

QUESTION 1

50 marks

1 Background

Soda-XP Ltd ('Soda-XP') is a diversified South African listed company with several subsidiaries. All companies in the Soda-XP Group apply International Financial Reporting Standards (IFRS). The financial year end of all companies in the Group is December.

The information below relates to –

- 1 Soda-XP's interest in a subsidiary, LightOn (Pty) Ltd ('LightOn'), which was sold during the financial year ended 31 December 2023 (FY2023), and
- 2 its glass manufacturing cash-generating unit, known as Glass-It

2 Disposal of majority interest in LightOn

Soda-XP subscribed for 60 000 ordinary shares (a 60% controlling interest) in LightOn on incorporation, for a consideration of R300 000. LightOn manufactures electric lights and its profits have declined over the last few years with the introduction of LED lights. Soda-XP accounted for the investment in LightOn at cost in its separate financial statements in accordance with IAS 27 *Separate Financial Statements*.

On 30 September 2023, Soda-XP sold 50 000 LightOn ordinary shares at a fair value of R90 per share. Soda-XP recognised a profit on the sale of the shares of R4,25 million in its separate financial statements.

LightOn was correctly never classified as held for sale or as a discontinued operation in terms of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. After the partial sale of LightOn shares, Soda-XP classified the remaining investment as subsequently measured at fair value through other comprehensive income in its separate financial statements.

The financial statements of LightOn were yet to be consolidated into the financial statements of the Group, and no consolidation adjustments were made in respect of LightOn. The preliminary total consolidated profit of the Group after the consolidation of Soda-XP and its other subsidiaries (excluding LightOn) amounted to R50 million for FY2023.

The accountant has correctly calculated the following information about Soda-XP's interest in LightOn for FY2023:

	R'000
LightOn's total profit for the period ended 30 September 2023	850
Total amount of Soda-XP's 60% interest in LightOn on 30 September 2023 (i.e., cost plus since-acquisition ¹ reserves attributable to Soda-XP)	4 700

- 1 Since acquisition relates to the period post subscription.

3 Impairment assessment of Glass-It

Glass-It is one of Soda-XP's operations that manufactures various glass products. During manufacturing, sand and other raw materials are melted at high temperatures, which requires a consistent electricity supply. The prolonged power outages in South Africa have negatively impacted the operations of Glass-It and have resulted in lower production and decreased profit margins.

At a meeting held in December 2023, the Board of Soda-XP approved a detailed plan to terminate the services of some employees, in an effort to save costs. The termination benefits will be paid in cash in FY2024, and will not be deductible for tax purposes by Soda-XP.

The carrying amount of Glass-It on 31 December 2023 was correctly determined as follows:

	Notes	R'000
Land (revalued on 31 December 2022)	1	13 000
Manufacturing plant (cost model)	2, 3	89 000
Allocated goodwill (grossed up: R2 880 000 / 75%)	4	3 840
	5	105 840

Notes

- 1 The land was acquired at a cost of R12 million and is revalued every two years.
- 2 The manufacturing plant consists of the building and heating system, and all items of machinery and equipment used in the manufacturing process. On 31 December 2023, the remaining useful lives of all items of the manufacturing plant, except for the glass-cutting machine, were five years. All items will be sold at the end of their useful lives. Soda-XP expects to receive R16 million (net after costs) from selling the manufacturing plant (excluding the glass-cutting machine) after five years.
- 3 The glass-cutting machine is used to cut flat glass and is a vital part of the manufacturing process. On 31 December 2023 the remaining useful life of the glass-cutting machine was correctly considered to be two years. After this it will need to be replaced at an expected cost of R7 million. The glass-cutting machine has no residual value.
- 4 Goodwill of R9 million arose when Soda-XP acquired a 75% ownership interest in PureGlass Ltd ('PureGlass') in FY2017. The non-controlling interest was initially measured at its proportionate interest in PureGlass' net identifiable assets. It was expected that Glass-It would also benefit from the synergies of the business combination, and goodwill of R2,88 million was correctly allocated to it in terms of IFRS. The amount of the goodwill included in Glass-It was adjusted to reflect the grossed-up amount of goodwill.
- 5 Soda-XP's items of inventory on hand on 31 December 2023 would be sold in the ordinary course of business and were correctly excluded from Glass-It. There are no other corporate assets servicing Glass-It.

Accounting policies

- 1 The land is revalued every two years and is not revalued before being classified as held for sale.
- 2 Before the assets are classified as held for sale, an impairment loss is first calculated and recognised in terms of IAS 36 *Impairment of Assets*.

During the impairment review of Glass-It, the financial accountant prepared the following value-in-use calculation:

Present value of expected (pre-tax) cash flows		
	Growth rates	R'000 (rounded)
FY2024 (22 800 000 – 3 000 000)		19 800
FY2025 (22 800 000 x 103,0%)	3,0%	23 484
FY2026 (23 484 000 x 103,3%)	3,3%	24 259
FY2027 (24 259 000 x 103,8%)	3,8%	25 181
FY2028 (25 181 000 x 103,5%)	3,5%	26 062
Present value discounted at 15%		81 690

The expected cash flows are expressed in real terms and do not include any capital expenditures. Furthermore, the expected cash flows have been adjusted for the risk of increased hours of load shedding post FY2023. The expected cash flows for FY2024 include the payment of R3 million as termination benefits to employees in terms of the liability correctly recognised on 31 December 2023.

While reviewing the calculations of the value in use, the financial director, Mr Max Major, ascertained the following:

- The operating cash flows, which were based on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions, are in line with the approved formal budget. As such, the expected cash flow in FY2024 of R22,8 million is reasonable.
- All cash flows correctly occur at the end of each month and are earned evenly throughout the year (except for the payment of the R3 million in termination benefits).
- The discount rate is a pre-tax rate that reflects current market assessments of the time value of money and all the risks specific to the assets (including the risk of increased hours of future load shedding). The discount rate includes the effect of price increases attributable to general inflation.
- The growth rates are deemed to be appropriate.
- The present value calculations are arithmetically accurate.

Max re-performed the calculations of Glass-It's recoverable amount. He correctly calculated the fair value less costs of disposal of Glass-It as R90 million, which was significantly higher than its value in use.

The only asset of Glass-It for which its individual fair value less costs of disposal could be determined was the land. This was determined to be R12,5 million.

The performance of Glass-It for FY2023 was as follows, before the recognition of any impairment or termination benefits:

	R'000
Revenue	93 000
Cost of sales	(75 000)
Other expenses	(10 000)
Profit for the year	8 000

All items in profit or loss are fully taxable or deductible unless otherwise stated.

4 Soda-XP strategic considerations

Soda-XP is considering ways to return to profitability and create value for shareholders, following the impairment indicators and the resultant impairment review of Glass-It as discussed in section 3. The key strategies identified include the following:

- The company will focus on operating effectiveness which enables it to create, sell and deliver high quality products and services, faster, better or with fewer resources and defects than the competition.
- There are two options with regard to Glass-It:
Option 1: Move Glass-It to Botswana.
Option 2: Sell Glass-It.

Option 1: Move Glass-It to Botswana

Soda-XP would sell the assets in the South African Glass-It operation and invest the proceeds in a new operation in Botswana. The following information that would impact the move to Botswana is available:

- Botswana is dependent on South Africa and Zambia for electricity. It imports more than 50% of its power requirements from these countries. Zambia predominantly generates hydro-electric power and is therefore dependent on adequate rainfall. In the first quarter of 2023 the country halted power cuts following adequate rainfall and good water levels. Botswana generates the remainder of its electricity requirements from coal power stations. The Botswana Power Corporation has been generating excess power to meet local demand during the off-peak hours, thus creating capacity to export to neighbouring countries.
- In addition to the power shortages, Glass-It had other challenges which impacted cash flow and profitability. It imports machines and primary raw materials from China and India. Following the impact of the Covid-19 pandemic, the operations of its Chinese and Indian suppliers have returned to normal. Due to global supply chain constraints, however, these suppliers are unable to source sufficient inputs to allow Glass-It to return to full production. This has significantly increased the lead times for Glass-It and has resulted in a backlog of unfulfilled customer orders. Botswana does not have suppliers who can replace the Chinese and Indian suppliers. Both machines and primary raw materials are priced in United States dollar and Soda-XP does not hedge against foreign currency risks. The rand weakened against the dollar between 2022 and 2023.

Option 2: Sale of Glass-It

The second option that the Board of Directors is considering, is to sell Glass-It. In that case Glass-It would correctly be classified as a disposal group held for sale and as a discontinued operation on 31 December 2023. It would have met all the relevant criteria for such classifications in accordance with IFRS 5. All the assets of Glass-It would be included in the disposal group, and there would be no related assets or liabilities that would also be included in the disposal group.

5 Financial information on the target revenue, cost-volume and profit for Glass-It

- 1 The relationship between the total cost of producing the glass components and the units produced is as follows:

Units produced	Total cost
	R'000
1 000 000	25 000
3 000 000	50 000

- 2 If option 1 is followed, the move to Botswana would reduce fixed costs by 25% because the fixed fuel costs are expected to be replaced by the relatively cheaper electricity.
- 3 The following information relates to the target revenue, mark up and contribution:
- Although the demand for glass is currently depressed, the target revenue and mark up on cost (for Glass-It) for FY2024 is R120 million and 25%, respectively.
 - The average contribution margin is 50%. The glass products and sales mix are expected to be constant.
 - Except for the specifically identifiable 25% reduction in fixed costs, the selling price, variable cost per unit and other expenses will remain the same after the move to Botswana.

6 Selected working capital, cash flow and debt ratios for Glass-It

The following are the financial metrics calculated for Glass-It from the most recent financial statements:

Metric	Glass-It	Sector median
Receivables turnover (days)	75	55
Days inventory on hand	140	127
Number of days payables	120	75
Debt ratio	85%	55%
Cash flow to revenue	12%	
Cash generated by operations	R4 560 000	

INITIAL TEST OF COMPETENCE, JUNE 2024

PROFESSIONAL PAPER 4

**This paper consists of two questions.
Answer each question in a separate answer book.**

PAPER 4 QUESTION 1 – REQUIRED		Marks	
		Sub-total	Total
(a)	<p>Calculate the consolidated profit of the Soda-XP Group from continuing operations for FY2023 after consolidating LightOn.</p> <ul style="list-style-type: none"> Ignore taxation. Show any fair value adjustment or remeasurement separately in your calculations. Ignore all adjustments relating to Glass-It. 	8	8
(b)	<p>Discuss five concerns that you may have about the calculation of the value in use for Glass-It, and for each concern, provide the appropriate treatment.</p> <ul style="list-style-type: none"> Limit your discussion to issues for which there is evidence of inaccuracies, inconsistencies, errors in application and/or non-compliance with IFRS in the scenario. <p><i>Communication skills – logical argument</i></p>	10 1	11
(c)	<p>Prepare, on the assumption that Soda-XP decided to adopt option 2 in section 4, the analysis of the single amount in respect of the discontinued operation in profit or loss in terms of IFRS 5.33b for inclusion in the notes to the consolidated financial statements of the Soda-XP Group for FY2023.</p> <ul style="list-style-type: none"> Indicate the allocation of the impairment loss to the respective assets in your calculations. Round and present all amounts in R'000. Do not split any income tax expense between current tax and deferred tax. Do not provide a disclosure of information relating to any allocation to the owners of the parent or the non-controlling interests. Do not provide comparative amounts. 	11	11

Continued on the next page

INITIAL TEST OF COMPETENCE, JUNE 2024

PROFESSIONAL PAPER 4

**This paper consists of two questions.
Answer each question in a separate answer book.**

PAPER 4 QUESTION 1 – REQUIRED (cont.)		Marks	
		Sub-total	Total
(d)	Using the information provided on the performance for FY2023 and in section 5, and on the assumption that the Soda-XP Group adopted option 1 –		
	(i) calculate the amount by which the current gross profit should increase to reach the target gross profit of Glass-It in FY2024;	2	
	(ii) calculate the sales value required for Glass-It to achieve the target gross profit for both the South African and Botswana operations in FY2024; and	4	
	(iii) calculate and conclude, taking into account your answer to part (d)(ii) above, the impact that the move to Botswana will have on Glass-It's profitability.	2	8
(e)	Determine, assuming the Soda-XP Group adopted option 1, based on the information provided in sections 4 to 6, the strategies that could have been used to ensure that Glass-It remained solvent and liquid following the move to Botswana.	11	
	<i>Communication skills – appropriate style</i>	1	12
Total for the question			50