UNIVERSITY OF JOHANNESBURG

UNIVERSITY OF JOHANNESBURG

DEPARTMENT OF ACCOUNTANCY

2014

B.COM HONOURS (ACCOUNTING WITH SPECIALISATION IN CHARTERED ACCOUNTANCY)

SESSION 4

LAST ASSESSMENT OPPORTUNITY
21 October 2014

This document consists of 15 pages including the cover page

MARKS: 100 **TIME: 3 HOURS**

ASSESSORS (A) AND MODERATOR (M):

Auditing:
Prof. Ben Marx (A)
Prof. Alex van der Watt (A)
Mr. Willem van der Post (M)

Financial Management:
Mr. Dewald Joubert (A)
Ms. Maria Weber (A)
Mr. Etienne Barnard (M)

Accounting:
Mr. Ahmed Mohammadali-Haji (A)
Mr. Jonathan Streng (A)
Prof. Kevin Maree (M)

Taxation:
Mr. Lyndsay Maseko (A)
Ms. Michelle van Heerden (A)
Ms. Lizelle Bruwer (UOFS) (M)

INFORMATION DOCUMENT

SESSION 4 QUESTION 1 **(70 MARKS)**

You are a partner in the audit firm of Midget Auditors Incorporated. The firm comprises of 8 audit practices situated in the main centres of South Africa and employs, on average, 50 professional staff.

The firm has been in existence since 1989 and has built a reputation of integrity and professionalism.

You are currently engaged on the 2014 audit of Glutenfoods Limited (hereafter referred to as Glutenfoods), a newly acquired client with a 30 June 2014 year end. Your firm was appointed as auditors in June 2013. This was after one of your audit managers, Alain Kolv CA (SA), informed you that his father in law, who is the Chairman of Glutenfoods's audit committee, had told him that Glutenfoods were considering replacing their existing auditors, Earth & Young, because they were upset with the fact that they received a qualified audit opinion for 2013. The auditors reported a reportable irregularity to IRBA regarding certain tax practices followed by the company in 2013 and qualified the audit report accordingly.

Kolv duly accepted the audit on the firm's behalf.

The following extracts from the 2014 audit working paper file of Glutenfoods are provided.

Working Paper	**Reference**
Planning: Understanding of the entity and its environment	B1
Planning: Understanding of the accounting information and control system: CIS	B3
Extract from the Board Minutes	C101
Planning information: Financial status	B5
Year end audit: Trade and other payables: Lead schedule	K1

Client :	Glutenfoods Limited	Prepared by : Alain Kolv	B1
Year end	30 June 2014	Reviewed : Alain Kolv	
		Date : 15/4/2014	
Subject	Planning: Understanding of the entity and its environment		

1. INTRODUCTION

Glutenfoods was founded 12 years ago by its present Chairman and Chief Executive Officer, Den Nel, who qualified as a food technologist in 1989. After doing his internship, he realised that the apartheid-era monopolies of the times were driving up food prices and that established natural brands were taking advantage of the situation by charging premium prices for their products. Accordingly, he decided to launch his own company and, having found investors, converted an old tanning factory in Newtown, Johannesburg, into a food processing plant. The company commenced business in 2000, with a staff complement of 30, many of whom are still with the company.

The company has grown from humble beginnings in 2000 and has since become a premier food processor of quality and value-added products of choice, both locally and internationally. Products include various well known spices, sauces and dressings.

The company currently operates 2 factories in South Africa, one in Newtown (Old factory) and one in Coega in the Eastern Cape, as well as a factory in Poland (through its wholly owned subsidiary Polka (Pty) Ltd).

All the products are sent by road transport, via its vehicle fleet, to the warehouse in Midrand from where all distribution takes place. The company currently employs over 6 000 staff members. The company went public in 2007 and listed on the Alt X of the JSE Securities Exchange.

2. BOARD OF DIRECTORS

The Board of Directors consists of:

Mr Den Nel, Chairman and CEO
Dr John Murray, Managing Director
Dr Jess Naido, Financial Director
Mrs S Venter, Sales Director
Dr J Mabale, Non-Executive Director
Dr JM Serach, Non-Executive Director
Mrs N Kortzen, Non-Executive Director
Mr M Malan*, Non-Executive Director

* Chairman of the audit committee

3. SHAREHOLDING

The share register shows, the following individual shareholding:

	Shares of R1
Mr Den Nel	20 000 000
Dr John Murray	5 000 000
Dr Jess Naido	5 000 000
Mrs S Venter	1 000 000
Non-Executive Directors	4 000 000
Institutional Investors	25 000 000
Sundry shareholders	30 000 000
	90 000 000

4. ACCOUNTING POLICIES

The accounting policies and methods of computation used in the preparation of the financial statements are consistent with those applied in the previous financial year ended 30 June 2013, except for the adoption of the following revised accounting standards which had no material impact on the results:

- IAS 39 – Financial instruments : recognition and measurement
- IFRIC 4 – Determining whether an arrangement contains a lease

Since the financial statements were prepared according to IFRS in 2013, audit team members do not need to concern themselves with IFRS1: *First-time Adoption of IFRS.*

The following are extracts from the accounting policies of Glutenfoods:

4.1 Financial instruments

Measurement

Financial instruments are initially measured at cost, which includes transaction costs, except for those items carried at fair value through profit or loss. Financial instruments are recognised when they become a party to the contract. Subsequent to initial recognition these instruments are measured as set out below:

Derivative instruments

The group uses derivative financial instruments to manage its exposure to foreign exchange and commodity price risks arising from operational, financing and investment activities. The group does not hold or issue derivative financial instruments for trading purposes.

Derivative instruments comprise foreign exchange contracts and food commodity futures contracts. Subsequent to initial recognition these are measured at fair value. Fair value adjustments are recognised in the income statement. Fair value is determined by comparing the contracted forward rate to the present value of the current forward rate of an equivalent contract with the same maturity date. However, where derivatives qualify for hedge accounting, recognition of any resultant gain or loss depends on the nature of the item being hedged.

Hedging

Where a derivative financial instrument is designated as a hedge of the variability in cash flows of a recognised asset or liability, a firm commitment, or a highly probable forecast transaction, the effective part of any gain or loss on the derivative financial instrument is recognised directly in equity.

4.2 Operating leases

Leases where the lessor retains the risks and rewards of ownership of the underlying asset are classified as operating leases. Payments made under operating leases are charged against income on a straight-line basis over the period of the lease.

4.3 Property, plant and equipment

Owned assets

Property, plant, equipment and vehicles are stated at cost less accumulated depreciation and impairment losses. Where components of an item of property, plant and equipment have different useful lives, those components are accounted for as separate items.

Leased assets

Leases that transfer substantially all the risks and rewards of ownership of the underlying asset to the group are classified as finance leases. Assets acquired in terms of finance leases are capitalised at the lower of fair value and the present value of the minimum lease payments at inception of the lease, and depreciated over the estimated useful life of the asset.

The capital element of future obligations under the leases is included as a liability in the balance sheet. Lease payments are allocated using the effective interest rate method to determine the lease finance cost, which is charged against income over the lease period, and the capital repayment, which reduces the liability to the lessor.

4.4 Black economic empowerment transactions (BEE)

BEE transactions involving the disposal or issue of equity interests are only recognised when the accounting recognition criteria has been met. Although economic and legal ownership of such instruments may have been transferred to the BEE partner, de-recognition of such equity interest sold or recognition of equity instruments issued in the underlying subsidiary by the parent shareholder is postponed until the accounting recognition criteria has been satisfied. A dilution in the earnings attributable to the parent shareholders (in the interim period) is adjusted for in the diluted earnings per share calculation by an appropriate adjustment to the earnings used in such calculation.

5. BACKGROUND INFORMATION ON THE BUSINESS MANAGEMENT AND OPERATIONS

The company manufactures its spices, sauces and dressings at its two factories in South Africa, as well as in its factory in Poland. Its products are sold on the South African market as well as being exported, mainly to England and Europe.

During the current year profits came under pressure, mainly due to negative publicity regarding certain spices, imported by competitors, which contained ingredients which are alleged to be harmful and might cause cancer. This, together with increased costs, mainly fuel and maintenance costs of the vehicle fleet, combined with higher interest costs, is expected to put strain on profits and cash flows. The board, under advice of Mr Nel and Dr Murray, decided, during December 2013, to implement a bonus scheme for certain senior managers and key staff. This will be cash incentive based, contingent upon certain sales and profit targets being met for the last 6 months of the financial year.

This was done to support management forecasts of increased sales and profits for the six months ended June 2014 as stated at the time interim results were published in January 2014.

In October 2013, the Board also decided to enter into a BEE transaction with a local group of well known businessmen. This will entail that 10% of the company's authorised share capital will be issued to the BEE company at a discount of 20% of net asset value. This transaction will be effective 30 January 2014.

The company is also involved in disputes with certain competitors regarding alleged trademark infringements. In addition to this, the South African Revenue Services ("SARS") issued additional assessments against the company towards the end of 2013, disallowing certain tax deductions claimed in relation to an intellectual property sale and leaseback transaction entered into during 2007. The company has objected against the SARS assessment and, based on advice obtained from senior counsel and other external advisors, will continue to defend this assessment and remains confident that it is unlikely that a significant liability will arise in this regard.

The Board, nonetheless, remains confident that the company will be sustainable and is very excited about the future. This is based, *inter alia,* on:

- The re-launch and marketing of the company's major brands, toward the end of 2013 and beginning of 2014.
- New acquisitions in 2013/2014, especially the acquisition of Mr Atchar Balls, a well-known and respected chutney, the business of which was acquired in full in November 2013.
- The fact that, in order to streamline operations, a new computerised database system and related applications software were implemented during the 2014 year (This is dealt with in working paper B3).

Client :	Glutenfoods Limited	Prepared by : Alain Kolv	B3
Year end	30 June 2014	Reviewed : Alain Kolv	
		Date : 15/4/2014	
Subject	Planning: Understanding of the accounting information and control system : CIS		

As the company's computer systems were old and the application programmes no longer met the company's requirements, the Board decided, in February 2014, to appoint Gigabytes Consulting to investigate the possibility of switching the company's CIS operations to an Enterprise Resource Planning and Management (ERPM) system.

Gigabytes completed its brief in January 2014 and recommended to the Board that the existing hardware be replaced and that the company should implement Oracle's ERPM software (generally known as Oracle Financials). The Board accepted Bytes' recommendation and acquired the following in March 2014.

Hardware	Software
• Dell Power Edge™ 1855 blade servers • Dell PowerEdge™ Rack 4210 • Dell EMC CX300 Storage area network (SAN) • Dell EMC 16 Port FC2 Switches	• Microsoft® Windows Server™ 2003 • Oracle 10g RAC database

As Glutenfoods's cash flow was under pressure, the hardware and related software was acquired under a formal lease arrangement through their bankers.

The company implemented the Oracle system (general ledger, sales-accounts receivable, purchases-accounts payable and the payroll system, with interdependent time keeping and access control systems). All information from the old system was copied on to the new Oracle database and the company went live on the new Oracle/ERPM system in March 2014.

The new sales application system also provided the opportunity for sales to customers and retailers via the internet.

Client :	Glutenfoods Limited	Prepared by : Alain Kolv	B5
Year end	30 June 2014	Reviewed : Alain Kolv	
		Date : 16/7/2014	
Subject	Planning: Understanding the entity and its environment: year-end financial status		

KEY FIGURES	**June 2014 R'million *Draft***	**June 2013 R'million *Audited***
Extracts from Statement of comprehensive income		
Revenue – Sales	321	251
Gross profit	64	51
Profit for the year (Note A)	22	13
Extracts from Statement of financial position		
Shareholders' equity	80	51
Long-Term borrowings	250	99
Accounts and other payable bank accounts	119	65
Property, Plant & Equipment	120	87
Computer systems (Note C)	29	-
Goodwill	5	-
Trade receivables (Note B)	75	23
Cash and bank	-	8

Extracts from the Cash flow statements

	R' million	
	June 2014	**June 2013**
Nett cash from operating activities	(20)	5

Notes

A. Sales

Sales have increased dramatically compared to the previous year. This is attributed mainly to sales increases during the last 6 months when sales have doubled.

The proportion of internet sales amounted to 5% of total sales for the year.

Client :	Glutenfoods Limited	Prepared by : Alain Kolv	B5
Year end	30 June 2014	Reviewed : Alain Kolv	
		Date : 16/7/2014	
Subject	Planning: Understanding the entity and its environment: year-end financial status		

B. Trade receivables: Debtors

The directors consider the carrying amount of trade and other receivables to approximate their fair value. The credit period of debtors ranges between 30 and 60 days.

C. Computer systems and equipment

This relates to the computer hardware and Oracle software system implemented in 2014 (working paper B3).

Client:	Year end:	C101/1
Prepared by: A Clerk	**Date:**	
Reviewed by:	**Date:**	
Subject: Extracts of Minutes of board meeting (extracts)		

(Extract of minutes of a board of directors meeting on 15 March 2014)

Quorum

A quorum being present, in person and via electronic media (Paul Marx – one of the members via Skype), the chairman declared the meeting duly constituted.

Welcome and apology

The chair welcomed all parties present as well as John Watt, The Chief Operating Officer and May Viljoen, the company secretary.

Approval of agenda
(Appropriate comment ....)

Previous minutes *(1 October 2013)*

It was agreed that no written record will be kept of minutes for future reference, but only electronic copies, and only for 5 years.

Matters arising

The board noted an action plan dealt with in the minutes of previous meetings and noted that all matters have either been dealt with or had been included in the agenda for consideration.

Feedback from sub-committees

- Audit committee

  The chair of the audit committee reported back that the company will not disclose any related party transactions or related party remuneration in its separate financial statements for 30 June 2014 as these will, in any case, be eliminated on consolidation in the group accounts.

  This decision followed discussion at the previous board meeting regarding the sensitivity of disclosing key management and directors' transactions, remuneration and relationships.

- Remuneration committee

  The chair of the Remuneration Committee reported that the company does not have any prescribed officers and accordingly no need exists to provide disclosure on remuneration in this regard in the financial statements.

Client :	Glutenfoods Limited	Prepared by : Alain Kolv	K1
Year end	30 June 2014	Reviewed : D Coetzee	
		Date : 26/7/2014	
Subject	Trade and other payables lead schedule		

Account		R'Million
NR	Heading	
2106	Trade creditors	R 85 000
2107	Sundry creditors and accruals	R 32 000
2107	Derivative instruments: Forward exchange contract*	R 2 000
		R119 000

*Glutenfoods uses the FEC's as a hedge for payment to foreign creditors. Contract terms vary from 46 to 95 days. The contracts are deemed to be an effective hedge instrument relating to outstanding creditors. The assistant accountant provided you with a list of the outstanding FEC contracts at year-end.

SESSION 4 QUESTION 2

(30 MARKS)

PMI Manufacturing (Pty) Ltd (hereafter "PMI" or "the Company") is a plastic packaging manufacturing company. The Company has two main business segments, namely Flexible Packaging and Structured Packaging.

After an extended period of poor financial results, a turnaround strategy was developed. The recovery plan has a timeframe of two years and implementation thereof started 18 months ago. The Company is now entering the final phase of the turnaround, which is due to be completed in six months' time.

The primary objective of the turnaround strategy is to strengthen PMI's medium to long-term competitive position. Extensive reviews and benchmarking exercises have taken place, with a focus on improving processes throughout the organisation. More detailed objectives include the following, amongst others:

- Improve profitability. Management is aware that earnings will not immediately reflect the extent of the transformation however profitability ratios should be closely monitored throughout the turnaround, in particular the gross profit and EBITDA margins.
- Improve the quality of revenue. While this is an objective for both divisions, it is of specific importance for the Flexible Packaging division. This division previously had a lot of low-margin turnover that management wants to eliminate. While management would ultimately like to grow revenue, they do not want to chase sales at the expense of return.
- Reduce administration costs by centralising and streamlining functions that were previously duplicated.
- Strengthen investment in people through undertaking more training and implementing change management initiatives while the restructuring is ongoing.
- Pay more attention to and improve working capital management.
- Maintain sufficient net interest cover.
- Invest in fixed assets to the extent necessary to maintain the current asset base.
- Execute the recovery plan without having to seek further funding.
- A target net interest bearing debt (i.e. after cash) to equity ratio of around 25% is envisaged.
- Management would like to continue declaring the full amount of preference dividends during the turnaround.

PMI's financial year-end is 28 February. They are therefore just over half way through the 2015 financial year. Extracts from the management accounts containing the interim results covering the six month period to 31 August 2014 have been made available to you.

Although there is still some "tidying up" to be done in the final phase of the turnaround, management believes that PMI is largely on track in terms of the objectives they had set. A set-back was however experienced in July of this year as labour unrest from the platinum-mining strikes spilled over into other sectors. This was the worst labour unrest ever experienced by PMI and production had to be stopped for almost an entire month. In addition to lost production and cost implications in that regard, the strike had an impact on other areas for example increased security, administration and distribution costs. Management estimates that the strikes had a negative impact of approximately R28 000 000 on profit from operations for the period and deem this to be irrecoverable.

Below are extracts from the management accounts:

Income Statement	Notes	6 months to 31 August 2014 R'000	6 months to 31 August 2013 R'000	Change
Continuing operations				
Revenue	1	1 054 270	1 018 548	+3.51%
Gross profit		171 676	198 392	-13.47%
Profit from operations before exceptional items	2	(4 551)	59 450	-107.7%
Exceptional items	3	(7 041)	(32 291)	
Profit from operations		(11 592)	27 159	-142.7%
Investment income	4	6 469	6 140	
Finance costs		(20 573)	(18 662)	
Profit before tax		(25 696)	14 637	-275.6%
Tax		4 617	(6 296)	
Profit / (loss) from continuing operations		(21 079)	8 341	-352.7%
Discontinued operations	5			
Profit / (loss) from discontinued operations		(19 432)	(24 745)	
Total profit / (loss)	6	(40 511)	(16 404)	146.96%

Cash Flow Statement (for total operations i.e. continuing and discontinued)	Notes	6 months to 31 August 2014 R'000
Cash from operations		31 367
Change in working capital		33 599
Net interest and tax		(27 863)
Dividends	7	(5 527)
Net cash flow from operating activities		**31 576**
Capital expenditure		(51 043)
Change in investments		1 976
Disposal of property		44 892
Net cash flow from investing activities		**(4 175)**
Net cash flow from financing activities		**(39 865)**
Cash and cash equivalents at the beginning of the period		57 298
Cash and cash equivalents at the end of the period		44 834

Other pertinent details	Notes	31 August 2014 R'000
Long-term interest-bearing debt	8	239 200
Short-term interest-bearing debt	8	105 360
Total equity		1 012 597
Preference shares outstanding	7	137 014

Notes:

1. Below are details pertaining to sales values and volumes sold in each of the two segments for the period under review.

	Structured Packaging	
	6 months to 31 August 2014	**6 months to 31 August 2013**
Sales (R'000)	793 260	716 124
Kilograms ('000)	20 073	19 118

	Flexible Packaging	
	6 months to 31 August 2014	**6 months to 31 August 2013**
Sales (R'000)	261 010	302 424
Kilograms ('000)	6 971	9 818

2. Profit from operations is after taking distribution and selling, administration and other expenses into account. Other expenses include costs relating to the restructuring such as professional fees.

3. Exceptional items in both periods relate to impairment of Property, Plant and Equipment.

4. Investment income relates to interest income received.

5. Discontinued operations relate to an operation that management believed did not meet their criteria for future optimal returns. The operation was therefore discontinued during the period and the building disposed of to a third party. The fixed assets were not sold and will be absorbed into other areas of the business.

6. Total depreciation for the period amounted to R51 315 000 (2013: R50 516 000). Of this amount, depreciation from continuing operations was R48 307 000 (2013: R45 477 000) and from discontinued operations was R3 008 000 (2013: R5 039 000).

7. No ordinary dividends were declared or paid.

   The balance pertaining to preference dividends outstanding included in current liabilities amounted to R3 697 000 as at 31 August 2014 and R3 700 000 at the beginning of the current six month period (i.e. as at 1 March 2014).

   The preference shares are non-redeemable, non-participating and cumulative. Dividends are calculated based on 89% of the average prime rate which prevailed during the relevant period and are declared every six months coinciding with PMI's financial year. The average prime rate during the six month period under review was 9.06%.

8. Roughly 75% of the interest-bearing debt has a variable interest rate. Management is concerned as they believe we have entered a rising interest rate cycle.