You are currently finalising the 2006 year-end audit of the Phoenix Ltd ("Phoenix") group of companies. Phoenix is listed on the JSE Ltd. The company's financial year end is 31 December. The group adopted International Financial Reporting Standards (IFRS) on 1 January 2005 to comply with the listing requirements of the JSE Ltd and in the annual financial statements for the year ended 31 December 2005 the directors stated explicitly and unreservedly that the financial statements complied with these standards.

You are the senior in charge of the audit and the engagement partner expects you to review and resolve the remaining outstanding issues before she commences with her review of the audit work papers. These outstanding issues are described in the attached work papers. The following index applies to these work papers:

<table>
<thead>
<tr>
<th>Work paper reference</th>
<th>Work paper description</th>
</tr>
</thead>
<tbody>
<tr>
<td>A1</td>
<td>Understanding the entity and its environment</td>
</tr>
<tr>
<td>B1</td>
<td>Plastic bumper supply agreement</td>
</tr>
<tr>
<td>C1</td>
<td>Controlling interest in Arizona (Pty) Ltd</td>
</tr>
<tr>
<td>D1</td>
<td>“World Cup Taxi Project”</td>
</tr>
<tr>
<td>E1</td>
<td>Nyati Ltd</td>
</tr>
</tbody>
</table>

**Overview of the group structure**

```
Unlisted bonds

NYATI LTD

INCORPORATED TENDER COMPANY (PTY) LTD

PHOENIX LTD

Plastic bumper supply agreement

51% shareholding

NXASANA LTD

ARIZONA (PTY) LTD
```

60% shareholding
**Phoenix group**

**Prepared by:** AC Trainee  
**Date:** 15 January 2007

**Year end:** 31 December 2006

<table>
<thead>
<tr>
<th>Understanding the entity and its environment</th>
<th>Reviewed by: .....</th>
<th>Date: .......</th>
</tr>
</thead>
</table>

**Overview of the main business activities**

Phoenix was incorporated in 1985 as a manufacturer of automotive engines and spare parts. The company listed on the then Johannesburg Stock Exchange (now the JSE Ltd) in 1990 and is now a major global player in the provision of world-class products to the automotive industry.

**See work paper B1 for supporting information**

The company has recently undergone a business process re-engineering (BPR) exercise in order to realign itself with market requirements and ensure the sustainability of its profit levels in the future. As a result of this exercise the company realised that in order to remain a major supplier of high-quality automotive engines and spare parts, it would have to focus on its core business activities. The company therefore decided to outsource some of its non-core activities to specialist providers of these services.

**See work paper C1 for supporting information**

Phoenix has two major business growth objectives:

- The first objective is to achieve a larger market share. To further this goal Phoenix acquired a controlling interest in an existing marketing company, called Arizona (Pty) Ltd (“Arizona”), on 1 January 2004. Arizona runs extensive marketing campaigns on behalf of Phoenix.

- The second growth objective is to focus on the upcoming FIFA Soccer World Cup that will be hosted by South Africa in 2010. In view of the extensive requirements for transportation during the Soccer World Cup, the South African government has requested a number of tenders relating to improvements to the public transport system of the country that will be implemented during the next three years. Phoenix submitted tenders for many of these government contracts by means of the Incorporated Tender Company (Pty) Ltd (“Tender Company”). Phoenix incorporated this company on 30 June 2006 with Nyati Ltd (“Nyati”), its black economic empowerment (BEE) partner. Nyati owns a 40% share of the Tender Company.

**See work papers D1 & E1 for supporting information**

**Relevant group accounting policies**

All items of property, plant and equipment are measured in accordance with the cost model in terms of IAS 16 (AC 123), *Property, plant and equipment*, and are depreciated on the straight-line basis over their expected useful lives.

Investment properties held by companies in the group are measured in accordance with the fair value model in terms of IAS 40 (AC 135), *Investment properties*. 
During an operations executive meeting held in 2005, management of Phoenix decided to scrap the plant used to manufacture plastic bumpers, because it was nearing the end of its economic life and would require a complete rebuild to remain useful. The decision to scrap the plant was in line with the recommendations from the BPR exercise as per work paper A1. Phoenix entered into a supply agreement to buy plastic bumpers for mini-buses (“bumpers”) from Nxasana Ltd (“Nxasana”), which would contribute to compliance with the sector BEE code on preferential procurement.

The agreement contains the following provisions:

- The contract to buy bumpers from Nxasana commenced on 1 January 2006 and will end on 31 December 2012. The contract may be extended at the discretion of Phoenix. Phoenix is however uncertain whether the contract will be extended at that date.
- Because of the unique nature of the bumpers, Nxasana constructed a special production line for their manufacture. The cost of constructing the production line, which is the only equipment that may be used to manufacture the bumpers that are supplied to Phoenix, was R50 million, which is also the fair value of the plant at this date. Nxasana does not own similar assets to this production line.
- The production line has capacity for 12 000 units per annum and an economic life of eight years.
- During the past ten years, Phoenix has on average sold 11 000 units per annum. The demand for the bumpers is expected to increase in the future.
- Phoenix Ltd is however obliged to purchase a minimum of 10 000 units per annum at a fixed price of R1 000 per unit, escalating by 10% per annum. Phoenix Ltd will be required to pay the minimum charge even if it does not need the stated minimum quantity.
- Nxasana is obliged to reserve for Phoenix sufficient capacity to produce the budgeted sales quantities for Phoenix.
- Nxasana is responsible for repairs and maintenance of the production line.
- The residual value of the production line for depreciation purposes is R8 million on 1 January 2006.

Phoenix has processed only the following journal entry relating to this agreement in its accounting records for the year ended 31 December 2006:

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory (B/S) / Cost of sales (I/S)</td>
<td>11 500 000</td>
</tr>
<tr>
<td>Bank</td>
<td>11 500 000</td>
</tr>
</tbody>
</table>

*Purchase of bumpers from Nxasana*
Acquisition of controlling interest in Arizona

On 1 January 2004 Phoenix acquired a 51% controlling interest in Arizona for an amount of R25 million.

At the date of acquisition of the interest, the net assets of Arizona were all regarded to be fairly valued, with the exception of land belonging to Arizona that was undervalued by R1 million at that date. Land is neither depreciated nor revalued in the records of Arizona. Arizona does not qualify for any capital allowances on the land for tax purposes and has no intention of disposing of the land in the foreseeable future. The base cost of the land for capital gains tax (CGT) purposes equals the original cost price thereof.

An amount of R2 million (correctly calculated after taking into account the fair values of net assets) arose as goodwill at the acquisition date of the interest in Arizona in terms of IFRS 3 (AC 140), Business combinations.

Arizona acquired a new storage warehouse on 1 January 2006 at a cost of R2,8 million (land: R500 000 and buildings: R2,3 million). These amounts exclude VAT. The storage warehouse had an expected economic life of 20 years on 1 January 2006. Arizona intends to use the building for its entire economic life. The directors of Arizona deem the carrying value of the storage warehouse to be recouped through use and not through sale as no intention exists to sell the warehouse in the foreseeable future.

On 1 January 2006 Phoenix entered into an agreement with Arizona for the lease of the storage warehouse for a period of five years. In its annual financial statements, Arizona has correctly classified the lease as an operating lease in terms of IAS 17 (AC 105), Leases.

In terms of the operating lease agreement, an annual instalment is payable to Arizona at the end of every year for the lease of the warehouse. The first instalment, which was payable on 31 December 2006, was R500 000 (excluding VAT). The lease agreement provides that the annual instalment payable will escalate by 10% per annum commencing on 31 December 2007 (i.e. the instalment payable on 31 December 2007 will be R550 000 and so forth). Arizona does not qualify for any capital allowances on the warehouse for tax purposes. Phoenix and Arizona are registered vendors for VAT purposes and Arizona uses the warehouse to generate taxable supplies.

Arizona accounts for the storage warehouse in terms of the fair value model in its financial statements. At 31 December 2006 an independent valuator placed a fair value of R3,5 million (land: R800 000 and buildings: R2,7 million) on the warehouse. These amounts exclude VAT.

Arizona is audited by another firm of registered auditors. Arizona prepares its financial statements in terms of IFRS.
Phoenix incorporated the Tender Company on 30 June 2006, as an entity to tender for public transport projects of the government. One such project, for which the Tender Company submitted a tender, relates to the “World Cup Taxi Project”. The Minister of Transport has requested tenders for a new taxi system, which entails replacing existing taxis with “Maxi-Taxis”. These new standardised public taxis, authorised to carry up to 30 passengers, are being promoted as an alternative form of public transport. The project will be a sustainable initiative.

Phoenix has structured, via the Tender Company, a package which should secure a competitive advantage for their “World Cup Taxi Project” tender. The package contains the following terms and conditions:

- Government must place a non-cancellable order for “Maxi-Taxi” engines with the Tender Company.
- Phoenix will then manufacture and supply all the engines for the new Maxi-Taxis to the Tender Company. The “Phoenix 2.3 liter turbo” engine is well proven and will be suitable for the new Maxi-Taxis. Phoenix will supply the engines to the Tender Company at manufacturing cost price.
- These engines will be offered to the government at the competitive price of R121 200 (including VAT at 14%) per engine. The selling price includes fitment of the engine to the Maxi-Taxi and a three-year engine maintenance contract.
- The selling price is to be settled over 24 months in equal, monthly instalments payable in arrears. To make the package deal more attractive to government, no interest will be levied on the outstanding purchase price. (The nominal pre-tax market-related interest rate that financial institutions offer to government on similar transactions is 8% per annum.)

Management is of the opinion that revenue resulting from the above package deal may be recognised in full upon the receipt of the non-cancellable order from government, as government will then be legally committed to the transaction.
When the Tender Company was incorporated (see work papers A1 and D1) on 30 June 2006, the shareholders of the new company were required to provide R20 million in equity at the date of incorporation.

However, Nyati Ltd, a black-owned company with interests in a number of sectors, did not have the cash resources to contribute their share of the equity at the time. Nyati Ltd therefore issued ten R1 million 8% non-redeemable bonds (“the unlisted Nyati bonds”) on 30 June 2006 to fund its investment in the Tender Company. The unlisted Nyati bonds pay annual coupons on 30 June and are not listed on any exchange.

These unlisted Nyati bonds were all taken up by Phoenix at the issue date at their fair value of R800 000 each. The directors are of the opinion that the investment in these bonds should be classified as held-to-maturity in the annual financial statements of Phoenix as it is Phoenix’s intention to retain these bonds permanently. The directors are not willing to carry these bonds at fair value in the accounting records.

On 5 January 2007 the following article appeared in the business section of one of the daily newspapers:

**JOHANNESBURG, 5 JANUARY 2007**

Reuters have reported that Nyati Ltd, a BEE company, defaulted on the December 2006 coupon payments on listed bonds they issued to the Royalty Group. It is believed that the company is experiencing severe cash flow problems after their recent spate of acquisitions.

On 10 January 2007 an expert in corporate bonds estimated that the cash flow problem identified in the above article will continue for the next three years, after which cash flows should return to normal. The expert informed you that the current required rate of return on similar risk bonds is 11% per annum and provided you with the following estimated cash flow schedule for the unlisted Nyati bonds:

<table>
<thead>
<tr>
<th>Date</th>
<th>30 June 2007</th>
<th>30 June 2008</th>
<th>30 June 2009</th>
<th>30 June 2010 and thereafter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected cash flow (total)</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
<td>Normal</td>
</tr>
<tr>
<td>REQUIRED</td>
<td>Marks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>----------------------------------------------------------------------------------------------------------------------------------------</td>
<td>-------</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| (a) Discuss the appropriate recognition and measurement of the supply agreement between Phoenix Ltd and Nxasana Ltd (see work paper B1) in the accounting records of Phoenix Ltd for the year ended 31 December 2006.  
  • Ignore VAT implications for this part of the question.                                                                            | 13    |
| (b) Provide the pro forma journal entries that would be processed in the consolidated annual financial statements of the Phoenix Ltd group of companies for the year ended 31 December 2006 in respect of Arizona (Pty) Ltd (see work paper C1).  
  • Use only the available information and provide brief narrations.                                                                     | 21    |
| (c) Discuss how the proposed revenue arising from the “World Cup Taxi Project” tender (see work paper D1) should be recognised and measured in the annual financial statements of the Incorporated Tender Company (Pty) Ltd. | 17    |
| (d) Discuss whether you agree with the directors’ opinion that the investment in the unlisted Nyati bonds (see work paper E1) should be classified in the held-to-maturity category in the consolidated annual financial statements of Phoenix Ltd for the year ended 31 December 2006. Recommend alternative classification options. | 6     |
| (e) Provide the journal entries in respect of the investment in the unlisted Nyati bonds that Phoenix Ltd would have processed in their accounting records for the year ended 31 December 2006 before the information in the article dated 5 January 2007 (see work paper E1) became known. Assume that these bonds are measured at amortised cost. | 5     |
| (f) Discuss and calculate the effect of the information in the article dated 5 January 2007 (see work paper E1) on the annual financial statements of Phoenix Ltd for the year ended 31 December 2006. | 8     |
| (g) Based on the information provided, discuss the inherent risks of material misstatement at the overall financial statement level that the audit team should have identified during the planning of the audit of the Phoenix Ltd group of companies for the year ended 31 December 2006. | 10    |