UNIVERSITY OF JOHANNESBURG

DEPARTMENT OF ACCOUNTANCY

ACCOUNTING 300 / BCTA

ASSESSMENT OPPORTUNITY 6
9 NOVEMBER 2015

ASSESSORS:	MS S CARSHAGEN MS K KEKANA MS Y KULIK MR L VEZI
MODERATORS:	PROF A MOHAMMADALI-HAJI MR J STRENG
TIME:	240 MINUTES
MARKS:	150 MARKS

- THE ASSESSMENT OPPORTUNITY PAPER CONSISTS OF 4 QUESTIONS AND 12 PAGES (front page included).
- SILENT NON-PROGRAMMABLE CALCULATORS ARE ALLOWED.
- SHOW ALL CALCULATIONS.
- START EVERY NEW QUESTION AT THE TOP OF A PAGE.
- IF PENCIL OR TIPPEX OR ERASABLE PEN WAS USED ON THE ANSWER SHEET, IT DOES NOT QUALIFY FOR REMARKING.
- SCRATCH OUT OPEN SPACES AND EMPTY PAGES.

QUESTION 1 **(50 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 their risks.

You have been appointed as a contractor to assist the group financial accountant with the consolidation process for the **30 June 20.15** year end. The information relating to the four investments, which have become known as the “fantastic four” due to their performance over the past year, is discussed separately below.

Sue Storm Limited

1. Baxter acquired an 80% controlling interest in Sue Storm Limited (hereafter “Sue Storm”) on 1 July 20.11 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 of no par value)
    - Accumulated Loss: (R2 000 000)
2. The assets and liabilities were fairly valued at the acquisition date.
3. Since the acquisition date, the operations of the company improved significantly. The retained earnings balance as at 1 July 20.14 was R1 000 000 and the profit, after tax, for the 20.15 year was R2 300 000.
4. Sue Storm’s performance enabled the company to pay out a total dividend amounting to R1 200 000 during the 20.15 year of assessment.
5. Sue Storm has been selling force field generators to Baxter since the acquisition date. Sue Storm maintains a profit margin of 20% on the sales price. On 30 June 20.14 Baxter had R800 000 of force field generators on hand, all of which were bought from Sue Storm. No inter-company sales occurred during the 20.15 financial year. The force field generators are recognised as inventories in both the records of Sue Storm and Baxter. All the field generators were sold during the current financial year.

Mister Fantas-stick Limited

6. Baxter acquired a 90% controlling interest in Mister Fantas-stick Limited, a putty manufacturer (hereafter “Mister Fantas-stick”), on 1 July 20.12 for R4 800 000. At the acquisition date the equity of Mister Fantas-stick was as follows:
    - Issued share Capital: R3 000 000 (1 500 000 ordinary shares of no par value)
    - Retained Earnings: R1 160 000

QUESTION 1 **(CONTINUED)**

7. On the date of acquisition, Baxter determined the purchase price by fair valuing the building of Mister Fantas-stick. Mister Fantas-stick did not revalue the building in their individual financial statements.

	Carrying Amount	**Fair Value**	**Remaining Useful Life**
Building	R5 000 000	R5 800 000	40 years

8. Mister Fantas-stick sold a spare teleporter with a carrying amount of R800 000 on 31 December 20.13 to Baxter for R1 000 000. The teleporter is used for business travel and is classified as property, plant and equipment for both companies. It originally cost Mister Fantas-stick R1 200 000. Baxter and Mister Fantas-stick accounted for the equipment under the cost model and depreciated the equipment at 20% per year under the reducing balance method. The residual value is negligible. Both companies assumed to recover the carrying amount of the equipment through use.

9. The retained earnings balance at 1 July 20.14 was R2 345 500 and the profit, after tax, for the 20.15 year was R2 200 000.

Human Torch Limited t/a Flames Industries

10. Mister Fantas-stick also acquired a 70% controlling interest in Human Torch Limited t/a Flames Industries (hereafter “Flames”) on 1 July 20.11 for R1 800 000 when the equity of Flames comprised of:
    - Issued share Capital: R500 000 (250 000 ordinary shares of no par value)
    - Retained Earnings: R1 000 000

11. The acquisition date assets and liabilities were fairly valued except for development costs of R300 000 (fair value R700 000) which were expensed in the separate financial statements of Flames. The project met the definition of an intangible asset from a group perspective in terms of IAS 38 *Intangible Assets* at the acquisition date, but was not recognised by Flames in its separate financial statements as the probability of future economic benefits could not be demonstrated in the stand-alone accounts of Flames. The intangible asset will be amortised over 4 years.

12. The retained earnings balance at 1 July 20.14 was R2 670 000 and the profit, after tax, for the 20.15 year was R2 188 800.

Grimm Thing Ltd

13. Baxter acquired a 60% interest in Grimm Thing Limited (hereafter “The Thing”) on 1 July 20.13 for R2 000 000. The Thing sells crushed rocks to landscapers. In terms of the agreement between the shareholders, Silver Surfer would exercise control over The Thing and Baxter is deemed to only have significant influence over the financial and operating policies of the company.

QUESTION 1 **(CONTINUED)**

14. The equity of The Thing comprised of the following at the date of the acquisition:
    - Issued share Capital: R1 000 000
    - Retained Earnings: R1 650 000
    - Revaluation Surplus: R856 000
15. Assume that all identifiable assets acquired and liabilities assumed at the acquisition date approximate their acquisition-date fair values.
16. The revaluation surplus balance has remained unchanged since the acquisition date.
17. The retained earnings balance at 1 July 20.14 amounted to R1 900 500 and the profit, after tax, for the 20.15 year was R568 000.
18. As from 1 July 20.13, Baxter has been purchasing crushed rocks from The Thing for use in its production processes. The Thing sells the crushed rocks at a profit margin of 20% on the sales price. The inventories purchased from The Thing and recorded in the books of Baxter were as follows:
    - 20.14: R100 000 (50% was still unsold at 30 June 20.14).
    - 20.15: R200 000 (50% was still unsold at 30 June 20.15. All the 20.14 inventories were sold during 20.15).

Additional Information

- Assume that all entities in the group are VAT vendors.
- Assume all amounts exclude VAT unless indicated otherwise.
- Assume a corporate tax rate applicable to all companies of the group of 28% and a capital gains tax inclusion rate of 66.6%.
- Management elected to measure the non-controlling interest at their respective fair values of the subsidiaries at the acquisition date.
- The following market values are applicable in relation to the different investments:

Company Name	Date	Market Value (per Share)
Sue Storm	1 July 20.11	R0.50
Mister Fantas-stick	1 July 20.12	R3.50
Flames	1 July 20.11	R11.50
The Thing	1 July 20.13	R10.00

QUESTION 1 **(CONTINUED)**

REQUIRED

a) Prepare the **pro forma consolidation journal entries** that relate to the investment in **The Thing** in preparation of the consolidated annual financial statements of the Baxter Foundation Limited Group for the year ended 30 June 20.15. **(15)**

Your journal entries should clearly indicate where an account is situated in the financial statements, i.e. statement of financial position (SFP); profit or loss (P/L); other comprehensive income (OCI); or statement of changes in equity (SCE).

Include all calculations as marks are awarded for them.

b) Prepare the **consolidated statement of changes in equity** of the Baxter Foundation Limited Group for the year ended **30 June 20.15**. **(35)**

Include **ONLY** the following column: **Non-Controlling Interest**

Comparatives and the total column are not required.

Show all calculations clearly as marks are awarded for these.

(50)

QUESTION 2 **(30 MARKS)**

S Limited ("SuperCo") is a South African mining company with a 31 December year end whose primary business is the mining of kryptonite ore. Kryptonite ore has special radioactive elements that give super-powers to those who come into contact with the material. The ore is a key ingredient in the manufacture of protective body armour worn by the league of Marvel superheroes in their fight against the evil villains of the world.

SuperCo mines the kryptonite ore at its mine in eMalahleni. The kryptonite ore is transported by trucks to the harbour in Durban, where it is loaded on to ships, and shipped to a storage warehouse in Switzerland. SuperCo handles all aspects related to the shipment of ore from eMalahleni to Switzerland. The company is in possession of the necessary permits for transporting the hazardous material and sales are only made from the Switzerland premises.

The storage warehouse is used to store a number of special materials used by various companies that manufacture body armour, transportation vehicles, and other items required by the Marvel superheroes. Switzerland is centrally located to the factories of these companies and material is therefore stored at this central location so that it is readily available when conflict breaks out and the manufacture of additional armour and related items is immediately necessary.

The storage warehouse in Switzerland does not take legal title of the materials as the materials are extremely hazardous, and they will require additional permits. The storage warehouse follows strict instructions from its suppliers every time it receives and stores these hazardous materials. Kryptonite ore is stored and transported in specially designed tanks to protect people from coming into contact with the radioactive rays emitted by the ore. SuperCo determines the price of kryptonite ore sales to customers, receives orders directly from customers and will instruct the storage warehouse where to and when to ship the required quantities of kryptonite ore. The storage warehouse receives a commission of 5% of the final sales value of all material sold to manufacturers of Marvel superhero equipment.

Although kryptonite ore is sold and priced per ton of material (ore), the purchase price is adjusted based on the radioactive content of the ore. Samples are analysed for radioactive content at the time that the customer takes ownership of the kryptonite ore. Kryptonite ore should carry a standard radioactive content of 85%. If the ore is found to contain higher or lower levels of radioactive content per ton, the purchase price is adjusted (up or down) by R1 000 per ton for every percentage point above or below the standard point of 85%. Based on past experience, SuperCo expects that:

- 15% of shipments contain ore with radioactive content levels of 80%
- 65% of shipments contain ore with radioactive content levels of 85%
- 20% of shipments contain ore with radioactive content of 90%

IronMan Limited ("IronMan") placed an order for 20 tons of kryptonite ore with SuperCo on 12 November 20.18 at an agreed price of R25 000 per ton. The contract also specifies railage services (discussed below). You may assume that the contract between IronMan and SuperCo met all of the criteria stipulated by IFRS 15.9 so as to be identified as a contract with a customer.

QUESTION 2 **(CONTINUED)**

The storage warehouse in Switzerland had no kryptonite ore in stock and SuperCo therefore loaded 50 tons of kryptonite ore onto a ship in the Durban harbour on 19 November 20.18, which set sail for Switzerland on the same day. The ship arrived in Switzerland on 27 December 20.18 and the purchased ore was immediately repackaged into a 20 ton tank and transported by rail to IronMan's factory in Germany. Although not part of the usual sales package offered to customers, due to the urgency of this transaction SuperCo also arranged for the necessary railage of the ore from Switzerland to Germany and charged IronMan a fee of R75 000 for this service.

The tank arrived at the IronMan factory on 30 December 20.18 and IronMan signed the waybill accepting legal title of the kryptonite ore on the same day. A sample of the kryptonite ore was immediately sent to the laboratory for testing and on 4 January 20.19 the radioactive content level of this shipment of ore was confirmed to be 90%.

You may assume that all prices quoted above represent the stand-alone selling prices of items (i.e. there is no discount applicable to this transaction).

REQUIRED

a) Discuss whether the storage warehouse in Switzerland would be regarded as a principal or an agent in transactions where it receives and dispatches kryptonite ore in terms of the requirements of IFRS 15 *Revenue from Contracts with Customers*. **(5)**

b) Assuming that the storage warehouse in Switzerland is regarded as an agent, discuss the appropriate recognition and measurement of revenue earned by SuperCo on the IronMan contract for the **period ended 31 December 20.18** in terms of the requirements of IFRS 15 *Revenue from Contracts with Customers*. **(25)**

Your answer should discuss the 5-step revenue recognition model and should specifically identify the date(s) at which revenue will be recognised by SuperCo and the amount of revenue that SuperCo will recognise in this regard.

Show all your calculations as marks are only awarded for calculations shown on the script.

Marks are allocated as follows:

- Step 1 (0)
- Step 2 (6)
- Step 3 (8)
- Step 4 (2)
- Step 5 (9)

(30)

QUESTION 3 **(30 MARKS)**

Dexter's Laboratory Limited (hereafter "Dexter") operates in Utopia Land. The company's main business is the manufacture and supply of Robotic Arms™. Dexter is a registered VAT vendor and has a 30 September year end.

Relevant extracts from liabilities section of the Statement of Financial Position as at **30 September 2014** are as follows:

	Notes	R
Liabilities		
Non-Current Liabilities		
Lease obligation	1	24 168 904
Legal provisions	2	1 540 000
Current Liabilities		
Operating lease	3	?
Current portion of the lease obligation	1	92 004

Note 1

Following a decision to expand its production facilities, Dexter began leasing a laboratory building ('Mandark's laboratory') on 1 October 2010 for a period of 10 years. The lease qualifies as a finance lease in terms of the requirements of IAS 17: *Leases.* The lease agreement includes the following key terms related to the lease of Mandark's laboratory:

- Lease instalments of R3 312 770.20 (VAT inclusive) are to be paid annually in arrears starting on 30 September 2011.
- The interest rate implicit in the lease is set at 12.75% p.a.
- Legal ownership of the leased asset will transfer to Dexter at the end of the lease term after payment of the guaranteed residual value.
- The guaranteed residual value is set at R24 500 000 (VAT inclusive).
- The fair value of the building on 1 October 2010 was R25 536 000

Additional information pertaining to Mandark's laboratory:

Due to the negative publicity around the Goku court case (refer note 2), the demand for Robotic Arms™ dropped below originally projected targets. This prompted Dexter to conduct an impairment review of the Robotic Arms cash generating unit. The impairment review revealed a recoverable amount of R13 450 000 applicable to the laboratory building at 1 October 2014.

QUESTION 3 **(CONTINUED)**

Note 2

During the 2014 financial year, Goku filed a civil law suit against Dexter claiming that a set of Robotic Arms™ he had purchased from Dexter had malfunctioned and did therefore not live up to their advertised standards. This was immediately after he had failed to defeat Majin Boo in his quest to protect Utopia Land. Goku alleges that his defeat by Majin Boo can only attributed to the failure of the Robotic Arms™. He filed a claim for R4 050 000 as compensation for pain and suffering and related hospital expenses. During the 2015 year Goku embarked on a 177-day journey along the snake way to seek King Kai and receive guidance in preparation for a second battle with Majin Boo. As Goku had not yet returned from this journey the court case has not been heard and was still pending as at 30 September 2015.

Having reviewed the footage of the battle, Dexter's legal team is of the opinion the Goku will probably be successful in his claim. The amount provided by Dexter at 30 September 2014 is based on the legal team's best estimate of the likely amount to be paid in terms of the law suit. The estimate has remained unchanged as at 30 September 2015, assume that the effect of discounting is immaterial.

Note 3

Goku's quest and absence from Utopia land has left Majin Boo to cause havoc in disrupting distribution channels in Utopia Land. After a number of shipments were destroyed, Dexter entered into a 5-year non-cancellable operating lease agreement with Batman Limited on 1 October 2014. Dexter will lease the Batmobile as a delivery vehicle in order to maintain a constant supply of Robotic Arms™ to the Marvel superheroes central warehouse in Switzerland.

In terms of the lease agreement, Dexter will not make any lease payments in the first year of use of the Batmobile. Thereafter annual lease payments of R450 000 (excluding VAT) will be made in October of each year, subject to a 15% increase at the beginning of year 4.

Additional information

- Dexter applies the cost model to items of property plant and equipment.
- Laboratory buildings are depreciated over 14 years on a straight-line basis to a residual value of R nil.
- Utopia's tax authorities have adopted a similar taxation model to that applicable in South Africa. It allows deductions for legal claims when these are paid in cash. Payments made in terms of all leases are allowed as a deduction when the relevant lease instalment is paid.
- A tax rate of 28% is applicable in Utopia Land.
- For the 2015 year Dexter's Laboratory expects that it will have sufficient taxable economic benefits in the future

QUESTION 3 **(CONTINUED)**

REQUIRED:

a) Prepare ALL the journal entries, including the deferred tax consequences, which Dexter would record in respect of the leased asset – Mandark's laboratory (note 1) for the financial year ended **30 September 2015**. Include journal narrations and clearly indicate where the journal entry will flow to (i.e. P&L, OCI, SFP or SCE). **(20)**

You are required to show ALL calculations. Marks will not be awarded for values used in journal entries if they are not supported by appropriate calculations.

b) Prepare an analysis of the deferred tax balance in respect of notes 2 and 3 by major category to be included in the deferred tax note, as at **30 September 2015**. You may assume that the deferred tax consequences arising from all of the items noted are considered a 'major' category for disclosure purposes. **(9)**

Note: no marks will be awarded if you do not utilise your calculations in the note disclosures as required.

Effective and efficient communication (parts a & b): *layout, logical flow, referencing of calculations to answers* **(1)**

(30)

QUESTION 4 **(40 MARKS)**

Dr Charles Xavier is the Chief Executive Officer at a special needs school. The government recently cut all funding to the school as they fundamentally disagree with the teaching methodologies and learning outcomes that Dr Xavier and his staff are pursuing in the school.

Dr Xavier is considering alternative means of raising capital to fund the school's activities and has approached you, a recent graduate from the University of Johannesburg, to assist him in the matter. He used his powers to seek out a specialist in financial instruments accounting and is confident that you have the ability to answer his questions.

The Chief Operating Officer, Mr Summers (affectionately known as Cyclops), has suggested that the school issue preference shares with specific rights to raise funding, as he only wants graduates from Dr Xavier's school to be ordinary shareholders in the company until the school's future is certain.

He has suggested that the school should issue the following instruments in order to fund their immediate cash flow needs: 100 000 9% per annum redeemable preference shares with a nominal value of R500 each, issued at the nominal value (which is the fair value at the issue date). Payment of the dividends on these shares is compulsory and payable six-monthly in arrears. The preference shares will mature 5 years after the issue date, and may be redeemed in cash at the nominal value, or by the issue of 1 ordinary share for every preference share held, at the option of the school, on that date. Similar instruments with no conversion option offer 10% returns per annum.

Dr Xavier is not comfortable with the idea of issuing preference shares with a conversion option, and would prefer to issue 100 000 R500 debentures at a 2% discount (representing fair value), with no conversion option, offering a 10% interest return on the nominal value per annum, to be paid semi-annually in arrears. The nominal value will be settled in cash on the date of maturity, being 5 years after the issue date.

Cyclops also suggested that the capital raised should be invested in listed shares in a local steel construction company, Magneto Limited.

The school classifies and measures all financial liabilities at amortised cost and has a 31 December financial year end.

The required is stated on the next page.

QUESTION 4 **(CONTINUED)**

REQUIRED

a) Prepare pro forma journal entries to illustrate to Dr Xavier how both the preference shares and the debentures would be accounted for in the financial statements for the year ending 31 December 2015, assuming that both instruments were issued on 1 January 2015. The school accounts for financial liabilities at amortised cost and not at fair value. **(28)**

You are required to show **ALL** you workings. Marks will not be awarded if the supporting calculations for the amounts used in the journal entries are not shown.

Communication: *Layout, journal dates, narrations and descriptions, calculation to journal referencing.* **(2)**

b) Discuss how the school should initially classify the investment in Magneto Ltd upon initial recognition. **(3)**

c) Identify and describe the financial risks that the school will be exposed to, assuming that the debentures are issued, and that the listed shares in Magneto Limited are acquired. **(7)**

For each financial risk identified, **briefly** describe the financial risk disclosures which will have to be included in the school's annual financial statements in terms of the requirements of IFRS 7 *Financial risk disclosure*.

(40)