Seaside Ltd is a company in the transport industry. Mr Sipho Sand owns 60% of the ordinary shares of Seaside Ltd. You have recently been appointed as the internal audit manager of Seaside Ltd. Your direct superior, the group financial manager, has asked you to consider the following issues:

**Property lease**

In their interim management letter for the year ended 31 December 2001, the external auditors of Seaside Ltd, namely Shipshape Inc., advised management that AC 135, *Investment properties*, would be effective for the year ended 31 December 2002. As a result the Sandton head office of Seaside Ltd, which was built in 1996 and is owned by the company, would have to be depreciated in the financial statements for the year ended 31 December 2002. The property was carried at its initial cost of R25 million.

According to the financial director, the value of the Sandton property has increased significantly since being built and the company wished to continue benefiting from this appreciation in value. “Depreciation,” said the financial director, “is nonsensical!” He accordingly approached the external audit partner, Joan Smith, of Seaside Ltd and asked her to find a solution to this accounting problem for the company. Ms Smith in turn asked the Shipshape Inc. corporate finance division to propose a structure that might enable the group to avoid depreciating the head office building.

Shipshape Inc. proposed the series of transactions set out below. These were accepted by the board of directors of Seaside Ltd and the necessary agreements were entered into on 1 January 2002.

![Diagram of transactions]

**Notes**

The transactions proposed by Shipshape Inc., and which were subsequently implemented on 1 January 2002, are as follows:

1. The bank lent R40 million to Teacup (Pty) Ltd, a wholly owned subsidiary of Shipshape (Isle of Man) Ltd. The repayment terms of the loan are as follows:
   - From 30 June 2002 to 31 December 2013: Semi-annual payments on 30 June and 31 December of R2 659 383.
   - On 31 December 2013: Bullet repayment of R40 million.
2. Teacup (Pty) Ltd purchased the head office of Seaside Ltd for R40 million.
3. Seaside Ltd then entered into a 12-year lease contract with Teacup (Pty) Ltd. Lease rentals of R2 659 383 are payable semi-annually in arrears.
Other features of the transactions are as follows:

- Harbour (Pty) Ltd has an option to purchase all of the ordinary shares of Teacup (Pty) Ltd from Shipshape (Isle of Man) Ltd for £24 on 31 December 2013. Mr Sand owns all of the ordinary shares in Harbour (Pty) Ltd.
- Harbour (Pty) Ltd has guaranteed all of Teacup (Pty) Ltd’s obligations to the bank.
- Shipshape (Isle of Man) Ltd, which is a subsidiary of Shipshape Inc., operates an investment management business from the Isle of Man.
- Teacup (Pty) Ltd was formed specifically for the purpose of acquiring the head office of Seaside Ltd. In terms of the loan agreement between Teacup (Pty) Ltd and the bank, Teacup (Pty) Ltd may not conduct any other business or dispose of any significant assets without the prior, written consent of the bank, Harbour (Pty) Ltd and Seaside Ltd.

Motor vehicle leases

Seaside Ltd’s motor vehicle retailing division offers two types of leases on new Toyota vehicles to its customers:

<table>
<thead>
<tr>
<th></th>
<th>Lease A</th>
<th>Lease B</th>
</tr>
</thead>
<tbody>
<tr>
<td>End-of-term purchase option price</td>
<td>20% of original purchase price</td>
<td>45% of original purchase price</td>
</tr>
<tr>
<td>Implicit rate</td>
<td>Prime</td>
<td>Prime less 2%</td>
</tr>
<tr>
<td>Maintenance option per annum</td>
<td>2% of original purchase price</td>
<td>2% of original purchase price</td>
</tr>
<tr>
<td>Term</td>
<td>48 months</td>
<td>60 months</td>
</tr>
<tr>
<td>Deposit</td>
<td>Nil</td>
<td>Nil</td>
</tr>
</tbody>
</table>

The prime overdraft rate is 17% per annum.

- Lease B is only available to premium customers of the motor vehicle retailing division.
- Fixed monthly rentals, including maintenance payments, are payable monthly in arrears.
- The lessee is entitled, but not obligated, to buy the vehicle from the motor retailing division at the end of the lease term for the amount of the purchase option price.
- The maintenance option provides the customer with maintenance for the period of the lease, but excludes fuel, oil and tyres. The maintenance option is priced to earn an 8% margin on maintenance costs for the motor vehicle retailing division over the life of the contract.
- Five-year-old Toyota vehicles are currently trading at 26% of their original purchase price.
- Lease A customers are charged a contract fee of R150 on entering into the lease.

The motor vehicle retailing division’s current accounting treatment of the leases is as follows:

- Recognition of a vehicle sale at the date that the lease is entered into. Sales revenue is calculated as the present value of total rentals.
- Recognition of a provision at each month end, for the present value of the expected costs to be incurred by the division to maintain vehicles that are subject to the maintenance option. The expected costs are determined on the basis of the division’s historical experience and the vehicle manufacturer’s database of expected maintenance costs.
- Recognition of contract fees as revenue when the contract is signed.

Transport contract

Seaside Ltd provides outsourced transport services to Choosy Ltd, a fast-moving consumer goods retailer in Botswana. In terms of the contract, Choosy Ltd pays Seaside Ltd pula 500 000 in advance on 31 May and 30 November of each year.

Seaside Ltd expects to make a pula margin of 20% on the contract revenue of the outsourcing contract. Costs on the contract, which are all pula denominated, are incurred evenly on a monthly basis over the term of the contract.

Seaside Ltd does not have a branch in Botswana nor does it have a “permanent establishment” in that country.
In May 2002, Seaside Ltd’s financial director became concerned that the Botswana pula would depreciate against the rand during the following months. He decided to hedge against that risk and on 1 June 2002 Seaside Ltd purchased a forward exchange contract to sell pula 500 000 on 31 October 2002 for R845 000.

On 1 June 2002, the financial director of Seaside Ltd designated the changes in the spot element of the forward exchange contract as a cash flow hedge until 31 October 2002 of the expected cash receipt on 30 November 2002. On 1 June 2002, the hedge met all the requirements for hedge accounting in terms of par. 143 of AC 133, Financial Instruments: recognition and measurement, except that ongoing effectiveness had not yet been measured.

Seaside Ltd received pula 500 000 on 30 November 2002 and had closed out the forward exchange contract on 31 October 2002.

Other information relevant to the contract is as follows:

1 Exchange rates – ZAR:Pula 1

<table>
<thead>
<tr>
<th></th>
<th>Spot</th>
<th>Forward exchange contract 31/10/2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 June 2002</td>
<td>1,61</td>
<td>1,69</td>
</tr>
<tr>
<td>31 October 2002</td>
<td>1,38</td>
<td></td>
</tr>
<tr>
<td>30 November 2002</td>
<td>1,35</td>
<td></td>
</tr>
<tr>
<td>31 December 2002</td>
<td>1,35</td>
<td></td>
</tr>
</tbody>
</table>

2 Short-term rand interest rates, for periods ranging from one month to seven months, remained constant at 15% per annum from 1 June 2002 to 31 December 2002. Seaside Ltd uses these interest rates to measure the effectiveness of foreign exchange hedges.

REQUIRED

(a) Discuss the appropriate recognition and measurement, in the annual financial statements of Seaside Ltd for the year ended 31 December 2002, of the transactions surrounding Seaside Ltd’s sale and leaseback of its head office property. Do not discuss the accounting implications for the bank, Teacup (Pty) Ltd or Shipshape (Isle of Man) Ltd. (16)

(b) Discuss the appropriate accounting treatment, in the consolidated financial statements of Harbour (Pty) Ltd for the year ended 31 December 2002, of Harbour (Pty) Ltd’s option to purchase all of the ordinary shares in Teacup (Pty) Ltd on 31 December 2013. (10)

(c) Prepare an audit programme to audit the transactions surrounding the sale and leaseback of the head office of Seaside Ltd. (13)

(d) Prepare a report to the group financial manager on the appropriateness of the motor vehicle retailing division’s recognition and measurement of leases, maintenance contracts and contract fees. If these are in your opinion inappropriate, describe the appropriate recognition and measurement of the leases, maintenance contracts and contract fees. (22)

(e) Prepare a report to the group financial manager of Seaside Ltd, based on the available information, on the income tax and VAT implications of the following:

(i) The lease A and B alternatives;
(ii) The maintenance option; and
(iii) The contract fees paid in respect of lease A.

Your report should include a discussion of the relevance for income tax purposes of the fact that the motor vehicles are initially acquired as trading stock and subsequently, on entering into the lease agreement, are treated as fixed assets. Also discuss the relevance for VAT purposes of whether the relevant agreement is an “instalment credit agreement”. You are not required to discuss capital gains tax implications. (14)
(f) Prepare the journal entries for the period 1 June 2002 to 31 December 2002 for the following transactions:

(i) The 30 November 2002 transport contract receipt from Choosy Ltd;
(ii) Related maintenance revenue and expenses;
(iii) The 31 October 2002 forward exchange contract; and
(iv) Taxation in respect of (i), (ii) and (iii).

Include narrations and workings to support the journal entries. Do NOT prepare journal entries in respect of the 31 May 2002 transport contract receipt from Choosy Ltd. (28)

(g) List and explain any specific corporate governance or ethics concerns apparent from the information provided. Suggest how each concern should be resolved. (17)