SCHOOL OF ACCOUNTING SCIENCES

HONS BCOMPT / CTA

TUTORIAL LETTER 306/2010
(TREKALS)

TEST 4 AND THE SUGGESTED SOLUTIONS WRITTEN ON 31 JULY 2010

Dear Student

This tutorial letter comprises of the fourth test that was written on 31 July 2010, as well as the suggested solutions and comments made by the markers.

Your marks are 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

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, Ms. A. de Wet, Mr. P.C. Malemone, Ms. J. Sturdy, Mr. G. Elliot, Mr. S.J. Boshoff, Mr. C.J. Els, Mr. J.M.L. Roux, 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 (Applied Financial Accounting) question consists of 6 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 9:15.

b) No student will be allowed to enter the venue after 08:15, once the test has commenced and no student will be allowed to leave the venue during the duration (08:15–09:15) 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.

PAPER 1: TOE407V / ZAC407G (APPLIED FINANCIAL ACCOUNTING)

(40 marks – 60 minutes)

The following question consists of two separate parts that do not relate to one another.

PART A **(25 marks)**

Masters Ltd ('Masters') is a new company founded by well-known persons of the golfing world. Masters is listed on the JSE. The company primarily invests in a number of diversified subsidiaries. All the companies in the group have a 30 September year-end.

Masters acquired an 87% holding in Woods Ltd ('Woods') on 1 October 2009 from Garcia Ltd ('Garcia'). The purchase agreement stipulated that the 87% interest in Woods must be settled as follows:

- A cash payment of R12 million was made to Garcia on 1 October 2009.
- An amount of R30 million will be paid to Garcia on 30 September 2015.
- Masters transferred land overlooking Green Jacket Estate, a prestigious residential development on the banks of Hartbeespoort dam, to Garcia. The land has a fair value of R50 million and a carrying amount of R42 million on 1 October 2009. The fair value increased to R55 million on 15 October 2009 when transfer was formally registered with the Deeds Office.
- An additional amount of R10 million will be paid in cash to Garcia on 31 March 2013 if the profits generated by Woods during the period 1 October 2009 to 31 March 2013, increase by 150% above the current level. The probability of this at 1 October 2009 is 45%. The fair value of this obligation, taking into account the probability and time value of money, is R3 198 066.
- Masters issued 200 000 call options on its own shares to Garcia on 1 October 2009. The options entitle Garcia to take up 200 000 ordinary shares in Masters on 30 September 2010 at an exercise price of R7 per share. If the share price of Masters drops before or on 31 March 2010, additional options will be issued to Garcia in order to maintain the original value of the options issued.
- An amount of R100 000 was paid to an attorney to draw up the purchase agreement. These costs were included in the cash amount of R12 million paid by Masters.
- Woods entered into an equity-settled share-based payment scheme with its employees on 1 October 2007. Each of the 100 000 employees is entitled to 50 share options. In order for employees to benefit from the scheme they have to work for Woods for a period of four years. In terms of the purchase agreement Masters is obligated to issue replacement awards. The employees are required to work for an additional period of three years. All the employees remained on 1 October 2009, and are expected to work for the additional three years.

The abridged statement of financial position of Woods at 1 October 2009 was as follows:

Equity

	R
Share capital (10 000 000 shares)	5 000 000
Retained earnings	55 957 000
Total equity	60 957 000

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

The net asset value of Woods is considered to be fairly valued with the exception of the following:

- Woods has owner-occupied property, consisting of land and buildings, with the following relevant information on the 1 October 2009:

	Cost (Post 1/10/2001) R	Carrying amount R	Fair value R	Residual value R
Land	19 million	19 million	25 million	-
Buildings	32 million	28 million	44 million	36 million

  It is the accounting policy of both Masters and Woods to account for property, plant and equipment using the cost model in terms of IAS16: *Property, plant and equipment*.

  SARS does not allow any tax allowances on the land or buildings of this nature.

- At acquisition Woods is facing legal action from Ellen Ltd due to a deal that went sour. The amount of the claim is R5 million. The legal advisors of Woods are of the opinion that there is a 30% chance that the claimant will be successful with its case. After talks with their legal team Woods is contemplating taking out insurance to cover the claim. An independent insurer has quoted a once-off premium of R750 000. SARS will not allow any deductions relating to the claim or the once-off premium.
- Woods is leasing its office building from Silver Bear (Pty) Ltd in terms of an operating lease agreement. Woods is paying monthly rentals of R1 000 000. At 1 October 2009 the remaining lease term is seven years. Market-related rentals on similar property is R1 250 000 per month.

1 October 2009	**R**
Present value of the remaining lease rentals at the rate implicit in the lease	19 278 591
Present value of the difference between the remaining market related rentals and the rentals per the agreement, at 10%	15 059 167

- The success of Woods is largely due to its workforce. Their staff have been trained by the best to be the best. Masters has taken note of this, and it is as a crucial reason for acquiring Woods. Woods has determined that in order to replace their workforce, to the same standard that they currently operate, would cost R6 000 000 (Masters accept this as the fair value).
- Another reason why Masters was interested in Woods is their huge customer data base. An independent valuer determined the fair value of the customer data base at R5 000 000. It can be assumed that customer data bases are frequently exchanged. Woods has signed confidentiality agreements with all its customers preventing them from exchanging information with third parties.

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

- At 1 October 2009 Woods had a defined benefit plan liability. The amount of the liability has been correctly calculated as follows:

	1 October 2009 (R)
Present value of the defined benefit obligation	2 460 000
Fair value of plan assets	(1 830 000)
	630 000
Unrecognised actuarial gains	850 000
Unrecognised past service costs	(40 000)
Carrying amount 1 October 2009	1 440 000

Additional information

- Unless stated otherwise assume a market related rate of 10% per annum, compounded annually.
- It is the accounting policy of Masters to measure non-controlling interest at fair value on acquisition date.
- Assume a tax rate of 28%.
- The following information relates to Masters:

	R
Fair value of Masters shares (per share)	
1 October 2009	15
31 March 2010	14,20
Fair value of call options to Garcia (per option)	
1 October 2009	6
31 March 2010	5,30
Fair value of options to employees (per option)	
1 October 2009 (Excluding the vesting condition)	6,50
1 October 2009 (Including the vesting condition)	5,50

- The following information relates to Woods:

	R
Fair value of Woods shares (per share)	
1 October 2009	9
Fair value of the options to employees (per option)	
1 October 2009 (Excluding the vesting condition)	4
1 October 2009 (Including the vesting condition)	3

REQUIRED

		Marks
(a)	Prepare the journal entries to account for the acquisition of Woods Ltd, as required in the separate financial statements of Masters Ltd on 1 October 2009, in accordance with IFRS 3: *Business combinations*.	10
(b)	Prepare the at acquisition consolidation journal entries that are required on 1 October 2009, in order to include Woods Ltd in the consolidated financial statements of the Masters Ltd group. Journals and deferred tax calculation should also include applicable items which have no value.	15

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

Please note: Round off to the nearest Rand.

PART B (15 marks)

Kalahari Limited is a diverse company with a number of investments in subsidiaries that make up the Kalahari group of companies. Kalahari Limited is listed on the JSE Limited and has a 30 June year-end. The following relates to specific transactions of the group:

Manager incentive scheme

On 1 June 2006 Kalahari Limited granted each of its 30 senior managers the right to either a cash payment equal to the value of 300 shares or alternatively 400 actual shares. The terms of the arrangement provide Kalahari Limited with the choice of settlement. Kalahari limited has no obligation to settle in cash and never had a policy or past practice to settle similar grants in cash.

The grant is conditional upon the completion of three years service with Kalahari Limited. If the shares are to be issued on vesting date, the shares must be held for three years after completion of the vesting period.

Share prices and fair values of the ordinary shares of Kalahari Limited were as follows:

	Share price R	Fair value after taking post-vesting transfer restriction into account R	Fair value without taking post-vesting transfer restriction into account R
1 June 2006	26	25	26
30 June 2007	29	28	29
30 June 2008	30	29	30
31 May 2009	34	32	34

During the period 1 June 2006 and 30 June 2006 none of the senior managers resigned. During 2007-financial year only one senior manager resigned and Kalahari Limited estimated at 30 June 2007 that 95% of its remaining senior managers would complete the three years service period. At 30 June 2008 this estimate was revised to only 90%, although none of the senior managers resigned during the year. On 1 January 2009, after turning his hobby into a profitable business, one senior manager with 25 years of service resigned with immediate effect from Kalahari Limited.

Kalahari Limited chose share settlement on 31 May 2009.

Employee share scheme

On 1 July 2008, Kalahari Limited granted 120 share options to 60 of Sahara Limited's employees, an 80% subsidiary of Kalahari Limited. On the vesting date the shares will be issued to the employees of Sahara Limited who have met the vesting condition. The condition of the grant was that only those employees that remain in the employment of Sahara Limited until 1 July 2009 will receive the shares. On 1 July 2009, all 60 employees met the condition and received their shares.

REQUIRED

		Marks
(a)	Calculate the expense amount that will be included in the Kalahari Ltd's statement of comprehensive income for the year ended 30 June 2009, relating to the manager incentive scheme. (UP 2009 – adapted)	6
(b)	Discuss the accounting treatment (classification, recognition and measurement) of the employee share scheme in the separate accounting records of Kalahari Ltd and Sahara Ltd as well as the Kalahari consolidated records, in terms of *IFRS 2: Share-based payment,* for the year ended 30 June 2009. (UOFS 2009 – adapted)	9

Please note: Ignore taxation.

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

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SUGGESTED SOLUTIONS TO PAPER 1: TOE407V / ZAC407G

PART A

(a)

	Dt	Kt	
	R	R	
Investment in Woods Ltd (SFP) (Balancing figure)	91 232 284		(1)
Legal expenses (P/L)	100 000		(1)
Bank (SFP)		12 000 000	(1)
Liability (SFP) [C1]		16 934 218	(2½)
Land (SFP)		42 000 000	(½)
Gain on land transferred (P/L)		8 000 000	(½)
Contingent consideration liability (SFP)		3 198 066	(1)
Options (SCE) [C2]		1 200 000	(1½)
Share-based payment reserve (SCE) [C3]		8 000 000	(4)
		Available	13
(Recognise the acquisition of B Ltd)		**Maximum**	10

(b)

	Dt	Kt	
	R	R	
Share capital (SCE)	5 000 000		(½)
Retained earnings (SCE)	55 957 000		(½)
Land (SFP) [C4.1]	6 000 000		(1)
Buildings (SFP) [C4.2]	16 000 000		(1)
Contingent liability (SFP)		750 000	(1)
Intangible asset (SFP) – Operating lease	15 059 167		(1)
Intangible asset (SFP) – Workforce	-		(1)
Intangible asset (SFP) – Customer data base	-		(1)
Defined benefit plan (SFP) [C5]	810 000		(1½)
Deferred tax (SFP) [C6]		8 083 367	(6½)
Goodwill (SFP) (Balancing figure)	12 939 484		(1)
Investment in Woods Ltd (Part (a))		91 232 284	(½)
Non-controlling interest (SFP) [C7]		11 700 000	(2)
		Available	18½
(At acquisition elimination journal of Woods Ltd)		**Maximum**	15

CALCULATIONS

C1. Liability – Deferred settlement

FV = 30 000 000 [½]
I = 10% [½]
N = 6 [½]
P/Y = 1
Pmt = 0
∴ PV = 16 934 218 [½]

SUGGESTED SOLUTIONS TO PAPER 1: TOE407V / ZAC407G continued

C2. Equity instrument – Share options

200 000 [½] x 6 [½] = 1 200 000

C3. Share-based payment

Fair value of the acquiree awards (100 000 [½] x 50 [½] x 4 [½])	20 000 000	
Vesting period completed at acquisition date	2	[½]
It will be the greater of:		
Total vesting period (2 completed + 3 Additional)	5	[1]
Original vesting period	4	[½]
Included in consideration (20 000 000 x 2/5)	8 000 000	

C4. Owner-occupied property

	Land		Building	
Fair value 1/10/09	25 000 000	[½]	44 000 000	[½]
Carrying amount 1/10/09	19 000 000	[½]	28 000 000	[½]
Fair value adjustment	6 000 000		16 000 000	
	[C4.1]		[C4.2]	

C5. Defined benefit plan

Unrecognised actuarial gains	850 000	[½]
Unrecognised past service costs	(40 000)	[½]
	810 000	

OR

Carrying amount in Woods	1 440 000
Present value of obligation	(2 460 000)
Fair value of plan assets	1 830 000
Adjustment for IFRS 3	810 000

SUGGESTED SOLUTIONS TO PAPER 1: TOE407V / ZAC407G continued

C6. Deferred tax

	Carrying amount	Tax base	Temporary difference	Deferred tax @28%/14%	
Land – Fair value	6 000 000	-	6 000 000	840 000	[1]
Land – Cost	19 000 000	19 000 000	-	Initial recognition exemption	
Building	44 000 000	28 000 000	16 000 000	2 800 000	
Above residual	8 000 000	-	8 000 000	2 240 000	[½]
Cost to residual	4 000 000	-	4 000 000	560 000	[½]
Up to cost	4 000 000	-	4 000 000	Tax provided for at 0%	[½]
Historic carrying amount	28 000 000	28 000 000	-	Initial recognition exemption	[½]
Contingent Liability	750 000	750 000	-	Initial recognition exemption	[1]
Intangible Asset – operating lease	15 059 167	-	15 059 167	4 216 567	[1]
Defined Benefit Liability	810 000	-	810 000	226 800	[1]
				8 083 367	

C7. Non-controlling interest

10 000 000 [½] x 13% [½] x 9 [½] = 11 700 000

PART B

(a) Calculation of manager incentive scheme expense for the year ended 30 June 2009

	R	
Expense for 2009		
2009: 28 employees x 400 shares x R25 FV x 36/36	280 000	(2)
2008: (29 x 90%) x 400 shares x R25 FV x 25/36	181 250	(2)
Expense until 31 May 2009 (vesting date)	98 750	
Settlement in shares at 31 May 2009		
Fair value of share alternative (28 x 400 x R32)	358 400	(1½)
Fair value of cash alternative (28 x 300 x R34)	285 000	(1½)
Additional expense to be recognised	72 800	
Share-based payment employee benefits expense [98 750 + 72 800]	171 550	[7]

SUGGESTED SOLUTIONS TO PAPER 1: TOE407V continued

(b) Share-based payment transactions among group entities

According to IFRS 2 par. 3A, a share-based payment transaction may be settled by another group entity on behalf of the entity receiving the goods or services. If this is the case, both entities will apply IFRS 2 in accounting for the share-based payment transaction. Sahara Ltd receives the services and Kalahari Ltd has the obligation to settle the share-based payment transaction. Therefore, Kalahari Ltd and Sahara Ltd should apply IFRS 2 to the share-based payment transaction. (2)

Sahara Ltd

The entity receiving the services, Sahara Ltd, should measure the services received as equity-settled or cash-settled by assessing:

- The nature of the award; and
- its own rights and obligations.

The entity receiving the services, Sahara Ltd, should measure the services received as equity-settled when:

- The award granted are its own equity instruments; or
- The entity has no obligation to settle the share-based payment transaction.

In all other circumstances the share-based payment transaction should be measured as a cash-settled share-based payment transaction. (IFRS 2 par. 43B)

Sahara Ltd has no obligation to issue its own shares or acquire shares in Kalahari Ltd to settle the share options issued to its employees. Therefore the transaction will be measured as an equity-settled share-based payment transaction in Sahara Ltd's accounting records. (1)

Services received from employees do not qualify for recognition as an asset, thus the services should be recognised as an expense. A corresponding increase in equity should also be recognised as a "contribution from Kalahari Ltd". (1)

As the fair value of services from employees cannot be reliably measured, Sahara Ltd will measure the share-based payment transaction with reference to the fair value of the equity instruments at grant date. (1)

The vesting condition represents a "service condition" as the employees are required to work for Sahara Ltd. The expense is recognised over the vesting period of one year. (1)

Kalahari Ltd

The entity settling the share-based payment transaction, Kalahari Ltd, when another entity receives the services, should recognise the transaction as equity-settled, only if it is settled in the entity's own equity instruments. Otherwise it would be accounted for as cash-settled. (IFRS 2 par. 43C)

Kalahari Ltd has the obligation to issue its own shares to the employees of Sahara Ltd for services rendered to Sahara Ltd. Therefore the transaction will be recognised as an equity-settled share-based payment transaction in Kalahari Ltd's accounting records. (1)

SUGGESTED SOLUTIONS TO PAPER 1: TOE407V / ZAC407G continued

Kalahari Ltd should recognise an asset, namely “Investment in Sahara Ltd”. A corresponding increase in equity should also be recognised. As with Sahara Ltd the transaction will be measured at the fair value of the equity instruments at grant date. (2)

Consolidated Kalahari Group

The share options granted to the staff of Sahara Ltd represent an equity-settled share-based payment in the consolidated financial statements of the group. (1)

On consolidation the "contribution from Kalahari Ltd" in Sahara Ltd will be eliminated against the "investment in Sahara Ltd" in Kalahari Ltd. The remaining accounting entries would be the expense in Sahara Ltd and equity in Kalahari Ltd. (1)

11

Maximum 9

MARKERS COMMENTS ON PAPER 1: TOE407V

General

- Writing in pencil will not be marked.
- If the question requires that a note to the financial statements should be prepared and only calculations are done, 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

- There are still students who do all the calculations for the journals but then they don't do the journals which were required. No marks will be awarded if students did not answer what was required.
- In part (a) some students did the consolidation journals where the journals in the separate financial statements were required - please ensure that you read the required carefully.

- Most students did not correctly calculate the deferred tax on the buildings:

  - Historic carrying amount (R28 000 000) = initial recognition exemption
  - Historic carrying amount to cost (R32 000 000 - R28 000 000) = tax at 0%
  - Cost to residual (R36 000 000 - R32 000 000) = tax at 14% (CGT)
  - Above residual (R44 000 000 - R36 000 000) = tax at 28%

Part B

- Students generally did reasonably well in part (a) of this question.
- In part (b) a lot of students only copied the theory from the standard and did not apply the theory to the question.
- A lot of students discussed the accounting treatment of the employee share scheme in the **separate** accounting records of Kalahari Ltd and Sahara Ltd, but did not discuss the accounting treatment in the **consolidated** records of the Kalahari Ltd Group.

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	Mr. L. Crafford
	Ms. A. Combrink	Mr. A. De Graaf
	Ms. J. Foot	Mr. S. Ndlovu
	Ms. A. Ravat	Ms. F. Tayob
	Ms. F. Venter	
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 (Applied Management Accounting) paper consists of 4 pages and is out of 40 marks.

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NB:

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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.

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

The Theatre Group (Pty) Ltd operates ten theatres in major cities in South Africa. The company was established by a group of entrepreneurs with significant experience in the performing art industry. The company's first theatre was opened in 2006 and immediately became popular amongst theatre lovers. The success of the first venue led to The Theatre Group (Pty) Ltd opening a further nine theatres over the next three years.

The Theatre Group (Pty) Ltd theatres offer patrons the opportunity to enjoy high quality theatrical productions. Except for the current year, the company has flourished at a time when theatre attendance generally has been on the decline. The Theatre Group's shows have entranced audiences due to the quality of productions and the brilliance of cast members. Patrons are permitted to purchase alcoholic and other beverages on the premises to consume before and during shows. However, The Theatre Group does not serve food or meals.

The company commissions independent contractors to write and produce musical shows on an annual basis. All rights to such shows are owned by The Theatre Group (Pty) Ltd and these shows may only be staged at its theatres. Independent contractors are paid a fixed amount per new show for their creative work. The company has its own casting directors, musical directors and choreographers who select cast members and direct and rehearse their performances. The company offers musicians and artists contract employment for the duration of shows, and hence does not offer them permanent employment.

The Theatre Group (Pty) Ltd has approximately five different shows running at its theatres nationally, at any point in time. These shows are rotated amongst the different theatres and care is taken to ensure that the same shows are not featured at theatres in close proximity to each other. The company commissions four new musical shows per year to continually provide patrons with opportunities to see new musicals.

Each theatre can accommodate 350 patrons and has standardised décor. The company has historically leased premises and lease agreements are generally for ten-year periods with five-year renewal options. The Theatre Group (Pty) Ltd is planning to build and own its theatres in future. This change in strategy resulted from the high cost of leasing premises. The Theatre Group (Pty) Ltd plans to build and open one new theatre with 350 seats during the 2011 financial year. The cost of erecting a theatre is estimated at R15 million. Sound equipment and furniture and fittings for a theatre are expected to cost a further R2.5 million. New theatres are to be financed by means of long-term loans from a commercial bank repayable over a ten-year period.

There are three individual shareholders who collectively own 100% of the shares in issue of The Theatre Group (Pty) Ltd. These individuals are all executive directors and are actively involved in the business.

The shareholders and executive directors of The Theatre Group (Pty) Ltd are concerned about the following issues facing the business:

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

- The financial results of The Theatre Group (Pty) Ltd for the year ended 30 June 2010 were lower than the budgeted results approved earlier by the board.
- Attendance levels at The Theatre Group's theatres have been declining over the past year. The shareholders are considering different strategies to boost attendance, including lowering ticket prices.

The budget and actual financial results of The Theatre Group (Pty) Ltd for the year ended 30 June 2010 as well as the draft budget for the 2011 financial year are summarised below:

DETAILED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED / ENDING 30 JUNE

	Notes	Budget 2010 R'000	Actual 2010 R'000	Budget 2011 R'000
Revenue		70 000	69 087	85 500
Ticket sales	1	60 000	57 561	67 500
Beverage sales		10 000	11 526	18 000
Cost of sales		(26 900)	(29 704)	(33 926)
Ticketing agent commission	1	(2 500)	(2 651)	(3 000)
Contractors fees for new shows		(1 000)	(1 100)	(1 200)
Beverage costs		(5 000)	(5 159)	(8 026)
New show stage props	2	(400)	(646)	(700)
Musicians and artist fees		(18 000)	(20 148)	(21 000)
Gross profit		43 100	39 383	51 574
Overheads		(38 638)	(39 943)	(46 204)
Depreciation	3	(1 838)	(1 754)	(3 748)
Marketing costs	4	(1 000)	(1 242)	(2 000)
Salaries and wages		(8 000)	(8 912)	(9 000)
Rental of premises	5	(20 000)	(20 800)	(22 256)
Travelling and accommodation	4,6	(4 000)	(4 135)	(4 500)
Utility costs	4	(1 000)	(980)	(1 200)
Other overheads	4	(2 800)	(2 120)	(3 500)
Profit from operations		4 462	(560)	5 370
Net interest income/finance costs		250	54	(1 500)
Profit before tax		4 712	(506)	3 870

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

Notes

1. Although The Theatre Group does sell tickets directly, the majority of sales are through an independent ticketing agent who has a national call centre and internet-based infrastructure. Commission of 5% of the face value of tickets is paid to the independent ticketing agent. The company operated ten theatres throughout the 2010 financial year, each with a capacity of 350 seats. The budgeted and actual attendance statistics and ticket sales for the year ended 30 June 2010, and budget assumptions for the year ending 30 June 2011 are summarised below:

June year end	**Budget 2010**	**Actual 2010**	**Budget 2011**
Seats per theatre	350	350	350
Tickets sold	900 542	800 750	1 005 000
Trading weeks at each theatre	49	49	49
Theatres open and trading for the year	10	10	11
Number of shows per week at each theatre	8	8	8
Maximum number of tickets available for sale	1 372 000	1 372 000	1 509 200

2. Construction costs of stage props for new shows are expensed in the year they are incurred.

3. Depreciation is budgeted to increase significantly in 2011 because of the new theatre being opened.

4. Utility, marketing, travelling and accommodation, and other overheads costs are fixed in nature.

5. Budgeted rental escalations are 7% based on the terms of lease agreements.

6. Musicians and artists sometimes follow particular shows from theatre to theatre. The majority of travelling and accommodation costs per the statements relate to expenses incurred by cast members travelling to different cities and their accommodation costs.

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

REQUIRED		**Marks**
(a)	Calculate the number of tickets that need to be sold by The Theatre Group (Pty) Ltd in the **2011** financial year, in order to break even. Assume that 70% of all ticket sales for this year will occur through the independent ticketing agent and that finance cost represents a fixed cost. Perform calculations to 3 decimal points.	(11)
(b)	Critically analyse the actual **operating results** of The Theatre Group (Pty) Ltd for the year ended 30 June **2010** and compare the results against the budget. Perform calculations to 3 decimal points. Your answer should include –	
	(i) Calculation of all possible sales variance amounts;	(6)
	(ii) Calculation of key ratios and percentage variances;	(12)
	(iii) Commentary on the major variance amounts, ratios and percentage variances; and	(7)
	(iv) Highlight any major issues that the executive directors of The Theatre Group (Pty) Ltd should consider and address as evident from your analysis.	(4)
		40

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SUGGESTED SOLUTIONS TO PAPER 2: TOE408W / ZAC408H

Part (a)

Fixed costs		**R**	
Contractors fees for new shows		1 200 000	(½)
New show stage props		700 000	(½)
Musicians and artists fees		21 000 000	(½)
Depreciation		3 748 000	(½)
Marketing costs		2 000 000	
Salaries and wages		9 000 000	(½)
Rent of premises		22 256 000	(½)
Travelling & accommodation costs		4 500 000	
Utility costs		1 200 000	
Other overheads		3 500 000	
Interest expense		1 500 000	
		70 604 000	
Ticketing agents commission		5%	
		R	
Ticket price (Rands)	(R67 500k/1 005 000)	67,164	(1)
Beverage contribution (profit) per patron (Rands)	(R18 000k-R8 026k)/1005 000	9,924	(2)
Contribution per patron			
Direct sales	(R67,164+R9,924)	77,088	(1)
Ticketing agent	[R67,164x(100-0,05)]+R9,924	73,730	(1)

Breakeven number of tickets:
Formula: Fixed costs / weighted contribution per patron

Fixed costs 70 604 000

Weighted contribution per patron	**Revenue mix**	**Contribution per patron**	**Weighted**	
Direct sales	30%	77,088	23,126	(1)
Ticketing agent	70%	73,730	51,611	(1)
			74,737	(1)

I.e. breakeven = 944 699,4

Therefore, number of tickets to breakeven: 944 700 — If rounded up 1

Maximum **10**

SUGGESTED SOLUTIONS TO PAPER 2: TOE408W / ZAC408H continued

Part (b)

(i) **Calculation of all possible sales variances**

		R		R		Marks	
Budgeted profit per ticket	(R4712k / 900 542)	5,232	*or* (R4462k / 900 542)	4,955		1	
or Budgeted selling price per ticket	(R60 000k / 900 542)	66,627				1	
Budgeted profit		4 712 000					
Ticket sales volume variance (profit)				(522 476)	Adverse	1	Amount and description (consequential)
Profit based on budgeted profit per ticket and actual sales	(R5,232x800 750)	4 189 524				1	
Or							
Budgeted operating profit		*4 462 000*					
Ticket sales volume variance (operating profit)				*(494 284)*	*Adverse*	1	Amount and description (consequential)
Profit based on budgeted profit per ticket and actual sales	*(R4,955x800 750)*	*3 967 716*				1	
Or							
Budgeted ticket sales		*60 000 000*					
Ticket sales volume variance (revenue)				*(6 648 430)*	*Adverse*	1	Amount and description (consequential)
Ticket sales (actual volume at budgeted selling price)	*(R66,627x800 750)*	*53 351 570*				1	
Actual volume budgeted price		53 351 570				1	
Sales price variance (ticket value)				4,209,430	Favourable	1	Amount and description (consequential)
Actual volume actual price		57 561 000				1	
Beverage sales (total variance)		10 000 000	11 526 000	1 526 000	Favourable	1	Amount and description
Maximum						**6**	

SUGGESTED SOLUTIONS TO PAPER 2: TOE408W / ZAC408H continued

(ii) **Calculation of key ratios and percentage variances**

	Budget	**Actual**	**Variance**	
Tickets sold	900 542	800 750	-11,1%	(1)
Average ticket price	R66,627	R71,884	7,9%	(1)
	R'000	**R'000**		
Total revenue	70 000	69 087	-1,3%	(1)
Beverage sales	10 000	11 526	15,3%	(1)
	R	**R**		
Average beverage revenue per patron	11,104	14,394	29,6%	(1)
Ticketing agents commission as % of revenue	5,00%	5,00%		
Revenue mix (amount):	**R'000**	**R'000**		
Direct ticket sales	10 000	4 541		
Ticketing agent (R2 500k / 0,05 ; R2 651k / 0,05)	50 000	53 020		(1)
Total	60 000	57 561		
Revenue mix (tickets):	**Number of**	**Number of**		
Direct ticket sales	150 090	63 171		
Ticketing agent (R50 000k/60 000k x 900542; R53 020k/57 561k x 800 750)	750 452	737 579		(1)
	900 542	800 750		
% of total				
Direct ticket sales	16,7%	7,9%		
Ticketing agent (R50 000k/60 000k; 53 020/57561)	83,3%	92,1%		(1)
Gross profit % (R43 100k/R70 000k; R39 383k / R69 087k)	61,6%	57,0%		(1)
Gross profit on beverages (R10 000k–R5 000k)/R10000; (R11 526k-R5 159k) / R11 526k)	50,0%	55,2%		(1)

SUGGESTED SOLUTIONS TO PAPER 2: TOE408W / ZAC408H continued

	Budget	Actual		Variance	
Or beverage markup on cost	*100.0%*	*123.4%*			(1)
Musician & artist costs	18 000	20 148		11,9%	(1)
Marketing costs/revenue	1,4%	1,8%			(1)
Salaries and wages	8 000	8 912		11,4%	(1)
Total overheads	38 638	39 943		3,4%	(1)
Total fixed cost (excl finance cost)					
Contractors fees for new shows	1 000	1 100			
New show stage props	400	646			
Musicians and artists fees	18 000	20 148			
Depreciation	1 838	1 754			
Marketing costs	1 000	1 242			
Salaries and wages	8 000	8 912			
Rent of premises	20 000	20 800			
Travelling & accommodation costs	4 000	4 135			
Utility costs	1 000	980			
Other overheads	2 800	2 120			
	58 038	61 837		6,5%	(2)
Profit from operations			4 462	(560)	
Maximum					**<u>14</u>**

(iii) **Markers comments**

- Total revenue 1,3% lower than budget mainly due to reduced number of tickets sold (11,1% lower than budget). (This is particularly worrisome given high fixed costs and high breakeven point.) (1)
  An increase in ticket prices (7,9% to budget) compensated somewhat. (1)
- Beverage revenue 15,3% better than budget mainly due to higher sales to each patron (29,6%). (1)
- More tickets were sold through ticketing agent than budgeted (92% vs. a budgeted 83%) (1)
  This resulted in increased cost of sales due to increased commission. (1)
- Overall GP % was below budget due to:
  - higher ticketing commission (1)
  - higher cost of sales, particularly musician & artist costs (1)
- Lower GP's from above factors partially reduced by higher beverage margins (1)
- Marketing costs were higher than budget, reasons unknown. (1)
- Personnel expenses were significantly higher than budget (11,4%), which is cause for concern. (1)
- Rental expense was higher than budget, which is a cause of concern as these expenses should be known in advance. (1)
- Total overheads 3,4% higher than budget mainly due to overrun on personnel costs. (1)

SUGGESTED SOLUTIONS TO PAPER 2: TOE408W / ZAC408H continued

- Profit from operations was 112,5% below budget mainly due to:
  - R3,7m less gross profit (1)
  - R1,3m overhead cost overrun (1)

Maximum 6

(iv) Highlight issues

Major issues to consider and address from the above analysis are:

- What are the reasons for the decline in attendance? Was it increased selling prices, quality of shows, were some theatres not open for full 49 weeks, etc. (This is particularly worrisome given high fixed costs and high breakeven point.) (1)
- Cost controls and measures seem to be lacking. (1)
- Should company expand with further self-owned theatres? If we cannot resolve decline in attendance we should reconsider, especially as theatres will be custom built and difficult to resell. (2)

Maximum 4

Mark summary

(a)		10
(b)	(i)	6
	(ii)	12
	(iii)	6
	(iv)	4
Presentation (language, logic and layout)		2
	Maximum	**40**

MARKERS COMMENTS ON PAPER 2: TOE408W/ZAC408H

For these types of questions, candidates are urged to:
- Have a working knowledge of the various ratios belonging to the different areas of analysis.
- To properly read the required section and to plan their answers - before offering a solution.

The markers identified general and specific problem areas, which are further discussed below.

General
Candidates often neglected to number each section separately - specifically sections b i), ii), iii, and iv).

Part a)
This section required a candidate to calculate the number of units to be sold in order to break even. Candidates performed reasonably well in this section, but it is evident that candidates struggled with the following aspects:
- The different sales implying different contribution figures.
- Calculating the breakeven units, instead of a breakeven amount.
- Classification of expenditure as “fixed“ or “variable”, even though specific guidance was supplied in the question.

Part b)
This section specifically required the analysis of the operating results for the year ended 30 June 2010 and comparison to budget. Evidently candidates did not properly read or understand the required section, as many compared the actual results for the year ended 30 June 2010 to the budget for the year ending 30 June 2011.

Part b i)
This section specifically required the calculation of all possible sales variance amounts. Once again, it is evident that candidates did not properly read the required section as many did not calculate amounts here.

Part b ii)
This section required the calculation of key ratios and percentage variances, as part of the analysis of operating results for the year ended 30 June 2010 and comparison to budget. Here numerous candidates calculated ratios and percentages that did not analyse operating results specifically, e.g. interest cover and profit before tax (which included finance costs) as a percentage of revenue, instead of the profit from operations as a percentage of revenue.

Part b iii)
This section required commentary on the major variance amounts, ratios and percentage variances. Here, the extent of many comments was limited to “this ratio increased / decreased by... percent”, thereby not displaying enough insight, or adding enough value, to earn marks.

Part b iv)
This section required a candidate to highlight the major issues based on the analysis performed. Here, candidates often highlighted minor issues and often made impractical suggestions.

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 (Applied 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 and3) 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.

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

You are employed by Expert Trust Advice (a legal firm) as the tax consultant. All tax-related matters are referred to you. You have to sort out the following five queries as a matter of urgency.

Remember that all the taxpayers involved are residents, as defined, except where stated to the contrary. The firms does not have any special trust, as defined, as a client.

Query 1: **(10 marks)**

The Apple Testamentary Trust was formed in terms of the last valid will and testament of Pete Smith who died on 1 March 2009. All the assets in the trust were transferred by the executor of the estate of Pete Smith to the trustees of the Apple Testamentary Trust. The trust has two beneficiaries, namely Granny Smith and Top Red. The trust deed stipulated that the income must be retained in the trust for the benefit of Top Red until 30 June 2015 when Top Red attains the age of 30. If she dies before that date, her mother (Granny Smith) will replace her as beneficiary. Granny Smith has a vested right to the capital (the assets) of the trust.

The trust received foreign dividends of $450 000 (after deducting withholding tax of 10%) from Canned Fruit Plc (a controlled foreign company as defined) during its year of assessment ending 28 February 2010. The trust holds 15% of the participation (shares) and voting rights in Canned Fruit Plc. All the income of Canned Fruit Plc is excluded in terms of section 9D(9) in the calculation of the net income in terms of section 9D(2A). The net income (calculated in terms of the provisions of section 9D(2A) if the application of section 9D(9) does not apply) amounts to $5 985 000. The foreign corporate tax paid amounts to $1 550 000 in respect of its year of assessment ending 28 February 2010. The average exchange rate for the year of assessment under review is $1=R7,50.

REQUIRED	Marks
Advise the trustees (based on your calculations) whether they should elect the application of section 9D(12) or not.	10

Query 2: **(7 marks)**

The Butternut Trust is a testamentary trust that was formed on 1 December 2006 for the benefit of the late Butter Nut's children. All the assets in the trust were transferred by the executor of the estate of Butter Nut to the trustees of the Butternut Testamentary Trust.

The beneficiaries of the trust are Soup and Beetroot. Soup is a full-time student and was 19 years old on the last day of February 2010. Beetroot is not a resident, as defined, and was 25 years old on the last day of February 2010.

The trust deed stipulates that both children have an equal vested right to the income of the trust, but not the capital or capital gains of the trust. The trustees are allowed to sell the assets and to distribute the capital gain as they deem fit to either one of the beneficiaries or both of them.

During the year of assessment ending 28 February 2010 the trustees sold listed shares for R300 000. The base cost of the shares was R170 000 and the trustees remuneration amounted to R6 000 in respect of the sale of the listed shares. The capital gain was distributed in the discretion of the trustees in equal shares to Soup and Beetroot.

REQUIRED	**Marks**
Calculate the taxable capital gain to be included in the taxable income of Soup, Beetroot and the trust. (Assume that there were no other capital gains or capital losses for the parties involved nor any assessed capital losses brought forward from the previous year.)	7

Query 3: (10 marks)

Banana Spilt is 50 years old. He formed the Banana Trust five years ago. The beneficiaries of the Trust are his wife Parfait (who he is married to out of community of property) and his daughter Milkshake (17 years old and unmarried). The beneficiaries have a contingent right to both the income and the capital of the trust.

Banana Split sold foreign property to the trust at market value. The purchase price was funded by a loan made by Banana Split. The loan carries interest at a market-related interest rate. Pear Split, the father of Banana Split, donated foreign shares to the trust.

The following information relates to the 2010-year of assessment and all foreign amounts have been translated to Rand at the average exchange rate applicable in respect of the 2010 year of assessment:

Income statement of the Banana Trust:	**R Total**	**R Rentals**	**R Foreign dividends**
Rentals	240 000	240 000	
Foreign dividends received and not exempt in terms of section 10(1)(*k*)(ii)	30 000		30 000
Less: Interest paid to Banana Split	(200 000)	(200 000)	
	70 000	40 000	30 000
Less: Distributed to Parfait (wife of Banana)	(26 000)	(15 000)	(11 000)
Less: Distributed to Milkshake (daughter of Banana)	(26 000)	(15 000)	(11 000)
Retained income	18 000	10 000	8 000

REQUIRED	**Marks**
Write a short memo to all the parties involved and discuss in whose hands the trust income will be taxable and calculate the effect on the taxable income for all the parties concerned for the year of assessment ending 28 February 2010. You have to refer to relevant legislation. (NO marks will be awarded for calculations.)	10

PAPER 3: TOE409X (APPLIED TAXATION) continued

Query 4: (6 marks)

The Grape Trust is a discretionary *inter vivos* trust. It received a distribution of R250 000 from one of its investments during the 2010 year of assessment. This amount was the first and final distribution received from the liquidators of a company. The company has been trading since 1995. The shares in the company was bought with surplus trust funds on 5 January 2002 by the trust for R30 000. You have established that the R250 000 comprises of the following:

Repayment of:	**R**
Share capital (Pure)	10 000
Revenue profits earned	220 000
Capital profits earned before 1 October 2001	40 000
Capital profits earned on or after 1 October 2001	15 000
STC and normal tax paid	(35 000)
Net amount	**250 000**

The trustees decided to reinvest the R250 000 in listed shares.

REQUIRED	**Marks**
Calculate the normal tax liability of the Grape Trust resulting from the R250 000 distribution to the trust.	6

Query 5: (7 marks)

Jo Lemon sold a holiday beach cottage in Cape Town during the 2008 year of assessment at its market value to the Lemon and Orange *inter vivos* trust. The purchase price and the resultant transfer duty was funded by an interest-free loan of R1 000 000 from Jo Lemon. His minor son, aged 16, is the only beneficiary of the trust. He has a vested right to both the income and capital of the trust.

During the 2010 year of assessment a holidaymaker made an offer to buy the beach cottage for R2 000 000. The trustees accepted the offer and the title deed was registered on 28 February 2010 in the name of the new owner. The proceeds will be used to repay the loan owed to Jo Lemon and the balance will be invested on the money market until the trust dissolves. The following information relates to the trust:

PAPER 3: TOE409X (APPLIED TAXATION) continued

	Net rental income	**Distributed to son**	**Retained in trust**	**Market-related interest on interest free loan**
2008	80 000	40 000	40 000	100 000
2009	110 000	50 000	60 000	100 000
2010	140 000	60 000	80 000	100 000
Total over period	330 000	150 000	180 000	300 000
	Capital gain	**Distributed to son**	**Retained in trust**	**Market-related interest**
2010	1 000 000	Nil	1 000 000	As above

REQUIRED	**Marks**
Indicate in whose hands the R140 000 rental income and the R1 000 000 capital gain will be taxable and calculate the amount to be included as gross income and as capital gain in the relevant taxpayer's hands. (Assume that the trust does not speculate in property)	7

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SUGGESTED SOLUTIONS TO PAPER 3: TOE409X

QUERY 1 **(10 marks)**

It is a **testamentary trust** and the beneficiaries do not have any vested rights to the income of the trust. The trustees are not allowed to distribute the income to the beneficiaries. The trust will be taxable on the foreign income in terms of **section 25B**. *(Refer to TL 106 Section C - Questions 1 and 3 dealing with section 9D).*

Do not elect section 9D(12)

Description	Calculation	R	Marks
Net income CFC	None. All the income fulfils the requirements of s 9D(9)	**Nil**	(1)
Foreign dividend	$450 000 / 0.9 = $500 000 x R7,50/$	**3 750 000**	(1)
Taxable income		3 750 000	
Normal tax liability	R3 750 000 x **40%**	1 500 000	(1)
Less 6 *quat* rebate	$50 000 x R7,50/$	**(375 000)**	(1)
Tax payable		1 125 000	

Elect section 9D(12)

Description	Calculation	R	Marks
Net income CFC	**$5 985 000 x R7,50/$** x **15%**	6 733 125	(2)
Foreign dividend	R3 750 000 – (section 9D(2A) – section 6 *quat*)		
Exempt but limited	R3 750 000 - **(R6 733 125 – R1 743 750)** (s10(1)(k(ii)(cc))	Nil	(2)
Taxable income		6 733 125	
Normal tax liability	R6 733 125 x **40%**	2 693 250	(1)
Less 6 *quat* rebate	**$1 550 000 x R7,50/$** x **15%**	(1 743 750)	(1)
Tax payable		949 500	

CONCLUSION: Elect the application of section 9D(12) (1)

Total 11

Max 10

QUERY 2 **(7 marks)**

It is a **testamentary trust** and the beneficiaries do not have any vested rights to the capital or capital gains of the trust. **Paragraph 80** of the Eighth Schedule applies. The right to the capital gain becomes vested once the trustees exercised their discretion to distribute the capital gain. The gain will be taxable in the resident beneficiary's hands whereas the gain distributed to the non-resident will be taxed in the hands of the trust. Remember that the attribution rules do not apply because there was not donation. *(Refer to TL 106 Section C - Question 7 dealing with capital gains and capital losses.)*

Calculation of capital gain

Description	Calculation	R	Marks
Proceeds		300 000	
Less: Base cost	(R170 000 + R6 000)	(176 000)	(1)
Capital gain		124 000	(1)

SUGGESTED SOLUTIONS TO PAPER 3: TOE409X continued

Soup

Description	**Calculation**	**R**	**Marks**
Capital gain	(R124 000 / 2)	62 000	(1)
Less: Annual exclusion		(17 500)	(1)
Net capital gain		44 500	
Taxable capital gain	R44 500 x 25%	11 125	(1)

Trust

Description	**Calculation**	**R**	**Marks**
Capital gain	(R124 000 / 2)	62 000	
Taxable capital gain	R62 000 x 50%	31 000	(1)

Beetroot

Description	**Calculation**	**R**	**Marks**
Taxable capital gain	Non-resident (taxed in the trust's hands)	Nil	(1)

QUERY 3 **(10 marks)**

(Refer to TL 106 Section C - Questions 6 and 10 dealing with the taxation of trusts and beneficiaries.)

	Marks
MEMO (To; From; Date; Heading) You are not allowed to use your real name or the name of any institution.	(1)
The beneficiaries have **contingent rights** to the income of the trust.	(1)
Trust income is taxed in terms of **section 25B**. **Section 25B is subject to section 7.**	(1)
A **contingent right becomes vested** once the **trustees exercised their discretion**.	(1)
The foreign property was **sold at market value** on loan account. The loan carries **interest at a market related interest rate**. There was no donation, settlement or other disposition. Section 7(2) to 7(8) does not apply to Banana.	(1) (1)
The foreign shares **donated by Pear** (grandfather and father-in-law) of the beneficiaries. **Section 7(5)** will apply to all income from the donated assets not distributed to the beneficiaries.	(1) (1)
Pear will be taxed on the retained income of the trust relating to his donation. Thus, **R8 000** foreign dividend less the section 10(1)(i)(xv) foreign dividend exemption of R3 500 if not already utilised.	(1) (1)
Parfait and Milkshake's contingent rights became vested and they will each be taxed on the **rentals of R15 000** and the foreign dividends of **R11 000** less the section 10(1)(i)(xv) foreign dividend exemption of **R3 500** if not already utilised.	(1/2) (1/2) (1/2) (1/2)
The **trust will be taxed on the retained rental income of R10 000** because section 7 do not apply and the beneficiaries do not have a vested right to the retained income.	(1)
Banana will be taxed on the interest of **R200 000** earned on the loan account, less the section **10(1)(*i*)(xv) interest exemption of R21 000,** if not already utilised.	(1/2) (1/2)
Total	14
Maximum	10

SUGGESTED SOLUTIONS TO PAPER 3: TOE409X continued

QUERY 4 **(6 marks)**

It is an *inter vivos* discretionary trust which means that the beneficiaries do not have any vested rights to the income or capital gains of the trust. The shares were bought with surplus trust funds and therefore we can assume that there was no donation involved. Section 7 cannot apply. The distribution received was also reinvested (not distributed to the beneficiaries). The trust will be taxed.
(Refer to TL 106 Section B Examples 2 and 3 dealing with dividends and capital distributions.)

Description	Calculation	R	R	Marks
Dividend (capital and revenue profits)	(R220 000 + R40 000 + R15 000 – R35 000)		240 000	(2)
Less: Exempt dividend	(section 10(1)(*k*)(i))		(240 000)	(1)
Capital gain				
Capital distribution	(R10 000 + R40 000) (par 74 of the Eighth Schedule)	50 000		(1)
Less: Base cost		(30 000)		(1)
Net capital gain		20 000		
Taxable capital gain	R20 000 x 50%		10 000	(1/2)
Normal tax liability	R10 000 x 40%		4 000	(1/2)

QUERY 5 **(7 marks)**

It is an *inter vivos* trust. The beneficiary has a vested right to the income and capital of the trust. Both the “donor” and the beneficiary are residents.

Rental income
Section 25B is subject to section 7. Section 7 applies to the interest free loan made by the father to the trust. Section 7(3) will apply to Jo Lemon to all income distributed or accumulated for the benefit of his minor child, but limited to the interest forgone on the loan. You need to decide who will be taxed on the R140 000 rentals and you only have to consider the 2010 year of assessment. The maximum benefit that can be taxed in Jo’s hands, in terms of section 7, will be R100 000 (the interest forgone on the loan). R60 000 was distributed to the son and R80 000 was retained in the trust for the son’s benefit. Jo will be taxed on R60 000 distributed to his minor son and R40 000 of the retained in the trust. Thus R100 000.
His son has a vested right to the retained income of the trust and the minor child will be taxed on R40 000 (R140 000 – R100 000 already taxed in Jo’s hands).

Capital gain
Paragraph 80 of the Eighth Schedule is subject to the attribution rules. Paragraph 69 applies but paragraph 73 of the the Eighth Schedule limits the attribution of any capital gain to the donor to the reasonable interest forgone and the amounts already taxed in terms of section 7 (on a cumulative basis) in the hands of the donor. It is very important to remember that paragraph 73 relates to the total period where an “other disposition” had been made. The period under review is 2008 to 2010 (period in which the asset was sold).

The maximum capital gain that can be attributed to Jo is R300 000 (the interest forgone over the period). Thus he was taxed on the lesser of the actual rentals or the interest forgone. Jo had been taxed on the following amounts in terms of section 7 over the period:

2008 R 80 000
2009 R100 000
2010 R100 000
R280 000

The maximum capital gain that can be attributed to Jo is thus R20 000 (R300 000 – R280 000).
The minor son has a vested right to the capital of the trust and in terms of paragraph 80 the minor son has to include R980 000 (R1 000 000 – R20 000) in his calculation of taxable capital gains.

(Refer to TL 106 Section C Question 9 and SILKE Example 28.51 dealing with interest free loans and paragraph 73 of the Eighth Schedule.)

	Marks
The **R60 000** distributed to the minor son will deemed to be rental income of **Jo Lemon** in terms of **section 7(3).**	(1)
Jo Lemon (donor) will be taxed on the rental retained in the trust in terms of **section 7(3)** (accumulated for the benefit of his minor child) but limited to the interest forgone. Thus R100 000 – R60 000 = **R40 000.**	(1) (1)
The **minor son** will be taxed on the retained income which could not be attributed to Jo lemon's interest free loan (R80 000 – R40 000) = **R40 000.**	(1)
Between 2008 and 2010 **Jo Lemon was taxed on R280 000**. The attribution in terms of **paragraph 73 will limit to the capital gain to the benefit derived from the interest free loan** namely R300 000 less the amount that had been taxed before namely R280 000, thus **R20 000**. **Jo Lemon** must include a capital gain of R20 000 in terms of **paragraph 69** of the Eighth Schedule in the calculation of his taxable capital gain .	(1/2) (1/2) (1/2) (1/2)
The **minor son** (a resident with a vested right) must include a capital gain of **R980 000** (R1 000 000 – R20 000) in his calculation of taxable capital gain.	(1/2) (1/2)

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: Ms. 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 (Applied Auditing) paper 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 and3) 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.

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

You are an audit senior at Malemela & Co (Malemela), a firm of Registered Auditors, and you have been assigned to the 30 June 2010 year-end audit of Bizniz (Pty) Ltd ('Bizniz'). Bizniz imports a wide range of photocopying, facsimile and printing machines.

It is the policy of your firm that the senior in charge performs the final evaluation of the audit, attempts to resolve all outstanding matters and drafts the audit report. To finalise the audit, a discussion is held with the partner and manager in charge of the audit. The final materiality of the audit is R900 000.

During the review of the audit file, you became aware of the following:

1. Statutory matters

A second year trainee on the audit performed a statutory review of Bizniz and prepared working paper B1/1. **Refer to Annexure A.**

2. Schedule of misstatements

Description	**Notes**	**Assets Dr/(Cr) R'000**	**Liabilities Dr/(Cr) R'000**	**Equity Dr/(Cr) R'000**	**Income statement Dr/(Cr) R'000**
Purchase invoice not accrued at year-end	1	1 050	(1 252)		202
Provision for latent defects	2		(1 824)		1 824
Net effect of prior year's un-adjusted differences on current year	3		(46)	(210)	256
Total		**1 050**	**(3 122)**	**(210)**	**2 282**

Note 1: A cut-off test on a sample of invoices recorded after year end revealed that a number of these invoices were not correctly accrued at year end. These invoices relate mainly to equipment in transit. The error in the sample of invoices tested has been included in the schedule above. (5)

Note 2: During the year, Bizniz sold a number of printers. Later it was discovered that printers sold between November 2009 and April 2010 had manufacturing defects. In May 2010, management made a decision to recall all printers sold during that period. This was communicated to affected clients by means of letters and through the media. Management has refused to raise a provision at year end. They argue that customers returned the printers after year end. (6)

Note 3: After an analysis of the schedule of misstatements for the 2009 audit, those items that still have an impact on the 2010 annual financial statements are summarised and included as a single line item. (2)

PAPER 4: TOE412S / ZAC412D (APPLIED AUDITING) continued

REQUIRED

		Marks
(a)	Based on your review of working paper B1/1, comment on the information presented in terms of the requirements of King III.	20
(b)	Prepare a memorandum addressed to the partner, in which you set out your proposals indicating which of the misstatements Bizniz will have to adjust to enable you to express an unqualified opinion. For each misstatement, provide reasons to support your proposal. (*Use the mark allocation of each "Note" to guide you with your solution.*)	13
(c)	Assuming that the management of Bizniz refuses to make any of the adjustments you suggested: (i) Indicate what would be the impact on the audit opinion. (ii) Draft the appropriate opinion paragraph.	 2 5

ANNEXURE A ON NEXT PAGE

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ANNEXURE A

Client	Bizniz (Pty) Ltd	Prepared by	You	**B1/1**
Year end	30 June 2010	Reviewed by	KT	
Subject	Statutory matters			

1 Board of Directors

Karen Wells – Chief Executive Officer and Chairman
Bob Cilliers – Finance Director
Violet Mguni – Operations Director
Jane Witfield – Marketing Director*
Christo Van Tonder – Managing Director
Samuel Jackson – Professor in the Auditing Department at Unisa*
William Smith – Government official (only attends board meetings)

* Appointed during the current year

Bob, Violet and Christo have been serving on the board for the past three years.

The audit committee evaluates the board's performance. These performance evaluations form part of the determination of the board's development and of the training needs of directors.

The board meets as and when required and the board committees, as discussed below, meet annually.

2 Internal audit

- Internal audit reviews the implementation of the risk management plan on an annual basis.
- Jane Witfield heads the internal audit department and reports to Bob Cilliers, the finance director, annually.
- Internal audit identifies all the potential risks that Bizniz faces and makes decisions on how these risks will be mitigated.
- Internal audit is responsible for the preparation of the financial statements.

3 Committees

Audit Committee – Violet Mguni
– William Smith
– Bob Cilliers
– Freddie Mercury

During the meeting of the audit committee held on 15 May 2010, it was decided that Bizniz would acquire shares in Africa Coal, a coal mining company listed on the JSE Ltd. A detailed analysis of the coal-mining sector supported this decision.

Risk Committee – Christo van Tonder
– Samuel Jackson

The risk committee was dismissed during the year.

During the current financial year, the company only had these board committees in place.

SUGGESTED SOLUTIONSPAPER 4: TOE412S / ZAC412D **(40 Marks)**

(a) King III

Board of Directors

The board does not constitute a balance of power between executive and non-executive directors – majority of non-executive directors should be independent. (1)

- Five executive directors and two non-executive directors will not bring independent influence to the board. (1)

- The board does not have an independent non-executive director; all the directors are somehow involved with the company. (1)

Karen Wells fills the roles of both CEO and chairperson. (1)
1 mark allocated for any of the 2
- These roles should be filled by different individuals. (1)

- The chairperson should be an independent non-executive director. (1)

Maximum (2)

The board should be evaluated by the chairman or by an independent party, not by the audit committee. (1)

Evaluation of the chairman should be carried out by an independent non-executive director and the CEO should be evaluated by the chairman or board committee appointed for that purpose. (2)

The board should meet at least four times a year – not as and when required. (1)

The board does not appear to reflect the demographics of South Africa (race and gender). (1)

Internal Audit

The board should be responsible for the review of the company's risk management plan, not internal audit. (1)

In terms of sound corporate governance principles, Jane Witfield should report **administratively to the CEO** and **functionally to the audit committee**. At Bizniz **Jane reports to Bob Cilliers, the finance director.** (2)

The board should be responsible for the governance of risk, as a result the board should identify all potential risks that Bizniz faces and makes the decision on how these risks will be mitigated, not internal audit. (1)

The board can appoint the risk committee or audit committee to assist in carrying out the risk responsibilities. (1)

SUGGESTED SOLUTIONS TO PAPER 4: TOE412S / ZAC412D continued

Jane must also have access to the chairperson of the board and audit committee respectively. (1)

Head of internal audit is Marketing Director and might not sufficient experience and knowledge. (1)

Management is responsible for preparation of AFS, it cannot be internal oudit. (1)

Audit Committee

In terms of King III, the audit committee should comprise at least three members; Bizniz has 4 members. (1)

All members should be independent non-executive directors; three members of the committee are not independent non-executive directors, as they serve on the board and are involved in the day-to-day running of the business. (2)

It appears that the committee has only one independent non-executive director, Freddie Mercury. (1)

As part of risk management, the audit committee cannot make decisions on the acquisition of shares in Africa Coal. This should be the responsibility of the board (with the approval of shareholders). (1)

Risk Committee

The risk committee should consist of a minimum of three members. (1)

The members can be executive and non-executive directors. (1)

Composition of the risk committee is not in compliance with sound corporate governance as it has two directors. (1)

Dismissing the risk committee may be seen as an irresponsible act by management and not in compliance with corporate governance due to the following reasons: (1)

- The risk committee is an important part of integrated reporting that allows the company to report on the sustainability of the company to all stakeholders. (1)
- Part of this is commenting on the major risks facing the company and how such will be addressed. (1)
- King III requires that the company establish audit, risk, remuneration and nomination committees. (1)
- The company did not comply with this requirement as it only had an internal audit and audit committee and had dismissed the risk committee. (1)

Available	31
Maximum	20

SUGGESTED SOLUTIONS TO PAPER 4: TOE412S / ZAC412D continued

(b)

Memorandum

TO: Engagement Partner
FROM: Audit Manager
SUBJECT: Uncorrected misstatements
DATE: 25 July 2010 Presentation (2)

Your request for an analysis of the materiality of the uncorrected misstatements relating the 2010 audit of Malemela & Co refers.

The information below sets out the details of uncorrected misstatements, together with my proposals regarding which of these should be adjusted by the client to avoid qualification of the audit report.

Note 1

This amount is individually quantitatively material, as it is above the materiality figure of R900 000. (1)

The amount is unlikely to be qualitatively material, however there is a possibility that it can impact on the liquidity and solvency ratios therefore rendering it material. (2)

This is a factual misstatement as it is based on the dates indicated on the invoices when performing the cut-off tests. (1)

I would propose that management make an adjustment relating to this amount. (1)

Available 7
Maximum 5

Note 2

This misstatement is individually quantitatively material as it exceeds R900 000. (1)

The decision was made before year end and communication was done before year end, this created a valid expectation on the side of the client. (2)

Therefore there was an obligation at year end. (2)

The fact that the machines were returned after year end is irrelevant. (1)

A provision should therefore be raised at year end. (1)

I would propose that an adjustment be made and since management refuses to abide, I would inform them that this will result in a qualification of the audit report. (1)

Available 8
Maximum 6

SUGGESTED SOLUTIONS TO PAPER 4: TOE412S / ZAC412D continued

Note 3

In isolation these misstatements are not quantitatively nor qualitatively material. (1)

Therefore no adjustment is necessary. (1)

However, all other individually immaterial misstatements should be considered in aggregate to assess if these are still below the materiality figure. (1)

General
In aggregate these are above materiality figure. (1)

Available 4
Maximum 2

(c) (i) Should management refuse to correct any of the misstatements this would give rise to disagreement with management. (1)

The disagreement is material as these amounts exceed the materiality figure of R900 000. (1)

This would be material but not pervasive, as a result the audit report will be qualified, with an 'except for' qualification. (2)

Available 4
Maximum 2

(ii) *Basis for Qualified Opinion*

Malemela & Co acquired computer equipment to the value of R1 050 000, that was not accounted for in the financial statements. The dates on the invoices indicated that the computer equipment was purchased during the year, **therefore risks and rewards of ownership passed to the company during the year**. (3)

The company also sold a couple of printing machines during the year that were found to be defective. **As a result the company recalled these machines during the year, and a provision of R1 824 000 relating to latent defects had to be raised**. Management has not raised this provision. **These matters constitute departure from International Reporting Standards.** (3)

Qualified opinion

In our opinion, **except for the effects of the matters described** under the heading: Basis for Qualified Opinion, **the financial statements present fairly**, in all material respects the financial positions of Malemela & Co as at 30 June 2010, and its financial performance and cash flows for the year ended 30 June 2010, in accordance with the International Financial Reporting Standards. (2)

Available 8
Maximum 5

MARKERS COMMENTARY

Part (a)

- Students performed dismally in this part. This could possibly be attributed to the fact that they were intimidated by King III itself, since they have not been tested on King III. This resulted in students making mistakes and losing even the easiest marks of which there were many. Basic principles were tested and students failed to answer accordingly and found themselves applying King II principles in certain instances i.e. three year terms for directors (King II) instead of one third of directors rotated annually (King III).

- Some students wrote only concerns, yet they were asked to **comment**. You should have included both negatives and positives in your answer.

- Students lost easy marks by not identifying **all** the relevant/applicable King III recommendations. Go through the suggested solution in detail to update your knowledge.

- Students don't know the King III well enough and therefore they get confused by the different committees and the composition thereof.

Part (b)

- This was an easier part of the question, yet students did not demonstrate the knowledge required.

- It appears that students expected a different type of a question and therefore they were thrown off by the required. Many students misinterpreted the required and answered incorrectly.

- Many students could not correctly identify when an event is an adjusting post balance sheet event.

Part (c)

- Poor knowledge on the types of the audit reports was demonstrated. Students have not mastered the skill to use their open books to their advantage.

- Students only wrote the audit opinion paragraph, but not the **basis** for the qualified opinion paragraph

General

Remember to work through all four tests and tutorial letters 107 and 108 in order to properly prepare for the examination!