QUESTION 1 **100 marks**

Ignore value-added tax

You are a trainee accountant at a local audit firm, AIP Auditors, and have been assigned to the audit of R&M Ltd ('R&M'), a company listed on the Johannesburg Stock Exchange. R&M is the holding company of a group of companies that specialises in the manufacture and distribution of furniture and household appliances. While R&M has focused on South Africa as a market for several years, the company took a strategic decision in 2017 to expand to other African countries. New markets are typically identified by the R&M research team who ensures it is aligned with the R&M Board's risk appetite and strategic objectives.

R&M has owned 100% of Mxolisi (Pty) Ltd ('Mxolisi') since Mxolisi's incorporation. Mxolisi is a manufacturer and retailer of customised and unique furniture pieces. Although Mxolisi is a South African company, with the South African rand (ZAR) as its functional currency, it exports most of its furniture to clients in the United Kingdom (UK).

The financial year end of all entities that form part of the R&M group is 31 December. AIP Auditors has been the auditors of the R&M group since its inception. The independent non-executive directors of the group have raised concerns about the length of the relationship between the auditors and the R&M group. They have requested that R&M consider changing auditors after the completion of the audit for the financial year ended 31 December 2017 (FY2017). AIP Auditors has set a group materiality figure of ZAR1 million for the audit of the financial statements for FY2017.

The chief financial officer (CFO) of R&M, Mrs Thandeka Lou CA(SA), requested that AIP Auditors perform their audit of certain notes to the financial statements for FY2017 based on the information below. She was not sure that the disclosure she had included was correct and would appreciate their feedback on any areas they believe she should correct. She also requested that the FY2017 audit be completed much earlier than usual as the company's bankers require the audited financial information to determine whether they are willing to increase the limit of the overdraft facilities granted to the company.

You have received the following information:

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1 Extract of draft consolidated statement of financial position of the R&M group for FY2017

	Notes	ZAR
ASSETS		
Non-current assets		
Property, plant and equipment		17 000 000
Deferred tax asset	1.1	5 870 000
Current assets		
Forward exchange contract (balance as at 31 December 2016)	1.2	146 000
Trade and other receivables		1 054 800
Inventory	1.3	2 000 000
Non-current assets held for sale	1.4	22 146 637
TOTAL ASSETS		**48 217 437**
EQUITY AND LIABILITIES		
Total equity		1 669 093
Non-current liabilities		
Other long-term liabilities		23 547 000
Deferred tax liability		3 250 000
Current liabilities		
Proceeds on the forward exchange contract suspense account	1.2	270 000
Other current liabilities		19 481 344
TOTAL EQUITY AND LIABILITIES		**48 217 437**

A consolidated profit before tax of the R&M group for FY2017 amounting to ZAR1 960 264 is included in the total equity. This amount does not include any necessary adjustments in terms of the matters listed below under notes 1.2 to 1.4 to correctly account for the items.

Notes

1.1 Deferred tax asset

The deferred tax asset represents only the tax effect of the assessed loss of S&T Furnishers (Pty) Ltd ('S&T'), a subsidiary of R&M. S&T operates in South Africa. On 31 December 2017 management believed that there would be future taxable income against which the assessed loss could be utilised and therefore correctly recognised deferred tax on the full assessed loss. There are no other temporary differences included in the deferred tax asset.

1.2 Hedge of revenue transaction

During August 2016 R&M entered into an agreement with an entity in Ghana to sell 2 000 yellowwood desks at USD100 per desk to it. This contract was entered into with the expectation that delivery would take place in accordance with R&M's normal sales terms and conditions. The desks would be delivered on 28 February 2017. Furniture sold to Ghanaian companies is denominated in United States dollar (USD).

R&M was concerned about the volatility of the USD : ZAR exchange rate and the potential weakening of the USD against the ZAR. On 30 November 2016 management therefore entered into a forward exchange contract (FEC) with Stanx Bank to sell USD200 000 at the end of three months at a fixed USD : ZAR rate. The terms of the FEC provided that the contract would be net settled on 28 February 2017. On 30 November 2016 the FEC was designated in its entirety as a hedging instrument in terms of a cash flow hedge relationship in respect of the highly probable forecast transaction in 2017. This hedge relationship was correctly accounted for in 2016 and all requirements as indicated in IFRS 9 *Financial Instruments,* par. 6.4.1, have been adhered to for the duration of the hedging relationship.

The sale transaction of the 2 000 yellowwood desks was correctly recorded in the current year. However, the only entry recorded in FY2017 with regard to the hedging relationship was to create the following 'proceeds on FEC' suspense account upon the cash settlement of the FEC:

	Dr.	**Cr.**
	ZAR	**ZAR**
Bank	270 000	
Proceeds on FEC suspense account (SOFP)		270 000
Proceeds received from settlement of FEC [(14,35 – 13,00) x 2 000 x USD100]		

1.3 Inventory

The inventory includes 50 customised lounge chairs upholstered with print material of the South African flag. The customer, Furn&U, made a deposit of GBP6 750 (GBP = Great British Pound) on 25 August 2017 (which equated to 25% of the total contract price). These customised units were a specific order and not expected to be easily sold to any other customers. The contract would only have been fulfilled if all 50 units were delivered. In November 2017 Furn&U was liquidated before taking delivery of the chairs or paying the remaining 75%. As the contract was effectively breached, Mxolisi became legally entitled to keep the deposit already received. At year end Mxolisi set off the 25% deposit received against the carrying amount of the inventory. The total cost of the inventory amounted to ZAR366 000 before taking into account the 25% deposit. At 31 December 2017 the net realisable value of the customised lounge chairs was ZAR7 000 per chair. The contract is denominated in ZAR.

1.4 Disposal group classified as held for sale

On 31 December 2017 the directors of R&M and Mxolisi decided to sell off some of the assets of Mxolisi to improve the cash flow of the R&M group. The sale was considered to be highly probable. The assets were available for immediate sale in their current condition. The group of assets to be sold did not represent a cash-generating unit, separate major line of business or geographical area of operation. The assets were to be sold in a single transaction (i.e. as a group of assets) and were correctly classified as held for sale on 31 December 2017. The CFO has assessed the group of assets for impairment in terms of IAS 36, *Impairment of Assets* and has correctly concluded that no separate impairment is required on the individual assets. The directors of R&M nevertheless decided to sell the assets as a disposal group in view of the need to improve R&M's liquidity.

The directors began to actively seek a South African buyer for the assets. The assets were marketed at their total combined fair value of ZAR21 million and the sale was expected to occur within six months after the directors made their decision. Costs to sell were deemed to be negligible. One of the prospective buyers indicated that it would convert the head office building into an art gallery for local work and use the lounge chairs (inventory in note 1.3 above) as furniture.

Schedule 1: Carrying amounts of assets of Mxolisi to be sold as a disposal group				
	Notes	**Measurement basis**	**31 December 2017**	**31 December 2016**
			ZAR	**ZAR**
Investment property	1.4.1	Fair value	6 750 000	7 000 000
Head office in the central business district	1.4.2	Fair value	5 500 000	5 000 000
Investment in bonds	1.4.3	Fair value	8 630 137	8 366 720
Intangible asset	1.4.4	Historical cost (cost model)	1 000 000	–
Inventory (50 customised lounge chairs)		Cost less deposit	244 500	–
Carrying amount of disposal group			**22 124 637**	**20 366 720**

Notes to schedule 1

1.4.1 Investment property

The investment property consists of land that was purchased on 1 May 2002 for ZAR1 500 000. The land was held for capital appreciation and was correctly accounted for at year end in terms of IAS 40 *Investment Property*, as per the schedule above. The fair value of the investment property was determined by a third-party property valuer, Mr Prop Guru.

1.4.2 Head office building

The head office building in the central business district (CBD) was purchased for ZAR2 million on 31 December 2001. No tax allowances were granted on the building. At the date of purchase, the asset had a useful life of 50 years and the residual value of the building was estimated at ZAR0. The depreciable amount relating to the head office building is allocated using the straight-line method. These estimates have remained unchanged.

R&M changed its accounting policy on all buildings on 31 December 2016 to the revaluation model in terms of IAS 16 *Property, Plant and Equipment*. At that date the building was correctly revalued by ZAR3 600 000 to its fair value of ZAR5 million. It was correctly revalued to ZAR5 500 000 at 31 December 2017. The fair value of the head office building was also determined by Mr Prop Guru. It is the accounting policy of the R&M group to revalue buildings at the end of the financial year based on their fair value at that date and to recognise depreciation based on the revalued carrying amount as at the beginning of the year. R&M has not recognised any depreciation relating to the head office building for FY2017.

1.4.3 Investment in bonds

Mxolisi purchased 90 000 ZAR100 5% bonds in Angloville at their fair value of ZAR8 058 615 on 1 January 2015. The bonds mature on 31 December 2018. Interest is paid annually in arrears and commenced on 31 December 2015. Interest has consistently been paid on the due date. At the date of purchase, the credit quality of the bonds was not considered as 'low credit risk'. The instrument has been correctly classified and measured at fair value through other comprehensive income in accordance with IFRS 9, up until the end of the prior year (31 December 2016). The only entry processed for FY2017 was to reduce the carrying amount of the bonds by the interest of ZAR450 000 that was received in cash at year end. The fair value of the bonds was ZAR8 366 720 at 31 December 2016 and ZAR8 630 137 at 31 December 2017.

The following extract in terms of IFRS 7 *Financial Instruments: Disclosures* was presented in the audited financial statements as at 31 December 2016:

… if the investment in Angloville bonds had been classified at amortised cost, the carrying amount would have been ZAR8 292 418 (2015: ZAR8 117 004), determined as follows:

	2016	**2015**
	ZAR	**ZAR**
Gross carrying amount	8 492 418	8 267 004
Expected credit loss allowance	(200 000)	(150 000)
Amortised cost	8 292 418	8 117 004

At 31 December 2017, the following management assumptions in respect of the bonds were applicable:

	Expected credit loss as a percentage of gross carrying amount
12-month	3,0%
Lifetime	3,6%

The credit quality of the bonds remained unchanged throughout the period under review. The management assumptions represent the exposure (i.e. value) at the point of default.

1.4.4 Intangible asset

The intangible asset related to a patent developed by Mxolisi for a leather protector product. The patent was registered on 31 January 2017. ZAR860 000 of the ZAR1 million recognised related to the registration cost of the patent. A further ZAR140 000 was incurred during the production of initial marketing units, when alternative designs were researched, and was capitalised. These units were given to various customers during June 2017 to introduce and promote the product. The patent was expected to have a useful life of three years from 30 June 2017 when it became available for use. The South African Revenue Service permits the deduction of these costs in the same manner as which they are expensed in terms of IFRS.

2 iDish

One of R&M's wholly-owned subsidiaries, AppliCo (Pty) Ltd ('AppliCo'), manufactures various large kitchen appliances, such as dishwashers, washing machines, fridges and freezers. AppliCo is a South African registered company with a manufacturing plant in Durban. AppliCo is considering various strategies for selling 9 000 units of its latest product, called the iDish. iDish is an energy-efficient dishwasher marketed under a premium luxury brand that provides high-quality after-sales support.

AppliCo's annual production capacity for the iDish is 9 000 units. Based on market analysis findings of the research team, the Board is considering opportunities in the following African markets as opposed to only pursuing growing its market share in South Africa:

Country	South Africa (SA)	Kenya	Zambia
General facts and considerations			
Summary of key market information	• SA has a fairly large growing middle income group, and customers are generally brand conscious • Target market consumers surveyed scored high on environmental awareness and indicated a high preference for clean, energy efficient products • Given that large urban areas have an adequate water supply, it is expected that the product could be used with relative ease • Consumers have access to formal and informal credit providers • There is increased stability in the energy supply, with many in the middle to higher income groups moving to alternative sources of energy • Increased regulatory focus from credit and consumer protection agencies has	• Kenyans typically have less disposable income than South Africans, but a strong savings culture. In recent times the middle income group has grown significantly • Kenya has an unorthodox and developing financial services industry. Traditional finance products are not readily available, but innovative mobile money solutions and micro finance markets have emerged to cater for the growing demand • Energy and water supply is typically stable, but increasing demand is expected to place additional pressure on both supply networks • Target market surveys showed that Kenyan consumers have a preference for clean and efficient products but price is a big deterrent to such purchases	• Zambia is a typical dual currency market due to its highly volatile currency and inflation concerns • Zambians have relatively less disposable income than Kenyans and South Africans • Zambia is regarded as a commodity economy with copper and other mining resources making up most of its exports and foreign currency inflows into the country • The financial services industry is dominated by local branches of foreign banks; thus loans tend to be expensive with high interest rates and fees due to observed historic defaults • The power and water supplies are unreliable and unstable. The government is concerned about over-reliance on one type of energy (hydro power),

Country	South Africa (SA)	Kenya	Zambia
	damped economic growth and consumer spending • A recent article in a popular newspaper indicated that consumers are increasingly exercising their rights regarding product warranties	• A well-known management consulting company report highlighted Kenyans' appetite for global brands and imported products	but it is unsure how to resolve this in the immediate future. • According to target market surveys Zambian consumers demand durable, cheap and effective appliances
Economic considerations			
Gross Domestic Product per capita	USD5 800	USD1 700	USD1 300
Infrastructure			
• Electricity	34 000 megawatts 85% fossil fuels	2 200 megawatts 37% hydro power 33% fossil fuels 27% geothermal	2 347 megawatts 96% hydro power
• Transport			
• Road	947 000 km	161 000 km	40 000 km
• Rail	20 500 km	2 000 km	2 200 km
• Sea (harbours)	4,8 million container port traffic	1 million container port traffic	None
• Air	200 000 registered carrier departures	81 000 registered carrier departures	10 000 registered carrier departures
Financial considerations and assumptions			
Sales price per unit	ZAR6 500	KES64 000 (Kenyan Shilling) (ZAR8 500)	ZMK8 600 (Zambian Kwacha) (ZAR12 000)
Manufacturing cost per unit	ZAR3 000	ZAR3 000	ZAR3 000
Logistics cost per unit	ZAR100	ZAR1 200	ZAR1 600
Export/import duties per unit	ZAR0	ZAR200	ZAR2 500
Potential demand for units	35 000	6 000	2 000
Unknown factors	• Management does not know what the cost of insurance associated with transportation to each sales market would be • Management is unsure about global competitors' strategies for entering the African market, but does not think it will be a focus area due to the small demand		
Neutral factors	Sales/value-added tax does not affect the consideration of selecting a sales market		

3 Extract of the draft 2017 audit report

Key audit matters
Accuracy and recoverability of deferred tax asset A deferred tax asset has been recognised on the income tax loss of S&T, a subsidiary of the R&M group, to the extent that it is probable that future taxable income will be available against which the unused tax loss can be utilised. We focused on the accuracy and recoverability of this deferred tax asset because of its materiality and the level of estimation that is required when assessing S&T's expected future taxable income and whether it will result in the utilisation of the tax loss in the future.
Fair value of Mxolisi properties included in assets held for sale On 31 December 2017 the directors of the R&M group decided to sell some of the assets of Mxolisi. The directors accounted for the transaction in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. The R&M group was required to determine the fair value of the assets included in the sale. This included the valuation of an investment property (fair value: ZAR6 750 000) and a head office building (fair value: ZAR5 500 000) in the CBD. Due to the materiality of the fair values of the properties, they were considered to be key audit matters.

4 Summary of discussions held with the CFO on 14 January 2018

- R&M was almost placed in provisional business rescue on 15 August 2017, although this was ultimately unsuccessful when challenged in court. Due to the unsuccessful business rescue challenge and the going concern assessment performed by management, the Board of Directors believes that the preparation of the financial statements on a going concern basis is appropriate.
- Thandeka re-iterated the importance of completing the FY2017 audit much earlier than usual as the company's bankers are insisting on receiving the audited financial information to determine whether they are willing to increase the overdraft facilities granted to the company. The present overdraft facilities are secured by means of a notarial bond over debtors and inventory.
- R&M experienced significant losses in FY2015 and generated a small profit in FY2016. Thandeka suspects this was due to a drop in local demand for its furniture and related products and the economic downturn, which affected the sales of their luxury furniture products.

5 Additional information

- Assume a current tax rate of 28% and a capital gains tax inclusion rate of 80% for all periods under review.
- All companies within the R&M group prepare their financial statements in accordance with International Financial Reporting Standards (IFRS).
- The R&M group has early adopted IFRS 9, including section 6 on hedge accounting.

- Round all amounts to the nearest ZAR.
- The following exchange rates may be applicable to the above-mentioned issues:

	Spot rate		**3 month FEC rates**	**2 month FEC rates**
	GBP : ZAR	**USD : ZAR**	**USD : ZAR**	**USD : ZAR**
30 November 2016		1 : 14,10	1 : 14,35	1 : 14,25
31 December 2016		1 : 13,50	1 : 13,70	1 : 13,62
28 February 2017		1 : 13,00	1 : 13,30	1 : 13,20
25 August 2017	1 : 18,00	1 : 13,00		
31 December 2017	1 : 15,00	1 : 11,00		

INITIAL TEST OF COMPETENCE, JUNE 2018
PROFESSIONAL PAPER 3

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

QUESTION 1 PART I – REQUIRED		**Marks**	
		Sub-total	**Total**
(a)	Calculate the corrected consolidated profit before tax for the R&M group for FY2017. • Begin your calculation with the consolidated profit before tax of ZAR1 960 264 given in the scenario. • Round all amounts to the nearest ZAR.	26	26
(b)	Prepare the tax reconciliation note to the consolidated financial statements of the R&M group for FY2017, as required in terms of IAS 12 *Income Taxes,* par. 81(c)(i). • Assume, for purposes of this required only (thus independent of required (a)), that the corrected consolidated profit before tax after all adjustments is ZAR1 million. • Round all amounts to the nearest ZAR. • You are not required to calculate the final consolidated tax expense. *Communication skills – presentation*	10 *1*	11
Total for part I			**37**

INITIAL TEST OF COMPETENCE, JUNE 2018
PROFESSIONAL PAPER 3

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

QUESTION 1 PART II – REQUIRED		**Marks Sub-total**	**Marks Total**
(c)	Identify and discuss the key factors that the management of AppliCo should consider in evaluating in which African market(s) (South Africa, Kenya, Zambia) it should sell its iDish product.	14	
	Communication skills – clarity of expression	*1*	15
(d)	Prepare a memorandum addressed to the Risk Committee of the R&M group setting out the key business risks for the group arising from its strategy to operate in greater Africa.	13	
	Communication skills – presentation	*1*	14
(e)	Discuss the alternative courses of action that could be taken by the Board of Directors to address the liquidity issues that the R&M group is facing.	6	
	Communication skills – logical argument	*1*	7
(f)	Discuss the advantages to the quality of the external audit that should be considered if it is decided to change auditors as requested by the non-executive directors of the R&M group.	7	7
(g)	List the substantive audit procedures that AIP Auditors should perform to address the following key audit matters:		
	(i) Accuracy, valuation and allocation of the deferred tax asset on the tax loss of S&T; and	9	
	(ii) The fair value of Mxolisi's properties included in assets held for sale.	9	
	Communication skills – layout and structure; presentation	*2*	20
Total for part II			**63**
Total for the question			**100**