CASE STUDY QUESTIONS

PART A: **[30 MARKS]**

QUESTION 1:

What is meant by the term “financial distress”?

[2 marks]

Assessment objective: understand the concept of financial distress in business
Assessment criteria: understanding of definition
Level complexity: straight-forward theoretical question – based on recall
There is thus no ambiguity in the question as it is purely technical and theoretical but may use the concept of liquidity (technical insolvency) as a basis for the answer.

SUGGESTED SOLUTION:	**Marks**
Financial distress: is a term in corporate finance used to indicate a condition when obligations to creditors of a company are broken or honoured with difficulty. If financial distress cannot be relieved, it can lead to bankruptcy.	**2**
Situation where the assets of the business exceed the liabilities in the financial statements – technical insolvency.	**2**
Business does not have sufficient cash to pay its creditors when the obligations are due,	**2**
	Max: 2

QUESTION 2:

In the annual integrated report to the stakeholders, the CEO of Penny-Dreadful (Pty) Ltd remarked that, "2014 was a good year for the company with respect to our ability to meet our short-term obligations. We achieved a higher liquidity position largely due to an increase in highly liquid current assets (cash, account receivables and short-term marketable securities)." Analyse the liquidity, solvency and cash management ratios given and comment on whether the statement made by the CEO is correct.

[6 marks]

Assessment objective: analysis and interpretation of ratio in order to comment on the ability of the business to meet its obligations
Assessment criteria: identify which ratios should be used, analysis the appropriate ratios to comment on the ability of the business to meet is short-term obligations
Level of complexity: high as the candidates need to read and identify the appropriate ratios to be used for the purposes of analysis within a given context

SUGGESTED SOLUTION:	Marks
The answer should be focused on using the liquidity ratios - current and quick ratios.	1
While the current ratio has steadily increased, it is to be noted that the liquidity has not resulted from the most liquid assets as the CEO proposes.	1
Instead, from the quick ratio one could note that the increase in liquidity is caused by an increase in inventories.	1
For a retail business one could argue that inventories are relatively liquid when compared to other industries; however, the company is converting its inventory at a rate higher than the industry average but the collection of cash from customers are lagging.	1
The current ratio is lower the norm of 2:1, but has been close to the industry average and has increased above the average – reduces the financial risk to short-term creditors.	1
The quick ratio has been declining continuously over the past three years indicating the risk facing the company to meet its payment obligations.	1
The quick ratio is marginally higher than the norm of 1:1, indicating that any change in the market could significantly increase the risk to short-term creditors. Although the debtors' collection period is below that of the industry average, the period has increased consistently over the three years indicating that the company may be heading to cash flow constraints.	1
Also, given the information, the industry-benchmark can be used to derive that the firm's quick ratio is very similar to the industry level and that the current ratio is indeed slightly higher - again, this seems to come from inventories.	1
Additional marks for any valid comments	
Analysis of the liquidity of the business is to determine whether there are sufficient assets to meet the short-term obligations when they are due – measure the ability to pay debts when they are due.	1

Analysis of the solvency of the business is to determine the level of financial risks and security provided to the debt providers – sufficient assets to provide protection for the debt providers Analysis of the cash management is to determine whether the business has sufficient cash resources to meet the operating costs and short-term debt when they are due – management of cash flows of the business	**1** **1**
	Max: 6

There may be differences in interpretation of the question in term of the focus of the answer to obtain the marks allocated. Furthermore, candidates may answer the question from a theoretical perspective without making reference the ratios – lack of comparative analysis.

Note to markers: marks may be given for (i) identifying the appropriate ratios for each area of discussion; (ii) broad description of the key areas; (iii) is of graphical presentation reflecting comparative analysis. Where there were no use of ratios then the marks allocated should be limited to a maximum of 3.

QUESTION 3:

Analyse the information given and discuss the strategy of management to utilize its assets and resources to achieve the strategic goals of the company. Be as complete as possible given the above information.

[6 mark]

Assessment objective: analysis of financial information to evaluate the strategy implement by management achieve the objective of the business
Assessment criteria: identify the strategy of management and the ratios that can be used to evaluate the strategy of management to achieve the business objective
Level of complexity: high as it requires the candidates to understand business and strategies that can be implement to achieve business objectives, together with the use of information to evaluate management performance

SUGGESTED SOLUTIO	**Marks**
The discussion should focus on activity ratios such as inventory turnover, days sales in receivables, and the total asset turnover ratio are to be mentioned here. Inventory turnover has increased over time and is now above the industry average – this means the ability of the company to convert its sales are declining due to external market factors (disposal income and preference of customers) and internal factors relating to sales and inventory management.	4
This is good - especially given the fresh food nature of the firm's industry. In 2016 it means for example that every 365/62.65 = 5.9 days the firm is able to sell its inventories as opposed to the industry average of 6.9 days.	2
Days' sales in receivables has gone down over time, but is still better than the industry average. So, while they are able to turn inventories around quickly, they seem to have more trouble collecting on these sales, although they are doing better than the industry.	1
Finally, total asset turnover is went down over time, but it is still higher than the industry average. It does tell us something about a potential problem in the firm's long term investments, but again, they are still doing better than the industry. **Additional marks for any valid comments**	2
Qualitative information that should be considered when evaluating the strategies of utilizing the assets of the business - candidates might have also referred to the general issues in the case study and discussed the following:	1
• authoritarian management style of the CEO and what the impact of this would be on the liquidity, solvency and cash management. T	1
• the change in shareholders that will inject additional cash flow to the business • the replacement of assets to improve efficiency	1

•	change in management after the dismissal of the CEO	**1**
		Max: 6

The question was vague and provided no indications as to the method that should be used for the evaluation (examiner focused on the use of ratios as basis for analysis and evaluation). The vague of the method that should be applied to perform the evaluation may result in a general answer being given based on other information in the case study – this may contribute to candidates taking longer than the time and marks allocated.
Note to the markers: consider any valid comments in respect of the strategies and other factors, especially qualitative information, the supports the answer to the question.

QUESTION 4:

You are asked to provide the investors with an assessment of the firm's solvency and leverage. Be as complete as possible given the above information, but do not use any irrelevant information.

[4 mark]

Assessment objective: analysis of financial information to evaluate the capital structure of the business and its ability to provide security to its debt providers

Assessment criteria: identify the appropriate financial information to analyse the capital structure and solvency of the business

Level of complexity: high as it requires the candidate to understand the financial risk to the business based on its capital structure

SUGGESTED SOLUTIO	**Marks**
Solvency and leverage is captured by an analysis of the capital structure of the firm and the firm's ability to pay interest.	**1**
Capital structure: Both the equity multiplier and the debt-to-equity ratio tell us that the firm has become less levered.	**2**
To get a better idea about the proportion of debt in the firm, we can turn the D/E ratio into the D/V ratio: 2016: 43%, 2015: 46%, 2014:47%, and the industry-average is 47%.	**1**
So based on this, we would like to know why this is happening and whether this is good or bad. From the numbers it is hard to give a qualitative judgement beyond observing the drop in leverage. In terms of the firm's ability to pay interest, 2016 looks pretty bad.	**1**
However, remember that times interest earned uses EBIT as a proxy for the ability to pay for interest, while we know that we should probably consider cash flow instead of earnings.	**1**
Based on a relatively large amount of depreciation in 2016 (see info), it seems that the firm is doing just fine.	**1**
Additional marks for any valid comments	
	Max: 4

The method to be used in the analysis and evaluation was unambiguous – clear that ratios should be used. However, the selection of the relevant ratios must be been a challenge as it is not often that these ratios are used in the SME's sector.

QUESTION 5:

Suppose that the directors of Penny-Dreadful (Pty) Ltd were to apply for business rescue from the CIPC. Discuss what is the difference between a business rescue and liquidation?

[3 mark]

Assessment objective: understanding the difference between business rescue and liquidation
Assessment criteria: definition of concepts and terms
Level of complexity: low as it requires the recall of information

SUGGESTED SOLUTION:	Marks
Business rescue, as defined by the Companies Act 2008, aims to facilitate the rehabilitation of a company that is "financially distressed" by providing for: the temporary supervision of the company and management of its affairs, business and property by a business rescue practitioner, a temporary moratorium ("stay").	**2**
Liquidation is an event that usually occurs when a company is insolvent, meaning it cannot pay its obligations as and when they come due. The company's operations are brought to an end, and its assets are divided up among creditors and shareholders, according to the priority of their claims.	**2**
Going concern is when the business has sufficient resources to sustain its operations and there is a market for its products and/or services.	**2**
	Max: 3

Note to markers: a maximum of 2 marks should be awarded if only one concept is discussed in the answer.

QUESTION 6:

Perform the substantive procedures to test the accounts receivable balances.

[9 Marks]

Assessment objective: procedures that should be followed when verifying the accuracy of accounts receivables in the financial statements

Assessment criteria: skills required to verify the accounts receivables balance reported in the financial statements in terms of the appropriate standards (auditing)

Level of complexity: moderate as candidates may not be exposed to these procedures due to limited exposure to compilations

SUGGESTED SOLUTION:	Marks
A. Presentation and Disclosure [1]. Determine appropriate classification of account balances. [2]. Read or review the financial statements in order to verify disclosure of: • Restrictions—pledging, factoring and discounting • Related party transactions [3]. Trace amounts on trial balance to general ledger control accounts and subsidiary ledger totals.	**2**
B. Valuation or Allocation [1]. Confirm account balances where reasonable and practicable using positive and/or negative confirmation requests. [2]. Examine collections in the subsequent period cash receipts journal. [3]. Examine and verify amortization tables. [4]. Examine aging schedules. [5]. Review adequacy of allowance for doubtful accounts. [6]. Review collectibility by checking credit ratings (e.g., Dun and Bradstreet ratings). [7]. Verify clerical accuracy and <u>pricing</u> of sales invoices. [8]. Foot daily sales summaries and trace to journals. [9]. Perform tests for omitted and invalid (or unsupported) transactions with respect to subsidiary ledger account balances.	**5**
C. Completeness [1]. Perform sales and sales return cut-off tests. [2]. Perform analytical procedures. [3]. Test for omitted transactions.	**2**
D. Existence or Occurrence [1]. Inspect note agreements. [2]. Confirm accounts receivable and notes receivable balances. [3]. Review client documentation.	**2**

E. Rights and Obligations [1]. Read minutes of board of directors' meetings. [2]. Read leases for pledging agreements. [3]. Determine pledging and contingent liabilities to bank by using a standard bank confirmation.	**2**
F. Related Income Statement Effects [1]. Review installment sales profit recognition. [2]. Verify accuracy of sales discounts and term discounts. [3]. Review bad debt expense computations. [4]. Recalculate interest income on notes receivable.	**3**
	Max: 9

General comments on this section:

1. The questions was complex due to the reading time required to absorb and assimilate the information in the context of the scenario – reading of ratios is not a common practice
2. Level of thinking required to understand the financial information present required Higher Order Thinking – interpretation and analysis
3. Applying analytical techniques to evaluate and comment of the strategies and financial position of the business requires a high level of business knowledge and skills – beyond the ordinary activities of the Professional Accountant at entry level
4. The lack of direction to some of the questions may have resulted in alternative interpretations which should be considered when marking.

PART B: **[21 MARKS]**

QUESTION 7:

Advise the accountant how to recognise the factoring debtors as per the terms and conditions of the debtors' factoring agreement in the financial statements in compliance with the accounting standards.

[4 marks]

Assessment objective: understanding techniques that are used to manage the cash flow of the business
Assessment criteria: understanding the concept of debtor factoring and the financial accounting implications
Level of complexity: high as candidates may not have been exposed to the process of debtor factoring in practice

SUGGESTED SOLUTION:	Marks
Factoring is a financial transaction and a type of debtor finance in which a business sells its accounts receivable (i.e., invoices) to a third party (called a factor) at a discount. A business will sometimes factor its receivable assets to meet its present and immediate cash needs.	2
Debtor factoring represents the sale of the debtors balances at a reduced rate (received cash of 85% from the factoring institution), but the 10% which is receivable at a later date represents the amount due from the financing house and not the debtors.	2
The service fee charged by the financing house can only be recognised as an expense when the factoring house has rendered the service of collecting the monies from the customers – represents a prepaid expense when the debtors are factored.	1
When the debtors are return by the factoring house as a results of them not settling their accounts as agreed on, then the debtors must be raised and the company has an obligation to repay the factoring house – financial liability for the amount due. The 10% receivable amount should be cancelled accordingly.	2
	Max: 4

The concept of debtor factoring and the lack of exposure to these questions may skew the answers provided – concept marking should be applied.
Note to markers: marks should be awarded is the candidates provided calculations to support their answers.

QUESTION 8:

Discuss how the notification received from the factoring institution on 26 May 2017 should be recognised and reported in the financial statements for the reporting period ended 28 February 2017 in compliance with the accounting standards.

[4 marks]

Assessment objective: identification and disclose of events after the reporting date
Assessment criteria: identifying whether the transaction represents an even after the reporting date that require adjustment or note in financial statements
Level of complexity: moderate as candidate should understand how the report on events occurring after the reporting date

SUGGESTED SOLUTION:	Marks
The notification is received after the reporting date – decision to decide whether it is an adjusting entry or just for noting in the financial statements.	**2**
At the reporting date there may be a remote possibility that the customers may default. In such as case based on the past history of customers coupled with the professional judgement of management the likelihood of customers defaulting can be estimated (consider the track record with factoring institution) – recognise a provision for the defaulting customers by raising the obligation to repay the factoring institution.	**2**
However, if the is a high level of uncertainty about debtors defaulting on payment (no previous evidence to indicate its probable occurrence), then a contingent liability exist – it is sufficient to disclose the information by way of a note to the financial statements.	**2**
	Max: 4

Note to markers: candidates should be awarded marks if the provided definitions of events after the reporting date, provisions and contingent liabilities – maximum of one mark per definition. The identification that this transaction represents an event after the reporting date should be awarded the appropriate marks.

QUESTION 9:

Prepare the note relating to debtor factoring that should be disclosed in the financial statements for the reporting period ended 28 February 2017 in compliance with the accounting standards. [4 marks]

Assessment objective: disclosure requirements for debtor factoring
Assessment criteria: disclosure of the information in the notes to the financial statements in respect of debtor factoring
Level of complexity: high as candidate may not be exposed to this type of transaction in practice (treatment of receivables and the cash received)

SUGGESTED SOLUTION:	**Marks**
Trade receivables:	
Trade receivables that are factored with a factoring house and/or financial institutions are not derecognised until the recourse period has expired and the risks and rewards of the receivables have been fully transferred to the factoring institution.	**2**
The corresponding cash received from the factoring/financial institutions are recorded as borrowings and recognised as financial liabilities.	**1**
Any fee incurred to effect factoring is net-off against borrowings and taken to the Profit & Loss over the period of factoring using the effective interest method.	**1**
The monetary amounts linked to the transaction should be mentioned – total receivable, cash received, fees percentage and retention cash; as well as the details of the factoring house.	**2**
	Max: 4

Note to markers: marks should be awarded for the format and presentation of the note – maximum of 1 marks.

QUESTION 10:

Record the journal entries to recognise the transactions concluded with the customer benefits being used to settle the sales amount due. Support you answer with calculations and reasons, including the transactions relating to VAT.

[7 marks]

Assessment objective: understanding the accounting implications of sales transactions linked to 3rd party benefits
Assessment criteria: recognition and measurement of revenue for 3rd party benefit revenue transactions
Level of complexity: high as businesses in general apply the recognition of such transactions which may not comply with the accounting standards

SUGGESTED SOLUTION:			**Marks**
Recognition of revenue: Revenue must be recognised and measured based on the gross amount received or receivable; and therefore represents the value of the cash received and the customer benefits payable by the bank. VAT: Output VAT should be recognised on the earlier of the cash received or invoice issued; and is based on the sales value (value of the invoice – total invoice value)			**1** **1**
	Debit	Credit	
Bank [661,200 X 65%]	429 780		**2**
Receivable – Customer benefits [661,200 x 35%]	231 420		**2**
Revenue – sale of goods		580 000	**1**
Output VAT Control [661,200 x 14/114]		81 200	**2**
[Recognition of revenue with customer benefits from bank]			
			Max: 7

Note to markers: principle marks should be awarded if the revenue amount (exclusive of VAT) was used to apportion the revenue amounts. If the calculations were provided without any journal entries, then a maximum of 4 marks should be awarded.

QUESTION 11:

Discuss the income tax and VAT implication of the credit balances of the debtors' accounts in compliance with the provisions of the Tax Acts.

[4 marks]

Assessment objective: application of income tax and VAT implication of cash received from customers exceeding the balance due
Assessment criteria: application of gross income definition to cash received and the output VAT provisions for overpayments by customers
Level of complexity: moderate as the provisions for VAT are clear but the treatment for income tax may not be applied in practice with the provisions of the Income Tax Act

SUGGESTED SOLUTION:	**Marks**
Income tax:	
The accounts overpaid by customers (credit balance) cannot be included in gross	**1**
income because it was not earned by the company nor is it for the benefit of the	
company – company has an obligation to return the cash to the customers	**1**
	Max: 2
VAT:	
Output VAT will be levied depending the period the amounts has been over paid	
– window period of four months:	**1**
If the amounts are overpaid for a period of less than four months, then there are	
no VAT implications – considered to a financing transaction which is an exempt	
supply.	**2**
If the amount is overpaid for a period longer than four months, then the amount	
will be subjected to Output VAT – amount received in relation to the carrying on	
of an enterprise is deemed to be a taxable supply.	**2**
	Max: 3
	Max: 4

Note to markers: note the maximum marks awarded for the different implications. For VAT the important information is the window period and whether the repayment is within or beyond the window period.

QUESTION 12:

Discuss whether the recommendation by the accountant to set off the credit balances against trade receivables in the financial statements is acceptable in terms of the accounting standards.

[3 marks]

Assessment objective: setting off of assets and liabilities in the financial statements
Assessment criteria: assessing materiality and the application of the concept of setting off in the statement of financial position
Level of complexity: moderate as the application in practice may not comply with the accounting standards

SUGGESTED SOLUTION:	Marks
The company has an obligation to refund the debtors with credit account balances – present obligation to refund the customers and must therefore be recognised as a liability (cannot be set-off and must disclosed as a liability)	2
However, if the amount is considered immaterial and insignificant to the decisions of the users of financial statements then it may be set-off against trade receivables – professional judgement should be used.	1
If the same customer has a debit and credit balance, and agreement is obtained from the customer to set-off the balances, then the amounts can be set-off – directly relates to the same entity.	2
	Max: 3

Note to markers: award a mark if the candidate provided the definition of a liability.

General comments:

1. The question on debtor factor may be complex as most of the candidates may not be exposed to such transactions as this is more a management strategy which is often not reported in the financial statements
2. The question on revenue with 3rd party benefits, although it is similar to loyalty points, the manner in which it is treated in practice differs from what the recognition criteria is in terms of the accounting standards
3. Most of the questions highlighted the application in practice which may be in conflict with the requirements of regulations and standards

PART C: **[19 MARKS]**

QUESTION 13:

Discuss whether the statement made be the accountant relating to the valuation of the inventory and the recognition of the loss at the reporting date is acceptable in terms of the accounting standards.

[4 marks]

Assessment objective: recognition of valuation losses of inventory in the financial statements
Assessment criteria: application of the principles of impairment losses of inventory in terms of the accounting standards
Level of complexity: moderate/low as this was discussed in detail but candidate may not be exposed to this type of transaction in practice

SUGGESTED SOLUTION:	**Marks**
The accounting standards recommend that inventory should be measured at the lower of cost or not realisable value – the loss on valuation is specifically excluded from the standard on Impairment of assets.	**2**
The loss recognised on the valuation of inventory is based on the loss recognised for finished goods – maximum loss that can be recognised for all items of inventory.	**1**
The loss recognised for finished goods is allocated to the other categories of inventory from the bottom up (starting with raw materials through to finished goods).	**2**
The loss recognised for raw materials is based on the difference between the carrying amount and recoverable amount, but limited to the loss recognised for finished goods.	**1**
	Max: 4

Note to markers: candidate may treat the losses as impairment losses and account for the losses separately, rather than as a collective valuation loss – awarded a maximum of 2 marks.

QUESTION 14:

Discuss whether the loss recognised on valuation at the reporting date (impairment loss) will be allowed as a deduction for the calculation of taxable income.

[2 marks]

Assessment objective: claiming inventory losses resulting from valuation as deduction for income tax purposes
Assessment criteria: application of the treatment of inventory and related valuation losses for income tax purposes
Level of complexity: low as inventory valuation for accounting purposes is used as the basis for tax purposes – may not understand the reasons why

SUGGESTED SOLUTION:	Marks
Inventory (trading stock) is recognised for the calculation of income tax purposes in terms of s22 – the opening trading stock of one period represents the amount carried forward from the previous period(closing stock).	1
Trading stock is measured at the valuation based on the accounting policy	1
(lower of cost or net realisable value) – loss on valuation is recognised as a	1
deduction via the measurement of trading stock.	1
Inventory valuation loss is not treated as other forms of losses (theft, etc.) which will be deducted in terms of the general deduction formula – s 11(a)	1
The valuation loss for inventory represents a form of provision accounting which is generally prohibited as deductions for tax purposes.	1
	Max: 3

It is important that candidate are able to distinguish between inventory valuation losses (which is a provision) and other forms of losses which is treated as a general deduction.

QUESTION 15:

Record the journal entry to account for the loss recognised on the valuation of inventory at the reporting date in compliance with the accounting standards.

[3 marks]

Assessment objective: recording of transaction relating to the recognition of inventory losses
Assessment criteria: recording transactions for valuation losses of inventory as a result of impairment loss
Level of complexity: moderate/low as candidates may not be exposed to this type of transaction in practice – affected by the answers given in Question 13

SUGGESTED SOLUTION:			**Marks**
	Debit	Credit	
Cost of goods sold – valuation loss	45,000		**1**
Raw materials [110,000 – 86,000]		24,000	**1**
Finished goods [672,000 – 627,000 – 24,000]		21,000	**1**
[Recognition of valuation loss for inventory]			
			Max: 3

Note to markers: question 15 and 13 must be marked simultaneously as the understanding of the concept of valuation losses for inventory (question 13) directly impacts the manner in which the journal entries are recorded. Furthermore, if the losses were accounted for separately in the journal entries then a maximum of 2 marks should be awarded.

QUESTION 16:

Calculate the variable production cost per unit cost, if the total production overhead costs are considered to be mixed costs.

[4 marks]

Assessment objective: using High-low method to analyse mixed costs
Assessment criteria: application of the High-Low method to separate mixed costs between variable and fixed costs
Level of complexity: low as this is a straight-forward calculation process

SUGGESTED SOLUTION:				**Marks**
	August	October	Difference	**1**
Number of units produced	165 000	280 000	115 000	**2**
Total production overhead costs	547 500	720 000	172 500	**2**
Average cost per unit (variable cost)			1,50	**1**
Total variable cost	247 500	420 000	Apply to question 17	
Total fixed cost	300 000	300 000		
Total cost	547 500	720 000		
				Max: 4

Note to markers: if the calculations were not based on the highest and lowest periods, then a maximum of 3 marks should be awarded. A principle mark should be awarded in the average amount is not calculated accurately.

QUESTION 17:

Advise management whether the order received from the customer in Germany should be accepted taking into consideration the expected profits that management intend to realise.
[6 marks]

Assessment objective: applying break-even analysis to make operating decisions
Assessment criteria: application of break-even analysis with target profits to make business decisions
Level of complexity: moderate/complex as the question as the fixed cost component needs to be determined to perform the calculations

SUGGESTED SOLUTION:		**Marks**
Direct materials cost per unit - given	56,70	**0.5**
Direct labour cost per unit - given	17,50	**0.5**
Variable production costs – calculated in Q 16 (principle mark)	1,50	**0.5**
Variable selling expenses – non-manufacturing costs	3,50	**2**
Total variable costs (principle mark)	79,20	**0.5**
Selling price per unit	150,00	**0.5**
Contribution per unit (principle mark)	70,80	**1**
Fixed production costs – see table for calculation in Q 16	300 000	**3**
Other fixed costs (principle mark)	340 000	**0.5**
Total fixed costs	640 000	
Adjusted contribution per unit [70,80 – 20]	50,80	**2**
Break-even point (units) (principle mark)	12 598	**1**
Management should accept the offer as it exceeds the break-even point including the expected profit – excess of units compared to order of 20,000 units		**1**
		Max: 6

Note to markers: question 16 and 17 should be marked simultaneously as the results and calculation of question 16 influences the calculations in question 17. If the candidates used the total production costs of R 560,000 as fixed costs then only award .05 of a mark.

General comments:

1. The question and calculations were not complex, but the information was scattered and thus required intensive reading to identify and extract the information.
2. The manual computation may be time consuming and thus the time and mark allocation may not be appropriate.

PART D: **[20 MARKS]**

QUESTION 18:

Record the journal entries recording the finance lease agreement for the reporting period ended 28 February 2017 in compliance with the accounting standards. Ignore the effects of deferred taxation.

[6 marks]

Assessment objective: recording of financial lease transactions at inception
Assessment criteria: the measurement of the initial cost of the leased asset and the use of the amortisation to determine the interest expense for the period
Level of complexity: moderate as the question focuses on the preparation of the amortisation table

SUGGESTED SOLUTION:					**Marks**
	Balance	Interest	Payment	Balance	
01-Jul-16	427 855	-	65 000	362 855	
01-Jan-17	362 855	21 771	65 000	319 626	
01-Jul-17	319 626	19 178	65 000	273 804	
01-Jan-18	273 804	16 428	65 000	225 232	
01-Jul-18	225 232	13 514	65 000	173 746	
01-Jan-19	173 746	10 425	65 000	119 171	
01-Jul-19	119 171	7 150	65 000	61 321	
01-Jan-20	61 321	3 679	65 000	-	
			Debit	Credit	
01-Jul-16	Motor Vehicles		427 855		**0.5**
	Finance lease creditor			427 855	**0.5**
	[Recognition of motor vehicle acquired in terms of finance lease]				
01-Jul-16	Finance lease creditor		65 000		**0.5**
	Bank			65 000	**0.5**
	[Instalment payment]				
01-Jan-17	Finance lease creditor		65 000		**0.5**
	Bank			65 000	**0.5**
	[Instalment payment]				
28-Feb-17	Finance charges		21 771		**2.5**
	Finance lease creditor			21 771	**0.5**
	(427,855 – 65,000) x 6% = 21,771				**3**
	[Finance charges for the period]				
28-Feb-17	Finance charges		6 393		**2.5**
	Accrued expenses			6 393	**0.5**
	[(362,855 + 21,771) – 65,000) x 6% x 2/12] = 6,393				**3**
	[Finance charges accrued for the period]				
					Max: 6

Notes to markers: candidates may not apply the concepts of payments in advance and half-yearly payments in the amortisation tables correctly, award marks based on the principles of the amortisation table. Award marks if financial calculators are used as follow: max of 3 marks PV = 427,855; PMT = 65,000, Begin mode; n = 4 x2 = 8; I = 12% v ½ = 6%; and FV = 0. Indicate on the mark schedule the additional marks with + …. (a maximum of 6 bonus marks)

QUESTION 19:

Disclose the information relating to the finance lease creditors in the financial statements including the note for the reporting period ended 28 February 2017 in compliance with the accounting standards.

[9 marks]

Assessment objective: disclosure of finance lease information in the financial statements
Assessment criteria: disclosure of finance lease liability including the notes to the financial statements
Level of complexity: moderate/high as the disclosure depends on the calculations as per the amortisation table

SUGGESTED SOLUTION:				**Marks**
Statement of financial position at 28 February 2017				**0.5**
Non-current liabilities				
Finance lease creditor			225 232	**1**
Current liabilities				
Finance lease creditor			94 394	**1**
Notes to the financial statements - 28 February 2017				**0.5**
Finance lease creditor				
The finance lease creditors is measure at the present value of the minimum lease payments discounts at the effective interest rate. The rental payments inclusive of VAT amounts to R 65,000 for a period of three years, the final payment is payable on 01 January 2020. The effective interest rate is 12%. (principle mark)			319 626	**2** **1**
Less: Current portion of lease liability			94 394	**2**
Non-current liability (principle mark)			225 232	**1**
Future lease commitment				
	Following year	Thereafter	Total	
Capital	94 394	225 232	319 626	**2.5**
Finance charges	35 606	34 768	70 374	**2.5**
Lease payment	130 000	260 000	390 000	**2.5**
				Max: 9

Candidate may not present the future lease commitment as a part of the note to the lease liability as it is based on the amortisation table which is time consuming to complete – there may be a mismatch between the time and mark allocation.
Note to markers: indicate on the mark schedule the additional marks with + ….

QUESTION 20:

Discuss whether the interest of R 1 200 000 paid is deductible by Penny Dreadful (Pty) Ltd for the year of assessment ended 28 February 2017 in accordance with the provisions of the Income Tax Act.

[5 marks]

Assessment objective: deduction of interest on loans raised by the business
Assessment criteria: application of the provisions of Tax Act for interest deduction in term f general and specific deductions
Level of complexity: high as candidate may claim the interest is a business expense and therefore is a general deduction

SUGGESTED SOLUTION:	Marks
In terms of section 102 of the Tax Administration Act, the onus of proof is on the taxpayer to prove that an amount is deductible.	1
In terms of s23B(3), no deduction may be allowed under s11(a) where a deduction or allowance may be granted under a specific provision.	1
Therefore, s11(a) cannot be used as s24J(2) is applicable.	1
Further, s24J(2) requires the interest to be deducted from the income of Penny derived from the carrying on of a trade, if the interest is incurred in the production of income.	2
The interest was incurred in the carrying on of a trade due to Penny Dreadful utilising the loan to assist with their cash flow problems during an economic down turn.	1
The interest is incurred in the production of income if the interest incurred is closely connected with the income earning activity from which the expenditure arose(PE Electric Tramway)	1
Therefore, the interest on the R1 200 000 is incurred in the production of income as the interest paid is closely connected to the normal income earning activities of the business.	1
The interest incurred on the loan of R1 200 000 will be deductible in terms of s24J(2).	1
	Max: 5

Generally, most of the candidates will argue that the interest is deductible in terms of the general deduction formula - s 11(a).
Note to markers: award marks if the candidates provide the definition and criteria for the general deduction formula – maximum of 3 marks should be awarded.

General comments:

1. The question was not complex, but the calculations involved, especially the amortisation table are time consuming.
2. The deduction of interest will be taken as a general deduction which is common in practice.

PART E **[30 MARKS]**

QUESTION 21:

Discuss whether the transaction recorded by the accountant to recognise the impairment loss complies with the accounting standards. Support your answer with reasons and appropriate calculations.

[8 marks]

Assessment objective: recognition of impairment losses for revalued assets
Assessment criteria: separation of an impairment losses for revalue assets between the impairment loss and the devaluation (reversal of revaluation surplus)
Level of complexity: high as it involves the application of integrated concepts and principles, viz. revaluation of assets and the impairment of assets

SUGGESTED SOLUTION:				**Marks**
	Cost	Revalue	Surplus	
Cost/revaluation	960 000	1 200 000	240 000	**0.5**
Accumulated depreciation [960,000/8 = 120,000 per year]	-240 000	-300 000	-60 000	**1**
Carrying amount (28 Feb 2015]	720 000	900 000	180 000	**0.5**
Depreciation (2 years)	-240 000	-300 000		**1**
Carrying amount [28 Feb 2017]	480 000	600 000		
Recoverable amount	450 000	450 000		
Impairment loss	30 000	150 000		**3**
Devaluation [600,000 - 480,000]		120 000	-120 000	**2**
Balance			60 000	
Impairment loss is measured by the difference between the recoverable amount and the carrying amount based on the historical cost model – R 30,000 as calculated.				**1**
The decline from the carrying amounts from the revaluation model to the historical cost model represent a devaluation and not an impairment loss – reduction against revaluation surplus via OCI.				**2**
The accountant is incorrect as the decrease from the carrying amount (revaluation model) to the recoverable amount should be separated between the devaluation and the impairment loss.				**1**
				Max: 8

The candidates may ignore tracking the historical cost model on which the impairment loss is based, while the decrease between the carrying amount based on the revaluation and historical cost models represents a devaluation.
Note to markers: indicate on the mark schedule the additional marks with + ….

QUESTION 22:

Discuss whether the impairment loss can be claimed as a deduction for income tax purposes in terms of the provisions of the Income Tax Act.

[3 marks]

Assessment objective: recognition of impairment losses as deductions for tax purposes
Assessment criteria: application of the principles of deductions for tax purposes – actually incurred during the year of assessment
Level of complexity: low as it is based on the basis principles of deductions – actually incurred

SUGGESTED SOLUTION:	Marks
For any transaction to be recognised as a deduction, the amount must be incurred during the year of assessment – actual amount and transaction.	1
The impairment loss is a valuation required in terms of the accounting standards and is not actually incurred, therefore, not allowed as a deduction for income tax purposes.	1 1
Also provision accounting is specifically prohibited in terms of s23(e)	1
	Max: 3

Candidates may only focus on the application of general deduction formula principles (actually incurred) and may not consider the prohibition.

QUESTION 23:

Discuss whether the accountant recognised the building correctly as part of Property, Plant & Equipment for the reporting period 28 February 2017 in compliance with the accounting standards

[8 marks]

Assessment objective: classification of buildings between PPE and Investment Property
Assessment criteria: classification of property is based on its intended use and the criteria application
Level of complexity: moderate/high as a results of the varying information provided in the case study

SUGGESTED SOLUTION:	Marks
Whether the property is classified as Property, Plant & Equipment or Investment property, land and buildings should be recognised as separate assets. Land is not depreciated for accounting purposes.	2
When the intended use of the property changes, management should determine whether the property should be reclassified – the decision to lease the building to tenants change the intended use of the building.	2
As the building will be used by the company as well as tenants, it is important to determine whether the building are separately identifiable as it affects whether the portions can be identified separately.	1
The property is not separately identifiable (insufficient information) coupled with the fact that the major part of the building is used to generate rental income, the entire property must be classified as Investment Property.	2
At the date the intended use changes, the property should be re-classified to Investment Property at its fair value.	1
Investment property is valued at each reporting date at its fair value and thus the building cannot be depreciated.	1
	Max: 8

Question complicated by the manner in which the information was presented. Reading and the extraction of the relevant information was critical for this question.

QUESTION 24:

Record the journal entry to re-classify the building from Property, Plant & Equipment to Investment Property in compliance with the accounting standards.

[8 marks]

Assessment objective: recording the re-classification of property from PPE to Investment Property

Assessment criteria: recognition and measurement of the re-classifications of property from PPE to Investment property – treatment of fair value adjustment

Level of complexity: moderate as the re-classification included both buildings and land

SUGGESTED SOLUTION:			**Marks**
	Debit	Credit	
Accumulated depreciation	400,000		**0.5**
Property, Plant & Equipment		400,000	**0.5**
[Elimination of accumulated depreciations]			**0.5**
Property, Plant & equipment	1,220,000		**0.5**
Revaluation surplus (OCI)		1,220,000	**2**
[Revaluation of property to its fair value]			**0.5**
Investment Property - Land	120,000		**1**
Investment Property - Building	1,500,000		**1**
Property, Plant & Equipment		1,620,000	**1**
[Re-classification of property]			**0.5**
			Max: 8

Note to markers: the re-classification without the separation between Land and Building is also acceptable.

QUESTION 25:

Advise management whether the capital allowance for the building including the land is correct in terms of the provisions of the Income Tax Act.

[3 marks]

Assessment objective: deduction of capital allowances for land & buildings
Assessment criteria: capital allowance is only on the buildings, but if the land and buildings cannot be separated then an apportionment is applied
Level of complexity: moderate as the allowance is calculated on the total amount in practice

SUGGESTED SOLUTION:	**Marks**
The purchase of the land and buildings is capital in nature. Therefore we would need to look at any capital allowances.	
There are no allowances on land.	**1**
Capital allowance of 5% is allowed on buildings if such buildings are used in the process of manufacture.	**1**
Therefore, the capital allowances on the land is incorrect however on the building it is correct.	**1**
	Max: 3

Candidate may apply the accounting principles and separate land and buildings to determine the capital allowances.

General comments:

1. The impairment loss for an asset using the revaluation method is complex in terms of separating the loss between the reversal of revaluation surplus and the impairment loss.
2. Re-classification of property (land and buildings) from PPE to Investment Property needs to be accounted for through OCI.
3. Tax implications was focused on the treatment of provision accounting and the change of use of the asset which has no tax implications.

PART E: **[30 MARKS]**

QUESTION 26:

Advise management whether the "roll-over" option can be used for income tax purposes for the year of assessment ended 28 February 2017. Support your answer with reasons.

[3 marks]

Assessment objective: selection of the "roll over" for voluntary disposals
Assessment criteria: basis of selecting the "roll over" – cash benefits for the taxpayer
Level of complexity: low as this focused on the definition of "roll over"

SUGGESTED SOLUTION:	Marks
The roll-over provision can be applied at the election of the taxpayer - s66 as it is a voluntary replacement of the asset used in the production of income.	1
The option is only selected by the taxpayer if it is financial beneficial, viz. reduces the strain on the cash flows of the business and that there will not be an increase in the tax rate in future.	1
The conditions are that the replacement asset must be contracted for within 12 months and brought into use within three years of the disposal.	1
Conclusion: the tax benefit of electing the roll-over improves the cash flow of the business -recommended that the roll-over is implemented.	1
	Max: 3

Candidate may ignore the fact that the voluntary replacement of the asset can also be used when electing the "roll over".

QUESTION 27:

Discuss how the back-up generator and the spare part should be accounted for accounting and income tax purposes taking into consideration the provisions of the appropriate standards and legislation.

[12 marks]

Assessment objective: treatment of spare parts and support assets for accounting and tax purposes

Assessment criteria: accounting treatment of spare parts and support assets (general vs specific use) and the tax implications of spare parts and support assets

Level of complexity: high as the treatments have different criteria for accounting and tax purposes

SUGGESTED SOLUTION:			**Marks**
Accounting		**Income Tax**	
Generator: Generator satisfy the criteria of being classified as an asset – future economic benefits under the control of the company.	**1**	Generator represents a capital expenditure and therefore does not meet the requirements of being a deduction in terms of s11(a).	**2**
Satisfy the criteria to be classified as PPE – used in the production process. Specific the machinery and equipment – capitalised as part of the cost of the machinery & equipment (same useful life).	**1**	The generator was acquired for the purposes to be used by the company for the production of income – entitle to capital allowance (same as the underlying asset).	**1**
		As the generator is used in the process of manufacture and is new, a s12C allowance can be claimed, 40% in the first year and 20% thereafter. Or if they assumed second hand, 20% per year of assessment. In both cases, not apportioned.	**2**
		If the candidates, assumed that SBC, 100% write off as an allowance for manufacturing machinery.	**2**
Spare parts: Spare parts satisfy the criteria of being classified as an asset – future economic benefits under the control of the company.	**1**	Spare part are acquired for the purposes of being used to repair machinery used in the production of income.	**1**

As the spare parts are used for more than one machine, it satisfy the criteria of being classified as inventory – recognised as an expense when it is used.	**1**	If the spare part are for general purposes then it will be classified as consumables (trading stock) – deduction is in terms of s11(a). If it is still on hand, then it will be accounted for as trading stock. Closing stock will be added to taxable income and opening stock is a deduction to taxable income. If it is acquired for a specific asset, then it will be recognised as repairs and deducted as a general deduction in terms of s11(d).	**2** **1** **1**
	Max: 4		**Max: 8**

It is important that candidate separate the treatment for accounting and tax – candidates may not specific under which they are discussing the items.
Note to markers: award marks based on the concepts discussed as candidates may not itemise the discussions in terms of the appropriate sections.

QUESTION 28:

Record the journal entries, if any, in respect of deferred taxation relating the abovementioned machinery and equipment transactions (existing, new, generator and spare parts) for the reporting period ended 28 February 2017 in compliance with the accounting standards. Support your answers with relevant calculations.

[10 marks]

Assessment objective: calculation and the recording of deferred tax
Assessment criteria: calculation of deferred tax based on the identification of temporary differences and the recording of the transaction
Level of complexity: moderate/high as candidates may have difficulty in identifying the temporary differences

SUGGESTED SOLUTION:					**Marks**
	Accounting	Taxation	Difference	Deferred tax	
Existing machinery – balance	800 000	400 000	400 000	112 000	**1**
Existing machinery – disposal	-	-	-	-112 000	**1**
Deferred recoupment	-	-288 000	288 000	80 640	**2.5**
Deferred capital gain	-	-50 400	50 400	14 112	**2**
New machinery	3 050 000	2 640 000	410 000	114 800	**2**
Generator	330 000	324 000	6 000	1 680	**2**
Repairs	90 000	90 000	0	-	**1**
(principle mark)	3 470 000	2 715 600	754 400	211 232	**1**
			Debit	Credit	
Deferred tax liability (SFP)			112 000		**1**
Deferred tax expense (P&L)				112 000	**1**
[Reversal of deferred tax balance i.r.o asset disposal]					**1**
Deferred tax expense (P&L)			211 232		**2**
Deferred tax liability (SFP)				211 232	**1**
[Provision for deferred tax for the current period]					**1**
					Max: 10

Note to markers: candidate may record a single transactions to reconcile the opening and closing balances on the deferred tax account.

General comments:

1. The question focused on the application of the accounting and tax principles in comparison which could contribute to the increased level of thinking required for the question.
2. Deferred tax may be calculated different by reconciling the opening and closing balances – this is an area that many candidate may struggle with as it is not applied that often in practice.