

QUESTION 1

47 marks

Ignore taxation

You are a prospective chartered accountant in business and work as a financial manager at Cooba Ltd ('Cooba'). You report to the financial director, Mrs Meryl Moller CA(SA). Cooba is a well-known technology company in South Africa. Clients are able to arrange rental vehicles for a period with independent third-party providers using Cooba's mobile application ('Cars4U') on various platforms.

Cooba is a wholly-owned subsidiary of Valare Ltd ('Valare'), a company listed on the ZARX stock exchange. All entities within the Valare group prepare their annual financial statements in accordance with International Financial Reporting Standards. The presentation and functional currency of all companies within the Valare group is the South African rand (ZAR).

The current financial year end is 31 December 2017 (FY2017) and the outstanding issues that need to be addressed are listed in the notes below.

1 CARS4AFRICA LTD

Meryl had a meeting with you on 11 December 2017 during which she informed you that the Board of Directors of Valare had decided to diversify the operations of the group. The company had accordingly acquired a controlling stake in Cars4Africa Ltd ('Cars4Africa') effective on 30 September 2017. Cars4Africa operates car rental agencies all over Africa, and also has a 31 December year end. The net asset value of Cars4Africa, excluding items 1.1 to 1.3 below, at acquisition date amounted to R9 million.

All aspects of the acquisition of Cars4Africa have been correctly accounted for by the Valare group except for the items mentioned below:

1.1 Acquisition details

Valare purchased 80% of the issued shares in Cars4Africa, thereby obtaining control. Valare paid R5 million for the acquisition of these shares as follows:

- R2 500 000 on 30 September 2017 in Valare shares; and
- The balance will be payable in cash two years after the acquisition date.

Cars4Africa is the service provider of several multinational organisations operating across the African continent. Cars4Africa has developed a client list of its key clients and is actively seeking to expand and build upon these business relationships. This internally generated client list was a crucial point for Valare during the acquisition negotiations and Valare estimates its fair value to be R1 500 000. Valare believes that it can unlock significant future benefits by offering services of other entities within the Valare group to these clients. While there are no legislative restrictions on Cars4Africa with regard to the selling, leasing or otherwise exchange of information of its clients, its management have indicated to Valare that client confidentiality is of the utmost importance to them.

1.2 Client claim

Meryl stated that Cars4Africa was sued by one of its clients after the client was involved in an accident on 1 August 2017 in a vehicle rented from the Cars4Africa fleet. The client sustained multiple injuries. He claims that the brakes of the car failed, and that this caused the accident. The client has sued Cars4Africa for damages, arising from negligence for renting out a vehicle that had not been properly serviced and maintained.

The matter was discussed with the legal representatives of Cars4Africa who believe that although the vehicle was not properly maintained (as evidenced by the vehicle's maintenance records) it is unlikely that the company will be required to pay for the damages. However, if Cars4Africa is required to pay damages, the legal advisors estimate that it would cost no more than USD1 500 000. The probability of this occurring is estimated to be only 15%. This estimate remained unchanged at 31 December 2017.

1.3 Closure of certain branches

There has been a decrease in demand for rental cars in certain African countries, which has led to a substantial decrease in Cars4Africa's revenue and earnings per share (EPS) for FY2017. As a result, some of the Cars4Africa branches were scheduled for closure early in 2018. Detailed plans stipulating which employees and branches would be affected as well as the closure dates had been finalised and the affected employees were informed by 15 September 2017. Cars4Africa will not be able to withdraw retrenchment offers as these have already been contractually agreed with the relevant employee unions. It is therefore unlikely that the plan will undergo significant changes.

Meryl noted that the 60 affected employees at the closing branches will be offered the option either to relocate to another branch or to accept a retrenchment package. They have to make their choice by 31 March 2018. Retrenched employees will be offered a package of R125 000 per person, payable on 30 June 2018. Relocation and retraining costs amounting to R500 000 in total are expected to be paid for the employees choosing to relocate.

Cars4Africa estimates that 70% of the employees will choose to relocate, while the rest will be retrenched. The company has not yet made accounting entries with regard to this restructure because of the uncertainty regarding how many employees will actually choose relocation and how many retrenchment. This estimate remained unchanged at 31 December 2017.

Meryl stressed the importance of showing an increase in the EPS number in the financial statements. She therefore proposed that the losses made by the branches that are going to be closed should be deferred until FY2018 and that no restructuring provision should be raised for the scheduled closure. She also noted that the annual bonuses of management level employees are based on reaching a certain EPS target, which they do not expect will be attained. Both you and Meryl qualify for these annual bonuses. Meryl said: 'Your future at this company is at stake if you cannot follow orders.'

1.4 Message from director

On 2 September 2017 you received the following sms from one of the directors serving on the Valare Board:

'Hi, hope you are well. I am so excited about my holiday next week. Cannot wait to leave. Just trying to rush through the investigatory process involved in the much-anticipated acquisition of Cars4Africa. To be honest – I'm not even going to look at it. I'll just give my go ahead. Please communicate this to the Board. Cheers!'

2 TRAVEL AUTHORISATION

All directors of Cooba can use rental vehicles owned by Cars4Africa for free when they travel for business purposes. To qualify for this travel benefit, the directors have to fill in a standard electronic form (which details the purpose of the business trip, destination, as well as time period covered) which is then authorised by yourself as the financial manager.

When you came back from leave in January 2018, you received a request to authorise free travel for Meryl for the period 15–25 December 2017. The business purpose was stated as

'marketing' and the destination was 'Durban'. You are aware that Meryl was on holiday with her family in Durban during this period of time.

3 EXECUTIVE COMPENSATION

3.1 Share incentive awards

In an attempt to align the interests of directors and shareholders, Cooba granted the seven directors in Cooba's service on 1 January 2017 share incentive awards in its performance reward scheme. The terms of the scheme are as follows:

- Each participant still in service of Cooba on 31 December 2019 will receive 5 000 Valare shares, provided that both the EPS and share price of Valare increased by more than 10% over the period 1 January 2017 to 31 December 2019.
- The shares will be provided by Cooba, who will purchase the Valare shares in the open market.

The following information is relevant regarding the fair value of a performance share:

	1 Jan. 2017	31 Dec. 2017
Fair value (not adjusted for probability that EPS and share price targets will be met)	R30	R33
Fair value (adjusted for the probability that both EPS and share price targets will be met)	R15	R18
Fair value (not adjusted for probability relating to EPS target, but adjusted for probability related to share price target)	R22	R25
Fair value (not adjusted for probability relating to share price target, but adjusted for probability related to EPS target)	R23	R26

By 31 December 2017 one of the directors had resigned, and it was expected that another one would resign before the vesting date. Cooba has correctly accounted for the scheme in its accounting records for FY2017, but no entries have been made with regard to the scheme in the Valare group's consolidated financial statements.

3.2 Long service awards

From 1 January 2017 all senior employees of Valare who remain in service for a period of ten years from that date will receive a lump sum payment of R50 000 on the completion of the ten-year period. Valare had 80 senior employees in service on 1 January 2017. On 31 December 2017 it was expected that 70% of these employees would complete ten years of service. No entries regarding the long service awards have been made in the accounting records of Valare for FY2017.

ADDITIONAL INFORMATION

- A before-tax discount rate of 8% per annum should be used where applicable.
- Assume that all amounts are material.
- It is the accounting policy of all companies within the Valare group to apply a threshold of 10% when considering whether an outcome is remote for reporting purposes.
- Non-controlling interests are measured at the proportional share in the acquiree's identifiable net assets within the Valare group.
- Applicable spot rates for FY2017:

	USD : ZAR
30 September 2017	12,00
31 December 2017	13,00

**INITIAL TEST OF COMPETENCE, JANUARY 2018
PROFESSIONAL PAPER 1**

QUESTION 1 – REQUIRED		Marks	
		Sub-total	Total
(a)	<p>Discuss the appropriate accounting treatment of the client claim (note 1.2) in the financial statements of both Cars4Africa and the Valare group for FY2017.</p> <ul style="list-style-type: none"> • Do not address presentation and disclosure in your discussion of both Cars4Africa and the Valare group. • Ignore cash flows. <p><i>Communication skills – clarity of expression</i></p>	13	
		1	14
(b)	<p>Briefly discuss the appropriate measurement of the restructuring provision (note 1.3) in the financial statements of both Cars4Africa and the Valare group for FY2017, assuming that a restructuring provision should be recognised by Cars4Africa on 15 September 2017.</p>	6	6
(c)	<p>Calculate the amount of goodwill or gain on bargain purchase recognised within the Valare group arising from its acquisition of Cars4Africa on 30 September 2017.</p>	9	9
(d)	<p>Provide all pro forma consolidation and other journal entries required to correctly account for the executive compensation for FY2017 in the consolidated financial statements of the Valare group.</p> <p>Closing entries are not required.</p> <p><i>Communication skills – presentation</i></p>	11	
		1	12
(e)	<p>Discuss any ethical concerns that may arise from the events in the scenario, and recommend any actions that should be taken or safeguards that should be implemented to address these concerns.</p>	6	6
TOTAL FOR THE QUESTION			47