

## QUESTION 2

50 marks

All amounts include value-added tax (VAT) where applicable, unless stated otherwise.

### 1 Background information

You are a trainee accountant on the audit of Barista (Pty) Ltd ('Barista') for its financial year and year of assessment ended 31 December 2021 (FY2021). Barista is a South African resident company and a registered Category B vendor for VAT purposes. It manufactures high-end office coffee machines. Barista makes 90% taxable supplies. The company has an annual turnover of R10 million.

Corporate customers purchase these coffee machines, which are connected to the internet and work with an application ('app'). Employees of the corporate customers download the app of their office coffee machine onto their mobile phones and can then pre-program how they like their coffee. The app tracks the employee's proximity to the office, with the result that a hot cup of coffee is ready, based on an employee's taste, when he/she arrives at the office.

### 2 Provisional tax

You have been assigned to audit the taxation balances of Barista. During your investigation of the documents submitted in respect of provisional tax, you came across penalty assessments issued by the South African Revenue Service (SARS) for the underestimation and late payment of provisional tax. When you asked the financial manager of Barista, Bruce Wills CA(SA), about the penalty assessments, he responded that Barista has suffered immensely due to the Covid-19 pandemic because many of its clients are no longer using Barista's coffee machines in their offices. This has resulted in an oversupply in the market of second-hand coffee machines, which are much cheaper to purchase than the newly manufactured coffee machines available from Barista.

The return for the first provisional payment of R259 700 was submitted and paid on 30 June 2021 and was based on the correct basic amount of R1,855 million.

In view of Barista's cash-flow pressures, Bruce did not prepare an accurate estimate of taxable income to calculate the final estimate for the second provisional tax payment and he used a taxable income estimate of R1 540 500 for FY2021. Bruce did not make use of any Covid-19 deferral relief.

The assessment for FY2021 was received on 19 February 2022 and reflected a final assessed taxable income of R1 954 100.

Bruce stated that the return for provisional tax (IRP6) had been filed on time, but that the payment of the provisional tax was 20 days late as the company did not have sufficient cash to make the electronic transfer on the same date. The salaries of the employees were paid on 31 December 2021 and it had depleted Barista's bank balance.

Bruce requested that your audit firm write a letter to SARS stating that Barista missed the payment date because the audit of the financial statements had been delayed. He also wanted your firm to ask SARS to waive the penalty and interest charged because of this. The partner on the audit asked you to draft a submission to SARS, for him to review, in which you explained the circumstances of the late payment. The partner said that you could use 'bona fide inadvertent error' as a defence against SARS. Bruce noted that he was upset about the

penalty, as a penalty had also been levied against Barista because of a late payment of VAT for the two-month tax period ended 30 April 2019.

### **3 Manufacturing machinery**

Due to the specialised technology used in the coffee machines, Barista uses the latest available equipment in its manufacturing process. The manufacture of coffee machines has been accepted as a process of manufacture for tax purposes. Barista regularly replaces parts of its manufacturing equipment due to new features and technology.

Barista purchases all machinery used in the process of manufacture from a single local supplier, who is a VAT vendor. Barista ordered a new manufacturing machine from this supplier for R135 500 on 14 December 2021 to replace a two-year old machine which required regular maintenance. The machine was transported by road at a cost of R10 650 and was delivered to Barista's premises on 4 January 2022. The supplier issued the invoice for the transport costs and machine on 5 January 2022 and Barista paid the outstanding amount on 15 January 2022. The machine was ready and brought into use on 20 January 2022.

In an effort to alleviate the cash-flow problems being experienced by the company, Bruce included the input tax on the machine in the VAT return for the tax period which ended on 31 December 2021 by using the order form of the supplier.

### **4 Reversal of invoices**

During the audit of sales, you noticed a significant number of credit notes. When you investigated the matter, it came to light that several material sales transactions had been reversed and re-invoiced in the subsequent VAT period. Bruce explained that the invoice description on a number of sales invoices erroneously stated that the coffee machines had a black finish, while white machines were ordered by and shipped to the customers. Credit notes were issued to reverse these transactions and new invoices were issued during the subsequent VAT period to ensure that the sales invoices matched the description on the order form and delivered goods.

You noticed that these reversals took place in months during which Barista had struggled to collect cash from debtors. You also noted that all reversals and re-invoicing were completed during the current financial year only. The sales invoices were always re-issued after big incoming payments cleared in Barista's bank account. Barista's management could provide no reason to explain why the invoices were not re-issued on the same dates as the original invoices.

### **5 Budgeting process**

Since the Covid-19 pandemic caused many of Barista's customers to adopt a work-from-home policy, the demand for Barista's coffee machines has declined severely. Barista still managed to show a small profit in FY2021. The budgets for the next two years projected limited profit growth. The directors of Barista did not prepare long-term budgets as the situation is currently too volatile, and because many of the company's traditional customers have indicated that they will adopt a more flexible policy regarding work location and expect more staff members to work from home. As a result, they were reluctant to spend money on expensive office coffee machines.

Since the Covid-19 pandemic has placed the company under severe financial pressure, management is considering applying for an overdraft facility to address its cash flow issues. Bruce is of the opinion that the FY2021 financial statements are crucial for obtaining approval for an overdraft facility and recognised a deferred tax asset on the temporary difference between the carrying amount and tax base of manufacturing equipment. His reason was that 'the world will surely return to normal at some point in the future and then Barista will undoubtedly again start to realise bigger profits'.

## **6 Other information**

The accounting policy of Barista is to write off manufacturing machinery over a useful (and economic) life of three years.

**INITIAL TEST OF COMPETENCE, JANUARY 2022**

**PROFESSIONAL PAPER 4**

<b>PAPER 4 QUESTION 2 – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(a)	(i) Discuss whether Barista was liable for any penalty(ies) in respect of the underestimation and late payment of provisional tax for FY2021.	5	11
	(ii) Assuming that Barista is liable, calculate the amount of the penalty(ies) that would be payable.	5	
	<i>Communication skills – layout and structure</i>	1	
(b)	Discuss whether Barista has any grounds to request the remittance of the penalty imposed by SARS for the late payment of provisional tax.	5	5
(c)	Discuss whether your firm could comply with Bruce’s request that you write a letter to SARS in an attempt to persuade SARS to waive the penalties on the late payment of provisional tax.	6	7
	<i>Communication skills – clarity of expression</i>	1	
(d)	Discuss whether Barista applied the correct VAT treatment for the acquisition of the new manufacturing machine for the two-month tax period ended 31 December 2021.	5	5
(e)	Discuss the matters your audit firm should consider with regard to its reporting responsibility, based on the information in section 4.	6	6
	<ul style="list-style-type: none"> <li>• Exclude the detailed steps to be followed when reporting the matter.</li> <li>• Exclude any impact this matter may have on the performance of the audit of Barista’s financial statements.</li> </ul>		

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**INITIAL TEST OF COMPETENCE, JANUARY 2022  
PROFESSIONAL PAPER 4**

<b>PAPER 4 QUESTION 2 – REQUIRED (cont.)</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
For purposes of required (f) and (g), assume that the following audit procedures have been successfully completed: <ul style="list-style-type: none"> <li>• Obtain schedules reflecting the computation of the VAT balance and deferred tax asset as at 31 December 2021.</li> <li>• Re-perform the calculations on these schedules.</li> <li>• Agree the total to the balances in the general ledger, trial balance and the financial statements.</li> <li>• Agree the opening balances to prior-year working papers and financial statements.</li> </ul>			
(f)	Formulate the additional substantive audit procedures you would perform on the VAT balance in the statement of financial position as at 31 December 2021.	5	5
(g)	Formulate the additional substantive audit procedures you would perform on the deferred tax asset balance in the statement of financial position as at 31 December 2021 pertaining to the manufacturing equipment.	10	
	<i>Communication skills – clarity of expression</i>	1	11
<b>Total for question 2</b>			<b>50</b>
<b>TOTAL FOR THE PAPER</b>			<b>100</b>