

**QUESTION 1****79 marks**

Nortan Africa Holdings Ltd ('NAH') is an industrial engineering company whose main business activities are the design, manufacture and marketing of specialised air- and gas-handling equipment for use in the mining and industrial sectors. The company was established in 2002 and listed on the Johannesburg Stock Exchange in 2005 at R8,00 per share. NAH is a subsidiary of Nortan International Holdings Plc, a Scottish company founded by Tanya North, a highly-qualified and well-respected engineer.

Nortan International Holdings Plc has operations globally. All the group operations in Africa are conducted through NAH, which has manufacturing plants in Johannesburg and Port Elizabeth. NAH plans to open two additional manufacturing plants in Nigeria and Kenya within the next three years.

**Financial performance and related information**

NAH has traded profitably in recent years, recording growth in revenue and operating profit in excess of 10% per annum. This success is largely attributable to the company's Broad-Based Black Economic Empowerment (B-BBEE) status, which has enabled NAH to secure numerous contracts when tendering for work. NAH's competitors all have lower B-BBEE ratings. The company's audited financial results for the past two financial years are summarised below.

<b>Nortan Africa Holdings Ltd</b>			
<b>Income statement for the year ended 31 December 2015</b>			
	<b>Notes</b>	<b>2015</b>	<b>2014</b>
		<b>R million</b>	<b>R million</b>
<b>Revenue</b>	1	1 682	1 501
Cost of sales		(1 086)	(972)
<b>Gross profit</b>		596	529
Distribution costs		(37)	(36)
Administrative expenses	2	(162)	(151)
Other income		3	6
<b>Operating profit</b>		400	348
Investment income	3	22	16
Finance costs		–	(2)
<b>Profit before tax</b>		422	362
Tax	4	(118)	(101)
<b>Profit for the year</b>		304	261

Nortan Africa Holdings Ltd Statement of financial position as at 31 December 2015			
	Notes	2015 R million	2014 R million
<b>Assets</b>			
<b>Non-current assets</b>		256	237
Property, plant and equipment		187	168
Intangible assets		48	49
Trade and other receivables		21	20
<b>Current assets</b>		1 276	1 099
Inventories		275	331
Trade and other receivables		350	421
Cash and cash equivalents	5	651	347
<b>Total assets</b>		1 532	1 336
Ordinary share capital and premium	6	40	40
Retained earnings	7	1 041	889
<b>Total equity</b>		1 081	929
<b>Non-current liabilities</b>			
Deferred taxation		2	1
<b>Current liabilities</b>		449	406
Trade and other payables		437	358
Tax		1	33
Bank overdraft		–	3
Provisions		11	12
<b>Total equity and liabilities</b>		1 532	1 336

## Notes

- 1 The majority of NAH's revenue is derived from the sale of fans, heat exchangers and cleaning equipment. This represented 82% of total revenue in the financial year ended 31 December 2015 ('FY2015'). The balance of revenue is attributable to the sale of equipment and systems that reduce atmospheric pollution generated by industrial plants.
- 2 Administrative expenses in 2015 include a provision for bonuses of R3 515 330 in terms of the management incentive scheme introduced in 2015.
- 3 Investment income relates to interest earned at an average rate of 5,75% per annum (FY2014: 5,53%) on NAH's excess cash, which is invested in interest-bearing savings accounts.
- 4 The company pays income tax at a rate of 28%.
- 5 The company's operating cash requirement (held in NAH's current bank account) has historically been an average of 2% of revenue. The balance of excess cash and cash equivalents is invested in interest-bearing savings accounts.

- 6 NAH had 80 million ordinary shares in issue at 31 December 2015 (FY2014: 80 million) and the year-end share price at 31 December 2015 was R32,55. The shareholders of NAH are categorised as follows:

Shareholder/ shareholder group	Percentage holding
Nortan International Holdings Plc	52,5%
Tanya North Family Trust	4,5%
Employee Share Trust	3,6%
Lindham Ltd*	5,5%
Private investors invested through NAH's B-BBEE scheme	10,0%
Institutional and private investors	23,9%

- \* Lindham Ltd ('Lindham'), a company resident in the Republic of South Africa, acquired its 5,5% shareholding at R8,00 per share when NAH listed in 2005. Lindham is an investment holding company which seeks a 15% return on capital invested.

- 7 NAH has declared and paid dividends equivalent to 50% of its after-tax profits in each of the past five years. NAH generally declares one dividend every year in February after finalisation of its annual results by the board of directors and pays the dividend to shareholders at the end of March. This dividend policy is expected to be maintained for the foreseeable future.

### Management incentive scheme

NAH introduced an incentive scheme for senior management at the beginning of FY2015. The incentive scheme is structured in such a way that senior management, including executive directors, receive an annual bonus calculated based on the following formula:

$$\left\{ (ROE_{CY} - ROE_{PY}) + \left( \frac{EPS_{CY}}{EPS_{PY}} - 1 \right) \right\} \times \text{Annual basic salary of employee(s)}$$

ROE = Return on equity ratio, calculated on the basis of year-end balances and prior to the accrual for bonuses in terms of the management incentive scheme

EPS = Earnings per share, calculated prior to the accrual for bonuses in terms of the management incentive scheme

CY = Current year (the most recent financial year)

PY = Prior year (the previous financial year)

If the above bonus formula results in a negative figure, then no bonuses will be paid. If bonuses are payable, these are paid in March following the most recent financial year end. The Chief Financial Officer of NAH calculated the total bonuses due to senior management in FY2015 as R3 515 330, based on the following information:

$$\left\{ (28,3\% - 28,1\%) + \left( \frac{383,0}{326,3} - 1 \right) \right\} \times \text{R20 million}$$

The bonuses were approved by the remuneration committee.

## Share buyback programme

At a recent board meeting one of the agenda items discussed was entitled 'Excess cash – share buyback proposal'. This proposal was tabled by two senior managers who are part of NAH's senior management team but not executive directors. The two senior managers tabled a proposal that NAH perform a share buyback for amongst others the following reasons:

- NAH currently has a 'lazy' balance sheet with far too much excess cash – the company's cash is essentially 'burning holes in NAH's pockets';
- The excess cash should be returned to shareholders who would be happy to receive a significant cash receipt which should subsequently improve NAH's ROE ratio; and
- A share buyback is a more tax efficient method to distribute surplus cash to shareholders than a special dividend.

The board of directors debated a potential share buyback programme at length, especially since NAH had never in its history repurchased shares from shareholders.

This proposal was discussed in detail and strongly supported by all the directors, except for the Chief Executive Officer, Mr Daniel Ramokgadi. Mr Ramokgadi, a qualified CA(SA), reminded his fellow board members that it was minuted at a previous board meeting that the excess cash would be used to fund NAH's expansion into the rest of Africa (through the establishment of manufacturing plants in Nigeria and Kenya). In addition, he indicated that he was concerned about the two senior managers' motives for proposing the share buyback.

Although the remaining directors acknowledged that they had previously decided to use the excess cash for expansion into Africa, they felt that circumstances had changed and the motivation provided by the two senior managers was strong enough to justify a share buyback. The remaining directors stated that the African expansion of R500 million was furthermore only planned for FY2017 and if necessary NAH could easily raise debt facilities to finance this.

The board of directors therefore resolved that a R600 million share buyback programme be implemented subject to the following conditions:

- Shares be purchased on the open market at prevailing share prices at any time during the next three years (FY2016, FY2017 and FY2018), limited to a maximum of R200 million in any financial year; and
- The board of directors obtain the necessary approvals in terms of the Companies Act and the Johannesburg Stock Exchange Listing Requirements prior to the share buyback programme being implemented.

## Other information

- The current yield on long-term RSA government bonds is 8,2% per annum.
- The long-term average market risk premium in South Africa is 5,6%.
- NAH's beta coefficient over the past five years was calculated to be 0,86.
- NAH has budgeted to achieve profit before taxation of R470 million in FY2016, before any provision for bonuses in terms of the management incentive scheme.
- Senior management received an average salary increase of 6,0% with effect from 1 January 2016.
- NAH's contributed tax capital (CTC) amounted to R40 million at 1 January 2011. NAH has made no distributions of or additions to its CTC since January 2011.

**INITIAL TEST OF COMPETENCE, JUNE 2016  
PROFESSIONAL PAPER 1**

The required section of this question consists of two parts. Answer each part in the correct, separate answer book.

QUESTION 1 PART I – REQUIRED		Marks	
		Sub-total	Total
(a)	Estimate the amount of economic value added (EVA®) that has been created or destroyed by NAH during FY2015.	5	5
(b)	Estimate the total bonus amount due to senior management at the end of FY2016 in terms of the management incentive scheme, assuming the share buyback programme is not implemented.	10	10
(c)	Estimate the total bonus amount due to senior management at the end of FY2016 in terms of the management incentive scheme.  Assume that – <ul style="list-style-type: none"> <li>the share buyback programme is implemented; and</li> <li>NAH acquired shares to the value of R200 million on the open market on 1 January 2016 at an average price of R32,55.</li> </ul>	12	12
(d)	Critically discuss the management incentive scheme implemented in FY2015 from the perspective of NAH.  <i>Communication skills – logical argument</i>	12  1	  13
(e)	Discuss the potential merits and pitfalls of the proposed share buyback programme from the perspective of NAH and its shareholders.  <i>Communication skills – clarity of expression</i>	12  1	  13
<b>Total for part I</b>			<b>53</b>

## INITIAL TEST OF COMPETENCE, JUNE 2016 PROFESSIONAL PAPER 1

The required section of this question consists of two parts. Answer each part in the correct, separate answer book

QUESTION 1 PART II – REQUIRED		Marks	
		Sub-total	Total
(f)	Discuss the primary ethical dilemma, including related governance and statutory implications, inherent in the share buyback proposal tabled by the two senior managers and describe the appropriate action(s) that Mr Ramokgadi should have taken.  <i>Communication skills – clarity of expression</i>	12  1	  13
(g)	Discuss, with supporting calculations, the tax implications in terms of the Income Tax Act for Lindham should it sell 7,68% of its total shareholding to NAH on 30 June 2016 as part of the share buyback programme.  Assume that NAH – <ul style="list-style-type: none"> <li>will, to the extent possible, fully utilise its CTC to buy back shares; and</li> <li>purchases shares from Lindham at R32,55 per share.</li> </ul> <i>Communication skills – clarity of expression</i>	12      1	      13
<b>Total for part II</b>			<b>26</b>
<b>Total for the question</b>			<b>79</b>