

## QUESTION

100 marks

AAA Nama (Pty) Ltd ('Nama') is a medium-sized meat supplier operating in Stellenbosch. Nama is a registered VAT vendor. Its business operations entail the processing of beef and other meats. Nama subscribes to fair treatment of animals and fair trade with its suppliers. Nama has a 30 June financial year end.

### 1 Fire in the beef-processing factory

Since 2013, Nama has conducted its beef-processing operations from a factory situated in Stellenbosch. On 1 November 2018 a fire broke out in the factory and completely destroyed it. None of the factory workers was injured during the incident. On 1 December 2018 the insurer paid out compensation amounting to R14,95 million in relation to the factory building and R230 000 in relation to the machinery.

Nama had constructed the factory building for R13,3 million. It was completed and brought into use on 1 August 2013. If a similar factory building had been purchased at that date instead of it being constructed by Nama, it would have cost R12 million.

Second-hand production machinery, which had been purchased on 1 August 2018 at a cost of R600 000 from a non-VAT vendor in an arm's length transaction, was also completely destroyed in the fire.

Management considered with regard to the financial year ended 30 June 2019 (FY2019), if there were any indicators of impairment on the carrying amount of the beef factory, and if so, whether Nama should recognise any associated impairment. Management stated that as the insurance sufficiently covered the loss of the factory, no impairment was required on the beef factory.

### 2 Construction of a new factory

The proceeds received from the insurer in respect of the destroyed factory building were used to pay a third party (not a connected person in relation to Nama) to construct a new factory. It was completed at a cost of R12,5 million and brought into use on 1 May 2019.

During the construction Nama attempted to speed up the building process to ensure completion by 1 May 2019, and as a result was fined R100 000 (which is not included in the R12,5 million) for contravening building regulations. Nama paid the fine on 1 April 2019.

Nama decided to purchase units in a newly constructed block of flats to be used as accommodation for their factory workers. They purchased 20 of the 100 available flats for R840 000 (including VAT) each on 1 December 2018 and paid for the units in cash on that date. As part of management efforts to speed up construction of the factory, Nama allowed the construction workers to occupy all 20 flats rent-free from this date to 30 April 2019, at which date the construction workers moved out.

From 1 May 2019 the flats were leased at R3 000 per month each to 20 factory workers. The rental was payable monthly in advance, on one-year lease agreements. All monthly rentals for FY2019 were received on the due dates.

### 3 Lease of production machinery

The production machinery destroyed in the fire was replaced by leased machinery. In terms of the agreement Nama pays LeaseLet (Pty) Ltd R15 000 (including VAT) per month for a period of five years, beginning on 1 May 2019. This agreement is an instalment credit agreement and the arm's length cash cost of the machinery on this date was R575 000 (including VAT).

#### **4 Purchase of shares in Landic (Pty) Ltd ('Landic')**

Nama would like to use an existing storage facility that is situated on a site next to the new factory. The shareholders of Landic, the company that owns and rents out the facility, did not want to sell the storage facility and land directly, but preferred instead to sell 100% of the ordinary shares in Landic to Nama for R4,3 million. Nama purchased the shares on 1 May 2019 and began using the storage facility on the same day. The purchase price was calculated on the basis that 60% relates to the storage facility and 40% to the land.

Nama obtained a loan of R4,3 million from Squared Bank on 1 May 2019 to fund the purchase of the shares in Landic. No transaction costs were incurred. The interest expense on the loan for the period 1 May to 30 June 2019 amounted to R85 000 and was settled in cash on 30 June 2019.

On 1 May 2019 Nama signed a 15-year lease with Landic for use of the storage facility. In terms of the lease agreement Nama pays R20 000 per month in arrears to Landic. This is a market-related rental. No transaction costs were incurred. Landic is not a VAT vendor.

#### **5 Taxable income**

The taxable income of Nama for the year of assessment ended 30 June 2019, excluding the effects of the information in items 1 to 4, was R15,604 million.

#### **6 Expansion into the vegetarian-meat market**

##### **6.1 Research and development of a new product**

Mr Taylor Selebi, the founder, majority shareholder and managing director of Nama, was intrigued by an article published in a scientific journal highlighting the success of meat substitutes in the United States of America. These were quoted as being 'almost indistinguishable from real meat'. Taylor started researching the scientific requirements and processes required to produce plant-based meat substitutes.

On 1 July 2016, after performing extensive research and having developed a workable design, Taylor rented a small laboratory in Technopark, Stellenbosch, in which to undertake research and testing of a plant-based meat substitute, for a period of five years. The initial rental amounted to R15 000 per month, excluding water and electricity, and the rental increases by 5% per annum on the anniversary of the lease. In the event of an early termination, a cancellation fee of R180 000 would become payable.

Taylor hired two food science graduates, Mr Sandile Ishmail and Ms Julia van Dyk, as well as a biochemical engineer, Mr Aphiwe Vambe, to work on this new project. Taylor also hired Ms Megan Smythe, an experienced food scientist, to lead the team. All four started their employ with Nama on 1 July 2016.

Taylor and Megan defined their mission as the creation of a sustainable vegetable protein that looks, feels and tastes so much like real meat that even meat lovers would happily buy it. Nama registered a trademark and copyright for the names vMeat<sup>®</sup> and vBeef<sup>®</sup> on 30 April 2019. After discussing possible marketing strategies, Taylor and Megan decided to use vMeat<sup>®</sup> as the go-to market brand.

By 1 February 2020, Megan and her team had made meaningful progress in their research and announced that they were confident they had created a successful product. The product was primarily based on the inclusion of two chemicals, EE-G243 and AF-723, into their products. These chemicals, which Megan and her team had developed, add the necessary flavour and texture to their vegetarian product so that it mimicked real meat.

The Nama Board of Directors met on 1 March 2020 and were impressed by the progress made by the team. The Board remains committed to the vMeat project and has approved the project budget for the next ten years.

By 15 March 2020 Taylor had already decided that the development would be viable, and from this date dedicated an existing member of the Nama accounting department to maintain separate records for vMeat. This would enable Nama to reliably determine the cost of development, production and profit.

## **6.2 Production and distribution during the trial period**

The company decided on a three-year production trial for the vMeat product, with a commencement date of 1 July 2020.

The rebuilt factory buildings owned and used by Nama in the processing of its traditional beef meat products have a large unused space that could be used for the production of the vMeat product. The space is otherwise expected to remain idle for the foreseeable future. Nama does not intend sub-letting the space. The unused space would be available for the entire trial period. A market-related rental for a similar space is R25 000 per month.

A part of the building wall is unstable due to damage caused by a tractor hitting the wall. The wall would need to be reinforced immediately and also rebuilt before this section of the building could be used. Nama obtained two quotes to reinforce and rebuild the wall. One was from a builder with extensive building knowledge and expertise for R500 000 and the second was a cheaper quote from a newly qualified builder with limited experience for R400 000. Taylor felt it would be preferable to use the more experienced builder to ensure that the wall was completed by 30 June 2020.

Nama would have to purchase machinery and equipment of R3 million for use in the trial production. This machinery and equipment would have to be sold and replaced after the trial production period because of the significant increase in the expected post-trial consumer demand. The market value of the machinery and equipment at the sale date would be R400 000.

The trial production process would be largely mechanical and require five full-time staff (currently in Nama's employ), including Megan. These full-time staff members are regarded as scarce labour and consequently Nama does not envision retrenching any of the staff in the foreseeable future. The vMeat team would move out of the laboratory into the manufacturing building once it was ready to be occupied. Should Nama choose not to cancel the laboratory contract, the laboratory space would remain unused for the duration of the rental contract. A mechanical engineer would also need to be recruited from 1 July 2020 at an annual salary of R850 000.

The cleaning and delivery staff from Nama's current operations would reallocate time from their existing roles to work on the vMeat side. It is estimated that this would require 15% of their total available hours. The total salary cost per annum for the cleaning and delivery staff is currently R1,2 million.

The process of making vMeat is water and electricity intensive. In production test runs in the laboratory, water and electricity costing R3 500 were used to produce 1 000 kg of vMeat in one month, and R2 000 to produce 500 kg of vMeat in the next month, based on FY2020 prices. It is expected that the fixed portion of water and electricity costs incurred during the test runs, which is specific to the production of vMeat, will double during the trial production of vMeat in Nama's own manufacturing buildings.

Direct materials for the production of each kilogram of vMeat, based on FY2020 prices, will require the following ingredients:

| Ingredients                              | Kg   | Price / kg R | Cost of vMeat / kg R |
|--|------|--------------|----------------------|
| Vegetable protein                        | 0,75 | 54           | 40,50                |
| EE-G243 flavouring and binding agent     | 0,10 | 275          | 27,50                |
| AF-723 texture additive                  | 0,50 | 78           | 39,00                |
| Colourant powder                         | 0,01 | 120          | 1,20                 |
| <b>Total direct material cost per kg</b> |      |              | <b>108,20</b>        |

Nama would also have to make an upfront investment of R250 000 in packaging materials and other raw materials to start the vMeat trial production process. The working capital requirements from 2020 to the end of the trial period in 2023, as reflected in the budgeted statement of financial position, are as follows:

|                            | 2020 R    | 2021 R    | 2022 R    | 2023 R |
|----------------------------|-----------|-----------|-----------|--------|
| Working capital investment | (250 000) | (291 500) | (339 889) | –      |

According to current market research on expected customer demand, conducted by Nama at a cost of R100 000, there are encouraging signs of a strong demand for vMeat, priced at between R140/kg and R160/kg. The research indicated that both a direct retail store sales strategy and partner distribution network would be required to secure a meaningful market share within the Western Cape region.

The following are the forecast sales volumes for vMeat, based on the assumption of an average price of R150/kg and delivery of the product to the market using both a direct retail store sales strategy and partner distribution network:

| Probability | Kg sold per month |
|-------------|-------------------|
| 30%         | 20 000            |
| 50%         | 10 000            |
| 20%         | 5 000             |

Taylor has set sales volume growth targets of 10% per year, which is similar to the growth Nama experienced when it started its beef processing operations. Due to the fast obsolescence of food products, Nama does not intend holding any opening or closing inventory of either the raw materials or of finished goods.

Nama would need to acquire a delivery vehicle at a cost of R1,4 million on 1 July 2020, to meet customer demands arising from forecast sales. This would ensure on-time deliveries and enable Nama to open additional direct sales stores in nearby regions.

### 6.3 Bulk processing after the trial period

The cost of new bulk processing machinery and equipment to be used for the production of vMeat after the trial period is currently R5,8 million. The price is not expected to increase in view of competitive pressures arising from Chinese and Indian companies entering the local market. The new bulk processing machinery and equipment are expected to have a ten-year commercial life and would be able to produce up to 75 000 kg of vMeat per month.

## 7 Outsourcing production of vMeat

As an alternative to producing in-house, Nama could outsource the production of vMeat to Yarnworths (Pty) Ltd ('Yarnworths') because it has the required machinery and equipment to produce vast quantities of the vMeat product. Taylor raised some concerns about using a competitor to produce and sell its products, as Yarnworths is currently selling their own house brand meat-substitute products, called 'Veggie Power'. However, according to Megan, Yarnworths would be happy to discuss potential production process synergies with the vMeat team.

The Yarnworths marketing manager suggested a selling price of R125/kg for vMeat to be produced and delivered to Yarnworths stores, fixed for the full trial period. If Nama wanted delivery to their own stores or other retailers, delivery and other related costs would be for their own account. Legal fees relating to drawing up the contract would amount to R50 000. Yarnworths has expressed a keen interest in this venture and would be open to other ideas from the vMeat team, given their reputation in the industry.

In the event production was outsourced, the laboratory lease would be honoured as development and research would still be maintained in-house. The unused factory space would not be required under the outsourcing arrangement.

## 8 Additional information

- SARS considers the processing of beef and other meats as well as the production of meat substitutes to be a process of manufacture.
- Nama has not made an application to the Department of Science and Technology in respect of section 11D of the *Income Tax Act, 1962* (Act 58 of 1962), as amended.
- Nama accounts for property, plant and equipment as well as investment property using the cost model.
- Nama's weighted average cost of capital is 14% (after tax)
- Nama's incremental borrowing rate is 14% (before tax).
- Nama's direct costs, water and electricity, and salaries and wages are expected to increase annually by an inflation rate of 6%.
- vMeat's average selling price per kg is expected to increase by an inflation rate of 6% per annum.
- Write-off periods as per Binding General Ruling no. 7 are as follows:
  - Production machinery 6 years
  - Delivery vehicles 4 years
- Depreciation as per the accounting policies of Nama is as follows:
  - All buildings 30 years
  - Production machinery 4 years
  - Delivery vehicles 4 years
- Assume that Nama will make use of all possible tax benefits and will therefore elect any option available that will minimise or defer the company's normal tax liability.

**INITIAL TEST OF COMPETENCE, NOVEMBER 2020**

**PROFESSIONAL PAPER 1**

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

| <b>PART I – REQUIRED</b> |  | <b>Marks</b>     |              |
|--------------------------|--|------------------|--------------|
|                          |  | <b>Sub-total</b> | <b>Total</b> |
| (a)                      | Discuss the tax consequences of the information contained in item 4 for Nama for the year of assessment ended 30 June 2019.<br><br><i>Communication skills – logical argument</i>  | 12<br><br>1      | <br><br>13   |
| (b)                      | Calculate the taxable income of Nama for the year of assessment ended 30 June 2019 based on all the available information provided in items 1 to 5.  | 21               | 21           |
| (c)                      | Discuss whether the amount spent to rebuild the wall mentioned in item 6.2 would be deductible for normal tax purposes in respect of Nama’s year of assessment ended 30 June 2020.<br><br>For purposes of answering part (c) of the question, assume that information provided in the 2018/2019 SAICA Legislation Handbook is correct and applicable despite the company having a 30 June 2020 year end. | 4                | <br><br>4    |
| <b>Total for part I</b>  |  |                  | <b>38</b>    |

**INITIAL TEST OF COMPETENCE, NOVEMBER 2020**

**PROFESSIONAL PAPER 1**

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

| <b>PART II – REQUIRED</b>     |  | <b>Marks</b>     |              |
|-------------------------------|--|------------------|--------------|
|                               |  | <b>Sub-total</b> | <b>Total</b> |
| (d)                           | <p>Provide the journal entries required to account for the information in item 2 in the financial statements of Nama for FY2019.</p> <ul style="list-style-type: none"> <li>• Do not provide any journal entries for current or deferred tax.</li> <li>• Do not provide any closing entries.</li> <li>• Journal dates and narrations are not required.</li> <li>• Round all calculated amounts to the nearest rand.</li> </ul> | 14               | 14           |
| (e)                           | <p>Critically discuss, with reference to International Financial Reporting Standards, the statement made by management in item 1.</p> <p>Support your discussion with calculations, where relevant.</p> <p><i>Communication skills – logical argument</i></p>  | 9<br><br>1       | 10           |
| (f)                           | <p>Determine, with reference to IAS 38 <i>Intangible Assets</i>, whether and from which date any expenditure on vMeat would qualify for capitalisation as an intangible asset in the financial statements of Nama.</p> <p>Do not discuss the definition of an intangible asset.</p> <p><i>Communication skills – logical argument</i></p>  | 7<br><br>1       | 8            |
| (g)                           | <p>Calculate, for the trial period only, whether Nama should produce vMeat in-house or outsource production to Yarnworths. Provide a reason for any cash flows that are deemed to be irrelevant.</p> <p>Assume that any cash flows resulting from income tax would arise in the same period as the underlying taxable income or tax-deductible expense.</p> <p><i>Communication skills – presentation</i></p>                  | 29<br><br>1      | 30           |
| <b>Total for part II</b>      |  |                  | <b>62</b>    |
| <b>TOTAL FOR THE QUESTION</b> |  |                  | <b>100</b>   |