



UNIVERSITY
OF
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DEPARTMENT OF ACCOUNTANCY

ACCOUNTING 300 / BCTA102 / S3BCTQ2

FINAL ASSESSMENT OPPORTUNITY

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INFORMATION

ASSESSORS:	MS Y KULIK MS K KEKANA MR K TRIEGAARDT
MODERATORS:	PROF A MOHAMMADALI-HAJI MS K ODENDAAL (MONASH)
READING TIME:	45 MINUTES
WRITING TIME:	225 MINUTES
MARKS:	150

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QUESTION 1**(35 MARKS)**

Batman Limited (hereafter "Batman") is the largest private security company in Southern Africa. The company was established in 1994 and was listed on the Johannesburg Stock Exchange in 2004. Batman has a 31 March year end.

Your audit firm – Poison Ivy Incorporated – outsourced you to assist the finance department at Batman with the finalisation of the group annual financial statements for the year ended 31 March 2016. Mr. Alfred Pennyworth, the finance manager, has requested you to assist with the following matter that he has been unable to resolve:

Consolidation: Robin (Pty) Limited

Batman acquired a **controlling** 40% interest in Robin (Pty) Limited (hereafter "Robin") effective 1 April 2012. At the acquisition date, all the assets and liabilities were considered to be fair valued, with the exception of the following three items:

- i. Vehicles – a replica of the Batman's patented bat mobile - was undervalued by R200 000 and had a remaining useful life of 5 years with a residual value of R50 000. The useful life and residual value remained unchanged. This vehicle was not revalued in the individual records of Robin.
- ii. Robin had a disclosed contingent liability at the acquisition date with a fair value of R350 000. Robin had a present obligation at the acquisition date, but the outflow of economic benefits was not probable. The case has been long outstanding and a provision of R250 000 was subsequently correctly recognised by Robin on 1 January 2016.
- iii. Robin has an excellent, reliable workforce – the Teen Titans – with access to the company's secrets and expertise that Batman considers to be very beneficial for the operations of Robin. At the acquisition date a fair value of R350 000 was assigned to the Teen Titans and the average employee had a remaining contractual term of 4 years.

The following information relates to transactions subsequent to the acquisition of Robin:

1. The vehicle mentioned above (replica of Batman's bat mobile) was sold to Batman on 1 April 2015 at a profit of R300 000. The remaining useful life and the residual value of the vehicle remained unchanged at this date.
2. Batman purchases all their inventory from Robin. Robin applies a 50% mark-up on cost on all inventory sold to Batman. Total sales of inventory from Robin to Batman for the 2016 financial year amounted to R1 000 000. The inventory on hand at 31 March in the records of Batman was as follows:

31 March 2015	R150 000
31 March 2016	R250 000*

* Included in the inventory balance on 31 March 2016 is inventory with a cost price of R100 000 (in the records of Batman), that has already been written down to its net realisable value of R50 000.

QUESTION 1**(CONTINUED)**

3. Robin commenced with the construction of a qualifying building – “Teen Tower” – during the 2016 financial year. The building is a qualifying asset in terms of IAS 23 *Borrowing Costs*. Construction of the building began 1 July 2015 and is expected to be completed on 31 March 2017. In order to construct the building, Robin entered into an interest-free, R1 000 000 loan arrangement with Batman on 1 April 2015. The loan is repayable on 31 March 2020. Both companies classified the loan as an amortised cost financial instrument. Any day-1 gains or losses will be recognised on a straight-line basis over the term of the loan.

Observable, market-related annual interest rates for similar loan agreements are as follows:

1 April 2015	8.1320%
1 July 2015	9.0500%
31 March 2016	9.2530%

Investment in Superman Limited

4. Batman acquired a 30% interest in Superman Limited (hereafter “Superman”) on 1 July 2013 for R2 500 000, thereafter exercising significant influence over Superman in terms of IAS 28 *Associates*. The book net asset value of Superman on 1 July 2013 was R8 500 000 (including retained earnings of R2 500 000). All the assets and liabilities were fairly valued at this date except for machinery that was undervalued by R500 000.

The retained earnings balance on 31 March 2016 increased by R4 500 000 since acquisition (including profit in the current year of R2 888 000). The machine mentioned above was sold for a profit on 30 September 2014, and this profit was correctly included in the profit after tax.

Superman revalued their land for the first time in the current year by R650 000. The land had never been revalued and Superman has no other revaluation surplus. No dividends were declared in the current year.

Additional Information

You may ignore the tax consequences arising from the above adjustments for the purposes of this question.

QUESTION 2**(50 MARKS)**

Charles Xavier, a highly accredited professor of mutation in the Republic of South Africa, established a research company, Xavier Research Limited (hereafter "X Ltd") in 1982. The company was listed on the Johannesburg Stock Exchange in 2002 and as a result of the listing, the entity diversified their activities by investing in some properties and shares.

Ms Rogue, the current chief financial officer is currently on a special mission to save fellow mutants in America and is therefore unable to complete the annual financial statements for the financial year ending **31 December 2016**. Ms Rogue heard that you are in the process of completing your accounting degree and has requested your assistance in completing the financial statements. She has provided you with the following information relating to the assets and liabilities of X Ltd for 31 December 2016.

General accounting policies:

The major classes of property, plant and equipment are land, buildings, machinery and vehicles. X Ltd applies the cost model to machinery and vehicles. Land and buildings are subsequently accounted for using the revaluation model, with revaluations processed at the end of every two years. In applying the revaluation model the company eliminates the accumulated depreciation balance against the gross carrying amount of the asset at the date of the revaluation and transfers a portion of the revaluation surplus to retained earnings as the respective asset is used. Except for land, all classes of assets are depreciated on a straight line basis over their respective useful lives to their residual values. Investment property, where applicable are carried under the cost model.

Specific transactions:**1. Vehicles**

X Ltd leased a fleet of four vehicles from Y Ltd since 1 January 2013. The terms of the lease are summarised below as follows:

Lease term: 5 years

*Lease instalment: R267 277.1 per vehicle (VAT **inclusive**) payable annually in arrears*

Lessee's incremental borrowing rate at commencement of the lease: 10.515%

Ownership of the vehicles never passes to X Ltd

At the beginning of the fourth year of the lease (1 January 2016), the lessee and the lessor agreed to amend the original lease and increase the lease term by an additional two years. The annual payments for the vehicles remained unchanged at the commencement of the lease modification. The lessee's incremental borrowing rate at this date had decreased to 7.51%.

The agreement between X Ltd and Y Ltd is not classified as an instalment sale agreement by SARS, and SARS allows a deduction equal to the annual payments excluding the VAT input portion of the payment claimed as a deduction.

QUESTION 2**(CONTINUED)****2. Machinery**

X Ltd acquired 4 specialised mutant locating machinery from a special research company in Paris, France for €120 000 each. The purchase contract was signed on 1 March 2016. The purchase price of the machinery is to be settled on 18 January 2017, and this is not considered to be a material passage of time. The machinery were shipped free-on-board (FOB) on 15 March 2016 and arrived at the Cape Town harbour on 31 March 2016.

X Ltd paid import duties of R888 000 on the machines due to the specialised nature of the machines. The machines were transported to the school in Johannesburg at a cost of R112 000 and the machines were available for use on 1 May 2016. X Ltd may only claim back 75% of the import duties incurred in terms of a SARS directive. The machinery have a useful life of 5 years with no residual value.

The following exchange rates are applicable:

	Spot rate €1: R?
1 March 2016	18.01
15 March 2016	18.50
31 March 2016	18.65
20 April 2016	19.30
1 May 2016	19.45
31 December 2016	19.31

SARS assumes the purchase price of the machines as it is calculated for accounting purposes, except for import duties. SARS allows an unapportioned wear and tear allowance on the machines of 20% per annum. Foreign exchange gains and losses are also included in gross income and allowed as a deduction respectively, when incurred.

3. Investment property

X Ltd began the construction of a building on 1 May 2016 in Marvel, Johannesburg. X Ltd intends to lease out the building as residential accommodation to the mutants once the construction of the building has been completed. The building, when completed, will meet the definition of investment property in terms of IAS 40 *Investment Properties*. Ms Rogue has determined that it is unlikely that the fair value of the building will be available due to the location of the building and considering the sanctions government has imposed on mutants.

X Ltd incurred a total cost of R8 100 000 evenly for the construction of the building which will be completed 31 October 2017. In order to finance the construction of the building, X Ltd obtained a loan from LMK bank on 1 May 2016 of R3 000 000 at a market related interest rate of 9% per annum. The loan together with the interest will be repayable on 30 April 2020. X Ltd invested the funds with DMR bank from 1 May 2016 and earns interest of 3% per annum on the positive balances.

QUESTION 2**(CONTINUED)****3. Investment property (*continued*)**

X Ltd has access to a bank overdraft of up to R9 500 000 and will make use of the overdraft should the funds from the specific loan run out. Interest of 12.5% is charged on all amounts used from the bank overdraft. X Ltd assessed the useful life of the building to be 50 years with no residual value.

SARS will grant an unapportioned allowance of 5% per annum on the building when the building is ready for use. All interest income earned is included in gross income at the earlier of the accrual or receipt of the amount. All interest expense is allowed as a deduction at the accrual of the interest, even if the interest is incurred before the asset is ready for use.

4. Land and building

The land and building were acquired on 1 July 2009 for the purposes of providing lecture rooms for the school of mutation for R7 000 000 and R10 000 000 respectively. The building has a residual value of R50 000 and the details of the fair value of the building are provided below. SARS grants an unapportioned 5% allowance on the buildings.

The land and building were last revalued on 31 December 2014 and the next revaluation was performed on 31 December 2016. The building had a remaining useful life of 12.5 years at 31 December 2016.

Fair value	Land	Building
31 December 2016	9 500 000	6 600 000

Additional Information:

- You may assume the following information:
 - Corporate income tax rate: 28%;
 - Capital gains tax inclusion rate: 66.6%;
 - All amounts exclude VAT except where explicitly stated.
- During the budget speech on 24 February 2016, the Minister of Finance, Professor Kelly, announced that the capital gains inclusion rate would increase from 66.6% to 80% for years of assessments beginning on or after 1 March 2016. The inclusion rate adjustment should be applied at the end of the year 31 December 2016.
- X Ltd correctly calculated an assessed loss of R1 503 210 as at 31 December 2016 and at this date it was not probable that X Ltd will have sufficient profits in the future against which to utilise the assessed loss.

QUESTION 3**(65 MARKS)**

Baxter Foundation Limited (hereafter “Baxter”) is a holding company with investments in diverse entities and is listed on the Johannesburg Stock Exchange (JSE). Baxter maintains a long-term view on its underlying investments and invests in a variety of unique assets in order to diversify its risks. You were appointed as a contractor to assist the group financial accountant with the consolidation process last year, and did such a good job that they have requested your assistance again for the 30 June 2016 year end. All companies in the group have the same financial year end.

Baxter owns four investments, which have become known as the “Fantastic Four” due to their performance over previous year. However, you are only expected to assist the accountant with the following transactions this year:

1) Sue Storm Limited

Baxter acquired an 80% controlling interest in Sue Storm Limited (hereafter “Sue Storm”) on 1 July 2011 for R2 300 000. On this date the equity of Sue Storm was as follows:

- Issued Share Capital: R5 000 000 (5 000 000 ordinary shares with no par value)
- Accumulated Loss: (R2 000 000)
- Sue Storm’s assets and liabilities were fairly valued at the acquisition date.

Since the acquisition date, the operations of the company improved significantly. The retained earnings balance as at 1 July 2015 was R2 100 000 and the profit, after tax, for the 2016 year was a staggering R6 300 000 (2015: R2 300 000). This profit figure includes the entries in respect of the dividends from VonDoom Limited, share options issued to Baxter, and preference shares (all referred to in 2 and 3 below).

Sue Storm’s continued great performance enabled the company to declare a total dividend (total ordinary and preference share dividends combined) amounting to R1 500 000 for the 30 June 2016 year of assessment.

Sue Storm did not issue any additional share capital since 1 July 2011.

2) Acquisition of VonDoom Limited

Sue Storm acquired a 60% controlling interest in VonDoom Limited (hereafter “VonDoom”) on 1 December 2015 for R5 200 000.

The equity of VonDoom was as follows:

- Issued Share Capital at 1 December 2015: R3 000 000 (1 000 000 ordinary shares with no par value)
- Retained Earnings at **30 June 2015**: R4 500 000

The acquisition date assets and liabilities were fairly valued except for certain scientific development costs of R500 000 (representing the fair value) in respect of a ground-breaking force field research project which were expensed in the separate financial statements of VonDoom during September 2015.

Question 3**(Continued)****2) Acquisition of VonDoom Limited (*continued*)**

VonDoom did not assess the project to be feasible, however the project certainly met the definition of an intangible asset from a group perspective in terms of IAS 38 *Intangible Assets* at the acquisition date. The research activities were still ongoing at year-end.

The group amortises intangible assets over 6 years and amortisation only commences once the assets are available for use as intended by management. The South African Revenue Services (SARS) allows a full deduction of research and development expenditure in the period that it is incurred.

The profit, after tax, for the 2016 year was R1 665 000 and it was earned evenly throughout the year, with the exception of the research expenses referred to above that was incurred in a specific period.

Von Doom declared and paid a total dividend amounting to R1 000 000 for the year ended 30 June 2016.

3) Potential business venture: Mister Fantas-stick Limited and Sue Storm

Another of Baxter's subsidiaries, Mister Fantas-stick Limited, a putty manufacturer (hereafter "Mister Fantas-stick"), and Sue Storm have been discussing potential business opportunities which they would like to pursue together in the new financial year. The business model that they both favour is to start a new organisation and cut most ties with Baxter. Sue Storm will be the ultimate parent in the new group structure that they are busy investigating.

a) Share option issued to Baxter

Consequently, Sue Storm approached Baxter on 1 January 2016 and offered to issue a put option. Sue Storm waived any initial consideration when the contract was issued. The option contract gives Baxter the right to sell 3 000 000 ordinary Sue Storm shares back to Sue Storm on 30 June 2018 at an exercise price of R15.50 per share. The option can only be settled by physical delivery of the shares. Sue Storm's effective weighted-average cost of capital (WACC) is 10.5% on the issue date.

The fair value of the option contract, and market price of one Sue Storm share, was as follows on key reporting dates:

Date	Market Value (per share)	Option value (per option)
30 June 2015	12.00	Not applicable
1 January 2016	14.00	0
30 June 2016	15.00	1.00

You may assume that the put option does not change Baxter's 80% controlling interest in Sue Storm at 30 June 2016 (i.e. the non-controlling interest in Sue Storm remains 20% for the period 1 July 2011 to 30 June 2016).

Question 3**(Continued)****b) Preference shares issued**

In order to raise some of the additional capital that will be required to fulfil its obligations under the option contract, Sue Storm issued one 11% convertible participating preference share on 1 January 2016. The share was issued to The Impossible Man (Pty) Limited, a party unrelated to the group, at a fair value of R30 million (also the face value).

This share is convertible to 500 000 ordinary shares in Sue Storm at the option of Sue Storm. Sue Storm is only likely to exercise the conversion option if Baxter exercises the put option referred to in 3.a above.

If Sue Storm does not convert the preference share, it will be redeemed at the issue price on 31 December 2018. The compulsory, cumulative 11% dividends are payable annually in arrears. In addition to the 11% dividend, the preference shareholder will be entitled to an additional 3% dividend, calculated based on the profit for the year, if Sue Storm's profit after tax increases by more than 20% year-on-year.

This additional dividend is payable at the end of each financial year, and is apportioned for the time period that the share was held (where relevant). Following the staggering 2016 profit, an additional dividend was paid in 2016.

Similar preference shares with no conversion option or participation rights, currently earn dividends at a rate of 9% per annum.

Additional Information

Assume that all entities in the group are VAT vendors and assume all amounts exclude VAT unless indicated otherwise.

Assume a corporate tax rate applicable to all companies of the group of 28% and an unchanged capital gains tax inclusion rate of 66.6%. You may ignore dividend withholding taxes.

Management elected to measure the non-controlling interests at their respective fair values of the subsidiaries at the acquisition date.

The following market values per shares are applicable in relation to the different investments:

Company Name	1 July 2011	1 December 2015
Sue Storm Limited	R0.50	R13.95
Von Doom Limited	R6.50	R10.00