QUESTION 2 50 marks

1 Background

Take-to-the-Air SA Ltd (‘Ta-ta SA’) is a company listed on the Johannesburg Stock Exchange. The most recent financial year of Ta-ta SA ended on 31 December 2017 (FY2017). The company operates two divisions within its airline segment, namely Fly and Grand.

The details of the two divisions can be summarised as follows:

<table>
<thead>
<tr>
<th></th>
<th>Fly</th>
<th>Grand</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aircraft type</td>
<td>Boeing 737A aircraft (larger capacity)</td>
<td>Boeing 737B aircraft (smaller capacity) Boeing 737A aircraft (larger capacity)</td>
</tr>
<tr>
<td>Model</td>
<td>Low-cost airline</td>
<td>Luxury model</td>
</tr>
<tr>
<td>Cabin type</td>
<td>Economy class only</td>
<td>Business class (limited number) Economy class (remaining seats)</td>
</tr>
<tr>
<td>Loyalty programme</td>
<td>None</td>
<td>Established programme</td>
</tr>
<tr>
<td>Extras</td>
<td>None</td>
<td>Access to exclusive airport lounges</td>
</tr>
<tr>
<td>Destinations</td>
<td>Domestic destinations only</td>
<td>Domestic destinations Windhoek, Harare, Livingstone, Victoria Falls and Mauritius</td>
</tr>
<tr>
<td>Meals</td>
<td>Pay-as-you-go</td>
<td>Complimentary snacks and refreshments</td>
</tr>
<tr>
<td>Target market</td>
<td>Domestic tourists</td>
<td>Foreign tourists Corporate travellers Public sector travellers</td>
</tr>
</tbody>
</table>

Fly has implemented a market development growth strategy resulting in a change in its target market from the domestic tourist market only to an increased focus on the corporate traveller market as well as on the foreign tourist market. The latter is being achieved by means of strategic partnerships with a number of foreign airlines.

The table below illustrates the key performance indicators that were measured for each of the three most recent financial years of the company:

<table>
<thead>
<tr>
<th>Strategic focus area</th>
<th>Key performance indicator</th>
<th>Notes</th>
<th>FY2015</th>
<th>FY2016</th>
<th>FY2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commitment to quality</td>
<td>On-time departure</td>
<td>1.1</td>
<td>85,00%</td>
<td>86,00%</td>
<td>85,00%</td>
</tr>
<tr>
<td></td>
<td>Fly</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Grand</td>
<td></td>
<td>86,00%</td>
<td>87,00%</td>
<td>85,00%</td>
</tr>
<tr>
<td>Operational effectiveness</td>
<td>Quantity of fuel burned per passenger (kilogrammes per passenger)</td>
<td></td>
<td>32,49</td>
<td>32,65</td>
<td>32,14</td>
</tr>
<tr>
<td></td>
<td>Number of passengers transported</td>
<td>5 196 507</td>
<td>5 140 599</td>
<td>5 428 678</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Passenger load factor</td>
<td>1.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fly</td>
<td></td>
<td>88,17%</td>
<td>86,02%</td>
<td>91,40%</td>
</tr>
<tr>
<td></td>
<td>Grand</td>
<td></td>
<td>70,07%</td>
<td>69,08%</td>
<td>71,16%</td>
</tr>
<tr>
<td></td>
<td>Average aircraft turnaround time (minutes)</td>
<td>1.3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fly</td>
<td></td>
<td>34,20</td>
<td>34,45</td>
<td>32,86</td>
</tr>
<tr>
<td></td>
<td>Grand</td>
<td></td>
<td>53,84</td>
<td>54,12</td>
<td>53,44</td>
</tr>
<tr>
<td>Managing risk</td>
<td>Number of significant safety incidents</td>
<td>1.4</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Responsible corporate citizen</td>
<td>Carbon inventory – footprint per employee (tonnes of CO₂ emissions)</td>
<td></td>
<td>328,05</td>
<td>317,10</td>
<td>316,84</td>
</tr>
</tbody>
</table>
Notes

1.1 The norm in the domestic market is 81%.
1.2 Passenger load factor measures the capacity utilisation of the aircraft by dividing the number of seats occupied by the total number of seats available.
1.3 Turnaround time is defined as the time needed for unloading, servicing and reloading an aircraft between flights.
1.4 The incident in FY2017 involved the collapse of the landing gear of one of Grand’s older aircraft on landing at OR Tambo International Airport. There were no fatalities or injuries. The aircraft was subsequently withdrawn from service and scrapped.

2 Industry sustainability

The following is an extract from a recent article in a local aviation magazine:

**Sustainability of low cost carriers**

A key driver of sustainability in this industry is the quick turnaround of the aircraft. While aircraft are on the ground and not being utilised, instead of being gas guzzlers, they become dollar chompers.

A local aviation specialist, Lindelwa Skhosana, recently found that the average turnaround time in the domestic low-cost airline industry is 39,24 minutes. It appears that this aspect of participants in the industry continues to be a hot topic.

In closing, the global aviation industry continues to be challenged by turbulence, not in the air but in the economic environment in which it operates. This is evidenced by decreasing load factors in the industry on the one hand and increasing operating costs on the other.

_Piper Cherokee – aviation specialist_

3 Key resolutions tabled at previous Ta-ta SA Board meetings

The Board of Directors of Ta-ta SA resolved during FY2015 –

- to renew the fleet by replacing the ageing Boeing 737B aircraft with the newer technology Boeing 737A aircraft. Initially the focus of the replacements would be on the Fly fleet, with the Grand fleet replacements being addressed thereafter; and
- to upgrade the enterprise-wide IT platform to improve the on-line reservation systems and check-in facilities.

4 Ta-ta SA financial results for FY2017

The following has been extracted from the management accounts for FY2017:

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Airline</td>
<td>Non-airline</td>
<td>Total</td>
</tr>
<tr>
<td></td>
<td>R'000</td>
<td>R’000</td>
<td>R’000</td>
</tr>
<tr>
<td>Revenue</td>
<td>5 725 892</td>
<td>233 681</td>
<td>5 959 573</td>
</tr>
<tr>
<td>EBITDA</td>
<td>743 896</td>
<td>85 896</td>
<td>829 792</td>
</tr>
<tr>
<td>Profit on sale of assets</td>
<td>12 419</td>
<td></td>
<td>12 419</td>
</tr>
<tr>
<td>Unrealised translation loss on dollar loan</td>
<td>(73 946)</td>
<td>(73 946)</td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortisation</td>
<td>(361 072)</td>
<td>(11 031)</td>
<td>(372 103)</td>
</tr>
<tr>
<td>Write-off of damaged aircraft</td>
<td>(64 462)</td>
<td>(64 462)</td>
<td></td>
</tr>
<tr>
<td>Compensation for write-off of damaged aircraft</td>
<td>84 155</td>
<td></td>
<td>84 155</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>340 990</td>
<td>74 865</td>
<td>415 855</td>
</tr>
</tbody>
</table>
An average return airfare on the Johannesburg–Cape Town route based on the airfares published on the reservation website of Fly during FY2017 was R2 175 and on the website of Grand during FY2017 was R2 762.

5 Reporting to the International Civil Aviation Organisation (ICAO)

The ICAO requires Ta-ta SA to report on the operating expenses of Fly and Grand annually. The Chief Financial Officer (CFO) has pre-populated the template with the data he has available for FY2017, but still has to complete the cost allocation:

<table>
<thead>
<tr>
<th>Notes</th>
<th>Ta-ta SA (R’000)</th>
<th>Fly (R’000)</th>
<th>Grand (R’000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Flight operations</td>
<td>5.1</td>
<td>1 499 793</td>
<td></td>
</tr>
<tr>
<td>Maintenance and overhaul</td>
<td></td>
<td>596 941</td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortisation</td>
<td></td>
<td>361 072</td>
<td></td>
</tr>
<tr>
<td>User charges and station expenses</td>
<td>5.2</td>
<td>976 812</td>
<td></td>
</tr>
<tr>
<td>Passenger services</td>
<td>5.3</td>
<td>596 941</td>
<td></td>
</tr>
<tr>
<td>Ticketing, sales and promotions</td>
<td>5.4</td>
<td>759 743</td>
<td></td>
</tr>
<tr>
<td>General and administration</td>
<td>5.4</td>
<td>593 600</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>5 384 902</td>
<td></td>
</tr>
</tbody>
</table>

Notes

5.1 Flight operations comprise flight crew salaries, expenses and training, aircraft fuel and oil, insurance and uninsured losses and operating lease charges. The strongest correlation exists between flight operation costs and block hours. Block hours consist of the number of hours an aircraft is in use and are measured from the time the doors are closed prior to departure until they are opened on arrival of the aircraft at its destination.

5.2 User charges and station expenses comprise landing and airport charges, navigation charges and airport office expenses. These costs are based on the number of flights flown.

5.3 Airlines find that passenger service costs are mainly based on the number of passengers transported.

5.4 The CFO of Ta-ta SA is of the opinion that the ticketing, sales and promotion costs of Fly are 50% of those of Grand. He is also of the opinion that the general and administration costs of Fly are 40% of those of Grand.

The following spreadsheet was prepared by the CFO for FY2017:

<table>
<thead>
<tr>
<th>1</th>
<th>Key indicator for FY2017</th>
<th>Fly</th>
<th>Grand</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Number of passengers transported</td>
<td>3 102 500</td>
<td>2 326 178</td>
</tr>
<tr>
<td>3</td>
<td>Number of flights flown</td>
<td>18 250</td>
<td>21 751</td>
</tr>
<tr>
<td>4</td>
<td>Number of aircraft</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>5</td>
<td>Owned</td>
<td>10</td>
<td>9</td>
</tr>
<tr>
<td>6</td>
<td>Leased (operating leases)</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td>7</td>
<td>Total block hours (from take-off to arrival)</td>
<td>31 237.92</td>
<td>39 171.67</td>
</tr>
<tr>
<td>8</td>
<td>Maintenance: Cost of aircraft parts used</td>
<td>R178 644 380</td>
<td>R251 540 620</td>
</tr>
<tr>
<td>9</td>
<td>Maintenance: Hours spent maintaining aircraft</td>
<td>36 000 hours</td>
<td>70 800 hours</td>
</tr>
<tr>
<td>10</td>
<td>Depreciation and amortisation</td>
<td>R240 714 667</td>
<td>R120 357 333</td>
</tr>
</tbody>
</table>

Ta-ta SA has not early adopted IFRS16 Leases. To date, Ta-ta SA has not followed a practice of absorbing its fixed overheads, but has recognised the actual fixed overheads incurred.

6 Query on overheads

Dakota Harvard, a new member of the financial management team of Ta-ta SA, asked why there was no adjustment for the over/(under) allocation or recovery of the fixed overheads of Ta-ta SA.
## QUESTION 2 – REQUIRED

<table>
<thead>
<tr>
<th></th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sub-total</strong></td>
<td><strong>Total</strong></td>
</tr>
<tr>
<td>(a) Complete the cost allocation for the ICAO report by allocating the costs to Fly and Grand for FY2017.</td>
<td>12</td>
</tr>
<tr>
<td>(b) Critically discuss the allocation bases used to allocate the operating expenses between Fly and Grand.</td>
<td>14</td>
</tr>
<tr>
<td>Communication skills – logical argument</td>
<td>1</td>
</tr>
<tr>
<td>(c) Discuss the factors that demonstrate Fly could have a competitive advantage in the low-cost airline market.</td>
<td>16</td>
</tr>
<tr>
<td>Communication skills – clarity of expression</td>
<td>1</td>
</tr>
<tr>
<td>(d) Provide an explanation for the over/(under) allocation or recovery of the fixed overheads in response to Dakota’s query.</td>
<td>6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>50</strong></td>
</tr>
</tbody>
</table>