

QUESTION**100 marks**

Mofasa Service Station (Pty) Ltd ('Mofasa') operates a successful fuel service station, motor repair workshop and second-hand car dealership from premises on the N6 route on the outskirts of Aliwal North. Mofasa was formed in 2002 by three friends who are also the three shareholders and directors of the company. Their roles in the business are as follows:

Name	Role	No. of staff in department	Share-holding
Mr Mo Pillay	Manager of second-hand car dealership	9	40%
Mr Fani Lebelo	Manager of repair workshop	10	30%
Mr Sarel du Plooy	Manager of fuel service station	37	30%

Sarel's wife, Mrs Lana du Plooy CA(SA), is the financial manager of the company, and is assisted by a bookkeeper, Mr Scara Mokoena.

Mofasa purchases and sells fuel as a franchise operation for Pride Oil, a major fuel retailer in Southern Africa. The franchise agreement is burdensome and limits the products that Mofasa may sell. Pride Oil provides all the fuel-pumping systems and in terms of the franchise agreement Mofasa may only purchase inventory (fuel and related products) from Pride Oil. Pride Oil owns the land and buildings occupied by Mofasa. In 2002 Mofasa entered into a five-year lease agreement with Pride Oil, which is automatically renewable every five years.

The repair workshop and second-hand car dealership currently do not form part of the Pride Oil franchise, but the franchise agreement prescribes how related businesses should be branded in order not to infringe on the operations of the fuel station.

The following documents are available:

Description	Reference
Background and understanding of the entity	WP 102-1 (five pages)
Proposal to the Board of Directors of Mofasa	Attachment 1 (two pages)
Tax information	TWP 603-1 (one page)

Client: Mofasa Service Station (Pty) Ltd	Year end: 31 December 2019	WP 102-1
Prepared by: Junior Rifaki	Date: 16 January 2020	
Reviewed by:	Date:	Page 1/5
Subject: Background and understanding of the entity		

1 Background

Mofasa is a successful business and has been a client of Timon & Co Inc. ('TCI'), a firm providing audit, advisory and taxation services, since Mofasa's incorporation. Mr Tim Timon, the senior partner of TCI, has always been involved with Mofasa, first as the partner responsible for the audit and later as business and tax advisor. Mr Jimmy Timon, Tim's son, has been the partner responsible for the audit since 2014.

In terms of the franchise agreement with Pride Oil, a full statutory audit is required and financial statements must be prepared in accordance with International Financial Reporting Standards (IFRSs). The company's current year end is 31 December 2019 (FY2019).

Two months ago Mo married Zenzi, who recently qualified as a CA(SA) and completed her training contract at TCI in September 2019. They met when Zenzi did some control testing at the second-hand car dealership. Zenzi, who now owns her own consulting practice, regularly questions the technical IFRS skills of Lana and her team and she has in fact made accusations of financial mismanagement. Although not proven, the accusations placed pressure on the relationship between the three directors and caused them to lose focus on the running of their departments.

Zenzi has also highlighted some internal control deficiencies, non-compliance with health and safety regulations and corporate governance issues that she identified during the audit she performed in 2018. In her opinion Jimmy had not properly responded to these at the time. She also feels that some of the tax planning opportunities proposed by Tim, which the company has implemented, are too risky. She proposed that the company appoint her as a consultant to address these issues and also to compile the company's 2019 annual financial statements in terms of IFRSs.

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2 Accounting records

Lana maintains the company's financial records using a basic off-the-shelf accounting package, called Savanna Accounting. Savanna Accounting was proposed by TCI as a suitable package to use for a company of Mofasa's size, but TCI was not involved in the implementation of the software.

Savanna Accounting has modules that can be added to the basic general ledger module. Lana installed the following four modules:

- Cashbook and automated bank reconciliation module;
- Inventory control module (used for the parts in the repair workshop only);
- Sales invoicing and debtors module; and
- Creditors module.

The fixed assets register and second-hand car inventory records are maintained on Excel spreadsheets. Entries from these records are journalised monthly once Lana has performed detailed reviews of the information and reconciliations.

In addition, the recording of sales from the fuel pumps is automated on the system maintained by Pride Oil. All fuel sales are recorded as soon as a pump is switched off, that is, once a vehicle has been filled to the required level. More than 50% of fuel sales are settled in cash. The sales according to the pump system are summarised at midnight each night and recorded by means of a daily journal in Savanna Accounting by Scara.

The volume of fuel inventories is measured at 6 am and 6 pm each day. These readings are captured on the pump system maintained by Pride Oil and any discrepancies are investigated. It is the industry norm that losses of 0,25% of litres pumped are incurred due to spillage and evaporation. Lana expressed her concern that inventory losses and cash shortages have increased significantly during the past year and is currently at 0,7% of litres pumped.

The Savanna Accounting package is not a sophisticated system and Lana relies on the auditors to ensure that her financial statements comply with IFRSs. The auditors provide her with an IFRS-compliant template of financial statements, which she uses to populate the company's financial statements. These are then reviewed in detail by the auditors.

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3 Extract from management accounts

The following departmental income statements for FY2019 have been prepared by Lana:

Income statements for the year ended 31 December						2019	2018
						Un-audited	Audited
	Notes	Car sales	Fuel sales	Repair work-shop	Admin-istration	Actual	Actual
		R'000	R'000	R'000	R'000	R'000	R'000
Turnover	3.1	86 860	170 604	13 849	–	271 313	257 223
Cost of sales		81 243	154 626	9 688	–	245 557	229 519
Labour		1 854	2 916	2 820	–	7 590	6 827
Commission		1 823	–	124	–	1 947	1 777
Parts		–	–	6 023	–	6 023	5 232
Vehicles		74 888	–	–	–	74 888	65 999
Fuel		286	151 635	424	–	152 345	147 263
Service of cars	3.2	2 329	–	–	–	2 329	2 022
Other costs		63	75	297	–	435	399
Gross profit		5 617	15 978	4 161	–	25 756	27 704
Gross profit percentage		6,5%	9,4%	30,0%	–	9,5%	10,8%
Overhead expenditure		4 252	1 865	2 565	1 999	10 681	9 943
Property lease payment	3.3	2 423	622	957	202	4 204	3 920
Administration staff salaries		–	–	–	1 320	1 320	952
Directors' remuneration	3.4	952	952	952	–	2 856	2 700
Municipal charges	3.5	712	204	613	65	1 594	1 122
Other costs		165	87	43	412	707	1 249
EBITDA		1 365	14 113	1 596	(1 999)	15 075	17 761
Depreciation		(101)	(237)	(214)	(149)	(701)	(749)
Interest expense	3.6	(963)	(271)	(122)	–	(1 356)	(1 229)
Interest income	3.7	–	–	–	310	310	200
Net profit		301	13 605	1 260	(1 838)	13 328	15 983

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Notes

3.1 Turnover quantities

	Budget	Actual	Actual
	FY2020	FY2019	FY2018
Number of second-hand cars sold	270	297	310
Litres of fuel sold	11 050 000	10 689 000	10 393 000
Number of vehicles serviced	850	943	1 722

3.2 Before a vehicle is sold, it is sent to the repair workshop to be fully serviced. This cost is charged to the second-hand car dealership by the repair workshop on the same basis as repairs are charged to external customers. The charge for the service is capitalised to the cost of the vehicle. At 31 December 2019 there were 14 second-hand cars in stock that had already been serviced and that were ready for sale.

3.3 Lease payments are allocated to the departments based on floor area occupied (m²). The second-hand car dealership uses a large open area covered by a steel roof.

3.4 The directors agree annually on their remuneration for the year. This is allocated to the department for which each is responsible.

3.5 Municipal charges are allocated based on floor area occupied, except for water used by the car wash, which is allocated to the repair workshop.

3.6 The company has entered into term loan agreements to fund the vehicle stock. Interest is charged at 9,25% per annum (compounded annually). Departments have entered into instalment sale agreements for equipment and the interest on these agreements is allocated to each relevant department.

3.7 Surplus cash is deposited in money market accounts and interest earned is allocated to the administration department.

4 Management reports and corporate governance

Lana prepares monthly departmental income statements (up to gross profit level) which are reviewed in detail by the directors and discussed at monthly directors' meetings.

Any significant new projects, capital expenditure and compliance with the Pride Oil franchise agreement are discussed at the monthly directors' meeting. Because of the size of the business and the fact that all the shareholders are also directors, the Board decided to postpone application of King IV for the time being.

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5 Second-hand car dealership

Mo and his salesmen buy and sell second-hand motor vehicles. Vehicles are bought by Mofasa from other dealers, as trade-ins or for cash. These vehicles are then sold to customers on the following terms:

- Payment in full must be made on delivery (either by the customer or the bank financing the transaction). Mofasa does not finance any sales itself.
- Although the vehicles are sold 'as is' (AFr.: 'voetstoots'), the repair workshop will undertake a repair if a customer identifies a problem in the first month after the sale. There have only been two cases in the past five years where substantial repair costs were incurred.
- Vehicles are sold fully serviced.
- Every vehicle is sold with a full tank of fuel – the cost of filling up the vehicle's fuel tank is expensed to cost of sales (of the second-hand car dealership division) when incurred.

6 Proposal for restructuring

Following the disagreements between Lana and Zenzi, Fani and Sarel started discussions to potentially purchase Mo's shareholding in Mofasa. The second-hand car dealership has not been doing very well and Pride Oil has indicated that it will assist the company by building a convenience store in the area currently occupied by the second-hand car dealership. However, it is essential that at least two thirds of the shares remain in the hands of individuals from previously disadvantaged groups (currently Fani and Mo) to retain the Pride Oil franchise.

A proposal in this regard was tabled at the 18 December 2019 Board meeting – see attachment 1.

Mo expressed his concerns regarding the proposal as he had no interest in managing a convenience store and he felt that the other two directors did not have the knowledge to run such a business.

ATTACHMENT 1

PROPOSAL TO THE BOARD OF DIRECTORS OF MOFASA SERVICE STATION (PTY) LTD

PREPARED BY LANA DU PLOOY BASED ON INFORMATION RECEIVED FROM PRIDE OIL

1 Background

The company's net profit margins have been eroding over the past few years. This is putting strain on the day-to-day management of the business. As the three directors will all reach retirement age 10–12 years from now, a longer term plan for the business needs to be considered.

2 Proposed restructuring: Closing down the second-hand car dealership and erection of a convenience store

The part of the business that contributes least to profitability is the second-hand car dealership. Discussions with Pride Oil resulted in the following proposal, which needs to be considered by the Mofasa Board of Directors:

The second-hand car dealership will be closed down and Pride Oil will erect a new building, which will be used as a convenience store, small bakery and coffee shop, in the area currently occupied by the second-hand car dealership. All the different parts of the business will from that time onward be regulated by a franchise agreement and strict compliance will be required, in particular with regard to shareholding by designated groups. If the agreement is breached, Pride Oil will have the right to terminate the franchise agreement and the property lease agreement.

Based on Pride Oil's experience with similar convenience stores, it has prepared a preliminary estimate of what the Mofasa convenience store results would have been for FY2019, if it had opened the store on 1 January 2019:

Estimate for FY2019	Notes	R'000
Gross revenue		156 228
Cost of sales		(99 320)
Gross profit		56 908
Salaries	a	(28 987)
Lease	b	?
Municipal charges	c	?
Franchise fee	d	(3 125)
Other costs		(9 654)

Notes

- The estimated retrenchment cost of staff employed in the existing second-hand car dealership would have been R1,1 million. This has not been included in the cost of salaries.
- The initial lease payments for both the new and existing buildings would have been set at R6,5 million per annum, payable in 12 equal monthly payments. The basis on which

lease payments is allocated to the different departments of Mofasa is not expected to change.

- (c) Municipal charges would have increased by R900 000 in FY2019 because of the new convenience store.
- (d) As the store would have been jointly branded with a well-known retailer, an additional franchise fee of 2% of the gross revenue from the convenience store would have been payable to that retailer.

3 Long-term convenience store lease agreement

If Mofasa decides to undertake the proposed restructuring, it will be required to enter into a new lease agreement for both the existing buildings and the new building. The terms and conditions will be as follows:

- (i) The lease period is expected to be ten years from 1 December 2020.
- (ii) The company will have an option to renew the lease for a further five-year period thereafter. If the option is not exercised, a balloon lease payment of R11,2 million will be payable at the end of the initial lease term.
- (iii) The initial lease payment for the first year of the contract will be set at R7,5 million per annum, payable in 12 equal monthly payments at the beginning of each month.
- (iv) Thereafter lease payments will escalate annually on the anniversary of the contract with the consumer price index (CPI) + 1%, but with a minimum escalation of 6% and a maximum escalation of 9%.
- (v) If the revenue from the convenience store exceeds R200 million per annum, adjusted annually by CPI, an additional 1% of the amount by which the revenue exceeds the threshold for that year will be payable annually in arrears.
- (vi) If Mofasa elects to renew the lease, ownership will transfer to it at the end of the lease term in 2035. If the lease is not renewed, Mofasa does not have the right to obtain ownership of the property.
- (vii) The useful life of the buildings is expected to be 25 years with a residual value of R3 million.
- (viii) The following incremental borrowing rates are being considered, as the interest rate implicit in the lease cannot be readily determined:

Term	10 years	15 years	25 years
Secured rate	9,25%	9,50%	9,80%
General unsecured rate	10,00%	10,25%	10,55%

Client: Mofasa Service Station (Pty) Ltd	Year end: 31 December 2019	TWP 603-1
Prepared by: John Teximanni	Date: 13 September 2019	
Reviewed by:	Date:	Page 1
Subject: Tax information		
The following information relates to the remuneration and benefits received by Mo for his year of assessment ended 28 February 2019:		
		R
1	Salary	556 933
2	Use of motor vehicle The directors are allowed to use a vehicle from the second-hand car inventory provided that no individual vehicle is used for longer than six months. This includes use of the vehicles for private purposes. None of the periods below are considered to be short term in nature for tax purposes. All costs are paid for by the company. Mo used the following two vehicles during the year: 2.1 1 March 2018 to 31 August 2018: A 2017 model BMW X5 – acquired in February 2018 as a trade-in at a value of R849 000 when the retail market value was R910 000. The vehicle was sold to a customer for R900 000 on 2 September 2018. The logbook of this vehicle was lost when the vehicle was sold. 2.2 1 September 2018 to 28 February 2019: 2018 Audi Q7 SUV – acquired at an auction on 20 August 2018 at a retail market value of R875 000. During this period Mo drove 9 555 km, of which 4 298 km were for business purposes. A detailed logbook was maintained and is available.	
3	Medical aid contributions The company paid the annual medical aid contributions to the Circle of Life Fund for Mo, Zenzi and two adult children from a previous marriage who are still financially dependent on him.	132 432
4	Insurance premiums The company paid life insurance premiums on Mo's life. The policy will compensate the company for costs incurred to find a replacement for Mo in the event of his death.	36 480
5	Provident fund contribution The company contributes to an approved provident fund as part of his director's remuneration. Mo has a balance of unclaimed contributions made to the provident fund after 1 March 2016 of R23 333.	351 733
6	Other The company paid the wages of Mo's domestic workers. These payments are included in the salaries and wages of Mofasa and not as part of his director's remuneration.	102 600
7	Other income received Mo's only other income is interest received from Rock Bank.	32 499

INITIAL TEST OF COMPETENCE, JANUARY 2020

PROFESSIONAL PAPER 3

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

PART I – REQUIRED		Marks	
		Sub-total	Total
(a)	With reference to workpaper WP102-1 (excluding attachment 1) – (i) describe the risks of material misstatement at an overall financial statement level that TCI should consider during the planning of its audit for FY2019; and (ii) for each risk identified, state an appropriate audit response to address the risk. Detailed audit procedures are not required. Present your answer in a tabular format. <i>Communication skills – appropriate style</i>	7 7 1	 15
(b)	Discuss the risks of material misstatement related to the inventory account balance in the 2019 financial statements of Mofasa, with reference to WP 102-1 (excluding attachment 1).	6	6
(c)	Discuss the threats, and identify appropriate actions TCI should consider to mitigate the threats, to ensure its partners and staff comply with the SAICA Code of Professional Conduct, with reference to workpaper WP 102-1 (excluding attachment 1). Present your answer in a tabular format. <i>Communication skills – logical argument</i>	13 1	 14
(d)	Discuss the professional conduct of Zenzi in terms of the SAICA Code of Professional Conduct with reference to workpaper WP 102-1 (excluding attachment 1).	6	6
Total for part I			41

INITIAL TEST OF COMPETENCE, JANUARY 2020

PROFESSIONAL PAPER 3

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

PART II – REQUIRED		Marks	
		Sub-total	Total
(e)	Estimate what impact the proposed restructuring in attachment 1 could have had on the profitability of Mofasa in FY2019.	7	7
(f)	Discuss the issues the management of Mofasa should consider when evaluating the proposal from Pride Oil with reference to attachment 1 and the extract of the management accounts included in workpaper WP 102-1. <i>Communication skills – appropriate style</i>	16 1	 17
(g)	With reference to attachment 1 – (i) discuss the factors that the directors of Mofasa would consider to determine whether or not to renew the lease at the end of the first ten years. No calculations are required; (ii) discuss the inputs that Lana will use to determine the required present value to account for the lease of the premises in terms of IFRS 16 Leases; and (iii) prepare the relevant journal entries for Mofasa to account for the lease agreement for FY2020 on the following assumptions: <ul style="list-style-type: none"> • The agreement is implemented on the proposed terms; • The renewal of the lease is reasonably certain; and • The present value of the minimum lease payments is R83 920 955 on 1 December 2020. Ignore tax; and Ignore closing entries. <i>Communication skills for part (g)(i) and (ii) – clarity of expression</i> <i>Communication skills for part (g)(iii) – presentation</i>	6 4 8 1 1	 20
(h)	Calculate the taxable income of Mo for the year of assessment ended 28 February 2019 with reference to TWP 603-1. Provide reasons for items not included in the calculation of taxable income.	15	15
Total for part II			59
Total for the question			100