

Part (a) Discuss, with regard to the R2 800 000 facilitation fee paid to P&P and the VAT treatment adopted on sales to Distill Africa, any concerns that you might have regarding the management's ethical and corporate governance practices.	Marks
<b>1 The payment made to P&amp;P (company owned by Alicia Florrick's father)</b>	
1.1 The <i>nature of the payment</i> authorised by Alicia to P&P is <i>questionable</i> because the facilitation payment could be seen as <b>bribery</b> . (Business Ethics)	1
1.2 The contract could also be seen to have an element of <b>nepotism (favouritism)</b> involved as Alicia is awarding the contract (plus a large facilitation payment) to a company in which her <b>father has a financial interest</b> . (Business Ethics)	1
1.3 The facilitation <i>payment was made based on discussions only</i> and was <b>not formalised into a contract</b> , which are further indications of its suspicious nature. (Business Ethics)	1
1.4 Alicia being a <b>member of the governing body</b> (Board), in terms of <b>King IV Code</b> should lead <i>ethically</i> and effectively. Individually and collectively cultivate <b>integrity, fairness and transparency</b> (principle 1).	1
1.5 Management is thinking about <b>hiding the payment in cost of sales</b> and not being <b>transparent</b> about the nature of the payment.	1
1.6 The payment/contract is <b>significant in both amount and nature</b> and accordingly would require <b>Board approval</b> which did not happen as Alicia as CEO entered into the contract and did the payment.	1
1.7 <b>Section 75</b> of the Companies Act is applicable, as the contract will lead to significant <b>personal interest for Alicia (CEO) and her husband (CFO)</b> , as <b>her father is the majority shareholder</b> of P&P (related person to both Alicia and Peter).	1
1.8 Following the requirements from <i>section 75</i> , Alicia should: - not have taken part in the consideration of the matter ( <b>not have voted</b> ); - <b>disclosed her personal financial interest in the contract with P&amp;P</b> .	1 1
<b>1.9</b> Accordingly, Alicia did not comply with <i>her fiduciary duties of care, skill and diligence</i> as required by the <i>King Code</i> and the <i>Companies Act (section 76)</i> .	1
1.10 Alicia <i>may also incur liability</i> <b>to section 77 of the Companies Act</b> should the company or other parties suffer losses.	1
1.11 Alicia is reasoning that including the facilitation fee in the cost of sales line item would further ensure that it did not receive too much attention, which could lead to financial statements <b>being false or misleading in a material respect</b> , a contravention of <b>Section 29</b> of the Companies Act.	1
1.12 <b>Hiding information from the auditors</b> is also in direct contravention of the King Code and Companies Act.	1
1.13 The company could also possibly incur liability for <b>reckless trading (section 22)</b> as the company is experiencing <b>cash flow difficulties, yet paying out a significant amount</b> for a facilitation fee.	1
<b>2 The incorrect treatment of VAT charged to Lesotho clients</b>	
2.1 The VAT charged to the Lesotho clients at a South African VAT rate of 15% is incorrect and not in terms of the South African <b>VAT Act and SARS requirements</b> .	1
2.2 The <b>governing body (Board)</b> , in terms of <b>King IV</b> , should govern <b>compliance with applicable laws</b> and adopted, non-adopted, non-binding rules, codes and standards in a way that supports the organisation being ethical and a good corporate citizen (principle 13)	1
2.3 This is because VAT should have been <b>charged at 0%</b> , as the goods were delivered to an address in an export country, which constitutes a <b>direct export of goods</b> .	1
2.4 Peter (CEO) appear to have <b>intentionally</b> accounted for the VAT charged in an effort to <b>increase the company' reported sales</b> , due to their intention to use their AFS to secure additional funding.	1

2.5	Peter also appear to be <b>extorting additional cash from their Lesotho client</b> (not treating their customers fairly), due to experiencing cash flow difficulties (Business Ethics)	1
2.6	Accordingly, Peter did not comply with <b>his fiduciary duties of care, skill and diligence</b> as required by the <i>King Code</i> and the <i>Companies Act (section 76)</i> .	1
2.7	Peter may also <b>incur liability</b> <i>ito section 77 of the Companies Act</i> should the company or other parties suffer losses.	1
2.8	The company could also possibly incur liability for <b>reckless trading (section 22)</b> as it appears there is an intent to <b>defraud their client and the bank</b> (reliance on the financial statements for additional funding) by overstating sales and debtors	1
2.9	Materiality figure is R285 000, VAT on R4 165 000 = R543 378, hence overstatement is material quantitatively and qualitatively.	1
2.10	Peter's inclusion of the VAT in the sales and debtors figures could lead to <b>financial statements being false or misleading in a material respect</b> , a contravention of <b>Section 29 of the Companies Act</b> .	1
3	Should the auditors became aware of both these transgressions it could also then constitute a <b>Reportable Irregularity</b> .	1
<b>Available</b>		<b>25</b>
<i>Communication skills – appropriate style</i>		1
<b>Maximum for part (a)</b>		<b>15</b>

<b>Part (b) With reference to the background information and workpaper C01, draft a memorandum to Alicia in which you critically analyse the factors that influence the effective management of Smart-Pack's working capital for FY2018. Include recommendations to address factors identified.</b>	<b>Marks</b>
<p><b>Memorandum</b></p> <p><b>To:</b> Alicia Florrick (CEO of Smart-Pack (Pty) Ltd)  <b>Date:</b> X January 2019  <b>From:</b> ITC candidate  <b>Subject:</b> Analysis and recommendations of the factors that impact on the current decrease in the liquidity of Smart-Pack as at 31 December 2018</p> <p>Dear Alicia</p> <p>Thank you for providing us with the opportunity to add value to your business through unpacking the issues that impact on your current liquidity as well as possible recommendations.</p> <p>Your liquidity problem appears to be due to the following reasons:</p>	
<i>Communication skills – layout and structure (memorandum)</i>	1
<p><b>1. Factor:</b>  The business is <b>at risk of over-trading</b> given the demand for the product and increased growth in sales (<b>business grew more quickly</b> than its processes/ financing arrangements not keeping up with increased trading). This is evident in its <b>overreliance on an overdraft facility and cash flow issues</b>.</p>	1
<p><b>1.1 Recommendations:</b>  Smart-Pack should attempt to acquire <i>more long-term financing (or funding more aligned to its working capital cycle)</i>, preferably <b>equity or preference shares</b>, rather than increase its overdraft.</p>	1

1.2 <b>More debt (vs equity)</b> might <i>put the company at risk of liquidation</i> , and therefore a <b>capital injection by the owners</b> (or by introducing new shareholders) would probably best address Smart-Pack's current cash flow problems ( <i>equity capital vs debt</i> ).	1 1
1.3 If the business decides to retain debt financing, consider approaching banks to <b>raise working capital specific debt facilities</b> that enable more reasonable <b>alignment</b> of the debt term to the working capital cycle at potentially <b>lower interest rates</b> .	1
1.4 <b>Consider employing a CA(SA) (or treasury expert) to assist with the working capital management</b> (credit management, stock control, cash management, etc). This is critical given the <i>current CFO may no longer be suitable</i> to manage a business at this stage of its lifecycle due to lack of treasury/finance expertise (as evidenced by the VAT dispute/error with Distill Africa).	1 1
1.5 Consider <b>strengthening the board composition to include a non-executive director with specific finance skills and experience</b> to provide insight and oversight over the development of finance and risk policies.	1
<b>2. Factor:</b> The increased production needs (primarily to service increased production needs in Botswana and Lesotho) indicates a <b>possible accumulation of excess inventory</b> , which increases the potential for damaged/wasted/lost inventory and associated holding costs	1
<b>2.1 Recommendations:</b> <i>Implement a Just-in-Time or another Inventory Management System</i> (particularly in Botswana and Lesotho) to reduce the need to produce and hold large quantities of inventory	1
2.2 Consider <i>negotiating extended supplier/creditor terms</i> to mitigate the inventory holding costs by having creditors fund part of the increased inventory needs in South Africa and the foreign subsidiaries	1
<b>3. Factor:</b> The trade receivables for Smart-Pack show <b>significant amounts of working capital are being tied up</b> , with a substantial portion of this related to sales in <b>foreign countries</b> ( <i>approximately 75% of the trade receivables balances disclosed are due to two customers, Distill Africa in Lesotho and BotAir in Botswana</i> ).	1 1
A portion of the trade receivables is in <b>dispute</b> (in some cases related to VAT), indicating potentially <b>poor paperwork and/or lax invoicing</b> .	1
The business <b>does not seem to have developed an appropriate credit management policy and/or incentives to reduce the amount</b> of working capital tied up in receivables.	1
<b>3.1 Recommendations:</b> <i>Improve controls within the systems of working capital management, such as carrying out reconciliations at least monthly</i> to have better control over the trade debtors' accounts and systems.	1
3.2 Introduce <b>credit limits, credit checks</b> to reduce sales on credit to customers who have already reached a predefined exposure level that is considered tolerable.	1
3.3 Consider <b>factoring</b> of large debtors' balance. (Costly, but could provide some temporary relief for cash flow position) or <b>insuring</b> the debtors balance for non-payment.	1
3.4 From the debtors sample provided it appears the Botswana, and possibly <b>Lesotho debtors</b> are the biggest problem and <i>actions should be considered to improve collection of such foreign debts</i> (e.g. <b>outsourcing collection to local agents; opening foreign bank accounts</b> ).	1
3.5 Given <i>exchange rate fluctuations</i> , consideration should be given to <b>take out forex cover</b> on Lesotho and Botswana sales.	1
3.6 Attempt to reach a <b>compromise</b> with debtors to ensure the company is able to <b>recover</b> as much of the amount outstanding as possible.	1
3.7 Develop more <i>stringent controls around sales on credit</i> , with <b>confirmations generated and signed by clients</b> indicating amounts purchased and key terms of payment.	1
3.8 Develop an appropriate <b>legal/arbitration process for future disputes</b> that avoids lengthy and costly legal processes.	1

3.9 Consider agreeing to <b>interest payments</b> in exchange for <b>slightly longer credit payment</b> periods.	1
3.10 The <b>growth in international sales and the debtors</b> should be a focus of management that is actively managed and controlled. Smart-Pack should consider <b>developing reporting by region</b> to track the working capital evolution of the different geographies in more detail in order to <b>assess if action needs to be taken faster</b> .	1 1
3.11 Introduce incentives (e.g. <b>discounts for quick settlements</b> ) to encourage customers to actively pursue speedy settlements of amounts outstanding.	1
3.12 Introduce <b>interest charges and penalties</b> on <b>overdue</b> accounts (within reason).	1
3.13 <b>Assign responsibility</b> to a team or an individual in the finance function <i>to assess the accumulation of balances, perform reconciliations, of outstanding amounts and to follow up with customers owing money</i> . If a team already exists, <b>introduce training to up-skill</b> the responsible individuals.	1
3.14 Consider <b>cutting off</b> , or changing terms to cash on supply only for <b>defaulting customers</b> to encourage a culture of payment.	1
	<b>Available</b>
	<b>32</b>
	<b>Maximum for part (b)</b>
	<b>16</b>

<b>Part (c) With reference to workpaper T05, advise Alicia on the tax implications for Smart-Pack for the 2018 and 2019 years of assessment. Support your advice with calculations.</b>	<b>Marks</b>
<b>1 Bad debts</b>	
1.1 Section 11(i) of the Income Tax Act provides that a <b>deduction of a debt</b> that has <b>become bad in the current year of assessment shall be allowed</b> , provided that such an amount was <b>included in the income</b> of the taxpayer during the current year or prior of assessment. (Thus deduct the bad debt amount excluding VAT.)	1
1.2 Section 22 of the <b>VAT Act provides for an input tax deduction</b> , and any debt written off as bad in terms of section 11(i) of the Income Tax Act will be the amount <b>net of the input tax</b> adjustment. (Claim input tax on bad debts ito section 22.)	1
1.3 <b>Pet World:</b> <b>2018:</b> The debt <b>will not be allowed as a deduction of bad debt as the amount has not become bad during the year of assessment.</b>	1
Advise Alicia to include the amount on the <i>schedule for allowance for credit losses</i> for 2018 and accordingly a <i>deduction of 25%</i> will be allowed, which will be added back in 2019	1
The amount will be $R419\ 750 \times 100/115 \times 25\% = R91\ 250$	1
<b>2019</b> Pet World has been declared insolvent on 10 January 2019 and accordingly the full amount excluding VAT will be allowed as a deduction ito s11(i).	1
The amount allowed as a deduction is $R419\ 750 \times 100/115 = R365\ 000$	1
The VAT will be claimed as <b>input tax</b> = $R54\ 750 (419\ 750 \times 15/115)$	1
1.3 <b>We-Pack:</b> The taxpayer will <i>qualify for a tax deduction</i> in terms of section 11(i) because the <b>amount written off was included in income</b> and it has <b>become bad</b> during the 2018 year of assessment.	1

	The full amount excluding VAT will be allowed as a deduction is <b>R63 800</b> (R73 370 x 100/115)	1
	The VAT will be claimed as <b>input tax</b> = [R73 370 x 15/115) = R9 570	1
	The taxpayer will however need to <i>prove that the debt is irrecoverable</i> , which proof usually includes proof that attempts been made to recover the debt, discounts offered, letters of demand, etc. (i.e. proof of actions to recover).	1
<b>2</b>	<b>Doubtful debt</b>	
2.1	Section 11(j) provides for the <b>deduction of debt</b> included in a taxpayer's income, that the Commissioner considers to be <b>doubtful</b> , in this case 25%, which should then be included in the income in the next year of assessment.	1
2.3	<b>Mr Street staff loan:</b> The amount of R81 500 relates to the debt of an employee who was dismissed and is <i>capital in nature</i> and <b>will not qualify as a deduction</b> in terms of section 11(i) or s11(j) of the Income Tax Act.	1
	Advise Alicia that this amount can be claimed as a <b>capital loss for CGT</b> when it is written off.	1
	There are <b>no VAT consequences</b> as the loan is regarded as financial services and is therefore exempt.	1
2.4	<b>Lucky Gin Distillery and Bespoke Packets:</b> the full amount excluding VAT will qualify as a <b>deduction</b> in terms of section 11(i) should it become bad.	1
	The VAT will then be claimed as <b>input tax:</b> R53 504 (R410 200 (R250 000 + R160 200) x 15/115)	1
2.5	<b>2018:</b> The amount that will <b>qualify for a section 11(j) allowance</b> will be the doubtful debts amounts <i>less VAT</i> . (R410 200 (R250 000 + R160 200) x 100/115) = R356 696.	1
	The amount to be claimed will then be 25% x R356 696 = R89 174	1
	<b>2019:</b> This amount will then be added back to the income.	1
	<b>Available</b>	<b>23</b>
	<i>Communication skills – clarity of expression</i>	1
	<b>Maximum for part (c)</b>	<b>11</b>
	<b>TOTAL FOR PART I</b>	<b>42</b>