

Report on the extracts from HlukileWena’s draft consolidated financial statements for the year ended 31 December 2018	Marks
<p style="text-align: right;">Financial Reporting Specialist 100 IFRS House Johannesburg 2001</p> <p style="text-align: right;">19 June 2019</p> <p>The Audit Committee Chairperson HlukileWena.com</p> <p>Dear Madam</p> <p>This report is in response to your request to draft a report for the Audit Committee on the matters set out below.</p> <p>The detailed findings along with suggested corrective disclosures are provided in parts (a) to (d) of the report.</p> <p>Should you have any further queries or would like to discuss any aspect of this report, please contact me.</p> <p>Kind regards Financial Accountant CA(SA)</p>	
<i>Communication skills – layout and structure</i>	1

Part (a) Discuss any concerns that you may have and recommend any improvements regarding the revenue recognition policy that has been provided in note 1.1.			
You are not required to re-produce an accounting policy note			
Concerns	Why is the concern raised	Recommendations	Marks
The current revenue accounting policy may be considered to be boiler plate and not specific to HW’s business. (1)	The wording in the note is inconsistent. In the first sentence reference is made to “the entity” and subsequently (in the same note/paragraph) reference is made to “the group” . (1)	It should be tailored specific to the business of the group , e.g. stating its sources of revenue: sale of unique clothing items. (1)	3
The current policy recognises revenue when risks and rewards are transferred to the customer (when products are dispatched). (1)	IFRS 15 specifies that revenue should only be recognised when control of goods passes to the customer. (1)	It should have stated in its accounting policy note this is upon delivery, when control transfers, and not merely when risks and rewards are transferred . (1) It is also noted that there is an inconsistency between the policy note and the information where the policy note says revenue recognised at despatching when control is indicated as being transferred on delivery (1).	4
The current accounting policy does not mention the	This should be included in the accounting policy based on the specific facts and	The following should be disclosed:	5

<p>accounting treatment of product returns. (1)</p>	<p>return policy of HW. This is also a specific disclosure requirement in terms of IFRS 15.119(d). (1)</p>	<ul style="list-style-type: none"> • The estimation for products which are expected to be returned (i.e. 15%); (1) • The impact this has on revenue recognition (i.e. only 85% of consideration received is initially recognised as revenue); and (1) • The accounting treatment when the right of return expires (i.e. any remaining refund liability is recognised as revenue after 30 days). (1) 	
<p>There is no disclosure around judgements and changes in judgements relating to the uncertainty in variable consideration of the 15% and 50% returns. (1)</p>	<p>Disclosure requirement in terms of IFRS 15.110(b) and 15.119(b). (1)</p>	<p>The group should have disclosed the judgements and changes in judgements relating to the uncertainty in variable consideration of the 15% and 50% returns. This has been informed by historical evidence based on customer preferences. (1)</p>	3
<p>Available marks</p>			15
<p>Maximum marks</p>			6
<p>Total for part (a)</p>			6

Part (b) Discuss, with reference to IFRS 12, <i>Disclosure of Interests in Other Entities</i> , any additional disclosures in HW's consolidated financial statements for FY2018 that may be required regarding the group's decision to consolidate Boutique.		Marks
1	The investment in Boutique Emporium is classified as an interest in a subsidiary while HW only holds a 45% interest in the company. HW should disclose information to enable users of the financial statements to understand why BEL is a subsidiary of HW.	1
2	IFRS 12.9 states that an entity shall disclose significant judgements and assumptions made in determining that it controls another entity even though it holds less than half of the voting rights of the other entity.	1
3	HW should therefore have disclosed to the users of its financial statements their consideration in reaching their conclusion around control of BEL. The size of their voting rights relative to the size and dispersion of holdings of the other vote holders (which would have been significant) and the following:	1
3.1	HW is the only significant shareholder with a single interest of 45% in Boutique , which is close to a majority vote;	1
3.2	All other shareholders of BEL hold less than 1% of the shares in BEL – therefore HW holds significantly more voting rights than any other shareholder, indicating an increased likelihood of control of its relevant activities; and	1 1
3.3	The other shareholders are widely dispersed , which implies that more than 50 parties will have to act together to outvote HW, which would be unlikely.	1
3.4	3 of the 4 directors of BEL are also directors of HW which can imply that HW has power over the majority of the directors of BEL and HW can therefore direct the relevant activities of BEL.	1
	Available	8
	Maximum	5
	Total for part (b)	5

Part (c) Discuss whether Retail is a related party to HW and, where relevant, provide the disclosures required in terms of IAS 24 <i>Related Parties</i> in HW's consolidated financial statements for FY2018.			Marks																											
1	It is stated that V Ismail controls Retail and that she is the wife of R Ismail, who is a director of HW.		1																											
2	As a director of HW, R Ismail is a member of the key management personnel of HW, making him a related party to HW.		1																											
3	IAS 24.9(a) defines a person or a close member of that person's family to be related to a reporting entity if that person is a close member of the key management personnel of the reporting entity or of a parent of the reporting entity.		1																											
4	IAS 24.9 further states that a spouse or domestic partner of an individual is a close member of that person.		1																											
5	IAS 24.9(b)(vi) states that an entity (Retail) is related to a reporting entity (HW) as Retail is controlled or jointly controlled by a person identified in IAS 24.9(a).		1																											
6	Accordingly, V Ismail is a close member in relation to R Ismail as the scenario states that she is his wife and therefore a related party of HW.		1																											
7	Therefore, Retail is a related party to HW as it is controlled by a close person (V Ismail) who is a member of the key management personnel of HW (R Ismail).		1																											
8	Because of this, HW should also disclose any transactions and balances with Retail in the related party note. The additional disclosure required is detailed below:		1																											
9		<table border="1"> <thead> <tr> <th></th> <th>Amount of transaction</th> <th>Amounts due by/(to) related party</th> </tr> <tr> <th></th> <th>R'000</th> <th>R'000</th> </tr> </thead> <tbody> <tr> <td>Dividends received</td> <td></td> <td></td> </tr> <tr> <td>Retail</td> <td>600</td> <td>–</td> </tr> <tr> <td>Additional investments made</td> <td></td> <td></td> </tr> <tr> <td>Retail</td> <td>400</td> <td>2 000</td> </tr> <tr> <td></td> <td></td> <td>Available</td> </tr> <tr> <td></td> <td></td> <td>Maximum</td> </tr> <tr> <td></td> <td></td> <td>Total for part (c)</td> </tr> </tbody> </table>		Amount of transaction	Amounts due by/(to) related party		R'000	R'000	Dividends received			Retail	600	–	Additional investments made			Retail	400	2 000			Available			Maximum			Total for part (c)	1
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Part (d) With regard to the designer fabric agreement – (i) Discuss the classification of the designer fabric agreement in terms of IFRSs		Marks
1	HW should have considered whether the designer fabric agreement contains a lease arrangement. IFRS 16 <i>Leases</i> defines that a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for a consideration.	1
2	A contract is said to convey the right to control the use of an identified asset for a period of time if the contract – (a) grants a customer the right to obtain substantially all of the economic benefits from use of the identified asset ; and (b) grants a customer the right to direct the use of the identified asset.	1
3	FMC does not have a substantive substitution right as it only has the one plant which is dedicated to the manufacture of batik clothing in South Africa and no batik clothing may be imported. FMC thus lacks the practical ability to substitute the plant.	1
4	The batik plant is therefore implicitly specified.	1
5	The agreement therefore contains an identified asset , being the batik plant.	1
6	The supply agreement provides HW with the right to use the full capacity of the batik plant of FMC as HW always has the first right to use the entire 100 000 unit capacity of the plant and must grant permission for any other party to use the output of the plant.	1
7	HW directs the use of the plant through its control over the production and delivery schedules and approval for any external work.	1
8	Despite the fact that HW is expected to take only 90% of the capacity of the plant, HW will still obtain substantially all of the economic benefits from the use of the plant, as it controls the plant for the duration of the agreement.	1
9	HW obtains a refund for the fixed overhead expenditure from external work.	1
10	HW has the right to control the use of the batik plant during the five-year agreement period.	1
11	HW has a contractual obligation to pay a minimum consideration of R150 000 per month to FMC for use of the plant during the five-year term.	1
12	The supply agreement with FMC should therefore be classified as a lease as it provides HW with the right to control the use of the batik plant for a period of five years in exchange for a minimum consideration of R150 000 per month.	1
Available		12
Maximum		8
Total for part (d)(i)		8

Part (d)	With regard to the designer fabric agreement – (ii) calculate, with supporting reasons, whether a material prior period error exists. In your calculations, consider the effect on each relevant line item.	Marks																												
1	<p>Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:</p> <p>a) was available when financial statements for those periods were authorised for issue; and</p> <p>b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.</p>	1																												
2	<p>The classification of the contract as the purchase of inventory and not a lease represents a prior period error given that the available information was not applied/used correctly as a lease agreement.</p>	1																												
3	<p>In accounting for the agreement as a lease, HW should have recognised a lease liability and right of use asset at commencement date at the present value of the lease payments that were not paid at that date.</p>	1																												
4	<p>The liability at 31 December 2017 which should have been recognised amounts to R6 072 925.</p> <table style="width: 100%; border: none;"> <tr> <td style="width: 50%;">BGN</td> <td style="width: 50%;">END</td> </tr> <tr> <td>FV = 0</td> <td>FV = 0</td> </tr> <tr> <td>PMT = 150 000 (1)</td> <td>PMT = 150 000 (1)</td> </tr> <tr> <td>N = 60 (1)</td> <td>N=59 (1)</td> </tr> <tr> <td>I = 9%/12 (1)</td> <td>I = 9%/12 (1)</td> </tr> <tr> <td>PV = ? = 7 280 201</td> <td>PV=?=7 130 201+150 000 = 7 280 201</td> </tr> </table> <table style="width: 100%; border: none;"> <tr> <td style="width: 50%;">AMRT 12 BAL = 6 027 717</td> <td style="width: 50%;">AMRT 12 BAL = 5 922 925</td> </tr> </table> <p>BGN Mode: Balance at 31/12/2017 = 6 027 717 + 45 208 (amort 13 int) = 6 072 925</p> <p>OR End Mode: Balance at 31/12/2017 = 5 922 925 + 150 000 = 6 072 925</p>	BGN	END	FV = 0	FV = 0	PMT = 150 000 (1)	PMT = 150 000 (1)	N = 60 (1)	N=59 (1)	I = 9%/12 (1)	I = 9%/12 (1)	PV = ? = 7 280 201	PV=?=7 130 201+150 000 = 7 280 201	AMRT 12 BAL = 6 027 717	AMRT 12 BAL = 5 922 925	<p>1 1 1 1C</p>														
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5	<p>The right of use asset at 31 December 2017 which should have recognised amounts to R5 824 161 (7 280 201 x 4/5).</p>	1																												
6	<p>The effect of the error is an increase of R6 072 925 in total liabilities and an increase of R5 824 161 in total assets. Both of these amounts are not quantitatively material as they are less than the materiality level determined by the directors of R8 million.</p>	1																												
7	<p>The error may, however, be qualitatively material as it impacts on the debt:equity ratio and therefore also impacts the loan covenants.</p>	1																												
8	<p>This could impact on the decisions of the bank to withdraw funding and in turn could create a potential going concern issue which could impact the decisions of other users of the financial statements.</p>	1																												
9	<p>The terms and conditions define debt as all liabilities recognised in the audited separate financial statements. However, the separate financial statements have not been provided.</p>	1																												
10	<p>However, using the consolidated financial statements, the revised debt:equity ratio after adjusting for the error would be 2,10:1:</p> <table style="width: 100%; border: none;"> <tr> <td style="width: 40%;">Previous liability balance</td> <td style="width: 20%;">81 800 000</td> <td style="width: 20%;"></td> <td style="width: 20%;"></td> </tr> <tr> <td>Add lease liability</td> <td><u>6 072 925</u></td> <td></td> <td></td> </tr> <tr> <td>Total liabilities</td> <td>87 872 925</td> <td></td> <td></td> </tr> <tr> <td colspan="4"> </td> </tr> <tr> <td>Previous equity balance</td> <td>42 000 000</td> <td></td> <td></td> </tr> <tr> <td>Net change in equity</td> <td><u>(248 764)</u></td> <td>(6 072 925 – 5 824 161)</td> <td></td> </tr> <tr> <td>Total equity</td> <td>41 751 236</td> <td></td> <td></td> </tr> </table>	Previous liability balance	81 800 000			Add lease liability	<u>6 072 925</u>			Total liabilities	87 872 925							Previous equity balance	42 000 000			Net change in equity	<u>(248 764)</u>	(6 072 925 – 5 824 161)		Total equity	41 751 236			<p>1P 1P</p>
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	Debt:equity ratio = 87 872 925:41 751 236 = 2,10	1P
11	If the error is material, the error should be corrected in the 2018 consolidated financial statements by restating the 2017 comparative period as follows:	1
12	Non-current assets/Right of use asset will increase by R5 824 161 (1/2P) Non-current liabilities will increase by R4 752 398 (amort 24) + 34 518 (amort 25 int) (1/2P) Current liabilities will increase by R1 320 527 (R6 072 925-R4 752 398)(1/2P) Equity will decrease by R248 764 (1/2P) Equity calculated as follows: Depreciation: 1 456 040 (1/2P) Interest expense: 592 724 (amort 13) (1/2P) Cost of sales: (1 800 000) (1/2P)	½P ½P ½P ½P ½P ½P ½P
	Available	19.5
	Maximum	12
	Total for part (d)(ii)	12

Part (d) With regard to the designer fabric agreement – (iii) provide the journal entries to account for the agreement in FY2018, assuming the prior period error has already been corrected.			Marks
	Dr.	Cr.	
	R	R	
Lease liability (SoFP)	1 800 000		1P
Bank (SoFP)		1 800 000	
<i>Recognition of the cash flow paid (12 x R150 000)</i>			1
Interest expense (P/L)	479 473		1P
Lease liability (SoFP)		479 473	
<i>Recognition of the interest expense for FY 2018 AMRT BGN: (N14-N25) INT = R479 473 OR AMRT END: (N13-N24) INT = R479 473</i>			1
Depreciation (P/L)	1 456 040		1P
Accumulated depreciation/Right of use asset (SoFP)		1 456 040	
<i>Recognition of the depreciation on the right of use asset (7 280 201/5)</i>			1
		Available	6
		Maximum	6
		<i>Communication skills – presentation (journal narrations)</i>	1
		Total for part (d)(iii)	7
		Total for part (d)	27

Part (e)	Discuss, with regard to the designer fabric agreement and the FY2019 SPV proposal, any ethical concerns you may have regarding the conduct of Tsepo and recommend actions that Samira as the Audit Committee Chairperson should take in response to your concerns.	Marks
1.	<p>Ethical Concerns The financial director (Tsepo) CA(SA) in business should adhere to the Code of Professional Conduct issued by the South African Institute of Chartered Accountants (SAICA).</p>	1
2.	<p>Tsepo's statement regarding him finally being recognised and receiving a bonus he deserves, and hence forcing/force the accountant to use the incorrect accounting treatment on the designer fabric scheme created the following threats to Tsepo's objectivity and integrity:</p> <ul style="list-style-type: none"> • self-interest threat The financial director (Tsepo) is acting in his own interest/protecting his own interest regarding the actions that he has taken for his own benefit as the incorrect classification will lead to manipulation of the financial statements and Tsepo will earn a bonus as a result. This is significant because Tsepo is the financial director and has significant influence on the classification of the costs and the financial statements. • intimidation threat In view of the loan covenants, there is pressure on Tsepo, which influences his judgement and behaviour inappropriately. It is significant because he is the financial director and is in a position of influence and is able to manipulate the financial statements accordingly. 	<p>1 $\frac{1}{2} + \frac{1}{2}$ $\frac{1}{2}$ 1 1 $\frac{1}{2}$ 1 1</p>
3.	<p>The financial director failed to comply with the Companies Act (section 29), which require financial statements to be presented in accordance with IFRS. Tsepo therefore did not comply with relevant laws and regulations, potentially discrediting the accounting profession (fundamental principle of professional behaviour/professional competence and due care) A further breach of the Companies Act (section 76), financial director's fiduciary duty to act in the best interest of the company (HW).</p>	<p>1 1 $\frac{1}{2}$ 1</p>
4.	<p>Recommended Actions The chairman of the audit committee is a CA(SA) in business and should adhere to the Code of Professional Conduct issued by the South African Institute of Chartered Accountants (SAICA).</p>	1
5.	<p>The audit committee chairperson should perform the following steps:</p> <ul style="list-style-type: none"> • Obtain and document all of the relevant facts; • Determine which ethical issues are involved; • Determine which fundamental principles relate to the matter in question; and • Determine the internal procedures for ethical breaches at HW. 	<p>$\frac{1}{2}$ $\frac{1}{2}$ $\frac{1}{2}$ $\frac{1}{2}$</p>
6.	<p>Further actions/considerations to be taken in ensuring whether sufficient action was taken by the board to rectify situation:</p>	

	<ul style="list-style-type: none"> • Audit committee should also ensure that this matter (accounting errors) are corrected retrospectively in the financial statements if material to financial statements. • Notify JSE of accounting error/restatement (SENS announcement to be made alerting stakeholders of restatement). • The revision of prior periods' audit opinion should also be considered by auditor – audit committee should ensure auditor is aware of this. • Consideration of whether debt covenants are still met after restating/correcting error – adjust disclosures accordingly etc. 	1
7.	The chairperson should determine whether to consult with those charged with governance of HW , such as the board of directors or the rest of the audit committee.	1
8.	If the matter cannot be resolved satisfactorily, the chairperson should consider obtaining professional advice from the relevant professional body or from legal advisors.	1
9.	In doing so, the chairperson should carefully consider the information and parties to which it is shared, so as to avoid breaching the fundamental principle of confidentiality .	1
10.	If after further consultation it is not possible to resolve the matter, the chairperson should consider refusing to remain associated with HW.	1
11.	The chairperson should determine if she has a responsibility to report the non-compliance with the Companies Act under Non-Compliance with Laws and Regulations Standard as adopted by SAICA.	1
12.	The Audit Committee Chairperson should also consider the conduct of the auditor and whether there has been any breach in the independence of the auditor , based on the statement by Tsepo that the auditors signed off on the current accounting of the agreement.	1
Available		24.5
Maximum		8
Total for part (d)		8
TOTAL FOR QUESTION		53