LEARNING UNIT NUMBER	**1**
TITLE OF LEARNING UNIT	**The Conceptual Framework for Financial Reporting; Presentation of Financial Statements; Income Taxes; Accounting Policies, Changes in Accounting Estimates and Errors; Financial Instruments; The Effects of Changes in Foreign Exchange Rates**
NOTIONAL STUDY HOURS	**30**
NUMBER OF PLANNED SELF-REFLECTIVE ACTIVITIES	**3 Examples; 7 Questions; 1 Case study**
NUMBER OF ASSESSMENT LINKED ACTIVITIES	**1 (Test 1/2024)**

1.1 Introduction

Within learning unit 1 we will discuss the following individual topics:

Topic	IFRS Standard	Description
1.1		The Conceptual Framework for financial reporting
1.2	IAS 1, IFRIC 17	Presentation of Financial Statements
1.3	IAS 12, FRP 1, IFRIC 23	Income Taxes
1.4	IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
1.5	IAS 32, IFRS 7, IFRS 9, IFRIC 19	Financial Instruments
1.6	IAS 21	The Effects of Changes in Foreign Exchange Rates

The above will be discussed as individual topics within this learning unit.

1.2 Purpose of learning unit

Students should be able to:

- Apply financial reporting in integrated case studies as set out in the Conceptual Framework for IFRS.
- Assess the recognition and derecognition criteria of an element as specified in the relevant IFRS in an integrated case study.
- Evaluate the measurement basis that is applicable to an element as guided by the relevant IFRS in an integrated case study.
- Prepare and discuss general purpose financial statements, including consolidated financial statements, in accordance with IFRS.

1.3 Assessment criteria

- Interrogate integrated case studies to evaluate the Conceptual Framework for IFRS.
- Recognise an item that is an asset, a liability, equity, income, or expense for inclusion in the financial statements.
- Derecognise from the financial statements an item that is no longer an asset, a liability, equity, income or expense.
- Interpret the recognition and/or derecognition of an asset, a liability, equity, income, or expense

in a given scenario against the applicable IFRS.

- Assess the measurement basis for an asset or a liability in a given scenario against the requirements of the applicable IFRS.
- Propose improvements to the measurement basis for an asset or a liability based on the requirements of the applicable IFRS.
- Compile the general financial statements, including consolidated financial statements, in accordance with IFRS.
- Assess the appropriateness of disclosures of financial information in relation to general purpose and consolidated financial statements, prepared in accordance with IFRS.

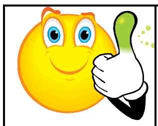
1.4 How to approach each learning unit

- Please read the prescribed study material for each topic in the learning unit thoroughly before studying the additional information.
- Study the overview of the individual topic – we have included an overview for each individual topic.
- Answer the examples/questions in the individual topic, if applicable, and make sure you understand the principles contained in the questions.
- Consider whether you have achieved the exit level outcomes (refer to learning unit 0).
- After you have completed all the individual topics in the learning units, answer the integrated questions to test whether you have mastered the contents of this learning unit.
- You will be assessed in test 1 on the contents of this learning unit.

Discussion forum

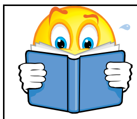
A general discussion forum has been set up for each topic within this learning unit. It is strongly recommended that you post your questions and comments on the forum as you work through the learning unit. Your lecturers are more than happy to assist you on your learning journey.

TOPIC 1.1
THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING



INTRODUCTION

The Conceptual Framework for Financial Reporting (Conceptual Framework) describes the objective of, and the concepts for, general purpose financial reporting. The Conceptual Framework is not a standard. Nothing in the Conceptual Framework overrides any Standard or any requirement in a Standard.



PRESCRIBED STUDY MATERIAL

The Conceptual Framework for Financial Reporting

SAICA Student Handbook 2022/2023; Volume1; Part A1; pages A19 to A95

The Conceptual Framework for Financial Reporting was covered as part of your undergraduate studies. It is important that you revise the study material and concepts if you are not familiar with the content.

Also, note that Unisa follows the limited open-book policy as prescribed by SAICA and that you will be allowed to use the SAICA Student Handbook during assessments.

Let’s look at the overview of the Conceptual Framework for Financial Reporting.

Overview of the Conceptual Framework

Chapter 1
Objective of general purpose financial reporting

Introduction.
Objective, usefulness and limitations of general purpose financial reporting.
Information about the reporting entity's economic resources, claims against the entity and changes in resources and claims.
• Economic resources and claims.
• Changes in economic resources and claims.
• Financial performance reflected by accrual accounting.
• Financial performance reflected by past cash flows.
• Changes in economic resources and claims not resulting from financial performance.
Information about use if the entity's economic resources.

Chapter 2
Qualitative characteristics of useful financial information

Introduction.
The qualitative characteristics of useful information.
The **fundamental** qualitative characteristics are:
- Relevance
- Faithful representation
- Applying the fundamental qualitative characteristics

The **enhancing** qualitative characteristics are:
- Comparability
- Verifiability
- Timeliness
- Understandability
- Applying the enhancing characteristics

The cost constraint on useful financial reporting.

Chapter 3
Financial statements and the reporting entity

Financial statements:
- Objective and scope of financial statements.
- Reporting period.
- Perspective adopted in financial statements.
- Going concern assumption.

The reporting entity.
- Consolidated and unconsolidated financial statements.

Chapter 5
Recognition and Derecognition

The recognition process.
Recognition criteria - An asset or liability is recognised only if recognition will provide users of financial statements with information that is useful, i.e. with:
- Relevant information;
- Faithful representation of the asset or liability

Derecognition.

Chapter 4: Elements of the financial statements

Introduction.
Definition of an asset
An asset is a present resource controlled by the entity as a result of past events.
An economic resource is a right that has the potential to produce economic benefits.
This section discusses three aspects of the definition:
- Right.
- Potential to produce economic benefits.
- Control.

Chapter 6

Introduction.
Measurement bases:
- Historical cost.
- Fair value.
- Value in use and fulfilment value.
- Current cost.

Information provided by particular measurement bases
- Historical cost.
- Fair value.
- Value in use and fulfilment value.
- Current cost.

Factors to consider when selecting a measurement basis.
Measurement of equity.
Cash flow-based measurement techniques.

Definition of a liability
- A present obligation of the entity to transfer an economic resource as result of past events.

For a liability to exist, three criteria must be satisfied:
- Obligation.
- Transfer of an economic resource.
- Present obligation as a result of past events

Assets and Liabilities
- Unit of account.
- Executory contract.
- Substance of contractual rights and contractual obligations.

Definition of equity
- The residual interest in the asset of the entity after deducting all its liabilities

Definition of income and expenses
- Income is increases in assets or decreases in liabilities that result in increases in equity other than those relating to contributions from holders of equity claims.
- Expenses are decreases in assets or increases in liabilities that result in decreases in equity other than those relating to distributions to holders of equity claims.

Chapter 7: Presentation and Disclosure

Presentation and disclosure as communication tools.
Presentation and disclosure objectives and principles.
Classification.
Aggregation.

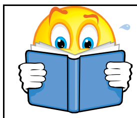
Chapter 8: Capital

Concepts of capital.
Concepts of capital maintenance.
Capital maintenance adjustments.

TOPIC 1.2 – PRESENTATION OF FINANCIAL STATEMENTS

INTRODUCTION

The objective of this Standard is to provide guidelines for the structure and content of general-purpose financial statements, as well as to explain certain underlying principles.



PRESCRIBED STUDY MATERIAL

IAS 1 Presentation of Financial Statements

SAICA Student Handbook 2022/2023; Volume1; Part A2; pages A1160 to A1208

IAS 1 was covered as part of your undergraduate studies. It is important that you revise the study material and concepts if you are not familiar with the content.

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Let’s look at the overview of IAS 1 Presentation of Financial Statements.

Overview of IAS 1 Presentation of Financial Statements

PRESENTATION OF FINANCIAL STATEMENTS

Purpose of IAS 1	Prescribes the **basis for preparation** of general-purpose financial statements. Sets out minimum requirements for **presentation** as well as guidelines for **structure and content** of financial statements.
Objective of financial statements	To provide useful information about the financial position, financial performance and cash flows of an entity to a wide range of users for making economic decisions.
Complete set of financial statements	**Structure and content**
Statement of financial position (SFP)	▪ Certain line items should be presented on the face of the SFP (e.g. property, plant and equipment, inventories, provisions, etc.). ▪ Certain information should be presented either on the face of the SFP or in the notes (e.g. sub-classifications of line items and details regarding share capital). ▪ Assets and liabilities should be presented as either **current** or **non-current**, unless presentation is based on liquidity.
Statement of profit or loss and other comprehensive income (SPLOCI)	▪ All income and expense items recognised in a period are presented as either: – a **single statement** of profit or loss and other comprehensive income; OR – **two separate statements** (one displaying profit or loss and the other displaying other comprehensive income together with profit or loss as an opening amount). ▪ Expenditure items should be classified either by their **function** or their **nature**. ▪ Specific line items are required to be presented in the profit or loss section (e.g. revenue, finance cost, tax expense, share of profit of associates and joint ventures, etc.). ▪ The nature and amount of material items to be presented either on the face of the SPLOCI or separately in the notes. ▪ Other comprehensive income items to be classified as either: – items that will not be classified subsequently to profit or loss; OR – items that will subsequently be reclassified to profit or loss. ▪ Items of other comprehensive income must be presented as either: – net of related tax effects; OR – before related tax effects, with one amount shown for the aggregate amount of income tax relating to those items. ▪ Reclassification adjustments relating to components of other comprehensive income need to be disclosed, either on the face, or in the notes. ▪ The notion of extraordinary items has been abandoned.
Statement of changes in equity	▪ Reconciliation of equity at the beginning of the reporting period with equity at the end of the reporting period. ▪ Includes: – total comprehensive income for the period, separated between amounts attributable to the owners of the parent and non-controlling interests; – effect of retrospective restatements; and – transactions with owners in their capacity as owners (e.g. issue of shares, dividends paid). ▪ Dividends paid and the related dividends per share should be presented either on the face, or in the notes.
Statement of cash flows	▪ Refer to learning unit 6.

Notes	▪ Basis of preparation of the financial statements. ▪ Specific accounting policies applied. ▪ Present information required by IFRS not already presented elsewhere. ▪ Supporting information for items presented in the financial statements. ▪ Additional information on items not presented in the financial statements. ▪ Sources of estimation uncertainty. ▪ Disclosures regarding capital.
General features for the presentation of financial statements	▪ Fair presentation and compliance with IFRSs. ▪ Financial statements are prepared on the going concern assumption. ▪ Items recognised on the accrual basis (i.e. when items satisfy the definitions and recognition criteria of the Conceptual Framework for Financial Reporting). ▪ Materiality and aggregation (present each material class of similar items separately). ▪ Offsetting (not allowed unless required/permitted by an IFRS). ▪ Frequency of reporting (at least annually). ▪ Comparative information (in respect of preceding period for all amounts presented and for the beginning of the earliest period presented where prior year numbers have been restated). ▪ Consistency of presentation (retain presentation and classification between periods).

TOPIC 1.3 – INCOME TAXES

INTRODUCTION

Taxation represents an unavoidable expense for most entities. Apart from various income taxes that include all domestic and foreign taxes, it is also necessary to account for deferred taxation. Deferred tax represents tax that will be paid/saved in future periods when the carrying amounts of the assets/liabilities are recovered/settled.

PRESCRIBED STUDY MATERIAL

1. **IAS 12 Income Taxes**
2. **FRP 1 Substantively enacted tax rates and tax laws**
3. **The following document is excluded:**
   SIC 25 Income taxes – Changes in the tax status of an entity or its shareholders

SAICA Student Handbook 2022/2023; Volume1; Part A2; pages A1309 to A1359

IAS 12 and FRP 1 were covered as part of your undergraduate studies. It is important that you revise the study material and concepts if you are not familiar with the content.

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Let's look at the overview of IAS 12 Income Taxes.

Overview of IAS 12 Income Taxes

CURRENT TAX

Amount of income tax payable on taxable profit for a period based on tax law

Measurement	**R**
Accounting profit	xx
Add back:	
Accounting items (e.g. depreciation)	xx
Include tax treatment (e.g. tax allowance)	xx
Taxable profit	xx
Current tax @ 27%	xx

Recognition	**Dr R**	**Cr R**
Current tax expense	xx	
Liability		xx

Tax expense is usually in P/L but recognises tax consequence where the item was recognised (P/L, OCI, Equity)

DEFERRED TAX

Recovery or settlement of carrying amount of assets and liabilities will make future tax payments larger or smaller than they would have been if they had no tax consequence
= recognised deferred tax, with limited exceptions

Carrying amount	**–**	**Tax base**	**=**	**Temporary difference**

Some temporary differences are **exempt:** No deferred tax (show in tax reconciliation in the note)

Taxable
Deferred tax liability

Deductible
Deferred tax asset
(to the extent probable that could be utilised)

Measurement

- Tax rate expected to apply when temporary differences reverse;
- based on the manner in which the carrying amount is expected to be recovered or settled.

Recognition

Movement in deferred tax balance usually in P/L, but recognises tax consequence where the item was recognised (P/L, OCI, Equity)

Detailed disclosure

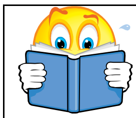
VIDEOS

Watch the five videos discussing deferred taxation.

TOPIC 1.4
ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

INTRODUCTION

The purpose of this standard is to prescribe criteria for the selection of an accounting policy, as well as for the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and correction of prior period errors, to ensure consistent preparation and presentation of financial statements. The standard enhances the comparability of the entity's financial statements with previous periods, as well as with financial statements of other entities.



PRESCRIBED STUDY MATERIAL

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

SAICA Student Handbook 2022/2023; Volume1; Part A2; pages A1268 to A1284

IAS 8 was covered as part of your undergraduate studies. It is important that you revise the study material and concepts if you are not familiar with the content.

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Let's look at the overview of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Overview of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

Accounting policies

Initial decision

Determined by Accounting Standards and Interpretations.

If no Standard or Interpretation exists, management should apply its judgement.

Application of accounting policy should be consistent from period to period and for all similar transactions.

Accounting policies are only changed if:

- required by an Accounting Standard or Interpretation; or
- the change will provide more relevant and reliable information.

Accounting policy changes must be applied in terms of the transitional provisions of a new Accounting Standard, or **retrospectively** (all comparative amounts and opening balances, where appropriate).

Changes in accounting policy should be appropriately disclosed.

Changes in estimates

Changes are applied **prospectively**, namely current reporting period and future periods (where appropriate).

Changes in estimates should be appropriately disclosed, including the effect of the change on future reporting periods (where appropriate).

Prior period errors

Corrections are made **retrospectively** as if the error was never made.

Restate comparative amounts and opening balances, where appropriate.

Corrections must be appropriately disclosed. Note that only corrections of **prior** period errors are disclosed.

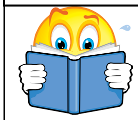
VIDEOS

Watch the video discussing errors and accounting policy.

TOPIC 1.5 – FINANCIAL INSTRUMENTS

INTRODUCTION/ PURPOSE

Financial instruments include a wide variety of instruments, including shares, debentures, receivables, payables and derivative instruments (for example share options and forward exchange contracts). The accounting treatment and disclosure of financial instruments are prescribed in three different standards.



PRESCRIBED STUDY MATERIAL

1. **IAS 32 Financial Instruments: Presentation**
2. **IFRS 9 Financial Instruments**
3. **IFRS 7 Financial Instruments: Disclosure**

SAICA Student Handbook 2022/2023; Volume1; Part A2; pages A1618 to A1674
SAICA Student Handbook 2022/2023; Volume1; Part A1; pages A418 to A626
SAICA Student Handbook 2022/2023; Volume1; Part A1; pages A324 to A384

The above standards were covered as part of your undergraduate studies. It is important that you revise the study material and concepts if you are not familiar with the content.

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Let’s look at the overview of Financial Instruments.

Overview of IAS 32 Financial Instruments: Disclosure and Presentation

Definitions

Financial instruments
Financial assets
Financial liability
Equity instrument

Presentation

Liabilities and equities

No contractual obligation to deliver cash or another financial asset
Settlement in the entity's own equity instrument

- **Variable number of its own equity instruments**
- **Fixed number of its own equity instruments**
- **Contracts (options) on own equity instruments**

Contingent settlement provisions
Compound financial instrument
Treasury shares
Interest, dividends, losses and gains
Offsetting a financial asset and a financial liability

Excluded

The following concepts and topics are excluded from the syllabus:

Definitions

- Purchased or originated credit-impaired financial assets
- All definitions relating to hedge accounting

Presentation

- Puttable instruments and obligations arising on liquidation (par. 16A-16F & 22A)

Overview of IFRS 9 Financial Instruments

Definitions
12-month expected credit losses
Amortised cost
Credit impaired financial asset
Credit loss
Derivative
Effective interest rate
Expected credit losses
Financial liability at FVTPL
Gross carrying amount of financial asset
Held for trading
Loss allowance
Modification gair or loss
Transaction costs

Recognition/Derecognition
Initial recognition
- First-day gains and losses
Derecognition of financial assets
Derecognition of financial liability
- Exchange of debt instrument

Classification
Financial assets
- At amortised cost
- At FVTOCI
- At FVTPL
Financial liabilities
- At FVTPL
Embedded derivatives
Reclassification

Measurement
Initial measurements
Subsequent measurements
- financial assets
- financial liabilities
Amortised cost
- Modifications
- Write offs
Impairments
Recognition of expected credit losses
Identify when significant increase in credit risk or when credit impaired
Modified financial assets
Simplified approach
Measurement of expected credit losses
Reclassification of financial assets
Gains and losses
- Investments in equity instruments
- Liabilities at FVTPL
- Assets at FVTOCI

Excluded
Definitions
• Purchased or originated credit impaired (POCI) financial assets
• All definitions relating to hedge accounting
Initial recognition
• Regular way purchase or sale of financial assets (trade date and settlement date accounting).
Derecognition of financial assets
• Transfers/continued involvement and applying the requirements to a part or a whole
Classification of financial liabilities
• Financial guarantee contracts
• Loan commitments
Embedded derivatives (only pertains to liabilities)
Hybrid instruments where the host is not a financial instrument
Initial measurement
• Regular way purchase or sale of financial assets (trade date and settlement date accounting).
Impairment
• Purchased or originated credit-impaired financial assets
Hedge accounting
Application guidance and Illustrative Examples follow the related levels of the main body in the standard.

EXAMPLES

Complete the following two comprehensive questions.

QUESTION 1 (60 marks/ 90 minutes)

The financial directors of Blue Ltd (Blue) and Pink Ltd (Pink) requested you to explain to them how the following financial instruments should be **classified** in the financial statements of Blue and the financial statements of Pink in terms of IAS 32 *Financial Instruments: Presentation.* All the transactions below occurred during the financial year ended 31 December 20.23.

Transaction 1

On 1 January 20.23 Blue purchased 100 000 shares in Pink. These were acquired at fair value on transaction date.

Transaction 2

On 1 December 20.23 Blue obtained a short-term loan of R20 000 from Pink and is required to **repay** the total loan within 90 days. The loan is still outstanding on 31 December 20.23.

Transaction 3

On 1 December 20.23 Blue obtained a short-term loan of R20 000 from Pink and is required to settle the total loan within 90 days in as many **shares** as equal to R20 000. The loan is still outstanding on 31 December 20.23.

Transaction 4

On 1 December 20.23 Blue issued share options to Pink. The share options entitle Pink to purchase 2 000 ordinary shares in Blue at a price of R2 per share.

Transaction 5

On 31 December 20.23 Blue issued 1 000 redeemable cumulative preference shares to Pink at an issue price of R1 per preference share. The dividend rate is an 8% cumulative preference dividend per annum, calculated on the issue price. All accumulated (unpaid) dividends will roll up until redemption date. The redemption of preference shares will take place on 31 December 20.25 at R1,20 per share.

Transaction 6

On 31 December 20.23 Blue issued 1 000 non-redeemable cumulative preference shares to Pink at an issue price of R1 per preference share. The dividend rate is an 8% cumulative preference dividend per annum, calculated on the issue price. The payment of a preference dividend is solely at the discretion of the directors of Blue.

Transaction 7

On 31 December 20.23 Blue issued 1 000 cumulative compulsory convertible preference shares to Pink at an issue price of R1 per preference share. On 31 December 20.25, the conversion date, each preference share will automatically be converted into two ordinary shares. The dividend rate is an 8% cumulative preference dividend per annum calculated on the issue price. All accumulated (unpaid) dividends will roll up until the conversion date.

Transaction 8

On 1 January 20.23 Blue issued 500 debentures to Pink. Each debenture will be converted into one ordinary share on 1 January 20.25 if the revenue of Blue increases by more than 8% per annum. If the increase in Blue's revenue is less than 8% per annum, the debentures will be redeemed in cash on 1 January 20.25.

Transaction 9

On 1 January 20.23 Blue has 80 000 ordinary shares in issue which were originally issued at R5 each. On 1 July 20.23 10 000 of the ordinary shares were bought back from Pink at R6 per share.

REQUIRED

	Marks
Provide an explanation to the financial directors of Blue Ltd and Pink Ltd of how the above-mentioned financial instruments should be **classified** in their respective financial statements for the year ended 31 December 20.23, in accordance with IAS 32 *Financial instruments: Presentation.* **Please note:** • You are not required to include calculations in your explanation. • Ignore the effect of the time value of money in the scenarios above. • Ignore any normal income tax implications. • Ignore any Value Added Tax (VAT) implications. • Your answer must comply with International Financial Reporting Standards (IFRS).	60

QUESTION 1 - Suggested solution

PART A

Transaction 1

Blue's financial statements (investor):
The investment in shares will be classified as a **financial asset,** since Blue holds the equity instrument of another entity (IAS 32.11). (1)

Pink's financial statements (issuer):
The shares issued will be classified as **equity instruments,** since it is a contract which evidences a residual interest in the assets of Pink after deducting its liabilities (IAS 32.11). (1)

Transaction 2

Blue's financial statements:
A loan payable will be recognised as a **financial liability,** since Blue has a **contractual obligation** to deliver **cash** to Pink within 90 days (IAS 32.11). (1)

Pink's financial statements:
A loan receivable will be recognised as a **financial asset** in the records of Pink, since it represents a **contractual right** to receive **cash** from Blue (IAS 32.11). (1)

Transaction 3

Blue's financial statements:
In terms of the agreement, Blue has **no contractual obligation** to deliver **cash** or another **financial asset** to settle the loan. (1)
Blue is, however, required to settle the loan with its **own shares (equity instruments)**. It is important to note that the fact that Blue is required to deliver its own equity instruments **does not automatically** classify the loan as an equity instrument (IAS 32.21). (1)
It is essential to determine the **substance of the contract**. In other words, is the number of shares to be issued by Blue in terms of the contract fixed or variable (IAS 32.21). (1)
The amount that Blue needs to settle remains fixed at R20 000. However, the number of shares that Blue will need to deliver to settle the loan **varies** (the number of shares issued on delivery date is dependent on the share price of the ordinary shares). (1)
The contract will, therefore, be settled by delivering a **variable number** of Blue's own shares in exchange for a fixed amount. Accordingly, the loan payable is a **financial liability** (IAS 32.11). (1)

Pink's financial statements:
A loan receivable will be recognised as a **financial asset,** since it meets the definition of a financial asset (Pink receives an equity instrument from another entity) (IAS 32.11). (1)

Transaction 4

Blue's financial statements (issuer):
Blue has **no contractual obligation** in terms of the option contract to deliver **cash** or another **financial asset** to Pink. (1)
The issued share options, however, give Pink the right to buy a **fixed number** of Blue's shares (2 000 ordinary shares) at a **fixed price** (R2 per ordinary share) (IAS 32.16 and IAS 32.22). (1)
Accordingly, the share options issued by Blue are **equity instruments** in accordance with IAS 32.22. (1)

Pink's financial statements (holder):
The share options meet the definition of a **derivative** (IAS 32.AG15 and IFRS 9 Appendix A) from Pink's perspective. (1)
The investment in the shares will only be recognised as a financial asset of Pink when the share options are exercised (IAS 32.AG17). (1)

Transaction 5

Blue's financial statements (issuer):
Blue should consider the **two cash flow streams** (components) related to preferences shares (i.e., the payment of preference **dividends** and the payment of the **principal** amount) separately for classification purposes. (1)

Principal amount
When assessing the substance of the agreement between Blue and Pink, it is clear that Blue has a **contractual obligation** to deliver **cash to Pink** on 31 December 20.25 (the preference share agreement contains a **mandatory** redemption feature) (IAS 32.18(a)). (1)
The principal amount is classified as a **financial liability**. (1)

Dividends
It has to be determined if Blue has a **contractual obligation** to make dividend payments to assess if the dividend component of this agreement is equity or a financial liability. (1)
Cumulative dividends accumulate (accrue) if the company does not earn sufficient profits to declare and pay a preference dividend i.e., if the dividend is not declared in one year it will be carried forward to successive years. (1)
Since this preference share agreement contains a **redemption feature**, all accumulated (unpaid) dividends will roll up until redemption date and will have to be paid on 31 December 20.25 when the preference shares are redeemed. (1)
Therefore, based on the substance of this transaction, Blue has a **contractual obligation** to declare and pay all preference dividends on or before 31 December 20.25. (1)
In light of the above the preference dividends are classified as a **financial liability**. (1)

Conclusion
The preference shares are classified as a financial liability (IAS 32.11 and IAS 32.18a). (1)
Take note that the dividends paid to Pink will be recognised in profit or loss as finance costs since the classification of the financial instrument determines how the related payment will be treated in the financial statements. (1)

Pink's financial statements (holder)
The investment in the preference shares will be classified as a **financial asset** in the records of Pink. (1)

Transaction 6

Blue's financial statements (issuer):
As with the above transaction, if we evaluate the **two cash flow streams** related to preferences shares, we can conclude the following: (1)

Principal amount
Non-redeemable preference shares are preference shares that do not have a maturity date and will, therefore, **not be bought back** by the issuer (Blue) (also known as perpetual preference shares). (1) This feature makes non-redeemable preference shares very similar to **equity**. (1)

Dividends
The cumulative dividends accumulate (accrue) if the company does not earn sufficient profits to declare and pay a preference dividend. (1)
Since the non-redeemable preference shares do not contain a redemption obligation and the payment of preference dividends are at the directors' discretion, the preference shares establish **no contractual right** to a preference dividend (IAS 32.AG26). (1)
Accordingly, the preference dividends are similar to ordinary dividends (equity). (1)

Conclusion
Accordingly, the preference shares should be classified as equity instruments. (1)

Pink's financial statements (holder):
The investment in the preference shares will be classified as a **financial asset** in the records of Pink, since it is an equity instrument of another entity. (1)

Transaction 7

Blue's financial statements (issuer):
The **two cash flow streams (components)** related to preferences shares (i.e., the payment of preference **dividends** and the payment of the **principal** amount) are considered separately for classification as equity or a financial liability (IAS 32.28). (1)

Principal amount
The substance of this agreement between Blue and Pink contains a **compulsory conversion feature** that will force Blue to convert the preference shares into ordinary shares on 31 December 20.25. (1)
Therefore, in terms of the agreement, Blue has **no contractual obligation** to deliver **cash** or a **financial asset** to Pink on the conversion date. (1)
Blue is, however, required deliver its **own shares (equity instruments) to Pink on the conversion date**. (1)
The substance of the contract determines that Blue has to deliver a **fixed number** of ordinary shares to Pink on the conversion date (20 000 ordinary shares). (1)
In light of the above, the principal amount is classified as an **equity instrument**. (1)

Dividends

It has to be determined if Blue has a **contractual obligation** to make dividend payments to assess if the dividend component of this agreement is equity or a financial liability. (1)

Since this preference share agreement contains a **compulsory conversion feature**, all accumulated (unpaid) dividends will roll up until conversion date and will have to be paid on 31 December 20.25 when the preference shares are converted. (1)

Therefore, based on the substance of this transaction, Blue has a **contractual obligation** to declare and pay all preference dividends on or before 31 December 20.25. (1)

In light of the above, the preference dividends are classified as a **financial liability**. (1)

Conclusion

The preference shares are classified as a **compound financial instrument** as it contains both an equity and a liability component (IAS 32.28). (1)

This would lead to a "split accounting" treatment, whereby at issue date the net present value of the amount payable to Pink will be classified as a liability and the balance of the proceeds received on issue date will be classified as equity (IAS 32.32). (1)

Pink's financial statements (holder)

The investment in the preference shares will be classified as a **financial asset** in the records of Pink, since it is a contractual right to receive cash or another financial asset. (1)

DISCUSSION

If the convertible preference shares are not compulsory convertible, but convertible at the **option of the holder** at any time up to maturity, the preference shares will still be classified as a **compound financial instrument** for the following reasons:

- Blue has a contractual obligation to declare and pay all accumulated preference **dividends** when Pink exercises its option to convert to ordinary shares (financial liability component).
- If Pink does not exercise its option to convert to ordinary shares, Blue will have to **redeem** the preference shares on 31 December 20.25 (financial liability component).
- Pink has a call option (the right to exchange the preference shares for a **fixed number of ordinary shares**) at any time before maturity date (equity component).

Transaction 8

Blue's financial statements (issuer):

The obligation attached to the debentures (settling in cash or by issuing equity instruments) is dependent on the **occurrence or non-occurrence** of uncertain future events. (1)

It has to be determined if the uncertain future event (the rise in future revenue) is within the **control** of Blue and Pink. (1)

In terms of IAS 32.25 the issuer's future revenues are **not within the control** of the **issuer** and the **holder**. (1)

In light of this, Blue does not have an unconditional right to avoid delivering cash on the maturity date. (1)

Therefore, the debentures are classified as a **financial liability** in terms of the contingent settlement provisions of IAS 32.25. (1)

Pink's financial statements (holder):

The investment in the debentures will be classified as a **financial asset** in the records of Pink, (1)

since Pink has a contractual right to receive cash. (1)

Transaction 9

Blue's financial statements:

Blue reacquired its own equity instruments and should classify them as treasury shares (IAS 32.33). (1)

In terms of South African legislation, the shares reacquired by Blue must be cancelled as issued share capital. (1)

An amount equal to the **initial** proceeds of the shares (10 000 x R5 = R50 000) is debited to the share capital account in Blue's financial statements. (1) (1)

No gain or loss is recognised in profit or loss on the share buy-back.

The remaining R10 000 (R60 000 – R50 000) is debited to any available equity reserve in Blue's financial statements (including retained earnings) (IAS 32.33). (1)

Pink's financial statements:

Before the share buy-back, the investment in equity instruments is classified by Pink as a financial asset. The share buy-back transaction is accounted for as a disposal of a financial asset by Pink. (1)

Total (60)

QUESTION 2 (75 marks/ 113 minutes)

During the year ended 28 February 20.23 Fincor Ltd entered into the following transactions:

Transaction 1

On 1 March 20.22 the company acquired an investment in Bamboo Ltd, a listed company, for share trading purposes. On this date 25 000 ordinary shares were acquired at R12,00 per share. Transaction costs paid by Fincor Ltd amounted to R1 200. The transaction costs are included in the base cost of the shares in terms of the Eighth Schedule to the Income Tax Act. On 28 February 20.23 the market value of the shares was R23,25 per share.

Transaction 2

On 30 June 20.22 Fincor Ltd purchased 15 000 ordinary shares in Brick (Pty) Ltd, an unlisted company, at R12,00 per share. The shares were purchased as a long-term investment. Costs associated with the transaction amounted to R1 800 and are included in the base cost of the shares in terms of the Eighth Schedule to the Income Tax Act. On 28 February 20.23 the shares were valued by the directors at R13,50 per share.

The management of Fincor (Ltd) irrevocably elected in terms of IFRS 9.5.7.5 to present subsequent changes in the fair value of the investment in Brick (Pty) Ltd in other comprehensive income.

Transaction 3

On 1 August 20.22 Fincor Ltd disposed of an investment in Dodgeball Ltd at a fair value of R160 000. The costs related to the disposal of the investment amounted to R1 500. The investment in Dodgeball Ltd was an investment in equity shares and was not held for share trading purposes. The management of Fincor Ltd irrevocably elected on initial recognition to designate this investment as a financial asset at fair value through other comprehensive income in terms of IFRS 9.5.7.5. The carrying amount of the investment in Dodgeball was R150 000 on 1 March 20.22.

Transaction 4

Convertible debentures amounting to a fair value of R250 000 were issued by Fincor Ltd on 1 March 20.22. The debentures have a nominal value of R2 per debenture and pay interest at 14% per annum in arrears on 28 February until conversion. The debentures are convertible into ordinary shares with a nominal value of R2 each, at a ratio of one share for one debenture, at the option of the debenture holders at any time before 28 February 20.27. The market interest rate for similar instruments without conversion rights is 16%.

Transaction 5

On 1 September 20.22 Fincor Ltd issued 5 000 compulsory convertible debentures with a face value of R80 per bond. The debentures are compulsory convertible on 1 September 20.25 into two ordinary shares for every debenture held. A market related interest rate of 6% on the debentures is payable annually in arrears. The market interest rate for similar instruments without conversion rights is 8%.

Transaction 6

On 1 March 20.22 Fincor Ltd purchased bonds in Pear Ltd at a discount of 10% of the face value when market interest rates on similar instruments were 16,3493% per annum. The total face value of the investment in bonds is R200 000. A coupon rate of 12% per annum is payable in arrears on 30 August and 28 February. The bonds will be repaid on 28 February 20.25 at face value. Transaction costs paid by Fincor Ltd amounted to R2 000. The investment in bonds is held within a business model with the objective to collect contractual cash flows of interest and principal.

On 1 March 20.22 Fincor Ltd assessed the probability that Pear Ltd might default on payments and estimated the 12-month expected credit losses on the bonds to be R2 000. On 28 February 20.23 there was no significant deterioration in the credit quality of Pear Ltd and the 12-month expected credit losses on the bonds were estimated to be R2 500.

Transaction 7

On 1 March 20.22 Fincor Ltd purchased bonds in Apple Ltd at a discount of 10% of the face value when market interest rates on similar instruments were 16,3493% per annum. The total face value of the investment in bonds is R200 000. A coupon rate of 12% per annum is payable in arrears on 30 August and 28 February. The bonds will be repaid on 28 February 20.25 at face value. Transaction costs paid by Fincor Ltd amounted to R2 000. The investment in bonds is held within a business model whose objective is to collect contractual cash flows and sell the bonds. In other words, both collecting contractual cash flows and selling the debentures are integral to achieving the business model.

On 1 March 20.22 Fincor Ltd assessed the probability that Apple Ltd might default on payments and estimated the 12-month expected credit losses on the bonds to be R 2 000. At 28 February 20.23 there was no significant deterioration in the credit quality of Apple Ltd and the 12-month expected credit losses on the bonds were estimated to be R 2 500. The total investment in bonds was sold at 28 February 20.23 for cash at its fair value of R180 000.

Transaction 8

On 1 March 20.22 Fincor Ltd acquired an investment in listed bonds of Tradex Ltd. Fincor Ltd's objective with the investment was to hold the assets in terms of a business model to collect contractual cash flows of interest and principal. The bonds will mature at the end of four years when the principal amount of R1 000 000 will be received. The coupon rate is 10% per annum payable in arrears, whereas a market related interest rate on similar bonds is 11% per annum.

On 1 March 20.22 Fincor Ltd assessed the probability that Tradex Ltd might default on payments and estimated the 12-month expected credit losses on the bonds to be R2 000. At 28 February 20.23 there has been no significant deterioration in the credit quality of Tradex Ltd and the 12-month expected credit losses on the bonds is estimated to be R2 500 on reporting date.

On 1 September 20.22 Fincor Ltd purchased a large investment banking operation. As a result of the purchase, Fincor Ltd combined its debt investment with the new banking investment portfolio. The investment banking portfolio has the objective of collecting contractual cash flows and realising fair value gains through sale, which is also now the business model of the debt investment portfolio held by Fincor Ltd. In other words, both collecting contractual cash flows and selling the bonds are integral to achieving the business model.

Transaction 9

Fincor Ltd has a portfolio of trade receivables of R5 430 000 at 28 February 20.23 and only operates in one geographical region. The trade receivables do not have a significant financing component in accordance with IFRS 15 *Revenue from Contracts with Customers*. To determine the expected credit losses for the trade receivables, Fincor Ltd uses a provision matrix. The provision matrix is based on its historical observed default rates over the expected life of the trade receivables and is adjusted for forward-looking estimates. Fincor Ltd uses the following provision matrix:

	Current	**1-30 days past due**	**31-60 days past due**	**61-90 days past due**	**More than 90 days past due**
Default rate	0,3%	1,1%	3,1%	6%	13%

The age analysis of the trade receivables is as follows:

	Gross carrying amount R
Current	4 072 500
1-30 days past due	543 000
31-60 days past due	362 000
61-90 days past due	271 500
More than 90 days past due	181 000
Total	**5 430 000**

Transaction 10

Fincor Ltd borrowed R98 500 cash from Blair Bank Ltd on 1 March 20.22. The loan is repayable in four equal instalments of R33 475 at the end of each year.

On 28 February 20.23, after paying the first instalment, Fincor Ltd was able to renegotiate the terms of the loan payable in order to improve its cash position for the next three years. Fincor Ltd issued 10 000 of its own ordinary shares as full and final settlement of the loan payable. The quoted price (level 1 input) of one Fincor Ltd share on 28 February 20.23 amounted to R8,00.

Additional information

1. Assume a normal tax rate of 27% and a capital gains tax inclusion rate of 80%.

2. SARS will not allow impairment losses (expected credit losses) on the bonds as a deduction for income purposes.

3. There are no temporary differences other than those evident from the above-mentioned information. The deferred tax balance on 1 March 20.22 was Rnil.

4. You may assume that none of the financial assets or financial liabilities (other than those indicated as such) was designated to a specific category.

REQUIRED

		Marks
(a)	Provide all the journal entries in the records of Fincor Ltd since acquisition or issue date of the financial instrument until 28 February 20.23 for **transactions 1 to 8**. **Please note:** • Journal narrations are not required. • Ignore any normal income tax implications. • Round off all amounts to the nearest rand. • Round off all calculated effective interest rates to four decimals. • Your answer must comply with International Financial Reporting Standards (IFRS).	61
(b)	Provide the journal entries in the records of Fincor Ltd to account for the loss allowance on the trade receivables (**transaction 9**) for the year ended 28 February 20.23 and the settlement of the loan from Blair Bank Ltd (**transaction 10**) on 28 February 20.23.	9
(c)	Calculate the deferred tax balance on 28 February 20.23 of **transactions 1 to 3**.	5
Please note: • Round off all amounts to the nearest rand. • Ignore any Value Added Taxation (VAT) implications. • Your answer must comply with International Financial Reporting Standards (IFRS).		

QUESTION 2 - Suggested solution

(a) JOURNAL ENTRIES

TRANSACTION 1

		Dr R	Cr R	
	1 March 20.22			
J1	Financial asset at fair value through P/L (SFP)			
	(25 000 x R12,00)	300 000		(1½)
	Transaction costs (P/L)	1 200		(½)
	Bank (SFP)		301 200	(½)
	Recognise investment and expense transaction costs			
	28 February 20.23			
J2	Financial asset at fair value through P/L (SFP)			
	[(25 000 x R23,25) – 300 000]	281 250		(1½)
	Fair value adjustment (P/L)		281 250	(½)
	Remeasure investment to fair value at year end			
				(4½)

DISCUSSION

This investment in equity instruments is classified as a financial asset at fair value through P/L. The purpose for the acquisition (i.e., trading or long term) does not impact on the **classification** of the financial asset in terms of IFRS 9 (it does, however, have an impact on the tax rate applied for deferred tax purposes). Take note **transaction costs** are **expensed** and not included in the carrying amount of the investment in terms of IFRS 9.5.1.1.

TRANSACTION 2

		Dr R	Cr R	
	30 June 20.22			
J1	Financial asset at fair value through OCI (SFP)	181 800		(½)
	Bank (SFP) [(15 000 x 12,00) + 1 800] (SFP)		181 800	(1½)
	Recognise investment and capitalise transaction costs			
	28 February 20.23			
J2	Financial asset at fair value through OCI (SFP)			
	[(15 000 x 13,50) – 181 800]	20 700		(1½)
	Mark-to-market reserve **(OCI)**		20 700	(½)
	Remeasure investment to fair value at year end			
				(4)

DISCUSSION

This investment is classified as a financial asset at fair value through **OCI,** since the management of Fincor (Ltd) made the **election** in terms of IFRS 9.5.7.5. Take note that management may only make this election if the investment is in an **equity instrument** and if it is **not held for trading.**

TRANSACTION 3

		Dr R	Cr R	
	1 August 20.22			
J1	Financial asset at fair value through OCI (SFP) (160 000 – 150 000)	10 000		(1)
	Mark-to-market reserve (OCI)		10 000	(½)
	Remeasurement of investment to fair value on date of sale			
J2	Bank (SFP) (160 000 – 1 500)	158 500		(1)
	Selling expenses (P/L)	1 500		(1)
	Financial asset at fair value through OCI (SFP)		160 000	(½)
	Sale of investment in Dodgeball			
				(4)

DISCUSSION

The investment is revalued to its new fair value on the selling date **(prior to derecognition)**. The fair value gains/losses on the investment in Dodgeball are recognised in other comprehensive income, but the **selling expenses** are recognised in profit or loss. The cumulative fair value gains/losses presented in OCI through the mark-to market reserve **may** not be transferred to profit/loss on selling date (IFRS 9 B5.7.1). However, Fincor may transfer the cumulative fair value gains/losses within **equity** (to retained earnings for instance) (IFRS 9 B5.7.1).

TRANSACTION 4

		Dr R	Cr R	
	1 March 20.22			
J1	Bank (SFP)	250 000		(½)
	Liability component of convertible debentures (SFP) [C1]		233 629	(2)
	Equity component of convertible debentures (SCE) [C1]		16 371	(½)
	Recognise the convertible debentures issued			
	28 February 20.23			
J2	Finance costs (P/L) [C1]	37 381		(1)
	Bank (SFP)		35 000	(½)
	Liability component of convertible debentures (SFP) [C1]		2 381	(½)
	Recognise effective interest and interest paid			

(5)

CALCULATIONS

C1. Convertible debentures

Calculation of present value of liability component

N	=	5	[½]
I	=	16% (market interest rate)	[½]
PMT	=	35 000 (250 000 x 14%) (coupon rate)	[½]
FV	=	250 000	[½]
PV	=	233 629	

Financial liability (PV of **interest** and **principal amount**)	233 629	
Equity component (balancing figure)	16 371	[½]
Proceeds of the debenture issue	250 000	

Amortisation table

	Opening balance R	Effective interest fixed at 16% R	Interest coupon R	Closing balance (gross carrying amount) R	
Year ended 28 February 20.23	233 629	37 381	(35 000)	236 010	[1½]
					[4]

Effective interest can also be calculated with “1 amort” on the HP or SHARP calculator.

DISCUSSION

- From Fincor’s perspective the convertible debentures represent a **compound instrument** and comprise two components: a **financial liability** (a contractual obligation to deliver cash in the form of interest and principal) and an **equity instrument** (option granting the holder the right to convert the debentures into a **fixed** number of ordinary shares of Fincor).
- The financial liability component of the convertible debentures is measured at **amortised cost** using the effective interest rate method in terms of IFRS 9.
- It should be noted that it is **not** important **which party has the option** to convert the debentures into ordinary shares. The issuer’s obligation to make payments of **interest** and **principal** exists as long as the instrument is not converted (irrespective of which party holds the option to convert).

		Dr R	Cr R	
	TRANSACTION 5			
	1 September 20.22			
J1	Bank (SFP) (5 000 x R80)	400 000		(½)
	Liability component of convertible debentures (SFP) [C1]		61 850	(2½)
	Equity component of convertible debentures (SCE) [C1]		338 150	(1)
	Recognise the convertible debentures issued			
	28 February 20.23			
J2	Finance costs (P/L) [C2]	2 474		(1)
	Liability component of convertible debentures (SFP) (balancing)		2 474	(½)
	Recognise effective interest accrued for 20.23			
				(5½)

CALLCULATIONS

C1. Compulsory convertible debentures

Calculation of present value of liability component

N	=	3	[½]
I	=	8% (market interest rate)	[½]
PMT	=	24 000 (400 000 x 6%) (coupon rate)	[½]
FV	=	0	[½]
PV	=	61 850	
			[2]

Financial liability (PV of **interest**)	61 850	
Equity component (balancing figure)	338 150	[1]
Proceeds on the debenture issue (5 000 x R80)	400 000	

DISCUSSION

- The substance of this agreement is a **compulsory conversion feature** that will force Fincor to convert the convertible debentures into ordinary shares on 1 September 20.25. Therefore, Fincor has **no contractual obligation** to deliver **cash** or a **financial asset** to debenture holders on conversion date.
- Fincor is, however, required to deliver its **own shares (equity instruments)** to debenture holders on conversion date. The substance of the contract determines that Fincor has to deliver a **fixed number** of ordinary shares to debenture holders on conversion date. Accordingly, the principal amount contains an **equity instrument**.
- Fincor has a **contractual obligation** to make interest payments up until the conversion date of the bonds. The future interest payments are a **financial liability**.
- In light of the above, the convertible debentures are classified as a compound financial instrument.
- **Please take note that since the conversion of the debentures into shares is compulsory, the liability component of the compound financial instrument is only represented by the future interest payments.**

C2. Accrued interest on debentures

Effective interest (61 850 x 8% x 6/12)	2 474	[2]

		Dr R	Cr R	
	TRANSACTION 6			
	1 March 20.22			
J1	Financial asset at amortised cost: bonds (SFP) (180 000 [C1] + 2 000)	182 000		(3)
	Bank (SFP)		182 000	(½)
	Recognise investment and capitalise transaction costs			
J2	Impairment loss (P/L)	2 000		(1)
	Allowance for expected credit losses (SFP)(given)		2 000	(½)
	Recognition of 12-month expected credit loss			
	30 August 20.22			
J3	Bank (SFP) [C2]	12 000		(1)
	Financial asset at amortised cost: bonds (SFP) (balancing)	2 457		(½)
	Interest income (P/L) [C2]		14 457	(1)
	Recognise effective interest income and coupon interest received			
	28 February 20.23			
J4	Bank (SFP) [C2]	12 000		(1)
	Financial asset at amortised cost: bonds (SFP) (balancing)	2 652		(½)
	Interest income (P/L) [C2]		14 652	(1)
	Recognise effective interest income and coupon interest received			
J5	Impairment loss (P/L)	500		(1)
	Allowance for expected credit losses (SFP) (2 500 (given) – 2 000 [J2])		500	(1)
	Adjust allowance for expected credit losses			
				(12)

CALCULATIONS

C1. Present value of financial asset at amortised cost: bonds

N	=	6	[½]
I	=	16,3493% per annum (set HP on 2 P/Y; SHARP = 16,3493/2 = 8,1747)	[½]
PMT	=	12 000 (200 000 x 12% x 6/12)	[½]
FV	=	200 000	[½]
PV	=	-180 000	
			[2]

DISCUSSION

- The present value of the investment in bonds is R180 000, which is equal to the amount paid by Fincor Ltd (R200 000 x 90%).
- The credit risk on the bonds did not increase significantly since initial recognition and, therefore, an allowance for expected credit losses equal to 12-month expected credit losses is recognised at the reporting date (28 February 20.23).

C2. Effective interest rate on financial at amortised cost: bonds after transaction costs were capitalised

N	=	6	
PV	=	-182 000 (180 000 + 2 000)	[½]
PMT	=	12 000 (200 000 x 12% x 6/12)	
FV	=	200 000	
I	=	15,8870% per annum (HP) (SHARP 7.94% for 6 months)	[½]

Amortisation table for financial asset at amortised cost: bonds

	Gross carrying amount Opening balance R	Effective interest fixed at 15,8870 % p.a. R	Interest coupon R	Gross carrying amount Closing balance R
Six months ended 30 August 20.22	182 000	14 457	(12 000)	184 457
Six months ended 28 February 20.23	184 457	14 652	(12 000)	187 109

EXAM TECHNIQUE

The effective interest is 15,8870% per annum. The effective interest rate for six months is 7,9435% (15,8870% x 6/12). The effective interest income can be calculated on the **gross carrying** amount for the six months ended 30 August 20.22 as follows:

- 182 000 x 15,8870% x 6/12 = 14 457;
- 182 000 x 7,9435% = 14 457; or
- using the Amort function.

To save time in the exam or test situation, the student can indicate the calculation of interest as per the calculations indicated above, instead of writing out an amortisation schedule which can be time consuming.

		Dr R	Cr R	
	TRANSACTION 7			
	1 March 20.22			
J1	Financial asset at fair value through OCI: bonds (SFP) (200 000 x 90%) + 2 000 (given))	182 000		(3)
	Bank (SFP)		182 000	(½)
	Recognise investment and capitalise transaction costs			
J2	Expected credit losses (P/L)	2 000		(1)
	Expected credit loss reserve (OCI)		2 000[1]	(½)
	Recognition of 12-month expected credit loss			
	30 August 20.22			
J3	Bank (SFP) (200 000 x 0,12 x 6/12)	12 000		(1)
	Financial asset at fair value through OCI: bonds (SFP) (balancing)	2 457		(½)
	Interest income (P/L) [C2 transaction 6]		14 457	(1)
	Recognise effective interest income and coupon interest received			

		Dr R	Cr R	
	28 February 20.23			
J4	Bank (SFP) [C2]	12 000		(1)
	Financial asset at fair value through OCI: bonds (balancing) (SFP)	2 652		(½)
	Interest income (P/L) [C2 transaction 6]		14 652	(1)
	Recognise effective interest income and coupon interest received			
J5	Expected credit losses (P/L) (2 500 – 2 000)	500		(1)
	Expected credit loss reserve (OCI) (2 500 – 2 000)		500	(½)
	Adjusting of 12-month expected credit loss			
J6	Fair value loss (OCI)	7 109[2]		(1)
	Financial asset at fair value through OCI: bonds (SFP) ((182 000 + 2 457 + 2 652) – 180 000 (given))		7 109	(1)
	Recognition of fair value loss on investment			
J7	Bank (SFP)	180 000		(1)
	Financial asset at fair value through OCI: bonds (SFP)		180 000	(1)
	Disposal of investment in bonds			
J8	Fair value loss (P/L) [J6]	7 109		(1)
	Fair value loss (OCI)		7 109	(1)
	Reclassify fair value loss accumulated in equity to profit or loss			
J9	Expected credit loss reserve (OCI)	2 500		
	Expected credit losses (P/L) (2 000 [J2] + 500 [J5])		2 500	
	Reclassify accumulated impairment amounts in equity to profit or loss on derecognition			
				(17½)

DISCUSSION

[1] An expected credit loss reserve is recognised in other comprehensive income when those expected credit losses relate to a financial asset **mandatorily** measured at fair value through other comprehensive income (IFRS 9.4.1.2.A).

[2] The cumulative fair value gain or loss and the expected credit loss reserve recognised in equity via other comprehensive income are reclassified to profit or loss when the financial asset is derecognised.

[3] The **effective interest income** recognised in 20.23 is calculated using the **original** effective interest on the **gross carrying amount** of the bonds. The gross carrying amount is the amortised cost of a financial asset, **before** adjusting for any **loss allowance**.

		Dr R	Cr R	
	TRANSACTION 8			
	1 March 20.22			
J1	Financial asset at amortised cost (SFP)	968 976		(2)
	Bank (SFP)		968 976	(½)
	(FV = 1 000 000; N = 4; I = 11%; PMT 100 000)			
	Initial recognition of investment at fair value (PV)			
J2	Impairment loss (P/L)	2 000		(1)
	Allowance for expected credit losses (SFP)(given)		2 000	(½)
	Recognition of 12-month expected credit loss			
	28 February 20.23			
J3	Bank (SFP) (1 000 000 x 10%)	100 000		(1)
	Financial asset at amortised cost (SFP)(balancing)	6 587		(1)
	Interest income (P/L) (968 976 [J1] x 11%)		106 587	(1)
	Recognition of effective interest income and coupon interest [J1]			
J4	Expected credit losses (P/L)	500		(1)
	Allowance for expected credit losses (SFP)			
	(2 500 (given) – 2 000 [J2])		500	(½)
	Recognition of 12-month expected credit loss			
				(8½)

DISCUSSION

The change in Fincor's business model will result in the reclassification of the investment at amortised cost to fair value through other comprehensive income. The reclassification will only be effected for accounting purposes on the **reclassification date,** i.e., the first day of the reporting period after the change in the business model occurred (in this case 1 March 20.23). Accordingly, the investment in Tradex will not be reclassified during 20.23. The reclassification will be done on 1 March 20.23 and the journal will be as follows:

	Dr R	Cr R
Financial asset at fair value through OCI (SFP)	975 563	
Financial asset at amortised cost (SFP)		975 563
(968 976 (J1) + 6 587 (J2))		

Immediately after reclassification the investment is adjusted to the fair value of the investment on the reclassification date. Say the fair value of the investment on 1 March 20.23 was R980 000:

	Dr R	Cr R
Investment Tradex at fair value through OCI (SFP)	4 437	
Fair value adjustment (OCI) (980 000 – 975 563)		4 437
Allowance for expected credit losses (SFP)	2 500	
Expected credit loss reserve (OCI)		2 500

When a financial asset is reclassified out of the amortised cost measurement category and into fair value through other comprehensive income measurement category, the allowance for expected credit losses recognised in the statement of financial position should be derecognised and recognised as an accumulated impairment in other comprehensive income (IFRS 9.B5.6.1(b)).

(b) JOURNAL ENTRIES

Transaction 9

		Dr R	Cr R	
	28 February 20.23			
J1	Expected credit loss (P/L) [C1]	69 233		(3)
	Loss allowance on trade receivables (SFP)		69 233	(½)
	Recognition of lifetime expected credit losses			
				(3½)

DISCUSSION

In accordance with IFRS 9.5.5.15, the loss allowance for trade receivables is always measured at an amount equal to the lifetime expected credit losses. A provision matrix can be used to determine the amount of lifetime expected credit losses on trade receivables.

CALCULATIONS

C1. Loss allowance on trade receivables

Provision matrix

	Gross carrying amount **R**	**Default rate**	**Lifetime expected credit loss allowance** **R**	
Current	4 072 500	0,3%	12 218	[½]
1-30 days past due	543 000	1,1%	5 973	[½]
31-60 days past due	362 000	3,1%	11 222	[½]
61-90 days past due	271 500	6%	16 290	[½]
More than 90 days past due	181 000	13%	23 530	[½]
Total	**5 430 000**		**69 233**	[2½]

Transaction 10

		Dr R	Cr R	
	28 February 20.23			
J1	Financial liability at amortised cost (SFP) [C2]	78 344		(3½)
	Loss from derecognition of loan payable (P/L) (balancing)	1 656		(1)
	Ordinary share capital (SCE) (10 000 x R8,00)			
	Derecognition of loan payable		80 000	(1)
				(5½)

C2. Settlement with equity instruments
Effective interest rate

N	=	4 years	[½]
PV	=	(98 500)	[½]
PMT	=	33 475	[½]
FV	=	0	[½]
I	=	13,522%	

Amortisation table of loan

Date	Opening balance R	Effective Interest fixed at 13,522% R	Interest R	Closing balance R	
31 December 20.23	98 500	13,319	(33 475)	78,344	[1]
					[3]

DISCUSSION

The issue of an entity's equity instruments to a credit to extinguish all or part of a financial liability is seen as consideration paid. Fincor Ltd will remove the loan payable from its statement of financial position, since the shares were issued as full and final settlement of the loan payable (IFRIC 19).

(c) Deferred tax

	Carrying amount R	Tax base R	Notes	Temporary differences at 100% or 80% R	Deferred tax asset/ (liability) R	
Investment in Bamboo (transaction 1) (25 000 x 23,25); (25 000 x 12,00) + 1 200	581 250	301 200	1	280 050	(75 614)	(2)
Investment in Brick (at 80%) (transaction 2) (15 000 x 13,50); (15 000 x 12) + 1 800	202 500	181 800	2	(16 560)	(4 471)	(2)
Investment in Dodgeball (transaction 3)	-	-		-	-	(1)
						(5)

DISCUSSION

1. Tax base of an asset: Amounts deductible in the future. Take note that 100% of the temporary differences are included in the deferred tax calculation, since the investment is of a speculative nature.

2. Tax base of an asset: Amounts deductible in the future. If the investment is disposed of in the future it will result in capital gains tax. The amount that will be deductible from the proceeds is the tax base of the investment (cost of the investment plus transaction costs). Take note that the capital gains tax inclusion rate of 80% is applied to the deferred tax calculation, as the investment is of a capital nature since it is held for long-term purposes.

TOPIC 1.6 - THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

INTRODUCTION

The key issues in accounting for the effects of changes in foreign exchange rates are to determine the appropriate exchange rate to be used for the initial and subsequent recognition of foreign currency transactions in the functional currency of the reporting entity, and how to recognise exchange differences that arise on these transactions.

In this learning unit we will focus on foreign currency transactions only. The translation of foreign operations will be dealt with in Learning unit 5.

PRESCRIBED STUDY MATERIAL

IAS 21 The Effects of Changes in Foreign Exchange Rates

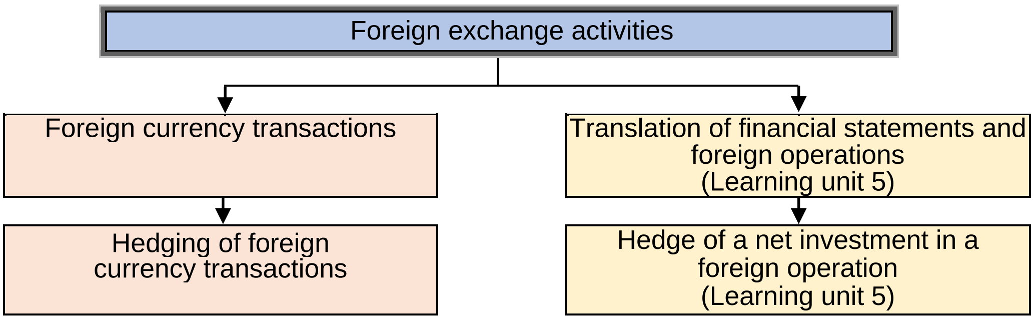
SAICA Student Handbook 2022/2023; Volume1; Part A1; pages A1488 to A1507

IAS 21 was covered as part of your undergraduate studies. It is important that you revise the study material and concepts if you are not familiar with the content.

Also note that Unisa follows the limited open-book policy as prescribed by SAICA and that you will be allowed to use the SAICA Student Handbook during assessments.

Let’s look at the overview of IAS 21 The Effects of Changes in Foreign Exchange Rates.

Overview of IAS 21 The Effects of Changes in Foreign Exchange Rates



The following concepts and topics in IAS 21 are **excluded** from the syllabus:

- Hyperinflation
- Changes in functional currency

EXAMPLE

Complete the following question.

QUESTION 1 (20 marks/ 30 minutes)

On 1 September 20.21 Ebenezer Ltd placed a cancellable order amounting to $120 000 to purchase inventory from a supplier in the USA. The inventory was shipped free on board, at the agreed port of departure. The inventory was delivered to the Port Newark-Elizabeth Marine Terminal, New Jersey, which is the agreed port of departure, on 28 September 20.21. The inventory was loaded on the ship on 28 September 20.21, but the ship only departed to South Africa on 10 October 20.21. Ebenezer obtained control of the inventory on 28 September 20.21.

The debt was payable as follows:

	$
1 December 20.21	72 000
15 January 20.22	48 000
	120 000

By 31 December 20.21 30% of the inventory was sold on credit, while the other 70% was sold during the year ended 31 December 20.22 for cash. Ebenezer Ltd had no closing inventory on 31 December 20.20 and 31 December 20.22.

The applicable exchange rates were as follows:

	$1 = R
1 September 20.21	7,70
28 September 20.21	7,78
10 October 20.21	7,74
15 November 20.21	7,71
1 December 20.21	7,80
31 December 20.21	7,72
15 January 20.22	7,85

Additional information

1. Profit before tax, before taking the acquisition of the inventory into account, for the years ended 31 December 20.21 and 31 December 20.22, amounted to R1 250 000 and R1 900 000, respectively. The revenue on the sale of the inventory has been correctly recorded.

2. It is the company's policy not to hedge its foreign currency exposure on foreign currency transactions due to the fact that these transactions take place on an ad hoc basis. As a result, Ebenezer Ltd did not take out a forward exchange contract (FEC) to hedge its foreign currency risk on the future payment of the foreign creditor.

3. Assume the time value of money relating to the foreign creditor is not material.

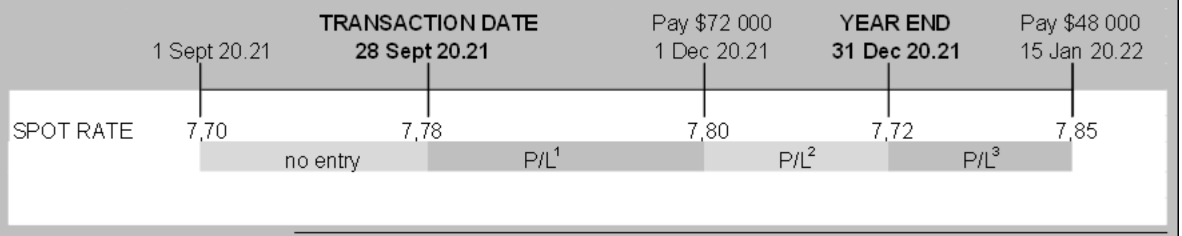
REQUIRED

		Marks
(a)	Prepare the journal entries in respect of the above transaction for the years ended 31 December 20.21 and 31 December 20.22.	17
(b)	Prepare the profit before tax note to the financial statements for the year ended 31 December 20.22 in respect of the above transaction.	3
Please note:		
•	Round off all amounts to the nearest rand.	
•	Ignore any normal income tax implications.	
•	Ignore any Value Added Taxation (VAT) implications.	
•	Your answer must comply with International Financial Reporting Standards (IFRS).	

QUESTION 1 - Suggested solution

DISCUSSION

Drawing a quick timeline can be of great assistance. An example of the timeline for this question is as follows:



REMEMBER

Foreign currency transactions:

- Record inventory (non-monetary item) and foreign creditor (monetary item) at spot rate on transaction date (IAS 21.21).
- Restate creditor (monetary item) to closing rate at year end or spot rate on settlement date and recognise the foreign exchange differences in P/L (IAS 21.23).

(a) JOURNAL ENTRIES

		Dr R	Cr R	
	Year ended 31 December 20.21			
	28 September 20.21			
J1	Inventory (SFP) ($120 000 x 7,78)	933 600		(1½)
	Creditor (SFP)		933 600	(½)
	Record inventory purchased on transaction date			
	1 December 20.21			
J2	Foreign exchange difference (P/L)			
	(refer to P/L¹ on timeline) ($120 000 x (7,80- 7,78))	2 400		(2)
	Creditor (SFP)		2 400	(½)
	Remeasure entire creditor to spot rate on date of first payment (loss)			
J3	Creditor (SFP) ($72 000 x 7,80)	561 600		(1½)
	Bank (SFP)		561 600	(½)
	Make first payment to creditor at spot rate			
	31 December 20.21			
J4	Creditor (SFP) (refer to P/L² on timeline)			
	($48 000 x (7,80 – 7,72))	3 840		(2)
	Foreign exchange difference (P/L)		3 840	(½)
	Remeasure creditor to closing rate at year end (gain)			
J5	Cost of sales (P/L) (R933 600 (refer J1) x 30%)	280 080		(1½)
	Inventory (SFP)		280 080	(½)
	Transfer cost of inventory sold to P/L (cost of sales)			

		Dr R	Cr R	
	Year ended 31 December 20.22			
	15 January 20.22			
J6	Foreign exchange difference (P/L)			
	(refer to P/L[3] on timeline) ($48 000 x (7,85 – 7,72))	6 240		(2)
	Creditor (SFP)		6 240	(½)
	Remeasure creditor to spot rate on date of settlement (loss)			
J7	Creditor (SFP) ($48 000 x 7,85)	376 800		(1½)
	Bank (SFP)		376 800	(½)
	Final payment to settle creditor at spot rate			
	31 December 20.22			
J8	Cost of sales (P/L) (R933 600 x 70%)	653 520		(1)
	Inventory (SFP)		653 520	(½)
	Transfer cost of inventory sold to P/L (cost of sales)			
			Total	(17)

(b) EBENEZER LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.22

2.	**Profit before tax**	**20.22 R**	**20.21 R**	
	The following items are included in profit before tax:			
	Income			
	Net foreign exchange gains (J2 and J4 in part (a))	-	1 440	(1½)
	Expenses			
	Net foreign exchange losses (J6 in part (a))	6 240	-	(1½)
			Total	(3)

EXAM TECHNIQUE

Always provide the comparative information in a disclosure question, except if required not to do so.

The treatment of foreign exchange differences corresponds with the treatment of the gain or loss of the underlying non-monetary item. Therefore, the **net** foreign exchange differences will be recognised in profit or loss and the net amount disclosed in the financial statements.

INTEGRATED QUESTIONS

Question	Question name	Marks	Topics covered
1	Jota Ltd	25	Disclosure: Income taxes Discussion: Prior year error
2	Lallana Ltd Maiweather Ltd	27	Disclosure: Income taxes Discussion: Presentation of financial statements
3	Leo Ltd	35	Financial instruments Presentation of financial statements Income taxes
4	Satoshi Ltd	40	Financial instruments The effects of foreign exchange rates Other (Share-based payment)
5	Shantui Construction Ltd	20	Financial instruments The effects of foreign exchange rates
6	Exclusive Clocks Ltd	15	Financial instruments
7	Ultra Motors Ltd	25	Financial instruments The effects of foreign exchange rates
Case study			
1	Mining Ltd	100	The Conceptual Framework for Financial Reporting Income taxes Financial instruments Presentation of financial statements Other (Leases, etc.)

QUESTION 1 **25 marks**

YOU HAVE 9 MINUTES TO READ THIS QUESTION

ALL AMOUNTS EXCLUDE VALUE ADDED TAX (VAT) UNLESS OTHERWISE INDICATED.

You are a student studying towards your Certificate in the Theory of Accountancy (CTA) qualification. As part of your preparation for your final financial accounting examination, you assisted an audit firm with the following client queries:

Jota Ltd (Jota)

Jota conducts business in the retail industry. You are responsible for the preparation of the financial statements of Jota for the year ended 31 December 20.20.

The following information is available for the 20.20 financial year.

DRAFT SUMMARISED TRIAL BALANCE AS AT 31 DECEMBER 20.20

	Notes	Dr R	Cr R
Office buildings at carrying amount	1	2 442 000	
Plant and machinery at carrying amount	1	945 000	
Inventory		831 500	
Cash and cash equivalents		2 044 000	
Prepaid insurance premium	2	88 900	
Trade and other receivables	3	2 405 600	
~~Deferred tax asset~~ (1 January 20.20)	4	~~122 360~~	
Share capital			350 000
Retained income			5 956 860
Profit before tax	5		882 500
Trade payables			1 690 000
		8 879 360	8 879 360

Deferred tax liability Cr (R29 400)
Amend retained earnings as the balancing amount

Notes

1. Property, plant and machinery

Property, plant and machinery are accounted for according to the cost model in terms of IAS 16 *Property, Plant and Equipment.*

On 1 January 20.20 Jota purchased land for the future development of a new plant. Due to the worldwide economic crisis and a decline in the property market during the second half of 20.20, the directors agreed to sell the land as soon as possible. The land was sold on 31 October 20.20 at a loss of R200 000 (which is a capital loss for tax purposes – also refer note 4). The purchase and sale transactions on land were correctly recorded in the accounting records of Jota.

Jota depreciates the office buildings at R165 500 per annum, while the South Africa Revenue Service (SARS) permits no deduction on the buildings.

The tax base of the plant and machinery on 31 December 20.20 was R546 000.

2. Insurance contract

The annual insurance premium of R88 900 for the year ending 31 December 20.21 was paid in advance during the current financial year. There were no prepaid expenses for the financial year ending 31 December 20.19.

3. Trade and other receivables

Trade and other receivables consisted of the following on 31 December 20.20:

	Dr/(Cr) **R**
Trade receivables	2 595 300
Allowance account for credit losses	(410 600)
Other receivables	220 900
Balance at year end	2 405 600

SARS allowed Jota to claim a doubtful debt allowance of R102 650 in terms of section 11(j) of the Income Tax Act.

4. ~~Deferred tax asset~~ Deferred tax liability

The net deferred tax liability of R29 400 at 31 December 20.19 was correctly calculated and consists of the following:

	Dr/(Cr) **R**
Property, plant and equipment	(143 661)
Allowance account for credit losses	67 221
Unused tax loss	47 040
Net deferred tax liability	(29 400)

All the temporary differences that gave rise to the net deferred tax liability of R29 400 were taxed at 27%. The final tax assessment issued by SARS for the financial year ended 31 December 20.19 reflected an assessed tax loss of R174 222 which was accepted by Jota.

On 31 December 20.19 the management of Jota was of the opinion that future taxable profits and future capital gains were probable as the budget for the coming financial year showed a sharp increase in profits as a result of a new contract obtained by Jota. This opinion of management remained unchanged for the financial year ended 31 December 20.20.

The current tax expense for the year ended 31 December 20.20 was correctly calculated at R657 434 (after taking into account all the information provided in these notes). Deferred tax for the year ended 31 December 20.20 has not yet been calculated or provided for.

5. Profit before tax

You may assume that all transactions, except for the accounting error in note 6, were correctly accounted for in profit before tax.

The following items are included in profit before tax:

5.1 Dividend income received from a local resident company to the amount of R140 000.

5.2 Fines

On 28 July 20.20 the Competition Commission fined Jota for retail price fixing. The Competition Commission imposed a penalty of R1 398 500 on Jota because of the existence of a vertical agreement between Jota and Origi Ltd for setting retail prices. The fine was immediately payable.

6. Accounting error

On 30 November 20.19 Jota received an amount of R575 000 (VAT inclusive) from a customer for services that were only rendered during March 20.20. The accountant recognised the R575 000 as revenue in November 20.19 and did not allocate the VAT of 15% to the VAT output account. As a result the R575 000 was included in revenue for the financial year ended 31 December 20.19. For tax purposes, the R575 000 was taxed in the financial year ended 31 December 20.19. SARS indicated that they will re-open the 20.19 assessment to correct the amount of VAT that was incorrectly included in taxable profit. The figures in the trial balance have not yet been adjusted to account for the correction of the accounting error (the error is regarded as material).

Additional information

- The normal tax rate is 27%. The capital gains tax inclusion rate is 80% for the years ended 31 December 20.19 and 31 December 20.20.

- The VAT rate is 15% for all periods.

- Jota is a registered VAT vendor.

REQUIRED

YOU HAVE 38 MINUTES TO ANSWER THIS QUESTION

		Marks
(a)	Prepare the following note to the financial statements of **Jota Ltd** for the financial year ended 31 December 20.20: • Income tax expense in terms of IAS 12.79-12.80 and 12.81(c)(i). **Please note:** • Comparative figures are not required. • The movement in temporary differences in the current tax calculation must be calculated using the statement of financial position method.	16
(b)	Discuss the effect that the correction of the R575 000 with regard to services rendered (which was incorrectly recognised as revenue in the 31 December 20.19 financial year) will have on all the line items in the **statement of profit or loss and other comprehensive income of Jota Ltd** for the year ending 31 December 20.20.	8
	Communication skills: logical argument	1
	Please note: • Your discussion should include amounts where relevant.	
Please note: • Round off all calculated amounts to the nearest Rand. • Your answer must comply with International Financial Reporting Standards (IFRS).		

QUESTION 1 – Suggested solution

(a) JOTA LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.20

3. Income tax expense

Major components of tax expense

	20.20 R	
SA normal tax		
Current tax		
Current year (given)	657 434	(1)
Deferred tax	110 986	
Movement in temporary differences (taxable) [C1]	107 146	(7)
Unused tax loss utilised [C1]	47 040	(1)
Unused capital loss created [C1]	(43 200)	(1)
	768 420	
Tax rate reconciliation		
Accounting profit (882 500 + (575 000 x 100/115)))	1 382 500	(1)
Tax at 27%	373 275	(1)
Tax effect of non-taxable /non-deductible items		
Dividends not taxable (140 000 x 27%)	(37 800)	(1)
Capital loss on sale of land not deductible (200 000 x 20% x 27%)	10 800	(1)
Depreciation on office buildings not deductible (165 500 x 27%)	44 550	(1)
Penalties not deductible (1 398 500 x 27%)	377 595	(1)
	768 420	
	Total	(16)

CALCULATIONS

C1. Deferred tax

The office building has no tax allowance, and the tax base is thus nil. Therefore, the temporary difference for PPE in 20.19 relates to the plant and machinery.	**Carrying amount** **R**	**Tax base** **R**	**Temporary difference at 100% or 80%** **R**	**Deferred tax at 27% asset/ (liability)** **R**	(½)
31 December 20.19					
Property plant and equipment (given)	?	?	[1]532 078	(143 661)	(1)
Allowance for credit losses (given)	?	?	[2](248 967)	67 221	(1)
Revenue received in advance (error)	500 000)	-	(500 000)	135 000	(1)
			(216 889)	58 560	
Unused tax loss (given)		174 222	(174 222)	47 040	(1)
Net deferred tax asset			(391 111)	105 600	
[1] 143 661/27% = 532 078 [2] 67 221/27% = 248 967 [3] 575 000 x 100/115 = 500 000					
31 December 20.20					
Office building	2 442 000	-	Exempt	-	(1)
Property plant and equipment	945 000	546 000	399 000	(107 730)	(1)
Allowance for credit losses (given)	(410 600)	[1](102 650)	(307 950)	83 147	(1½)
Prepaid insurance premium	88 900	-	88 900	(24 003	(1)
			179 950	(48 586)	
Unused capital loss	-	200 000	[2](160 000)	43 200	(1)
			19 950	(5 386)	

[1] 410 600 x 25% = 102 650 or 410 600 – (410 600 x 75%) = 102 650

[2] 200 000 x 80% = 160 000

Movement in temporary differences (excluding unused tax loss and unused capital loss) (taxable) (179 950 - (216 889))	396 839	(107 146)
Movement in unused tax loss (reversal of deductible)	174 222	(47 040)
Movement in unused capital loss (deductible)	(160 000)	43 200
Total movement in temporary differences	411 061	(110 986)

(b) Discuss the correct accounting treatment of the accounting error

The R575 000 which have been incorrectly recognised as revenue in the 31 December 20.19 financial year constitute a **prior period** material **error** in terms of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and has to be **corrected retrospectively.** (1)

An entity shall correct material prior period errors **retrospectively** in the **first set of financial statements** authorised for issue after their discovery by restating the comparative amounts for the prior period(s) presented in which the error occurred (IAS 8.42 (a)). (1)

A prior period error shall be corrected by retrospective restatement as the period-specific effect is **not impracticable to determine (the applicable financial year is 20.19)** (IAS 8.43). (1)

Jota must, therefore, correct the error in the financial statements for the year ended 31 December 20.20 by restating the 20.19 comparative figures. (1)

The following line items of the statement of profit or loss and other comprehensive income have been affected by the error and must be restated as follows:

- The **20.19 comparative figures for revenue** must be **decreased** with **R575 000** since it should be reflected as revenue received in advance for the year ended 31 December 20.19. Revenue amounting to **R500 000** (excluding VAT) must only be recognised in March 20.20. Therefore, the **revenue** for the year ended **31 December 20.20 need to be increased with R500 000.** (2)

- The **20.19 comparative figures for the income tax expense (current tax)** has to be **decreased** with **R20 250** (R75 000 x 27%), to correct the VAT that was incorrectly included in the 20.19 comparative figures for revenue, since the SARS agreed to reopen the prior year assessment. (2)

- The 20.19 **comparative figures for income tax expense (deferred tax)** has to be **decreased** with **R135 000** (500 000 x 27%), to provide for the deferred tax asset relating to the revenue received in advance. (1)

Total	(9)
Maximum	(8)
Communication skills: logical argument	(1)

QUESTION 2 **27 marks**

YOU HAVE 10 MINUTES TO READ THIS QUESTION

IGNORE ANY VAT IMPLICATIONS

You are an IFRS expert who is employed by Jsauhm Consultants. The following independent and unrelated issues were brought to your attention for your expert advice and opinion.

Client 1: Lallana Ltd (Lallana) **18 marks**

Lallana is a company operating in the manufacturing and maintenance industry. Lallana is listed on the Johannesburg Stock Exchange and has a 31 December financial year end.

You are currently reviewing the financial statements of Lallana. Your assistant has presented the following schedule of information relating to the year ended 31 December 20.27:

Item	**R**
Lallana's accounting profit for the year ended 31 December 20.27 after correctly accounted for all items:	5 750 000
Dividends received: Dividends received are exempt from normal tax in terms of s 10(1)(k).	74 500
Foreign income received (after deduction of R5 000 relating to foreign taxes): The foreign income is not taxable in South Africa.	35 000
Gain on disposal of land: Lallana purchased land for the future development of a new factory building on 31 March 20.26. Due to the recent availability of factory buildings in the area, Lallana sold the land at an amount of R1 550 000 on 1 January 20.27. The original cost of the land amounted to R1 200 000. Land is measured according to the cost model in terms of IAS 16 *Property, Plant and Equipment.* The proceeds from the sale of land is a receipt of a capital nature for tax purposes.	350 000
Depreciation on plant and equipment: The tax allowances on the plant and equipment amounted to R900 000. On 31 December 20.27 the carrying amount of the plant and equipment amounted to R3 168 000 while the tax base was R2 500 000.	876 000
Correction of prior period error: On 30 November 20.26 Lallana received an amount of R300 000 from a customer for services that were rendered during February 20.27. The accountant recognised the R300 000 as revenue in November 20.26. For tax purposes, the R300 000 was taxed in the financial year ended 31 December 20.26.	300 000
Assessed tax loss on 31 December 20.27: Lallana suffered operating losses during the previous financial year and had an assessed tax loss of R900 000 on 31 December 20.26. The company correctly utilised R344 000 of the assessed tax loss by recognising a deferred tax asset of R96 320 relating to the assessed loss on 31 December 20.27.	-

Additional information

1. There are no temporary differences other than those that are apparent from the information contained in the question.

2. The only non-taxable and non-deductible items included in the accounting profit or loss are those that are apparent from the information provided.

3. The normal income tax rate is 27% and the capital gains tax inclusion rate is 80%.

4. You may assume that all amounts are material.

Client 2: Maiweather Ltd (Maiweather) **9 marks**

The financial manager, Mr Matlala, prepared the statement of financial position of Maiweather as at 31 December 20.27 and sent you a copy for a final review. You have assisted Mr Matlala with the previous year's financial statements and he awaits your feedback to finalise the financial statements for the year ended 31 December 20.27 before he sends it to the chief financial officer for approval. Mr Matlala provided you with notes regarding the matters that he is unsure of.

MAIWEATHER LTD

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.27

	Notes	**20.27 R'000**
ASSETS		
Non-current assets		
Property, plant and equipment		39 500
Intangible assets		6 700
		46 200
Current assets		
Inventories		20 200
Trade receivables	1	20 500
Other current assets		1 500
Cash and cash equivalents		2 500
		44 700
Total assets		90 900

	Notes	20.27 R'000
EQUITY AND LIABILITIES		
Equity attributable to the owners of the parents		
Share capital		14 200
Retained earnings		31 000
Other components of equity		1 500
Total equity		46 700
Non-current liabilities		
Long-term borrowings	2	24 600
Total non-current liabilities		24 600
Current liabilities		
Trade and other liabilities		3 300
Allowance for credit losses	1	1 500
Short-term borrowings	3	2 500
Current tax payable		9 500
Deferred tax		2 800
Total current liabilities		19 600
Total liabilities		44 200
Total equity and liabilities		90 900

Notes

1. Maiweather uses the simplified approach in accordance with IFRS 9 *Financial Instruments* when determining the expected credit losses for trade receivables. The R1 500 000 allowance for credit losses is the lifetime expected credit losses of the trade receivables.

2. Long-term borrowings of R24 600 000 represents a loan obtained from Africa Bank. The interest rate charged by Africa Bank is market related. The loan is repayable over 10 years. The loan instalments of R4 500 000 each are payable on 31 December of each year. The instalment on 31 December 20.28 will consist of R1 860 000 interest and a R2 640 000 capital re-payment.

3. On 1 April 20.27 Maiweather obtained a short-term loan from Smart Bank amounting to R2 500 000. The loan and interest is repayable on 31 March 20.28, however the terms of the agreement stipulates that Maiweather has the discretion to extend the loan's repayment date to 31 December 20.29 at an additional fee of R50 000. The applicable interest rate for the extended period will be renegotiated. Mr Matlala indicated that the chief financial officer has instructed him to start with the negotiation of the new interest rate for the extended loan period with Smart Bank since Maiweather intends to extend the loan.

REQUIRED

YOU HAVE 41 MINUTES TO ANSWER THIS QUESTION

		Marks
(a)	Prepare the income tax note to the financial statements of Lallana Ltd for the year ended 31 December 20.27 as required by IAS 12.79, 80 and 81(c)(i) *Income Taxes* (refer to client 1). **Please note:** • Comparative figures are not required. • The movement in temporary differences in the current tax calculation has to be calculated by using the statement of financial position method.	17
	Communication skills: presentation and layout	1
(b)	Discuss the presentation and classification issues in terms of IAS 1 *Presentation of Financial Statements* relating to the statement of financial position of Maiweather Ltd as at 31 December 20.27 (refer to client 3). **Please note:** • Your feedback should include any incorrect presentation and classification and the suggested corrections of the errors noted. • Your answer should include calculations.	8
	Communication skills: logical argument	1
Please note: • Round off all amounts to the nearest Rand. • Your answer must comply with International Financial Reporting Standards (IFRS).		

QUESTION 2 – Suggested solution

(a) LALLANA LTD

NOTES FOR THE YEAR ENDED 31 DECEMBER 20.27

11. Income tax expense

Major components of tax expenses

	20.27 R	
SA normal taxation		
Current tax		
- Current year	1 172 205	(5)
Deferred tax	180 360	
- Movement in temporary differences	87 480	(4)
- Recognition of unused tax loss not previously recognised ((900 000 – 344 000) x 27%))	(150 120)	(1)
- Unused tax loss uitilised (900 000 x 27%)	243 000	(1)
	1 352 562	
Foreign Tax	5 000	(1)
	1 357 565	
Tax rate reconciliation		
Accounting profit	5 750 000	(½)
Taxation at 27%	1 552 500	(½)
Tax effect of non-deductible/non-taxable items:		
- Dividends received (74 500 x 27%)	(20 115)	(1)
- Accounting profit on land not taxable (350 000 x 20% x 27%)	(18 600)	(1)
Difference in tax rate on foreign income (5 000 - (40 000 x 27%)	(5 800)	(1)
Unused tax loss that was not previously recognised	(150 120)	(1)
	1 357 565	
	Total	(17)
	Communication skills: presentation and layout	(1)

CALCULATIONS

C1. Deferred tax

	Carrying amount	Tax base	Temporary difference at 100% or 80%	Deferred tax 27% asset/ (liability)	
31 December 20.26					
Land	1 200 000	1 200 000	-	-	
Plant (3168 + 876) (2500 + 900)	4 044 000	3 400 000	644 000	(173 880)	
Contract liability	(300 000)	-	(300 000)	81 000	
			344 000	(92 880)	
Unused tax loss		900 000	(344 000)	92 880	
			-	-	
31 December 20.27					
Land	-	-	-	-	
Plant	3 168 000	2 500 000	668 000	(180 360)	[1]
			668 000	(180 360)	
Unused tax loss	-	-	-	-	
			668 000	(180 360)	
Movement in temporary differences through P/L (668 000 - 344 000)			324 000	(87 480)	[3]
Movement in unused tax loss			344 000	(92 880)	
			668 000	(180 360)	

C2. Current tax calculation

Profit	5 750 000	
Non-taxable/Non-deductible items:		
- Dividends received not taxable	(74 500)	[½]
- Accounting profit on land not taxable (350 000 x 20%)	(70 000)	[1]
- Foreign income (35 000 + 5 000)	(40 000)	[1]
Movement in temporary differences	(324 000)	[1]
Taxable profit before tax loss	5 241 500	
Unused loss of prior year	(900 000)	[1]
	4 341 500	
Tax at 27%	1 172 205	[½]
		[5]

(b) Maiweather Ltd

Comparative information
According to IAS 1.38 an entity shall present comparative information in respect of the preceding period for all amounts reported in the current period's financial statements.

IAS 1.38A stipulates that a minimum of two statements of financial position shall be presented.

Maiweather Ltd needs to present comparative information in respect of the preceding financial period ended 31 December 2016, this will also ensure there is a minimum of two statements of financial position presented. (2)

Long-term borrowings
IAS 1.61 stipulates that an entity shall disclose the amount expected to be settled after more than twelve months for each liability line item that combines amounts expected to be settled no more than twelve months after reporting period and more than twelve months after reporting period.

Therefore, the amount that is included in the R24 600 000 long-term borrowings that will be settled on or before 31 December 20.28 must be shown as the current portion of long-term borrowing and classified as current liabilities. (1)

The capital re-payment amount of R2 640 000 must be disclosed as current liabilities and the amount of R21 960 000 (R24 600 000 – R2 640 000) as non-current liabilities. (1)

Offsetting
In terms of IAS 1.32 and .33 an entity shall not offset assets and liabilities and should report both assets and liabilities separately.

According to IAS 1.33 measuring assets net of valuation allowance is not offsetting.

Therefore, the classification of the allowance for credit losses under current liabilities is not correct and should be offset against the trade receivables of R20 500 000. (1)

The final trade receivables presented in the statement of financial position should be R19 000 000 (R20 500 000 – R1 500 000). (1)

Short-term borrowings
In terms of IAS 1.73 if an entity expects and has the discretion to roll over an obligation for at least 12 months after the reporting period under an existing loan facility, it classifies the obligation as non-current even if it would otherwise be due within a shorter period.

According to the terms of the loan agreement Manyonga Ltd has the discretion to roll over the loan from Smart Bank and Manyonga Ltd expects that the entity will roll over the loan since they have already started to negotiate this with Smart Bank. (1)

The loan of R2 500 000 should be classified as non-current liabilities since the rollover of the loan to 31 December 20.29 is more than 12 months after the reporting period of 31 December 20.27. (1)

Deferred tax
According to IAS 1.56 when an entity presents current and non-current liabilities as separate classifications in its statement of financial position, deferred tax liabilities shall not be classified as current liabilities.

Therefore, the deferred tax balance of R2 800 000 is incorrectly classified as current liabilities and should be classified as part of non-current liabilities. (1)

Total	(9)
Maximum	(8)
Communication skills: logical argument	(1)

QUESTION 3 **35 marks**

YOU HAVE 13 MINUTES TO READ THIS QUESTION

Leo Ltd (Leo) specialises in the manufacturing and selling of sports clothing products and is listed on the Johannesburg Stock Exchange. Leo Ltd is a wholly owned subsidiary of Panther Ltd (Panther) since its incorporation. You are a recently qualified chartered accountant and recently started working at Leo Ltd as a financial accountant. You are preparing the financial statements for the financial year end 31 December 20.20 and have been provided with the following information:

1. Preference shares

Leo issued 800 000 compulsory convertible preference shares at an issue price of R10 per preference share on 1 July 20.20. The convertible preference share has a face value of R11 each. Dividends are payable annually on 30 June at 12%. These preference shares are compulsory convertible on 30 June 20.25 at one ordinary share for each preference share held. A market-related interest rate on 1 July 20.20 for preference shares issued without conversion rights was 10% per annum.

Panther purchased the 800 000 preference shares when they were issued and does not hold them for trading purposes. The fair value of one convertible preference shares was R12 on 31 December 20.20.

2. Share-appreciation rights

On 1 January 20.19 Leo entered into an agreement with the directors of Panther. According to the agreement all 12 directors of Panther will each receive 4 500 share appreciation rights (SARs). This is part of Panther's remuneration policy for subsidiaries to reward its executive directors. The SARs will vest on 31 December 20.21, provided that the directors remain in service of Panther.

Each SAR entitles the director to a cash amount equal to Leo's share price on the exercise date. Vested SARs may be exercised on or before the earlier of 31 December 20.23 or the date on which an employee resigns. If they are not exercised by this date, the rights will lapse.

The fair value of SARs was determined using an option pricing model. The following information in respect of the SARs scheme is provided:

Date	Actual number of employees still employed at relevant date	Estimated number of employees expected to be employed at vesting dates	Fair value per SAR	Leo share price
			R	R
1 January 20.19	12	11	7,80	35
31 December 20.19	12	11	8,20	38
31 December 20.20	11	10	9,50	39
31 December 20.21	?	10	10,20	41

3. Bond at fair value

Leo purchased a foreign bond on 1 January 20.20 for its fair value (which also equalled the face value at this date). Leo correctly classified this bond at fair value through other comprehensive income. The bond has five years to maturity and carries an arrear annual coupon rate of 8% payable on 31 December each year. The bond coupon rate is equivalent to its effective interest rate, as there are no transaction costs nor premium or discount on redemption of the bond relative to the face value.

The credit risk since initial recognition of the bond is determined as follows:

- 1 January 20.20 – low credit risk, and
- 31 December 20.20 – no change since initial recognition

Details relating to the bond:

Date		**Bond**		
			Total expected credit losses	
	Spot rate $1=	**Fair value $**	**12 Month $**	**Lifetime $**
1 January 20.20	R12,50	120 000	1 800	2 500
31 December 20.20	R13,75	128 000	1 800	2 750
Average rate 20.20	R11,12			

At no stage was the bond considered to be credit impaired and the interest payments were received on time.

Assume that the South African Revenue Services (SARS) will not allow expected credit losses on the bonds as a deduction for income tax purposes and that the SARS accepts the amortised cost of the bonds as the tax base of the bonds. Only when the credit risk realises will the SARS allow such losses as actually incurred.

The SARS indicated that any future taxable profits will be taxed at 27%.

QUESTION 3

YOU HAVE 53 MINUTES TO ANSWER THIS QUESTION

REQUIRED

		Marks
(a)	Discuss how Panther Ltd should classify the compulsory convertible preference shares.	7
	Communication skills: clarity of expression	1
(b)	Prepare an extract of the statement of financial position of Leo Ltd as at 31 December 20.20, showing how the convertible preference shares and share appreciation rights will be presented. **Please note:** • Comparatives are not required. • Ignore all tax implications.	9
	Communication skills: presentation and layout	1
(c)	Provide the journal entries to account for the bond for the year ended 31 December 20.20 in the accounting records of Leo Ltd. **Please note:** • Journal narrations are not required. • Journals should be dated. • Ignore all tax implications.	13
(d)	Discuss the tax implications of the bond transaction. Calculations are not required.	4
	Please note: • Round off all amounts to the nearest rand. • Your answer must comply with International Financial Reporting Standards (IFRS).	

QUESTION 3 – Suggested solution

(a) Preference shares

Panther purchased the convertible preference shares and should recognise a financial asset and determine classification in terms of IFRS 9. (1)

To classify the preference shares, consideration of the nature of the contractual cash flows should be made: (1)

- Panther has a contractual right to receive dividends annually in the form of interest income. (1)
- There is no capital repayment, since the preference shares are compulsory convertible into shares. Panther has the right to receive ordinary shares. (1)
- The contractual cash flows do not represent payments solely of interest and capital. (1) Therefore, the amortised cost classification to measure debt instruments cannot be applied. (1)

Panther should then consider classification at fair value through profit or loss or the option to elect fair value thorough other comprehensive income in terms of IFRS 9.5.7.5. (1)

However, the IFRS 9.5.7.5. cannot be elected by Panther, since the preference shares are not pure equity instruments, as there is a contractual right for Panther to receive interest payment. (1)

Therefore, Panther should classify the preference shares as measured at fair value through profit or loss (1)

Total	(9)
Maximum	(7)
Communication skills: clarity of expression	(1)

(b) LEO LTD

EXTRACT OF STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20.20

	R	
Equity and liabilities		
Equity component of convertible preference shares (C1)	3 996 929	(3)
Non-current liabilities		
Financial liability (4 203 225 (C1.2) – 200 153)	4 003 072	(3)
Cash settled share-based payment (4 500 x 10 x 9,50)	130 000	(2)
Current liabilities		
Financial liability – short term portion (C1.2)	200 153	(1)
Total		(9)
Communication skills: clarity of expression		(1)

CALCULATIONS

C1. Convertible preference shares

C1.1 Fair value of financial liability component

N	=	5	[½]
I	=	10%	[½]
PMT	=	1 056 000 (800 000 x R11 x 12%)	[½]
FV	=	0	[½]
PV	=	4 003 071	

Proceeds (800 000 x R10)	8 000 000	[1]
Present value of financial liability	(4 003 071)	
Equity component (balancing)	3 996 929	
		[3]

C1.2 Value of liability component

4 003 071 [C1.1] + 1 Amort interest 400 307 x 6/12 = 200 153	4 203 225	[2]

(c) Journal entries – Bonds

		Dr R	Cr R	
	1 January 20.20			
J1	Financial asset at fair value through OCI: bond (SFP)	1 500 000		(1)
	(120 000 x 12,5) Bank (SFP)		1 500 000	(1)
	Recognise purchase of bond			
J2	Expected credit losses (P/L) (1 800 x 12,5)	22 500		(1)
	Expected credit loss reserve (OCI)			
	Recording 12-month expected credit loss		22 500	(1)
J3	**31 December 20.20**			
	Bank (SFP) (120 000 x 8% x 13,75)	132 000		(1)
	Financial asset at fair value through OCI: bond (balancing) (SFP)		25 248	(1)
	Interest income (P/L) (120 000 x 8% x 11,12)		106 752	(1)
	Recognise effective interest income and coupon interest received			
J4	Financial asset at fair value through OCI: bond (SFP) ((1 500 000 (J1) - 25 248 (J3)) – (120 000 x13,75))	175 248		(1)
	Expected credit loss reserve (OCI ((22 500 (J2) - 1 800 x 13,75)		2 250	(1)
	Foreign exchange gain (OCI) (175 248 – 2 250)		172 998	(1)
	Recognition of foreign exchange gain			
J5	Financial asset at fair value through OCI: bond (SFP)	110 180		(2)
	Fair value gain (OCI) ((1 500 000 (J1) – 25 248 (J3) + 175 248 (J4)) – (128 000 x13,75))		110 180	(1)
	Recognition of fair value gain on investment			
			Total	(13)

(d) Discuss deferred tax implications on bond

There is no deferred tax on the amortised cost accounting for the bond, as the carrying amount and tax base will be the same. (1)

Expected credit losses on the bond are not allowed as a deduction for income tax purposes, and only when the credit risk realises will the SARS allow such losses as actually incurred. (1)

The interest income and foreign exchange adjustments will attract current tax at the normal tax rate of 27%. (1)

The Income Tax Act does not allow a tax deduction for fair value adjustments and, therefore, there will be deferred tax consequences on the fair value adjustments recognised in other comprehensive income. (1)

As the bond is held to collect contractual cash flows and for sale (requirement to account for at fair value through OCI), it is likely that the applicable tax rate on sale of the bond is the normal tax rate of 27%. Therefore, the CGT rate will not be applicable. (1)

Total (5)

Maximum (4)

QUESTION 4

YOU HAVE 15 MINUTES TO READ THIS QUESTION

PART I **28 marks**

IGNORE ANY NORMAL INCOME TAX IMPLICATIONS

Satoshi Ltd (Satoshi) is a South African company listed on the Johannesburg Stock Exchange and has a 31 December year end. Satoshi sells rock drilling machines which are used in quarries and open pit mines throughout South Africa.

After a successful exhibition at the Electra Mining Africa show during 20.27, Satoshi received various queries from companies operating in Botswana relating to the rock drilling machines. Satoshi imports machines that can withstand extreme temperatures from South Korea.

The profit before tax for the year ended 31 December 20.27 is R32 560 000 before processing the necessary journals to account for the transactions below. The balance of share capital and retained earnings at 1 January 20.27 is R243 678 000 and R56 780 000, respectively.

1. Rock drilling machines imported

To ensure that Satoshi will be able to meet the increased demand for the rock drilling machines that can withstand extreme temperatures, Satoshi decided on 1 September 20.27 to import three rock drilling machines at a cost of KRW 204 000 000 each. The official currency of South Korea is the South Korean Won (KRW). The machines were delivered to Satoshi on 1 October 20.27. Control of the machines passed to Satoshi on delivery date.

The foreign creditor was payable as follows:

	KRW
1 December 20.27	408 000 000
1 February 20.28	204 000 000
	612 000 000

The above repayment terms are normal credit terms.

On 1 October 20.27 Satoshi entered into a five-month forward exchange contract (FEC) for the KRW 204 000 000, payable on 1 February 20.28, to hedge itself against foreign currency risk at a forward rate of KRW 1 = R0,01. Satoshi does not apply hedge accounting in terms of IFRS 9 *Financial Instruments*.

The applicable exchange rates were as follows:

	Spot rate	Forward rate
	R1 = KRW	**R1 = KRW**
1 September 20.27	110	
1 October 20.27	102	
1 December 20.27	95	90 (2 months)
31 December 20.27	90	85 (1 month)
1 February 20.28	98	

One of the machines was sold to a new Botswana client on 1 December 20.27 for R2 500 000 and the other two machines were sold in March 20.28.

2. Disposal of investment

Satoshi holds an investment in Nakamoti Ltd bonds with an amortised cost of R5 600 000 on 31 December 20.26. These bonds were held within a portfolio of investments that Satoshi manages in order to collect contractual cash flows of interest and principal. The bonds have an effective interest rate of 10% per annum, interest is payable annually and the bonds are redeemable at par value on 31 December 20.20. On 1 July 20.27, Satoshi decided to sell the bonds for R5 950 000 to finance capital expenditure. The bonds were never credit impaired and no credit losses were expected throughout the life of the financial asset.

3. Share-based payment arrangement

On 1 January 20.26 Satoshi entered into an arrangement with a key senior employee. The terms of the arrangement are as follows:

- Satoshi grants the employee the right to receive either a cash payment equal to the value of 800 shares or 900 actual shares.
- Satoshi has the choice of settlement.
- The grant is conditional on the completion of two years' service.
- If shares are issued, they should be held for two years after vesting date.

Satoshi does not have a present obligation to settle in cash. It was expected that the senior employee will remain with the company until 31 December 20.27. The fair value of one Satoshi share was as follows on the respective dates:

Date	Fair value	Fair value with a two-year post-vesting transfer restriction
	R	**R**
1 January 20.26	198	190
31 December 20.26	211	200
31 December 20.27	220	210

On 31 December 20.27 Satoshi decided to elect the choice of settlement with the lower fair value as at 31 December 20.27.

4. **Investment in debt instrument**

On 1 January 20.27 Satoshi acquired an investment in Redid Ltd bonds at a fair value of R3 000 000. No transaction costs were paid. The bonds pay coupon interest of R400 000 on 31 December of each year and will be redeemed on 31 December 20.29 at a face value of R2 500 000. Satoshi holds these bonds to collect the contractual cash flows and, when an opportunity arises, it will sell the bonds to re-invest the cash in other financial assets at a higher return. Therefore, both collecting contractual cash flows and selling the bonds are integral in achieving the business model's objective. On 1 January 20.27 the bonds were not credit impaired and no credit losses were expected. However, on 31 December 20.27 the credit risk had increased significantly since initial recognition, but the bonds were not credit impaired. The fair value of the bonds on 31 December 20.27 is R2 500 000.

The financial manager of Satoshi provided you with the following schedule of the assessed credit risk and estimated expected credit losses of its investment in the Redid Ltd bonds:

Date	Assessed credit risk	12-month expected credit losses R	Lifetime expected credit losses R
31 December 20.27	High (not credit impaired)	32 000	500 000

PART II **12 marks**

GreenBottles Ltd is a manufacturer of water bottles and jugs that are made with economic-friendly fibre. The company was incorporated in 20.21 and has a 31 December year end. You are the newly appointed financial manager of GreenBottles Ltd. The financial director sent you an extract of the statement of financial position, the accounting policies and notes relating to the financial assets of GreenBottles Ltd.

GreenBottles Ltd

Extract from the statement of financial position as at 31 December 20.27

	Notes	20.27 R
Non-current assets		
Financial assets measured at fair value through OCI	4	500 000
Financial assets measured at amortised cost	5	600 000
Current assets		
Trade and other receivables	6	380 000

Extract from the notes for the year ended 31 December 20.27

1. Accounting policies

1.1 Trade receivables

Trade receivables consist of the day-to-day trade receivables only, and do not contain a significant financing component.

1.2 Allowance for credit losses for trade receivables

The allowance for credit losses is assessed each year based on the following:

- If the credit risk has not increased significantly, 12-month expected credit losses are used.
- If the credit risk increased significantly, the loss allowance will be equal to the lifetime expected credit losses.
- Interest is calculated using the effective interest rate method.

4. Financial assets at fair value through other comprehensive income

These investments consist of shares in two companies listed on the Johannesburg Stock Exchange (JSE). At initial recognition, the entity irrevocably elected to measure these equity instruments at fair value through other comprehensive income in terms of IFRS 9.4.1.4. Both companies declared dividends during the financial year.

5. Financial assets measured at amortised cost

The investments in financial instruments comprise the following:

Type of instrument	**R**
1 000 Bonds in Morning Ltd	247 000
800 Bonds in Flowers Ltd	190 000
100 Bonds in Rose Ltd	163 000
Total	600 000

The contractual cash flows received from bonds consist solely of payments of principal and interest on the principal amount outstanding. The funding needs of GreenBottles Ltd are predictable and the maturity of the investments in bonds is matched to the estimated funding needs of GreenBottles Ltd. As per the policy of the portfolio, if the bonds fall below the F1 rating in terms of Fitch Ratings, the risk of collecting contractual cash flows will become high. Under such circumstances the bonds will be disposed of. The bonds in Flowers Ltd were disposed of during the year, as their ratings dipped below F1.

6. Trade and other receivables

	R
Trade receivables	400 000
Less: Allowance for credit losses	20 000
Net trade receivables	380 000

Additional information

- All risk related disclosure has correctly been disclosed in a separate note in the financial statements and is correct in terms of IFRS 7 *Financial Instruments: Disclosure.*
- The financial director is of the opinion that the portfolio of investment in bonds (refer to disclosure note 5) should be reclassified from amortised cost to financial assets measured at fair value through other comprehensive income, because the bonds will probably not be held to maturity due to the possible increase in credit risk or unanticipated funding needs of GreenBottles Ltd.

QUESTION 4

YOU HAVE 60 MINUTES TO ANSWER THIS QUESTION

REQUIRED

	Marks
PART I	
(a) Provide the journal entries to account for the investment in Nakamoti Ltd bonds (refer to note 2) in the financial statements of Satoshi Ltd for the year ended 31 December 20.27. **Please note:** • Journal narrations are not required.	5
(b) Calculate the profit before tax in the financial statements of Satoshi Ltd for the year ended 31 December 20.27.	13
(c) Present the information provided of Satoshi Ltd in the statement of changes in equity for the year ended 31 December 20.27.	8
Communication skills: presentation and layout	2
Please note: • Total columns are not required. • Comparative amounts are not required, but opening balances at 1 January 20.27 are required.	
PART II	
(a) Discuss in terms of IFRS 9 *Financial Instruments* whether the portfolio of bonds (refer to disclosure note 5) should be reclassified as financial assets measured at fair value through other comprehensive income.	4
(b) Write an email to the financial director discussing your concerns in terms of IFRS 7 *Financial Instruments: Disclosures* and IFRS 9 *Financial Instruments* relating to the following notes provided: 1. Accounting policies 4. Financial assets measured at fair value through other comprehensive income 6. Trade and other receivables	7
Communication skills: layout and conclusion	1

QUESTION 4 – Suggested solution

PART I

(a) Journal entries

		Dr R	Cr R	
	1 July 20.27			
J1	Financial asset at amortised cost (SFP)	280 000		(½)
	Interest income (P/L) (5 600 000 x 10% x 6/12)		280 000	(1½)
J2	Bank (SFP)	5 950 000		(1)
	Financial asset at amortised cost (SFP) (5 600 000 + 280 000)		5 880 000	(1)
	Gain on disposal (P/L)		70 000	(1)
				(5)

(b) Profit before tax

	R	
Profit given	32 560 000	(½)
Investment in bonds sold (from a):		
- Interest income	280 000	(½)
- Gain on disposal	70 000	(½)
Inventory imported:		
Foreign exchange difference (loss): creditor remeasure 1 December (KRW 612 000 000/102 = R6 000 000) – (KRW 612 000 000/95 = R6 442 105)	(442 105)	(2)
Foreign exchange difference (loss): creditor remeasure at closing 31 December (KRW 204 000 000/95 = R2 147 368) – (KRW 204 000 000/90 = R2 266 667)	(119 299)	(2)
Cost of sales (KRW 204 000 000/102)	(2 000 000)	(1)
Sales	2 500 000	(½)
FEC:		
Fair value gain of FEC ((KRW 204 000 000/100 (1/0,01) or (KRW 204 000 000x0.01) = R2 040 000)) – (KRW 204 000 000/85 = 2 400 000)	360 000	(2)
Share-based payment:		
Employee benefit cost (900 x 190 x ½)	(85 500)	(1)
Investment in debt instrument:		
- Interest income (3 000 000 x 8,21%[1])	246 298	(2)
[1] Effective interest rate (PV = (3 000 000); PMT = 400 000; FV = 2 500 000; N = 3)		
- Expected credit losses	(500 000)	(1)
Total	32 869 394	
		(13)

(c) Statement of changes in equity of Satoshi Ltd for the year ended 31 December 20.27

	Share capital	Retained earnings	Fair value adjustments on debt instruments	Expected credit losses reserve	Share-based payment reserve	
	R	**R**	**R**	**R**	**R**	
Balance at 1 January 20.27	**243 678 000**	**56 780 000**			[1]**85 500**	(2)
Share-based payment (from b)					85 500	(½)
Share-based payment settlement		[2&3](5 000)			[3](171 000)	(3)
Total comprehensive income						
- Profit for the year (from (b))		32 869 394				(½)
- Other comprehensive income			(346 298)[4]	500 000		(2)
Balance at 31 December 20.27	**243 678 000**	**89 644 394**	**(346 298)**	**500 000**	**-**	
					Total	(8)
		Communication skills: Logical flow and conclusion				(2)

[1] (900 x 190 x ½) [1]

[2] Lowest fair value (cash option): cash 800 x 220 = 176 000 or equity 900 x 210 = 189 000 [2]

[3] 176 000 – 171 000 (85 500 + 85 500) = 5 000 [1]

[4] (2 500 000 – 2 846 298 (3 000 000 + 246 298 (from (b) – 400 000)) [1½]

PART II

(a) Portfolio of bonds

In terms of IFRS 9.4.1.2A a financial asset shall be measured at fair value through other comprehensive income if both of the following conditions are met: - The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. - The contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding.	
In terms of IFRS B4.1.3, although the objective of an entity's business model may be to hold assets in order to collect contractual cash flows, the entity need not hold all of those assets until maturity. Thus, an entity's business model can be to hold financial assets to collect contractual cash flows, even when sales of financial assets occur or are expected to occur in the future.	
In terms of IFRS 9 B4.1.3A the business model may be to hold assets to collect contractual cash flows, even if the entity sells the financial assets when there is an increase in the credit risk. To determine whether there has been an increase in the credit risk, the entity considers **reasonable and supportable information**, including forward looking information. Selling a financial asset because it no longer meets the credit criteria specified in the entity's document investment policy is an example of a sale that has occurred due to an increase in credit risk.	
In terms of IFRS 9 B4.1.4B a business model whose objective it is to both collect contractual cash flows and sell financial assets will typically involve a greater frequency and value of sales. This is because the selling of the financial asset is integral to achieving the business model's objective, instead of being only incidental to it.	
When determining cash flows that will be realised, it is necessary to consider the frequency, value and timing of sale in prior periods.	(½)
Fitch Ratings are provided by banks and can be relied upon as being reasonable and used as support to assess the credit risk of the bonds, as they are external ratings done by a 3rd party.	(1)
In terms of IFRS 9.4.4.1, when and only when an entity changes its business model for managing financial assets, it shall reclassify all affected financial assets in accordance with paragraphs 4.1.1 – 4.1.1.4.	
GreenBottles did not change its business model, as contractual cash flows received is solely payments of principal and interest.	(½)
It is not GreenBottles' intention to sell the bonds. The bonds are sold if the risk of recovery of contractual cash flows increases.	(½)
GreenBottles sells the bonds only when there is an increase in the credit risk and the Fitch ratings go below F1, indicating that the risk of non-collection of contractual cash flows are high. Therefore, the sales of bonds are rather incidental to the credit risk increasing and not of greater frequency.	(1½)
Although the possibility exists of GreenBottles Ltd selling the bonds before maturity, it does not make it the objective of the business model to sell the assets. The sales are infrequent due to credit risk management or resulting from unanticipated funding needs.	(1)
Therefore, the portfolio of bonds should not be classified to be measured at fair value through other comprehensive income, but should be measured at amortised cost	(1)
Total	(6½)
Maximum	(4)

(b)

To: Financial director
From: Financial manager
Re: Concerns regarding specific notes to the financial statements

Good day

As requested, I have reviewed the financials provided. Please find my concerns listed below:

1.	**Accounting policies**	
	In terms of IFRS 7.21, in accordance with paragraph 117 of IAS 1, an entity discloses its significant accounting policies comprising the measurement basis used in preparing the financial statements.	
	Only the accounting policy of trade receivables is given - there is no policy note that includes other financial assets.	(1)
	Trade receivables and allowances for credit losses policy note	
	In terms of paragraph 5.5.15 of IFRS 9 an entity shall **always measure the loss allowance at an amount equal to lifetime expected credit losses** for: (a) **trade receivables** or contract assets that result from transactions that are within the scope of IFRS 15, and that (b) **do not contain a significant financing component** in accordance with IFRS 15	
	As the trade receivables do not contain a significant financing component, the allowance for credit losses is the amount equal to lifetime expected credit losses (simplified approach) and, therefore, the policy note should be corrected and exclude the 12 month credit losses component.	(1)
	The policy should not include interest calculations, as there is no significant financing component included in the trade receivables.	(1)
4.	**Financial asset at fair value through OCI**	
	In terms of IFRS 7.11 A, if an entity has designated investments in equity instruments to be measured at fair value through other comprehensive income, as permitted by paragraph 5.7.5 of IFRS 9, it shall disclose (a) which investments in equity instruments have been designated to be measured at fair value through other comprehensive income.	
	GreenBottles Ltd correctly stated that the investments are in shares of companies listed on the JSE, but did not name the companies.	(½)
	(b) the reason for using this presentation alternative.	
	No valid reason is provided for electing to measure the equity instruments at fair value through other comprehensive income.	(½)
	(c) The fair value of each such investment at the end of the reporting period.	
	The fair value of each of the investments is not disclosed as required by IFRS 7.	(½)
	(d) Dividends recognised during the period.	
	There is no disclosure regarding the dividends received by GreenBottles Ltd from the investments designated as measured through other comprehensive income.	(½)
6.	**Trade and other receivables**	
	GreenBottles Ltd needs to explain the changes in the loss allowance and the reasons for those changes. An entity shall provide, by class of financial instrument, a reconciliation from the opening balance to the closing balance of the loss allowance in a table, showing separately the changes during the period for the loss allowance measured at an amount equal to lifetime expected credit losses for trade receivables, contract assets or lease receivables for which the loss allowance is measured in accordance with paragraph 5.1.15 of IFRS 7.25H(b)(iii)9.	

There is no reconciliation performed and disclosed for the lifetime expected credit losses from the opening to the closing balances.	(½)
In terms of IFRS 7.35G an entity shall explain the inputs, assumptions and estimation techniques used to recognise the expected credit losses. For this purpose, an entity shall disclose (a) The basis of inputs and assumptions and the estimation techniques used to (i) measure the lifetime expected credit losses (ii) determine whether a financial asset is a credit impaired financial asset	
(b) how forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomics information	
(c) changes in the estimation techniques or significant assumptions made during the reporting period and the reasons for those changes.	
Greenbottles did not disclose any basis of input, assumptions and estimation, any forward-looking information that has been incorporated into the determination of the expected credit losses, any changes in the estimation technique or significant assumptions, and the reasons for those changes.	(1½)

I trust that you will find the above comments helpful.

Kind Regards

Financial Manager

Total	(7)
Communication skills: logic and conclusion	(1)

QUESTION 5 **20 marks**

YOU HAVE 8 MINUTES TO READ THIS QUESTION

Shantui Construction Ltd (Shantui) is a South African company founded on 1 July 20.0. Shantui specialises in equipment used in the construction industry, such as bulldozers, industrial vehicles and concrete mixers. Shantui owns the equipment and leases the equipment to their customers operating in the construction industry in South Africa. Shantui's financial year end is 31 December.

The financial manager requested your assistance with the following transactions that have not been accounted for in the financial statements of Shantui for the year ended 31 December 20.25.

1. Foreign loan

On 1 September 20.25 Shantui borrowed CNY800 000 from its holding company in China. The currency of China is the Chinese yuan (CNY).

The loan from the holding company was utilised to finance the purchase of new bulldozers acquired in South Africa for a total amount of R1 500 000. The contract term of the loan agreement between Shantui and the holding company is four years. The loan agreement stipulates that annual capital instalments of CNY200 000 are payable on 31 August of each year, commencing on 31 August 20.26. The interest rate on the loan equals a market related interest rate of 9% per annum. Interest is payable six-monthly in arrears, commencing on 29 February 20.26.

On 1 October 20.25 the directors of Shantui expected adverse foreign currency fluctuations. On this date the directors of Shantui decided to enter into an eleven-month forward exchange contract (FEC) at a forward rate of R2 as part of their risk management strategy in respect of the first capital instalment of the loan.

Shantui does not apply hedge accounting.

The exchange rates at the relevant dates are as follows:

	Spot rate CNY1 = R	**Forward rate CNY1 = R**
1 September 20.25	1,95	
1 October 20.25	2,05	2,00 (11 months)
31 December 20.25	2,20	2,10 (8 months)
29 February 20.26	2,15	2,08 (6 months)
Average for period 1/09/20.25 – 31/12/20.25	2,02	
Average for period 1/01/20.26 – 29/02/20.26	2,10	

The purchase of the bulldozers, as well as the related depreciation, was correctly accounted for in the financial statements of Shantui Ltd for the year ended 31 December 20.25.

2. Allowance for expected credit losses

Shantui acquired an investment in listed bonds on 1 January 20.25. The listed bonds are held by Shantui within a business model whose objective is to collect contractual cash flows of interest and the principal amount. The classification and measurement of the investment in listed bonds were correctly accounted for in the financial statements of Shantui for the year ended 31 December 20.25.

The financial manager of Shantui is unsure about the calculation and measurement of the loss allowance for expected credit losses of the investment in listed bonds for the year ended 31 December 20.25. He asked for your assistance in this regard. The financial manager provided you with the following schedule from the company's actuary containing the information relevant to the bonds:

ABC Actuaries

Date: 5 January 20.26

Dear financial manager of Shantui Ltd

We assessed the investment in listed bonds acquired by you on 1 January 20.25 and determined the following:

Credit risk on 31 December 20.25	Low risk
Present value on 31 December 20.25 of contractual cash flows on the listed bonds in terms of the bond contract.	R920 520
Present value on 31 December 20.25 of expected contractual cash flows on the listed bonds over the contract term of the bonds, based on the risk or probability of default occurring over the expected life of the bonds. We estimate that there is a very low possibility of a credit loss occurring on the listed bonds.	R899 320
Probability of default occurring between 1 January 20.26 – 31 December 20.26	0,5%

In our assessment, above, we made use of reasonable and supportable information about past and current conditions, as well as forecasts on the listed bonds available to us. We trust the above calculation will assist with your accounting of the listed bonds.

Yours sincerely
Mrs. Jacobs

Additional information

- Assume all amounts are material.
- The normal income tax rate is 27%.

QUESTION 5

YOU HAVE 30 MINUTES TO ANSWER THIS QUESTION

REQUIRED

		Marks
(a)	Prepare the journal entries for the financial year ended 31 December 20.25 in respect of transaction 1 in the records of Shantui Construction Ltd. **Please note:** • Ignore journal narrations. • Ignore any normal income tax implications. • Ignore the time value of money.	10
(b)	Discuss the recognition and measurement of the expected credit losses on the investment in listed bonds in the financial statements of Shantui Construction Ltd for the year ended 31 December 20.25 in accordance with IFRS 9 *Financial Instruments*. Your answer should include calculations.	9
	Communication skills: logical argument	1
Please note: • Ignore all Value Added Taxation (VAT) implications. • Round off all amounts to the nearest rand. • Your answer should comply with the International Financial Reporting Standards (IFRS).		

QUESTION 5 - Suggested solution

(a) Journal entries

		Dr R	Cr R	
	1 September 20.25			
J1	Bank (SFP) (CNY800 000 x 1,95)	1 560 000		(1½)
	Foreign loan (SFP))		1 560 000	(½)
	Recognise loan received at spot rate			
	31 December 20.25			
J2	Foreign exchange difference (P/L)	200 000		(1½)
	[CNY800 000 x (2,20 – 1,95)]			
	Foreign loan (SFP)		200 000	(½)
	Remeasure foreign loan to spot rate at reporting date			
J3	Finance costs (P/L)			
	(CNY800 000 x 9% x 4/12 = 24 000 x 2,02)	48 480		(1½)
	Accrued interest (SFP)			
	(CNY800 000 x 9% x 4/12 x 2,20)		52 800	(1½)
	Foreign exchange difference (P/L)	4 320		(1)
	Year end accrual for interest for four months ended 31 December 20.25			
J4	FEC Asset (SFP) [CNY200 000 x (2,10 – 2,00)]	20 000		(1½)
	Fair value adjustment (P/L)		20 000	(½)
	Remeasure FEC (derivative financial instrument) at year end			
			Total	(10)

(b) Recognition and measurement of expected credit losses

Recognition

Shantui is required to recognise a loss allowance for expected credit losses on financial assets measured at amortised costs (IFRS 9.5.5.1). (1)

The investment in listed bonds is classified as a financial asset measured at amortised cost, since it is held within a business model whose objective is to collect contractual cash flows of interest and the principal amount (IFRS 9.4.1.2). (1)

At each reporting date, Shantui should assess whether the credit risk of listed bonds increased significantly since the initial recognition of the listed bonds (IFRS 9.5.5.9). (1)

This assessment of the increase in credit risk determines if a loss allowance equal to an amount of lifetime expected credit losses or 12-month expected credit losses is recognised on the listed bonds (IFRS 9.5.5.3 and IFRS 9.5.5.5). (1)

An entity may assume that the credit risk on a financial instrument has not increased significantly if the financial instrument is determined to have a low risk at reporting date (IFRS 9.5.5.10).

The actuary indicated that the listed bonds had a low risk on 31 December 20.25. For this reason, Shantui may assume that the credit risk on the listed bonds did not increase significantly since the initial recognition of the listed bonds. (½) (½)

Based on the above, a loss allowance for expected credit losses equal to 12-month expected credit losses should be recognised on the investment in listed bonds. (1)

Measurement

In terms of IFRS 9.5.5.17 Shantui should measure the expected credit losses on the bonds in a way that reflects

- an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes.

  Even though the actuary determined that there is a very low possibility of a credit loss occurring on the listed bonds, the risk or probability that a credit loss may occur still has to be considered. (1)

  The actuary used a probability weighted amount when calculating the expected cash flows of the listed bonds. (½)

- The time value of money.

  The actuary used the contract term of the listed bonds to determine the present value of the expected contractual cash flows. (½)

- Reasonable and supportive information that was available to the actuary of Shantui without undue cost or effort about past events, current conditions and forecasts of future economic conditions. (1)

- The loss allowance for expected credit losses on the listed bonds, which are determined as follows:

	R	
Present value of contractual cash flows on 31 December 20.25	920 520	(½)
Present value of expected cash flows on 31 December 20.25	899 320	(½)
Lifetime expected credit losses	21 200	
Loss allowance equal to 12-month expected credit losses (21 200 x 0,5%)	106	(1)
Total		(11)
Maximum		(9)
Communication skills: logical argument		(1)

QUESTION 6 **15 marks**

YOU HAVE 6 MINUTES TO READ THIS QUEGSTION

Exclusive Clocks Ltd is a renowned clock maker in South Africa. Exclusive Clocks Ltd produces a range of beautiful clocks based on English clock making techniques and the latest technology in the industry. In order to produce authentic and high-quality clocks, Exclusive Clocks Ltd imports the necessary clock parts from England. The assembly of the clocks and engraving of dials take place at the assembly plant of Exclusive Clocks Ltd in Cape Town.

You have been asked to assist the accountant of Exclusive Clocks Ltd in finalising the financial statements of Exclusive Clocks Ltd for the year ended 30 June 20.25. The outstanding issues on which he requires your assistance are explained below:

1. Import of clock parts

On 31 December 20.24 Exclusive Clocks Ltd received an order from a major Johannesburg clock wholesaler for mantel clocks. To meet the required quantity of clocks for this order, Exclusive Clocks Ltd placed a non-cancellable order for the required clock parts from its supplier in England on 31 December 20.24 for an amount of £20 400. Due to the quantity of clock parts ordered and the risk it holds for foreign currency fluctuations, Exclusive Clocks Ltd entered into a four-month forward exchange contract (FEC) at a forward rate of £1 = R16,60 for the full amount payable. Exclusive Clocks Ltd entered into the FEC on the same date as the order was placed. The supplier in England requires settlement of the outstanding purchase price on 30 April 20.25. The clock parts were shipped free on board on 28 February 20.25 and arrived in Cape Town on 31 March 20.25.

The following exchange rates are applicable:

	Spot rate £1 = R	**Forward rate £1 = R**
31 December 20.24	16,25	16,60 (4 month FEC)
31 January 20.25	16,90	17,00 (3 month FEC)
28 February 20.25	17,45	17,20 (2 month FEC)
31 March 20.25	17,85	17,60 (1 month FEC)
30 April 20.25	18,10	

Exclusive Clocks Ltd does not apply hedge accounting in terms of IFRS 9.

2. Investment in listed bonds

On 1 July 20.23 Exclusive Clocks Ltd invested in listed bonds in Money Dreams Ltd. On this date Exclusive Clocks Ltd estimated the 12-month expected credit losses on the bonds at an amount of R35 000. The bonds were purchased on the following terms:

Maturity date	30 June 20.26
Coupon interest rate	6% per annum
Interest payment date	30 June
Nominal value per bond	R12 000
Number of bonds purchased	150
Redemption value	At nominal value

On 30 June 20.24 Exclusive Clocks Ltd assessed the credit risk of the bonds to estimate the expected credit losses at reporting date. During this assessment the directors of Exclusive Clocks Ltd obtained information that Money Dreams Ltd was in financial distress.

Exclusive Clocks Ltd determines that the credit risk of the bonds increased significantly since recognition of the bonds. Consequently, Exclusive Clocks Ltd measures the lifetime expected credit losses on 30 June 20.24 at R125 000.

On 30 June 20.25 Exclusive Clocks Ltd determines that the credit risk of the bonds has still increased significantly since initial recognition and measures the lifetime expected credit losses on this date at an amount of R165 000.

Additional information

- Assume all amounts are material.

QUESTION 6

YOU HAVE 23 MINUTES TO ANSWER THIS QUESTION

REQUIRED

		Marks
(a)	Prepare the journal entries to account for the transactions relating to the importing of clock parts in the financial statements of Exclusive Clocks Ltd for the year ended 30 June 20.25. **Please note:** • Ignore journal narrations but include journal dates. • Ignore the time value of money.	11
(b)	With reference to the investment in the listed bonds, disclose the changes in the loss allowance (allowance for expected credit losses) of the bonds in the financial statements of Exclusive Clocks Ltd for the year ended 30 June 20.25 in terms of IFRS 7.35H and the illustrated example contained in IFRS 7.IG20B. Comparative information is required.	3
	Communication skills: presentation and layout	1
Please note: • Round all amounts off to the nearest rand. • Ignore normal income tax implications. • Ignore Value Added Taxation (VAT) implications. • Your answer must comply with International Financial Reporting Standards (IFRS).		

QUESTION 6 - Suggested solution

(a) Journal entries

		Dr R	Cr R	
	28 February 20.25			
J1	Inventory (SFP) (£20 400 x 17,45)	355 980		(1)
	Creditor (SFP)		355 980	(½)
	Recognise inventory at spot rate on transaction date			
	30 April 20.25			
J2	Foreign exchange difference (P/L) (£20 400 x (18,10 – 17,45))	13 260		(1½)
	Creditor (SFP)		13 260	(½)
	Remeasure creditor to spot rate on settlement date (loss)			
J3	FEC asset (SFP) (£20 400 x (18,10 – 16,60)	30 600		(1½)
	Fair value adjustment (P/L)		30 600	(½)
	Remeasure FEC to fair value on settlement date (gain)			
J4	Creditor (SFP) (£20 400 x 18,10)	369 240		(1)
	FEC asset (SFP) (12 240 + 18 360) or (£20 400 x (18,10 – 16,60))		30 600	(1½)
	Bank (SFP) (£20 400 x 16,60)		338 640	(1)
	Derecognition of FEC and payment of creditor			
			Total	(11)

(b) EXCLUSIVE CLOCKS LTD

NOTES OF THE YEAR ENDED 30 JUNE 20.25

15. Listed bonds – loss allowance

	12-month expected credit losses R	Lifetime expected credit losses R	
Loss allowance at 1 July 20.23	-	-	
New bonds originated	35 000		(½)
Transferred to credit impaired financial assets	(35 000)	35 000	(1)
Changes in risk parameters		90 000	(½)
Loss allowance at 30 June 20.24	-	125 000	
Changes in risk parameters		40 000	(½)
Loss allowance at 30 June 20.25	-	165 000	(½)
		Total	(3)
	Communication skills: presentation and layout		(1)

QUESTION 7 **25 marks**

YOU HAVE 9 MINUTES TO READ THIS QUESTION

You are the financial manager of Ultra Motors Ltd (Ultra Motors). Ultra Motors is a company that manufactures and sells vehicles and vehicle component parts. Most of Ultra Motors products are exported to Australia and America, although some products are sold in the local market. Ultra Motors manufacturing plants are located in Port Elizabeth and most of the exports are made via the Port Elizabeth harbour.

Ultra Motors' financial year end is 30 September, and you are currently compiling the financial statements for the year ended 30 September 20.22. These financial statements must be submitted for approval at the directors' meeting on 15 November 20.22.

Except for transaction 1 which was correctly accounted for, transactions 2 to 4 must still be accounted for in the financial statements of Ultra Motors for the year ended 30 September 20.22.

Transaction 1: Import of machine

On 1 September 20.22 a non-cancellable order was placed to import a machine from Australia. The purchase price of AUS$ 99 000 was paid on 1 December 20.22. The machine was shipped free-on-board on 1 November 20.22. Ultra Motors obtained control of the machine on 1 November 20.22.

On 1 September 20.22 Ultra Motors entered into a forward exchange contract (FEC) for an amount of AUS$ 99 000 in anticipation of the future import. The FEC expired on 1 November 20.22 and was not renewed.

Ultra Limited does not apply hedge accounting in terms of IFRS 9.

The exchange rates applicable were as follows:

	Spot rate	2 months FEC rate	1 months FEC rate
	1 AUS$=R	**1 AUS$=R**	**1 AUS$=R**
1 September 20.22	8,00	8,18	8,20
30 September 20.22	8,11	8,34	8,32
1 November 20.22	8,30	8,48	8,45
1 December 20.22	8,35	8,58	8,54

Transaction 2: Loan incurred

Ultra Motors borrowed R1 000 000 from Altex Ltd (Altex) on 1 October 20.7. Interest amounting to R100 000 is payable annually on 30 September in respect of the loan. The repayment terms state that the loan capital must be repaid at a premium of R200 000 on 30 September 20.22 (to compensate for the low nominal interest rate compared to a market-related interest rate on a similar loan). You may assume that the loan and the related interest were treated correctly in the accounting records of Ultra Motors up to and including 30 September 20.22. The loan amounted to R1 200 000 in Ultra Motors' books on 30 September 20.22.

During September 20.22 Ultra Motors was in the process of expanding its business operations. To reserve funds for the expansion, Ultra Motors renegotiated the terms of the repayment of the loan with Altex. Ultra Motors proposed the following terms of the redemption of the loan:

- To redeem the loan by issuing 120 000 preference shares of Ultra Motors to Altex on 30 September 20.22.
- Preference dividend payments are within the discretion of Ultra Motors.
- The preference shares will be converted on 30 September 20.24, into the ratio of two ordinary shares for every one preference share held.

Altex accepted the proposal on the basis of growing their investment portfolio. The loan was redeemed on 30 September 20.22 by Ultra Motors issuing 120 000 preference shares to Altex. The redemption of loan has not been accounted for by Ultra Motors. You may assume that the preference shares are correctly classified as equity instruments in terms of IAS 32 *Financial Instruments: Presentation* and that the total fair value thereof amounted to R1 400 000 on 30 September 20.22.

SARS regards the redemption of the loan (by the issue of preference shares) as capital in nature and, therefore, allows no tax deductions in respect of the redemption of the loan.

Transaction 3: Issue of convertible debentures

To generate additional cash, Ultra Motors issued a total of 100 000 R10 debentures at a discount of 20% on 1 January 20.22. The debentures carry a coupon interest rate of 12% per annum, which is payable annually on 31 December. The compulsory convertible debentures will be converted into Ultra Motors ordinary shares in the ratio of one debenture for two ordinary shares on 31 December 20.28. There is no option for cash settlement. A market-related interest rate on similar debentures without conversion rights amounted to 9% per annum on 1 January 20.22. No entries have been made in respect of this transaction. Assume that SARS accepts the amortised cost of the debentures as the tax base of the debentures. Ultra Motors received a tax directive from SARS indicating that future taxable profits on the debentures will be taxed at 27%.

Transaction 4: Investment in shares

Ultra Motors invested in 200 000 ordinary shares of Speedfast Ltd (Speedfast) on 1 October 20.21, which represents 10% of the issued shares of Speedfast. Ultra Motors is dependent on Speedfast for the supply of its products and, therefore, regards this investment as a long-term strategic investment. On initial recognition of the investment in Speedfast, the management of Ultra Motors elected to recognise changes in the fair value of the equity instrument in other comprehensive income using the mark-to-market reserve.

The investment was acquired at fair value when the share price of Speedfast’s ordinary shares was R6,20 per share. Transaction costs directly attributable to the acquisition of the investment amounted to R23 000. The fair value of Speedfast’s ordinary shares on 30 September 20.22 amounted to R8,45 per share. For tax purposes the transaction costs are included in the tax base of the investment.

Additional information

- The issued share capital and retained earnings balance of Ultra Motors on 1 October 20.21 amounted to R3 000 000 and R2 340 000, respectively.
- Ultra Motors’ profit after tax amounted to R3 765 000 for the year ended 30 September 20.22, before considering the redemption of the loan in transaction 2 and transactions 3 and 4.
- The normal income tax rate is 27% and capital gains tax inclusion rate is 80%.

QUESTION 7

YOU HAVE 38 MINUTES TO ANSWER THIS QUESTION

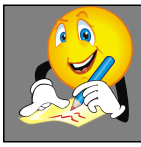
REQUIRED

		Marks
(a)	Prepare the journal entries for the financial years ended 30 September 20.22 **AND** 30 September 20.23 in respect of transaction 1 in the records of Ultra Motors Ltd. **Please note:** • Ignore depreciation journals in respect of the machinery. • Journal narrations are not required. • Ignore any normal income tax implications. • Ignore the time value of money.	11
(b)	Prepare the statement of changes in equity of Ultra Motors Ltd for the year ended 30 September 20.22. The total column and comparative figures are not required.	12
	Communication skills: presentation and layout	2

QUESTION 7 - Suggested solution

(a) Journal entries

		Dr	Cr	
	20.22 year	**R**	**R**	
	30 September 20.22			
J1	FEC asset (SFP) [(8,32 – 8,18) x $99 000]	13 860		(1½)
	Fair value adjustment (P/L)		13 860	(½)
	Fair value adjustment of FEC at year end			
	20.23 year			
	1 November 20.22			
J2	Fair value adjustment (P/L) [(8,30 – 8,32) x $99 000]	1 980		(½)
	FEC asset (SFP)		1 980	(1½)
	Fair value adjustment of FEC on expiry date.			
J3	Machine (SFP) [8,30 x $99 000]	821 700		(1)
	Creditors (SFP)		821 700	(½)
	Recognition of asset and creditor on transaction date			
J4	Bank (SFP) [(8,30 – 8,18) x $99 000]	11 880		(1½)
	FEC asset (SFP)		11 880	(½)
	Settlement of FEC on expiry date			
	1 December 20.22			
J5	Foreign exchange differences (P/L) [(8,35 – 8,30) x $99 000]	4 950		(1½)
	Creditors (SFP)		4 950	(½)
	Restatement of creditor to spot rate on payment date			
J6	Creditor (SFP) [99 000 x 8,35]	826 650		(1)
	Bank (SFP)		826 650	(½)
	Settlement of creditor			
			Total	(11)



EXAM TECHNIQUE

When preparing journals, always date your journals. This demonstrates to the examiner that you understand the occurrence of the specific dates of transactions.

(b) ULTRA MOTORS LTD

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 SEPTEMBER 20.22

	Ordinary share capital R	Preference share capital R	Retained earnings R	Convertible debentures equity component R	Mark-to market reserve R	
Balance at 1 October 20.21	3 000 000	-	2 340 000	-		(1)
Total comprehensive income for the year						
- profit for the year [C1]	-	-	3 535 240	-		(5½)
- other comprehensive income	-	-	-	-	[C3]334 768	(3½)
Issue of preference shares [C2]	-	1 400 000	-	-		(1)
Issue of convertible debentures [C4]	-	-	-	143 114[1]		(1)
Balance at 30 September 20.22	3 000 000	1 400 000	5 875 240	143 114	334 768	
					Total	(12)
					Communication skills: presentation and layout	(2)

[1]196 046 [C4] x 73% = 143 114

CALCULATIONS

C1. Profit for the year

Profit after tax (given)	3 765 000	[½]
Loss on redemption of loan (IFRIC 19) [C2]	(200 000)	[1]
Interest on the liability portion of the compulsory convertible debentures [C4]	(40 767)	[3]
Tax on the interest (40 767 x 27%)	11 007	[1]
	3 535 240	
		[5½]

C2. Loss on redemption of loan

IFRIC 19

Loan outstanding (given)	1 200 000	[½]
Preference shares issued at fair value	(1 400 000)	[½]
Loss on redemption of loan (P/L)	(200 000)	
		[1]

The loss is not deductible for tax purposes, since it is capital in nature. It is, therefore, considered in the profit **after** tax for 20.22 as it has no impact on the income tax expense for 20.22.

C3. Mark-to-market reserve

Fair value on 1 October 20.21 (200 000 x R6,20)	1 240 000	[½]
Capitalise transaction costs	23 000	[½]
	1 263 000	
Fair value on 30 September 20.22 (200 000 x R8,45)	1 690 000	[½]
Fair value adjustment	427 000	
Tax (R427 000 x 80% x 27%)	(92 232)	[1]
Mark-to-market reserve (net of tax)	334 768	
		[2½]

C4. Convertible debentures

Present value of the liability

N	=	7 years	[½]
I	=	9% p.a. (market interest rate)	[½]
PMT	=	(100 000 x R10) x 12% = 120 000	[½]
FV	=	0 (no cash option)	[½]
COMP PV	=	603 954	
			[2]

Financial liability	603 954	
Equity component (balancing figure)	196 046	[1]
Proceeds (100 000 x 10 x 80%)	800 000	
Interest income for the year ended 30 September 20.22		
1 AMORT (interest) R54 356 x 9/12	40 767	[1]
OR		
(603 954 x 9%) = 54 356 x 9/12	40 767	
		[4]

CASE STUDY 1 — 100 marks

YOU HAVE 30 MINUTES READING TIME. SPEND 30 MINUTES READING THE CASE STUDY BEFORE YOU CONTINUE TO THE REQUIRED SECTION.

QUESTION 1 — **58 marks**

IGNORE ANY VALUE-ADDED TAX IMPLICATIONS.

CRYPTOCURRENCY

You are a first-year auditing clerk who has been appointed to assist with the audit of Mining Ltd (Mining) for the year ended 28 February 20.29. For the last few days you have been situated at the head offices of the company which is in Johannesburg.

Early on the morning of 28 February 20.29, while you were still enjoying a double short latte in your recyclable Seattle take-away cup, Mr IT Guy came running out of the fish tank (an office partitioned off with glass) with his laptop held high above him. You could see that his excitement was overflowing, as he was shouting enthusiastically. All attention was drawn to the thrilled information technology (IT) specialist and as the realisation dawned through to everyone else in the office, they started to put their hands together. Slowly at first, but then with eagerness and shouts of congratulations.

An employee sitting across you saw your puzzled face and tried to speak above the noise: “Bitcoin”. “Bit of what?” you asked confused. “BitCOIN” she repeated herself, this time a bit louder, smiling. “He was successful in mining another Bitcoin. You know, cryptocurrency”, she explained.

Interesting, you thought to yourself – you were under the impression that mining was in the business mining of coal only. You soon learnt that the company is mining Bitcoins mainly for the long-term growth opportunity which potentially lies within this decentralised convertible virtual currency. The coin hit an all-time high in December 20.27 when it traded at $19 783,21 a coin. It also dropped with more than 50% within 16 days thereafter. Currently it has a value amounting to R55 000 each.

A Bitcoin does not have a unique identification number, but the transaction from which it originates (named a Satochi, after the founder(s) of Bitcoin) is traceable. However, in order to receive and transfer bitcoins, or a portion thereof, a Bitcoin Wallet is required. Each Bitcoin Wallet has a unique address.

The Bitcoin Wallet address of Mr IT Guy’s laptop is 18TGt8oGgLzkCpjxMbiRfvbDo9NqMiningg and within this wallet the balance of the owned Bitcoins is reflected. Mining secures the Bitcoin Wallet by safeguarding all their computers and the information thereon.

In November 20.23 the first Bitcoin automated teller machine (ATM) opened in a coffee house in Vancouver, Canada. In May 20.28, South Africa’s first cryptocurrency ATM was installed in Johannesburg, which made cryptocurrency accessible to individuals who do not have a bank account.

Mining can also exchange its Bitcoins for goods or services.

Considering the above, you commenced your day by writing a very important e-mail to your audit manager who spent her virtual currency (in the form of air miles) to travel to the Seychelles before the expiry of the miles. She did however indicate that she could be reached via e-mail for important matters.

To: auditmanager@audit.co.za
From: me@audit.co.za
RE: Virtual Currency

Mrs Audit Manager,

It came to my attention that our client, Mining Ltd, is also mining virtual currencies - *Bitcoin* in particular. The value of the Bitcoins (Bitcoin holdings) that have been mined during the year have not yet been accounted for in the financial statements of Mining Ltd.

According to the South African Reserve Bank a virtual currency is a digital representation of value that can be digitally traded and functions as a medium of exchange, a unit of account and/or a store of value, but does not have **legal tender*** status.

Further readings on Bitcoin indicated that the potential of Bitcoin is not solely limited to serving as a payment alternative, it has also been viewed as a commodity, asset class or security ripe for speculative investment.

Considering the above, I have compiled a list of the possible recognition and measurement of Mining Ltd's Bitcoin holdings and will appreciate an indication on the way forward.

The Bitcoin holdings can be recognised and measured either as:

(1) A financial asset; or
(2) An intangible asset.

Hope the air miles rewarded you with fun in the sun.

Regards,
Me
Audit clerk
Audit in Action Inc

* **Legal tender** *is a medium of payment recognised by a* ***legal*** *system to be valid for meeting a financial obligation. Paper currency and coins are common forms of legal tender in many countries*.

DEFERRED TAXATION

After the e-mail was written you returned to assist the accountant with finalising the company's deferred taxation calculation. The following incomplete calculation, as well as related information, was supplied to you: (You may assume that the below information is correct.)

	Notes	Carrying amount	Tax base	Temporary differences at 100% or 80%	Deferred tax at 27% asset/ (liability)
		R	R	R	R
28 February 20.28					
Temporary differences				6 250 000	(1 687 500)
Unused tax loss			8 500 000	(6 250 000)	1 687 500
Deferred tax liability				-	-
28 February 20.29					
Land	1	13 000 000	?		
Buildings	2	[a]7 200 000	?		
Plant	3	[b]3 500 000	?		
Inventory	4	1 050 000	?		
Deferred tax					

[a] R3 000 000 x 3 buildings x 20/25 years = R7 200 000
[b] R7 000 000/7 x 3,5 years = R3 500 000

1. Land

Land is accounted for according to the revaluation method. On 28 February 20.29 the revaluation surplus account reflects a closing balance of R2 352 000 relating to land only. This amount was correctly recognised during the current financial year.

2. Buildings

The three buildings are accounted for according to the cost model and depreciated over their useful lives according to the straight-line method.

On 28 February 20.29 the following journal entry was processed relating to one of the warehouse buildings after the above schedule was already compiled:

	28 February 20.29	**Dr** R	**Cr** R
J1	Non-current assets held for sale (SFP) (Balancing)	2 000 000	
	Accumulated depreciation and impairment (SFP) (R3 000 000/25 years x 5 years)	600 000	
	Impairment loss (P/L) (R2 400 000 – R2 000 000)	400 000	
	Warehouse building at cost (SFP) (given)		3 000 000
	Reclassification of warehouse to Non-current assets held for sale on 28 February 20.29		

The South African Revenue Services (SARS) allows a building allowance of 5% per annum, not apportioned for part of a year, in terms of section 13(1)(b), on these buildings.

3. Plant

Plant was commissioned on 1 September 20.25 at a cost amounting to R7 000 000. The SARS allows a wear and tear allowance with regard to the plant at 40% of the cost for the first year and 20% for the subsequent three years (not apportioned for part of a year).

4. Inventory

Mining valued its inventory at its net realisable value amounting to R1 050 000, which is R150 000 below its cost price. According to section 22(1) of the Income Tax Act, the Commissioner found that only 20% of the write-down to net realisable value to be just and reasonable to represent the amount by which the value of such trading stock has diminished.

5. Lease of computers

The lease agreement for the lease of computers contains the following information:

Commencement date	1 September 20.28
Lease term	3 years
Options contained within the lease agreement	Options to purchase computers at end of lease term
	At commencement of lease, there was no indication that the option will be exercised
Lease payment	R20 000 bi-annually in arrears

The SARS allows a wear and tear allowance over three years on a straight-line method according to section 11(e) on the cost of computers. Mining depreciates right-of-use assets according to the straight-line method. On 1 September 20.28 the computers had an expected useful life of three years.

Mining could not determine the rate implicit in the lease. The incremental borrowing rate of Mining was as follows:

- 7,75% per annum (compounded bi-annually) at 1 September 20.28; and
- 8,25% per annum (compounded bi-annually) at 28 February 20.29.

At inception of the lease, Mining acquired additional random-access memory (RAM) from Incredible Connection to enhance the processing power of the computers. The cost of the RAM amounted to R14 729.

On 28 February 20.29 Mining informed the lessor that they will exercise the option to purchase the computer equipment at the end of the lease term. The lessor indicated that a final payment amounting to R40 000 will be payable at the end of the lease term in order to exercise the purchase option.

6. Bonus

It is company policy to reward deserving employees each financial year with a bonus, which is payable in the month after the financial year end. For the year ended 28 February 20.28 R95 000 was paid for exceptional performance and in the current financial year that amount totalled R146 500.

Section 7B of the Income Tax Act deems the expenditure incurred in respect of bonuses to be incurred by the employer on the date during the tax year on which the amount is paid to the employee by the employer.

7. **Leave pay**

Employees are granted 28 days of leave during each calendar year. All leave that is not utilised (taken) during a calendar year, may roll over to the following calendar year for six months only. There after the leave will be forfeited.

Only personnel who resign will receive a cash payment for any unutilised leave at the date of resignation. Leave accrues to employees on a pro-rata basis for the number of months of employment. The following information relates to the leave balances of Mining.

	Number of days
Opening balance 1 March 20.28	1 150
Accrued during the year	3 220
Utilised during the year	(3 265)
Paid during the year	(70)
Closing balance 28 February 20.29	1 035

It is expected that 2 employees will resign in March 20.29. They have each accrued 13 days of unused leave on 28 February 20.29. The average cost to company per employee per day amounts to R960, while the average gross salary per employee per day totals R850. Mining remunerates employees based on their gross salary, when leave is paid out at resignation and accrues leave based on the cost to the company.

8. **Taxation**

On 12 February 20.29 an additional assessment was issued for the 20.28 tax year. According to this assessment R15 000 is payable to the SARS of which R2 500 relates to a penalty for late payment. Mining did not object this additional assessment.

9. **Foreign income**

During the current financial year Mining received foreign income which is only taxable in the country of origin at a rate of 25%. The tax that was paid to the company of origin amounted to R15 000.

10. **Profit before tax**

After considering the abovementioned items, the profit before tax for the year ended 28 February 20.29 correctly amounted to R6 000 000.

Additional information

- Assume that the normal income tax rate is 27% and that the capital gain inclusion rate is 80%.
- There are no temporary differences, other than those that are apparent from the information contained in the question.
- The only non-taxable and non-deductible items included in the accounting profit or loss are those that are apparent from the information provided.
- Mining expects to realise capital gains in the nearby future.
- You may assume that at inception of the lease contract Mining determined that the contract is a lease in terms of IFRS 16.9.
- Property, plant and equipment (including computers) are accounted for at the cost model and depreciated over its useful life according to the straight-line method.

QUESTION 2 **42 marks**

IGNORE ANY VALUE-ADDED TAX IMPLICATIONS.

PART I

Furn Decor Ltd (Furn Decor) is a listed company on the Johannesburg Stock Exchange and deals in the manufacturing and wholesaling of elegant home furniture. It has been in operation for the past 20 years and built a reputation for being the best when it comes to quality home furniture.

You are the newly appointed financial manager of Furn Decor. The financial director has asked you to assist with the completion of the financial statements for the year ended 30 September 20.29.

An extract of the following balances was presented to you:

Balance on 1 October 20.28	**R**
Ordinary share capital	40 000 000
Retained earnings	10 250 000

The profit before tax amounted to R18 475 000 before taking the following information into account:

1. On 1 December 20.28, Furn Decor acquired 500 000 ordinary shares in CAP Ltd (CAP) for R5,50 per share. The fair value of the shares on this date was R2 400 000. Furn Decor paid R20 000 in transaction costs to acquire these shares. On 28 February 20.29, CAP repurchased 15% of their shares *pro-rata* from all the shareholders at its fair value. Transaction costs of R8 000 were paid by CAP. On 30 April 20.29, CAP issued dividends of R0,80 per share to its existing shareholders.

   This is the first time that Furn Decor has purchased equity instruments.

   Furn Decor irrevocably elected in terms of IFRS 9.5.7.5 to present subsequent changes in the fair value of the investment in the mark-to-market reserve.

   Furn Decor has a policy of reclassifying previous fair value adjustments to retained earnings upon derecognition or financial assets designated at fair value through OCI.

   The following fair value schedule was made available to you:

Date	**Fair value**
1 October 20.28	R4,80 per share
28 February 20.29	R6,85 per share
30 September 20.29	R8,20 per share

2. On 1 October 20.27, Furn Decor purchased unlisted corporate bonds at its face value (also fair value) of R5 000 000. The bonds pay interest every four months at a nominal market related coupon rate of 8% per annum. The bonds will mature on 30 September 20.22 at a premium of 15% of its face value. The bonds are correctly held within a business model where the objective is achieved both by holding financial assets in order to collect contractual cash flows of principal and interest as well as to sell the bonds.

The financial director also made the following schedule regarding the credit losses balances and fair values relating to these bonds available to you:

Financial year ended	**12 month expected credit losses**	**Lifetime expected credit losses**	**Credit risk parameters**	**Fair value**
30 September 20.28	R24 000	R120 000	Low	R5 300 000
30 September 20.29	R30 000	R150 000	High (but not credit impaired)	R5 550 000

3. On 1 April 20.27, Furn Decor obtained a loan from Best Bank in order to finance a lucrative investment project. The loan was for an amount of R5 000 000 and R785 000 is repayable every 6 months, starting from 30 September 20.27, for the next 4 years. On 1 April 20.29, Furn Decor decided to renegotiate the terms of the loan payable to maintain its liquidity. The loan was settled by issuing 60 000 non-redeemable Class A preference shares of Furn Decor with a fair value of R51 each. Preference dividend payments are at the discretion of Furn Decor.

PART II

You have been appointed as the IFRS consultant for Swiss Ltd (Swiss), a chocolate manufacturer that is listed on the Johannesburg Stock Exchange. Swiss manufactures different varieties of milk and dark chocolate and has branches all over South Africa.

Currently, the company is trying to expand its footprint in other African countries.

After extensive market research, it was determined that opening up a new branch in Zambia will assist Swiss to gain entrance in the African market. In order to finance the expansion, Swiss issued 5 000 debentures with a nominal amount of R11 000 000 at a fair value of R2 000 per debenture on 30 September 20.29. Interest of R165 000 is payable quarterly, in arrears, and the debentures will mature on 30 September 20.23. Each debenture is convertible at the option of the holder into 20 ordinary shares for every five debentures held. Debentures not converted, will be redeemed at their nominal amount.

On 30 September 20.29 transaction costs of 800 000 were incurred by Swiss. Any transaction costs incurred on the issuance would be deductible for tax purposes in the tax year in which these costs are incurred. A market-related interest rate on 30 September 20.29, for similar debentures without conversion rights is 11% per annum, paid quarterly in arrears.

Only the following entries have been processed in respect of the issue of these debentures:

	Dr R	**Cr R**
30 September 20.29		
Bank (SFP)	11 000 000	
Financial Liability: Debentures (SFP)		11 000 000
Transaction costs (P/L)	800 000	
Bank (SFP)		800 000

CASE STUDY 1

REQUIRED

YOU HAVE 150 MINUTES TO COMPLETE THE CASE STUDY

QUESTION 1

		Marks
(a)	Prepare the audit work paper as instructed by your audit manager in the e-mail below which she sent in response to your enquiry: To: me@audit.co.za From: auditmanager@audit.co.za RE: Virtual Currency Dear Me Thank you for your e-mail, and the information relating to cryptocurrency. With regard to your query, please refer to my comments below: It is evident to me that Mining Ltd acquired the Bitcoin holdings mainly for capital appreciation (investment) purposes, to gain from increases in the market value thereof and will realise it at fair value when it is sold. Should the company decide to transact with the Bitcoin holdings in order to obtain other goods or services, the Bitcoin holdings will also be realised at fair value. Therefore, in my view, to increase the usefulness of the information provided in the financial statements, the Bitcoin holdings should be measured at fair value, with any movement in the fair value thereof recognised in profit or loss, since this will provide both relevant information to users of the financial statements as well as faithful representation of the financial performance of Mining Ltd. While I am on leave, please prepare a work paper containing the following:	
	(i) Discuss whether the recognition and measurement of the Bitcoin holdings at fair value, with any movement in the fair value thereof recognised in profit or loss, will be best achieved by accounting for the Bitcoin holdings as a financial asset or as an intangible asset in terms of the International Financial Reporting Standards relevant to each option; **Please note:** • Your answer should not refer to the Conceptual Framework.	16
	(ii) Also kindly discuss whether Mining Ltd's Bitcoin holdings qualifies as an asset in terms of the definition of an asset according to the Conceptual Framework; and	4

	Marks
(iii) If the Conceptual Framework supports the recognition and measurement of the Bitcoin holdings at fair value, with the movement in the fair value thereof recognised in profit or loss. Regards, Audit Manager	6
Communication skills: logical argument	1
(b) Disclose the taxation note to the financial statements of Mining Ltd for the year ended 28 February 20.29 as required by IAS12.79-.80. **Please note:** • Comparative figures are not required • The movement in temporary differences in the current tax calculation has to be calculated by using the statement of financial position method.	30
Communication skills: logical argument	1
Please note • Round off all amounts to the nearest rand. • Assume all amounts are material. • Your answer must comply with International Financial Reporting Standards (IFRS).	

QUESTION 2

REQUIRED

	Marks
PART I Prepare the equity and liabilities section of the Statement of Financial Position of Furn Decor Ltd for the year ended 30 September 20.29.	24
Communication skills: presentation and layout	1
Please note: • Comparative amounts **are** required. • Round off all amounts to the nearest Rand. • Ignore any tax implications.	
PART II Prepare the correcting journal entries to account for the issue of debentures by Swiss Ltd for the year ended 30 September 20.29.	17
Please note: • Include journal entries relating to current and/or deferred taxation. • Journal narrations are not required. • Round off all amounts to the nearest Rand. **Please note:** • Your answer must comply with International Financial Reporting Standards (IFRS).	

CASE STUDY 1

QUESTION 1 – Suggested solution

(a) Working Paper

Client	Mining Ltd	SFP 2
Preparer	ME	
Reviewer	Mrs Audit Manager	
Date	1/03/.19	

Recognition and measurement of a Bitcoins

(i) Recognition and measurement options

(1) Financial asset

Recognition

IFRS 9 *Financial* Instruments allows for financial instruments to be measure at **fair value,** with the **movement in the fair value thereof to be recognised in profit or loss.** However, in order to account the Bitcoin holdings as a financial asset, the Bitcoin holdings has to meet the definition of a **financial instrument** in terms of IAS 32 *Financial Instruments: Presentation*. (1)
In order for the Bitcoin holdings to meet the definition of a financial instrument as defined in IAS 32; it has to be a **contract that gives rise to a financial asset of one entity and a financial liability (or equity instrument) of another entity.** (1)

However the Bitcoin holdings:

- Is not a financial asset as defined in IAS 32, since:
  - It is **neither cash**, due to the South African Reserve Bank that does not regard bitcoins as legal tender and it cannot be readily exchanged for goods or services (IAS 7 *Statement of Cash Flows*); (1)
  - nor **cash equivalents** since their value is exposed to significant changes in market value (IAS 7); (1)
- Is, not a contractual right since possession of a Bitcoin does not grant the holder thereof any contractual right to receive cash or another financial asset; and (1)
- Is not an equity instrument or a contract to be settled in equity instruments. (1)

Therefore the Bitcoin Holdings cannot be recognised as a financial asset. (1)

(2) Intangible asset

In order to account for the Bitcoin holdings as an intangible asset the definition and recognition requirements should be met (IAS 38.18).

Definition

The Bitcoin has to be an **identifiable non-monetary asset without physical substance.** (no mark)

Since Bitcoin is a form of digital money (virtual currency), it **does not have any physical substance.** (1)

Each Bitcoin Wallet in which the value of the Bitcoin holdings is contained has **a unique address** and the Bitcoin holdings can be traded on an exchange or in peer-to-peer transactions, **therefore is identifiable.** (1)

Bitcoin is also identifiable as it identified to be separable since **Mining Ltd can transfer it via ATM of exchange it for other goods and services.** (1)

Monetary assets are money held and assets to be received in fixed or a determinable amount of money. The value of the Bitcoin holdings is **not fixed or determinable,** but subject to major fluctuations that arise from supply and demand that cannot be predicted. Therefore, it is not monetary but non-monetary in nature. Also, it **does not have legal tender status** under the South African Reserve Bank and therefore will remain **non-monetary.** (2)

Mining **controls** the Bitcoin as it can **benefit from its long-term growth** and it has **restricted access to the Bitcoin wallet** by safeguarding their computers (IAS 38.13). (1)

Recognition

Mining Ltd can benefit economically from long term growth and by exchanging it for other goods and services. (½)

The cost of the bitcoin can be measured reliably at R55 000. (½)

Conclusion

Considering the above, Mining Ltd can account for its Bitcoin holdings as an **intangible asset.** (1)

Measurement

The Bitcoin was not purchased, but mined, therefore the **initial measurement at cost** will consist of **cost directly attributable** in obtaining the Bitcoin (being the cost of leasing the computer equipment, employee cost as well as the electricity cost). (1)

The Bitcoin holdings will **subsequently be measured** on either the **cost model** or the **revaluation model.** (1)

Since Bitcoin transactions takes place with sufficient frequency and volume to provide pricing information on an ongoing basis **an observable, active market exists** in order to account for Bitcoin according to the **revaluation model.** (2)

The Bitcoin holdings has an **indefinite useful life** and therefore will **not be amortised.** (1)

However, all movements, **other than decreases greater than previous increases,** will be **accounted for in other comprehensive income** (OCI) and any realised gain will **not be recycled through profit or loss.** Therefore the movement in the fair value of the Bitcoin holdings will **not be reflected in profit or loss.** (2)

Conclusion

Since the Bitcoin holdings fail to meet the criteria to be recognised as a financial instrument, recognition and measurement of the Bitcoin holdings at fair value will be best achieved by accounting for the Bitcoin holdings as an intangible asset according to the revaluation method. This will, however, not achieve the recognition of the movement in the fair value of the Bitcoin holdings in profit or loss. (2)

To ensure that the financial statements will provide relevant information to the users thereof, Mining Ltd can consider additional disclosure of relevant information.

Total (24)
Maximum (16)

(iii) Classification of a Bitcoin holdings as an asset

According to the revised *Conceptual Framework*, Mining Ltd will be able to classify its Bitcoin holdings as an asset, if a past event(s) has led the company to have control over a present right to the Bitcoin holdings that has the potential to produce economic benefits to Mining Ltd which will encompass an economic resource for Mining Ltd. (1)

Mining Ltd has obtained its Bitcoin holdings due to the **mining thereof which is the past event.** (1)

Mining Ltd also obtained a **right that has the potential to produce economic benefits** since the Bitcoin holdings entitles or enables Mining Ltd to receive **cash by either selling the coins on an exchange or redeeming it for cash at an automated teller machine** (ATM). It also enables Mining Ltd to **receive another economic resource or extinguish liabilities by transferring the coins.** (2)

Mining Ltd also **has control over its Bitcoin holdings** since it has the **present ability to direct the use** (either sell it on the exchange or exchange it for goods or services) of the coins and to **obtain the economic benefits that may flow from it.** Mining Ltd also has the **present ability to prevent other parties from directing the use** of the coins and **obtaining the economic benefits that may flow from it,** since it is securely stored on Mining Ltd's computers which is under their control only. (2)

Conclusion:

According to the revised *Conceptual Framework*, the Bitcoin holdings can be classified as an asset. (1)

Total (7)
Maximum (4)

(iv) Support of fair value measurement

The revised *Conceptual Framework* of 2018 (Conceptual Framework) allows for a measurement bases which accounts an asset at its **current value,** which includes the fair value thereof. (1)

The revised *Conceptual Framework*, does however, also indicate that the **enhancing qualitative characteristics** of comparability, understandability and verifiability together with the **cost constraint** need to be taken into account to **select the measurement basis.** Since an **active market** exists for Bitcoins, there will be **limited cost constraints** for Mining Ltd to elect that its Bitcoin holdings should/can be measured **at fair value.** (3)

Lastly, the revised *Conceptual Framework* indicates that since the **statement of profit or loss is the primary source of information about an entity's financial performance for the period, all income and expenses should be included in this statement.** Only in exceptional circumstances income or expenses arising form **a change in the current value of an asset or liability will be included in other comprehensive income,** should it result in **the statement of profit or loss to provide more relevant information or be a more faithful presentation of the company's financial performance** for the period; which imply that any movements in the fair value of Mining Ltd Bitcoin holdings for the period under review should be **recognised in profit and loss.** (4)

Conclusion

Therefore, the revised *Conceptual Framework* supports the recognition and measurement of Mining Ltd's Bitcoin holdings at fair value with the movement in the fair value thereof recognised in profit or loss. (1)

Total	(9)
Maximum	(6)
Communication skills: logical argument	(1)

(b) Tax note to the financial statements of Mining Ltd

MINING LTD

NOTES FOR THE YEAR ENDED 28 FEBRUARY 20.29

12. Income tax expense

	20.29 **R**	
Major components of tax expense		
SA Normal tax		
Current tax	126 022	
- Current year [C1]	113 522	(26½)
- Under provision for prior years (R15 000 – R2 500)	12 500	(1)
Deferred tax	896 953	
- Movement in temporary differences [C2]	(790 547)	(½)
- Recognition of unused tax loss not previously recognised [C3]	(607 500)	(1)
- Unused tax loss utilised [C3]	2 295 000	(½)
Foreign tax (given)	15 000	(1)
	1 037 975	
	Total	(30)
	Communication skills: Presentation and layout	(1)

CALCULATIONS

C1. Current tax calculation

	R	
Profit before tax	6 000 000	[½]
Non-taxable/Non-deductible items:		
- Foreign income not taxable (R15 000/25%)	(60 000)	[1]
- Impairment below tax base not deductible (250 000 x 20%)	50 000	[1]
- Penalty not deductible	2 500	[½]
Movement in temporary differences (taxable) [C2]	2 927 950	[22½]
Taxable profits before unused tax loss	8 920 450	
Unused tax loss of prior year (given)	(8 500 000)	[1]
Taxable profit for the year	420 450	
Tax at 27%	113 522	[½]
		[26½]

C2. Deferred tax

	Carrying amount	Tax base	Temporary differences at 100% or 80%	Deferred tax at 27% asset/ (liability)	
	R	R	R	R	
28 February 20.28					
Deferred tax at 100% inclusion rate			6 250 000	(1 687 500)	
Unused tax loss	-	8 500 000	(6 250 000)	1 687 500	
			-	-	
28 February 20.29					
Land @ 100% (cost)	10 000 000	10 000 000	-	-	[1]
Land @ 80% (revaluation surplus)	[a]3 000 000	-	2 400 000	(648 000)	[2]
Buildings	[b]4 800 000	[c]4 500 000	300 000	(81 000)	[2]
NCAHFS – Building @ 80%	[d]2 000 000	[e]2 250 000	(200 000)	54 000	[2]
Plant	[f]3 500 000	[g]-	3 500 000	(945 000)	[2]
Right-of-use asset	[C5]132 055	-	132 055	(35 655)	[4]
Lease of computers	[C4](121 405)		(121 405)	(32 779)	[4]
Inventory	[f]1 050 000	[h]1 170 000	(120 000)	32 400	[2]
Bonus accrual	[f](146 500)	-	(146 500)	39 555	[1]
Leave pay accrual	[i](990 740)	[j]968 640	(22 100)	5 967	[2]
			5 722 050	(1 544 953)	[22]
Movement in temporary differences through P/L – excluding unused tax loss (R5 722 050 – R2 400 000) – R6 250 000)			(2 927 950)	790 547	[22½]
Movement in temporary differences through OCI (taxable)			2 400 000	(648 000)	
Movement in unused tax loss (R0 – (R6 250 000))			6 250 000	(1 687 500)	[½]
			5 722 050	(1 544 953)	

[a] R2 352 000 x 100/[100 - (100 x 27% x 80%)] = R3 000 000 [1]
[b] R3 000 000 x 2 x 20/25 = R4 800 000 or R7 200 000 x 2/3 [1]
[c] R3 000 000 x 2 x 5% x 15 = R4 500 000 [1]
[d] Fair value (given) [½]
[e] R3 000 000 x 5% x 15 = R2 250 000 or R4 500 000/2 [1]
[f] Given [½]
[g] Fully written off for tax purposes [1]
[h] R1 050 000 + (R150 000 x 80%) = R1 170 000 [1]
[i] (1 035 days – (13 days x 2)) x R960 + (13 days x 2) x R850) = R990 740 [2]
[j] 990 740 - 26 days x R850 = R968 640 [½]

C3. Movement in unused tax loss

	R	
Unused tax loss not previously recognised[1]	(607 500)	[1]
Unused tax loss utilised[2]	2 295 000	[1]
	1 687 500	
		[2]

[1] (R8 500 000 – R6 250 000) x 27% = R607 500
[2] R8 500 000 x 27% = R2 295 000

C4. Lease liability

Sharp EL-738		**HP 10BII**		
1. 2ndF MODE	(Clear all)	1. 2ndF C	(Clear all)	
2. 2ndF I/Y 2 ENT	(P/Y)	2. 2 2ndF	PMT(P/YR)	[½]
3. R20 000	PMT	3. R20 000	PMT	[½]
4. 7,75%	I/Y	4. 7,75%	I/YR	[½]
5. 6	N	5. 6	N	[½]
6. COMP PV ⇒	R105 271	6. PV ⇒	R105 271	

Sharp EL-738	**HP 10BII**	
1. AMRT 2 ENT ▽ 2 ENT	1. 1 INPUT 1 2ndF FV(AMORT)	[1]
2. ▽	2. = = =	
3. BALANCE: R89 350	3. BALANCE: R89 350	

Sharp EL-738		**HP 10BII**		
1. 2ndF MODE	(Clear all)	1. 2ndF C	(Clear all)	
2. 2ndF I/Y 2 ENT	(P/Y)	2. 2 2ndF	PMT(P/YR)	
3. R20 000	PMT	3. R20 000	PMT	
4. 8,25%	I/Y	4. 8,25%	I/YR	[½]
5. 5	N	5. 5	N	[½]
6. R40 000	FV	6. R40 000	FV	[½]
7. COMP PV ⇒	R121 405	7. PV ⇒	R121 405	

C5. Right-of-use asset

	R	
Lease liability	105 271	[2]
Indirect costs	14 729	[½]
	120 000	
Depreciation (R120 000/3 x 6/12)	(20 000)	[1]
	100 000	
Reassessment: change in lease liability (R121 405 – R89 350)	32 055	[2½]
	132 055	

QUESTION 2

FURN DECOR LTD

EXTRACT OF STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20.29

	20.29 R	20.28 R	
Equity and liabilities			
Equity			
Ordinary share capital	40 000 000	40 000 000	(½)
Retained earnings [C2]	28 799 664	10 250 000	(7)
Mark-to-market reserve [C3]	1 428 000	-	(5)
Fair value adjustment on debt instruments [C4]	C4.2 294 747	C4.1 (178 856)	(4½)
Allowance for credit losses	150 000	24 000	(1)
Non-redeemable Class A preference share capital (60 000 x 51)	3 060 000		(1)
Non-current liabilities			
Long-term borrowings [C5.2]		2 123 292	(4)
Liabilities			
Current liabilities			
Current portion of long-term borrowings [C5.1]		1 241 514	(1)
			(24)
Communication skills: presentation and layout			(1)

CALCULATIONS

C1. Retained earnings

	R	R	
Opening balance		10 250 000	[½]
Profit for the year		18 392 914	
Given		18 475 000	[½]
Ordinary shares – CAP Ltd			
Fair value	2 400 000		[½]
Paid (500 000 x 5,50)	(2 750 000)		[1]
Day 1 loss on purchase of shares		(350 000)	
Dividends received = 500 000 x 85% x 0,80		340 000	[1½]
Unlisted corporate bonds			
Expected credit losses (150 000 – 24 000)		(126 000)	[1]
Interest on bonds [C4.1] (4 AMORT 6) INT		534 108	[½]
Loan from Bank			
Interest on 30 April 20.29 [C5] 4 input 4		(180 454)	[½]
Balance 4 input 4	2 760 260		[½]
Issue of preference shares (60 000 x R51)	(3 060 000)		[½]
IFRIC 19 – Loss on derecognition of loan payable		(299 740)	
Transfer from mark-to-market reserve		150 750	[½]
		28 793 664	
			[7½]

C3. Mark-to-market reserve

	R	
Fair value adjustment 28 February 20.29		
Paid (2 400 000 + 20 000)	2 420 000	[1]
Fair value (500 000 x 6,85)	3 425 000	[1]
	1 005 000	
Sale of 15% of shares (1 005 000 x 15%) (transfer to retained earnings)	(150 750)	[1]
Fair value adjustment 30 September 20.29		
500 000 x 85% x (8,20 – 6,85)	573 750	[2]
	1 428 000	
		[5]
OR		[5]
Fair value adjustment 28 February 20.29		
(500 000 x 15%) = 75 000 x (6,85 – 4,80)	153 750	[2]
Less: capitalised transaction costs (20 000 x 15%)	(3 000)	[1]
	150 750	
Fair value adjustment 30 Sep 20.29		
(500 000 x 85%) = 425 000 x (8,20 – 4,80)	1 445 000	[1½]
Less: capitalised transaction costs (20 000 x 85%)	(17 000)	[½]
	1 428 000	[5]

Note: If student did not use or perform first calc, award ½ to the second 500 000 if used

C4. Fair value adjustment on debt instrument

C4.1	P/YR	=	3		[½]
	FV	=	-5 750 000 (5 000 000 x 1,15)		[½]
	N	=	15 (5 years x 3)		[½]
	PV	=	5 000 000		[½]
	PMT	=	-133 333 [(5 000 000 x 8%)/3]		[½]
	I	=	10,34%		
	Balance on 30 September 20.28 (3 AMORT 3/1 AMORT 3)			5 121 144	[½]
	Fair value (given)			5 300 000	[½]
	Opening fair value – 1 October 20.28			178 856	
C4.2	Balance on 30 September 20.29 (6 AMORT 6)			5 255 253	[½]
	Fair value			5 550 000	[½]
	Closing fair value			294 747	
					[4½]

C5. Long-term loan

P/YR	=	2		[½]
PV	=	-5 000 000		[½]
FV	=	0		
N	=	8 (4 x 2)		[1]
PMT	=	785 000		[½]
I	=	10,73%		
Balance on 30 September 20.28 (3 AMORT 3) (balance)			3 364 806	[½]
				[3]

C5.1 Current portion of long-term loan

Capital of PMT 4 and PMT 5	1 241 514	
PMT 4 =	604 546	[½]
PMT 5 =	636 968	[½]
		[1]

C5.2 Long-term loan

Long-term portion (3 364 806 – 1 241 514)	2 123 292	[1]
		[4½]

PART II

FURN DECOR LTD

JOURNALS FOR THE YEAR ENDED 30 SEPTEMBER 20.29

		Dr R	Cr R	
J1	Liability component of convertible debenture (SFP) [C2]	1 760 629		(1½)
	Bank (SFP) [11 million – (R2 000 x 5 000)]		1 000 000	(1)
	Equity component of convertible debentures (SCE) [C1]		760 629	(4)
J2	Liability component of convertible debentures (SCE) [C3]	739 150		(1½)
	Equity component of convertible debentures (SFP) [C3]	60 850		(1)
	Transaction costs (P/L)		800 000	(1)
J3	Current tax payable (SFP)	216 000		(1½)
	Equity component (SCE) [C4]		16 430	(1)
	Income tax expense (P/L) [C5]		199 570	(1)
J4	Income tax expense (P/L)	199 570		(1½)
	Equity component (SCE) [C6]	205 370		(1½)
	Deferred tax liability (SFP) [C6]		404 940	(2½)
				(17)

CALCULATIONS

C1. Calculation of debt/equity component

			R	
Proceeds (R2 000 x 5 000)			10 000 000	[½]
Liability component				
PMT	=	165 000 (given)		[1]
N	=	16 (4 x 4)		[½]
FV	=	11 000 000		[½]
I	=	11%		[½]
PV	=		9 239 371	
Equity component			760 629	[½]
				[3½]

C2.	11 000 000 – 9 239 371	1 760 629	[1]

C3. Allocation of transaction costs

	R	
Liability component: 9 239 371/10 000 000 x 800 000	739 150	[1]
Equity component: 760 629/10 000 000 x 800 000	60 850	[½]
	800 000	
		[1½]

		R	
C4.	800 000 x 27%	216 000	[1]
C5.	739 150 x 27%	199 570	[½]
		R	
C6.	60 850 x 27%	16 430	[½]

C7.	**Deferred tax**	**CA**	**TB**	**TD**	**DT**	
	Liability component	[1]18 500 221	[2]10 000 000	1 499 779	(404 940)	[½]

1 9 239 371 – 739 150 [1]
2 Proceeds [½]

OR

Carrying amount of liability at 30 September 20.29 (9 239 371 - 739 150)	8 500 221	[1]
Tax base of liability at 30 September 20.29	10 000 000	[½]
Taxable temporary difference	1 499 779	
Deferred tax liability (1 499 779 x 27%)	404 940	[½]
Recognise in equity (760 629 [C1] x 27%)	(205 370)	[1]
Recognise in profit and loss	199 570	