Background of the H Ltd group

The H Ltd group is a multinational, diversified group listed on the Johannesburg Securities Exchange. The year end of all the companies in the group is 31 December. The group has sophisticated internal reporting systems.

One of the group’s strategies over the past five years has been to maximise growth and it has achieved this by acquiring 12 businesses during this period. These acquisitions were funded by borrowings. Prior to the acquisitions H Ltd only operated a motor vehicle rental business in South Africa.

As a result of the acquisitions the H Ltd group now has invested in the following types of businesses:

- Importing and distribution of high-quality branded industrial products in the Southern African region;
- Distribution and retailing of motor vehicles;
- Motor vehicle rental;
- Construction;
- Mining; and
- Manufacture and distribution of food products.

The businesses H Ltd acquired are based in South Africa, the United Kingdom (UK), Zimbabwe, the United States of America (USA) and Nigeria.

The 2012 financial year has been challenging for the following reasons:

1. The revised broad-based black economic empowerment (B-BBEE) industry charters applicable to the H Ltd group have changed the BEE requirements relating to ownership, management and control in such a way that these would be the primary items assessed in the BEE scorecard from 2014. To date the H Ltd group has focused on preferential procurement and enterprise development and is highly rated based on these aspects.

2. The mining business has made huge losses as a result of a prolonged strike in which miners were demanding much higher minimum wages. After unsuccessful discussions between management and the unions, the employees initiated protest action. When these protests became violent, several employees and journalists reporting on the strike were seriously injured.

3. Management has spent significant time trying to sell four loss-making subsidiaries that were acquired in 2010.

4. Five members of the executive team will reach retirement age within the next three years. The Board of Directors plans to continue with its current approach to recruitment, namely that the majority of the executives should be external appointees, to ensure a fresh approach to the business.

5. A transport strike has resulted in delivery delays and loss of business in the food manufacturing business.

6. In the branded industrial products business, if the rand strengthens the purchase prices of the products drop, and selling prices must therefore be reduced if the group is to remain competitive. However, as many of the costs are rand denominated, the effect is that for each 5% by which the rand strengthens, operating profit decreases by R70 million per annum.

7. The South African Revenue Service (SARS) has disputed a deduction relating to an interest expense of the group in 2010. SARS has indicated that it may disallow this
interest deduction, but wants further information from H Ltd before taking a final decision.

8 In the 2011 Worldwide Corruption Perceptions ranking of countries, South Africa, Nigeria and Zimbabwe featured at the 63rd, 143rd and 154th positions respectively. The lowest ranking is 182.

9 According to the most recent real gross domestic product (GDP) growth rates, South Africa, the USA and the UK all scored below the world average of 3.7%.

On 5 September 2012 Mr James Ermwee, the financial director, attended a seminar on *The Code of and Report on Governance Principles for South Africa (King III)*. He panicked when he heard that a risk committee or audit committee should assist the Board in carrying out its risk responsibilities. He was told that this would include identifying the key risks and the responses to address these key risks. To date the H Ltd group has not complied with this requirement of King III.

**Finalisation of the consolidated financial statements**

The group accountant is currently finalising the outstanding matters listed below:

**Matter 1 (all amounts exclude VAT)**

On 1 May 2011 H Ltd purchased 55% of the ordinary shares of S Ltd, thereby obtaining control over S Ltd. S Ltd purchased land for R1 million on 31 March 2010. The fair value of the land was R1 million throughout the period from date of purchase to 31 December 2012.

The following information relates only to the building constructed by S Ltd on this land (i.e. cost and fair values below exclude the land):

<table>
<thead>
<tr>
<th>Date</th>
<th>Events</th>
</tr>
</thead>
</table>
| 1 July 2010     | • S Ltd commenced construction of a building.  
                  • The building was to be leased to an unrelated third party in terms of an operating lease.  
                  • At this date the total estimated cost of completion was R6 350 000. |
| 31 December 2010| Costs of R3 million have been incurred but it was not possible to determine the fair value of the incomplete building reliably at this date. |
| 1 May 2011      | • The cumulative costs incurred on the building to this date amounted to R5 200 000.  
                  • The fair value of the building was estimated to be R5 500 000. |
| 31 August 2011  | • Construction has been completed at a total cost of R7 100 000.  
                  • At this date the building became available for occupation. However, the lessee indicated that it was in the process of filing for liquidation and was no longer in a position to pursue the original lease. S Ltd continued to search for another lessee.  
                  • At this date the expected useful life of the building was estimated to end on 31 August 2036 and remained as such until 31 December 2012. |
### 1 November 2011
- H Ltd, which has been searching for new premises, commenced occupation of the building by way of an operating lease for eight years.
- The lease terms are as follows:
  - An annual lease instalment of R750 000 is payable in respect of years 1 to 4.
  - An annual lease instalment of R850 000 is payable in respect of years 5 to 8.
  - The instalments are payable at the end of each 12-month lease period.
- At this date the fair value of the building amounted to R7 300 000.

### 31 December 2011
- At this date the fair value of the building amounted to R7 500 000.

### 31 March 2012
- H Ltd acquired the building from S Ltd for R8 500 000, which was its fair value at this date.
- The lease agreement was accordingly cancelled.

### 31 December 2012
- The building was damaged in a major flood.
- The recoverable amount, as defined in IAS 36, *Impairment of Assets*, was correctly determined to be R6 500 000.

The estimated residual value of the building has remained unchanged at R5 million since the completion of the building.

On 31 March 2012 the ownership of the land was also transferred to H Ltd for R1 million.

S Ltd had a net deferred tax liability and H Ltd a net deferred tax asset in their accounting records at 31 December 2011.

**Matter 2 (all amounts include VAT)**

On 1 January 2012 H Ltd entered into an agreement to lease five delivery vehicles for a period of 48 months from Unico Motors. At the inception of the lease agreement H Ltd made an initial payment of 10% of the cash price equivalent of the delivery vehicles in terms of the lease agreement. Monthly rentals amount to R5 400 per vehicle and are paid monthly in arrears. H Ltd is responsible for all insurance and maintenance expenses of the leased delivery vehicles.

The cash price equivalent (which is also the fair value) of each delivery vehicle amounted to R228 000 on 1 January 2012. The economic life of each delivery vehicle is estimated to be six years. H Ltd will return the delivery vehicles to Unico Motors at the end of the lease agreement. H Ltd was not able to reliably determine the unguaranteed residual value of the delivery vehicles at inception of the lease. H Ltd has correctly classified the lease as a finance lease in terms of IAS 17, *Leases*.

The nominal interest rate at which H Ltd could borrow funds with the vehicles as security would amount to 10,5% per annum.

H Ltd and Unico Motors are both registered VAT vendors.

**Matter 3 (all amounts exclude VAT)**

On 1 August 2011 H Ltd purchased 65% of the ordinary shares in IMP Ltd (‘IMP’) for a cash amount of R4 500 000, thereby obtaining control over the IMP group. At this date the assets and liabilities of the IMP group were fairly valued in terms of IFRS 3, *Business Combinations*, with the exception of the following:
- Land, which had a fair value of R1 500 000 (carrying amount of R1 million in the accounting records of IMP). This fair value remained unchanged at 31 December 2012;
- A research and development asset with a fair value of R2 million (carrying amount of zero in the accounting records of IMP). The research and development asset is expected to have a useful life of ten years with no residual value; and
- A manufacturing building with a fair value of R3 million (carrying amount of R2 700 000 in the accounting records of IMP).

The net asset value of the IMP group as per its accounting records at 1 August 2011 amounted to R3 750 000. H Ltd regards IMP as a cash-generating unit. H Ltd measured the non-controlling interest at a fair value of R2 500 000 and attributed all goodwill arising on the acquisition of IMP to the IMP cash generating unit. This goodwill was not impaired in the H Ltd audited consolidated financial statements for the year ended 31 December 2011.

The H Ltd group tests goodwill for impairment annually on 31 December. The H Ltd group correctly calculated the recoverable amount of the IMP cash-generating unit as R6 500 000 at 31 December 2012.

The recoverable amount of the research and development asset recognised by the H Ltd group on the acquisition of IMP could not be reliably determined on 31 December 2012.

The following information was extracted from the audited consolidated statement of financial position of the IMP group at 31 December 2012:

<table>
<thead>
<tr>
<th></th>
<th>Notes</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land, at cost</td>
<td>6</td>
<td>1 000 000</td>
</tr>
<tr>
<td>Manufacturing buildings, at fair value</td>
<td>1, 6</td>
<td>3 000 000</td>
</tr>
<tr>
<td>Equipment</td>
<td>2</td>
<td>550 775</td>
</tr>
<tr>
<td>Goodwill</td>
<td>3</td>
<td>125 000</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td></td>
<td>775 000</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>4</td>
<td>275 000</td>
</tr>
<tr>
<td>Inventory</td>
<td>5</td>
<td>880 000</td>
</tr>
<tr>
<td>Trade payables</td>
<td></td>
<td>(525 980)</td>
</tr>
<tr>
<td>Total net asset value</td>
<td></td>
<td>6 079 795</td>
</tr>
</tbody>
</table>

Notes

1. The manufacturing buildings, being owner occupied, are carried at revalued amounts in line with the IMP group policy.
2. During their audit, the IMP auditors identified an impairment with regard to the equipment. The equipment is accordingly stated at recoverable amount.
3. The goodwill arose from a previous business combination. IMP tested the goodwill for impairment on 31 December 2012 and an impairment loss amounting to R225 000 was recognised. This goodwill had not been impaired previously.
4. Trade receivables are stated net of impairment allowances.
5. Inventory is measured at net realisable value.
6. The costs to sell the land and buildings are negligible.

Matter 4 (all amounts exclude VAT)

H Ltd launched a share ownership scheme for 500 of the group’s employees. In terms of the scheme, H Ltd granted each employee 8 000 share options on 30 June 2012. At this date the fair value of each share option amounted to R2,50. Upon vesting, these share options will entitle the holder to purchase shares in H Ltd at an exercise price of R10 per share.
These share options are conditional on –
- the employee remaining in the employ of the H Ltd group until 30 June 2015; and
- the H Ltd group achieving a cumulative revenue target of R200 million before 31 December 2014.

For each full month that the revenue target is achieved ahead of time, an additional 50 options will be granted to each employee.

The following table provides the basic information regarding the scheme:

<table>
<thead>
<tr>
<th>Expected revenue target achievement date</th>
<th>31 December 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected number of employees at vesting date</td>
<td>478</td>
</tr>
<tr>
<td>Fair value of an option</td>
<td>R33 per option</td>
</tr>
</tbody>
</table>

Additional information relating to the H Ltd group

1. It is the accounting policy of all companies in the H Ltd group to apply the revaluation model for the subsequent measurement of owner-occupied buildings as per IAS 16, *Property, Plant and Equipment*. It is the policy to revalue such buildings annually on 31 December. Depreciation for the year is calculated using the revalued amount at the end of the previous year. The accumulated depreciation is eliminated against the gross carrying amount of the asset on 31 December each year. All other items of property, plant and equipment are carried in terms of the cost model. It is the accounting policy of all companies in the H Ltd group to transfer the revaluation surplus included in other comprehensive income in respect of an item of property, plant and equipment to retained earnings when the related asset is derecognised as a result of being retired or disposed of.

2. It is the accounting policy of all companies in the H Ltd group to apply the fair value model for buildings qualifying as investment properties in terms of IAS 40, *Investment Property*.

3. The H Ltd consolidated profit before tax for the 31 December 2012 financial year has been provisionally determined to be R12 million. However, the provisional amounts require adjustment in respect of the following:
   - The accounting treatment of matter 1 in the separate financial statements of H Ltd and S Ltd is correct. No journal entries have been processed for pro forma adjustments or to eliminate intercompany transactions for purposes of the consolidated financial statements;
   - The lease agreement in matter 2 has been correctly classified as a finance lease but has not been accounted for;
   - No impairment has been recognised in respect of the investment held in IMP, other than that included in the audited consolidated statement of financial position of the IMP group at 31 December 2012; and
   - The share ownership scheme in matter 4 has not been accounted for.