QUESTION **100 marks**

All amounts exclude value-added tax (VAT), unless otherwise indicated.
Assume that all persons are South African residents for taxation purposes, unless otherwise indicated.

1 Background

Real Pirates (Pty) Ltd ('RP') is a soccer club that owns a soccer stadium called 'Bacca Stadium' in Johannesburg. RP is not a recreational club approved by the Commissioner in terms of section 30A of the Income Tax Act. The stadium, which has a maximum capacity of 50 000 seats for supporters, also has a clubhouse and a retail store that sells soccer jerseys, tracksuits, soccer boots, bags and jackets (collectively known as merchandise).

Soccer seasons typically run from 1 August to 30 April of the following year. The 2019/2020 season thus ran from 1 August 2019 to 30 April 2020. RP is a registered vendor for VAT purposes and makes 100% taxable supplies.

Revenue streams of RP

RP 'acquires' and 'sells' soccer players to and from other soccer clubs. These transactions generally mean that these players are contracted with RP for fixed periods and that RP acquires (or sells) the commercial rights to these players. Commercial rights give a soccer club the exclusive image rights of a player. The commercial rights include public events that a player is required to attend to represent the club, player participation in radio and/or TV broadcasts and the use of the player's face and name on marketing material and merchandise. One such player that the company acquired on 1 May 2019 is Mr Cristiano Shabalala. Details of the acquisition have been included in section 2.

Apart from the above, the club also earns revenue from the following activities:

- Sale of tickets for games played at the Bacca Stadium (see section 3);
- Sponsorships from companies (see section 4);
- Participation in the national South African soccer league:
  - RP receives various payments from the sporting body managing the national league in which it participates. These payments reflect the revenue arrangements that the national league has made with broadcasters of soccer games on TV. The revenue is then distributed to all the clubs that participate in the national league games. These distributions are usually twofold: a fixed 'solidarity' component, determined at the start of the soccer season, to compensate each club for participation in the national championship, and a variable component, which depends on the club's final ranking in the league.
- Various other income streams, such as the following:
  - The sale of soccer kits and other merchandise in the retail store (also see section 5); and
  - Rental income from the Bacca Stadium.

Developments during the current year

The Covid-19 outbreak that affected many parts of the world, also had a negative impact on South Africa. The strict lockdown regulations included limitations on group gatherings such as sporting events (including games played at the Bacca Stadium) and prohibited the sale of non-essential items until 31 May 2020. These restrictions had also negatively affected the cash flows of RP. The board of directors are currently considering various strategies to address the situation (see section 7).

The financial director of RP, Mr Lucas Messi, is currently finalising the financial results for the financial year ended 30 April 2020 (FY2020). RP's annual financial statements are prepared in accordance with International Financial Reporting Standards (IFRSs). Jackson Inc. was appointed as the Registered Auditor of RP for FY2020.

2 Acquisition of Cristiano Shabalala

Cristiano Shabalala was a famous soccer player who had a very large social media following. He used to be a player for Chappies Mamelodi soccer club, but was recruited at the start of the 2017/2018 season by another soccer club, Chiefs United (Pty) Ltd ('Chiefs United'), on a three-year contract. Chiefs United paid R1,2 million for the transfer. When Chiefs United acquired Cristiano, it had no intention of selling the image rights it had acquired during the term of the contract. Neither Chappies Mamelodi nor Chiefs United are recreational clubs approved by the Commissioner in terms of section 30A of the Income Tax Act.

RP approached Chiefs United during January 2019 with an offer to acquire Cristiano. RP acquired Cristiano on a four-year contract from Chiefs United on 1 May 2019. In terms of the contract RP paid R2 million to Chiefs United for the transfer of Cristiano's commercial rights to RP and a further R1 million to transfer registration of Cristiano's membership to RP. The contract gave RP exclusive rights to use Cristiano's image rights, with the exception of some existing smaller sponsorship agreements Cristiano had had in place for many years.

The Chiefs United accountant classified the R3 million received upon the sale of Cristiano to RP as income in nature for normal tax purposes and consequently included the full amount in Chiefs United's gross income. His argument for this tax position was that the club paid Cristiano a monthly salary while he was contracted to Chiefs United, which was deductible in terms of section 11(a) of the Income Tax Act. The reason Chiefs United was prepared to accept the offer and to sell the player's rights was because it needed the money for its operations.

Cristiano had been a top player in the South African soccer league for the past five soccer seasons, and RP expected to attract more spectators to games played at the Bacca Stadium because of his participation. RP also expected the use of Cristiano's face and name on its merchandise to increase its merchandise sales by 33%.

In terms of Cristiano's contract, he would receive 15% of the sales of the merchandise that had his name and face on it as royalty income. RP would pay him an annual salary of R5 million as well as an additional amount of R350 000 per month for living expenses. Cristiano also received income from various other sponsors in addition to providing marketing on his social media platforms, where he had more than three million active followers.

The sale of merchandise with Cristiano's face and name commenced on 1 June 2019 and amounted to the following:

Period	R
1 June 2019 – 31 July 2019	800 000
1 August 2019 – 31 October 2019	1 150 000
1 November 2019 – 30 April 2020	1 356 000

Cristiano suffered a heart attack during a training session and passed away on 31 July 2019. Cristiano had bequeathed his image rights to his parents in his will. Cristiano's parents are married in community of property and his image rights, as well as the income derived from the rights, would form part of their joint estate. Cristiano's image rights were registered in the names of his parents on 1 November 2019.

3 Ticket sales

RP sells tickets for home soccer games (i.e. games played at the Bacca Stadium) in the following three ways:

- *Season tickets:* RP collects cash from the sale of season tickets for league games at the beginning of a new soccer season. Season ticket holders receive access to all 15 home games of the regular soccer league season, and the right to sit in a pre-selected seat. A season ticket holder does not receive a refund if a home game is cancelled or postponed for whatever reason or the ticket holder does not attend a game. All season ticket holders receive a 10% discount, except during the annual sale, when they purchase club merchandise from the club's retail store for the duration of the season.

  The 2019/2020 season ticket sold for R900 per ticket. RP calculated that R750 of this amount related to access to the games and R150 to the discount on merchandise.

- *Individual tickets:* These tickets for league games are purchased at the gate by non-season ticket holders on the day of the match.

- *Cup game tickets:* These are tickets for home games that are not part of the regular soccer league, such as national cup games or trophy games, and have to be purchased separately by supporters. The prices of these ticket vary, depending on the popularity of the game.

The following information is available on ticket sales for FY2020:

Type	Number of tickets	Average price per ticket	Total received
League game season tickets	10 000	R900	R9 000 000
League game individual tickets	420 000	R75	R31 500 000
Cup game tickets	375 000	R75	R28 125 000

4 Sponsorship deal

On 1 May 2017, RP had signed a five-year sponsorship agreement with Spud Ltd ('Spud').

In terms of this deal the sponsor agreed to –

- pay an upfront amount of R3 million to the club; and
- pay an additional annual amount of R10 million per season, if the club finished in the first two places of the league at the end of that particular season. RP only receives this payment three months after a season has ended. RP finished second in the league during the 2018/2019 season and the amount due was received during FY2020. The 2019/2020 soccer season could not be completed by 30 April 2020, because of the disruptions caused by the Covid-19 pandemic.

In exchange RP agreed that Spud's name and logo –

- would appear on the soccer team's shirts; and
- would be displayed on ten of the total of 50 fixed advertisement boards located in the Bacca Stadium. However, the agreement did not specify on which specific advertising boards the name and logo had to be displayed.

5 Other amounts received

- On 15 May 2019, the majority shareholder of RP donated R20 million to the club as the club was struggling with its cash flow. The payment is not subject to any condition that has to be met or any repayment terms.

- The following information is available on the sale of merchandise in the club's retail store:
  - Total sales of merchandise with Cristiano's face and name on it amounted to R3 306 000 for FY2020 and no discounts were applicable to these items.
  - Total sales of other merchandise using normal selling prices (i.e. before any discounts) amounted to R14 870 000 for FY2020. 7% of this amount related to sales to season ticket holders, while 5% related to sales during the annual sale.
  - The club's retail store holds an annual sale during the week before Christmas. During this sale merchandise is sold at a 70% discount. Season ticket holders are not entitled to use their 10% discount during the annual sale.

6 Jackson Inc.'s audit of journal entries

As part of the audit of the financial statements of RP for FY2020, the audit senior selected a number of general journal entries, processed by Lucas on 30 April 2020, for further verification. Lucas provided the following journal entries together with explanatory notes to the audit senior:

	Dr	Cr
	R	**R**
Journal 9033		
Suspense account	1 800 000	
Profit or loss on scrapping of office equipment		1 800 000
Office equipment: Accumulated depreciation	515 000	
Profit or loss on scrapping of office equipment	2 069 000	
Office equipment: Cost		2 584 000
Explanation *RP's administration offices are situated on the lower level of the Bacca Stadium. On 3 December 2019, heavy rains caused these offices to flood and all the office equipment was damaged beyond repair. An insurance claim was lodged and the proceeds were received on 5 April 2020. The cash book clerk did not know where to post this amount, and accordingly recorded it in a suspense account.*		
Journal 9037		
Salaries and wages	1 522 600	
Accruals		1 522 600
Explanation *All staff in management positions (excluding directors) at RP qualify for an annual bonus, which is calculated as 5% of their annual 'cost to company' remuneration package, provided the*		

	Dr	Cr
	R	R
budgeted revenue for the financial year is achieved or exceeded.		
Journal 9038		
Cash on hand / Petty cash	18 750	
Loan account: Lucas Messi		18 750
Explanation *This entry is to account for cash that Lucas placed in the petty cash on 25 March 2020 in order to clear the debit balance on his loan account before year end. It is related to journal 8761.*		

The audit senior found the related journal entry, which was recorded on 5 January 2020:

	Dr	Cr
	R	R
Journal 8761		
Loan account: Lucas Messi	18 750	
Cash on hand / Petty cash		18 750

Upon receipt of the above journal entries, the audit senior instructed the audit team to immediately perform the following general audit procedures:

- Consider the effectiveness of internal controls regarding classes of transactions and account balances and their impact on the nature, timing and extent of the substantive procedures;
- Obtain schedules indicating the composition of the amounts making up the journal entries (where these amounts have been aggregated);
- Re-perform the casts and extensions of such schedules;
- Trace the posting of the journal entries to the correct accounts in the general ledger; and
- Request a signed management representation letter dealing with all assertions regarding the classes of transactions and account balances affected by these journal entries.

7 Strategies considered to address RP's cash flow situation

RP had been experiencing financial difficulties since the lockdown regulations were put into place. While RP had started FY2020 with R70 million in the bank, it ended the financial year with a R30 million overdraft. In total, the club had debts of about R40 million (including unpaid taxes) at year end (30 April 2020).

In order to address the cash flow situation of the company, RP's board of directors called a special general meeting, after the end of FY2020, at which it pleaded for assistance to help save the club. This was also a requirement to provide sufficient and appropriate audit evidence to Jackson Inc. that RP is and will be a going concern for the foreseeable future.

The board is proposing to leverage off the current market value of the Bacca Stadium to raise funds. The club constructed the stadium at a cost of R86 million and it was brought into use on 1 June 2010 for the purposes for which RP intended to use the stadium (thus in RP's trade). The stadium qualifies as a building for income tax purposes. The stadium represents more than half of the club's assets. The stadium was partially financed by a loan from ANB Bank Ltd ('ANB Bank'), at a fixed interest rate of 9,5% per annum.

RP's capital structure currently consists of equity (estimated cost of equity: 16%) and debt (estimated cost: 9% before tax), bringing the total weighted average cost of capital to 14%.

Option 1

One of the options that the Board of Directors is considering to end its financial woes, is to enter into a sale and leaseback agreement. In terms of this agreement the Bacca Stadium will be sold to Group Q, an independent alternative investment firm, for R102 million on 1 August 2021 and then immediately leased back to RP. If this option were selected, the stadium would be registered in the name of Group Q on 1 August 2021 and the full selling price would be received by RP on the same date.

Total annual lease payments of R7,2 million will be payable in advance for ten years, with the first payment on 1 August 2021. At the end of the lease contract, RP will be required to repurchase the stadium at an agreed-upon market price. Capital appreciation is expected to be 4% per annum.

RP has in the past and will continue to only utilise 80% of the stadium. Under the proposed lease, RP will retain the exclusive use of 80% of the stadium.

The remaining 20% of the stadium, which is not used by RP, is used by an events company. The events company pays rental of R2 million per annum to RP, payable in arrears. The rental is expected to increase by 12% on 1 August 2026. If RP enters into the sale and leaseback agreement, the contract with the events company will be taken over by Group Q on the same terms, effective from 1 August 2021.

Option 2

If RP chooses not to enter into the sale and leaseback agreement, an alternative would be to raise loan funding with the Bacca Stadium as security. The original bond with ANB Bank was paid off and settled with proceeds received during successful earlier seasons and donations from the majority shareholder.

RP approached ANB Bank for a new loan: ANB Bank is willing to provide a loan to RP of up to the market value of the stadium (i.e. R102 million), with equal annual repayments of R15,5 million, payable in arrears, over ten years.

INITIAL TEST OF COMPETENCE, APRIL 2021

PROFESSIONAL PAPER 4

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

PAPER 4 PART I – REQUIRED		**Marks** Sub-total	**Marks** Total
(a)	Discuss whether it would be correct for RP to capitalise the cost incurred for the acquisition of Cristiano`s commercial rights as an intangible asset in terms of IAS 38 *Intangible Assets* on 1 May 2019.	10	
	Communication skills – appropriate style	*1*	11
(b)	Discuss the performance obligations that will result from the sale of a season ticket in terms of IFRS 15 *Revenue from Contracts with Customers*.	10	
	• Assume that the sale of a season ticket meets the requirements of a contract in terms of IFRS 15.9.		10
(c)	Prepare the journal entries to record the ticket sales (section 3), sponsorship deal (section 4) and other amounts received (section 5) in the accounting records of RP for FY2020.	8	
	• No journal narrations are required. • Ignore all tax consequences.		8
(d)	Critically discuss the income tax position taken by the accountant of Chiefs United in respect of the amount received by that club upon the sale of Cristiano.	8	
	Communication skills – logical argument	*1*	9
(e)	Calculate the normal tax implications for RP if the club decides to sell the Bacca Stadium to Group Q in terms of the sale and leaseback agreement.	6	
	• Assume that RP will not have any other capital gains or losses for that year of assessment. • Assume that the tax legislation will remain unchanged.		6
(f)	Discuss the normal tax consequences of only the royalty income accrued before and after Cristiano's death, for Cristiano, his estate and his parents.	6	
	Communication skills – logical argument	*1*	7
Total for part I			**51**

INITIAL TEST OF COMPETENCE, APRIL 2021

PROFESSIONAL PAPER 4

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

PAPER 4 PART II – REQUIRED		**Marks**	
		Sub-total	**Total**
(g)	Describe the additional substantive procedures that the audit team should perform to gather sufficient and appropriate audit evidence about each of the following journal entries: (i) Journal entry 9033; (ii) Journal entry 9037; and (iii) Journal entries 9038 and 8761. *Communication skills – clarity of expression*	 7 6 12 *1*	 26
(h)	Calculate and discuss whether RP should enter into the sale and leaseback agreement of the Bacca Stadium to Group Q or rather enter into the loan agreement with ANB Bank. • Use the internal rate of return method. • Ignore all tax consequences. *Communication skills – presentation*	14 *1*	 15
(i)	Discuss any operational changes that RP could implement to improve its liquidity. • Exclude material changes to the capital structure.	8	 8
Total for part II			**49**
TOTAL FOR THE PAPER			**100**