QUESTION 1 **55 marks**

Ignore Value-Added Tax

Sticky (Pty) Ltd ('Sticky') was incorporated in South Africa in 1999 and manufactures adhesive tape for sale on local and international markets. Practice Note 42 issued by the South African Revenue Service (SARS) considers this to be a process of manufacture.

Ms Rebecca Maseko CA(SA) is the junior financial manager of Sticky and is in the process of finalising the consolidated financial statements for the year ended 31 December 2019 (FY2019). Sticky has only two related parties, namely MyMat (Pty) Ltd ('MyMat') and Klebrig GmbH ('Klebrig').

As part of this process she obtained the following information:

1 Investment in subsidiary: MyMat

On 1 January 2019 Sticky acquired 80% of the ordinary shares in issue of MyMat, a company incorporated in South Africa.

2 Investment in associate: Klebrig

On 1 January 2019 Sticky acquired 30% of the ordinary shares of Klebrig, a company incorporated in Germany, for an immediate cash payment of ZAR1,5 million. The functional currency of Klebrig is the euro. On this date, all the identifiable assets and liabilities of Klebrig were considered to be fairly valued in terms of IFRS 3 *Business Combinations* and amounted to EUR750 000 and EUR350 000 respectively. Sticky has since the acquisition date exercised significant influence, as defined in terms of IAS 28 *Investment in Associates and Joint Ventures*, over the operating and policy-making decisions of Klebrig. The normal tax rate in Germany has been 15% since FY2010 and capital gains are also taxed at 15%.

Sticky has been selling adhesive tape to Klebrig since 1 January 2019 at a mark-up of 25% on cost, which Klebrig sells to its customers in the ordinary course of its business. Total sales by Sticky to Klebrig amounted to ZAR850 000 during FY2019. Klebrig still had ZAR350 000 of this inventory on hand at the end of FY2019. The 25% mark-up on the cost of the adhesive tape sales to Klebrig is considered to be at arm's length.

Klebrig declared and paid a total dividend of EUR180 000 on 18 July 2019. The dividend was not subject to any taxation in Germany.

One of the junior accountants gave Rebecca the following figures (correctly calculated), pertaining to the investment in Klebrig; these were then correctly included in the consolidated financial statements:

	ZAR
Investment in Klebrig at 31 December 2019	2 460 000
Foreign currency translation reserve movement (credit) during FY2019 pertaining to the investment in Klebrig and recognised in other comprehensive income	307 200

3 Current and deferred taxation

The junior accountant also provided Rebecca with the following balances and amounts in the consolidated financial statements after all the above information was correctly taken into account:

	Notes	ZAR million
Deferred tax asset at 31 December 2018	3.1	30,5
Deferred tax asset at 31 December 2019	3.1	50,8
Consolidated profit before tax	3.2	120,5

Notes

3.1 In FY2018 only 80% of the total net deductible temporary differences was recognised. In FY2019 Sticky concluded that it could recognise 100% of the deductible temporary differences.

3.2 The consolidated profit before tax above includes the following transactions that were already correctly taken into account in calculating the current and deferred taxation for FY2019 in the individual separate accounts of Sticky and MyMat and consequently the consolidated accounts of Sticky:

3.2.1 Total favourable net fair value adjustments to the original cost of investment property (land) during FY2019, amounting to ZAR2,7 million. All the companies in the Sticky group account for investment property on the fair value model in terms of IAS 40 *Investment Property*.

3.2.2 A dividend that MyMat received from an equity investment in an unrelated South African resident company, amounting to ZAR360 000. The fair value gains and losses relating to the investment were recognised in other comprehensive income by MyMat.

3.2.3 Sticky paid an amount of ZAR500 000 in terms of a restraint of trade agreement to an unrelated individual, Mr Jone Balantine. This was correctly expensed during FY2019 as it did not meet the definition of an intangible asset in terms of IAS 38 *Intangible Assets*. Jone has never been in the employ of any of the companies in the Sticky group.

3.2.4 The profit share in Klebrig is calculated by applying the equity method in terms of IAS 28. The junior accountant noted that he was not sure what the impact of this, if any, would be on the consolidated tax rate reconciliation.

3.3 The following transactions were correctly accounted for in the consolidated profit before tax. However, Rebecca noted that the junior accountant did not take into account the current and deferred taxation implications for Sticky for FY2019:

3.3.1 During FY2019, Sticky ordered a new adhesive tape packaging machine at a cost of ZAR1,081 million and paid for it in cash on the same date. A further ZAR12 420 was paid to transport the packaging machine to Sticky's factory. The packaging machine was ready for use on 1 December 2019. However, since Sticky's factory was closed for the December festive season, the packaging machine was used for the first time when the factory reopened on 2 January 2020. The production manager of Sticky estimates that the company will be able to use the packaging machine for a period of ten years, after which it will likely be scrapped for no compensation. Sticky has always intended to use the asset until the end of its useful life.

3.3.2 Upon commencing operations on 1 October 1999, Sticky purchased an adhesive tape roller machine for use in its manufacturing operations at a cost of ZAR40 000. By 2006 the company had fully depreciated the roller machine for both financial reporting and tax purposes. After realising that the roller machine contained substantial amounts of valuable metals that could be salvaged, it was sold for ZAR575 000 on 15 October 2019. Other than the company's fixed asset register, Sticky no longer has the records to substantiate the purchase cost of the roller machine.

3.3.3 Sticky purchased an office building on 1 January 2010 for ZAR3,750 million in cash. The previous owner had primarily used the office building for administrative purposes. The office building had an estimated useful life of 20 years as of 1 January 2010 and was ready for use and taken into use on the same date. The residual value on 1 January 2010 was considered insignificant. Sticky has always intended to use the asset until the end of its useful life. Sticky used and continues to use the office building for administrative purposes.

3.3.4 Sticky's total gross trade receivables amounted to ZAR75 million and ZAR85 million at the end of FY2019 and FY2018 respectively. Sticky correctly concluded that its trade receivables do not include a significant financing component as determined by IFRS 15 *Revenue from Contracts with Customers*. Sticky's total lifetime expected credit losses on its trade receivables amounted to ZAR12,5 million as at 31 December 2019. The allowance for credit losses amounted to ZAR8,2 million at the end of FY2018 and SARS allowed a deduction of 25% of this allowance during FY2018. The 2018 allowance was correctly accounted for in the 2018 current and deferred taxation calculations.

3.3.5 On 29 November 2019 Sticky received a non-refundable advance payment amounting to EUR2 million from a customer in Barcelona, Spain, in respect of a bulk consignment of adhesive tape. Sticky shipped the tape directly to Barcelona on 1 February 2020 which is the date when control over the adhesive tape, as determined in terms of IFRS 15, transferred to the customer. The amount was deposited into Sticky's general transactional account on 29 November 2019. No advance payments were received during FY2018.

3.3.6 The following exchange rates were obtained from a reputable financial institution:

Date	**EUR1 : ZAR**
1 January 2019	15,10
18 July 2019	15,50
29 November 2019	15,75
31 December 2019	15,90
Average rate for the year*	15,30

***** You may assume that the exchange rates did not fluctuate significantly during FY2019.

3.4 Mr Rex Smith, the Financial Director of Sticky, set up a meeting with Rebecca to discuss some tax saving ideas:

3.4.1 The legal costs incurred in relation to the purchase of Klebrig could be changed to general consulting services on the invoice so that the costs can be deducted for tax purposes. Rex stated that this has been done in the past and he has always been able to justify the costs. He added that the Sticky group has to meet certain targets based on lender expectations. Rex hinted to Rebecca that, if she made this change, it would reflect favourably on her performance evaluation.

3.4.2 Whether the Sticky group should use an overseas tax haven for some of its operations.

4 Additional information

- All the companies in the Sticky group have 31 December financial year ends and apply International Financial Reporting Standards.
- The Sticky group presents its consolidated financial statements in South African rand.
- Sticky accounts for its investments in subsidiaries and associates on the cost method in its separate financial statements in accordance with IAS 27 *Separate Financial Statements*.
- All the companies in the Sticky group account for property, plant and equipment on the cost model in terms of IAS 16 *Property, Plant and Equipment* and depreciate these assets on the straight-line method to their residual values.

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INITIAL TEST OF COMPETENCE, NOVEMBER 2020

PROFESSIONAL PAPER 3

QUESTION 1 – REQUIRED		**Marks**	
		Sub-total	**Total**
(a)	With reference to the transactions listed in note 3.3 and for FY2019 – (i) calculate the current and deferred taxation implications for Sticky (company); and (ii) prepare the correcting journal entries in the accounts of Sticky (company).	26 2	 28
(b)	Prepare the consolidated tax reconciliation to be disclosed in the consolidated financial statements of the Sticky group for FY2019 as prescribed by IAS12.81(c)(i). • Comparative figures are not required. • Do not separately calculate the consolidated tax expense. *Communication skills – presentation*	17 *1*	 18
(c)	Discuss the ethical issues that Rebecca is facing with regard to the tax savings ideas in note 3.4 from the perspective of the SAICA Code of Professional Conduct. *Communication skills – logical argument*	8 *1*	 9
Total for question 1			**55**