QUESTION **100 marks**

In this question –
- **ignore all effects of any changes in functional currency in Zimbabwe; and**
- **assume that there is no hyperinflation in Zimbabwe.**

1 Background

The Toon World Entertainment Group ('TWE Group') is a Zimbabwean creative media and entertainment group involved in the production and distribution of animated movies and TV series. TWE Group has been operating in this industry since 1992 and listed on the Zimbabwe Stock Exchange in 2015.

Key information pertaining to the TWE Group:

- All companies in the TWE Group are incorporated in Zimbabwe and have 30 June financial year ends.
- The TWE Group prepares its financial statements in accordance with International Financial Reporting Standards (IFRSs).
- Assume that the functional and presentation currency of all companies in the TWE Group is the Zimbabwe dollar (ZWL), for all periods relevant to this scenario.

At 30 June 2020 (FY2020) the TWE Group consisted of the following separate legal entities which are all material to the TWE Group:

- TWE Holdings Ltd ('TWE Holdings'): This is the listed holding company. TWE Holdings is not an investment entity as defined in IFRS 10 *Consolidated Financial Statements* and no person has control or joint control over TWE Holdings.
- TWE Productions (Pvt) Ltd ('TWE Productions'): This entity is responsible for the production of animated movies and TV series. It outsources some of its functions to third-party animation studios.
- TWE Manufacturing (Pvt) Ltd ('TWE Manufacturing'): This entity is responsible for the manufacture, packaging and distribution of digital versatile discs (DVDs) to customers. This entity also has a division responsible for the manufacture of clothing and accessories related to the TWE Group's movies and TV series. It includes items such as toys and video games.
- Digital Streaming Solutions (Pvt) Ltd ('DSS'): DSS is a technology start-up company involved in the development of applications for a wide range of customers, including retailers expanding into the online shopping space.

During the year TWE Holdings had the following executive directors, who are also full-time employees of the company:

Role and responsibility	Executive director
Chief Executive Officer	Mr Sheriff Woody
Chief Operating Officer	Mr Buzz Lightyear (passed away on 15 September 2019, replacement yet to be identified)
Chief Financial Officer	Ms Andrea Peep
Chief Investment Officer	Ms Sally Carrera

Awdit Inc. ('Awdit') has been re-appointed as the auditors of the TWE Group and some of the separate legal entities for FY2020. You are one of the audit trainees who has been allocated to the FY2020 TWE Group audit team.

The following separate legal entities are also audited by your audit team:

- TWE Holdings,
- TWE Productions, and
- TWE Manufacturing.

2 Investment in TWE Manufacturing

On 1 July 2017 TWE Holdings decided to diversify its business activities and invested in TWE Manufacturing. The details regarding this investment are tabled below:

Nature of relationship with the group	Manufacturing and packaging of DVDs Manufacturing of clothing and accessories
Number of ordinary shares in issue	100 000 ZWL1 shares
Ownership interest acquired	35% (35 000 shares)
Purchase price	ZWL500 000 cash consideration settled on 1 July 2017
Long-term loan	TWE Holdings lent TWE Manufacturing ZWL80 000 with no fixed terms of repayment on 1 July 2017. The settlement of this loan is not considered likely, nor is it planned to occur in the foreseeable future.
Additional information	This share acquisition has not resulted in TWE Holdings acquiring control or joint control of TWE Manufacturing. The net asset value of TWE Manufacturing amounted to ZWL1,2 million on 1 July 2017 and all the identifiable net assets of TWE Manufacturing were fairly valued at that date. As at 30 June 2020 TWE Manufacturing had inventory on hand to the value of ZWL45 000 that had been acquired from TWE Holdings during FY2020. TWE Holdings levied a 25% mark-up on cost.

The TWE Group has disclosed all information in relation to TWE Manufacturing as follows in the consolidated annual financial statements for FY2020:

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2020	
18. Interest in associate	**ZWL**
	Dr/(Cr)
TWE Manufacturing	
Investment in associate	594 500
Summarised financial information for the year	
Financial position	
Non-current assets	1 570 000
Current assets	320 000
Non-current liabilities	(380 000)
Current liabilities	(40 000)
Net assets	1 470 000
Share capital	(100 000)
Retained earnings	(1 370 000)
	–
Profit or loss for the year	
Revenue	(180 000)
Profit after tax for the year	(120 000)

The investment in TWE Manufacturing is accounted for using the equity method. Equity accounted income that is included in the carrying amounts of the investments represents the group's proportionate share of the associate company's retained earnings after accounting for dividends received/payable by the associate.

3 Investment in DSS

TWE Holdings identified DSS as a possible investment opportunity because customers were changing the way media content was being used. In 2017 TWE Holdings therefore decided to acquire a 10% equity interest in DSS for a total cash consideration of ZWL300 000. At acquisition, TWE Holdings correctly classified the 10% equity interest as a financial asset in its separate and consolidated financial statements and elected to measure the investment at fair value through other comprehensive income.

TWE Holdings also had an option to acquire a further 35% equity interest in DSS on or before 30 June 2023 for a fair market value, to be determined by an independent external valuation expert. The shareholders' agreement stated that if TWE Holdings exercised its option to acquire the further 35% interest, it would also be entitled to appoint three of the five directors of DSS.

The Board of TWE Holdings decided to exercise the option and acquired the additional 35% equity interest on 1 September 2019. This resulted in TWE Holdings correctly obtaining control of DSS in terms of IFRS 10 *Consolidated Financial Statements* from that date and it was correctly identified as a business combination in terms of IFRS 3 *Business Combinations*. TWE Holdings elected to measure non-controlling interests from this acquisition at its fair value of ZWL1,45 million on the acquisition date. On 1 September 2019 the fair value of the initial 10% equity investment in DSS amounted to ZWL380 000.

The acquisition was settled as follows:

1 An immediate cash payment of ZWL990 000 on 1 September 2019. On 31 May 2020 the senior accountant of TWE Holdings identified that ZWL65 000 of this payment related to costs in respect of valuations and legal agreements for the acquisition of DSS. It was paid to Moche Consultants in September 2019;
2 The issuance of 5 000 TWE Holdings ordinary shares to the sellers on 30 June 2020, contingent on DSS reaching a cumulative sales target of R16 million for FY2020, with no option for a pro rata issuance of shares. On 1 September 2019 it was expected that the cumulative sales target would be met, and the fair value of the contingent consideration was correctly measured at ZWL35,60 per share offered; and
3 A payment of ZWL10 000 per month to Mr Rex Green, a former shareholder of DSS, for a period of 12 months (commencing on 1 September 2019). This was subject to the condition that the monthly operating cost of DSS remain below budget during this 12-month period. Rex acted as the chief operating officer of DSS during this period, at a lower than market-related salary.

The fair value of the identifiable net assets was equal to their carrying amounts at the acquisition date, except for the following:

1 DSS's internally developed software that is critical to their application development processes. DSS has copyright over this software and has expensed all costs incurred in respect of this software to date. The fair value of the software amounted to ZWL620 000 and is expected to have an indefinite useful life.
2 DSS's accrued leave liability for their employees, which was correctly accounted for in terms of IAS 19 *Employee Benefits,* and which amounted to ZWL160 000. The fair value of the liability was estimated to be ZWL210 000.

3 Computer equipment purchased on 1 July 2017 for ZWL300 000. This equipment was written off in full in FY2019 but is still actively being used by DSS. The information technology policy of TWE Holdings states that group computers are to be replaced every three years. TWE Holdings estimated the value of the computer equipment acquired at acquisition date in 2017 was approximately ZWL100 000, but based on transactions of similar items in the market at the time could be sold externally for ZWL150 000.

Details of the net asset value of DSS at the relevant dates are as follows:

	1 September 2019 ZWL	30 June 2020 ZWL
Share capital (100 000 shares)	100 000	100 000
Retained earnings*	1 860 000	3 090 000

* Including profit or loss line items to date.

The income and expenses of DSS accrued evenly throughout the financial year.

DSS achieved sales of ZWL15,8 million in FY2020.

JPA Auditors Inc. ('JPA') –
- has been appointed as the auditors of DSS for FY2020;
- is an audit firm with a 30-year experience in auditing small and medium-sized businesses;
- is not affiliated with Awdit; and
- has never audited companies within Awdit client groups.

4 Related party transactions

The following is an extract from the notes to the separate financial statements of TWE Holdings for FY2020:

NOTES TO THE SEPARATE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2020

39. Related party transactions

During the year, the company entered into the following transactions with related parties:

	Sale of goods/services		Purchase of goods/services	
	2020 ZWL	2019 ZWL	2020 ZWL	2019 ZWL
Digital Streaming Solutions (Pvt) Ltd	140 000	–	–	–
TWE Manufacturing (Pvt) Ltd	358 000	380 000	–	450 000
TWE Productions (Pvt) Ltd	132 000	120 000	–	–

TWE Holdings Ltd charges a management fee to each of these companies due to its ability to control or significantly influence them.

39. Related party transactions (continued)

The amount earned from TWE Manufacturing (Pvt) Ltd consists of a sale of inventory for ZWL160 000 (2019: ZWL200 000) and a management fee of ZWL198 000 (2019: ZWL180 000). The amounts earned from the other related parties pertain solely to management fees.

	Dividends received	
	2020 ZWL	2019 ZWL
TWE Productions (Pvt) Ltd	150 000	134 000

The following amount was outstanding at the reporting date:

	Amounts owed by related parties		Amounts owed to related parties	
	2020 ZWL	2019 ZWL	2020 ZWL	2019 ZWL
Digital Streaming Solutions (Pvt) Ltd	14 000	–	–	–

The amount outstanding relates to the management fee earned by the company. The amount outstanding is unsecured and will be settled in cash.

No expense has been recognised in the period for bad or doubtful debts in respect of the amounts owed by related parties.

Remuneration of key management personnel

During FY2017 all the executive directors of TWE Holdings Ltd acquired 10 000 shares each in TWE Productions (Pvt) Ltd for ZWL150 per share when the market value on the date of purchase was ZWL280 per share. They may only sell these shares in 2022.

5 Group instructions to JPA

The email below was sent from the engagement partner of the TWE Group audit, Ms Michelle Furr, to the engagement partner of the DSS audit, Mr Arjun Naidoo.

From: michelle.furr@awdit.co.za
To: ANaidoo@jpa.co.za
Date: 17 June 2020 7:25 am
Priority: Urgent
Subject: Audit of DSS for the purposes of consolidation of the TWE Group

Good Day Arjun

We are the auditors of the TWE Group, and understand that JPA has again been appointed as external auditor of DSS for FY2020.

As DSS is considered to be a significant component of the TWE Group in terms of ISA 600, the results of your audit will be used to limit ~~the~~ our audit work on DSS. We will then focus on auditing the consolidation of the TWE Group for FY2020. We therefore request that you also report to us, as group auditors, in terms of the attached instructions and International Standards on Auditing.

I summarise the key points pertaining to the attached instructions below:

1 Given that your firm has already considered all relevant ethical requirements (including independence requirements) before accepting DSS as a client, it is not necessary to consider ethical requirements (including independence requirements) related to the TWE Group audit.
2 You may set the planning and performance materiality for DSS at whatever level you deem appropriate.
3 For your consideration during the audit of DSS, note that there is a number of related party transactions among the entities in the TWE Group, similar to what has been disclosed in the TWE Group financial statements for the previous financial year.
4 Please send me only your audit report, even if it is still in draft format, as soon as you have completed your audit.

Please do not hesitate to contact me should you have any questions regarding the attached instructions.

Regards
Michelle

After completing the DSS audit, Arjun sent the following email to Michelle:

From: ANaidoo@jpa.co.za
To: michelle.furr@awdit.co.za
Date: 31 July 2020 17:25 pm
Priority: Urgent
Subject: Audit of DSS for the purposes of consolidation of the TWE Group

Good Day Michelle

Per your e-mail sent on 17 June 2020, I attach our draft audit report on the annual financial statements of DSS for FY2020.

As part of our audit, we identified a management fee paid by DSS to TWE Holdings. We did not perform any audit procedures on the management fee as, for the purposes of the TWE Group audit, the intercompany transactions should be eliminated upon consolidation.

We also identified a number of control deficiencies while performing our control testing over the approval of costs incurred in the maintenance of IT infrastructure (such as servers, hardware and network costs). Based on our enquiries we were given to understand that the whole TWE Group is using the same supplier for IT-related costs, and as a result we took no further steps to respond to the deficiencies. We were hoping that the controls performed at a group level are operating effectively and would therefore provide us with assurance that the control deficiencies at DSS would not be an issue for the TWE Group.

All the best with the finalisation of the TWE Group audit.

Regards
Arjun

6 Additional information

- It is the policy of the TWE Group to account for investments in subsidiaries on the cost method in its separate financial statements in accordance with IAS 27 *Consolidated and Separate Financial Statements,* par. 10(a).
- It is the policy of the TWE Group to account for investments in associates on the cost method in its separate financial statements in accordance with IAS 27.10(a), and by using the equity method as per IAS 28 *Investments in Associates and Joint Ventures* in the consolidated financial statements.
- The TWE Group has elected to transfer cumulative gains or losses on investments in equity instruments previously recognised in other comprehensive income to retained earnings on disposal of the instrument.
- TWE Holdings has elected to apply IFRS 3 *Business Combinations* to the recognition and measurement of the 5 000 shares that would have been issued by TWE Holdings in partial settlement of the acquisition of the 35% interest in DSS in its separate financial statements.

7 Incorporation of a sole trader into a private limited company

Assume, for section 7 of the scenario only, that you are an independent tax consultant.

Two years ago you were approached by a client, Mr James Butcher, and his son Michael, to assist with a matter. They provided the following information about James:

- He carried on a sole trader business as a fast-food distributor.
- He commenced the business on 1 March 2016.
- James did not own shares in any other business.
- He employed three full-time employees in addition to himself.
- James confirmed that, for the period 1 January 2018 to 28 February 2018, the business made a profit before tax of ZWL1,2 million on a turnover of ZWL7,5 million. The profit before tax included depreciation for those two months of ZWL20 000.
- James was a VAT registered operator and only made taxable supplies.
- He operated the business with a gross profit of 50%.

At that time Michael, who has a BCom degree, suggested that his father's business be incorporated into a private limited company to take advantage of the limited liability afforded by a company.

Michael suggested the following action plan to bring this about:

- On 1 March 2018 James would exchange all the assets and liabilities of his business for a fresh issue of shares by the new company.

- James' business held accounts receivable of ZWL600 000 and accounts payable of ZWL400 000 on 1 March 2018.

- The other business assets held by James on 1 March 2018 were as follows. These would be transferred to the private limited company at their market values.

	Notes	Date acquired	Original cost ZWL	Carrying value ZWL	Market value ZWL
Fast food equipment		1 March 2016	400 000	160 000	180 000
Delivery vehicle	1	31 August 2016	240 000	150 000	180 000
Laptop computers	2	31 August 2017	40 000	10 000	6 000
Registered patents	3	1 March 2016	200 000	200 000	300 000

Notes

1 The delivery vehicle (not a passenger vehicle as defined in the Income Tax Act) was acquired for cash from a supplier not registered for VAT. The original cost had not been reduced by any VAT when depreciation was calculated.

2 The laptop computers were acquired from a registered operator and the relevant VAT on the transactions was claimed as input tax deductions.

3 The trademarks were registered in terms of the Trade Marks Act [Chapter 26:04] and related to the fast food brands used by the business.

- James had a ten-year lease over the fast-food outlet from which he operated. He would sublet the premises to the new company at a monthly rental of ZWL12 000 (excluding VAT). His lease with the lessor was ZWL10 000 per month (excluding VAT). This lessor is a registered VAT operator.

- The new company would register for VAT from the commencement of trade on 1 March 2018.

- James' business was treated as a small to medium sized entity in terms of the Finance Act and the new company would have the same status.

INITIAL TEST OF COMPETENCE, NOVEMBER 2020

PROFESSIONAL PAPER 4

This question consists of two parts. Answer each part in a separate answer book.

PART I – REQUIRED		**Marks** Sub-total	**Marks** Total
(a)	Discuss the accuracy and completeness of Note 18: *Interest in associate* for FY2020 in accordance with IFRSs.	10	
	Do not re-draft the note, except with regard to potentially omitted disclosures.		
	Communication skills – logical argument	*1*	11
(b)	Discuss how TWE Holdings should recognise and measure the 5 000 shares that would have been issued by TWE Holdings in partial settlement of the acquisition of the 35% interest in DSS in its separate financial statements for FY2020.	6	
	Ignore tax.		6
(c)	Prepare the pro forma journal entries to account for the investment in DSS in the consolidated financial statements of the TWE Group for FY2020.	24	
	• Do not provide journal entries for the attribution of the FY2020 profit to the non-controlling interests. • Do not provide separate journal entries for the elimination of profit or loss line items during FY2020 up and until the acquisition date.		
	Communication skills – presentation	*1*	25
(d)	Assuming that James took Michael's advice and converted his business into a private limited company, calculate the following:		
	(i) James' taxable income for the 2018 year of assessment;	8	
	(ii) The capital allowances that would have been available to the new company for the 2018 year of assessment; and	3	
	(iii) The capital gains tax that would have arisen in James's hands for the 2018 year of assessment.	4	15
Total for part I			**57**

INITIAL TEST OF COMPETENCE, NOVEMBER 2020

PROFESSIONAL PAPER 4

This question consists of two parts. Answer each part in a separate answer book.

PART II – REQUIRED		**Marks Sub-total**	**Marks Total**
(e)	Describe the fraud and/or errors that could occur during the consolidation process that would increase the risk of material misstatement in the FY2020 consolidated financial statements of the TWE Group. Ignore any matters related to presentation and disclosure.	11	
	Communication skills – clarity of expression	*1*	12
(f)	Describe the risks of material misstatement regarding the presentation and disclosure of the related party transactions and balances in the separate financial statements of TWE Holdings for FY2020.	6	6
(g)	Describe the substantive procedures Awdit should perform to gather sufficient and appropriate audit evidence with regard to the management fee earned from DSS.	10	
	Communication skills – appropriate style	*1*	11
(h)	Discuss any concerns you may have regarding the summary of key points listed in the email sent by Michelle to Arjun.	6	
	Communication skills – logical argument	*1*	7
(i)	Discuss the impact that the control deficiencies reported by JPA in Arjun's email would have on the nature of the further audit procedures that Awdit should undertake in relation to the 2020 consolidated annual financial statements of TWE Holdings.	7	7
Total for part II			**43**
TOTAL FOR THE QUESTION			**100**