 – Extract: FreschKart annual financial statements

Statement of profit or loss		
	2024	2023
	R million	R million
Gross profit	27 693	29 935
Other income	2 505	2 265
Operating expenses	(18 014)	(21 154)
Finance income	525	451
Finance costs	(11 972)	(10 963)
Profit before tax, before capital items	737	534
Loss on capital items	(288)	(73)
Profit before tax, after capital items	449	461
Income tax	(547)	(538)
Loss for the period	(98)	(77)

Statement of financial position		
	2024	2023
	R million	R million
ASSETS		
Non-current assets	88 054	111 061
Current assets	61 530	35 995
Total assets	149 584	147 056
EQUITY AND LIABILITIES		
Total equity	10 418	10 516
Non-current liabilities	111 372	101 984
Lease liabilities	3 657	9 133
Interest-bearing loans	107 715	92 851
Current liabilities	27 794	34 556
Trade and other payables	13 976	17 661
Deferred revenue	385	377
Interest-bearing loans	10 625	10 800
Current tax liabilities	280	269
Provisions	2 528	5 449
Total equity and liabilities	149 584	147 056

INITIAL ASSESSMENT OF COMPETENCE, JANUARY 2025

PROFESSIONAL PAPER 2

**This paper consists of one scenario and two required parts.
Answer each required part in a separate answer book.**

PAPER 2 PART I – REQUIRED		Marks	
		Sub-total	Total
(a)	Discuss the key risks that FreschKart was exposed to in its operating environment before the company shifted to an eco-friendly strategy. <ul style="list-style-type: none"> Ignore risks that would be addressed by a shift to an eco-friendly strategy. <i>Z2: Business external environment</i>	11 1	 12
(b)	Critically evaluate the strategic actions that FreschKart has undertaken to become more eco-friendly.	8	8
(c)	Write a memorandum to the board of directors in which you critically review its decision to vote against a rights issue as a means of reducing the company's debt. <ul style="list-style-type: none"> Include calculations and key ratios. <i>Calculations: 10 marks; discussion: 16 marks</i> <i>Y4: Judgement and decision making</i> <i>X1: Communication skill – layout and structure</i>	26 1 1	 28
(d)	Discuss the ethical behaviour and ethical leadership of FreschKart as demonstrated by the directors towards the following stakeholders: the lenders, suppliers represented by Cisty, the store managers and the local communities. <i>Y6: Ethical reasoning</i>	8 1	 9
Total for part I			57

INITIAL ASSESSMENT OF COMPETENCE, JANUARY 2025

PROFESSIONAL PAPER 2

**This paper consists of one scenario and two required parts.
Answer each required part in a separate answer book.**

PAPER 2 PART II – REQUIRED		Marks	
		Sub-total	Total
(e)	<p>Prepare the correcting journal entries to account for the sales made by the selected FKB stores via GoFresch (see section 2) during December 2024 in FreschKart's FY2024 financial statements.</p> <ul style="list-style-type: none"> Ignore all forms of taxation. Dates and journal narrations are not required. Assume all amounts are material. Round all calculated amounts to the nearest rand. <p><i>Y1: Critical thinking</i></p>	15	
		1	16
(f)	<p>Calculate the annual effective cost of the new loan from Bank Finance Ltd.</p> <ul style="list-style-type: none"> Ignore all forms of taxation. 	8	8
(g)	<p>Prepare, based on the information on the Sandton store in section 4, an extract of FreschKart SA's FY2024 property, plant and equipment note as it would appear in the notes to its financial statements.</p> <ul style="list-style-type: none"> Total columns are not required. Round all calculated amounts to the nearest rand. <p><i>X1: Communication skill – presentation</i></p>	8	
		1	9
(h)	<p>Prepare all the journal entries necessary to account for all aspects relating to the solar panels in FreschKart's FY2024 financial statements.</p> <ul style="list-style-type: none"> Ignore all forms of taxation. Dates and journal narrations are not required. Round all calculated amounts to the nearest rand. 	13	
			13

Continued on page 2

PAPER 2 PART II – REQUIRED (cont.)		Marks	
		Sub-total	Total
(i)	<p>Calculate the total FY2024 profit or loss effect related to one FKB store of –</p> <p>(i) the Cisty contract; and</p> <p>(ii) the change in the leave policy.</p> <ul style="list-style-type: none"> Assume the following additional information: <ul style="list-style-type: none"> On 1 January 2024 and 30 November 2024, each FKB store had (on average) 4 000 and 9 000 Cisty detergent units respectively on hand and were able to sell Cisty detergent units (on average) at R120 per detergent unit prior to 1 December 2024. The 9 000 units on hand on 30 November 2024 were sold to Pay and Choose on 1 December 2024. All other cash flows occur at the end of each month. An appropriate discount rate is 10% per annum (compounded monthly). The FKB stores did not buy more than the minimum number of Cisty detergent units they were contractually required to purchase. Ignore all forms of taxation. Round all calculated amounts to the nearest rand. 	10 7	17
Total for part II			63
TOTAL FOR PAPER 2			120