Part (a)

1 Need to review and assess whether operating profit in 2003 is sustainable
   Compare 2003 results to 2002

2 Restated operating profit
   Mrs Strand’s representation 229 729
   Cost of employing a manager (60 000)
   \[\text{Restated operating profits} = 169 729\]

3 Operating profit multiple
   Restated operating profits 169 729
   Average multiple 2,3 or 2,4
   \[\text{Fair purchase price} = 407 350\]

Do we need to adjust for assets and liabilities not taken over?
- The tax liability cannot be transferred to the purchaser
- Should purchase price be adjusted for other assets and liabilities not taken over?
  One view is that if assets are not required for purposes of generating profits, no adjustment should be made. Alternatively, it could be argued that assets and liabilities not taken over affect settlement of the purchase price as opposed to affecting the determination of value

4 Net asset value acquired
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity capital and reserves</td>
<td>175 301</td>
</tr>
<tr>
<td>Add back interest-bearing liabilities</td>
<td>258 294</td>
</tr>
<tr>
<td>Less cash on hand</td>
<td>(129 641)</td>
</tr>
<tr>
<td>Less rent deposit</td>
<td>(30 000)</td>
</tr>
</tbody>
</table>
   \[\text{Net asset value} = 273 954\]

   *An alternate method is to list individual assets and liabilities, but the end result is the same*

5 Free cash flow valuation
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating profit (revised)</td>
<td>169 729</td>
</tr>
<tr>
<td>Add back depreciation</td>
<td>77 018</td>
</tr>
<tr>
<td>Less cash taxes paid (30%) [a calculation based on cash taxes actually paid would also be acceptable]</td>
<td>(50 919)</td>
</tr>
</tbody>
</table>
   \[\text{Free cash flow} = 195 828\]

   \[\text{Alternate method that would be acceptable: Capitalise free cash flow at 40%} = 481 133\]

6 There is a divergent range of fair values for the business depending on which method is employed
   - Operating profit multiple 407 350
   - Net asset value 273 954
   - Capitalisation of cash flows 481 133
   - Original set up cost 450 000

7 Conclusion
   Mrs Strand’s asking price is too high
   We would therefore advise the buyer to aim to pay the lowest possible price acceptable.
   Any reasonable conclusion, on paying between R407 000 and R480 000
<table>
<thead>
<tr>
<th>Part (b)</th>
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</table>
| **1** Rent/lease agreement  
  - It has only three years to run, so is it transferable?  
  - Without the lease secure for foreseeable future, the business has limited value (location!!)  
  - Thus a new agreement must be negotiated with landlord, which should include options to renew |
| **2** Reliability of financial information  
  - Did auditors prepare the accounts and audit them?  
  - Ask for warranties with regard to the net asset value  
  - How can Mr Abrahams achieve some comfort on trading performance? |
| **3** Staff  
  - Will they remain employed?  
  - Are there formal employment agreements?  
  - What provisions exist for leave pay? |
| **4** Assets  
  - Mr Abrahams needs to ensure that assets are registered in the name of the company and any assets which do not belong to it (such as fridges) must be identified.  
  - Are the fixed assets encumbered?  
  - How collectible are the debtors?  
  - An inventory count will have to be done on 31 March 2003  
  - Is all equipment in good working order? |
| **5** Liabilities  
  - Are there any unrecorded liabilities? |
| **6** VAT/taxation  
  - How is Mr Abrahams going to purchase business? Is he going to establish a company or close corporation?  
  - He will have to be a registered vendor in order for sale transactions to be zero rated  
  - Are the VAT affairs of the business up to date?  
  - The tax affairs seem suspect (personal expenses, etc.). Mr Abrahams will have to ensure there is no risk for the new owner of the business arising from tax matters |
| **7** Purchase agreement  
  - Do the key provisions include warranties?  
  - How will the payment of the purchase price be made?  
  - Who will be responsible for legal costs of the agreements? |
| **8** Hand over procedures  
  - Will Mrs Strand stay on to teach the new manager?  
  - What creditor and debtor arrangements are in place? |
| **9** An Insolvency Act notice is required when selling of a business |
| **10** Is Mrs Strand going to sign a restraint of trade/non-competition agreement? |
| **11** 1 March 2003 has already passed.  
  - What is to happen with the profits for March 2003?  
  - The assets and liabilities need to be checked. |
<table>
<thead>
<tr>
<th>Part (c)</th>
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</table>
| 1 | The lack of segregation of duties is a major control weakness. Waiters record sales and also handle cash!  
   • A designated person, not a waiter, should be made responsible for the cash register (recording sales and collecting cash) |
| 2 | There are no controls and procedures to check completeness of revenue  
   • Copies of customer orders must be collected daily and the total of sales to be computed and compared to entries per the cash register  
   • Pre-numbered customer order forms should be used to assist in accounting for all sales  
   • The new owner should consider investing in a sophisticated POS system |
| 3 | The controls over cash are poor, and purchases paid for out of the till!  
   • No purchases should be paid for with cash in the till |
| 4 | Accounting is outsourced, but daily information regarding trading performance is required  
   • Basic daily reporting procedures should be instituted to monitor margins and profits |
| 5 | Personal expenditure is charged to business, creating a tax risk  
   • No personal expenditure should be charged to the business |
| 6 | Manual calculations are used with regard to invoices  
   • Consider installing a POS system, or otherwise a third party should check the calculations |
| 7 | Unused documentation is not controlled  
   • There should be security over unused order books, etc. |
| 8 | Orders are not pre-numbered  
   • Only pre-numbered order documentation should be used |
| 9 | Till slips contain no details of individual items  
   • Descriptions should be inserted on the till system, or otherwise a POS system should be installed |
| 10 | Cash is not banked on a daily basis  
   • Daily banking controls should be instituted |