

IGNORE VALUE-ADDED TAX**1 Background**

SA Motor Manufacturing Ltd ('SA-MM') is a vehicle manufacturer situated in Durban. SA-MM specialises in the manufacturing and assembling of luxury sports utility vehicles (SUVs) and sedan vehicles. SA-MM is a South African resident company for tax purposes. The company sells its luxury vehicles to various independent dealerships across South Africa and exports some to Europe. The company also uses some of the vehicles produced in the manufacturing process as their own vehicles. The vehicles are sold under assurance-type manufacturer's warranties and the warranties are not sold separately. Both humans and robots are involved in the company's process of manufacture.

There has been a global supply shortage of semiconductors and microchips (collectively referred to as microchips) in the current year, which also affected SA-MM. This hampered the production of new cars, which created a surging demand for second-hand vehicles. The microchips serve as the 'brain' of the modern electronics within a vehicle. These highly engineered components are essentially a type of electronic circuit and include a series of transistors that function as tiny switches to control the flow of electrons. The vehicles manufactured by SA-MM have 100 to 150 distinct electronics modules, each with multiple chips. The electronics systems powered by the microchips comprise 40% of the manufacturing cost of a luxury SUV and 30% of the manufacturing cost of a sedan.

The financial year end of the current reporting period is 31 December 2022 (FY2022). The financial statements will be authorised for issue on 1 April 2023. SA-MM complies with International Financial Reporting Standards.

2 Accounting policies

- Expenses are classified based on their function for presentation in the statement of profit or loss and other comprehensive income.
- Owner-occupied land is carried under the revaluation model. The land is revalued at the end of each financial reporting year.
- Other items of property, plant and equipment are carried under the cost model.
- The depreciation methods of items of property, plant and equipment have been assessed as follows:

Item	Depreciation method
Manufacturing building	Straight line (taking residual values into account, where applicable)
Manufacturing plant	Units of production (no residual value)
Vehicles	Straight line (taking residual values into account, where applicable)

3 Employee benefits

The total gross salary of all the SA-MM employees for FY2022 amounted to R50 million. In addition, the total company contributions (medical, defined contribution plans, etc.) amounted to 35% of the gross salary per employee. On 14 December 2022, SA-MM and the labour unions agreed to a general increase to all salaries of 5%.

All employees work an average of 300 days per year and are entitled to 25 working days of paid leave per year. The directors and senior managers may not carry any unused leave days forward to the next year. Administrative and factory employees may carry a maximum of five days forward to the next year, and this falls away at the end of that year if unused. Any available leave days exceeding five days are forfeited at the end of each year or when an employee resigns.

The opening balance of the leave accrual on 1 January 2022 amounted to R32 000. The following information was available regarding unused leave days on 31 December 2022:

LEAVE INFORMATION			
Category	Number of employees	Average gross salary per employee for FY2022	Unused leave days per employee on 31 December 2022
Administrative	20	R200 000	5*
Factory	200	R180 000	0

* The expectation is that these employees will use only four of these days during the next year.

The shortage of microchips caused various delays in the production process and resulted in the retrenchment of three administrative and ten factory employees during FY2022. The parties agreed to a retrenchment package of R65 000 per administrative employee and R60 000 per factory employee. Each retrenched factory employee also received a toolset, which cost R4 000 per set, to assist them in finding alternative employment.

The retrenched administrative employees had no unused leave days. The retrenched factory employees each had six unused leave days when they were retrenched and, in terms of their retrenchment package, they were paid in cash for any unused leave days. The cash payment was made by the end of FY2022 after the leave records had been verified. The cash payment is based on their gross salaries, and excludes any company contributions, in the year during which the leave days accrued.

The financial manager correctly determined that all amounts regarding employee costs and retrenchment packages are deductible for tax purposes.

4 Luxury SUVs used by the directors

At the shareholders' meeting on 1 March 2022, the shareholders approved the use of SUVs by the four executive directors of SA-MM as part of their remuneration package. The SUVs were manufactured in February 2022 at a total production cost of R670 000 each. The SUVs were correctly transferred from inventory to property, plant and equipment at cost on 1 March 2022. The directors started to use the SUVs on the same date. The economic life of the SUVs is estimated at 15 years. The directors will receive a new SUV every two years (on 1 March of each year), and the old SUVs will then be sold in the open market.

The following market values of this type of SUV are available for FY2022 (these values did not change during FY2022):

	R
Current selling price of a new SUV	750 000
Current market value of a two-year-old SUV	560 000
Expected future market value of a two-year-old SUV (two years later)	590 000
Expected future market value at the end of the economic life of the SUV (scrap value)	20 000

5 Trial use of locally sourced microchips

The microchips that are used in SA-MM's manufactured vehicles are imported from China and Taiwan. As a result of the supply shortage, SA-MM decided to use microchips manufactured locally on a trial basis. SA-MM's engineers extensively tested these microchips and approved their use in 50 luxury sedan vehicles manufactured in December 2022. The local microchips cost the same as those from China.

The selling price of these vehicles to the dealerships was fixed at R560 000 each from December 2022 to June 2023. SA-MM's average distribution costs for transporting the vehicles to the dealerships are R5 000 each. The total manufacturing cost is R500 000 per vehicle.

By 31 December 2022, 30 of these vehicles had been sold, and the rest were included in finished goods as inventory. During January 2023, SA-MM sold another eight vehicles and the company expected that the remaining vehicles would be sold before June 2023.

Early in January 2023, many of the vehicles sold from December 2022 to January 2023 were returned to the dealerships due to a malfunction. Although no injuries or deaths had occurred, the malfunction was considered to be life-threatening.

SA-MM's engineers performed additional tests on the microchips in middle January 2023. They discovered that the malfunction was caused by sub-standard silicon used by the local manufacturer, resulting in the microchip melting. SA-MM then cancelled the use of the locally sourced microchips and all the vehicles sold with these microchips were recalled.

SA-MM also appointed a legal firm to deal with the legal consequences. SA-MM contacted the owners who had bought these vehicles, to arrange for the replacement of the microchips. The estimated recall costs per vehicle were as follows:

- Costs to transport the vehicle from and back to the owner and renting a similar vehicle for the owner's use while the replacement is being undertaken: R15 000; and
- Costs to replace the microchips: R160 000 (material of R150 000 and labour of R10 000).

Sufficient microchips were in inventory at the end of FY2022 to replace the defective microchips.

The local microchip manufacturer stopped trading in late January 2023 and will be liquidated. The accountant of SA-MM suggested that because the problem with the microchips, although material, only became known during FY2023, no adjustments needed to be made to the FY2022 financial statements. Any expenditure or losses referred to above had not been included, and would not be covered by SA-MM's current provision for warranty claims as at 31 December 2022.

The South African Revenue Service determined that the value of the closing stock on 31 December 2022 has not diminished due to damage, deterioration, a change in fashion or any other reason.

6 Land and manufacturing building

In 2019, SA-MM acquired a property, with a new and unused building, close to the Durban harbour. The total cost was R3 million for the land and R17 million for the building. The building was available for use and brought into use on 1 January 2020. The building is considered to be mainly used by SA-MM in its process of manufacture for tax purposes. The useful life of the building for SA-MM was considered to be 30 years, with a residual value of R2 million.

Since 2020, many local businesses have experienced problems with their imports and exports due to various administrative inefficiencies at the Durban harbour. Furthermore, widespread unrest in the Durban area in 2021 caused property prices to drop, and many businesses moved their operations elsewhere.

The fair values of the land acquired by SA-MM at each reporting date were as follows:

Date	Fair value
31 December 2021	R2,8 million
31 December 2022	R3,1 million

During FY2022, SA-MM decided it would move its operations to Emalahleni in Mpumalanga. This is closer to suppliers of specific metals to SA-MM and to the Maputo harbour, which runs smoothly and could be used for its imports and exports. SA-MM plans to vacate its building in Durban by 31 December 2028.

On 31 December 2022, the building's residual value was re-estimated at R11,3 million, based on its revised useful life.

7 Manufacturing plant

SA-MM constructed a manufacturing plant on the Durban property. It was completed on 1 January 2020 and manufacturing commenced on the same date. This plant is used for the manufacturing of both SA-MM's SUVs and sedans. The total cost of the manufacturing plant was R980 million. The expected total manufacturing capacity (useful life) of the manufacturing plant was 35 000 vehicles.

Number of vehicles manufactured at Durban plant	Vehicles
FY2020 and FY2021	15 000
1 January 2022 to 31 October 2022	3 000

On the night of 31 October 2022, a severe storm with heavy rains led to localised flooding that caused damage to many parts of the greater Durban area. The roof of SA-MM's plant was damaged in the storm, which caused water to leak onto a robotic arm.

The roof was fixed at a total cost of R40 000 and was correctly treated as repairs for accounting and tax purposes.

Unfortunately, the robotic arm was damaged beyond repair. Manufacturing had to be stopped, and no production could take place during November 2022. The manufacturing staff was not given leave and assisted with taking down the damaged robotic arm and fulfilling other duties.

The robotic arm looks like a human arm and is used in the production process to assemble and weld various parts onto the vehicle body. It contains numerous electronic components. The robotic arm was not accounted for as a separate component of property, plant and equipment on initial recognition. The original cost of the robotic arm as at 1 January 2020 was R12,5 million. The cost attributable to the robotic arm for tax purposes was R12,5 million.

On 5 November 2022, SA-MM acquired a second-hand robotic arm, Arm 2, that SA-MM had previously owned and used, at a cost of R5 million. SA-MM had sold Arm 2 five years ago to another vehicle manufacturer, Cars Plus, after it became redundant in SA-MM's manufacturing process due to outdated components. Although Cars Plus, which is not a connected person, improved the robotic arm significantly, it was still not suited to SA-MM's manufacturing process.

After re-acquiring Arm 2, SA-MM spent R7,6 million to improve and modify it to fulfil the specific functions within SA-MM's manufacturing plant. The expected total manufacturing capacity (useful life) of the improved and modified Arm 2 is 16 000 vehicles, and the remaining useful life of the manufacturing plant did not change. Arm 2 was available for use and brought into use on 1 December 2022, and production commenced again on the same date. SA-MM manufactured 300 vehicles during that December. In terms of Binding General Ruling No. 7, Arm 2 qualifies for a four-year write-off period.

8 Insurance claim

SA-MM submitted a claim of R15 million (the replacement cost) to its insurance company, Manufac-sure, for the damage to the robotic arm. The shortage of microchips led to a significant increase in the cost of a replacement robotic arm. Manufac-sure did not fully accept the claim as it argued that the current market price was inflated. Manufac-sure paid SA-MM R13 million in cash on 10 December 2022, stating that this was a realistic market price.

On 10 December 2022, SA-MM lodged a complaint with the Ombudsman for Short-Term Insurance (OSTI) of South Africa regarding the unpaid amount of R2 million (the difference between the amount received from the insurance company and the claim amount). OSTI provides consumers with a free, efficient and fair dispute resolution mechanism. SA-MM and Manufac-sure both agreed to accept the ruling of OSTI. SA-MM is hopeful that the unpaid claim of R2 million will be granted but is not confident. OSTI has indicated that it expects to finalise its investigation and make a ruling in May 2023.

9 SA-MM's Beat-till diesel engine – Green Car of the year award

SA-MM is a trusted corporate brand among the world's most socially responsible companies. It is committed to reducing its carbon footprint by cutting its energy and water consumption, carbon dioxide (CO₂) emissions, and waste per vehicle manufactured by 25% by 2025, compared to its 2020 baseline. A recent study performed by one of the leading universities in South Africa reported that environmental issues significantly impact customers' purchase behaviours in South Africa. In line with SA-MM's aim and commitment, it included its carbon footprint reduction as an environmental key performance indicator for the determination of executive directors' annual performance bonuses.

In January 2020, SA-MM's Beat-till diesel engine model won the Green Car of the Year award for its 'ground-breaking clean diesel' engine. SA-MM uses the services of a company called Emission Testing Enterprise Ltd ('ETE') to perform various tests and report on the greenhouse gas emissions. In May 2021, ETE provided a report to SA-MM with emission tests on the Beat-

till diesel engine that revealed that the CO₂ emissions for this engine were almost 40 times the permitted threshold levels.

The South African Carbon Tax Act imposes a tax on CO₂ greenhouse gas emissions. A taxpayer is liable for the carbon tax if it exceeds one of the thresholds listed in Schedule 2 of this Act.

A board meeting was called to discuss the results of the ETE report. A heated debate followed after the operations director, Sonny Smutz, admitted that he had been aware of this issue and that the regulatory test results on this engine had been manipulated by SA-MM. The manipulation was achieved by installing specialised software in its diesel-powered vehicles prior to regulatory testing. During the normal use of these vehicles, the engines emitted far more emissions.

Sonny admitted that he had discovered the specialised software before ETE discovered it and had in fact informed the chief executive officer (CEO) about the issue and the potential implications it may have for SA-MM. The CEO reacted to Sonny's concerns by blaming this transgression on a small number of rogue engineers, who operated without informing management. The CEO therefore decided to not do anything about the situation for the time being. According to Sonny there were more than 500 000 of these Beat-till diesel engine vehicles in the market. He added that none of this was public knowledge yet.

10 Optimal manufacturing volumes for FY2023

The ratio of SA-MM's manufacturing and sales volumes for FY2022 was 1 : 2 for SUVs and sedans. Management is unsure whether this is the optimal ratio given the production constraints experienced. Sonny was requested to forecast manufacturing volumes for the next financial year, based on the optimal mix between SUVs and sedans to maximise the profits for the year. The market demand for both vehicles is more than the maximum capacity of SA-MM.

The availability of microchips for FY2023 is estimated to be 30% more than the quantity acquired in FY2022. Sufficient microchips were bought to manufacture 3 300 vehicles during FY2022. The supplier has agreed to keep the cost per unit of the microchips the same as in FY2022.

The dealership demand is that SA-MM should deliver at least 430 SUVs and 750 sedans to them during FY2023. SA-MM's sales team estimated maximum demand to be 2 000 SUVs and 4 200 sedans for FY2023.

The cost accountant supplied the following information regarding the cost structure of SA-MM:

- Fixed manufacturing costs per vehicle of both SUVs and sedans: 10% of the total manufacturing cost per vehicle. The variable manufacturing costs comprise the microchips, material and variable overheads.
- Variable operating costs (non-manufacturing) are R18 000 and R12 000 per SUV and sedan respectively. The balance of the non-manufacturing costs comprises operating fixed costs and finance costs.

11 Additional information

- The financial director of SA-MM has already correctly calculated the company's profit before tax for FY2022, after making all necessary adjustments included in the scenario, as R45 million.
- All taxpayers will make any available election to minimise their tax liability.

INITIAL TEST OF COMPETENCE, JANUARY 2023

PROFESSIONAL PAPER 2

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

PAPER 2 PART I – REQUIRED		Marks	
		Sub-total	Total
(a)	<p>Calculate the total amount for employee benefits to be disclosed by SA-MM in the notes to the statement of profit or loss and other comprehensive income for FY2022.</p> <ul style="list-style-type: none"> Ignore the disclosure requirements on related parties and comparative information. 	17	17
(b)	<p>Prepare the journal entry(ies) SA-MM should process in its accounting records for FY2022 relating to the problems with the locally sourced microchips.</p> <ul style="list-style-type: none"> Do not provide closing entries. Do not provide journal narrations. Ignore tax. 	9	9
(c)	<p>(i) Discuss the correct accounting treatment for the unpaid insurance claim of R2 million in the accounting records of SA-MM for FY2022 in terms of IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i>; and</p> <p>(ii) Discuss why the amount of R2 million should not be taken into account as an accrual for tax purposes when calculating SA-MM's normal taxation for the 2022 year of assessment.</p> <p><i>ommunication skills – appropriate style</i></p>	6 4 1	11
(d)	<p>Advise management on the following:</p> <p>(i) The optimal sales mix to maximise the contribution of SA-MM in FY2023; and</p> <p>(ii) Other factors it should consider before implementing the recommended mix.</p> <ul style="list-style-type: none"> Assume that production volumes will equal sales volumes and inventory quantities will remain unchanged in FY2023. <p><i>Communication skills – layout and structure</i></p>	10 5 1	16
Total for part I			53

INITIAL TEST OF COMPETENCE, JANUARY 2023

PROFESSIONAL PAPER 2

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

PAPER 2 PART II – REQUIRED		Marks	
		Sub-total	Total
(e)	<p>Calculate the taxable income of SA-MM for its 2022 year of assessment by starting with the profit before tax of R45 million.</p> <ul style="list-style-type: none"> Ignore sections 5, 9 and 10. Indicate the accounting adjustment separately from the tax adjustment in respect of each item. Indicate any accounting adjustments for depreciation separately from impairments, if any. Include nil effects and provide brief reasons for the nil effects in your answer. Ignore the unpaid insurance claim of R2 million and assume that the R13 million claim paid on 10 December 2022 was the final insurance claim amount accepted by both parties. <p><i>Communication skills – presentation; logical argument</i></p>	34	
		2	36
(f)	<p>Discuss the ethical considerations for the individual directors and the board regarding the use of the specialised software in SA-MM’s Beat-till diesel engine vehicles.</p> <ul style="list-style-type: none"> Ignore King IV in your answer. <p><i>Communication skills – appropriate style</i></p>	10	
		1	11
Total for part II			47
TOTAL FOR PAPER 2			100