Part 1 – Paper 2  
Suggested solution – Question 1

Part (a)  
Lease between Seaside Ltd and Teacup (Pty) Ltd

A finance lease is defined by AC 105, Leases, as “a lease that transfers substantially all the risks and rewards incident to ownership of an asset”. The classification of a lease is a matter of substance, rather than legal form. However, any one of the following criteria would normally indicate a finance lease:

- **The lease transfers ownership of the asset to the lessee by the end of the lease term.** In this case Seaside Ltd does not become the owner of the property
- **The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised.** Seaside Ltd does not have an option to repurchase the property.
- **The lease term is for the major part of the economic life of the asset even if title is not transferred.** Twelve years is unlikely to be the major part of the useful life of a relatively new building, such as the head office building of Seaside Ltd.
- **At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.** In this case:
  - Minimum lease payments = R2 659 383 every 6 months for 12 years
  - Implicit interest rate = 13.3 % per annum
  - (IRR of cash flows: $T_0 - (\text{R40 000 000}); T_1 \text{ to } T_{24} - \text{R2 659 383}; T_{24} - \text{R40 000 000})$
  - Therefore, present value of minimum lease payments = R31 466 049
  - This is 79% of the fair value at inception and therefore:
    - is not substantially all (see first possible solution), or
    - is substantially all (see alternative solution below).
- **The leased assets are of a specialised nature such that only the lessee can use them without major modifications being made.** This is unlikely to be true of a building in Sandton.

**First possible solution: Operating lease**

If 79% is regarded as not substantially all of the fair value at inception, and in view of the other criteria, the lease should be classified as an operating lease in the company financial statements of Seaside Ltd.

The property should be derecognised.

A profit on disposal of R15 million should be recognised.

If R40 million is less than or equal to the fair value of the property
  - the profit should be recognised immediately

If R40 million is more than the fair value of the property at inception of the lease
  - the excess over fair value
    - should be deferred and recognised in earnings over the asset’s useful life

The lease payments should be recognised as an expense when incurred.

**Alternative solution: Finance lease**

79% is substantially all of the fair value of the asset at inception and the lease is therefore a finance lease

The property should not be derecognised. Because it is owner occupied, it should be depreciated in accordance with AC 123

The “profit” on disposal of R15 million should be deferred and recognised over the terms of the lease

NO MARKS ARE TO BE AWARDED FOR DISCLOSURE ITEMS. ONLY RECOGNITION AND MEASUREMENT ARE REFERRED TO IN THE REQUIRED SECTION.
Part 1 – Paper 2
Suggested solution – Question 1

Part (b)
Consolidation of Teacup (Pty) Ltd

Harbour (Pty) Ltd’s option to purchase the shares in Teacup cannot be exercised at present. Consolidation would therefore not be required in terms of AC 433.

AC 412 requires consolidation of all entities where the substance is that the reporting enterprise has
  o power to govern the financial and operating policies of the entities
  o so as to obtain benefits from it.

AC 412 considerations:
  • In substance, the activities of the SPE are being conducted on behalf of the enterprise according to its specific business needs so that the enterprise obtains benefits from the SPE’s operation. Although Teacup (Pty) Ltd was set up to avoid depreciation of Seaside’s head office, that is, to achieve off-balance sheet presentation of the asset, Harbour (Pty) Ltd benefits from the assets of Teacup (Pty) Ltd.
  • In substance, the enterprise has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an “autopilot” mechanism, the enterprise has delegated these decision-making powers. Teacup (Pty) Ltd operates on “autopilot”. It may not enter into any other business or dispose of its assets without the consent of Harbour (Pty) Ltd, Seaside or the bank.
  • In substance, the enterprise has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE, or in substance, the enterprise retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities:
    o The benefits and risks of Teacup (Pty) Ltd are the upside and downside risk respectively of the head office property.
    o Harbour (Pty) Ltd has the rights to the benefits in the form of the option to purchase the shares of Teacup (Pty) Ltd at a nominal amount.
    o Harbour (Pty) Ltd is exposed to the risks incident to Teacup (Pty) Ltd via its guarantee of that company’s debt obligations.

Therefore, Teacup (Pty) Ltd should be consolidated by Harbour (Pty) Ltd.

The head office property is an investment property in the consolidated financial statements.

Therefore the head office property should be depreciated in terms of AC123 or measured at fair value through earnings in accordance with AC 135.

Liability to the bank

The liability to the bank should be measured in the consolidated financial statements at amortised cost.

Part (c)
  • Agree the lease rentals, sales price and loan amount to the contracts.
  • Inspect that the contracts are signed.
  • Determine whether the signatories to the contracts on behalf of Seaside Ltd are appropriate.
  • Determine, through internal or external valuation process, fair value of head office at lease inception.
  • Consider qualifications, professional competence and independence/objectivity of the valuator.
  • By enquiry of a specialist, compare rentals paid to market related rentals for a property of this nature.
  • Agree the approvals process for the transactions to Seaside Ltd’s approvals framework.
  • Inspect the minutes of directors’ meetings – for authorisation of the contract.
  • Agree the receipt of the sales proceeds to Seaside Ltd’s bank statement.
  • Review the calculation of the prior year adjustment for depreciation of the property in the group.
  • Recalculate the recognisable profit on the sale of the property.
  • Check the journal entries recording the transaction in the accounting records.
  • Check the postings of the journals to the general ledger.
  • Review the basis for classification of the lease in the company financial statements.
  • Inspect appropriate approvals in terms of the Companies Act, e.g. shareholder approval if it concerns a major portion of assets.
Part 1 – Paper 2
Suggested solution – Question 1

- Inspect that the disposal is recorded in the fixed asset register.
- Confirm that the title deed has been transferred.
- Recalculate deferred taxation and VAT.
- Because transaction is non-systematic, controls are unlikely to address audit risks.

Part (d)
Recognition of the sale margin

<table>
<thead>
<tr>
<th></th>
<th>Lease A</th>
<th>Lease B</th>
</tr>
</thead>
<tbody>
<tr>
<td>PV</td>
<td>-100</td>
<td>-100</td>
</tr>
<tr>
<td>Interest</td>
<td>17%</td>
<td>15%</td>
</tr>
<tr>
<td>FV</td>
<td>20</td>
<td>45</td>
</tr>
<tr>
<td>Period</td>
<td>48</td>
<td>60</td>
</tr>
<tr>
<td>Pmt</td>
<td>R2,59</td>
<td>R1,87</td>
</tr>
<tr>
<td>Bargain purchase option price</td>
<td>20</td>
<td>0</td>
</tr>
<tr>
<td>PV of lease payments</td>
<td>(R89,82)</td>
<td>(R78,64)</td>
</tr>
<tr>
<td>PV of bargain purchase option</td>
<td>(R10,18)</td>
<td>0</td>
</tr>
<tr>
<td>PV of minimum lease payments</td>
<td>(R100,00)</td>
<td>(R78,64)</td>
</tr>
</tbody>
</table>

**Lease A**
- At current prime overdraft rates, the present value of the minimum lease payments, excluding maintenance, due by a Lease A lessee amounts to 90% of the selling price of the vehicle. This is substantially all of the selling price. (AC105.10)
- The current selling price of five-year-old vehicles (26% of original cost) indicates that it is unlikely that a vehicle leased under lease A will be returned, which further indicates that the risks and rewards of ownership have been transferred to the lessee.
- The lease is therefore a finance lease.
- The motor vehicle should be derecognised.
- A lease receivable should be recognised for the lower of the fair value of a vehicle leased under Lease A and the present value of the minimum lease payments.
- The lower of the fair value of a vehicle leased under Lease A and the present value of the minimum lease payments, excluding maintenance, is correctly recognised as revenue. (AC105.38)
- The finance income (interest) on the finance lease should be recognised over the term of the lease on an effective yield basis

**Lease B**
- At current prime overdraft rates, the present value of the minimum lease payments, excluding maintenance, due by a Lease B lessee amounts to 79% of the selling price of the vehicle. It is submitted that this is less than substantially all of the selling price. (AC105.10)
- The current selling price of five-year-old vehicles (26% of original cost) indicates that it is highly likely that a vehicle leased under lease B will be returned to the motor vehicle retailing division after five years. This further indicates that the motor vehicle retailing division retains significant risks and rewards of ownership.
- Lease B is therefore an operating lease.
- Recognition of sales revenue therefore appears to be inappropriate.
- The lease rentals, excluding maintenance, should be recognised as revenue when they are due in terms of the lease. (AC105.44)
- The vehicles leased out in terms of Lease B should continue to be recognised as property, plant and equipment. (AC105.43)
- These leased assets should be depreciated over their useful life. (AC123.45)
Maintenance revenue

In terms of AC 111, revenue should be recognised “when the outcome of a transaction involving the rendering of services can be estimated reliably, … by reference to the stage of completion of the transaction at the balance sheet date”.

- A provision is “a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits”.
- The past event in this case is the signing of the contract and the receipt of the maintenance payment.
- The present obligation arises from the contract.
- The expected outflow of economic benefits is the costs of providing the maintenance.
- However, although a provision is required, the current accounting treatment results in immediate recognition of the profit element in maintenance revenue (PV of maintenance revenue included in minimum lease payments less PV of expected costs included in provision).
- This is inappropriate because it does not bear reference to the stage of completion of the services.
- The motor vehicle retailing division should defer all maintenance revenue and recognise the revenue in earnings on a percentage of completion basis.
- The percentage of completion may be determined by reference to the maintenance costs incurred to date relative to the total maintenance costs expected to be incurred over the life of the contract.

Contract fees

- Fees which are an integral part of the effective yield of a financial instrument are generally treated as an adjustment to the effective yield. However, when the financial instrument is to be measured at fair value subsequent to its initial recognition, the fees are recognised as revenue when the instrument is initially recognised.

- Origination fees received by the enterprise relating to the creation or acquisition of a financial instrument which is held by the enterprise as an investment may include compensation for activities such as evaluating the borrower’s financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an ongoing involvement with the resultant financial instrument and, together with the related direct costs, are deferred and recognised as an adjustment to the effective yield. (Paragraph 14(a)(i) of Appendix to AC111)

- Servicing fees included in the price of the product: When the selling price of a product includes an identifiable amount for subsequent servicing (for example, after sales support and product enhancement on the sale of software), that amount is deferred and recognised as revenue over the period during which the service is performed. The amount deferred is that which will cover the expected costs of the services under the agreement, together with a reasonable profit on those services. (Paragraph 11 of Appendix to AC111)

- Since no contract fees are charged on Lease B contracts, it will probably be difficult to argue that there are significant acts or services rendered on entering into the contract.
- As such the fee is received for the rendering of a service, that is, the provision of loan finance.
- The fee should be recognised in revenue as an increase in the interest received over the Lease A lease term. OR
- The fees should be recognised on a straight line basis as service fees over the terms of the contract.
Part 1 – Paper 2
Suggested solution – Question 1

Part (e)
Income tax

Lease A transactions and Lease B transactions
- If the leased motor vehicle is therefore transferred from trading stock to fixed assets, the transfer should be at market value in terms of s22(8), thereby realising a profit upfront as gross income for tax purposes. This principle will apply whether the lease is treated as a financial lease (lease A) or an operating lease (lease B).
- On the assumption that the market value for s22(8) purposes is accepted to be the sale price recognised by the retail division, the lease rentals currently recognised for accounting purposes will be taxed as and when they accrue in terms of the contract.
- Seaside Ltd would claim wear and tear (s11(e)) over the life of the leased motor vehicles, based on an amount equivalent to the market value of the assets transferred from trading stock (less output VAT).
- If the motor vehicles could be said to have been acquired purely for lease rental purposes, then
  - the s11(e) allowance would be calculated on the purchase price of the assets, and
  - the full lease rental paid by the customer would be taxable as and when it accrues in terms of the contract.
- If the customer exercises its end of term purchase option the difference between the purchase price and the tax value is recoupable/deductible.

Maintenance revenue
- The maintenance revenue, which is included in the lease rentals, will be included in taxable income when it accrues in terms of the lease contract.
- Seaside Ltd will deduct any maintenance expenses actually incurred (s11(a)).
- Seaside Ltd will claim a deduction in terms of s24C of the expected costs to be incurred in respect of maintenance payments already received, to the extent that those expected costs exceed the actually incurred expenditure.

Contract fees
- The contract fees will be included in taxable income when the contract is signed.

VAT
Lease A transactions and lease B transactions
- The VAT incurred on the purchase of the vehicles should be claimed as an input credit.
- It is not clear from the information provided whether these leases do or do not meet the definition of an “instalment credit agreement” in terms of section 1 of the VAT Act.
- If the lease meets the definition of an instalment credit agreement, VAT is payable on the cash price, which would presumably be the sale price recognised by Seaside Ltd, i.e. excluding maintenance payments.
- No further VAT will be charged on the lease rentals, because those are financial transactions.
- If the lease is not an instalment credit agreement for VAT purposes, VAT is payable on the full amount of each lease rental as and when it accrues.

Maintenance revenue
- Maintenance revenue included in the lease rentals is subject to VAT when it accrues.
- The VAT incurred on the purchase of parts or services to perform maintenance should be claimed as input credit.

Contract fees
- Contract fees will be subject to VAT when the contract is signed.
### Part (f)

**Using spot rates for expected hedged item cash flows (AC133.145)**

<table>
<thead>
<tr>
<th>Date</th>
<th>DR Description</th>
<th>CR Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>31 October 2002</strong></td>
<td>DR FEC asset ((500,000 \times 1.38) – 845,000)</td>
<td>CR Equity</td>
<td>115,000</td>
</tr>
<tr>
<td></td>
<td>CR Income statement</td>
<td></td>
<td>40,000</td>
</tr>
<tr>
<td></td>
<td>Measurement of FEC at fair value. Gain attributable to spot rate movements recognised in equity to extend of effectiveness (see below). Gain attributable to forward premium (40,000) recognised in earnings</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Movement in FEC at spot rates – ((500,000 \times (1.61-1.38)))</td>
<td></td>
<td>115,000</td>
</tr>
<tr>
<td></td>
<td>Movement in PV of expected hedged item cash flows at spot – ((500,000 \times (1.61-1.38)))</td>
<td></td>
<td>(115,000)</td>
</tr>
<tr>
<td></td>
<td>Effectiveness percentage</td>
<td></td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>Therefore the hedge is within the 80-125% range (AC133.147)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>DR Bank</td>
<td>CR FEC asset</td>
<td>155,000</td>
</tr>
<tr>
<td></td>
<td>DR Income statement</td>
<td>CR FEC asset</td>
<td>155,000</td>
</tr>
</tbody>
</table>

#### 30 November 2002

<table>
<thead>
<tr>
<th>Date</th>
<th>DR Description</th>
<th>CR Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DR Bank ((500,000 \times 1.35))</td>
<td>DR Equity</td>
<td>675,000</td>
</tr>
<tr>
<td></td>
<td>CR Deferred revenue</td>
<td></td>
<td>115,000</td>
</tr>
<tr>
<td></td>
<td>Receipt of revenue in advance for outsourcing and basis adjustment of deferred revenue (AC133.161)</td>
<td></td>
<td>790,000</td>
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</table>

#### 31 December 2002

<table>
<thead>
<tr>
<th>Date</th>
<th>DR Description</th>
<th>CR Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DR Deferred revenue ((790,000 \times 1/6))</td>
<td>CR Revenue</td>
<td>131,667</td>
</tr>
<tr>
<td></td>
<td>Recognition of one month’s outsourcing revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>DR Operating expenses</td>
<td>CR Bank/Creditors</td>
<td>90,000</td>
</tr>
<tr>
<td></td>
<td>Accrual of operating expenses for December</td>
<td></td>
<td>90,000</td>
</tr>
<tr>
<td></td>
<td>(P500,000*80%<em>1/6</em>1.35)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>CR Current tax expenses</td>
<td>Cr Receiver of revenue</td>
<td>87,000</td>
</tr>
<tr>
<td></td>
<td>Revenue receipt</td>
<td></td>
<td>675,000</td>
</tr>
<tr>
<td></td>
<td>Foreign exchange gain</td>
<td></td>
<td>155,000</td>
</tr>
<tr>
<td></td>
<td>S11(a) deduction ((P500,000*80%<em>1/6</em>1.35))</td>
<td></td>
<td>(90,000)</td>
</tr>
<tr>
<td></td>
<td>S24C deduction ((P500,000*80%<em>5/6</em>1,35))</td>
<td></td>
<td>(450,000)</td>
</tr>
<tr>
<td></td>
<td>Taxable income</td>
<td></td>
<td>290,000</td>
</tr>
<tr>
<td></td>
<td>Tax at 30%</td>
<td></td>
<td>87,000</td>
</tr>
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<table>
<thead>
<tr>
<th>Date</th>
<th>DR Description</th>
<th>CR Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Deferred taxation (balance sheet)</td>
<td>Cr Deferred taxation expense</td>
<td>62,500</td>
</tr>
<tr>
<td></td>
<td>Deferred tax on temporary difference between carrying value of deferred revenue (658,333) and tax base, i.e. s24C deduction (450,000)</td>
<td></td>
<td>62,500</td>
</tr>
</tbody>
</table>
### Part (g)

<table>
<thead>
<tr>
<th>Concern</th>
<th>Basis for concern</th>
<th>Suggested resolution</th>
</tr>
</thead>
<tbody>
<tr>
<td>The internal audit manager reports directly to the group financial manager</td>
<td>Undermines the independence of the internal audit function</td>
<td>The internal audit function should report directly to the audit committee</td>
</tr>
<tr>
<td>Shipshape (Isle of Man) Ltd, a subsidiary of Seaside Ltd’s external auditors, is the sole shareholder of Teacup (Pty) Ltd. Harbour (Pty) Ltd, which is under common control with Seaside, has an interest in Teacup (Pty) Ltd in the form of a call option on the shares</td>
<td>A joint business interest with the external auditor undermines the independence and appearance of independence of the external auditor</td>
<td>Shipshape (Isle of Man) Ltd should be instructed to immediately sell, at no profit, its interest in Teacup (Pty) Ltd or else Shipshape Inc should be dismissed as external auditors. The audit committee should be informed of the mutual interest. Shipshape should be reported to the PAAB</td>
</tr>
<tr>
<td>Shipshape Inc renders services to Seaside Ltd other than the external audit</td>
<td>The performance of other services may compromise the appearance of independence</td>
<td>The audit committee should approve all other services provided to the company by Shipshape Inc. The audit committee should instruct Shipshape Inc to use staff on the audit of the sale and leaseback who were not involved in the development or implementation of that series of transactions.</td>
</tr>
<tr>
<td>The financial director’s desire to change the accounting for transactions without changing the substance of the transactions</td>
<td>Raises doubt as to management’s commitment to accurate and fair financial reporting</td>
<td>The accounting for the sale and leaseback transactions should reflect the substance of the transactions</td>
</tr>
<tr>
<td>Harbour (Pty) Ltd, a wholly-owned company of Sipho Sand (the controlling shareholder of Seaside Ltd) obtained the option to purchase Teacup (Pty) Ltd for a nominal amount</td>
<td>There are minority shareholders in Seaside Ltd. Did the minority shareholders approve the transaction? Was the pricing of the lease and the option appropriate, given these circumstances?</td>
<td>The minority shareholders should be fully informed of the terms of the transaction and Sipho Sand’s conflict of interest. The minority shareholders should be provided an opportunity to ratify the transaction. If there has been a deliberate attempt to defraud the minorities, legal counsel should be sought in this regard to consider and advise on future actions. The related party transaction should be disclosed. Directors’ interests in contracts (if Sand is assumed to be a director) should be included in the register.</td>
</tr>
<tr>
<td>The property may comprise the majority of the assets of Seaside Ltd (insufficient information is provided to assess this with certainty)</td>
<td>The Companies Act requires shareholder approval where the major portion of a company’s assets is disposed of. Failure to comply with statutory requirements is irregular and to an erosion of shareholder protection.</td>
<td>The value of the property in relation to the total asset base must be assessed. If it is the major portion of the assets, requisite shareholder approvals need to be sought. No further action is required if the asset does not comprise the major portion of assets.</td>
</tr>
</tbody>
</table>
### Concern | Basis for concern | Suggested resolution
---|---|---
The amounts of the sale price (R40 million) and the lease rentals (R2.6 million) | Are these reasonable fair values? | The directors should obtain valuations and expert assistance to confirm the fair values.
Was the sale of the head office transaction referred to the audit committee of Seaside? | The audit committee should consider and approve all complex financial reporting matters | Immediately report the circumstances of the transaction and the proposed accounting treatment to the audit committee.
The financial director took the decision to hedge the Pula outsourcing revenue exposure | Is this in accordance with the approval framework and risk management strategy of Seaside Ltd? | If not, obtain the necessary approvals and take relevant disciplinary action.