

QUESTION 1

50 marks

Ignore taxation.

1 Background

Tshepo Tenza is a young entrepreneur who started his own jeans manufacturing and retail business, Rainbow Threads, in 2017. He began operations from his house and steadily grew the business over time as the popularity of his jeans increased. The jeans are unique because they have vibrant prints along the hems and on the pockets. These prints are inspired by the colourful patterns seen in Ndebele artworks. Tshepo has kept his costs as low as possible, with the result that his unique style of clothing remains affordable. Rainbow Threads aims to keep on growing the number of customers who are loyal to the brand.

In early 2018, Tshepo managed to secure equity funding from Flash Venture Capitalists ('FVC') through its early-stage investment programme, which enabled him to expand Rainbow Threads faster. To obtain the funding, he had to incorporate Rainbow Threads as a private company, Rainbow Threads (Pty) Ltd ('RainbowT') in which he holds 80% of the shares, with FVC owning the balance. As part of the shareholders' agreement, FVC also required that RainbowT adopt full International Financial Reporting Standards (IFRS) and provide audited annual financial statements. The audit for the financial year ended 30 June 2021 (FY2021) is currently in progress.

Tshepo used part of the funds obtained from FVC to enter into a lease agreement for premises in the Mall of Africa, located in Gauteng, effective from 1 July 2018.

2 Changes to the business model

Since 1 January 2019, Tshepo decided to offer customers the option to purchase jeans on credit. The aim was to increase sales. Customers now have the following payment options for purchases:

- Paying cash and receiving a 4% discount;
- Paying on credit and receiving a 3% discount if they settle within 15 days; or
- Paying on credit but receiving no discount if they settle within 16 to 30 days.

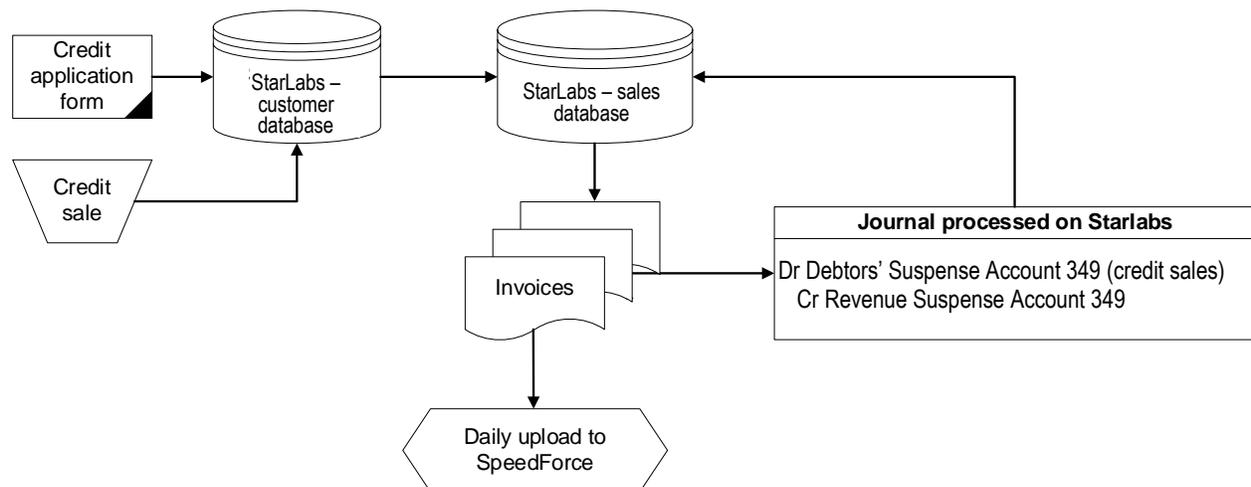
Although this has resulted in an increase in sales volumes, it has also meant that RainbowT had to put credit risk controls in place to avoid potential bad debt write-offs.

3 Accounting for sales

Tshepo believes in making use of technology to manage his business and therefore invested in an effective point-of-sale system ('StarLabs') and integrated accounting system ('SpeedForce'). StarLabs contains all the account information of customers who buy on credit, as well as integrated revenue, inventory and accounts receivable masterfiles. SpeedForce is automatically updated for all of the transactions recorded on StarLabs at midnight each night. Both StarLabs and SpeedForce make use of cloud computing technology and the processing of transactions are done in the cloud.

Once a customer has selected goods for purchase, the customer goes to the checkout counter, where the products are then scanned, and the sale is recorded on StarLabs. A sales invoice is generated which is then printed for the customer after cash/card payment has been received or the system has authorised the credit sale in the case of customers who have credit accounts with RainbowT. If customers make credit purchases, they are required to sign a copy of the sales invoice as evidence of receipt of the goods.

All credit sales and layby sales in StarLabs are accounted for in Account 349 (Debtors' Suspense Account). However, SpeedForce does not permit the use of suspense accounts, and therefore Account 349 is accounted for as trade receivables in SpeedForce. The process to update SpeedForce with the credit sales data on StarLabs is illustrated below:



At the end of every day, once the shop closes, each cashier performs a daily cash-up procedure. The first step is to select the <Cashup> option. This generates the following reports by StarLabs:

- Debtors exceeding credit terms; and
- A revenue report, showing the total credit and cash sales for the day.

Once the reports have been generated and any exceptions addressed, the cashier selects the <Update SpeedForce> option, which sends an instruction to StarLabs to automatically update SpeedForce at midnight by uploading all the transactions for the day. As all transactions are placed into suspense accounts on StarLabs, these suspense accounts are cleared after the automatic update. Once SpeedForce has been updated with the data from StarLabs, the following revenue journal entry is processed on SpeedForce to account for daily sales recorded on StarLabs:

Description	Dr	Cr
Account 350 Accounts Receivable	XXX	
Account 200 Bank	XXX	
Account 800 Revenue		XXX

Once the journal entry has been loaded on SpeedForce, the following journal entry is processed on StarLabs to remove the data:

Description	Dr	Cr
Revenue Suspense Account 349	XXX	
Debtors' Suspense Account 349		XXX
Bank Account		XXX

4 Report generated from SpeedForce

Tshepo has been struggling to manage RainbowT's cash flow. SpeedForce provides monthly reports of accounts receivable balances. These reports provide details of –

- the customer's name, credit limit and credit terms;
- an age analysis split of amounts owing per customer (15 days or less, 16–30 days, 31–60 days, 61–90 days, and over 90 days); and
- the total amounts outstanding.

5 Improving liquidity

The continuing effect of the Covid-19 lockdown restrictions and subdued economic activity has led to significant pressure on both cash sales and cash recovered from credit sales. It is a concern to Tshepo that there has been a continuous increase in the allowance for credit losses calculated as a percentage of credit sales.

Tshepo has begun an analysis of the working capital cycle of RainbowT with the values provided in the table below. Some values denoted by question marks (?) are still outstanding. All amounts are arithmetically correct.

Working capital analysis	FY2019	FY2020	FY2021
Trade receivable balance (before any allowance for credit losses)	R1 020 598	R2 601 607	?
Inventory	R2 364 514	R2 502 040	R2 495 568
Trade payables	?	R702 104	R810 355
Bank balance	R1 230 957	R502 604	R301 006
Credit sales	R5 387 618	R6 801 006	R9 501 508
Cost of sales	R9 158 951	?	R9 290 363
Allowances for credit losses	R269 381	R576 080	R1 068 217
Gross profit margin	15%	10%	12%
Percentage of sales on credit	50%	80%	90%
Trade receivable days (gross)	69	140	145
Inventory days	?	?	98
Cash conversion cycle days	125	?	?

6 Advice from accountant

Tshepo is worried about the current financial position of the business. Because he only has basic accounting knowledge, he approached his life-long friend, Lebogang Tshabala CA(SA), for advice. Lebogang is the managing partner at a consultancy firm, TT Consultants. Tshepo asked Lebogang if TT Consultants could help him to ensure that his accounting records and financial statements continue to meet the requirements of IFRS.

Lebogang discussed the proposed engagement with her partners at TT Consultants, and they agreed to provide these services to RainbowT. However, before Lebogang could share the news with Tshepo, another partner at the firm informed Lebogang that he had reached out to some of his friends and obtained possible funding to assist Tshepo. He proposed the following:

- TT Consultants should accept RainbowT as a consulting client, and RainbowT will pay an agreed-upon rate per hour for accounting services provided.
- TT Consultants would then refer RainbowT to MSM Bank ('MSM'), a privately-owned financial institution. MSM provides competitive rates on revolving credit facilities and transactional products and has agreed to purchase some of the trade receivables of RainbowT in a factoring agreement and to provide additional funding.
- TT Consultants will receive a substantial fee for referring RainbowT to MSM as well as 5% commission on all future revenue generated by MSM on the RainbowT contract.

Lebogang is concerned about the proposal, as she is aware that the chief executive officer of MSM has been implicated in corrupt practices. In fact, he is due to testify before a commission of enquiry regarding these allegations. MSM has been accused of bribing regulators, cabinet ministers and other government officials.

INITIAL TEST OF COMPETENCE, JANUARY 2022

PROFESSIONAL PAPER 2

PAPER 2 QUESTION 1 – REQUIRED		Marks	
		Sub-total	Total
(a)	Describe four business risks relating to the granting of credit to RainbowT customers and one relevant control to mitigate each risk. • Provide your answer in a tabular format.	8	8
(b)	Describe the automated information processing controls that should be in place to ensure that all data transferred from StarLabs to SpeedForce is accurate and complete.	7	7
(c)	Describe the additional substantive audit procedures that the external auditor of RainbowT should perform relating to the accuracy, occurrence and completeness of the debtors' age analysis as at 30 June 2021. The following procedures have already been performed on the accuracy, occurrence and completeness of the debtors' age analysis: • Obtaining all client schedules to support the classes of transactions and account balances. • Re-performing the casts and cross-casts on these schedules. • Agreeing the closing balance of these schedules to the amounts in the general ledger, trial balance and annual financial statements. • Agreeing the opening balance of these schedules to the prior-year workpapers and audited financial statements. • Obtaining a signed management representation letter regarding the accuracy, occurrence and completeness assertions relating to the classes of transactions and account balances being audited. • Considering 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.	6	6

Continued on page 2

INITIAL TEST OF COMPETENCE, JANUARY 2022

PROFESSIONAL PAPER 2

PAPER 2 QUESTION 1 – REQUIRED (cont.)		Total	
		Sub-total	Total
(d)	<p>In order to assist Tshepo with the working capital analysis –</p> <p>(i) calculate the trends in the working capital cycle of RainbowT for the period FY2019 to FY2021; and</p> <p>(ii) comment on the outcomes of the analysis.</p> <ul style="list-style-type: none"> • Round all workings and final answers to the nearest whole number. • Use year-end (and not average) balances in the calculation of any supporting amounts or ratios. • Use 365 days per year when calculating relevant ratios. <p><i>Communication skills – clarity of expression</i></p>	12 7	20
(e)	<p>Discuss, with reference to ethical considerations, whether or not Lebogang should advise RainbowT to accept assistance from MSM.</p> <ul style="list-style-type: none"> • Do not discuss any aspect of the SAICA and IRBA codes of professional conduct. <p><i>Communication skills – appropriate style</i></p>	8 1	9
Total for question 1			50