SCHOOL OF ACCOUNTING SCIENCES

HONS BCOMPT / CTA

TEST 3: 19 JUNE 2010

TEST 3 QUESTIONS AND PROVISIONAL SUGGESTED SOLUTIONS

Dear Student

Please note that this letter includes the test 3 questions and the provisional suggested solutions. This will be replaced with the general TREKALS Tutorial Letter 305/2010 which will be completed within the next two weeks.

Once the tutorial letter is out, your marks will also be available on the internet **(www.unisa.ac.za)** under **"myUnisa"**. (Refer to section 8.2.2. [Demarcation of tests] in tutorial letter 301/2010.)

Best wishes

YOUR LECTURERS

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TEST 3 WRITTEN ON 19 MAY 2010

SCHOOL OF ACCOUNTING SCIENCES
HONS BCOMPT/CTA

TEST 3: 19 JUNE 2010

PAPER 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:	Prof. Z.R. Koppeschaar	Mr. S.J. Boshoff
	Ms. A. de Wet	Mr. C.J. Els
	Mr. P.C. Malemone	Mr. J.M.L. Roux
	Ms. J. Sturdy	Ms. C. Wright
	Mr. G. Elliot	
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 5 pages and is out of 40 marks.

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

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NB:

a) This question paper is written continuously for one hour, i.e. there will be no breaks till 09:15.

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d) The text books **MUST** be the latest version: **2009/2010.**

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g) Flags **may** be referenced.

PAPER 1: TOE407V / ZAC407G (APPLIED FINANCIAL ACCOUNTING) **(40 marks)**

Mr A Smartie (Smartie) is the newly appointed group accountant at Whatalotigot Holdings Ltd (Whatalotigot). Whatalotigot is a listed South African company that imports and distributes sweets and chocolates. Whatalotigot's financial year-end is 28 February.

Smartie, an undergraduate friend of yours, decided not to continue with CTA and instead accepted the group accountant position at Whatalotigot. Smartie has been left in charge of finalising the group's financial statements for the year ended 28 February 2010, while the financial director is on maternity leave.

The following consolidated trial balance, as at 28 February 2010, was presented to you:

	Transaction	Dr R	Cr R
Accrued interest income	2	53 797	
Loan receivable	2	1 265 823	
Other assets		2 149 236	
Bank (Take-a-Break Ltd)	3	145 800	
Bank (Whatalotigot Ltd)	2	333 800	
Non-controlling interest (P/L)		55 888	
Income tax expense		352 000	
Ordinary interim dividends paid: 31 December 2009		60 000	
Share capital (ordinary shares)	4		400 000
10% cumulative preference shares	1		500 000
Retained earnings: 1 March 2009			1 687 000
Profit before tax			1 256 000
Non-controlling interest			452 011
Other liabilities		–	121 333
		4 416 344	4 416 344

Smartie has requested your assistance on some of the outstanding accounting issues.

Transaction 1

Whatalotigot issued 100 000 10% preference shares on 1 March 2009 at R5 per share (dividends are cumulative and compulsory). The preference shares are redeemable at the option of Whatalotigot, unless the company's share price drops to below R10 per share, in which case the preference shares are redeemable immediately. During the current financial year Whatalotigot's share price traded between R20 and R15 per share.

Smartie processed the following journal to account for the issued shares:

	Dr R	Cr R
1 March 2009		
Bank (SFP)	500 000	
Preference shares (Equity)		500 000

Smartie faintly recalls that the classification of preference shares can be problematic; however he is unsure if *IAS 32: Financial Instruments: Presentation*, will apply in this instance.

Transaction 2

Smartie finalised the bank reconciliation, except for a forex payment that he was unsure how to process:

Bank reconciliation of Whatalotigot Ltd as at 28 February 2010

	R
Balance as per bank statement	842 875
Forex payment received (Botswana Pula 253 766) per bank statement	(305 742)
Outstanding cheques and deposits	(203 333)
Balance as per general ledger (debit)	333 800

Smartie gathered the following information regarding the forex payment they received: On 1 September 2008, Whatalotigot granted a loan to a company registered in Botswana. The company is one of Whatalotigot's customers. The loan is denominated in Botswana Pula (BWP). The loan was granted at fair value (BWP 1 000 000) and is repayable in five equal instalments, payable annually in arrears on 1 September of each year. The loan bears interest at 8.5% per annum, which is market-related.

The applicable exchange rates were as follows:

	Spot rate R1 = BWP
1 September 2008	0,82
28 February 2009	0,79
31 August and 1 September 2009	0,83
28 February 2010	0,87

Average exchange rates can be assumed as the average between the two exchange rates at the beginning and end of each six-month period.

Transaction 3

Smartie discovered a file labelled "Pending transactions" in one of the filing cabinets. The file included a forward exchange contract (FEC) entered into on 1 February 2009. Smartie questioned the junior accountant about the transaction and he had the following explanation:

Take-a-Break Ltd (Take-a-Break), a 100% subsidiary of Whatalotigot, imports exclusive chocolates from Belgium. Due to the economic crisis and the anticipated increase in the price of chocolate, Take-a-Break anticipated on 1 February 2009 that the company would purchase inventory to the value of €180 000. On the same day, Take-a-Break entered into a six-month FEC to buy €180 000 in order to hedge itself against changes in the future cash flows of the highly probable forecast purchase of inventory, as well as changes in the fair value of the resulting creditor. The inventory was shipped FOB on 1 May 2009 and arrived in Durban harbour on 20 May 2009.

The creditor was settled on 1 August 2009. At inception of the hedge, the hedge met all the hedging criteria of IAS 39.88. It is the policy of the group to include amounts that result from cash flow hedges of forecasted transactions in the initial measurement of the associated asset. Take-a-Break does retrospective effectiveness on a period-by-period basis. The periods that were retrospectively tested for effectiveness are 1 February 2009 to 28 February 2009; 1 March 2009 to 1 May 2009 and 1 May 2009 to 1 August 2009. The application of IAS 39.96 did not indicate any ineffective hedging.

The applicable exchange rates were as follows:

	Spot rate €1 = R	**Forward rate €1 = R**
1 February 2009	8,85	9,00 (6 month FEC)
28 February 2009	8,90	9,06 (5 month FEC)
1 May 2009	8,93	9,10 (3 month FEC)
1 August 2009	9,05	

The above information has not been accounted for in the group's accounting records. Realising this was a mistake, Smartie wanted to demonstrate his technical accounting knowledge by preparing the disclosure for the above transaction, had it been recorded correctly.

Transaction 4

On 1 March 2009 Whatalotigot had 200 000 issued shares.

Whatalotigot made a rights issue of one ordinary share for every five ordinary shares held at R10 per share on 1 December 2009. The fair value immediately before the rights issue was R15 per share. Smartie calculated the factor with which the number of shares should be adjusted due to the rights issue, correctly as 1,05882. This transaction has not yet been accounted for in the trial balance above and Smartie requested your assistance with the calculation of basic earnings per share and dividends per share.

REQUIRED		**Marks**
Write a memorandum to Mr A Smartie in which you address the following accounting issues:		
(a)	Discuss the classification of the preference shares (**transaction 1**) in the accounting records of Whatalotigot Ltd in terms of *IAS 32: Financial Instruments: Presentation*.	7
(b)	Provide the journal entries necessary to finalise the bank reconciliation as well as the year-end entries required in terms of *IAS 21: The Effects of Changes in Foreign Exchange Rates,* with regard to the forex payment received (**transaction 2**) for the year ended 28 February 2010.	16

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PAPER 1: TOE407V / ZAC407G (APPLIED FINANCIAL ACCOUNTING) continued

		Marks
(c)	Prepare a reconciliation of the opening to closing balance of the hedging reserve column in the consolidated statement of changes in equity of Whatalotigot Holdings Ltd for the year ended 28 February 2010, indicating all movements in other comprehensive income separately. Refer to **transaction 3**.	5
(d)	Calculate the basic earnings per share and dividends per share amount that would be disclosed in the consolidated financial statements of Whatalotigot Holdings Ltd for the year ended 28 February 2010, taking into account **transaction 1 to 4**.	10
Presentation		2

Please note: Ignore taxation.
Journal narrations are not required.
Round all amounts to the nearest Rand, except part d.
Your answer should comply with International Financial Reporting Standards.

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SUGGESTED SOLUTION TO QUESTION 1: TOE407V / ZAC407G

(Presentation: Maximum 2 marks)

(a) Preference shares issued

On initial recognition the instrument should be classified based on substance over form (IAS 32 par. 15). (1)

In determining whether a preference share is a financial liability or equity instrument, an issuer assesses the particular rights attached to the share to determine whether it exhibits the fundamental characteristics of a financial liability (IAS 32 par. AG25). (1)

- A financial liability according to IAS 32 is any liability that is a contractual obligation to deliver cash/financial asset to another party, or to exchange financial instruments under unfavourable conditions, or a contract that may be settled in own equity instruments. (½)
- An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. (½)
- A financial instrument may require the entity to deliver cash or another financial asset, in the event of occurrence or non-occurrence of uncertain future events that are beyond the control of the entity – contingent settlement provisions (IAS 32 par. 25) (1)

IAS 32 requires that the two cash flow streams (component parts) of preference shares, namely dividends and principal, be considered separately for classification as equity or a financial liability. (1)

Principal amount

- There is no contractual obligation to deliver cash as the preference shares are redeemable at the option of Whatalotigot Ltd. It appears to meet the classification criteria of equity. (1)
- However, Whatalotigot Ltd does not have an unconditional right to avoid delivering cash, or another financial asset to settle the contractual obligation, as Whatalotigot Ltd does not have control over the share price in the future. (1)
- Therefore, the obligation meets the definition of a financial liability (IAS 32 par. 25). (1)

Dividend stream

- The annual payment of dividends is compulsory and therefore the cash flow stream in respect of the dividends leads to a financial liability classification. (1)

Therefore the preference shares issued by Whatalotigot Ltd should be classified as a financial liability. (1)

(10)

Maximum 7

SUGGESTED SOLUTION TO QUESTION 1: TOE407V / ZAC407G continued

(b) Journals of Whatalotigot Holdings Ltd for the year ended 28 February 2010

	Dr R	Cr R	
1 September 2009			
Bank (SFP) (given)	305 742		(1)
Accrued finance income (SFP) (given)		53 797	(1)
Interest income (P/L) (85 000 x 6/12) / [(0,79 + 0,83)/2]		52 469	(3)
Loan receivable (SFP) (168 766 / 0,83)		203 333	(1½)
Forex exchange loss (P/L) (balancing)	3 857		(½)
			(7)
Forex exchange loss (P/L)			
[1 001 487 – (1 265 823 (given) – 203 333)]	61 004		(2)
Loan receivable (SFP)		61 004	(½)
			(2½)
28 February 2010			
Accrued finance income (SFP) [(70 655 x 6/12)/0,87]	40 606		(2½)
Interest income (P/L) (70 655 x 6/12) / [(0,83 + 0,87)/2]		41 562	(2½)
Forex exchange loss (P/L) (balancing)	956		(½)
			(5½)
Forex exchange loss (P/L) (955 441 – 1 001 487)	46 045		(1½)
Loan receivable (SFP)		46 045	(½)
			(2)

Instead of the second and last journal, the restatement of the loan account could also have been performed only at year-end:

	Dr	Cr
Forex exchange loss (P/L)		
[955 441 – (1 265 823 (given) – 203 333)]	107 046	
Loan receivable (SFP)		107 049

Total 17
Maximum 16

CALCULATIONS

PV = 1 000 000, i = 8.5, n = 5, COMP PMT = 253 766
1 AMORT = 85 000 interest, 168 766 capital, 831 234 balance
2 AMORT = 70 655 interest

Explanation: ***(not required)***

SUGGESTED SOLUTION TO QUESTION 1: TOE407V / ZAC407G continued

Capital:

		BWP	Rate	R
1 Sept 08	Loan given	1 000 000	0,82	1 219 512
	Forex difference – profit (balancing)			46 311
28 Feb 09	Balance	1 000 000	0,79	1 265 823
1 Sept 09	Installment	(168 766)	0,83	(203 333)
	Forex difference – loss (balancing)			(61 004)
1 Sept 09	Balance	831 234	0,83	1 001 487
	Forex difference – loss (balancing)			(46 045)
28 Feb 10	Balance	831 234	0,87	955 441

Interest:

		BWP	Rate	R
28 Feb 09	Interest income	42 500	0,81	52 469
	Forex difference – profit (balancing)			1 328
28 Feb 09	Balance	42 500	0,79	53 797
1 Sept 09	Interest income	42 500	0,81	52 469
	Interest received	(85 000)	0,83	(102 409)
	Forex difference – loss (balancing)			(3 857)
1 Sept 09	Balance	-		-
28 Feb 10	Interest income	35 328	0,85	41 562
	Forex difference – loss (balancing)			(956)
28 Feb 10	Balance	35 328	0,87	40 606

(c) Reconciliation of hedging reserve for the year ended 28 February 2010

	Hedging reserve R	
Balance 28 February 2009 (€180 000 x (9,06 – 9,00))	10 800	(1½)
Other comprehensive income for the year	(10 800)	
Gain on cash flow hedge (€180 000 x (9,10 – 9,06))	7 200	(1½)
Basis adjustment (€180 000 x (9,10 – 9,00))	(18 000)	(1½)
Balance 28 February 2010	-	(½)
		(5)

(d) Calculation of dividends and earnings per share for the year ended 28 February 2010

Dividends per share: R60 000 / 240 000 shares = R0,25 per share (1)

Earnings per share: R749 682 (6½ marks) (C1) / 218 823 shares (2½ marks) (C2) = R3,43 per share (9)

SUGGESTED SOLUTION TO QUESTION 1: TOE407V / ZAC407G continued

CALCULATIONS

C1. Profit attributable to the parent

	R	
Profit before tax (given)	1 256 000	[½]
Tax expense (given)	(352 000)	[½]
Non-controlling interest (given)	(55 888)	[½]
Interest expense preference dividends (from part a)	(50 000)	[1]
Interest income (52 469 + 41 562) (from part b)	94 031	[½]
Forex loss – loan receivable (3 857 + 61 004 + 955 + 46 045) (from part b)	(111 861)	[½]
Forex loss – creditor (€180 000 x (9,05 – 8,93)) (from part c)	(21 600)	[1½]
Forex loss – FEC (€180 000 x (9,10 – 9,05)) (from part c)	(9 000)	[1½]
	749 682	[6½]

C2. Weighted average number of ordinary shares

(200 000 shares x 1,05882 x 9/12) + (240 000 shares x 3/12) = 218 823 shares [2½]

Explanation: ***(not required)***

Theoretical ex-rights value/share:

$$\frac{(R15 \times 200\ 000 \text{ shares}) + (R10 \times 40\ 000 \text{ shares})}{200\ 000 \text{ shares} + 40\ 000 \text{ shares}} = R14{,}167$$

Adjustment factor: $\frac{15{,}000}{14{,}167} = 1{,}05882$

TEST 3 WRITTEN ON 19 MAY 2010

PAPER 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, Ms. A. Combrink, Ms. J. Foot, Ms. A. Ravat, Ms. F. Venter, Mr. L. Crafford, Mr. A. De Graaf, Mr. S. Ndlovu, Ms. 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) paper consists of 5 pages and is out of 40 marks.

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TEST 3 WRITTEN ON 19 MAY 2010

PAPER 2: TOE408W / ZAC408H (APPLIED MANAGEMENT ACCOUNTING) **(40 marks)**

THIS PAPER CONSISTS OF TWO INDEPEDENT PARTS

PART A: **25 marks**

Dust Cloud Limited is a manufacturer of packaging materials.

The following is an extract from the Statement of Financial Position of Dust Cloud Limited as at 31 March 2010:

	R'000
Issued share capital	500 000
Reserves	240 000
500 000 preference shares	200 000
12% irredeemable debentures	400 000

The current risk-free rate on RSA Treasury bonds is 9%. The expected market return is currently 19%. Dust Cloud Limited has a Beta of 1,2.

The preference shares are not redeemable, have no conversion rights and pay a dividend of R72 per share annually. Clean Cloud Limited, a competitor of Dust Cloud Limited, has recently issued preference shares with a par value of R1 000 each that pay a dividend of R110 per share annually, which is currently considered a fair market return.

Debentures similar to those of Dust Cloud Limited are currently trading at 15%.

The directors of Dust Cloud Limited have indicated that the company is targeting a ratio of 70% equity, 10% preference shares and 20% debentures.

The company is considering a new project with a five year life. The marketing manager has prepared the following cash flow for the project:

	1 **R'000**	**2** **R'000**	**3** **R'000**	**4** **R'000**	**5** **R'000**
Sales	4 500,0	5 535,0	6 697,4	7 702,0	8 703,2
Less:	(4 612,5)	(4 955,6)	(5 284,5)	(5 484,2)	(5 744,6)
Materials	(945,0)	(1 217,7)	(1 406,4)	(1 540,4)	(1 740,6)
Employee expenses	(450,0)	(553,5)	(669,7)	(770,2)	(870,3)
Overheads	(467,5)	(524,4)	(588,4)	(643,6)	(698,7)
Research and development costs	(50,0)	0,0	0,0	0,0	0,0
Other expenses	(100,0)	(110,0)	(120,0)	(130,0)	(135,0)
Wear and tear	(2 000,0)	(2 000,0)	(2 000,0)	(2 000,0)	(2 000,0)
Interest	(600,0)	(550,0)	(500,0)	(400,0)	(300,0)
Cash flow before taxation	(112,5)	579,4	1 412,8	2 217,8	2 958,6
Tax	31,5	(162,2)	(395,6)	(621,0)	(828,4)
Cash flow after taxation	(81,0)	(417,2)	(1 017,2)	(1 596,8)	(2 130,2)

Overheads include rental of R200 000 per year (no escalation). The project will be undertaken in the existing factory and therefore a portion of the rental will be allocated to the new project,

Overheads also include overheads allocated to recover Head Office costs e.g. financial and management reporting, tax and legal compliance. The policy is to allocate an amount equal to 10% of the project overheads (including allocated rental).

Investment in plant and equipment of R10 million will be made at the start of the project. The plant and equipment will be sold for R1 million at the end of the project.

Total working capital required for the project will be as follows in each year:

Year 0	R180 000
Year 1	R220 000
Year 2	R260 000
Year 3	R300 000
Year 4	R340 000
Year 5	R250 000

The current company tax rate is 28%. Ignore capital gains tax. A tax allowance has been agreed with SARS and correctly included in the calculation. This is in line with the depreciation method. The company is making positive cash flows from other projects. There is a one year tax time lag for tax purposes.

You are to assume that all cash flows, other than the plant acquisition, take place at the end of the year.

REQUIRED		**Marks**
(a)	Calculate the target weighted average cost of capital (WACC) for Dust Cloud Limited.	(7)
(b)	Calculate the net present value of the new project and conclude whether it should be accepted or not. Assume that the target WACC is 17%. Start your calculation by using the cash flow before taxation as calculated by the marketing manager and then make the necessary adjustments and additions. Show all your workings. Clearly indicate any assumptions made.	(18)

PART B: **15 marks**

Fastpack Ltd is a company listed in the Packaging and Printing Sector of the Johannesburg Securities Exchange SA (JSE). Fastpack Ltd manufactures cardboard boxes and is one of the top performers in this segment of the market.

You have been approached to assist in preliminary negotiations for the sale of a 30% equity interest in Fastpack Ltd to Sixpack Ltd. The shares are currently held by the directors of Fastpack Ltd and you have been provided with extracts of the latest statement of financial position and statement of comprehensive income for the year just ended as well as a financial forecast for the next three years.

You have recently completed a financial analysis of Fastpack Ltd in comparison to returns of similar companies quoted on the JSE and you have ascertained the following:

Covariance of returns between Fastpack and the market	+ 0,0294
Standard deviation of returns for Fastpack	0,18
Standard deviation of returns for the market	0,14
Market returns	18%
Risk free rate	9%

PAPER 2: TOE408W / ZAC408H (APPLIED MANAGEMENT ACCOUNTING) continued

Current and forecast statements of financial position for Fastpack Ltd as at 30 April, obtained from the management accounts

	Current	Forecast		
	2010	**2011**	**2012**	**2013**
	R'000	**R'000**	**R'000**	**R'000**
Capital employed				
Issued shares	1 000	1 000	1 000	1 000
Non distributable reserves	2 000	2 000	2 000	2 000
Distributable reserves	2 200	3 000	4 000	4 500
Preference shares	2 000	2 000	2 000	2 000
Debentures	3 000	3 000	3 000	3 000
Deferred taxation	340	620	410	380
	10 540	11 620	12 410	12 880
Employment of capital				
Non-current assets	7 960	8 670	8 820	10 180
Investments	2 000	2 000	2 000	2 000
Inventory and accounts receivable	2 000	2 500	3 200	2 800
Accounts payable	(600)	(900)	(700)	(1 200)
SARS	(320)	(450)	(610)	(500)
Short-term borrowings	(500)	(200)	(300)	(400)
	10 540	11 620	12 410	12 880

Statements of comprehensive income of Fastpack Ltd for the years ending 30 April

	Current	Forecast		
	2010	**2011**	**2012**	**2013**
	R'000	**R'000**	**R'000**	**R'000**
Gross profit	7 940	10 742	14 296	8 661
Depreciation	(500)	(750)	(900)	(1 100)
Expenses	(5 580)	(6 120)	(8 628)	(4 400)
Profit before interest	1 860	3 872	4 768	3 161
Debenture interest	(780)	(780)	(780)	(780)
Other interest	(120)	(48)	(72)	(96)
Profit before taxation	960	3 044	3 916	2 285
Taxation	(320)	(740)	(950)	(560)
Profit after taxation	640	2 304	2 966	1 725
Dividend income	600	636	674	715
Dividend preference shares	(340)	(340)	(340)	(340)
Dividends ordinary shares	(400)	(1 800)	(2 300)	(1 600)
Retained income	500	800	1 000	500

PAPER 2: TOE408W / ZAC408H (APPLIED MANAGEMENT ACCOUNTING) continued

- You may assume the following for the purposes of your valuation of Fastpack Ltd:

Corporate income tax rate	28%
Target debt : equity ratio	2:3
Cash flows are expected to grow at 14% from 2013 onwards	
Target debt structure is 50% preference shares : 50% debentures	15%
Current debenture rate	12%
Current preference share return	16%
Short-term overdraft rate (prime plus)	

REQUIRED	***Marks***
Determine the free cash flow and the terminal value of Faspack Ltd for purposes of valuing the company. Show your workings and any assumptions you make in your answer.	(15)

FORMULA:

$$\beta = \frac{\text{covariance}}{\sigma^2}$$

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SUGGESTED SOLUTION TO QUESTION 2: TOE408W / ZAC408H

THE QUESTION CONSISTS OF TWO UNRELATED PARTS **40 MARKS**

General Note: Marks should not be deducted for sensible rounding

PART A **25 marks**

(a) Weighted average cost of capital (WACC)

Cost of equity (Ke) Ke = Rf + β (Rm – Rf)
= 0,09 + 1,2 (0,19 – 0,09)
= 21,0% (2)

Note: Half mark allocated per veriable: Rf + β (Rm – Rf)

Cost of preference shares (Kd) = R110 / R1 000
= 11,0% (1)

Irredeemable debentures Kd = Market interest rate after tax
= 0,15 x 0,72
= 10,8% (1)

WACC	**% Weight**	**Cost**	**Weighted**	
Equity	0,70	0,210	0,147	
Preerence shares	0,10	0,110	0,011	
Debentures	0,20	0,108	0,022	
			0,18	(3)

Target WACC = 18%

Note: 1 Mark allocated for using the target weight and one mark allocated for weighing per the "Weighted" column and one mark allocated for the correct WACC of 18%

(b) Net present value (NPV)

Alternative 1:

Year	**N**	**0** **R'000**	**1** **R'000**	**2** **R'000**	**3** **R'000**	**4** **R'000**	**5** **R'000**	**6** **R'000**	
Cash flow before taxation		-	(112,5)	579,4	1 412,8	2 217,8	2 958,6	-	(1)
Adjustments:		-	2 842,5	2 797,7	2 753,5	2 658,5	2 563,5	-	
Overheads – Rental	1	-	200,0	200,0	200,0	200,0	200,0	-	(1)
Overheads – Head Office cost	2	-	42,5	47,7	53,5	58,5	63,5	-	(2)
Wear and tear	3	-	2 000,0	2 000,0	2 000,0	2 000,0	2 000,0	-	(1)
Interest	4	-	600,0	550,0	500,0	400,0	300,0	-	(1)
		-	2 730,0	3 377,1	4 166,3	4 876,3	5 522,1	-	(2)

<u>SUGGESTED SOLUTION TO QUESTION 2: TOE408W / ZAC408H</u> continued

Alternative 2:	*1*	*2*	*3*	*4*	*5*	
	R'000	*R'000*	*R'000*	*R'000*	*R'000*	
Sales	*4 500,0*	*5 535,0*	*6 697,4*	*7 702,0*	*8 703,2*	
Less:	*(1 770,0)*	*(2 157,5)*	*(2 531,0)*	*(2 825,7)*	*(3 181,1)*	
Materials	*(945,0)*	*(1 217,7)*	*(1 406,4)*	*(1 540,4)*	*(1 740,6)*	
Employee expenses	*(450,0)*	*(553,5)*	*(669,7)*	*(770,2)*	*(870,3)*	
Overheads adjusted	***(225)***	***(276.3)***	***(334.9)***	***(385.1)***	***(435.2)***	
Overhead cost was	*(467,5)*	*(524,4)*	*(588,4)*	*(643,6)*	*(698,7)*	
Rental adjustment	*200*	*200*	*200*	*200*	*200*	*(1)*
Head office cost adjustment	*42.5*	*47.7*	*53.5*	*58.5*	*63.5*	*(2)*
Research and development costs						
Other expenses	*(50,0)*	*0,0*	*0,0*	*0,0*	*0,0*	
Wear and tear	*(100,0)*	*(110,0)*	*(120,0)*	*(130,0)*	*(135,0)*	
Interest	*0*	*0*	*0*	*0*	*0*	*(1)*
	0	*0*	*0*	*0*	*0*	*(1)*
Cash flow as per alternative 1	*2 730,0*	*3 377,1*	*4 166,4*	*4 876,3*	*5 522,1*	*(2)*

Year	**N**	**0**	**1**	**2**	**3**	**4**	**5**	**6**	
		R'000	**R'000**	**R'000**	**R'000**	**R'000**	**R'000**	**R'000**	
Tax on cash flows above	5			(764,4)	(945,5)	(1 166,6)	(1 365,4)	(1 546,2)	(2)

Note: 1 Mark allocated for calculating the tax and one mark allocated for the correct period

	N	0	1	2	3	4	5	6	
Purchase plant and equipment		(10 000,0)							
									(1)
Wear and tear – tax impact	3			560,0	560,0	560,0	560,0	560,0	(1)
Sale of plant and equipment							1 000,0		
									(1)
Recoupment	6							280,0	(1)
Working capital	7	(180,0)	(40,0)	(40,0)	(40,0)	(40,0)	90,0		(1)
Working capital released	8						250,0		(1)
		(10 180,0)	2 690,0	3 132,7	3 740,7	4 229,7	6 056,7	(1 266,2)	
Discount rate 17%									(1)
NPV		1 269.30							(1)

Conclusion: The NPV is positive and therefore the project should be accepted. <u>(1)</u>

Note: Mark allocated for the correct conclusion based on the students NPV

Max <u>25</u>

Notes:

1. Overheads – Rental

   The rental of the existing factory is a sunk cost (not relevant). The costs are therefore added back.

2. Overheads - Head Office costs

   Year 1 = 467,5 x 10 / 110 = 42,5
   Year 2 = 524,4 x 10 / 110 = 47,7
   Year 3 = 588,4 x 10 / 110 = 53,5
   Year 4 = 643,6 x 10 / 110 = 58,5
   Year 5 = 698,7 x 10 / 110 = 63,5

   Head office costs allocated to the project are not relevant and are not cash costs. The costs are therefore added back.

SUGGESTED SOLUTION TO QUESTION 2: TOE408W / ZAC408H continued

3. Wear and tear / Depreciation	Wear and tear or depreciation is not a cash cost. The wear and tear / depreciation is therefore added back. The tax impact of the wear and tear allowance is however a cash flow: = R10 million x 20% x 28% = R560 000 per year There is a one year tax time lag, therefore the cash flows take place from year 2 to year 6.
4. Interest	Interest cost is not relevant for the investment decision since it has already been taken into account in the cost of capital. The costs are therefore added back.
5. Taxation	Tax is calculated at 28%. There is a one year tax time lag, therefore the cash flows take place from year 2 to year 6.
6. Recoupment	= R1 million x 28% = R280 000 There is a one year tax time lag, therefore the cash flow takes place in year 6.
7. Working capital	Year 0 = R180 000 (given) Year 1 = R220 000 - R180 000 = R40 000 increase (cash outflow) Year 2 = R260 000 - R220 000 = R40 000 increase (cash outflow) Year 3 = R300 000 - R260 000 = R40 000 increase (cash outflow) Year 4 = R340 000 - R300 000 = R40 000 increase (cash outflow) Year 5 = R250 000 - R340 000 = R90 000 decrease (cash inflow)
8. Working capital released	The total working capital employed in the project is released at the end of the project, therefore cash inflow.

SUGGESTED SOLUTION TO QUESTION 2: TOE408W / ZAC408H continued

PART B

Calculation of discount rate at WACC

Debt:

Cost of preference shares	12,0%	(0.5)
Cost of debentures [15% x 72%]	10,8%	(0.5)

Note that we use the after tax cost of interest when calculating the cost of debentures.

Target debt cost: (12% x ½) + (10,8% x ½) = 11,4% (1)

Equity:

β = covariance/σ^2_m = 0,0294/0,14^2 = 1,5 (1)

Return = $R_f + \beta(R_m - R_f)$

= 9% + 1,5 (18% - 9%) = 22,5% (1)

Note: 0.5 Allocated to 9% and 0.5 allocated to 18%

Note: The risk-free rate has not been adjusted for tax. One could argue that it would be appropriate to take tax into account.

WACC: Debt : equity ratio is 2:3.

WACC: (11,4% x 2/5) + (22,5% x 3/5) = 18,06%. (1)

Or (11,4%x40%) + (22,5%x60%) = 18,06%

Note: Mark allocated if the ratio was correctly applied

Cash flow valuation:

Fastpack Ltd cash flow statements for the 3 year planning period

Alternative 1:

	Note	**2011 R'000**	**2012 R'000**	**2013 R'000**	
Profit before tax		3 044	3 916	2 285	
Add back depreciation		750	900	1 100	(1)
Add back long-term interest	1	780	780	780	(1)
Adjusted Profit before tax		**4 574**	**5 596**	**4 165**	(1)
Less tax	2	(548)	(1 218)	(918)	

Note: 1 Mark allocated per correct line

SUGGESTED SOLUTION TO QUESTION 2: TOE408W / ZAC408H continued

Alternative 2:

		2011 R'000	2012 R'000	2013 R'000	
Gross profit		*10 742*	*14 296*	*8 661*	
Depreciation		*0*	*0*	*0*	*(1)*
Expenses		*(6 120)*	*(8 628)*	*(4 400)*	
Profit before interest		*4 662*	*5 668*	*4 261*	
Debenture interest		*0*	*0*	*0*	*(1)*
Other interest		*(48)*	*(72)*	*(96)*	
Profit before taxation		***4 574***	***5 596***	***4 165***	*(1)*
Working capital adjustments					
Current assets		(500)	(700)	400	(1)
Current liabilities		300	(200)	500	(1)
Short-term borrowings		(300)	100	100	(1)
Cash from operations		3 526	3 578	4 247	
Movement in fixed assets	3	(1 460)	(1 050)	(2 460)	
Free cash flows		2 066	2 528	1 787	

Note: 1 Mark allocated if all 3 years is correct, only 0.5 marks if only one or two amounts are correct.

Note 1. Only long-term interest is added back as it has been included in the calculation of WACC. Short-term interest is assumed to be part of working capital and is of a temporary nature only.

Note 2. Taxation

	2011 R'000	2012 R'000	2013 R'000	
Opening balance	(320)	(450)	(610)	(0.5)
Charge for the year	(740)	(950)	(560)	(0.5)
Deferred tax (2011: 620 – 340)	280	(210)	(30)	(0.5)
Closing balance	450	610	500	(0.5)
	(330)	(1 000)	(700)	
Adjust for tax on interest (780 x 28%)	(218)	(218)	(218)	(1)
	(548)	(1 218)	(918)	

Note: 0.5 Marks allocated if all 3 years is correct and 1 mark if "Adjusted for tax"

SUGGESTED SOLUTION TO QUESTION 2: TOE408W / ZAC408H continued

Note 3. Fixed assets

	2011 R'000	2012 R'000	2013 R'000	
Opening balance	7 960	8 670	8 820	(0.5)
Less depreciation	750	900	1 100	(0.5)
NBV beginning	7 210	7 770	7 720	
NBV end	8 670	8 820	10 180	(0.5)
Purchases	1 460	1 050	2 460	(1.5)

Note: 0.5 Marks allocated per correct purchase

Valuation:	2011 R'000	2012 R'000	2013 R'000	
Free cash flows	2 066	2 528	1 787	
Discount factor (18%)	0,85	0,72	0,61	(1)
Discounted cash flows	1 750,8	1 815,6	1 087,6	

Note: 1 Mark allocated if the correct discount rate of 18% was used

NPV = R4 654 000

Terminal value at 2013

Future cash flow R1 787 000 x 114% = R2 037 180 (1)

Note: 1 Mark allocated if future cash flow was adjusted with 14% growth

WACC = 18%
G = 14%
Therefore: R2 037 180/(0,18 – 0,14) = R50 929 500 (2)

Note: 0.5 Marks allocated for 18%, 0.5 marks allocated for 14% and 1 Mark if the future cash flow calculated above was used correctly.

PV at 30 April 2010

R50 929 500 x 0,61 = R31 066 995 **or** R 30 997 266 (1)

SUGGESTED SOLUTION TO QUESTION 2: TOE408W / ZAC408H continued

Note: 1 Mark is allocated for using 0.61 (or 0.609), **or if the correct steps were shown per the calculator.**

FV= R50 929 500
n = 3
i =18%
PV= R 30 997 266

Max 15
Total 40

TEST 3 WRITTEN ON 19 MAY 2010

PAPER 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: Ms. A.I. Becker, Prof. J.M.P. Venter, Ms. O. Swart

SECOND EXAMINER: Prof. M. J. Nieuwoudt

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) paper consists of 4 pages and is out of 40 marks.

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

This test paper remains the property of the University of South Africa and may not be removed from the test venue.

NB:

a) This question paper is written continuously for one hour, i.e. there will be no breaks till 11:45.

b) No student will be allowed to enter the venue after 10:45, once the test has commenced and no student will be allowed to leave the venue during the duration (10:45 – 11:45) of the test.

c) The test is a limited open-book test: Students are allowed to take in **ONE COPY** of the 2009/2010 version of the SAICA Legislation Handbook (two volumes) and the SAICA Handbook (five volumes: Volumes 1A, 1B, 1C, 2 and 3) into the venue.

d) The text books **MUST** be the latest version: **2009/2010.**

e) **No writing** is allowed in these text books.

f) Students are **allowed to highlight, underline, sideline and flag** in the above mentioned permitted texts.

g) Flags **may** be referenced.

TURN OVER

TEST 3 WRITTEN ON 19 MAY 2010

PAPER 3: TOE409X (APPLIED TAXATION) **(40 Marks)**

Plastic Ltd (a South African resident company) is a registered vendor for Value Added Tax (VAT) purposes and all amounts in the question exclude VAT, except where indicated otherwise.

Plastic Ltd (Plastic) manufactures plastic household products. This process is classified as a "process of manufacture" for purposes of the Income Tax Act. Plastic has a 30 April year-end and is not a small business corporation in terms of the Income Tax Act.

The financial accountant of Plastic, Andrew, calculated the profit before tax of Plastic as R42 820 400 for the year of assessment ended 30 April 2010. Plastic had an assessed capital loss (as envisaged in paragraph 9 of the Eighth Schedule to the Income Tax Act) of R150 000 for the 2009 year of assessment.

As Andrew was uncertain as to the correct tax treatment of the following items, these items have not yet been included in the calculation of the above profit before tax of Plastic.

Plastic would like to minimise its normal tax liability whenever possible.

1. Importation of manufacturing machine

On 1 March 2009 ("transaction date") Plastic purchased a new manufacturing machine for €200 000 from an independent supplier in Germany and on this date paid a deposit of €150 000. The remaining €50 000 was paid when it was shipped to South Africa on 1 July 2009. On 1 September 2009 the machine was cleared by Customs for home consumption after Plastic paid the duty (levied in terms of the Customs and Excise Act) of 20% on the customs duty value (R2 280 000) as well as the VAT in respect of the importation. On 1 September 2009 the machine was brought into use in the manufacturing process.

Plastic obtained a short-term loan from a local bank on 1 March 2009 in order to pay the deposit of €150 000 and incurred interest as follows:

	R
1 March 2009 until 30 April 2009	17 000
1 April 2009 until 31 August 2009	34 000
1 September 2009 until 30 September 2009 (after which the loan was repaid)	8 500

Plastic did not have to borrow money in order to pay the remaining €50 000.

The exchange rates were as follows:

1 March 2009	€1 = R11.00
30 April 2009	€1 = R12.80
1 July 2009	€1 = R12.00
1 September 2009	€1 = R11.40
30 September 2009	€1 = R11.50

Average exchange rate for Plastic's 2009 year of assessment was €1 = R10.00.
Average exchange rate for Plastic's 2010 year of assessment was €1 = R12.00.

2. Second-hand plant

On 1 October 2009 Plastic purchased plant from Tupper Ltd for R250 000. Plastic brought the plant into use in its process of manufacture on the same day. This plant was independently valued at a market value of R220 000 on 1 October 2009. Tupper Ltd holds 60% of the shares in Plastic.

Tupper Ltd purchased this manufacturing plant new on 1 January 2008 for a cash cost of R200 000. It was brought into use immediately. Tupper Ltd's year of assessment ends on the last day of February.

3. Residential property

3.1 Plastic rents a house for R5 000 per month from an independent letting agent. This house was made available to the managing director as a fringe benefit for the full 12 months of the 2010 year of assessment. The taxable value of the fringe benefit amounts to R5 250 per month, calculated in terms of the Seventh Schedule.

3.2 On 1 November 2008 Plastic bought five (5) flats in a newly erected building from the developer at a total cost of R245 000 each. Four (4) of these flats were rented out to employees for R2 000 each per month, effective from 1 December 2008. The other flat was immediately sold to Andrew (the financial accountant) for R230 000, financed by an interest-free loan. Andrew repaid R60 000 of the loan in the 2010 year of assessment. Plastic does not own any other residential units within the Republic.

4. Factory buildings and improvements to leasehold property

On 1 December 2007 Plastic purchased a plot of land for R500 000. Erection of a factory on this land commenced on 1 January 2008. It was completed on 31 August 2008 at a cost of R2 000 000. The factory was brought into use in a process of manufacture on 1 September 2008.

As a result of continued unrest in the vicinity of this factory, the board of directors of Plastic decided on 1 July 2009 to dispose of the land and buildings as soon as possible. The land and buildings were sold to a non-connected party on 30 September 2009 for R2 200 000, of which R300 000 was for the land and R1 900 000 for the buildings. Plastic continued to use the land and buildings in its process of manufacture for the period 1 July 2009 to 31 January 2010.

In anticipation of the proposed sale Plastic, on 1 September 2009, entered into a 30-year operating lease agreement with Blue Mountain Ltd for the lease of an industrial site. This lease agreement stipulated that Plastic would:

- pay a premium of R75 000 on 1 September 2009;
- erect a factory on the site at a cost of R3 200 000; and
- from 1 September 2009, pay an 18-month rental in advance of R252 000 (subject to an escalation of 5% for each 18-month period).

Erection of the factory commenced on 1 October 2009. It was completed on 31 January 2010. The factory was brought into use on 1 February 2010. The cost of the factory was R3 500 000.

TURN OVER

5. Investment in a Venture Capital Company ("VCC")

On 15 December 2009 Plastic paid R200 000 to obtain 10% of the shares in an approved VCC. Tupper Ltd (refer note 2) holds 20% of the shares in the same VCC. On 31 January 2010 Plastic acquired a further 15% of the shares in the VCC for R300 000.

6. Lump sum paid to retired employee

Plastic covers as part of the company's retirement benefit plan for employees, post-retirement medical aid contributions. This is done by paying a lump sum directly to the retired employee out of which the employee then funds his post-retirement medical aid contributions. On 31 January 2010 Plastic paid a lump sum (to fund post-retirement medical aid contributions) of R180 000 to Joshua Randals who retired at the age of 65.

7. Learnership agreement

Martha Lerato (who is disabled) has been in the employment of Plastic since 1 January 2008. Martha receives remuneration of R150 000 per annum. On 1 April 2008 Martha entered into a 24 month learnership agreement with Plastic. She successfully completed the learnership agreement on 31 March 2010.

REQUIRED	**Marks**
Calculate the taxable income of Plastic Ltd for the year of assessment ended 30 April 2010. **Round-off all amounts to the nearest Rand and show all your calculations.**	40

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TEST 3 WRITTEN ON 19 MAY 2010

SUGGESTED SOLUTIONS TO QUESTION 3: TOE409 (APPLIED TAXATION)

	Description and break down of marks	**R**	**R**	***Total marks***
	Accounting taxable income		42 820 400	
1	**Importation of manufacturing machine**			
	Section 12C-allowance			
	Cost of machine:			
	Purchase price (€200 000 x 11)	2 200 000	(√)	(1)
	Customs Duty (R2 280 000 x 20%)	456 000	(√)	(1)
		2 656 000		
	(VAT not taken into account as the full input tax would have been claimed)			
	Section 12C-allowance @ 40% as new machine only brought into use during 2010 year of assessment: - R2 656 000 x 40%(√)		(1 062 400)	(1)
	Interest	If R59 500 award both marks		
	Pre-production interest (section 11(*b*A)) (R17 000 + R34 000)		(51 000) (√)	(1)
	Post-production interest (section 11(*a*))		(8 500) (√)	(1)
	Exchange difference on creditor (section 24I)	If any profit/loss wrong deduct 1 mark		
	Loss on transaction date (€50 000(√) x (R11.00(½) – R12.80(½)))		(90 000)	(2)
	(Claim loss in 2010 year of assessment as machine brought into use on 1 September 2009 (section 24I(7)))			
	Gain on realisation date - (€50 000 x (R12.80(½) – R12.00(½)))		40 000	(1)
	OR €50 000(√) x (R11.00(√) – R12.00(√)) = R50 000 loss)			
	(Note that there is no exchange difference on the loan as it is a local loan)			
2	**Second-hand plant**			
	Section 12C applicable as second-hand plant used in manufacturing process.			
	Plant acquired from a connected person as defined (Tupper Ltd holds a 60% interest in Plastic Ltd), therefore section 23J is applicable.			

SUGGESTED SOLUTIONS TO QUESTION 3: TOE409 (APPLIED TAXATION) continued

	Section 12C allowance based on lesser of:					
			R			
	Cost to Plastic;			250 000		
	Or					
	Cost of asset to Tupper			200 000	(√)	(1)
	Less:allowances granted to Tupper (section 12C)			(160 000)	(√)	(1)
	2008 (R200 000 x 40%)		80 000			
	2009 (R200 000 x 20%)		40 000			
	2010 (R200 000 x 20%)		40 000			
			160 000			
			R	**R**	**R**	
	Add: recoupment on disposal of asset (section 8(4)(*a*))			160 000		(2)
	Selling price		250 000			
	Less: tax value (R200 000 – R160 000)		(40 000)	(√) mark through		
			210 000			
	Limited to R160 000 (allowances claimed)		160 000	(√) mark through		
	OR Tax value R40 000(√) mark through *less selling price limited to cost R200 000*(√)					
		R	**R**			
	Add: taxable capital gain to Tupper			10 000		
	Proceeds @ market value (par 38 of the Eigtht Schedule)	220 000	(√)			
	Less: recoupment	(160 000)	60 000			(1)
	Less: Base cost	200 000				
	Less: section 12C-allowances	(160 000)	(40 000)	(√) principle base cost less allowances claimed		(1)
	Capital gain		20 000			
	Taxable capital gain R20 000 x 50%√		10 000			(1)
				210 000		
	Therefore section 12C-allowance calculated on R210 000					
	R210 000 x 20%(√) (second-hand plant)				(42 000)	(1)
3	**Residential property**					
3.1	***Rent*** R5 000 x 12				(60 000)(√)	(1)
	(Tax value of fringe benefit no effect as section 18(3) of VAT Act not applicable as residential accommodion is an exempt supply.)					
3.2	***Residential units***					
	Residential units rented					
	Rent received R2 000 x 4 x 12 months				96 000(√)	(1)
	(Section 13*sex* does not apply as Plastic does not own at least 5 residential units within the Republic.)					

SUGGESTED SOLUTIONS TO QUESTION 3: TOE409 (APPLIED TAXATION) continued

	Residential unit sold on interest-free loan			
	The unit qualifies as a "low cost residential unit", as defined in section 1 of the Income Tax Act as the cost of the unit does not exeed R250 000.			
	Section 13*sept* allowance			
	Low cost residential unit sold on an interest-free loan to employee in previous year of assessment			
	(R230 000 – R60 000) (√) x 10%(√) (section 13*sept*(2)).		(17 000)	(2)
	Section 13*sept*(4) – recoupment of section 13*sept* allowance			
	Repayment of R60 000, limited to allowances claimed to date, thus R23 000(√) (R230 000 x 10%) (2009) + R17 000(√) mark through (2010)		40 000	(2)
		R	**R**	
4	**Factory buildings and improvements to leasehold property**			
	Existing factory building			
	Cost of land – capital – no deduction			
	Cost of factory buildings	2 000 000		
	Section 13(1) allowance 2009 (R2 000 000 x 5%)	(100 000)		
	Section 13(1) allowance 2010 (R2 000 000 x 5%)	(100 000)	100 000)(√)	(1)
	Tax value	1 800 000		
	Sold 30 Sept 2009 for	1 900 000		
	Recoupment of section 13(1) allowances (section 8(4)(*a*))	100 000	(√) principle recoup selling price less tax value	(1)
	In terms of section 13(3) this recoupment of R100 000 may be deferred (see below). It does not qualify for roll-over relief in terms of par 66 of the Eighth Schedule. It also does not qualify for par 65 of the Eighth Schedule because it was not disposed of by expropriation, theft or destruction.			
	New factory buildings			
	Section 11(*f*) lease premium allowance			
	R75 000/25(½) x 8/12(½) = R2 000		(2 000)	(1)
	Section 11(*g*) leasehold improvement allowance			
	R3 200 000(½)/25(½) x 3/12 (√)= R32 000		(32 000)	(2)
	Rental deduction – section 11(*a*)			

SUGGESTED SOLUTIONS TO QUESTION 3: TOE409 (APPLIED TAXATION) continued

	Section 23H applicable Prepaid amount not for more than 6 months after year-end, and prepaid amount R140 000 (R252 000 x 10/18); therefore more than R80 000.				
	Therefore claim R252 000 (√)x 3/18 (√)= R28 000 (OR R252 000 (√)x 8/18 (√)= R112 000)			(28 000)	(2)
	Section 13(1) annual allowance:				
	Cost of factory		3 500 000		
	Less: section 11(*g*) allowance (in total)		(3 200 000)	(√)	(1)
	Less: section 13(3) deferred recoupment (see above)		(100 000)	(√) mark for deferral of recoupment – mark through	(1)
			200 000		
	Section 13(1) annual allowance: - R200 000 x 5%(√)			(10 000)	(1)
	Capital gains tax implications				
	Land:				
	Proceeds		300 000		
	Less: Base cost		(500 000)		
	Capital loss		200 000		(1)
		R	**R**	**R**	
	Factory building				
	Proceeds				
	- Received on disposal	1 900 000	(½)		
	- *Less*: recoupment	(100 000)	(½) mark through 1 800 000		(1)
	Less: Base cost				
	- Cost	2 000 000	(½)		
	- *Less*: Section 13(1) allowances claimed	(200 000)	(½) mark through (1 800 000)		
	Capital gain/loss		Nil		(1)
	Capital gains tax implications taken into account at the end of the question				
5	**Investment in Venture Capital Company ("VCC")**				
	15 December 2009				
	Plastic and Tupper together hold 30% (less than 40%) of the shares in the VCC, therefore amount is deductible (section 12J(2) and 12J(3)(*b*))			(200 000) (√)	(1)

SUGGESTED SOLUTIONS TO QUESTION 3: TOE409 (APPLIED TAXATION) continued

	31 January 2010			
	Plastic and Tupper together hold (10% + 20% + 15%) 45% of the shares in the VCC, which is more than 40%; therefore no deduction allowed – section 12J(3)(*b*)		-(√)	(1)
6	**Lump sum paid to employee**			
	Amount deductible in terms of section 12M(2)		(180 000) (√)	(1)
7	**Learnership agreement**			
	Commencement allowance - R50 000 (√) (section 12H(5)) x 11/12 (√) (section 12H(2(*b*))		(45 833)	(2)
	Completion allowance – R50 000 (section 12H(5)) x 2(√) (section 12H(4))		(100 000)	(1)
	Capital gain/loss			
	Loss on disposal of land (see number 4)	(200 000)		
	Gain/loss on disposal of factory building	-		
	Net capital loss	(200 000)		
	Add: capital loss brought forward from 2009 year of assessment	(150 000)	(√) may not deduct the loss from taxable income	(1)
	Capital loss carried forward to 2011 year of assessment	(350 000)		
	Taxable income		40 876 667 Maximum	42 40

TEST 3 WRITTEN ON 19 MAY 2010

PAPER 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 EXAMINER:	Ms. C. Roets Mr. V.M. Motholo Ms. E.A.J. Terblanche Ms. R. Van Beek	Ms. S. Hassim Mr. M.M. Mudau Ms. N.V. Thoothe
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 (Auditing) question consists of 3 pages and is out of 40 marks.

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

This test paper remains the property of the University of South Africa and may not be removed from the test venue.

NB:

a) This question paper is written continuously for one hour, i.e. there will be no breaks till 13:00.

b) No student will be allowed to enter the venue after 12:00, once the test has commenced and no student will be allowed to leave the venue during the duration (12:00 – 13:00) of the test.

c) The test is a limited open-book test: Students are allowed to take in **ONE COPY** of the 2009/2010 version of the SAICA Legislation Handbook (two volumes) and the SAICA Handbook (five volumes: Volumes 1A, 1B, 1C, 2 and 3) into the venue.

d) The text books **MUST** be the latest version: **2009/2010.**

e) **No writing** is allowed in these text books.

f) Students are **allowed to highlight, underline, sideline and flag** in the above mentioned permitted texts.

g) Flags **may** be referenced.

TURN OVER

TEST 3 WRITTEN ON 19 MAY 2010

PAPER 4: TOE412S / ZAC412D (APPLIED AUDITING) **(40 Marks)**

You are the audit senior responsible for the audit of TOE (Pty) Ltd (TOE), a construction company that specialises in civil engineering projects with specific focus on road infrastructure. TOE has been your audit client for a number of years and the year end is 28 February 2010.

Due to the large number of road infrastructure upgrades taking place and large amounts of the government budget being allocated to roads specifically, TOE has enjoyed significant growth in revenue. TOE is currently increasing its operating capacity in order to take advantage of the current government infrastructure spend.

The following is an extract from the 28 February 2010 Statement of Financial Position:

	Notes	2010	2009
Current liabilities			
• Trade creditors	1	348 460	289 700
Non-current liabilities			
• Long-term loans	2	6 500 000	2 000 000

Note 1: Trade creditors

As part of your duties on the TOE audit, you have been requested to audit a sample of the client-prepared creditor's reconciliations.

Below is one of the reconciliations from the sample you selected:

Creditor's reconciliation: DIPAC (Pty) Ltd: 28 February 2010		
		R
Balance per creditors statement at 25 February 2010		681 656
Less : payment (electronic transfer on 28 February 2010)		(123 245)
		558 411
Less : Invoice number 0623	*(a)*	(87 914)
		470 497
Less : Goods returned note 0123	*(b)*	(39 495)
		431 002
Add : Invoicing error	*(c)*	13 000
Balance as per creditors ledger 28 February 2010		444 002

(a) The goods relating to this invoice were only received by TOE on 7 March 2009 due to a strike at the DIPAC (Pty) Ltd warehouse.

(b) The batch of cement relating to this invoice was delivered to TOE on 15 February 2010. However, upon unpacking the bags of cement in March, it was discovered that the cement was dry and unusable. DIPAC (Pty) Ltd acknowledged that the damage was caused in its warehouse and agreed to take back the entire batch and credit TOE. This return relates to DIPAC (Pty) Ltd's invoice number 7782.

(c) DIPAC (Pty) Ltd undercharged on its invoice number 6891. The 10 sets of tools were charged at R144.80 each instead of R1 444.80 each, inclusive of VAT.

Note 2: Long-term loans

- In order to be able to buy the capital assets required to favourably position TOE for the growth opportunities in the sector, the company has managed to raise the following long-term loan during the year:

    - Rand Mercantile Bank R4 500 000

- The directors were also able to renegotiate the terms on the existing loan of R 2 000 000 owed to Enterprise Partners. The result of this negotiation was that the repayment date was moved from December 2010 to December 2011 and that the loan would now be secured by a bond on the company's existing Land and Buildings.

Additional information regarding the audit:

The following journal entry was selected from the general journal. This journal entry was put through by the accountant during the second week of March 2010.

Dr Audit fee	100 000	
Cr Provision for audit fee		100 000
Additional provision required		

This relates to the additional provision for audit fees. The company raised a monthly provision of R25 000 for audit fees, but as result of additional work required by management, the audit committee approved the revised audit fee.

REQUIRED

	Marks
(a) List the substantive procedures that you would perform to verify: (i) The creditors' reconciliation statement for DIPAC (Pty) Ltd; (ii) The long term loans. *(**Note**: Do not concern yourself with audit procedures relating to Presentation and Disclosure)*	 18 16
(b) List the substantive procedures that you would perform to verify the journal entry.	6

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SUGGESTED SOLUTION TO QUESTION 4: TOE412S / ZAC412D

PART A

Substantive procedures over long-term liabilities:

General procedures

1. Consider the results of the tests of controls on the long-term liabilities and the effect thereof on substantive procedures. (1)

2. Include the commentary from management confirming the appropriateness of assertions over long-term liabilities in the management representation letter. (1)

3. Test the castings and calculations on the ledger accounts. (1)

4. Agree the balance of the relevant general ledger accounts to the trial balance and financial statements. (1)

Existence/Occurrence/Obligation

1. Inspect the loan agreements with the new loan provider and note all pertinent details:
   - name of party to whom loan was made (ie Crackerjack (Pty) Ltd)
   - amount of loan and interest rate
   - repayment terms
   - security offered
   - penalties for late or non-payment
   - loan covenants, e.g. ratios that must be adhered to by Crackerjack (Pty) Ltd
   - authorisation (4)

2. Inspect the articles of association to:
   - confirm that no loan covenants have been broken (1)
   - establish the level of authority required for authorisation of the loan (1)

3. Inspect the minutes of the meeting of directors or shareholders to confirm that the loans were authorised in terms of the company's requirements. (1)

4. Inspect the cash receipts journal, deposit slip or bank statement to confirm the receipt of the R4,5 million. (1)

SUGGESTED SOLUTION TO QUESTION 4: TOE412S / ZAC412D continued

5. Inspect the agreement or correspondence pertaining to the renegotiation of the existing loan (R2 million) to:

   - confirm that it remains a long-term loan (extension of repayment date) (1)
   - note details of the encumbrance (bond) for disclosure purposes (1)

Completeness

6. Discuss the financing of the proposed expansion with the financial director to satisfy myself that it is adequately covered by the loans and any other available funds. (Is there funding that has not been accounted for and disclosed?) (1)

7. Review the financial records and minutes of meeting of directors or shareholders for evidence of unrecorded long-term liabilities. (1)

8. Enquire of management as to the existence of any finance leases or other off-balance sheet financing. (1)

9. By analysis of the "interest paid account", confirm that the long-term loans, in respect of which interest has been paid, are included in the long-term loans account balance. (1)

Valuation

10. Inspect the prior year's work papers to confirm the opening balance of R2 million. (1)

11. Obtain written "confirmation of balance" from all long-term loan providers at year-end (two loan providers). (1)

12. Confirm by inspection of the two new loan agreements that no portion of the loan is to be repaid within 12 months of the financial year-end. (If there is, recalculate the short-term portion.) (1)

13. Confirm by inspection of the loan agreements that there are no terms or conditions that may result in the effective interest rates being different to the interest rates in the contract. Loans must be amortised at the effective interest rate. (1)

Total 24
Maximum 15

SUGGESTED SOLUTION TO QUESTION 4: TOE412S / ZAC412D continued

Audit procedures on the creditors' reconciliation statement:

General procedures

1. Inspect the DIPAC (Pty) Ltd statement to confirm that:

   1.1 the statement balance is R681 656 (1)

   1.2 the statement date is 25 February 2009 (1)

2. Inspect the DIPAC (Pty) Ltd account in the creditors' ledger to confirm that the balance is R444 472. (1)

3. Review the DIPAC (Pty) Ltd account in the creditors' ledger for any unusual or unexplained entries (and if necessary, follow up with creditors personnel). (1)

4. Re-perform:

   4.1 the casts of the reconciliation and the DIPAC (Pty) Ltd account in the creditors ledger (1)

   4.2 the logic of the reconciliation (ie that amounts have been correctly added or subtracted) (1)

5. Inspect DIPAC (Pty) Ltd's March statement to confirm that the necessary adjustments for reconciling items have been made by DIPAC (Pty) Ltd, eg correcting invoicing error. (1)

6. Review TOE (Pty) Ltd's receiving records for any goods received by the company from DIPAC (Pty) Ltd between the 25 and 28 February 2009. (1)

Electronic transfer

7. Inspect TOE (Pty) Ltd's February bank statement to confirm that an amount of R123 245 was transferred to DIPAC (Pty) Ltd. (1)

8. The transfer was effected before 28 February 2009. (1)

Invoice number 0623

9. Confirm by inspection of DIPAC (Pty) Ltd's February statement, that invoice 0623 was included in the balance of R681 656 for an amount of R87 914. (1)

10. Inspect the dates (of acceptance) on the DIPAC (Pty) Ltd delivery note and corresponding TOE (Pty) Ltd goods received note to confirm that delivery only took place on 7 March 2009 and not prior to 28 February 2009. (1)

SUGGESTED SOLUTION TO QUESTION 4: TOE412S / ZAC412D continued

Goods returned note 0123

11. Inspect correspondence from DIPAC (Pty) Ltd, acknowledging that it is responsible for the damage to the bags of cement and that they will pass a credit note for the full amount. (1)

12. Inspect DIPAC (Pty) Ltd's February statement to confirm that invoice 7782 was

    12.1 included in the balance owing of R681 656 (1)

    12.2 for an amount of R39 495 (1)

13. Inspect goods returned note 0123 to confirm that it was signed by a DIPAC (Pty) Ltd official, acknowledging receipt of the returned goods was for damaged cement as supplied on invoice 7782. (1)

14. Confirm with the audit manager that the discovery of the damaged stock is an adjusting post-balance sheet (subsequent) event. (1)

    (Note: the stock of cement was on hand at 28 February 2009 and only returned after year-end. However, the damage "existed" at balance sheet date.)

Error invoice 6891

15. Inspect invoice 6891 to confirm that the tools were charged at R144,80. (1)

16. Inspect the original order for the tools (or official supplier price list) to confirm that the correct price of the tools is R14 480,00. (1)

17. Re-perform the calculation (10 x R14 335,20) to confirm the amount of the adjustment. (1)

18. Inspect correspondence notifying DIPAC (Pty) Ltd of the mistake and requesting that the correct invoice be submitted. (1)

Total 21

Maximum 18

SUGGESTED SOLUTION TO QUESTION 4: TOE412S / ZAC412D continued

PART B

Audit procedures in respect of the journal entry:

1. Consider the results of the tests of controls on the expenses and the effect thereof on substantive procedures. (1)
2. Agree the postings of the journal entries to the general ledger accounts. (1)
3. Include the commentary from management on the appropriateness of entries in the management representation letter. (1)
4. Test the castings and calculations on all relevant accounts and supporting documentation. (1)
5. Agree the balance of the relevant general ledger accounts to the trial balance and financial statements. (1)
6. Agree the amount provided to the minutes of the audit committee's meeting. (1)
7. Agree the audit fee to our fee per audit file or billing schedule. (1)
8. Ensure that the fee and the related provision is correctly disclosed as audit fee or fees for consulting and provision for audit fee. (1)

Total 8

Maximum 6