

Ignore value-added tax

<b>1 Background</b>
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DentOut (Pty) Ltd ('DentOut') is a panel-beating business owned by the 32-year-old twin siblings, Michaela and Marcello Panelli. They are the only directors of the company. Michaela Panelli is a CA(SA) and full-time audit manager at a large audit firm named Confidence Assurance Inc. ('CAI'). Marcello is a qualified panel beater who takes care of the day-to-day operations of DentOut on a full-time basis.

Each sibling is entitled to an equal share of the after-tax profits of the business, and they re-invest at least 25% of these profits each year. In addition, Marcello draws a market-related monthly salary for the management of the business. The Panelli siblings work well together and decisions regarding the business are made after conversations at family gatherings. They are proud of the steady growth of the business which they started from scratch in Marcello's home garage.

DentOut now employs 30 operational and administrative staff and has a loyal customer base. The company has shown a steady increase in growth since incorporation in 2016 and is attracting the attention of larger companies who wish to share in the success of DentOut.

One such group is Regal Vehicle Rentals (Pty) Ltd ('RVR'), a large car rental group that was established in 2001 and has operations throughout South Africa. RVR would like to acquire a controlling interest in DentOut.

Following preliminary engagements between DentOut and RVR, RVR appointed a local corporate finance specialist company, CorpTru Inc. ('CorpTru') to perform a high-level due diligence of DentOut prior to deciding whether it wanted to purchase a stake in DentOut.

The following is an extract of the summary of the findings of CorpTru:

<p><b>Due diligence report (extract)</b></p> <p><b>DentOut (Pty) Ltd</b>  <b>Regal Vehicle Rentals (Pty) Ltd Executive Team</b></p> <p><i>Compiled by CorpTru Inc.</i>  <b>1 October 2023</b></p>
<p><b>Background of company</b></p> <p>DentOut rents premises in an industrial park in Johannesburg for use as a workshop and storeroom. DentOut currently does not have an ISO accreditation<sup>1</sup> and therefore does not attract business from any of the major insurers or motor manufacturers. Customers are typically individuals and businesses who do not have insurance cover, or prefer not to involve insurers. The Panellis are of the view that the King IV Report on Corporate Governance is only applicable to listed companies and that would not really be of benefit to a small company.</p>

<sup>1</sup> ISO accreditation refers to compliance with quality and safety benchmarks set by the International Organisation for Standardisation.

The current reporting period is for the financial year ended 30 September 2023 (FY2023). Michaela stated that, in her opinion, DentOut complies with International Financial Reporting Standards (IFRS) and is currently only required to have an independent review of its financial statements.

### Operating and financial information systems

DentOut operates a very basic off-the-shelf financial record-keeping system supported by Microsoft Excel spreadsheets, with limited internal controls.

The finance team currently consists of –

- a bookkeeper who oversees the data-capturing process and basic reconciliations;
- a debtors clerk who deals with all sales-related matters, follows up on outstanding debt, and keeps related accounting registers and files in order; and
- a creditors clerk who assists Marcello with ordering parts, keeping track of debt owed to suppliers, and keeps related accounting registers and files in order.

Michaela prepares DentOut’s annual financial statements, tax calculations and all tax returns. She submits the annual returns to the Companies and Intellectual Property Commission. Marcello manages all operations and staff-related matters.

The majority of transactions at DentOut are cash based. No accurate inventory movement records are kept. There are two types of inventories – new inventory and reconditioned / used inventory. The reconditioned spares and parts (inventory) are not accounted for in the accounting records since these are either obtained at a Rnil cost or a marginal cost. The fair value of these reconditioned / used spares and parts was estimated to be R1,83 million as at 30 September 2023. Stock counts are carried out at the end of each month for all new spares and parts kept in the DentOut storeroom, which is located at the same premises as the workshop. The appointed independent reviewer attends the stock count at year end and its working papers are available for audit purposes.

### Extract from the trial balance as at 30 September 2023

	Notes	R
Machinery and equipment	1	11 130 000
Inventory: New spares and parts		5 950 000
Inventory: Reconditioned / used spares and parts	2	20 000
Debtors	3	3 000 000
Bank and cash		3 500 000
Suppliers: 15-day credit terms		(6 500 000)
Accruals	4	(950 000)

### Notes

- 1 This includes a significant number of items that have been fully depreciated, but which are still in use. Management has not re-assessed the useful lives of these items since acquisition.
- 2 Most of the items were obtained at a marginal / Rnil cost price as they were obtained from scrapyards or tow-truck companies.
- 3 Payment terms: 70% cash deposit and the remaining 30% of the contract price payable within 30 days.
- 4 Accruals include insurance and one month’s rent outstanding. Management recognises rental expenses as invoices are received and has not considered IFRS 16 *Leases*.

## **Additional material findings**

### **1 *Faulty reconditioned spares***

The due diligence team identified instances where DentOut may have been using reconditioned or used parts in repairs but charged customers for new parts. One such instance relates to Ms Mandy Mondy, a driver who died in a car accident in August 2023. According to the Mondy family, DentOut replaced the brakes, steering system and the accelerator pedal of Mandy's vehicle during the first week of July 2023. A mechanic friend of the Mondy family assessed Mandy's wrecked vehicle and cited the cause of the accident as driving with worn-out brakes that had reached the end of their useful life.

The Mondy family further informed CorpTru that Mandy's father had spoken to Marcello Panelli on 4 August 2023 about the accident and reprimanded him for allowing DentOut employees to replace Mandy's brakes with old worn-out brakes. Marcello allegedly insisted that DentOut would not take responsibility for Mandy's reckless driving and insinuated that Mandy must have been under the influence of alcohol. The Mondy family showed CorpTru legal documents about a lawsuit they had filed against DentOut for loss of life. The lawsuit was filed on 25 August 2023 and DentOut received notification of the lawsuit on 27 August 2023. The Mondy family has also taken the matter to *Blanche Carte*, a popular South African investigative journalism television programme, which aired an episode on the matter in October 2023.

CorpTru conducted a background search on DentOut on the internet and identified reviews on Google and Hellopeter<sup>2</sup> that stated that several previous DentOut clients had claimed that DentOut fit reconditioned parts to vehicles and charged the customers for new parts. These reviews state that Marcello refused to acknowledge their claims and they are therefore going 'to follow a legal route'. No lawsuits have arisen from these allegations at the date of this report.

CorpTru met with the RVR inhouse legal team to discuss these allegations and the claim from the Mondy family. They informed CorpTru that after a detailed internal review of vehicle repair and job card records it appears more likely than not that some instances exist where reconditioned parts were used by the repair technicians.

The legal team however regard the possibility of legal action against DentOut being successful to be remote. The onus is on the claimants to prove their allegations beyond a reasonable doubt, which will be difficult.

The legal team estimates that total successful claims that could possibly arise from the allegations (including the Mondy family's claim) would amount to no more than R2,5 million. In addition, legal fees are expected to amount to R900 000.

These cost estimates were reflected in the final determination of the purchase price offered by RVR.

### **2 *Intangible asset treatment***

The due diligence team identified that DentOut purchased four digital dent pullers ('machinery') at a cost of R825 000 each for the first time on 1 October 2021. DentOut also incurred total costs of R2 555 000 on software that enables the digital dent pullers to connect

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<sup>2</sup> Hellopeter is an internet-based platform on which consumers can complement or complain about services or products that they purchase from businesses.

to the main car body repair system of the shop. Inspection of the fixed asset register showed that the software costs were capitalised to the digital dent pullers. The software installed is not integral to the digital dent pullers.

DentOut considered the digital dent pullers to have a total useful life of five years with a residual value of R100 000 each.

### **3 Income tax**

CorpTru noted that the company aggressively attempts to keep income tax payable as low as possible.

## **2 Proposed Regal Vehicle Rental transaction**

RVR representatives discussed its intention to buy a controlling interest in DentOut with Michaela and Marcello. Subsequently, the parties entered into a non-disclosure agreement regarding all aspects of the negotiations. RVR then provided the two with a summary of the due diligence findings and indicated that before the deal can go through, it would like Michaela and Marcello's response to the findings.

RVR also had the following requirements that DentOut needed to fulfil:

- 1 DentOut must ensure that it is fully compliant with IFRS as this will simplify the consolidation process for the RVR Group financial statements because RVR is fully compliant with IFRS.
- 2 To enhance the credibility of its financial information, DentOut must adopt the recommended practices of the KING IV Report on Corporate Governance.
- 3 DentOut must implement a strong internal controls system.
- 4 DentOut must adopt a technology-based integrated information system to manage its operations and finances.
- 5 Although DentOut will remain a separate legal entity after the take-over, its Memorandum of Incorporation (Mol) must be amended to include a provision that DentOut's financial statements are subject to an external audit. An audit will be required for the FY2023 financial statements.

RVR is due to rotate auditing firms soon in terms of the Mol of the parent company and would prefer the audit firm that audits DentOut to also become the auditors of RVR and the RVR Group. For this reason, RVR requested that a large audit firm be considered.

Both Michaela and Marcello were open to the idea of a buy-out, as it would create further growth potential for DentOut. Michaela shared RVR's intention and requests with the managing partner at Confidence Assurance Inc. The managing partner suggested that Michaela do as much as possible to ensure that CAI was awarded the contract for the audit and other services of DentOut; he also indicated that Michaela would be well rewarded if she could bring in work from the RVR Group.

Michaela then recommended that CAI be awarded the DentOut audit contract to the RVR representatives, should the two parties go ahead with the deal. She noted that CAI was one of the largest auditing and advisory firms in South Africa and had offices in seven provinces. Its head office is located in Johannesburg. Mr Jack Hammer would be nominated as the audit partner.

In addition, she recommended that to reduce the DentOut separate financial statement audit fee, CAI be awarded the contract for the following services:

- Design of a new internal control and information system for DentOut;
- Assistance with the selection or design of an integrated information technology system;
- Formalisation of board structures and committees; and
- Provision of tax planning and structuring advice.

The representatives of RVR agreed to Michaela's recommendations since they were keen for the deal to go ahead.

### **3 Offer to purchase a controlling stake in the business**

As part of RVR's strategic ambitions, the RVR Board of directors contemplates creating value for shareholders by investing in a company that aligns with the growth of the group through its car rental companies. RVR believes that the proposed transaction to acquire a controlling interest in DentOut would align with the group strategy as DentOut will become the preferred repairer of car rental vehicles within the RVR Group.

The Panelli twins received a non-binding offer from RVR on 10 October 2023. In terms of the offer, RVR would acquire a controlling interest of 51% in DentOut by subscribing for new shares for a total cash consideration of R11 million. In addition to the information provided in section 2, the following conditions were stipulated in the offer letter:

- 1 Michaela and Marcello must continue to be involved in the day-to-day operations of DentOut.
- 2 The R11 million purchase consideration will be invested in the business specifically to obtain ISO quality accreditation.
- 3 Michaela and Marcello must oversee the ISO quality accreditation process and upgrades to equipment.
- 4 Should the ISO quality accreditation not be achieved, the investment in DentOut will be converted into a loan, which will have to be repaid to RVR.
- 5 All branding related to DentOut must be removed and replaced with RVR branding.

### **4 Valuation of DentOut**

Michaela wanted to get her own estimates for the upcoming negotiations with representatives from RVR. She therefore asked a trusted friend and colleague from the corporate finance division of CAI to perform an initial valuation of DentOut. Michaela's colleague analysed the historic financial results of the company and discussed trends in the motor and panel-beating industry with Michaela and Marcello.

Marcello explained that plant and equipment incorporating artificial intelligence technologies are now being used more widely in the automotive industry. However, given Marcello's view that 'nothing can replace the good old machinery at DentOut', only maintenance capital expenditure was incorporated into the valuation.

Michaela paid R25 000 directly to her colleague for the valuation services that the colleague rendered in his free time. An extract of the valuation workings, which are arithmetically accurate, is presented in table 1.

**Table 1: Extract of valuation workings**

<b>Valuation: DentOut (Pty) Ltd</b>	
<b>Prepared for: Michaela and Marcello Panelli</b>	
<b>Valuation as at 30 September 2023</b>	
<b>Present value of free cash flows to the company</b>	<b>R'000</b>
Forecast period	5 841
Terminal value	20 120
<b>Value of operations</b>	<b>25 961</b>
Add: Excess cash	22
Less: Debt	(352)
	25 631
Control premium (25%)	6 408
<b>Value of equity</b>	<b>32 039</b>
<b>Notes</b>	
<ul style="list-style-type: none"><li>• No additional costs relating to RVR's conditions as stipulated in the offer letter were incorporated in the valuation.</li><li>• No implications of the potential settlement of claims from disgruntled customers were included in the valuation.</li></ul>	

## **5 Vehicle refurbishment project from RVR**

RVR recently reached an agreement with a financial services company, Ride Finance (Pty) Ltd ('RideFin'), which provides finance to Uber drivers for four-seater sedan vehicles. Due to poor economic conditions, many RideFin clients have been defaulting on their loan repayments. As a result, RideFin has had to repossess an increasing number of vehicles that were offered as security for loans.

In terms of the agreement between RVR and RideFin, RideFin will sell the vehicles to RVR at a discounted rate for the next year because these vehicles are in a good condition and would have recorded mileage of less than 10 000 km. RVR plans to use the vehicles for rentals. RVR has approached DentOut to refurbish the vehicles so that they will be appealing as rental vehicles. Marcello believes that if DentOut impresses RVR with the quality of its work on this project, Michaela would be able to justify a greater valuation for DentOut in the ongoing purchase negotiations.

The contract for refurbishments between RVR and DentOut would be for a period of one year from the date of the agreement. It is estimated that 26 vehicles will need to be refurbished by DentOut at a fee of R25 500 per vehicle.

A recent inventory count revealed that DentOut already has many items required for the vehicle refurbishments on hand. However, other items would need to be purchased from DentOut's suppliers.

### **1 Spray paint**

Spray paint for the refurbishments is available in several colours in DentOut's inventory warehouse. The spray-paint cylinders (1 litre each) were purchased for R400 per cylinder as the paint is used for day-to-day repairs by DentOut. The current retail price of the paint is R500 per cylinder. Each vehicle will require half a cylinder of paint.

## **2 Leather**

The refurbishment would involve re-upholstering the seats with soft leather and 20 m<sup>2</sup> of leather will be required for each vehicle. The leather would need to be purchased from a supplier in Cape Town at a cost of R650 per m<sup>2</sup>. In addition, a fixed delivery charge of R6 250 would be payable for a consignment of 300 m<sup>2</sup> of leather. Thereafter there would be an additional delivery cost of R1 800 for every 100 m<sup>2</sup> of leather (or part thereof) purchased.

## **3 Generator**

Marcello is concerned that loadshedding could cause delays in completing the vehicle refurbishments. A neighbouring business has recently begun leasing industrial generators. Marcello asked one of its salespersons to conduct an evaluation of the back-up power requirements for the refurbishment project. The cost of the evaluation service was R1 500. The salesperson established that the PowerUP900 portable generator would be most suitable. If DentOut accepts the refurbishment project, Marcello plans to lease the portable generator at a fixed cost of R7 000 per month, including fuel.

## **4 Labour**

Semi-skilled workers will carry out the work required for the refurbishments. These workers can be hired as required at a rate of R300 per day. Each vehicle refurbishment will require 12 days of labour from one worker in total.

## **6 Additional information**

- Software is measured on the cost model in terms of IAS 38 *Intangible Assets* over a useful life of three years with no residual value.
- Computer equipment is measured on the cost model in terms of IAS 16 *Property, Plant and Equipment*.
- The South African Revenue Service grants a wear-and-tear allowance on the digital dent pullers on a straight-line basis over five years and three years for the related software.
- A tax rate of 27% applies to all applicable years of assessment.
- All amounts are regarded as material.

**INITIAL TEST OF COMPETENCE, JANUARY 2024**

**PROFESSIONAL PAPER 1**

**This paper consists of two parts.  
Answer each part in a separate answer book.**

<b>PAPER 1 PART I – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(a)	<p>Discuss the key matters that the Panelli siblings should consider prior to accepting the buy-out offer from RVR, with regard to –</p> <p>(i) the impact for DentOut on its operations and growth; and</p> <p>(ii) considerations for the siblings as the existing shareholders.</p> <ul style="list-style-type: none"> <li>Ignore taxation.</li> <li>Do not discuss any ethical matters.</li> <li>Calculations are not required.</li> </ul> <p><i>Communication skills for part (a)(i) – logical argument</i></p>	14 8	23
(b)	<p>Determine, with reference to the percentage margin of safety, whether DentOut should accept the vehicle refurbishment project from RVR in section 5.</p> <ul style="list-style-type: none"> <li>Ignore taxation.</li> </ul>	12	12
(c)	<p>Discuss the appropriate accounting treatment arising from the faulty reconditioned spares in note 1 of the ‘additional material findings’ in the due diligence report in the –</p> <ul style="list-style-type: none"> <li>separate financial statements of DentOut for FY2023; and</li> <li>at acquisition consolidated financial statements of RVR, on the assumption that RVR acquired a controlling interest in DentOut on 1 October 2023.</li> </ul> <ul style="list-style-type: none"> <li>Do not discuss presentation and disclosure.</li> <li>Do not discuss any implications of IAS 2 <i>Inventories</i>.</li> <li>Do not discuss any implications of IAS 7 <i>Statement of Cash Flows</i>.</li> </ul>	8	8
(d)	<p>Prepare the prior-period error note in the separate financial statements of DentOut for FY2023 relating to the software described in the due diligence report.</p> <ul style="list-style-type: none"> <li>Assume that the tax was correctly treated in the income tax return.</li> <li>Assume all amounts are material.</li> </ul> <p><i>Communication skills – presentation</i></p>	10  1	11
<b>Total for part I</b>			<b>54</b>



**INITIAL TEST OF COMPETENCE, JANUARY 2024**

**PROFESSIONAL PAPER 1**

**This paper consists of two parts.  
Answer each part in a separate answer book.**

<b>PAPER 1 PART II – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(e)	<p>Discuss, with reference to the information provided in sections 1 and 2, any ethical threats and concerns you may have regarding the behaviour and actions of Michaela.</p> <ul style="list-style-type: none"> <li>• Do not discuss the significance of any threat.</li> <li>• Do not provide any safeguards.</li> </ul> <p><i>Communication skills – logical argument</i></p>	12	
		1	13
(f)	<p>Discuss, with reference to the information provided in sections 1 and 2, factors that Jack Hammer needs to consider in deciding whether to accept the audit engagement of DentOut.</p> <ul style="list-style-type: none"> <li>• Exclude any discussion related to the ethical conduct of Marcello and Michaela.</li> <li>• Do not discuss the significance of threats.</li> <li>• Do not provide any safeguards.</li> </ul> <p><i>Communication skills – clarity of expression</i></p>	22	
		1	23
(g)	<p>Discuss, with reference to the extract of the trial balance provided in section 1, the substantive procedures on the opening balances that can be performed to confirm the existence of DentOut’s assets as at 1 October 2022.</p> <p><i>Communication skills – clarity of expression</i></p>	9	
		1	10
<b>Total for part II</b>			<b>46</b>
<b>TOTAL FOR PAPER 1</b>			<b>100</b>