QUESTION 1   **53 marks**

Ignore value-added tax (VAT)

African Business Machines Ltd ('ABM') is a group of companies which is a leader in the information technology market. The group produces mainframe computers and computer hardware used across various industries by entities for bulk data processing, enterprise resource planning and transaction processing. In addition, the group provides cloud storage and IT security services to entities. The ABM group consists of a parent company, five subsidiary companies and also has an investment in another company, called i-Seva (Pty) Ltd ('i-Seva'). All entities in the group, including i-Seva, have financial years ending on 31 December.

ABM purchased 35% of the issued shares in i-Seva on 1 April 2014 for R18,35 million cash, representing the fair value of this 35% share of the net asset value. On 1 April 2014 i-Seva's retained earnings balance was R16,5 million and stated capital amounted to R35,93 million. On this date ABM correctly classified the investment in i-Seva as an investment in an associate in terms of IAS 28 *Investments in Associates and Joint Ventures.*

You recently qualified as a CA(SA) and accepted an appointment as an assistant accountant at ABM from 1 November 2019. You report to Mr Dube Dale CA(SA), the Financial Director.

During your introductory training at ABM you were presented with descriptions of all reporting processes in place, including the following document:

YEAR-END FINANCIAL REPORTING PROCESS AND TREATMENT OF i-SEVA
ABM uses a custom accounting software package, Professional Accounting Systems ('PAS'), to manage the accounting function for ABM, i-Seva and all ABM's subsidiaries. The preparation of the annual financial statements begins 15 days after year end, when Mr Dale exports the trial balances from PAS into Excel for each entity in the group. The 15-day period allows for any final journal entries which have been processed before year end to be approved. Mr Dale then sends the trial balances to AfsPack (Pty) Ltd ('AfsPack') via email. AfsPack is an external service provider that captures the trial balance of each entity into a report preparation software called Reporter Software ('RS'). RS is software that prepares financial statements in terms of International Financial Reporting Standards (IFRSs). In order to do this, RS is pre-programmed with the individual trial balance line item descriptions. Each trial balance line item is then classified into different financial statement line items for presentation and disclosure purposes. Mr Dale also provides a schedule of all intercompany accounts that should be eliminated on consolidation. He does not check or provide guidance on the classification of trial balance line items into financial statement line items. During the RS capturing process, AfsPack creates two trial balances for each entity. The first is an exact copy of the trial balance provided by Mr Dale. This trial balance cannot be edited after it has been uploaded by AfsPack. The second trial balance is created to allow for consolidation journal entries and can only be edited by AfsPack or Mr Dale. RS is also programmed by AfsPack with the journal entries that need to be processed to eliminate all intercompany transactions and balances which have been provided by Mr Dale. Once AfsPack

has completed the process, an email is sent to Mr Dale to indicate that the process is complete and that the consolidation trial balances can be edited.

Mr Dale then accesses the consolidation trial balances online and processes manual journal entries to the consolidation trial balances of each entity. These are journals processed to account for all pro forma consolidation journal entries and are calculated in a consolidation worksheet.

Treatment of i-Seva in RS

The RS program has been updated to allow for the inclusion of an associate trial balance with the percentage holding in the associate to automatically generate the associate note. AfsPack has included the trial balance of i-Seva in RS correctly.

Mr Dale still needs to process all equity accounting journal entries. He accounts for the associate from a manually prepared Excel spreadsheet which he prepares upon receiving the trial balance from the associate.

Once all manual journal entries have been processed, Mr Dale locks the process so it cannot be edited. RS then automatically sums all trial balances and prepares consolidated financial statements, based on a standard ABM financial statements template. No independent review of the consolidation is performed before the system is locked and the financial statements are prepared.

ABM and AfsPack have strong general controls over information technology.

The following is an extract from RS of the ABM group's consolidated trial balance and the individual trial balance received from i-Seva:

Extracts from trial balance as at 31 December 2019	ABM group consolidated*	i-Seva#
	R'000	R'000
	Dr/(Cr)	Dr/(Cr)
Profit before tax	(453 000)	(3 880)
Income tax expense	122 840	1 086
Investment in i-Seva at cost	18 350	–
Computer equipment at carrying amount	650 000	18 500
Inventory	178 500	800
Retained earnings as at 31 December 2018	(1 580 000)	(23 450)
Deferred tax liability	(6 250)	(92)
Taxation payable	(10 150)	(760)

*   *The consolidated trial balance includes all five subsidiary companies, which have been consolidated correctly. However, no equity accounting journal entries have been processed to account for the investment in i-Seva.*

\#   *See two matters that still need to be resolved, on page 3. The amounts above exclude any possible adjustments that may need to be made with regard to these matters.*

You identified the following two matters that still need to be resolved:

Item 1: Computer equipment

On 1 January 2018 ABM sold and installed a mainframe computer, which it had manufactured, to i-Seva for R14 million. This amount included installation costs of R1 million. On 2 January 2018 i-Seva brought the mainframe into use. ABM has correctly accounted for this sale in its separate accounting records and realised a gross profit of 25% on the transaction, which is market related.

i-Seva processed the following journal entry on 1 January 2018 to record the acquisition of the mainframe:

JNL 321	Dr	Cr
	R'000	R'000
Computer equipment – mainframe (SoFP)	13 000	
Installation cost expense (SoPL)	1 000	
Bank (SoFP)		14 000
Mainframe purchased from ABM capitalised, and installation costs expensed		

i-Seva considered the mainframe to have a useful life of five years with no residual value and depreciated it on a straight-line basis. The South African Revenue Service (SARS) grants a wear-and-tear allowance on the mainframe cost and the installation cost on a straight-line basis over five years.

Item 2: Tax deductions claimed

Candice Keen, i-Seva's financial accountant, referred a SARS matter to you. While comparing the deductions claimed in the tax return for FY2018 and FY2019 with the calculation of current tax for FY2019, you established that i-Seva had claimed the following amounts and accounted for the balance of the amount owing to SARS accordingly:

	2018	2019
	R'000	R'000
Deductions claimed		
Mainframe cost*	13 000	–
Installation cost*	1 000	–
Wear and tear: Mainframe and installation (R14 million/5)	2 800	2 800
Tax basis for deferred tax calculation	11 200	8 400

* The deduction of the mainframe cost and installation cost is a permanent difference with regard to deferred tax.

A review of the tax assessment for FY2018, which was received by i-Seva on 30 November 2019, showed that SARS had disallowed the deductions for the mainframe cost as well as the installation cost amounting to R14 million, which had been claimed in the tax return for FY2018.

Additional information

The following information applies to all entities in the group, including i-Seva:
- Computer equipment is measured on the cost model in terms of IAS 16 *Property, Plant and Equipment.*
- Investments in subsidiary and associate companies are accounted for at cost in the investor's individual financial statements.

INITIAL TEST OF COMPETENCE, JANUARY 2020

PROFESSIONAL PAPER 1

<table>
<tr><td rowspan="2" colspan="2">QUESTION 1 – REQUIRED</td><td colspan="2">Marks</td></tr>
<tr><td>Sub-total</td><td>Total</td></tr>
<tr><td>(a)</td><td>Prepare the prior year error note in the individual financial statements of i-Seva for FY2019.

Assume all amounts are material.

<i>Communication skills – presentation</i></td><td>10

1</td><td>

11</td></tr>
<tr><td>(b)</td><td>(i) Prepare the pro forma equity accounting journal entries to account for i-Seva in the group financial statements of the ABM group for FY2019.
(ii) Present the balance of the investment in the associate in the statement of financial position of the ABM group for FY2019. Ignore comparatives.

<i>Communication skills – presentation</i></td><td>22

3

1</td><td>

26</td></tr>
<tr><td>(c)</td><td>Discuss the control deficiencies in the year-end financial reporting process described in the scenario.

<i>Communication skills – appropriate style</i></td><td>15

1</td><td>

16</td></tr>
<tr><td colspan="2">Total for question 1</td><td></td><td>53</td></tr>
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