

## QUESTION

100 marks

- All amounts exclude value-added tax (VAT), unless indicated otherwise or where otherwise defined in the VAT Act.
- All documentary requirements in terms of the VAT Act have been complied with.
- All entities are South African residents for tax purposes, unless indicated otherwise.

### 1 Background and overview of operations

Beeprop Ltd ('Beeprop') is a property development company that is listed on the Johannesburg Stock Exchange. The end of the current reporting period of Beeprop is 31 December 2021 (FY2021). Beeprop is a VAT vendor and is registered in terms of Category C for VAT purposes. Beeprop prepares its financial statements in accordance with International Financial Reporting Standards (IFRS). JZKhize Auditors Inc. ('JZK Auditors') is the Registered Auditor of Beeprop for FY2021 and is currently busy with the FY2021 audit engagement.

Beeprop's diverse investment property portfolio, located across South Africa, consists of the following:

Office buildings	40%
Regional shopping malls	30%
Residential property	20%
Manufacturing buildings	10%

Beeprop's business model is to derive income from these investment properties through rental income. The majority of the investment properties in the portfolio was developed and is owned by Beeprop. However, it also has one new investment property that is held in terms of a lease agreement, which Beeprop is sub-leasing. Beeprop does not provide additional services such as cleaning, security, etc., at the various properties it manages.

The office buildings in the investment portfolio have been hit the hardest by the Covid-19 challenges, as many tenants have vacated the buildings because they adopted a work-from-home model. While the situation has improved slightly, with a decline in vacant office spaces from 13,2% to 11,8%, there are still several vacant office buildings.

The financial director of Beeprop, Delien Castelyn CA(SA), confirmed at a recent board meeting that she believes that the property market is on the road to recovery. Beeprop's focus this year is to protect its resources, strengthen its financial position and manage costs, in order to gain the maximum advantage from this upwards trend. As a result, Beeprop embarked on an aggressive strategy to market all vacant office buildings by means of a variety of marketing platforms. Some of the offices that became vacant during the current financial year, are being occupied by Beeprop's administrative employees while it is seeking tenants for the buildings. Delien believes that occupancy rates in the property market will recover, regardless of the views of some critics that a characteristic of the 'new normal' will be a lower demand for office space. She also believes that the return in demand for office space should be reflected in the valuation of Beeprop's investment property.

Beeprop is also investigating the implementation of a computerised system to manage the costs incurred while developing properties. Currently, the controls around the accumulation of costs are weak, resulting in inefficiencies and the inability to manage budgeted vs actual costs incurred.

## 2 Accounting policies

The following are extracts from Beeprop's accounting policies:

- Lease payments from operating leases are recognised as income on a straight-line basis.
- Investment properties are measured at fair value. Gains or losses arising from changes in the fair value of investment properties are included in profit or loss during the period in which they arise.
- Other properties, classified as property, plant and equipment, are carried at cost less any accumulated depreciation (except for items of land) and any accumulated impairment losses.
- Major sources of estimation uncertainty: The directors believe there are no uncertainties in measuring the fair value of the investment properties, as the valuation of all properties is done by a firm of independent professional valuers.

## 3 Notes to the draft financial statements

The following are relevant extracts from the notes to the draft financial statements:

Extract from note on investment properties		
	Additional information	FY2021 R'000
<b>Investment properties at the beginning of the year at fair value</b>		161 000
<b>Changes in investment properties during the year</b>		
Construction cost incurred, at cost	4.1	27 869
Replacement of components ( <i>correct in all aspects, including the items in para. 6.2 (see page 4)</i> )*		(6 200)
Right-of-use office building capitalised, at cost	4.2	12 498
Change in fair value		7 833
<b>Investment properties at the end of the year at fair value</b>	4.3	<b>203 000</b>
<b>Owned properties</b>		
Office buildings		67 169
Shopping malls		61 950
Residential properties		40 182
Manufacturing buildings		20 168
<b>Office in terms of lease agreement</b>		
Right-of-use office building	4.2	13 531

\* The replacement components are capitalised as part of construction costs incurred.

Beeprop uses the services of an independent registered firm of valuers, Expert Property Valuers (Pty) Ltd ('EPV'). This is a leading real estate appraisal firm that has been in business in South Africa for 33 years. Beeprop is proud to be associated with the firm, as the chief executive officer of Beeprop serves on the governing board of EPV. EPV's valuers hold professional qualifications and have up-to-date experience on the location and category of the properties being valued. Furthermore, its reports, known as the *EPV report on the SA property market*, is regarded as an authoritative reference source by many role players in the real estate and property market as well as among valuers.

The fair values of Beeprop's investment property are determined at the end of each financial period by EPV, using the discounted income method. This valuation technique has been

applied consistently over the past few years for the owned properties. The reasonableness is considered with reference to the open market value, if available.

The fair value hierarchy of investment properties is assessed as level 2 because the fair values are observable from the independent valuation reports.

<b>Extract from note on the lease liability</b>		
	<b>Additional information</b>	<b>FY2021 R'000</b>
<b>Lease liability at the beginning of the year</b>		0
<b>Changes in liability during the year</b>		
New lease	4.2	14 373
Immediate payment made	4.2	(1 875)
		12 498
Effective interest accrued		992
Payments made		(1 200)
<b>Lease liability at the end of the year, presented under non-current liabilities</b>	4.2	<b>12 290</b>

#### **4 Additional information on the notes to the draft financial statements**

Delien provided the following additional information:

- 4.1 The construction costs include all the material, labour and directly attributable expenditure regarding the construction of properties. The relevant items in para. 6.2 and 6.3 (see pages 4 and 5) were correctly capitalised at cost, where applicable.

During FY2021, the Covid-19 pandemic caused extensive and unexpected delays at various intervals, leading to abnormal material and labour costs. These abnormal costs amounted to R5,78 million and were included in the costs capitalised to the properties.

- 4.2 The right-of-use asset represents the right to use an office building acquired in terms of a lease agreement (the head lease) during FY2021. Beeprop is sub-leasing the office building to various tenants in terms of operating lease agreements. The asset was capitalised at the present value of the lease payments payable under the head lease, discounted using the interest rate implicit in the lease. The lease payments are payable monthly in arrears. The carrying amount of the lease liability on 31 December 2021 was correctly calculated as R12,29 million.


The fair value of the right-of-use investment property as at 31 December 2021 was correctly determined as R13,531 million, with the help of EPV. The fair value calculation took into consideration the future expected lease payments from subleasing the property, expected inflation, future expected discount rates, vacancy levels, etc.

- 4.3 The fair value (as obtained from EPV) represents the present value of expected lease payments receivable. The balance of Beeprop's accrued lease income (resulting from the straight-lining of the lease income) on 31 December 2021 amounted to R4 million.

The fair value of the investment properties that are leased fully furnished include the fair value of the furniture. The furniture is not recognised as a separate asset. The correct discount rate was used to fair value the investment properties, where relevant, and all the fair values obtained from EPV were correctly determined in terms of IFRS 13 *Fair Value Measurement*.

## 5 Matters relating to lease liability disclosure

The audit manager at JZK Auditors, John Eslo, sent the following email to the audit partner, Richard Kyrgios:

	<b>From:</b> John Eslo
	<b>Sent:</b> 28 February 2022 @ 8:10am
	<b>To:</b> Richard Kyrgios
	<b>Subject:</b> Lease liability disclosure
	! High Importance
Dear Richard	
<p>I discussed the proposed amounts to be disclosed in the financial statements for the lease liability with Delien. She stated that she was not going to make amendments, and the full amount outstanding will be disclosed as non-current liabilities. The amount that is payable within the next 12 months is R343 574.</p>	
<p>Delien is of the opinion that this amount is below the materiality level because it is below our materiality level of R4,2 million. During our conversation Delien acknowledged that the working capital ratio (amongst other ratios) is an important measure of financial health since creditors consider it a measure of a company's ability to pay off its debts within a year.</p>	
<p>Is this something that we need to discuss?</p>	
<p>John Eslo Audit manager: JZK Auditors</p>	

## 6 Other important information regarding the properties

### 6.1 Development of a residential townhouse complex

Beeprop completed the development of a townhouse complex at the end of FY2020. The townhouse complex is situated close to the OR Tambo International Airport. These townhouses are fully furnished and are targeted at millennials that need lock-up-and-go residential properties. Unfortunately, many of these townhouses are not currently let.

Delien's husband has a hunting business, Exquisite Safari Hunters ('ES Hunters'), that takes international guests on hunting trips to Limpopo on a regular basis. These guests usually arrive at OR Tambo International Airport on Sunday evenings. Delien gave permission that the guests may stay in the vacant townhouses. Delien's husband pays for the cleaning of these townhouses himself. Delien decided that no costs should be charged to ES Hunters as these townhouses are in any case vacant.

### 6.2 Conversion of buildings to increase occupancy rates

In view of the changes in the property market, Beeprop's management is considering the conversion of some of its unused office buildings to residential accommodation units. However, Delien is of the opinion that there will be negative VAT consequences and requested an investigation into these before such conversions are undertaken.

During FY2021 Beeprop followed another conversion option, namely the upgrade of one of its manufacturing buildings in Midrand to an environmentally friendly 'green building'. The building was originally constructed in FY2015. Beeprop had incurred the following costs by 31 October 2021:

<b>Conversion costs</b>		<b>R'000</b>
1	Air conditioning and heating system (to replace the current inefficient system, although it was still in a working condition)	624
2	Solar panels generating electricity from photo-voltaic solar energy not exceeding one megawatt (to reduce electricity bought from Eskom)	1 750
3	Water-saving system (to replace old, leaking water system and ensure the maximum conservation of water)	2 500
4	Re-orientation of doors and windows (to ensure optimal use of natural light)	3 000
5	Installation of an energy-efficient lighting system (to replace the current system which, while still in a working condition, was wasteful)	450
6	Installation of insulation material in ceilings (to reduce heat convection and radiation)	250
<b>Total costs</b>		<b>8 574</b>

Except for the air conditioning, heating system and solar panels, none of the alterations is removable. The upgrade was done to ensure that the building is more marketable, and as an additional benefit, the alterations improved the industrial capacity of the building. After the upgrade was completed, it was leased in terms of an operating lease agreement for 20 years from 1 November 2021. The lessee intends to use the building in a process of manufacture, recognised by the Commissioner of the South African Revenue Service (SARS) as such.

These expenditures were correctly accounted for in the financial statements. Although an IFRS expert confirmed that this was the correct accounting treatment, Delien asked the financial manager to deduct the entire amount of R8,574 million as repairs incurred in the production of income during the current year of assessment when determining taxable income. SARS allows a write-off period of six years on air conditioning and heating systems in terms of the Binding General Ruling No. 7.

Because of its success in upgrading the manufacturing building, management now also plans to upgrade an office building into a green building. Management asked the tax experts to investigate the income tax consequences of the upgrade costs related to a building if it were used for commercial purposes other than manufacturing.

### **6.3 Tenant installation allowance paid by the lessor**

Beeprop has signed a five-year operating lease agreement in respect of an existing office building in Sandton with Callme (Pty) Ltd ('Callme'), a company that operates a call centre. This lease commenced on 1 February 2021. Callme is a VAT vendor making only taxable supplies and is registered in terms of Category C for VAT purposes. The end of the reporting period of Callme is 31 December 2021. The lease agreement provides for a monthly lease payment of R200 000 payable by Callme to Beeprop before the seventh day of every month from February 2021.

The building needs considerable improvements to serve the lessee's needs. Because Beeprop was desperate to find a tenant, it agreed to pay a once-off tenant installation allowance. This was paid directly to Callme as part of its lease agreement. One of the terms of the lease agreement was that Callme must use these funds to effect improvements to the property.

Callme obtained the services of a contractor that understood the specialised nature of the call centre industry. The contractor commenced with the improvements on 1 February 2021, the same date the lease agreement was signed. Beeprop paid the tenant installation allowance of R3,45 million (inclusive of VAT) into Callme's bank account on 10 February 2021.

Beeprop's management was satisfied that the value of the building would be enhanced by the improvements Callme was making but was not prepared to pay an additional allowance if the expenditure amount exceeded the tenant installation allowance. The total improvements to the office building amounted to R4,6 million (inclusive of VAT). Callme paid the amount of R4,6 million on 1 June 2021, the date of completion of improvements and receipt of the contractor's invoice. Callme started trading on the same day. The details of the improvements were specified in the lease agreement, and Callme had to carry the cost of the difference between the R4,6 million spent and the R3,45 million installation allowance received.

#### ***6.4 Development of new office complex for which zoning has not yet been obtained***

Beeprop planned to commence with the development of property on a piece of land for which final zoning approval had not yet been obtained from the local municipality. Delien felt that obtaining the correct zoning was just a matter of time, and she granted approval for the building teams to commence with the building work on 10 January 2022.

**INITIAL TEST OF COMPETENCE, JUNE 2022  
PROFESSIONAL PAPER 1**

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

QUESTION 1 PART I – REQUIRED		Marks	
		Sub-total	Total
(a)	Discuss, based only on the information provided in section 1, the factors that increase the risk of material misstatement at the assertion level for investment properties in the financial statements of Beeprop for FY2021.	8	8
(b)	Describe the additional substantive procedures that should be performed by the JZK Auditors audit team to obtain sufficient and appropriate audit evidence regarding the right-of-use asset with reference to only the following assertions: (i) For the recognition and initial measurement of this transaction: existence, classification, accuracy, and valuation and allocation; and (ii) For the subsequent measurement: accuracy, and valuation and allocation.  • The following procedures had already been performed by the audit team: ○ Obtaining a management representation letter for all assertions relating to the right of use asset; ○ Agreeing, where applicable, all amounts in the schedules, reports and calculations to the general ledger, trial balance and annual financial statements; and ○ Casting of all totals and subtotals.  <i>Communication skills – clarity of expression</i>	8 10  1	19
(c)	Discuss the impact on the auditor's report if no changes were made to the classification of the full outstanding amount of the lease liability as non-current liabilities in the FY2021 financial statements (see sections 3 and 5).	4	4
(d)	Discuss five concerns that you may have relating to the accounting treatment and financial disclosures in respect of Beeprop's investment properties. For each concern, provide the treatment that management should have followed.  • Limit your discussion to issues in sections 2, 3 and 4 for which there is evidence of inaccuracies, inconsistencies, errors in application and/or non-compliance with IFRS in the scenario. • Exclude items not disclosed in the extracts. • Ignore all tax implications.  <i>Communication skills – logical argument</i>	10   1	11

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**INITIAL TEST OF COMPETENCE, JUNE 2022  
 PROFESSIONAL PAPER 1**

<b>QUESTION 1 PART I – REQUIRED (cont.)</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(e)	Discuss five ethical concerns you may have in terms of SAICA's Code of Professional Conduct with regard to the actions of Delien.	10	
	<ul style="list-style-type: none"> <li>Do not discuss any safeguards.</li> </ul> <p><i>Communication skills – appropriate style</i></p>	1	11
<b>Total for part I</b>			<b>53</b>



**INITIAL TEST OF COMPETENCE, JUNE 2022  
PROFESSIONAL PAPER 1**

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

<b>QUESTION 1 PART II – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(f)	On the assumption that the company does convert an office building into residential accommodation units (see para. 6.2) – <ul style="list-style-type: none"> <li>• discuss the VAT consequences for Beeprop; and</li> <li>• suggest an alternative to any adverse VAT consequences.</li> </ul> <i>Communication skills – logical argument</i>	12  1	  13
(g)	Calculate the effect of the conversion costs of the manufacturing building (see para. 6.2) on the taxable income of Beeprop for the 2021 year of assessment. <ul style="list-style-type: none"> <li>• Consider all amounts.</li> <li>• Provide brief reasons to support your answer.</li> </ul>	10	10
(h)	Discuss the deductibility of the tenant installation allowance for Beeprop in terms of the general deduction formula.  <i>Communication skills – clarity of expression</i>	7  1	  8
(i)	Calculate the effect of the lease agreement between Beeprop and Callme on the taxable income of the lessor (Beeprop) and the lessee (Callme) in respect of the 2021 year of assessment (see para. 6.3). <ul style="list-style-type: none"> <li>• Provide brief reasons for your answer.</li> <li>• Consider all nil effects.</li> </ul>	10	10
(j)	Discuss the VAT consequences of the leasehold improvements for Callme (see para. 6.3).	6	6
<b>Total for part II</b>			<b>47</b>
<b>TOTAL FOR THE QUESTION</b>			<b>100</b>