SOUTH AFRICAN INSTITUTE OF PROFESSIONAL ACCOUNTANTS™

YOUR WEALTH

QUESTION A:

Advise the company how the research and development costs incurred in respect of the product should be recognised in the financial statements in compliance with the accounting standards.

[10 minutes]

Active reading – understanding the required & identify the issue	**Determine how the research and development costs should be recognised in respective of the intangible asset – many candidates may not pick up the testing costs due limiting the reading to the required and the context of the scenario**	
B.O.K. – principles and frameworks to be applied to solve the issue	**Only capitalise the development costs if there is a potential to generate future economic benefits – candidate may have focussed their discussion and selection of the B.O.K based on PPE which was irrelevant information provided in the question**	
Information extracted – distinguish between relevant & irrelevant information	**Distinction between research and development costs – testing costs relates to the research phase – this will only be identified if the context of the business and scenario was read and linked to the technical knowledge of the candidate**	
Application – using the principles & information to construct an answer	**Expensing costs incurred during the research phase and capitalising those incurred during the development phase – this will only be achieved if the candidate clearly identified the issue and the appropriate B.O.K**	
		Grade
Research costs	**The research costs should be expenses as the results will determine whether there will be future economic benefits – uncertainty about the likelihood that the output will generate future economic benefits**	**C**
Testing costs	**Testing costs were incurred to assess the feasibility of the product design and marketability which will indicate the ability to generate future economic benefits – the expenses should be treated as an expense**	**C**
Development costs	**Development costs were incurred to making the asset ready for its intended use to realise the potential future economic benefit – costs must be capitalised as an intangible asset**	**C**
		2C
	Alternative Answer	

In terms of IFRS for SME's all costs (research, testing and development) should be expenses unless the output is an asset that will be used by the business and classified as Property, Plant & Equipment.	**C**
	1C
Note to markers: candidates may have ignored the recognition of the testing costs from the discussion. Candidates may also have focussed on the recognition criteria of probable occurrence and measured reliably.	

QUESTION B:

Discuss whether the recommendation of Mr. A. Count complies with the accounting standards. If not, make recommendations as to how the amount received should be recognised in the financial statements in compliance with the accounting standards.

[10 minutes]

Objective of the question: recognition of compensation received by government in respect of an asset
B.O.K: compensation received from the government can be recognised as income or set-off against the cost of the asset

Active reading – understanding the required & identify the issue	**determine how the compensation received from government in respect of a manufacturing plant should be treated (recognised as income or set-off against the cost) – candidate may not have identified that the grant has two components, viz. construction of the factory and the employment of youth (these should be recognised separately with the grant for employment as a conditional grant)**
B.O.K. – principles and frameworks to be applied to solve the issue	**Compensation received from the government for the construction of the plant represent a grant and can be recognised as income or set-off against the cost of the asset and the conditional grant should be recognised as an asset until the condition is fulfilled – candidates may not have identified that the grant consists of two components (construction of factory and employment of youth)**
Information extracted – distinguish between relevant & irrelevant information	**Compensation was received from the government in respect of the construction of the factory – assumption that there are no performance conditions.** **Grant received for employment should be recognised as a conditional grant which is recognised as income when the condition is fulfilled**
Application – using the principles &	**Depending on the terms and conditions of the compensation received, it can be recognised as income or set-off against the**

information to construct an answer	cost of the asset - based on the policy adopted by management	
		Grade
The compensation received from the government will be classified as a government grant. Assumption is that there are no performance conditions attached to the grant, then management must adopt the policy to recognise the compensation as income when it is received and amortise it over the remaining useful life of the asset; or set it off against the cost of the asset. If the grant has performance conditions, then it should be recognised as deferred income which is recognised when the conditions are satisfied and fulfilled.	C C C	
		2C
Note to the markers – candidates may have seen this as a conditional grant due to the amount received for the employment of the youth. Candidates may have ignored the conditions and purpose of the grant and treated it as income rather than setting it off against the cost of the construction – compensation received for costs capitalised.		

QUESTION C:

Discuss whether the statement of Mr. Do-No-Thing about the recognition of the training centre as Investment Property complies with the requirements of the accounting standards.

[8 minutes]

Objective of question: determine whether a change in the intended use of the land must be reclassified
B.O.K: change of intended use of the land must result in the reclassification at the date the decision is made

Active reading – understanding the required & identify the issue	**Determine whether a change in the intended use of the land should result in its reclassification – candidate may not have identified the change of intention as the required was not read in the context of the scenario**
B.O.K. – principles and frameworks to be applied to solve the issue	**Change in the intended use of the land should result in its reclassification at the market value at the date the decision is made – candidates may not regard the land as part of the property that must be reclassified due to the change in use**
Information extracted – distinguish between relevant & irrelevant information	**Intension for which the land was purchases (capital appreciation) and changed to construct the manufacturing plant & market value at date decision is made – candidate will view the construction of the factory independent of the land on which it was constructed**
Application – using the principles &	**Land was classified as Investment Property, but when the intended use changes it must be reclassified at market value –**

information to construct an answer	**land must be classified in the manner that the property is classified and that the fair value on reclassification becomes the cost of the land after reclassification**

	Grade
Land was acquired with the intention of realising capital appreciation and was correctly classified as Investment Property.	**C**
The date the decision was made to construct the manufacturing plant on the land represents a change of intended use – land must be classified aligned to the classification of the building constructed. As the manufacturing plant will be used by the company it should be classified as Property, Plant & Equipment.	**C**
The land should be reclassified as Property, Property & Equipment at the date the decision is made to change its intended use. The land should be reclassified at its market value at the date of reclassification.	**C**
Subsequent to the reclassification land must be measured at its historical cost – value at the date of reclassification.	**+C**
	2C
Note to candidates – candidate may have viewed the land independently of the construction of the factory and would have reclassified the land at cost ignoring its initial intention (capital appreciation).	

QUESTION D:

Record the journal entries including the related deferred tax implications (narrations are required) for the recognition of the land for the reporting period ended 31 December 2018 in compliance with the accounting standards. Provide reasons and calculations to support the journal entries.

[12 minutes]

Objective of question: record the transaction for the reclassification of land from Investment Property to Property, Plant & Equipment
B.O.K: reclassify the land at its open market value through Profit & Loss (Investment Property) which will result in deferred tax (no valuation of assets is allowed)

Active reading – understanding the required & identify the issue	**Record the reclassification of land from Investment Property to Property, Plant & Equipment – this question must be viewed in conjunction with QUESTION A**
B.O.K. – principles and frameworks to be applied to solve the issue	**Reclassification from Investment Property to Property, Plant & Equipment at market value at date of the decision via Profit & Loss the fair value adjustment must be made before the reclassification in terms of the Investment Property standards – via Profit & Loss**

Information extracted – distinguish between relevant & irrelevant information	**Historical cost & market value at the date decision is made – recognition of the fair value adjustment via Profit & Loss**
Application – using the principles & information to construct an answer	**Reclassification gain is recognised through Profit & Loss resulting in deferred tax at company rate (realised through Profit & Loss)**

			Grade
	Debit	**Credit**	
Investment Property – Land	**1,300,000**		
Reclassification gain (P&L)		**1,300,000**	
[Valuation gain for reclassification purposes]			**C**
Deferred tax expense (P&L)	**364,000**		
Deferred tax liability (SoFP)		**364,000**	
[Deferred tax relating to reclassification)			**C**
Property, Plant & Equipment – Land	**2,500,000**		
Investment Property – Land		**2,500,000**	
[Reclassification of land for own use]			**C**
			2C
Note to markers – this question must be marked in conjunction with Question A as the journal entry is dependent on the interpretation of the reclassification			

QUESTION E:

Discuss the tax and VAT implications, if any, for Worldwide Digi-Marketing in respect of the amount received by from Tech-Fan.

[12 minutes]

Objective of the question: determine whether the amount received by the business to conduct illegal activities can be included in gross income
B.O.K: all amounts received by a taxpayer from legal and illegal business activities must be included in gross income

Active reading – understanding the required & identify the issue	**Determine whether amount received to carry out illegal business activities should be included in gross income and whether output tax should be charged on the amount received – it is important that the transactions are evaluated**

	independently (income and expenses cannot be viewed collectively as a single transaction)	
B.O.K. – principles and frameworks to be applied to solve the issue	Group income include all amounts which are received in respect of carrying out the business activities (revenue in nature & received by/accrue to the taxpayer) & output tax should be charged in the services rendered is considered to be a taxable supply	
Information extracted – distinguish between relevant & irrelevant information	Amount was received as part of carrying out business activities & funds will be used to carry out business activities which are illegal (revenue in nature) – the income received must be separated from the expenses incurred or whether the income is used to fund the expenses	
Application – using the principles & information to construct an answer	Amount was received in terms of a business transaction, but the amounts were used to fund illegal business activities in carrying out the service functions	
		Grade
Income Tax implication: The amount was received in respect of a business contract to carry out the service obligation through its business activities – amount received is revenue in nature as it is linked to carry out its service obligations. The funds received were used to fund the expenses illegal business activities, even though they are revenue in nature does not affect the recognition of income received. The question is whether the amount was received for the benefit of the company or whether it was held in trust to fund expenses on behalf of the client. As the company has the discretion to determine how and when the funds will be used to fulfil its contractual obligations – this indicates that the amount was received for the benefit of the company and should therefore be included in gross income. **VAT implications:** Output tax can only be charged in respect of taxable supplies – rendering of marketing services to its clients. The amount received was in respect of the business contract to render services to its client – regarded as a taxable supply on which output tax must be charged. Even though no invoice is charged, VAT is charged based on the earlier of the cash received or invoice issued – thus, output tax should be charged as the amount was received for the rendering of income.	C C C C C C C	
		5C
Note to the markers – the income is received in terms of a valid and legal business transaction and how the funds are used must be separated from the revenue		

transaction. Candidates may view the transactions as being illegal due to how the funds are used.	

QUESTION F:

Discuss whether Mr. Taxifern's (tax practitioner) advice satisfies the professional and ethical conduct in terms of the Tax Administration Act and the Code of Conduct of a Professional Accounting Organisation (PAO) such as SAIPA.

[5 minutes]

Objective of the question: determine whether the advice and conduct of the tax practitioner complies code of ethics and Tax Administration Act
B.O.K: advice given by the tax practitioner must not violate the tax legislation and should ensure that it complies with the code of ethics

Active reading – understanding the required & identify the issue	**Determine whether the conduct of the tax practitioner in providing advice is ethical – conduct must be viewed in the context of the information of scenario**
B.O.K. – principles and frameworks to be applied to solve the issue	**The conduct of tax practitioners is governed by the code of ethics and Tax Administration Act which requires the application of the tax regulations – must separate the code of conduct of the profession and the Tax Administration Act**
Information extracted – distinguish between relevant & irrelevant information	**The tax practitioner is aware that the expenses were used to fund illegal activities & advice is given that there are no tax implications of the recipient of the amount – tax practitioner was aware of the transactions and provided advices as if he was ignorant**
Application – using the principles & information to construct an answer	**Gross income definition incorporate income received from illegal activities, but the expenses incurred to generate the income cannot be treated as deductions**

	Grade
The taxpayer is aware of the facts of the situation, viz. that the funds will be used to pay for illegal business activities and provided advice which in contrary to the tax legislation.	**C**
Through the advice provided by the tax practitioner represents behaviour which assist the taxpayer to violate the tax legislation and can be regarded as an accomplice to defrauding SARS.	**C**
The tax practitioner is also violating the fundamental principle of objectivity and due care when executing his engagement responsibility. Furthermore, the tax practitioner is assisting the taxpayer in violating the tax legislation which violates the conduct of the tax practitioner in terms of Tax Administration Act.	**C**
The action and behaviour of the tax practitioner in providing advice which he intentionally assist the taxpayer to violate the tax legislation represents an act which violates the ethical behaviour expected from the tax practitioner.	**C**
	3C
Note to the markers – the behaviour of the tax practitioner must be viewed independent of what the answer for Question E.	

QUESTION G:

Discuss criteria and date the revenue earned from the sale of Maximus should recognised with specific reference to:

(a) product and licencing
(b) warranty agreement

[15 minutes]

Objective of the question: understanding of the recognition of multiple revenue transactions
B.O.K: revenue transactions should be recognised based the various contractual obligations

Active reading – understanding the required & identify the issue	**Recognise revenue transactions for a sale of goods, rendering of service and warranty agreements – the sale agreement must be assessed based on its terms and conditions**
B.O.K. – principles and frameworks to be applied to solve the issue	**Revenue from the sale of goods should be recognised based transfer of rights and obligations, rendering of services should recognised based on work performed, and warranty is based the estimation of the obligation – separation of a single transaction with different sales obligations**
Information extracted – distinguish between relevant & irrelevant information	**Type of revenue transaction – sale of goods, resource and support services (license) and a warranty agreement – terms and conditions of the sales agreements**
Application – using the principles & information to construct an answer	**Measurement of the revenue transaction should be separated between the different revenue types and the terms and conditions of the warranty agreement (not given)**

	Grade
Single revenue transaction which contain different type of revenue transactions with different obligations (sale of goods, rendering of services and warranty agreement). The separation of the revenue amount should be based on the fair value (market value) for the different types of revenue transactions.	**C**
Revenue from the sale of goods should be recognised based on the obligation of transferring the risk and rewards to the buyer – when deliver takes place.	**C**
Revenue from the rendering of services should be recognised based on the level of work performed – degree of completion (periodically for the license).	**C**
The obligation for the warranty should be recognised at the date the sale of the goods is recognised and measured based on the costs and probability of the obligations.	**C**
	3C

Note to markers – candidate will not be able to distinguish between the warranty arrangement and the service agreement – warranty agreement does not affect revenue as it is a cost to the business	

QUESTION H:

Discuss whether the statement made by Mr. Radmak relating to the inclusion of revenue earned from the sale of Maximus in the gross income in compliance with the Income Tax Act.

[10 minutes]

Objective of the question: determine the amount of revenue that should be included in gross income for multiple sales transaction
B.O.K: revenue should be included in gross income based on the earlier of the cash received by or accrue to the taxpayer

Active reading – understanding the required & identify the issue	**Determining how multiple revenue transactions should be treated for inclusion of gross income – definition of gross income differs from the recognition of revenue**
B.O.K. – principles and frameworks to be applied to solve the issue	**Revenue should be included in gross income based on the earlier of the cash received or accrue to the taxpayer – critical is the concept of accrued to the taxpayer**
Information extracted – distinguish between relevant & irrelevant information	**Revenue from the sale of goods, services rendered and warranty agreements – important to understand the obligations to the seller based on the terms and conditions**
Application – using the principles & information to construct an answer	**Revenue is included in gross income based on the earlier of the cash received or accrue to the taxpayer – sale of goods from date the goods are delivered, services rendered when the work is performed and warranties when the obligations are fulfilled**

	Grade
Revenue is included in gross income based on the earlier of the cash received or accrue to the taxpayer – taxpayer is entitled to receive the income.	**C**
If the cash was received when the goods were sold, then the total amount for the sale of goods and services rendered will be included in gross income. However, if the goods were sold on credit then the revenue from sale of the goods and the services rendered, then the revenue is included in gross income from the date the taxpayer becomes entitled to the income – sale of goods will be recognised from	**C** **C**

the date the goods are delivered, but the revenue from the services rendered will be recognised periodically (depend on the terms and conditions of the sale).	**C**
The warranty agreement is included in gross income as part of the sale of the goods, but the expenses incurred to carry out the warranty obligations will only be treated as a deduction when the expenses are incurred.	**C**
	3C
Note to markers – candidate may confuse the principles of accounting with the rules of taxation. There may be an argument that the same criteria for accounting may be applied for taxation (technically not correct)	

QUESTION I:

Discuss how Mr. Daan Trompie can resolve the personal ethical dilemma he has in respect of the purchase of the motor vehicle.

[8 minutes]

Objective of the question: dealing with ethical issues identified by staff within the organisation
B.O.K: any professional in the accountancy profession should deal with ethical issues with the policies of the organisation

Active reading – understanding the required & identify the issue	**How staff should be dealing with ethical dilemmas within an organisation – identify the ethical dilemmas and following the procedures to address the matter**
B.O.K. – principles and frameworks to be applied to solve the issue	**Staff should follow the internal policies and process for when dealing with ethical dilemmas in the company – internal policies and procedures to deal with ethical dilemmas in a practice**
Information extracted – distinguish between relevant & irrelevant information	**Employee is concerned about the vehicle purchase by the company for the use of the wife of the shareholder – details of the issues that will raise ethical issues**
Application – using the principles & information to construct an answer	**Employee must raise and report the matter with senior staff or management and follow the processes and policies of the company – internal versus external processes for dealing with ethically issues**

	Grade
The employee must follow the policies and processes of the company dealing with ethical behaviours of management or directors/shareholders.	**C**

The employee should report the matter to management outlining the event which gives rise to the ethical dilemma as well as explaining the consequences to the company.	**C**
The employee is the financial manager will be held liable for the disclosure of information presented in the financial statements which results in a material misstatement of the financial statements – discuss the matter with the people responsible for the financial statement engagement.	**C**
The employee should discuss the matter with Mr. Taxifern as recommended by Mr. I. Fan (shareholder and director) and report on the outcome of the discussion.	**C**
If the employee is of the opinion that management will not correct the matter, then he should consider resigning from the company.	**C**
If the employee is a member of a PAO, then he can report the matter to his Professional Body seeking assistance to deal with the matter.	**C**
	4C
Note to markers – candidates may have discussed the external processes to be followed or mentioned the fundamental mitigating factors when dealing with ethical issues.	

QUESTION J:

Discuss the income tax implications if Judd Woznext decided to purchase the car utilising a loan received from the company.

[10 minutes]

Objective of the question: determine the income tax implications of the shareholder taking a loan from the company to purchase the vehicle
B.O.K: debit loans granted by the company may bear dividend tax implications

Active reading – understanding the required & identify the issue	**Treatment of debit loans granted to shareholders of the company – the assumption is that the shareholder does not have a credit loan and that no interest will be charged**
B.O.K. – principles and frameworks to be applied to solve the issue	**If the interest charged on debit loans to shareholders is less than the market value, then there may be dividend tax implications to the shareholder – identification of a deemed dividend as a result of the interest charged**
Information extracted – distinguish between relevant & irrelevant information	**Shareholder received an interest free loan from the company for personal use**

Application – using the principles & information to construct an answer	**The interest that would have been charged at the interest rate stipulated in the Income Tax Act will be regarded as a deemed dividend**

	Grade
The interest-free loan (debit loan) granted to the shareholder results in a deemed dividend, if during a year of assessment an amount is owing to a company by a person who is a resident.	**C**
Judd Woznext is regarded as a connected party as he holds more than 20% of shares of the company – Judd Woznext has the authority to authorise the loan granted to the shareholder.	**C**
The "deemed" dividend is regarded as a dividend in specie, therefore the dividend tax must be paid by the company.	**C**
The income Tax Act states that the amount of the dividend that is deemed to have been paid is deemed to be equal to the greater of: **(a) the market-related interest (official rate of interest) for that debt, less the amount of interest that is payable to that company for that debt for that year of assessment, or** **(b) Rnil.**	**C**
The 'deemed' dividend paid to the shareholder amounts to [575 000 x ((7,75% - 0%) x 122/365] R 14,895.	**C**
The "deemed" dividend is then deemed to have been paid on the last day of the year of assessment (31 December 201) and must be paid by the company on 31 January 2019.	**C**
	4C
Note to markers – the deemed dividend in only determined at the reporting date and no details of the repayment plan or terms and conditions are provided.	

QUESTION K:

The open market value of the motor vehicle at the date it was transferred to Mr. I. Fan as a dividend was R 100,000. Record the journal entries in respect of the motor vehicle distributed as a dividend to MR. I. Fan.

[12 minutes]

Objective of the question: record the transactions in respect of the assets distributed as a dividend to shareholder
B.O.K: distribution of an asset as a dividend must be recorded as a de-recognition of the asset and the distribution of the dividend in specie measured at market value

Active reading – understanding the	**Recording the transactions for the distribution of an assets as a dividend in specie**

required & identify the issue	
B.O.K. – principles and frameworks to be applied to solve the issue	**The distribution of a dividend in specie must be recorded as a de-recognition of the asset and the distribution of the dividend at the open market value of the asset – integration of accounting and tax knowledge relating to dividends in specie**
Information extracted – distinguish between relevant & irrelevant information	**Cost, carrying amount and open market value of the assets – information relating to the disposal of an asset**
Application – using the principles & information to construct an answer	**De-recognised the cost and carrying amount of the asset & recognise the dividend at its market value (proceeds of disposal of the asset**

			Grade
	Debit	**Credit**	
Accumulated depreciation – Vehicles	**300,000**		
Motor Vehicles - Cost		**300,000**	
[De-recognition of asset distributed as dividend]			**C**
Dividends paid (SoCE)	**100,000**		
Profit on Disposal of asset (P&L)		**100,000**	
[Recognition of the distribution of dividend in specie]			**C**
Dividend tax (P&L)	**20,000**		
Taxation due (SoFP)		**20,000**	
[Recognition of dividend tax due]			**C**
Taxation due (SoFP)	**20,000**		
Bank		**20,000**	
[Payment of dividend tax due]			**C**
			3C
Note to markers – candidate may not has recorded the disposal/de-recognition of the asset but only the dividend part			

QUESTION L:

Discuss how the gratuity received by Mrs. Etaze should be included her personal income tax return for the 2019 year of assessment. If it is included in her tax return, state the amounts at which it should be included.

[8 minutes]

Objective of the question: determine how the gratuity received by the employee should be treated in her tax return

B.O.K: gratuity received by the employee on retirement should be treated as part of gross income (linked to employment)

Active reading – understanding the required & identify the issue	**Determine how the gratuity received by the employee on retirement should be treated for income tax purposes – treatment for income tax purposes**
B.O.K. – principles and frameworks to be applied to solve the issue	**The gratuity received by the taxpayer in respect of services rendered should be treated as part of gross income – cash and otherwise (value of goods received)**
Information extracted – distinguish between relevant & irrelevant information	**Gratuity received by the employee on retirement consisted of cash & shares (shares must be value at its fair/market value) – issue of shares is a settlement transaction and does not affect a related party**
Application – using the principles & information to construct an answer	**All amount received by the employee in respect of being employed by the company must be treated as part of gross income**

	Grade
The gratuity received by the employee is in respect of being employed by the company and should be included as part of salaries received and must be included in gross income for the year of asset when it was received.	**C**
The shares received can only be included in gross income from the date the employee has a vested right in the shares – employee becomes the owner of the shares.	**C**
The shares must be included at its fair/market value – if there is no market value then an appropriate valuation accepted by the Commissioner can be used to determine its value.	**C**
	2C
Note to markers – candidates may not have realised that the issue of the shares forms part of the termination remuneration package	

QUESTION M:

Analyse the extract from the statement of cash flow and comment on the operating cash position of the company over the past three years.

[20 minutes]

Objective of the question: analyse and comment on the extract from the statement of cash flow
B.O.K: analyse and interpret the cash flow and cash position of the company

Active reading – understanding the required & identify the issue	**Analyse and interpret the extract from the cash flows statement – issue is limited to the discussion of the numbers and require no further calculation**
B.O.K. – principles and frameworks to be applied to solve the issue	**Statement of cash flow provides an indication of the cash management of the company – discussion must be limited to the cash generated from operations**
Information extracted – distinguish between relevant & irrelevant information	**Extract from the cash generated from operating activities – cash flows through carrying on day-to-day business operations**
Application – using the principles & information to construct an answer	**Cash generated from operation provides an indication of the cash inflows generated from revenue transactions and the ability to meet the operating cash requirements**

	Grade
Cash receive from customers increased gradually over the three years with the increase during the current period more than doubling that of previous period.	**C**
The indicate the management has improved is cash inflow management plans which may indicate that the management improved its debtor management (cash collection from debtors).	**C**
The significant increase during the current period could be linked to the increase in the sales performance of the business.	
Cash paid to suppliers and employees fluctuates over the past three years where it peaked during 2017 but declined significantly during the current period.	**C**
The implies that management realised the benefits of its cost and management payment management strategy, the impact of which was realised during the current period.	**C**
The cash generated from operations was positive throughout the three years but fluctuated significantly over the same period with a significant increase during the current period.	**C**
The significant increase during the current period was driven by the increase in cash received from customers coupled with the decrease in cash paid to suppliers and employees – the cash inflows and outflows from operations move in opposite directions with the increase in cash inflows being the dominant driver resulting in cash surplus generated from operations.	**C**

Payment of interest and taxes increased consistently over the past three years, but the cash generated from operations to meet these obligations, except for 2017, which resulted in cash surpluses that can be re-invested in the business activities for future growth and sustainability.	**C**
	5C
Note to markers – candidate may have provided ratios and trend analysis to support their answers or they may have discussed the position of the current year only.	

QUESTION N:

Review the ratios above and comment on the following areas:
(a) liquidity of the business
(b) leverage and financial risk of the business

[25 minutes]

Objective of the question: analyse, interpret and comment on the ratios to have insight to the business
B.O.K: using ratio analysis to comment on the performance and position of the business

Active reading – understanding the required & identify the issue	**Analyse and interpret the ratios to obtain insight and comment on the performance and financial position of the business – understanding how the ratios should be clustered to provide better insight**	
B.O.K. – principles and frameworks to be applied to solve the issue	**Ratio analysis provide insight into the short-term liquidity (ability to meet obligation) and solvency (financial risk and security) of the business**	
Information extracted – distinguish between relevant & irrelevant information	**Liquidity (cluster of ratios – current, quick and cash ratios) and solvency (cluster of ratios – gearing, asset and interest cover ratios)**	
Application – using the principles & information to construct an answer	**Analysis and interpreting the ratios to comment and the liquidity and solvency of the business**	
		Grade
(a) Liquidity: **The current ratio is below the norm of 2:1 but has consistently being higher than the industry average. However, even though the current ratio has declined annually over the past three years, indicating the operating and liquidity risk increased, it seems as if it within the liquidity risk tolerance level of the company. Management is controlling its liquidity position to ensure that is does become a risk to the business.** **The quick ratio (excluding inventory) is above the norm of 1:0 but during the current period the ratio fell below the industry average. This may indicate a certain level of liquidity risk to the business as which may result**		**C**

in it being difficult to on credit from suppliers. The comparison between the current and quick ratios indicate that a large proportion of the current assets of the business is represented by inventory which may increase the liquidity risk to the company if a risk arises in the company's ability to sell its inventory.	**C**
The cash ratio is above that of the industry average (about double) and even though it has declined over the past three years. This indicates that the business has enough resources to finance its operating and short-term payment obligations. However, by decreasing its cash resources the business may be depleting its reserves which could place future risks on the company's ability to expand its operations through internal financing.	**C**
Generally, the liquidity ratios indication that the business is in a healthy position in relation to the industry average, but there are indications that if the trend continues in a negative direction, then the business may face liquidity and short-term financing risks in future.	**C**
(b) Solvency:	
The gearing ratio (debt to equity) consistently increased over the past three years which indicates that the capital structure has shifted towards debt financing. Even though the gearing ratio is below the industry average, the trend has moved towards the average. The increase on the reliance on debt financing increases the financial risks (greater future payment obligations) and business risk (assets being used as security) which may impact on the future growth and sustainability of the business.	**C**
The interest cover ratio is above the industry average but declined by approximately 40% of the cover in 2016. This indicates that the risk to cover the servicing costs for the debt financing has increased as reflected by the change in the capital structure of the business.	**C**
The asset cover ratio is above that of the industry average but has declined consistently over the past three years. This indicate that the major part of the non-current assets are represented by depreciable assets which does not provide adequate security to debt financiers.	**C**
	5C
Note to markers – candidates may not have separated their discussion or analysis between the liquidity and solvency position of the company. Candidates may not have compared the ratios to the industry as benchmarks. Candidate may have comment on the other ratios given.	

QUESTION O:

Advise management with the acquisition of the equipment should be financed using the loan or leasing. Support your answer with calculations and reasons.

[20 minutes]

Objective of question: applying financing techniques to select the best available option to finance the investment decision
B.O.K: apply financing techniques (discounted cash flows) to select the most beneficial financing option for the company

Active reading – understanding the required & identify the issue	**Selecting the best possible financing option to fund investment decisions – determining the basis of selecting the best financing option**
B.O.K. – principles and frameworks to be applied to solve the issue	**Apply financing techniques which will results in the minimum cash outflow to the business over the financing period – candidate may not have identified that the present value should be considered**
Information extracted – distinguish between relevant & irrelevant information	**Financing options and cash flows – loan (capital repayments and interest payments and finance lease (lease payments) and the market interest rates – information affecting present value**
Application – using the principles & information to construct an answer	**Determining the present value of cash flows discounted at the market interest rate over the financing period**

		Grade
Loan financing:		

Present value:		
Capital repayments [(2,300,000/3) @ 15% for 3 years]		
[766,667 x 2.2832]	**1,750,473**	**C**
Interest payment:		
Period 1 [(2,300,000 x 13%) @ 15% after 1 year]		
[299,000 x 0.8696]	**260,000**	**C**
Period 2 [(2,300,000 – 766,667) x 13% @ 15% after 2 years]		
[199,333 x 0.7561]	**150,725**	**C**
Period 3 [(2,300,000 – 2 x766,667) x 13% @ 15 after 3 years]		
[99,667 x 0.6575]	**65,532**	**C**
Present value of loan	**2,226,730**	**C**
Lease financing:		
Immediate payment	**461,000**	**C**
Present value of lease payments		
[461,000 @ 16.07%/2 for 5 periods]		
[461,000 x 3.9000]	**1,839,368**	**C**
Present value of lease	**2,300,368**	**C**
Decision: based on the present value, the loan should use as the financing option.		**C**
		7C
Note to markers – candidate may not have calculated the interest on an annual basis and might have calculated the net present value of the machine as if it was an investment decision.		

QUESTION P:

Disclose the information in respect of the lease liability including taxation relating to the acquisition of the equipment for the reporting period ended 31 December 2019 in compliance with the accounting standards.

[15 minutes]

Objective of question: disclosure of the finance lease liability in terms of the accounting standards
B.O.K: disclosure of lease liability in statement of financial position (non-current & current liability) and accompanying note (liability and lease commitment payments)

Active reading – understanding the required & identify the issue	**Disclosing the information relating to a finance lease in the financial statements in compliance with accounting standards – only limit disclose to the finance lease liability**
B.O.K. – principles and frameworks to be applied to solve the issue	**Finance lease liabilities must be disclosed as any other long-term debt (non-current liability) together with the future lease commitment note – information was given and there was no need to complete the amortisation table**

Information extracted – distinguish between relevant & irrelevant information	**Finance lease details (terms and conditions) and amortisation table (measurement information for disclosure) – information relating to the disclosure of a finance lease agreement**	
Application – using the principles & information to construct an answer	**Disclosing the information in statement of financial position (non-current & current liabilities) & disclosure of notes for non-current liabilities and future lease commitments**	
		Grade
Statement of financial position at 31 December 2018		
Non-current liabilities		
Finance lease liability	**1,187,359**	**C**
Current assets		
Finance lease liability (sort-term)	**651,641**	**C**
Interest accrued	**40,865**	**C**
Notes to the financial statements for the period ended 31 December 2018		
Finance lease agreement		
The finance lease liability represents the present value of the minimum lease payments discounted at the effective interest rate of 16.07%. The minimum lease payments of R 461,000 are payable half-yearly for the remaining two and a half years.	**1,839,000**	**C**
Less: Current liability (short-term obligation)	**651,641**	**C**
Non-current liability	**1,187,359**	**C**
Finance lease obligation		
		7C
Note to markers – candidates may not have read the question correctly and disclosed all the information relating to the finance lease including the information relating to the asset.		

Finance lease obligation

	Following period	Thereafter	Total	Grade
Rental payments	**922,000**	**1,383,000**	**2,305,000**	**C**
Interest element	**270,359**	**195,726**	**466,085**	**C**
Capital repayment	**651,641**	**1,187,274**	**1,838,915**	**C**

QUESTION R:

Objective of the question: evaluating the accuracy of the calculation of WACC
B.O.K: WACC is calculated based on the capital structure and after-tax cost of capital

Review the schedule for the calculation of WACC prepared by Ms. J-Pee and comment on its accuracy in terms of the application of financial management principles.

[10 minutes]

Active reading – understanding the	**Evaluate the accuracy of the calculations of WACC – check the accuracy of the calculations**

required & identify the issue	
B.O.K. – principles and frameworks to be applied to solve the issue	**Calculation of WACC is based on the capital structure and the after-tax cost of capital – weighted average cost of capital (capital structure) and after-tax cost**
Information extracted – distinguish between relevant & irrelevant information	**Capital structure, cost of capital, tax rate and the accuracy of the calculation**
Application – using the principles & information to construct an answer	**Check the calculation of capital structure, after-tax cost of capital and WACC**

	Grade
WACC has been calculated based on simple average of the after-tax cost of capital (deducting the effects of tax on all capital components) – principles for calculating WACC were not applied.	**C**
The following are fundamental errors in the calculation:	
• **Simple average was use based on the assumption the capital structure is the same for all components – assume equal weighting even though the capital structure differs.**	**C**
WACC should be based on the capital structure – proportion of capital invested in the business.	**C**
• **The effect of tax was accounted for all components of capital structure – dividends paid do not results in any tax benefits to the company. The dividend tax should not be considered when calculating the after-tax cost of capital.**	**C**
• **WACC is calculated based on the capital structure and the after-tax cost of capital.**	**C**
Conclusion: WACC has been calculated in the schedule because the capital structure was not considered, and the effect of tax was calculated for the equity financing component.	**C**
	4C
Note to markers – candidates may have performed the calculation without commenting on its accuracy.	

QUESTION S:

Record the transactions including deferred tax in respect of the item of Property, Plant & Equipment for the reporting ended 31 December 2018 in compliance with the accounting standards.

[15 minutes]

Objective of the question: recording of transactions in respect of impairment losses subsequent to its initial recognition
B.O.K: reversal of an impairment loss cannot result in the carrying amount exceeding its value based on its original cost

Active reading – understanding the required & identify the issue	**Recording the transactions relating to initial and subsequent recognition of impairment loss – recognition of impairment loss and its subsequent reversal**
B.O.K. – principles and frameworks to be applied to solve the issue	**Reversal of the impairment loss cannot increase the carrying amount to a value higher than that based on the original cost – basis of calculating the recoverable amount and the reversal of the impairment loss**
Information extracted – distinguish between relevant & irrelevant information	**Carrying amounts (historical cost and after impairment), recoverable amount and tax value**
Application – using the principles & information to construct an answer	**Compare recoverable amount to carrying amount based on historical cost (limitation of reversal) and calculate temporary difference and deferred tax**

			Grade
	Debit	**Credit**	
Depreciation expense	**327,273**		
Accumulated depreciation		**327,273**	
[Depreciation for the period]			**C**
Deferred tax expense (P&L)	**76,364**		
Deferred tax liability (SoFP)		**76,364**	
[Deferred tax for period – [(600,00 – 327,273) x 28%]			**C**
Accumulated impairment loss (SoFP)	**167,045**		
Reversal of impairment loss (P&L)		**1567,045**	
[Reversal impairment loss - (1,312,500 – 1,145,455)]			**C**
Deferred tax expense (P&L)	**46,773**		
Deferred tax liability (SoFP)		**46,773**	
[Deferred tax relating to reversal of impairment loss]			**C**

			3C
Note to markers – candidate may not have recorded the transaction for depreciation and may have calculated a single transaction for deferred tax.			