SCHOOL OF ACCOUNTING SCIENCES

HONS BCOMPT / CTA

TUTORIAL LETTER 303/2010
(TREKALS)

Dear Student

This tutorial letter comprises of the Test 1 questions, the suggested solutions and the comments

Your marks are available on the internet **(www.unisa.ac.za)** under **"myUnisa"**. (Refer to section 8.2.2. [Demarcation of tests] tutorial letter 301/2010.)

It is in your own interest to work through the material carefully as the system of self-evaluating assignments and tests requires more responsibility from you as an advanced student.

Best wishes

YOUR LECTURERS

Question 1: TOE407V and ZAC407G

APPLIED FINANCIAL ACCOUNTING
(40 Marks)

Duration: 1 Hour (Time: 08:15 – 09:15). Students must be seated by 08:00. The test begins at 08:15.

FIRST EXAMINERS:	Ms. A. De Wet	Prof. Z.R. Koppeschaar
	Mr. P.C. Malemone	Mr. J.M.L. Roux
	Ms. J. Sturdy	Ms. C. Wright
SECOND EXAMINER:	Prof. HC. Wingard	

Please ensure that you have completed the cover of the answer book for this question in full i.e. name, address, student number, code of paper and test number.

This TOE407V / ZAC407G (Financial Accounting) question consists of 4 pages and is out of 40 marks.

THE USE OF A NON-PROGRAMMABLE POCKET CALCULATOR IS PERMISSIBLE.

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QUESTION 1: TOE407V / ZAC407G **(40 marks)**

My Little Horses Ltd (hereinafter referred to as MLH) is in the industry of manufacturing and selling tiny multi-coloured soft toy horses. You are responsible in assisting the new accountant with various issues that have arisen while finalising the annual financial statements for the year ended 30 April 2009:

The following information was gathered:

1. MLH has been selling their soft toy horses to various retail and toy stores for many years and has developed a good relationship with their customers. The selling price per soft toy horse is R190 (excluding VAT). The cost to manufacture one toy horse from start to finish is R100 (excluding VAT). Throughout the financial year ended 30 April 2009, 15 230 toy horses have been sold from MLH's normal business operations. Sales represent 30 percent cash on delivery sales and 70 percent credit sales. If debtors settle their accounts early, they qualify for an 8% early settlement discount. 40 percent of the companies purchasing on credit, opt to settle early in order to receive the 8% settlement discount.

2. On 1 March 2008, a special order was placed by a new company, 'Birthdays Are Us', who will purchase a significant quantity of soft toy horses to be included in their party packets. A contract was signed between the two parties for MLH to manufacture 8 550 soft toy horses. The delivery date of the 8 550 soft toy horses is 1 May 2008. A special lower selling price was arranged just for this large order of R171 (including VAT) per toy horse. The selling price will be settled in cash over the next 12 months, from date of delivery, in monthly instalments of R117 977,78 (including VAT) each, payable in arrears. The prevailing rate of interest (pre-tax) for similar transactions is 7% per annum. The accountant believes that the special order should be treated as other income in the statement of comprehensive income, as it is a once off transaction. The accountant was not sure how or when to process the special order information and therefore left it completely out of the trial balance.

3. Included in the administrative expenses of R120 000 is distribution costs of R30 000.

4. Since incorporation, MLH has been insured by 'Bestest Insurance Ever', to secure itself against fire and water damage. Each year on 1 January, MLH make an annual cash payment to 'Bestest Insurance Ever' for the year's insurance premiums. On 1 January 2008, MLH paid the annual insurance fee of R75 000. The insurance contract is subject to an escalation clause of 10% per annum. The annual insurance premium for 2009, as well as the correct prorated expense relating to the 2008 premium is included in the other expenses amount of R167 500.

5. A machine was purchased on 1 May 2006 at a cost of R2 540 000. The company has always depreciated machinery at 20% per annum on the reducing balance method. On 30 April 2009 the company revised the depreciation method and it was established that depreciation on machinery should rather be written off on the straight-line basis over the remaining useful life. The machinery had a remaining useful life of 3 years on 30 April 2009. SARS allowed a deduction of R450 000 on this machine for the year ended 30 April 2009.

6. MLH purchased a factory building on 1 November 2007 and it was immediately available for use. The company's accounting policy is to depreciate their factory buildings over their estimated useful life of 13 years and to revalue factory buildings at the beginning of each year. The residual value of the factory building is zero.

The carrying amount of the factory building on 30 April 2008 was R625 000.

On 1 May 2008, MLH revalued the factory building up to R950 000.

SARS allows a 5% per annum deduction on factory buildings.

7. A piece of land, owned by MLH, which is across the factory building was not used by the company. On 30 April 2009, MLH's management sold the land for R300 000. The originally cost of the land was R150 000. The accounting policy of MLH is to measure land at cost. This transaction has not yet been processed in the trial balance of MLH.

8. During the year ended 30 April 2009, MLH received dividend income of R50 000.

9. The prior year tax assessment (30 April 2008) of MLH had an assessed loss of R350 000. The company recognised a deferred tax asset for the carry forward of this unused tax loss as they were certain that future taxable profit will be available against which the unused tax loss can be utilised.

10. MLH donates R47 500 worth of toy horses annually to various non-profit organisations, in which they are actively involved. This amount is included in other expenses. SARS has indicated that they will not allow the amount as a deduction for income tax purposes.

11. During the year, MLH performed research on new soft toys they want to bring into the market. Research costs amounting to R25 500 were paid in cash. This amount is included in other expenses. SARS allows a 25% per annum allowance on research expenditure.

Additional information

- A cash flow hedge reserve gain of R50 000 arose during the year due to various imports from Australia. The tax effect of the cash flow hedge reserve amounted to R14 000.

- Other income amounted to R122 300 (excluding dividends received) for the year.

- Secondary Tax on Companies (STC) is levied at 10%. The company is unsure if any future dividends will be declared.

- On 15 May 2009, the Minister of Finance was in discussions about decreasing the company tax rate from 28% to 27%. The new rate is being strongly considered.

- The company is certain that there will be sufficient future taxable income and future taxable capital gains to utilise against unused tax losses and credits.

REQUIRED

		Marks
(a)	Discuss how and when the proposed revenue arising from the special order with ‘Birthdays Are Us’ (refer point 2) should be recognised and measured in the annual financial statements of MLH.	**8**
(b)	Prepare the statement of comprehensive income of My Little Horses Ltd for the year ended 30 April 2009. The gross amounts, tax effect and reclassification amounts of each component of other comprehensive income must be disclosed separately in the statement of comprehensive income. Comparative figures are not required. **In your current tax calculation, start with your profit before tax amount as calculated in the statement of comprehensive income.**	**28**
(c)	Prepare all the journal entries with regards to the taxation of My Little Horses Ltd for the year ended 30 April 2009 in terms of IAS 12. Journal narrations are not required.	**4**

Your answer should comply with International Financial Reporting Standards (IFRS).

Amounts must be rounded to the nearest Rand.

Question 2: TOE408W and ZAC408H

APPLIED MANAGEMENT ACCOUNTING
(40 Marks)

Duration: 1 Hour (Time: 09:30–10:30). Students must be seated by 09:15. The test begins at 09:30.

FIRST EXAMINERS:	Mr. FJC. Benade Mrs. A. Combrink Ms. J. Foot Mrs. A. Ravat Mrs. F. Venter	Mr. L. Crafford Mr. A. De Graaf Mr. S. Ndlovu Mrs. F. Tayob
SECOND EXAMINER:	Prof. B. Van Heerden	

Please ensure that you have completed the cover of the answer book for this question in full i.e. name, address, student number, code of paper and test number.

This TOE408W / ZAC408H (Management Accounting) question consists of 4 pages and is out of 40 marks.

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QUESTION 2: TOE408W / ZAC408H **(40 marks)**

Lekker Rusks (Pty) Ltd is a processor and distributor of the old South African favourite, rusks. The owner Mr Biscuit, uses his grandmother's secret family recipe to manufacture and package rusks for resale.

Lekker Rusks currently offers two types of rusks, buttermilk and muesli, both which are processed and sold in 1kg boxes.

Budgeted Data for the 28 February 2010 year end are as follows:

		Buttermilk	Muesli	Company
Units sold (boxes)		1 500 000	700 000	
Per unit (Rands)		**R**	**R**	**R**
Sales price		38,50	55,00	
Direct materials		12,00	15,50	
Costs in Total (Rands)				
Manufacturing overheads	Fixed			45 000 000
Manufacturing labour	Fixed			25 000 000
Admin salaries	Fixed			777 000
Sales and distribution cost	Fixed and variable			8 280 000

Mr Terry, the management accountant, provided the following information in respect of the actual figures for the year ended 28 February 2010:

		Buttermilk	Muesli	Company
Sales	R/unit	39,00	57,00	
Materials	R/unit	12,70	15,00	
Manufacturing overheads	R			44 000 000
Manufacturing labour	R			24 000 000
Admin salaries	R			777 000
Sales and distribution costs	R			8 000 000
Inventory – 1 March 2009 (R)		2 000 000	1 485 000	
Inventory – 28 February 2010		?	?	

Additional information:

1. Quantity schedule – actual (boxes)

	Buttermilk	Muesli
Sales	1 400 000	600 000
Opening inventory	100 000	55 000
Closing inventory	80 000	30 000

No inventory of raw materials or work in process are held. All baked rusks are packaged and taken into inventory.

Assume that there are no expired goods on hand. i.e. all inventory have been sold before expiry date and thus nothing should be written off.

Assume that the budgeted closing inventory = actual closing inventory (per above quantity schedule).

2. The inventory on 1 March 2009 includes fixed manufacturing overhead and manufacturing labour.

3. Manufacturing labour and fixed overheads are based on normal capacity of 1 000 000 hours per year. For the year ending 28 February 2010 the following information is applicable:

	Buttermilk	**Muesli**
Budgeted labour hours	450 000	550 000
Actual labour hours	460 000	555 000

4. Admin salaries and sales and distribution costs are divided on a 50/50 basis between the two products. R3 000 000 of the budgeted sales and distribution costs are fixed and the actual fixed costs equalled the budgeted fixed costs.

5. There is no difference between budgeted an actual depreciation.

6. Mr Terry, believes that the traditional costing system may be providing misleading information. He has developed an activity based analysis of the 2010 manufacturing overhead costs which is shown in the following table:

Activity	**Cost Driver**	**Cost R'000**
Materials handling	Set-ups	21 300
Quality control	Batches	2 100
Baking	Baking hours	10 500
Packaging time	Packaging hours	4 600
Not identifiable	-	5 500
		44 000

The actual data regarding the 2010 production of rusks are presented below:

	Buttermilk	**Muesli**
Batch size	10 000 boxes	10 000 boxes
Set-ups	3 per batch	4 per batch
Baking time	1 hour / 100 boxes	1 hour / 100 boxes
Packaging time	0,1 hr / 100 boxes	0,1 hour / 100 boxes

REQUIRED		**Marks**
(a)	Prepare an income statement for the year ended 28 February 2010 on the absorption costing basis. Show as much detail as possible and round all calculations off to 3 decimals	20
(b)	Using an activity based approach, calculate the actual manufacturing overhead cost of buttermilk and muesli rusks for the year ended 28 February 2010.	12
(c)	Briefly explain the impact of the ABC approach on the allocation of the two products' manufacturing overhead cost.	4
(d)	Calculate Lekker Rusks (Pty) Ltd's Rand break-even point based on expected sales of 1 350 000 boxes buttermilk and 450 000 boxes muesli.	4

Ignore tax for all calculations above.

Question 3: TOE409X

APPLIED TAXATION
(40 Marks)

Duration: 1 Hour (Time: 10:45-11:45). Students must be seated by 10:30. The test begins at 10:45.

FIRST EXAMINER: Prof. J.S. Wilcocks

SECOND EXAMINERS: Mrs. A.I. Becker, Mrs. O. Swart, Mrs. M.S. Vorster

Please ensure that you have completed the cover of the answer book for this question in full i.e. name, address, student number, code of paper and test number.

This TOE409X (Taxation) question consists of 4 pages and is out of 40 marks.

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QUESTION 3: TOE409X **(40 marks)**

Value-Added Services ("VAS"), a small firm in Pretoria, specialises in tax-related services and consulting. You have been employed by VAS for the past three years as a manager and have been confronted with the following problems and queries (all amounts **INCLUDE VAT** (if applicable) and **all parties are registered VAT vendors and South African residents**, unless specifically stated otherwise.)

PART A - VAT

QUERY 1 **17 Marks**

Flex Limited ("Flex") is a resident company that manufactures multi-vitamins that is sold both locally and internationally. Flex has a June year-end and a one-month VAT-period.

Flex purchased a rent-producing property (situated in South Africa) from a non-vendor for cash at its market value of R3 250 000 during 2006. Transfer duty of R325 000 was also paid by Flex during 2006 (transfer duty was 10% at the time of the purchase).

The rent-producing property consists of commercial offices (60%) and residential flats (40%). SARS also accepts this ratio for VAT apportionment purposes.

Flex is considering the sale of the rent-producing property as a going concern to Echinea Limited (a registered VAT vendor) for R4 500 000 (excluding VAT) on 30 April 2010. Echinea Limited will settle the full purchase consideration immediately and will continue to utilize the property as offices and flats in the same proportion as it was previously used by Flex.

REQUIRED		**Marks**
(a)	Calculate, supported by references to legislation, the input tax that Flex could claim on the original purchase of the rent-producing property in 2006.	3
(b)	Discuss, supported by calculations, all the VAT implications (including time of supply) of the proposed sale of the property for both Flex and Echinea Limited. You may assume that the transaction will be classified as the sale of a going concern in terms of section 11(1)(*e*) of the VAT Act.	14

QUERY 2 **12 Marks**

Ballet (Pty) Ltd ("Ballet") is a resident company that manufactures and sells leather ballet shoes both locally and internationally. Ballet has a two-month tax period (ending February, April, June, etc.) and makes only taxable supplies.

You have been requested to assist Ballet in calculating their VAT liability for the tax period ending June 2010. The net VAT liability due to SARS is R5 467 800, before the following transactions have been taken into account:

	R	R
• Export sales of ballet shoes to the United Kingdom		570 000
• Indemnity payment received A laptop, purchased in 2005 for R5 700 was stolen on 15 May 2010. The insurance company paid out an indemnity payment of R7 980 on 15 June 2010, on which date Ballet purchased a new laptop for R10 260.		7 980
• Interest on current account received		53 423
• Transport expenses incurred for business purposes, which consists of:		73 229
○ Air tickets for local flights	13 680	
○ Air tickets for international flights	56 000	
○ Car hire The hire of the motor cars, as defined, include insurance of R114, maintenance expenses of R171 and petrol expenses of R350.	2 003	
○ Taxi fares paid for sales persons (when on business) who do not own their own cars	1 546	
• Depreciation written off for accounting purposes for May and June 2010		435 000
• Company car The managing director has the exclusive use of a Toyota Fortuner which the company purchased 1 January 2010 for R304 950 from which date he used it. The managing director bears the full cost of maintaining the vehicle and also paid R450 to Ballet for fuel.		??

REQUIRED	**Marks**
Calculate the VAT liability for Ballet for the tax period ending June 2010. Show all your calculations and round off all amounts to the nearest rand.	12

PART B – ESTATE DUTY

QUERY 3 **11 Marks**

One of the junior staff members came to consult you whilst he was in the process of administrating the estate of the late Roger Rabbit (aged 86) who died on 28 February 2010 of natural causes. At the time of his death he was married out of community of property without the accrual system to Bunny Rabbit (aged 22), whom he married the previous Christmas Day (thus 25 December 2009). His first wife, Regina, aged 80, died in a car accident on 31 January 2009. The net value of Regina's estate was R4 500 000 (before any bequests were made). She left the assets in equal shares to Roger and their two children, Lui and Kitty (both majors). Roger and Regina were married out of community of property without the accrual system.

The net value of Roger's estate was R10 million at the date of death (before any bequests were made). He changed his will just after his marriage to Bunny, in order to include her in his last will. He left her half of his estate and the other half in equal shares to his two children, Lui and Kitty, from his marriage with Regina.

REQUIRED		**Marks**
(a)	Calculate the Estate Duty payable by Roger's estate. Support your answer with references to legislation.	6
(b)	The only fixed asset in Roger's estate (the residue of his estate consisted of cash), which is included in the net value of his estate, is a commercial office block which he purchased for R1 500 000 during 2002. The market value of the block was R2 250 000 on 28 February 2010, the date of his death. The office block was included in the portion of his estate bequeathed to Lui. Calculate the capital gains tax consequences (if any) for both Roger and Lui of this bequest at date of death. **Ignore VAT**. You can assume that Roger had no other capital gains or losses for the 2010 year of assessment (and that no balances were brought forward from 2009) and that the capital gains tax implications of this transaction has been correctly included in calculating the estate duty and the net value (as stated above) of Roger's estate.	5

Question 4: TOE412S and ZAC412D

APPLIED AUDITING

(40 Marks)

Duration: 1 Hour (Time: 12:00-13:00). Students must be seated by 11:45. The test begins at 12:00.

FIRST EXAMINERS:	Ms. C. Boswel	Ms. S. Hassim
	Mr. V.M. Motholo	Mr. M.M. Mudau
	Ms. E.A.J. Terblanche	Ms. N.V. Thoothe
	Ms. R. Van Beek	
SECOND EXAMINER:	Mrs. L. Du Plessis	

Please ensure that you have completed the cover of the answer book for this question in full i.e. name, address, student number, code of paper and test number.

This TOE412S/ZAC412D (Auditing) question consists of 4 pages and is out of 40 marks.

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QUESTION 4: TOE412S AND ZAC412D **(40 marks)**

You are a senior audit manager at Laka & Mashala Incorporated (Laka & Mashala). You joined the firm six years ago, after spending two years in New Zealand at one of the big four audit firms as an audit manager. Shortly after arriving back in South Africa, Laka & Mashala head-hunted you and made you an offer you could not resist. They offered you a favourable package and a good client profile.

Laka & Mashala recently won a tender to audit Groen Plaas (Pty) Ltd (Groen Plaas), a dairy and free-range livestock farm, for the year ended 31 December 2009.

You are currently engaged in planning the 2009 year-end audit of Groen Plaas and you obtained the audit file from the audit senior, which includes the following:

Description		**Page**
A1	New client pre-acceptance questionnaire	2
B1	Business background	3

Client	Groen Plaas (Pty) Ltd	**Year-end**	31 Dec 2009	A1
Prepared by	Audit senior	**Date**	11 Dec 2009	
Reviewed by		**Date**		
Subject	New client pre-acceptance questionnaire			

Services to be provided:
1. The statutory audit
2. Completion of the tax return and assisting management in preparing the financial statements

Criteria	**Complied?**		**Comments**
	Yes	**No**	
Audit firm will be independent in appearance when performing the engagements.	X		The engagement partner has received eight cows from the owner and CEO of the farm, Piet van Wyk. This will enable the partner to assist his son to pay lobola for the daughter of the King of Lesotho.
The firm and its staff are competent to perform the engagements and have the capabilities, time and resources to do so.	X		The audit manager audited a farm while working in New Zealand.
The potential client has demonstrated both the willingness and the ability to settle the fees for service rendered.	X		The fee for statutory audit work is of a little consideration, since high fees will be charged for tax services and preparation of financial statements.
There is no evidence of a history of litigation by the potential client against its auditors.	X		

The previous auditor has resigned or was removed in compliance with the Companies Act.	X		
The client is agreeable to the terms of engagement contained in the standard audit engagement letter.	X		The client has signed the letter but has expressed reservations regarding the right of access of the external audit staff to the client's shareholder register.
Contact previous auditor to confirm no professional reason not to accept the engagement.	X		Done telephonically by the engagement partner.

Procedures for gathering information	**Comments**
Enquiries and discussions with the potential client's board of directors and executive management.	*Held discussions with Mr Piet van Wyk, the CEO of the farm.*
Inspection of the potential client's prior year financial statements.	*Reviewed 2008 annual financial statements.*

Conclusion: All the criteria have been satisfied and Groen Plaas is accepted as a client.

Client	Groen Plaas (Pty) Ltd	**Year-end**	31 Dec 2009	B1
Prepared by	Audit senior	**Date**	11 Dec 2009	
Reviewed by		**Date**		
Subject	Business background			

Groen Plaas is a dairy and free-range livestock farm. The farm is situated in the Karoo in the Western Cape. The products that are produced on the farm are sold to local and international grocery retail outlets and butcheries. This is the first time that Laka & Mashala provides statutory audit services to Groen Plaas.

The farm is owned and managed by Mr Piet van Wyk (the CEO) and his cousins, Mr Johannes van Wyk (the operations director) and Ms Jana Swanepoel (the financial director).

The South African government has put pressure on the directors of Groen Plaas to be involved in the country's equity scheme. As a result, in May 2009 the Groen Plaas shareholders issued 50% of the shares in the farm at no cost to 210 previously disadvantaged black employees.

During the year under review, Groen Plaas lost most of its livestock due to a drought that hit the Karoo area. The farm has applied to the Land Bank to obtain financing. This will enable it to obtain infrastructure to have enough water on the farm, even in the event of a draught. The application is pending approval on condition that the farm provides the bank with its audited financial statements by no later than 15 January 2010.

The farm is currently involved in a court case in which it is being sued by a local butchery which claims that the farm sold them beef from a cow, that allegedly had mad cow disease. The butchery discovered this during their regular inspection of the meat that they get from local farmers.

The main assets of Groen Plaas are property, plant and equipment which consist mainly of land and tractors. The land will be provided as security in order to obtain financing from the Land Bank. Many of the tractors in the farm are not in working condition, but have a significant carrying value in the financial statements.

All the machines that are used in the dairy farming have been acquired on operating lease and are replaced every year.

In the past, Groen Plaas engaged Jan Schoeman (a land surveyor) to value the land. To ensure that the land surveyor remains independent from the client, Laka & Mashala decided to engage Gregory Phillips to value the land for the year ended 31 December 2009. Gregory Phillips runs his own practice as a land surveyor.

REQUIRED

	Marks
1. Discuss, with reference to Working Paper A1 (New client pre-acceptance questionnaire), your concerns regarding the acceptance of Groen Plaas as audit client.	18
2. Regarding Working Paper B1 (Business background):	
(a) Identify the risk of material misstatement at the overall financial statement level of Groen Plaas.	10
(b) Identify the risk at the assertion level that relates to the items of property, plant and equipment and the operating lease expenses of Groen Plaas.	6
(c) Describe the matters which should be included in the agreement with Gregory Phillips, to determine clarity regarding the nature, scope and objectives of his engagement to value the Groen Plaas land.	6

SUGGESTED SOLUTIONS AND COMMENTARY ON TEST 1

SUGGESTED SOLUTIONS TO QUESTION 1
TOE407V / ZAC407G
APPLIED FINANCIAL ACCOUNTING

(a) Recognition and measurement

The sale of the soft toy horses represents the sale of goods. In terms of IAS 18.14, revenue from the sale of goods should be recognised when all the following conditions have been satisfied:

1. The entity has transferred to the buyer the significant risks and rewards of ownership of the goods

- A contract was entered into between MLH and 'Birthdays Are Us' and in the contract all the necessary information was stipulated whereby the ownership of the goods will pass from MLH to 'Birthdays Are Us' on date of delivery (√).

2. The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.

3. The amount of revenue can be measured reliably

- Revenue is **measured** at the **fair value** of the consideration received or receivable (IAS 18.09) (½).
- Revenue **excludes VAT** (½), as it is an amount **collected on behalf of third parties** (½) and specifically excluded from the amount of R171.
- When the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash or cash equivalents (IAS 18.11) (½).
- The fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest (IAS 18.11) (√).

Therefore:	i	=	7/12 = 0,583%		(√)
	n	=	12		(½)
	FV	=	R171 x 8550 = R1 462 050		(√)

Therefore PV = R1 363 483

OR

	i	=	7/12 = 0,583%		(√)
	n	=	12		(½)
	PMT	=	117 977,78		(√)

Therefore PV	=	R1 363 483		
Less VAT	=	(R179 550)	[171x8550x14/114]	(½)
Revenue	=	R1 183 933		

- The difference between the R1 236 183 [R1 415 733 (117 977,78x12) less R179 550 (VAT)] and R1 183 933 of R52 250 should be recognised as **unearned finance income.** (√)

- The unearned finance income (R52 250) would be recognised over time using the effective rate method. (√)

- The interest revenue would be disclosed as other income or as revenue. (½)

4. It is probable that economic benefits associated with the transaction will flow to the entity

- A **contract** between the two parties has been signed, allowing for the collectability of the purchase price to be reasonably assured. (½)
- The revenue will flow to MLH as they are bound by a **contract** (½).

5. The costs incurred in respect of the transaction can be measured reliably

- The costs incurred will be 8550 x R100 = R855 000 (½).

Conclusion

Since all the above recognition criteria for the sale of goods have been met, the income derived from the toy horses is revenue as defined. (½) The revenue will be recognised on date of delivery (1 May 2008) (½) at the fair value of the consideration receivable of R1 183 933. (½)

MLH is in the business of selling soft toy horses and the special order was for 8550 soft toy horses, which is in line with MLH's normal business operations. Therefore the revenue should be recognised in the line item revenue and not other income in the statement of comprehensive income. (½)

(13)
Maximum 8

(b) MY LITTLE HORSES LTD

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 APRIL 2009

	R	
Revenue (2 828 881 [C1] (4) + 1 183 933 (from a) (½)	4 012 814	(4½)
Cost of sales [C2]	(2 378 000)	(1)
Gross profit	1 634 814	
Other Income (122 300 (given) (½) + 52 250(from a) (1) + 50 000 (dividend) (½) + 150 000 (½) (profit land)	374 550	(2½)
Distribution costs (given) (½)	(30 000)	(½)
Administrative expenses (120 000 (given) (½) – 30 000 (given)) (½)	(90 000)	(1)
Other expenses (167 500 (given) (½) – 55 000 [C3] (1½) + 406 400 [C4] (2½) + 76 000 [C5]) (1)	(594 900)	(5½)
Profit before tax	1 294 464	
Income tax expense [C6]	(242 750)	(11)
Profit for the year	1 051 714	

Other Comprehensive Income:

Cash Flow Hedge reserve gain	36 000	
Gross (given)	50 000	(½)
Tax (given)	(14 000)	(½)
Gains on property revaluation	234 000	
Gross [C5]	325 000	(1½)
Tax [C5]	(91 000)	(½)
Total other comprehensive income for the year, net of tax	270 000	
Total comprehensive income for the year	1 321 714	
Presentation		(1)
		30
	Maximum	28

(c) Journal entries

	Dr R	Cr R	
Current tax [C6]	246 677		(½)
SARS (F/P)		246 677	(½)
Tax on OCI (cash flow hedge reserve)	14 000		(½)
Tax on OCI (revaluation surplus)	91 000		(½)
Deferred tax (F/P)		105 000	(½)
Deferred tax (P/L) (assessed loss previous year)	98 000		(1)
Deferred tax (F/P)		98 000	(½)
Deferred tax (F/P) (movement in temporary differences)	3 927		(½)
Deferred tax (P/L)		3 927	(½)

5

Maximum 4

CALCULATIONS

C1. Revenue

15 230 x R190 = R2 893 700 (1)

Cash sales:	R2 893 700 x 30% (½)	=	868 110	
Credit sales:	R2 893 700 x 70% (½) x 40% (½) x 92% (½)	=	745 417	(settlement discount)
Credit sales:	R2 893 700 x 70% (½) x 60% (½)	=	1 215 354	(no discount)
			2 828 881	[4]

OR

Sale of goods	=	2 893 700
Discount (2 893 700 x 70% x 40% x 8%)	=	(64 819)
		2 828 881

C2. Cost of sales

15 230 + 8 550 = 23 780 [½] x R100 [½] = R2 378 000 [1]

C3. Insurance premiums (prepaid expense)

2009:	75 000 x 1,10 = 82 500 [½]	
2009:	82 500 ÷ 12 x 8 = 55 000 [1]	[1½]
2008:	75 000 ÷ 12 [½] = 6 250 x 8 [½] = 50 000	[1]

C4. Machinery: (change in estimate)

1 May 06 – 30 April 07 = 2 540 000 x 20% = 508 000
1 May 07 – 30 April 08 (2 540 000 – 508 000) = 2 032 000 [½] x 20% = 406 400
1 May 08 (2 032 000 – 406 400) = 1 625 600 [½] (carrying amount)

OR

1 May 06 – 30 April 07 = 2 540 000 x 80% = 2 032 000 [½]
1 May 07 – 30 April 08 = 2 032 000 x 80% = 1 625 600 [½]
1 May 08 = 1 625 600 (carrying amount)

Depreciation 1 625 600 [½] ÷ 4 years remaining from 1 May 2008 [1] = 406 400 [2½]

C5. Factory building

Depreciation (1 May 2008 – 30 April 2009)
R950 000 [½] ÷ 12,5 years [½] = 76 000 [1]

Revalued amount	950 000 [½]
Carrying amount on 1 March 2008	625 000 [1]
Revaluation surplus	325 000

Taxation: 325 000 x 28% = 91 000 [½] [2]

Cost price: (625 000 ÷ 12,5 x 13) = 650 000 [1]

Building allowances 650 000 x 5% = 32 500 [1] [2]

C6 Current tax calculation

	R	
Profit before tax (from part b)	1 294 464	[½]
Non-deductible and Non-taxable items		
Dividend Income (given)	(50 000)	[½]
Donations (given)	47 500	[½]
Capital profit on land (150 000 x 50%)	(75 000)	[1]
Temporary differences – deductable	14 025	
Depreciation on machinery [C4]	406 400	[½]
Wear and tear on machinery (given)	(450 000)	[½]
Depreciation on factory building [C5]	76 000	[½]
Building allowance on factory building [C5]	(32 500)	[2]
Prepaid insurance – 2008 [C3]	50 000	[1]
Prepaid insurance – 2009 [C3]	(55 000)	[½]
Research – accounting (given)	25 500	[½]
Research – tax [C7]	(6 375)	[½]
Assessed loss b/f (given)	(350 000)	[½]
Taxable income	880 989	
Current tax (880 989 x 28%)	246 677	[1]
Deferred tax (14 025 x 28%)	(3 927)	[1]
	R242 750	
		[11]

C7. Research costs

R25 500 – accounting

R25 500 x 25% = R6 375 – tax

TEST MARKERS COMMENTARY ON QUESTION 1: TOE407V and ZAC407G

General

- Writing in pencil will not be marked.
- If the question requires the statement of comprehensive income and only calculations are prepared, no marks will be given. Always ensure you answer what was required.
- It is very important to know that if calculations were done, but it was not referenced, no marks will be awarded.

Part A

- Students only copied the theory from the standard and did not apply the theory to the question.
- Students are unsure about the VAT treatment in the calculation of the present value. The present value calculation should include VAT. The amount of revenue taken to the statement of comprehensive income should exclude VAT as it is an amount collected on behalf of third parties.
- Very few students made a conclusion which was an easy 1½ marks.

Part B

- The majority of the students are not familiar with the statement of comprehensive income format.
- Students did not realise that the prepayment of the insurance is already included in other expenses - it is important to read the question carefully.
- Students did not take the prepaid insurance into account in the taxation calculation - remember that a prepaid expense is a temporary difference.
- Students did the tax calculation but didn't include it in the statement of comprehensive income. If only calculations were done and not the required part of the question (in this case the statement of comprehensive income), no marks will be awarded.

Part C

- A considerable number of students did not get to part C of the paper which was easy marks. Students have to plan their answer and practice to work against time.
- When journals are required, it is important to show what account must be debited or credited and if it is part of profit and loss, other comprehensive income or statement of financial position.

SUGGESTED SOLUTIONS TO QUESTION 2
TOE408W and ZAC408H
APPLIED MANAGEMENT ACCOUNTING

Part A

CALCULATIONS

Budgeted production

	Buttermilk	Muesli	
Opening stock	100 000	55 000	
Production	1 480 000	675 000	(1)
Closing stock	(80 000)	(30 000)	
Sold	1 500 000	700 000	

Actual production

	Buttermilk	Muesli	
Opening stock	100 000	55 000	
Production	1 380 000	575 000	(1)
Closing stock	(80 000)	(30 000)	
Sold	1 400 000	600 000	

Budgeted Fixed overhead rate

$\frac{45\ 000\ 000}{1\ 000\ 000}$ = R45/ hour (1)

Budgeted labour rate

$\frac{25\ 000\ 000}{1\ 000\ 000}$ = R25/hour (1)

Hours:

Buttermilk

$\frac{450\ 000 \text{ hrs}}{1\ 480\ 000 \text{ units}}$ = 0,304 hours per unit (1)

Muesli

$\frac{550\ 000 \text{ hrs}}{675\ 000 \text{ units}}$ = 0,815 hours per unit (1)

Income statement for the year ended 30 June 2010

		Buttermik	Muesli	Total	
Sales				88 800000	(1)
B: (1 400 000 x R39)		54 600 000			
M: (600 000 x R57)			34 200 000		
Opening stock				3 485 000	(1)
B: Given		2 000 000			
M: Given			1 485 000		
Production:					
Materials				26 151000	(1)
B: (12,70 x1 380 000)		17 526 000			
M: (15,00 x 575 000)			8 625 000		
Labour				22 203625	
B: (0,304 x 1 380 000 x 25)		10 488 000			(1)
M: (0,815 x 575 000 x 25)			11 715 625		(1)
1 mark if production numbers					
Overheads				39 966525	
B: (0,304 x 1 380 000 x 45)		18 878 400			(1)
M: (0,815 x 575 000 x 45)			21 088 125		(1)
1 mark if production numbers					
Closing stock:					
B: Material 80 000 x 12,70 =	1 016 000				
Labour 0,304 x 25 x 80 000=	608 000				
Overheads 0,304 x 45 x 80 000=	1 094 400				
	2 718 400	(2 718 400)			(2)
1 mark for 80T if value X					
M: Material 30 000 x 15 =	450 000				
Labour 0,815 x 25 x 30000=	611 250				
Overheads 0,815 x 45 x 30 000=	1 100 250				
	2 161 500		(2 161 500)	(4 79900)	(2)
1 mark for 30T if value X					
Cost of sales		46 174 000	40 752 250	86 26250	
Gross profit		8 426 000	(6 552 250)	1 873 750	

Over / Under recovery of overheads

Budgeted			
Overheads	45 000 000		
Labour	25 000 000		
	70 000 000		(1)
Recovered			
Per above: Labour	22 203 625		
Overheads	39 966 525		
	62 170 150		(1)
Under recovery		7 829 850	(1)
Give mark if **under**			
Expenditure variance (bonus)			
Budget (45 000 000 + 25 000 000)	70 000 000		
Actual (44 000 000 + 24 000 000)	68 000 000		
	2 000 000	(2 00000)	(1)
Admin salaries		777 000	(½)
(Sales and distribution costs		8 000 000	(½)
Net loss		(12 733100)	
		Max	20

Part B

ABC

Quality control

Buttermilk		**Muesli**		
1 380 000/10 000 =	138 batches	575 000/10 000 =	58 batches	(1)
138/196 x 2 100 000 =	1 478 571,43	58 / 196 x 2 100 000	621 428,57	(1)
Materials handling				
Buttermilk		**Muesli**		
138 x 3 =	414 set ups	58 x 4 =	232 set ups	(1)
414/646 x 21 300 000 =	13 650 464,40	232/646 x 21 300 000 =	7 649 535,60	(1)
Baking				
Buttermilk		**Muesli**		
1 380 000/100 x 1	13 800	575 000/100 x 1	5 750	(1)
13 800/19 550 x10 500 000	7 411 764,71	5 750/19 550 x 10 500 000	3 088 235,29	(1)

Packaging

Buttermilk		**Muesli**		
1 380 000/100 x 0,1	1 380	575 000 / 100 x 0,1	575	(1)
1 380 / 1 955 x 4 600 000 =	3 247 058,82	575/1 955 x 4 600 000	1 352 941,18	(1)

Non identifiable

1 mark if NI recognised but X dealt with

Buttermilk		**Muesli**		
5 500 000 x $\frac{460\ 000}{1\ 015\ 000}$	2 492 610,84	5 500 000 x $\frac{555\ 000}{1\ 015\ 000}$	3 007 389,16	(2)
Total	28 280 472,20		15 719 529,80	
Per unit / 1 380 000	20,49	/ 575 000	27,34	(2)
1 mark if unit value (X) calculated				
				12

Part C

REPORT

TO: Mr Terrry
FROM: CTA Student
SUBJECT: Profitability of Buttermilk and Muesli rusks

DATE: 20 June 2010

Traditional	**Buttermilk**	**Muesli**	
Overheads rate per unit			
Buttermilk $\frac{460\ 000 \text{ hrs}}{1\ 380\ 000 \text{ hrs}}$ x 45 hrs	15,00		(1)
Muesli $\frac{555\ 000 \text{ hrs}}{575\ 000 \text{ hrs}}$ x 45 hrs		43,44	(1)

ABC

	Buttermilk	**Muesli**	
	20,49	27,34	(1)

Mark through

Buttermilk

Where fixed production overheads are allocated on a traditional basis the product's overheads are 15,00 per unit. However when the ABC method is used the product's overheads per unit has increased to 20,49.

Muesli

Where fixed production overheads are allocated on the traditional basis the product incurs overheads of 43,44 whereas if the ABC method is used the overheads per unit decreases to 27,34.

The traditional costing method allocates overheads based on labour hours. Therefore, Muesli which uses more hours for production (0,96 hours per unit for Muesli compared to 0,33 hours per unit for Buttermilk) is allocated more overheads than Buttermilk.

However, when the ABC method is used Buttermilk which makes more use of the resources is allocated more overheads. (1)

ABC is a more accurate method for allocating overheads as it assigns costs more accurately. It will thus give the company a better insight on how each product is performing. (1)

Max 4

Part D

Fixed costs = 45 000 000 + 25 000 000 + 777 000 + 3 000 000
= 73 777 000 (1)

Sales of 1 350 000 Buttermilk and 450 000 Muesli

3B + 1 M = 1 bundle

Variable selling and administration costs = 5 280 000 → 2 640 000 ; → 2 640 000

Buttermilk $= \frac{2\,640\,000}{1\,500\,000}$ = 1,76 Muesli $= \frac{2\,640\,000}{700\,000}$ = 3,77 (½)

Marginal profit per unit	**Total value**	**B**	**M**	
Selling price	76 725 000	38,50	55,00	
Material	(22 950 000)	(12,00)	(15,00)	
Selling and administration	(5 280 000)	(1,76)	(3,77)	
	48 495 000	24,74	36,23	(1)
Number of units per bundle	63,21%	3	1	

Contribution in bundle = (3 x 24,74) + (1 x 36,23)
= 110,45 (½)

Break even = $\frac{73\ 777\ 000}{110,45}$ $\boxed{\frac{73\ 777,00}{,6321}}$

= 667 967 (½)

Break-even sales = (667 967 x 3) + (667 967 x 1)
= 2 003 901B + 667 967M (½)

Sales B = 2 003 901 x 38,50
= 77 150 189 (½)

Sales M = 667 967 x 55
= 36 738 185 (½)

Total sales = 113 888 374 R116 717 292 (½)

Max 4

ALTERNATIVE

- If the answer is exactly as below allocate 3 marks only 1 mark penalty for using actual Figures to do the calculation.

Fixed costs = 44 000 000 + 24 000 000 + 777 000 + 3 000 000
= 71 777 000 (1)

Sales of 1 350 000 Buttermilk and 450 000 Muesli

3B + 1 M = 1 bundle

Variable selling and administration costs = 5 000 000 → 2 500 000
→ 2 500 000

Buttermilk = $\frac{2\ 500\ 000}{1\ 400\ 000}$ Muesli = $\frac{2\ 500\ 000}{600\ 000}$

= 1,79 = 4,17

Marginal profit per unit

	B	M	
Selling price	39,00	57,00	
Material	(12,70)	(15,00)	
Selling and administration	(1,79)	(4,17)	
	24,51	37,83	(0)

Number of units per bundle	3	1

Profit in bundle = (3 x 24,51) + (1 x 37,83)
= 111,36

Break even = $\frac{71\ 777\ 000}{111,36}$

= 644 550 (½)

Break-even sales = (644 550 x 3) + 644 550
= 1 933 650B + 644 550M (½)

Sales B = 1 933 650 x 39
= R75 412 350 (½)

Sales M = 644 550 x 57
= 36 739 350 (½)

Total sales = 112 151 700 <u>(½)</u>

Max <u>**3**</u>

SUGGESTED SOLUTIONS TO QUESTION 3
TOE409X
APPLIED TAXATION

PART A - VAT:

QUERY 1 **17 Marks**
Part (a)

- The building is a "second-hand good" as defined, purchased from a non-vendor and therefore Flex was entitled to a notional input tax deduction at acquisition.
- It is calculated by using the tax fraction and applying it to the lesser of consideration in money or market value, limited to transfer duty paid (14/114 x R3 250 000 = R399 122,81, limited to R325 000). (Section 1, definition of input tax, sub paragraph (*b*)). (1) (1)
- As the building is used to make both taxable (60%) and exempt supplies (40%), input tax must be apportioned (section 17(1)).
- The input tax that Flex could deduct in 2006 was R325 000 x 60% = R195 000 (section 17(1)). (1)
- The input tax could be claimed in the period that the transfer duty was paid (section 16(3)(*a*)(ii)(*bb*) & 16(3)(*b*)(i)(*aa*)). It is irrelevant whether the purchase price has been paid or not.

Total 3

Part (b)
VAT implications for Flex

The sale of the property to Echinea Limited as a going concern is a zero-rated supply, as the property was used mainly (more than 50% (60% - renting of commercial offices, which is a taxable supply)) for taxable supplies. Thus output tax is Rnil. (2)

Flex will however be entitled to claim an additional input tax in terms of section 16(3)(*h*) of the VAT Act on the disposal, calculated as follows: (1)
A x B x C
A = tax fraction = 14/114
B = lesser of adjusted cost (R3 250 000) and the current market value (R4 500 000). (1)
C = percentage of non-taxable supplies = 40%

BUT:
A x B
$\frac{14}{114}$ x R3 250 000 = R399 123, (1)
must be limited to the transfer duty of R325 000. (1)

Flex only claimed a notional input tax deduction of 60% of transfer duty paid on purchase.
The adjustment is therefore:
R325 000 x 40% = R130 000. (1)

Thus a section 16(3)(*h*)-input tax of R130 000 can be claimed in the April 2010 tax period in which the date of the disposal (30 April 2010), falls. (1)

Echinea Limited

Echinea Limited will not be able to claim any input tax on the purchase, as it was a zero-rated supply (no VAT was payable on the purchase). (1)
(Note that since the transaction was subject to VAT, even though at 0%, transfer duty will not be payable).

Echinea Limited will have to make a section 18A-adjustment to output tax, since the property was acquired as a 100% taxable supply at a rate of 0%, but it will be partly used for purposes other than making taxable supplies (40% used for exempt supply of dwellings for rentals (section 12(1)(*c*))). (2)

The section 18A-adjustment will be made during the tax period (tax period in which 30 April falls) that the supply (purchase) was made. (1)

The adjustment will be:

	R	
Full cost of the going concern purchase	4 500 000	
Less: % intended to be used for taxable supplies (commercial offices – 60%)	(2 700 000)	
(or R4 500 000 x 40%)	1 800 000	(1)
Section 18A-adjustment to output tax (14% thereof)	252 000	(1)
	Total	14
	Total for query 1	17

QUERY 2 **12 Marks**

VAT liability for Ballet for the tax period ending 30 June 2010

		R	
Net VAT liability due to SARS		5 467 800	
Export	Zero-rated (section 11(1)(*a*)(i))	-	(1)
Indemnity payment –	Deemed supply – R7 980 x 14/114 (section 8(8))	980	(1)
Computer/laptop	Purchase – R10 260 x 14/114	(1 260)	(1)
Interest	Financial service and exempt (section 2(1)(*f*) read with section 12(*a*))	-	(1)
Transport expenses	• Local air tickets – taxable supply – R13 680 x 14/114	(1 680)	(1)
	• International flights – zero-rated (section 11(2)(*a*))	-	(1)
	• Car hire: input tax is denied i.t.o. section 17(2)(*c*)) – (R2 003 – R114 – R171 - R350) = R1 368, but rest is taxable	-	(1)
	• Insurance – R114 x 14/114	(14)	(½)
	• Maintenance – R171 x 14/114	(21)	(½)
	• Petrol – zero-rated (section 11(1)(*h*))	-	(½)
	• Taxi fares – Exempt transport of fare-paying passengers (section 12(*g*))	-	(1)

Depreciation	Not a taxable supply (accounting entry)	-	(½)
Company car	Fringe benefit i.t.o. section 18(3), thus a deemed supply: {(R304 950 x 100/114 = R267 500 (determined value) x 0.3%) – R85} = R717.50 x 14/114 x 2 months Note: Petrol is not deducted as it is a zero-rated supply	176	(2)
		5 465 981	

Total for query 2 12

QUERY 3 **11 Marks**

Part (a)

Estate Duty – Roger

	R	
Net value of estate (given)	10 000 000	(½)
Less: Section 4(*q*) bequest to wife (Bunny), exempt	(5 000 000)	(1)
Net value of estate	5 000 000	
Section 4A rebate (refer note 1)	(4 000 000)	
Dutiable amount	1 000 000	
Estate duty payable @ 20%	200 000	(1)

Note 1:

Regina's section 4A not utilised:	Net value of estate	4 500 000	(½)
	Less: Exempt bequest to husband i.t.o. section 4(*q*) (R4 500 000 / 3)	(1 500 000)	(1)
	Net value of estate	3 000 000	
	Rebate i.t.o. section 4A (R3 500 000 but limited to R3 000 000)	(3 000 000)	(1)
		0	
	Unutilised portion available to Roger (R3 500 000 – R3 000 000)	500 000	
Roger's section 4A available:	R3 500 000 plus R500 000 (unutilised from Regina)	4 000 000	(1)
	Total		6

Part (b)

Capital gains tax implications for Roger

	R	
Proceeds (par 40)		
Deemed disposal at date of death at market value (given)	2 250 000	(1)
Less: Base cost	(1 500 000)	(1)
Capital gain	750 000	
Less: Annual exclusion at death (par 5)	(120 000)	(1)
Net capital gain	630 000	
Taxable capital gain included in Roger's taxable income for 2010 year of assessment @ 25%	157 500	(1)

Capital gains tax implications for Lui

Base cost (par 40(2)):	Deemed to acquire asset at date of death at market value (given) – this value will be used as base cost when the asset is eventually disposed of by Lui	2 250 000	(1)
		Total	5
		Total for query 3	11

ASSESSMENT CRITERIA APPLIED (refer to TL 101 paragraphs 5.3, 5.4 and 8)

The following broad assessment criteria were applied, namely:

- You had to demonstrate that you are competent in the interpretation and application of the Value-Added Tax Act and Estate Duty Act to the facts of real life situations (case studies).

- You had to demonstrate that you are competent to determine and discuss the VAT implications of transactions as well as that you are competent to calculate estate duty and the Capital Gains Tax consequences of disposals of assets to and from the estate.

The test focussed on your technical and communication skills and the following summary will assist you in evaluating your learning strategies as well as where you can improve your technical skills. The question consisted of three queries.

	Topic	**Reference to legislation**	**Reference to examples or questions in TL or in SILKE**
Part A: Queries 1 and 2	VAT	Section 1, definitions of • second hand good • input tax Sections 2, 8, 11, 12, 16, 17, 18, 18A of the VAT Act	Section B (Integrated example) Section C: Questions 1 and 2 Section C: Question 3 (Part (b)) Section C: Question 4 Part 1 (Query 6) and Part 2 Section C: Question 5 (Milky Bar CC)
Part B	Estate duty and CGT relating to estates	Sections 4(q), 4A of the Estate duty Act Paragraphs 5 and 40 of the Eighth Schedule to the Income Tax Act	Two examples on pages 58 and 61 respectively in TL 103 Section C, Question 9 (Part 2) SILKE: Examples 30.11 to 30.13

It is important to note that if you had followed the suggested working method in TL 103 and worked through the examples and questions in TL 103, you would have easily obtained a very high mark. Please remember that we test the application of knowledge and that you must make time to work through the questions and examples in both the tutorial letter and the textbook.

TEST MARKERS COMMENTARY ON QUESTION 3: TOE409X

COMMENTARY ON THE ASSESSMENT RESULTS

- **Basic principles not applied:**

    - **Query 1 Part (a):** Students did not always use the correct order. It is important to
        1. multiply with the tax fraction (x 14/114),
        2. limit the notional input to the transfer duty paid and
        3. multiply it with the taxable portion (x 60%)

    - **Query 1 Part (b):** Students did not understand the principles.
        - **Flex** sold the property as a going concern at 0% (OUTPUT TAX). The sale as a going concern implies that it was for 100% taxable supplies. As Flex could not previously claim input tax on 40% exempt supplies, it can on date of sale claim an ADDITIONAL 40% INPUT TAX (in terms of section 16(3)(h)) (see suggested solution for formula and order of calculations).

        - **Echinea Limited** purchased the property as a going concern (0%) and can therefore not claim any INPUT tax (as none was paid). The sale as a going concern implies again that it was for 100% taxable supplies. But as 40% of supplies are exempt supplies, a section 18A adjustment must be made to OUTPUT TAX (100% - 40% exempt = 60% taxable). Note that the OUTPUT TAX is calculated at 14%!

    - **Query 2:** Some students did not use the correct reasons. Note that there is a difference between:
        - zero-rated supply
        - exempt supply
        - input tax is denied
        - is not a taxable supply

      Make sure that you know which reason to use! Please do NOT use the word "VATABLE" – "taxable" is the correct word.
      "Does not have VAT implications" is not a valid reason.

    - **Query 3 Part (a):** Students did not understand how to calculate the section 4A rebate and calculated the successive deaths rebate. Note that only the UNUTILISED portion of Regina's R3,5 million (section 4A rebate) must be added to Roger's R3,5 million (section 4A rebate). You therefore had to recalculate the net value of Regina's estate.

    - **Query 3 Part (b):** Students calculated the 25% taxable capital gain BEFORE deducting the annual exclusion of R120 000. It is incorrect. Make sure that you use the correct order of deductions!

- **Recommendations to improve your knowledge and skills:**
    - Work through the question, suggested solution and commentary and make sure you understand it.

SUGGESTED SOLUTIONS TO QUESTION 4
TOE412S and ZAC412D
APPLIED AUDITING

1. Concerns about the acceptance of Groen Plaas

Quality control for the firm (ISQC1)

1.1 Client acceptance and continuation

It appears that Laka & Mashala does not comply with quality control principles as per ISQC1, because leadership responsibilities at firm level are not in place. (1)
The audit senior performed the client screening and made the decision to accept the audit. This is evident from working paper A1. (1)
Responsibility for quality on the audit should have been taken by the engagement partner and management committee of the Laka & Mashala. (1)

1.2 Ethical responsibilities

- Laka & Mashala does not appear to have policies and procedures regarding the ethical conduct of staff (integrity, objectivity, independence and professional behaviour). (1)
- The firm appears to accept any client as long as the fee is big enough. (1)
- In Work Paper A1 it is stated that audit fee is of little concern, because there is the potential for making money from **lucrative** tax services and the preparation of financial statements. (1)
- The pre-acceptance consideration of independence is too **narrow** as only partner independence (and not staff independence) has been considered. (1)

1.3 No proper client screening has been done

No proper risk assessment procedures have been followed to obtain sufficient and appropriate information to screen the Groen Plaas – only discussions have been held with the CEO. (1)

- Other procedures (ISQC1.30) should have been performed, including communication with knowledgeable third parties. (1)
  The previous auditors were only contacted telephonically. (1)

Considerations

1.4 Independence and ethical considerations

The auditor did not consider independence sufficiently.

- The acceptance of eight cows by the partner constitutes a gift and the following threats to independence exist as a result: (1)
  - Familiarity threat
  - Intimidation threat
  - Self-interest threat (Max 1)

The issues surrounding the audit fee could represent a self-interest threat to the auditor's integrity, objectivity, independence and professional behaviour. (1)

- The audit fee may be too low, which means that quality and professional standards may be comprised. (1)

- The provision of tax service and the preparation of financial statements may also create a self-review threat to independence and objectivity as fees may be excessive in relation to the audit fee. (1)

1.5 The integrity risk and business risk related to the client appear excessive and have not been considered properly (ISQC paragraph 1.28)

- The client reservation about allowing us free access to the shareholder register could (1)
  – place a restriction on the scope of our work (1)
  – lead to questions about the integrity of management (1)
  – indicate intention to hide information on the part of the client (1)

1.6 Communicating with previous auditors

- It does not appear that a vacancy in terms of Companies Act was considered. (1)
- Done telephonically while it should have been done in writing. (1)
- A memorandum of the communication or a copy of the letter should also have been placed on file. (1)

1.7 Skills and competence

- No consideration of availability of staff and resources was done. (1)
- The audit of farms in South African can be complex and experts will be consulted. This was not done. (1)
- The audit manager has limited experience in auditing farms as he audited a farm in New Zealand. (1)
- Only the experience of the audit manager was considered and not for the rest of the team. (1)

1.8 Engagement conditions

- There appears to be only one engagement letter issued for both assurance engagement and non-assurance engagement. (1)

Available 27
Maximum 18

2. (a) Risk of material misstatement at the overall financial statement level of Groen Plaas

1. First time audit by Laka & Mashala.

1.1 There is a risk that material misstatement could go undetected because we are unfamiliar with the business. (1)

1.2 There is a risk that opening balances might be materially misstated. (1)

2. Groen Plaas sells its produce internationally.

2.1 There is a risk of foreign currency fluctuations and foreign transactions not measured at the correct exchange rate, which may result in material misstatements. (1)

3. The farm is managed by shareholders.

3.1 There is a risk that shareholders in management may engage in fraudulent financial reporting to reflect a better picture of the financial performance of the farm. (1)

4. Shares issued to employees for free.

4.1 There is a risk that these shares are not accounted for properly in the financial statements. (1)

5. Tight deadline (audited financial statements needed 15 days after year-end).

5.1 There is a risk that events after balance sheet date are not identified and properly disclosed. (1)

5.2 Material misstatement could go undetected. (1)

6. The Land Bank relies on audited financial statements.

6.1 There is a risk that Laka & Mashala might be liable to the Land Bank should an inappropriate audit opinion be expressed. (1)

7. The farm is currently involved in a court case.

7.1 There is a risk that the provision might not be properly accounted for in terms of IAS 37. (1)

7.2 Should the farm loose the court case, there is a possibility of loss of clientele. (1)

8. The fairly complex requirements for complying with IFRS (International Financial Reporting Standards) increase the risk of incorrect accounting treatment of measurement, recognition and disclosure for the following:

8.1 The property, plant and equipment, IAS 16 for all the assets owned by the farm. (1)

8.2 Leased assets, specifically compliance with IAS 17 regarding the machines used in the dairy farming in terms of operating leases. (1)

8.3 Revenue recognition as per IAS 18 for livestock and dairy products sold internationally and locally. (1)

9. There is a risk that the expert (land surveyor) to be engaged might not be competent, experienced and/or independent. (1)

10. There is possible going concern problems resulting from the following:

10.1 Loss of livestock due to drought. (1)

10.2 Lack of funds to raise capital to build the water infrastructure. (1)

10.3 The current court case. (1)

11. There is a risk that financial statements may not be prepared on the correct basis (liquidation basis) (1)

12. There is risk that management might be involved in fraudulent financial reporting due to going concern. (1)

13. There is a risk that Groen Plaas might not comply with laws and regulations e.g. Companies Act etc. (1)

Available 20

Maximum 10

(b) Risk at the assertion level relating to the items of property, plant and equipment and operating lease expense

1. There is the risk that the items of property, plant and equipment may be overstated because the farm wants to obtain finance from the Land Bank. (1)

2. There is the risk that the operating lease expense may be understated to reflect better profits, which puts the farm in a better position to obtain financing. (1)

3. There is a risk that operating lease expenses are not straight lined. (Accuracy) (1)

4. There is the risk that the Groen Plaas does not have a right to ownership of the items of property, plant and equipment, because it will be offered as security to obtain financing. (Rights) (1)

5. There is the risk that the land might not be carried at the correct value owing to the drought suffered during the year. (Valuation) (1)

6. There is a risk in having to rely on the work (expertise) of the expert when valuing the land. (Valuation) (1)

7. There is the risk that the tractors are not valued at the correct amount – most of them appear to have been written off. (Impairment/Valuation) (1)

8. There is also the risk that the depreciation policy with respect to the tractors is not in line with market rates, because tractors that are no longer in working condition are carried at significant carrying amounts. (1)

9. There is a risk that the items of property, plant and equipment are not valued correctly due to the following:
   a. Incorrect useful life. (1)
   b. Incorrect residual value. (1)

10. There is the risk that machines acquired in terms of an operating lease are capitalised as assets of the farm. <u>(1)</u>

Available <u>11</u>
Maximum <u>6</u>

(c) Matters to be included in an agreement about the nature, scope and objective of engagement of Gregory Phillips (using an auditor's expert ISA 620)

1. An explanation of the overall audit objective and the specific objectives (to gather sufficient appropriate evidence) pertaining to the value of the land on which we require his expert opinion. (1)

2. The extent of testing we believe would be necessary to achieve the audit objective. (1)

3. His right of access to land, documentation, explanations and so on from the Groen Plaas directors, including the report of the previous expert. (1)

4. The content and layout of his report (to ensure that his engagement provides the evidence we require). (1)

5. The assumptions, techniques and methods which he will use in fulfilling his obligation and that these will be compared to the assumptions, techniques and methods adopted in the reports of prior years. (1)

6. Whether communication with Jan Schoeman (previous surveyor) is necessary/ essential/desirable. (1)

7. That his report/working papers will need to be reviewed in a meeting with us at which he is present. (1)

8. Clear communication about the **date** of the land valuation, which is 31 December 2009 and any other reporting deadlines. (1)

9. Gregory has to communicate the relevant, technical performance standards or other professional or industry requirements that he will be following. (1)

10. Gregory's duty to comply with the fundamental principles of professional judgement (objectivity, confidentiality, etc) (1)

11. The amount payable to Gregory including the terms. (1)

Available 11
Maximum 6

TEST MARKERS COMMENTARY ON QUESTION 4: TOE412S and ZAC412D

General

Remember that this is only the first test of the year and it is just one the stepping stones toward passing this module. If your marks did not meet your expectations, stay positive and work harder!

Part 1

The required stated: "*Discuss, with reference to Working Paper A1 (New client pre-acceptance questionnaire), your concerns regarding the acceptance of Groen Plaas as audit client.*"

- This part of the question was poorly answered. This was disappointing considering that a similar question even though the scenario is different is in tutorial letter 102.
- ISQC 1 headings were not applied in answering this part of the required.
- Students who used heading did not know what to discuss under the headings so they settled for a memory dump of the theory they have learnt, without any application to the scenario.
- The question required concerns and not recommendations. Many students gave recommendations. For instance, safeguards for independence threats and procedures to be performed where there is a concern. This resulted in wasting time, by writing what was not required.

Part 2(a)

The required stated: "*Identify the risk of material misstatement at the overall financial statement level of Groen Plaas.*"

- Most students battled in formulating the actual risks from the risk indicators. This is covered in detail in many questions included in tutorial letter 102 and in the table on pages 13-16.

- As students battled to identify risk at the financial statement level, they settled for writing risk at the assertion level. Risk at the assertion level was asked in required 2(b) so, if students wrote them in this part of the required, no marks were awarded.

- Some students did very well in this part of the question and scored good marks. Well done!

Part 2(b)

The required stated: "*Identify the risk at the assertion level that relates to the items of property, plant and equipment and the operating lease expenses of Groen Plaas.*"

- Most students gave an explanation of the assertion as per IAS 315 para A111 instead of making it relevant to the scenario. For instance, the students wrote, "Valuation – there is a risk that PPE is not valued correctly", without explaining further why PPE might not be valued correctly.

- Students went even further to discuss the operating lease when the required specifically asked for operating lease expense.

- Students also battled to note that PPE is an account balance and operating lease expense is a class of transaction.

- We recommend that students study that memorandum in detail especially relating to this part of the required.

- Similar questions are often asked in exams and in the QE and therefore it is important that you master this section.

Part 2(c)

The required stated: "*Describe the matters which should be included in the agreement with Gregory Phillips, to determine clarity regarding the nature, scope and objectives of his engagement to value the Groen Plaas land*."

- This part of the question was poorly answered.

- Students had to apply their general knowledge in answering this question but battled to do so.

- All the matters entailed in the solution to this part of the required are directly from ISA 620 with application to the scenario of course. It appears that the students did not study these revised ISA at all.

- Poor time management also resulted in majority of students not answering this part of the question.
