Part (a)
To: The Group Financial Director
From: Leslie Canton
Subject: Customer acquisition costs

Dear Sir

I am responding to your request as follows:

- In order to be capitalised, the customer acquisition costs should meet the definition of an intangible asset.

- An intangible asset is (AC 129.08)
  - an identifiable, non-monetary asset
  - without physical substance
  - held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

- An asset is a resource (AC 129.08)
  - controlled by an enterprise as a result of past events, and
  - from which future economic benefits are expected to flow to the enterprise.

- An intangible asset may be recognised if (AC 129.20)
  - it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise, and
  - the cost of the asset can be measured reliably.

Contract customers

- The customer acquisition costs are as follows:
  - A resource controlled by the enterprise as a result of past events because the non-cancellable contract gives Sizacom the legal right to protect the relationship with customers (AC 129.17).
  - From which future economic benefits are expected to flow to the enterprise in the form of payments for network access and airtime.
  - Identifiable because the customer base is separable, that is, customer contracts could be sold to another network without selling other assets in the same revenue generating activity (AC 129.12).
  - Without physical substance, in that the rights over the customers do not have physical substance.
  - Held for use in the supply of services, namely airtime.

- The customer acquisition costs may be recognised as an asset because
  - The terms of the contract make it probable that future economic benefits will flow to Sizacom, and
  - The cost of the asset can be measured reliably as the amount paid to the service provider.

- The customer acquisition costs should be measured initially at the cash transferred to acquire the asset, namely at the R1 500 customer acquisition bonus (AC 129.24).

- The recognised asset should be limited to the present value of the minimum cash flows which the customer is obliged to pay, irrespective of usage, i.e. the fixed monthly access amount.

- The customer acquisition costs should subsequently be amortised over their useful life, which is the contract period of 24 months (AC 129.86).

- Alternatively, if there is an active market in contract customers, the intangible assets may be revalued on an annual basis, with the revaluation recognised directly in equity.

- It is therefore recommended that no change be made to Sizacom’s current accounting for contract customer acquisition costs.
Prepaid customers

- [No additional marks to be granted in respect of recognition requirement points similar to those under “Contract customers” above in respect of expectation of future economic benefits, identifiability, nature of use of asset, probability of economic benefits and cost of asset. Marks are granted once for these items because the discussion is similar for both types of customers]

- The prepaid customers are not controlled because there are no legal rights that protect Sizacom’s relationship with the customer (AC 129.17).

- Therefore, Sizacom should not recognise prepaid customer acquisition costs as an asset.

- The customer acquisition costs on prepaid customers should be expensed when incurred.

- Therefore, Sizacom’s current accounting policy is in error (AC 103.30).

- If the results of a prior year are no longer reliable (AC103.31), the prior period and the opening balance of retained earnings should be restated.

- If the error is not fundamental, it should be corrected in the current year.

Alternative solution—revenue recognition

- AC111 states that revenue from the sale of goods should be recognised when the risks and rewards of ownership have passed to the buyer; the seller does not maintain managerial involvement; the amount of revenue can be measured reliably; it is probable that economic benefits associated with the transaction will flow to the enterprise and the costs to be incurred can be reliably measured.

- The concept of matching requires costs to be matched against revenue earned over the period of the contract.

- With respect to customer acquisition costs, the costs can be reliably measured; the monthly revenue is a fixed amount and can therefore be measured reliably; it is probable that economic benefits will flow to the enterprise as the acquisition bonus is payable when a contract is signed and the contract is not cancellable; the service providers do not maintain managerial involvement in the sale of the airtime contracts.

Part (b)

Current taxation

- The customer acquisition costs may be deducted when incurred for SA normal tax purposes in terms of section 11(a) because they are:
  - Actually incurred – the amounts are paid in cash and Sizacom has a legal obligation to pay the amounts when the contracts are signed or the starter packs are activated
  - In the production of income – the amounts are incurred in order to earn income from the sale of airtime
  - Of a revenue nature – the cost is part of the cost of the performance of Sizacom’s income earning operations, similar in nature to commissions paid to sales agents
  - For the purposes of trade
  - During the year of assessment

Deferred taxation

- The customer acquisition costs have no tax base because there is no amount that will be deductible in future in respect of these costs. (The costs have already been deducted for current tax.)

- If the customer acquisition costs are recognised as an intangible asset, which is the case for contract customers, a taxable temporary difference therefore arises as the difference between the carrying value of the asset and its zero tax base.

- A deferred taxation liability should be provided in respect of the taxable temporary difference, measured at the current tax rate.

- If the customer acquisition costs are not recognised as an asset, which is the case for the prepaid customers, there is no temporary difference and therefore no deferred taxation to be provided.

Tax consequences of recognising revenue

- The acquisition bonus paid by customers to the service providers will be included in taxable income when the income accrues.

- A deferred taxation asset should be provided on the deductible temporary difference, measured at the current taxation rate.
### Part (c) R'000

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension fund deficit (Balance sheet)</td>
<td>2 980</td>
</tr>
<tr>
<td>Current service cost (Income statement)</td>
<td>3 520</td>
</tr>
<tr>
<td>Interest cost (Income statement)</td>
<td>3 000</td>
</tr>
<tr>
<td>Bank (Employer contributions (3 300) plus employee contributions (3 300))</td>
<td>6 600</td>
</tr>
<tr>
<td>Expected return on plan assets (Income statement)</td>
<td>2 900</td>
</tr>
<tr>
<td>Actuarial loss (Income statement)</td>
<td>14,1 or 17,05</td>
</tr>
<tr>
<td>Pension fund deficit</td>
<td>14,1 or 17,05</td>
</tr>
<tr>
<td>Pension fund obligation</td>
<td>5 300</td>
</tr>
<tr>
<td>Pension fund asset</td>
<td>5 300</td>
</tr>
<tr>
<td>Actuarial losses (3 300+500)</td>
<td>3 300</td>
</tr>
<tr>
<td>Pension fund deficit</td>
<td>3 300</td>
</tr>
</tbody>
</table>

Unrecognised net actuarial losses at 1 January 2003 = 3 100

Exceeds greater of:
- 10% of benefit obligation (28 180) = 2 818
- 10% of plan assets (25 900) = 2 590

That is, 2 818

Excess = 282

Divided by expected average remaining working life (20 years) = 14,1

OR (6 400 - 2 990)/20 = 17,05

Asset limited to (AC 116.59), lower of:

- Amount determined above (28 180 - 25 900 - 3 100 - 2 980 + 14,1) = 3 785,9
- Unrecognised net actuarial losses (3 100 - 14,1 + 2 800 + 500 - 14,1) = 6 385,9

### Part (d) R'000

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of plan assets</td>
<td>27 300</td>
</tr>
<tr>
<td>Present value of defined benefit obligation</td>
<td>(29 900)</td>
</tr>
<tr>
<td>Unrecognised actuarial losses (3 100 – 14,1 + 2 800 + 500)</td>
<td>6 385,9</td>
</tr>
<tr>
<td>Defined benefit asset</td>
<td>3 785,9</td>
</tr>
</tbody>
</table>
Part (e)

- The potential bonus payment is a financial liability because:
  - It is a contractual obligation – established in terms of the black empowerment transaction
  - To deliver cash to another enterprise – i.e. Dludla

- The potential bonus payment meets the definition of a derivative (AC 133.11) because:
  - It is a financial instrument – Sizacom has an obligation to pay cash in certain circumstances (a financial liability) and, in the same circumstances, Dludla has a right to receive cash (a financial asset).
  - Whose value changes in response to an underlying – namely the share price of Sizacom
  - That requires little initial net investment relative to other types of contracts which have a similar response to market conditions – the potential bonus payment has the nature of a call option with a strike price equivalent to the initial share price escalated by 15% per annum and adjusted for dividends. The premium on an option is significantly less than the cost of the underlying share, which would have a similar response to market conditions. (AC 133.16)
  - That is settled at a future date – In this case, on 31 December 2007

- From the perspective of Sizacom the potential bonus payment is a derivative liability, equivalent to a written call option.
- The derivative liability should initially be measured at its fair value of R3 million on 1 January 2003 (AC 133.67 read with IGC 66-3)
- The debit side of the entry should be recognised as an expense on 1 January 2003 because it does not meet the definition of an asset (IGC 66-3)
- The derivative liability should subsequently be measured at its fair value, namely R3,5 million on 31 December 2003 (AC 133.94).
- The loss arising on remeasurement of the derivative should be recognised as an expense in net income for the period (R500K in 2003) (AC 133.104).

Part (e) – Alternative solution using provisions

- A provision should be recognised for the potential bonus payment because
  - Sizacom has a present obligation (legal or constructive) as a result of a past event, that is entering into the black empowerment transaction
  - it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation
  - a reliable estimate can be made of the amount of the obligation – Flag Bank can provide the fair value of the obligation

- The provision should initially be measured at its fair value of R3 million on 1 January 2003 (AC 130.37 and .38)
- The debit side of the entry should be recognised as an expense on 1 January 2003 because it does not meet the definition of an asset
- The provision should subsequently be measured at its fair value, namely R3,5 million on 31 December 2003
- The loss arising on remeasurement of the derivative should be recognised as an expense in net income for the period (R500K in 2003) (AC 133.104).

Contingent liability

- A contingent liability is a possible obligation, as it has yet to be confirmed whether the enterprise has a present obligation that could lead to an outflow of economic benefits or present obligations that do not meet the recognition criteria as determined in AC130.
- An enterprise should not recognise a contingent liability; the contingent liability should be disclosed unless the possibility of an outflow of economic benefits is remote.
- The bonus payment can be classified as a contingent liability as Dludla is only entitled to the bonus payment if the return on the notional investment exceeds 15% per annum. There is no certainty that there is a current present obligation; it is also questionable whether a reliable estimate of the obligation can be made and whether it is probable that there will be an outflow of economic benefits required to settle the obligation.