



**TOE407V  
ZAC407G  
FIRST PAPER**

October/November 2011

**APPLIED FINANCIAL ACCOUNTING**

Duration : 3 Hours

100 Marks

EXAMINATION PANEL AS APPOINTED BY THE DEPARTMENT.

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Use of a non-programmable pocket calculator is permissible.

This examination question paper remains the property of the University of South Africa and may not be removed from the examination venue.

This paper consists of 10 pages (**QUESTION 1** and **QUESTION 2**).

**YOU HAVE 30 MINUTES TO READ THIS PAPER**

**This is a limited open book examination.**

STUDENTS ARE ALLOWED TO BRING THE FOLLOWING BOOK INTO THE EXAMINATION HALL:

**SAICA HANDBOOK (VOLUMES 1 TO 4) (2010/2011)**

**Departemental Examination Panel:**

**First Examiners:** Mr PC Malemone  
Ms J Sturdy  
Ms C Wright

**Second Examiner:** Prof ZR Koppeschaar

**External Examiner:** Prof C Lambrecht (University of Stellenbosch)

**QUESTION 1****70 marks**

Bugatti SA Ltd assembles and sells Bugatti luxury sport motors and is listed on the JSE Limited. Bugatti SA Ltd was incorporated five years ago when their French parent, Bugatti Automobile S.A.S., decided to relocate the Bugatti assembly plant to South Africa, as it is more cost effective to assemble the Bugatti models in South Africa.

The parent, Bugatti Automobile S.A.S. in Molsheim, France, manufactures the majority of the components for all the Bugatti models and ships semi knock down (SKD) car kits to South Africa for assembly.

The SKD car kits that are manufactured in France are shipped to East London in the Eastern Cape, South Africa, where the assembly plant of Bugatti SA Ltd is situated.

The financial year-end of Bugatti SA Ltd is 31 October 2011. Bugatti SA Ltd's functional currency is Rand.

You are a qualified CA(SA) and have recently been appointed as the financial manager of Bugatti SA Ltd. As you are familiar with all the International Financial Reporting Standards, the financial director asked you to work through the following information of Bugatti SA Ltd.

**BUGATTI SA LTD****TRIAL BALANCE FOR THE YEAR ENDED 31 OCTOBER 2011**

	Note	Dr R	Cr R
Revenue	3		580 000 000
Cost of sales	4	311 300 000	
Dividends received	6		300 000
Other expenses	4	6 700 000	
Salaries – assembly technicians (excluding October 2011)	4	5 200 000	
Salaries – administrative staff		4 200 000	
Finance costs	2	685 000	
Transaction costs	6	20 000	
Distribution costs		400 000	
Loan from Bugatti Automobile S.A.S.	1		12 513 600
Investment in Auto Electric Ltd	6	3 675 000	
9% Debentures	2		4 750 000
Suspense account	4	77 600 000	
Inventory (opening inventory 1 November 2010)	4	16 800 000	
Share capital	7		70 110 650
Deferred tax (closing balance 31 October 2010)	8		1 008 000
South Africa Revenue Services (SARS)	9	38 680 000	
Land at cost		60 000 000	
Plant and machinery at cost		170 100 000	
Accumulated depreciation (31 October 2011)			14 250 000
Bank		15 800 400	
Trade and other receivables		3 840 000	
Trade and other payables			2 800 500
Retained earnings			29 267 650
		<u>715 000 400</u>	<u>715 000 400</u>

The following information still needs to be considered in order to finalise the trial balance:

### 1. Loan from Bugatti Automobile S.A.S.

On 1 November 2010 Bugatti SA Ltd obtained a loan of €1 500 000 from Bugatti Automobile S.A.S. in order to upgrade the assembly plant for the assembly of the latest Veyron 16.4 models. The loan bears interest at 8% per annum which is a market-related interest rate. Interest is payable annually in arrears on 31 October while the total capital is repayable on 31 October 2013. The only journal entries made with regard to this loan were as follows:

	Dr R	Cr R
Bank	13 680 000	
Loan from Bugatti Automobile S.A.S. (€1 500 000 x 9,12)		13 680 000
Initial recording of the loan on 1 November 2010		
Loan from Bugatti Automobile S.A.S. (€1 500 000 x 8% x 9,72)	1 166 400	
Bank		1 166 400
Payment of interest on 31 October 2011		

Assume that the SARS accepts the accounting treatment of this loan from Bugatti Automobile S.A.S. for tax purposes in all respects.

### 2. Debentures issued by Bugatti SA Ltd

On 1 January 2011 Bugatti SA Ltd issued 5 000 9% debentures with a face value of R1 000 each at a discount of 5%. Bugatti SA Ltd incurred transaction costs of R25 000 with regard to the issue of the debentures. The transaction costs of R25 000 are included in finance costs.

Interest is payable annually on 30 June and 31 December. On 31 December 2015, at the option of the debenture holders, the debentures will either be converted in the ratio of 100 ordinary shares for each debenture held, or will be settled in cash. A fair return on debentures without conversion rights amounted to 11% on issue date and 11,5% on 31 October 2011. The interest paid is included in finance costs.

Assume that the SARS accepts the accounting treatment of the debentures for tax purposes in all respects.

### 3. Revenue

South African customers of Bugatti SA Ltd normally collect their sport motors in person from the assembly plant in East London.

An amount of R6 580 000 was received on 28 October 2011 from a customer for a Veyron 16.4 Super Sport that was ready for collection. This Veyron was only collected by its new owner on 3 November 2011. This amount was included in revenue on 31 October 2011.

#### 4. Inventory

- 4.1 On 1 December 2010, Bugatti SA Ltd placed a non-cancellable order to purchase 60 SKD car kits from Bugatti Automobile S.A.S. in France at a total cost of €8 000 000. On the same date the company entered into a six-month forward exchange contract (FEC) to buy €8 000 000, in order to protect the company against unfavourable fluctuations in the Rand/Euro exchange rate. It is Bugatti SA Ltd's intention to use the SKD car kits in the assembly of its sport motors.

The SKD car kits were shipped free-on-board on 15 January 2011 and arrived in the harbour at East London, South Africa on 28 January 2011, after which it was delivered to Bugatti SA Ltd's assembly plant on 5 February 2011.

Bugatti SA Ltd settled its account with Bugatti Automobile S.A.S. in respect of the above transaction on 1 June 2011.

Bugatti SA Ltd designated this FEC as a fair value hedge of the changes in the fair value of the unrecognised firm commitment and as a fair value hedge of the changes in the fair value of the foreign creditor. The hedge met all the criteria of IAS 39.88 *Financial Instruments: Recognition and Measurement*. You may assume that the hedge is effective. It is Bugatti SA Ltd's policy to include amounts that result from fair value hedges of a firm commitment in the initial measurement of the associated asset (basis adjustment).

The only transaction recorded for the purchase of the SKD car kits were as follows:

	<b>Dr</b> <b>R</b>	<b>Cr</b> <b>R</b>
Suspense account (€8 000 000 x 9,70)	77 600 000	
Bank		77 600 000

- 4.2 Bugatti SA Ltd also incurred the following local expenditure in respect of the importing of the SKD car kits that is **included** in other expenses in the trial balance above:

	<b>R</b>
Import duties charged by the South African customs (non-recoverable duty)	3 500 000
Transport costs from East London harbour to Bugatti's assembly plant	1 500 000
Administrative overheads	54 500

Six completed sport motors with a total value of R39 650 000 were in stock as at 31 October 2011. This is Bugatti SA Ltd's only closing inventory.

- 4.3 The following additional expenditure was incurred in assembling the sport motors and is **not included** in the trial balance given above:

	<b>R</b>
Other small motor vehicle parts purchased locally (used in the assembling process)	2 000 000
Depreciation on plant and machinery	2 850 000
Salaries for the month of October 2011 (Assembly technicians)	510 000

Included in the salaries paid to assembly technicians for October 2011, is an amount of R110 000 paid to an assembly technician who got injured at the assembly plant of Bugatti SA Ltd. An engine (weighing 1 ton) fell on Mr L Sorry's foot while the engine was being lifted by a crane. Bugatti SA Ltd paid Mr L Sorry R110 000 for the injuries and pain he suffered due to this incident. Assume that the payment to Mr L Sorry is not tax deductible.

Assume that the SARS accepts the accounting treatment of the above inventory transactions for tax purposes in all respects, except for the payment to Mr L Sorry.

## 5. Discontinued operations

The seats of all the models of Bugatti SA Ltd are handmade from ostrich leather by the seat division of Bugatti SA Ltd in Oudtshoorn. The seat division has its own operational manager and financial accounts. The cash flows and operations of the seat division can be clearly distinguished from the rest of Bugatti SA Ltd.

The board of directors of Bugatti SA Ltd decided on 28 February 2011 on a directors' meeting to implement a formal plan to close down the seat division. Bugatti SA Ltd decided to rather import already made seats from France in order to have a more authentic European look to the interior of the sport motors.

A task team was appointed on 28 February 2011 to begin with an active marketing program to close the seat division. The minutes of the meeting clearly indicate that the business operations must be suspended before 15 November 2011. The minutes also indicate that it is unlikely that a significant amendment to the plan will be made or that the plan will be withdrawn.

On 28 February 2011 the closure of the seat division qualified as a discontinued operation in terms of IFRS 5 *Non-current assets held for sale and discontinued operations*.

The following are the actual results of the seat division for the year ended 31 October 2011 and is **not included** in the trial balance above:

	<b>01/11/2010- 28/02/2011</b>	<b>01/03/2011- 31/10/2011</b>
	<b>R</b>	<b>R</b>
Revenue	1 240 000	2 658 000
Cost of sales	868 000	1 860 600
Operating costs (including depreciation of the seat manufacturing machines)	648 000	
Operating costs (excluding depreciation of the seat manufacturing machines)		995 000
Finance costs	85 500	192 500

The following information regarding the seat division is **not included** in the trial balance of the seat division and is also **not included** in the trial balance of Bugatti SA Ltd:

- 5.1. The closing of the seat division necessitates the dismissal of five employees. The termination benefits of these employees are estimated at R850 000 and will be paid on 30 November 2011.

- 5.2 Certain of the seat manufacturing machinery are leased. Due to the closing of the seat division, it is necessary to end the lease agreement prematurely and consequently an estimated fine of R265 000 is payable on 30 November 2011.
- 5.3 The SARS does not regard fines and termination benefits to be incurred in the production of income.
- 5.4 The actual direct cost of the discontinuance for the year ended 31 October 2011 amounts to R76 000 and the estimated direct cost of the discontinuance to be paid during November 2011 is R57 000. The SARS will allow the direct cost of discontinuance as a tax deduction.
- 5.5 On 28 February 2011, information relating to the sale of the assets of the discontinued operation was as follows:

	<b>R</b>
Land - cost and tax base	280 000
Land - contract price as per agreement	280 000
Buildings - carrying amount on 28 February 2011	544 000
Buildings - tax base on 31 October 2011	544 000
Buildings - contract price per agreement	537 000

All other assets and liabilities will be transferred at their carrying amounts. Assume that no temporary differences arose from the other assets and liabilities of the seat division for the year ended 31 October 2010.

It is Bugatti SA Ltd's accounting policy to present the analysis of the discontinued operation in the notes to the financial statements.

## **6. Investment in Auto Electric Ltd**

Bugatti SA Ltd acquired 150 000 ordinary shares in Auto Electric Ltd on 1 November 2010 for R24,50 per share. Transaction costs amount to R20 000. The transaction costs qualify to be part of the base cost of this investment in terms of paragraph 20 of the 8th Schedule of the Income Tax Act. Auto Electric Ltd is the South African manufacturer of all the electrical wiring (harnesses) that are fitted in all the Bugatti models. This investment constitutes a 30% interest in Auto Electric Ltd and has been made for strategic reasons. Bugatti SA Ltd irrevocably designated this investment to present subsequent changes in fair value in other comprehensive income (IFRS 9 *Financial Instruments* paragraph 5.7.5).

The fair value of the shares in Auto Electric Ltd was R27,00 on 31 October 2011. Apart from the initial recognition of this transaction and dividends received, no further entries have been recorded.

## **7. Share capital**

Bugatti SA Ltd had 58 550 258 ordinary shares in issue on 1 November 2010.

## **8. Deferred tax**

The net taxable temporary differences were R3 500 000 (including temporary differences on land, plant and machinery) on 31 October 2011 before taking into account the effect of the above transactions.

**9. Income tax**

The balance of the SARS account on 31 October 2011 was as follows:

	<b>R</b>
Balance on 1 November 2010 (payable to SARS)	2 800 000
Payment made in final settlement of 2010 assessment (including a penalty of R200 000 for late submission of returns and interest of R80 000)	(3 280 000)
Provisional payments in respect of 2011	(38 200 000)
	<u>(38 680 000)</u>

**10. Additional information**

10.1 The following exchange rates were applicable:

<b>Date</b>	<b>Spot rate</b>	<b>Forward rate expiring on 1 June 2011</b>
1 November 2010	€1 = R9,12	
1 December 2010	€1 = R9,17	€1 = R9,23
15 January 2011	€1 = R9,15	€1 = R9,24
28 January 2011	€1 = R9,16	€1 = R9,27
5 February 2011	€1 = R9,13	€1 = R9,25
1 May 2011	€1 = R9,40	N/A
1 June 2011	€1 = R9,70	N/A
31 October 2011	€1 = R9,72	N/A
Average exchange rate from 1 November 2010 until 31 October 2011	€1 = R9,60	N/A

10.2 The income tax rate is 28%. Capital gains are taxed at 50% of the normal rate.

10.3 The directors of Bugatti SA Ltd are of the opinion that sufficient taxable income will be available in future to utilise any deductible temporary differences.

**Please note**

The financial year-end date in this question is 31 October 2011. The date was selected in order to test IFRS 9 *Financial Instruments* (issued October 2010).

**QUESTION 2****30 marks**

Afrique Safaris (Pty) Ltd ("Afrique") operates in the 4x4 tourism industry. Afrique is a South African company with a 28 February year-end. The following is an extract from Afrique's website in which an overview is given of the 4x4 tours that Afrique offers.

"On a wildlife explorer safari in Botswana, guests will travel overland in a comfortable Unimog 4x4 truck, allowing for a first-hand view of Botswana's spectacular and varied landscapes with awesome wildlife thrown into the mix."

Historically, approximately 60% of Afrique's tourists have been non-South African residents. However, because of the strengthening of the South African Rand during the past few years, the number of nonresident tourists has steadily declined, but significantly declined in the current year. This decline has not been compensated for by an increase in the number of South African resident tourists.

Information relating to the significant assets of Afrique is set out below:

**1. Vehicles – Unimog 4x4 trucks**

Afrique acquired four newly manufactured Unimog 4x4 trucks on 1 March 2004 from a manufacturer at a total cost of R8 million. Unimog 4x4 trucks had an estimated useful life of 10 years, after which Afrique expects to purchase new Unimog 4x4 trucks. At initial recognition, Afrique estimated the residual value of a Unimog 4x4 truck at R700 000. The company still intends to sell the Unimog 4x4 trucks on 28 February 2014.

The manufacturer of the Unimog 4x4 trucks maintains records of resale values of various Unimog 4x4 trucks. On 28 February 2011, the resale prices of Unimog 4x4 trucks of the same make and model as those of Afrique were as follows:

- Ten-year-old Unimog 4x4 trucks were selling for R700 000 each.
- Seven-year-old Unimog 4x4 trucks were selling for R1 million each.

The costs of selling second-hand Unimog 4x4 trucks are negligible.

The carrying value of the Unimog 4x4 trucks have not been reduced for any amounts other than the annual depreciation charge, which is calculated at the end of each financial year.

Prior to finalising the financial statements of the company for the year ended 28 February 2011, executive management had to present budgets for the next three financial years to Afrique's board of directors.

The board of directors approved the following recent financial budgets for the Unimog 4x4 trucks operation:

	Year to			
	28 Feb 2011 Actual R'000	28 Feb 2012 Budgeted R'000	28 Feb 2013 Budgeted R'000	28 Feb 2014 Budgeted R'000
Cash revenue	4 300	4 100	4 050	3 900
Total expenses	4 000	3 940	3 910	3 850
Cash operating costs	3 480	3 420	3 390	3 330
Depreciation	520	520	520	520
Pre-tax (loss)/profit	300	160	140	50

The above estimates include the effects of inflation. Revenue is earned and received evenly throughout the years.

The following discount rates are applicable to investments equivalent in risk to the Unimog 4x4 trucks operation:

- Pre-tax nominal rate (including the effect of inflation) 15%
- Pre-tax real rate (excluding the effect of inflation) 10%

## 2. Vehicles – SUV Bush Cruiser

The popularity of self-drive 4x4 trips into Africa has increased during the last few years. Afrique decided to purchase four 80-series second-hand SUV Bush Cruisers (value of tyres negligible) to be modified with the latest 4x4 accessories. Afrique will rent out the SUV Bush Cruiser vehicles to tourists who would like to do self-drive 4x4 trips into Africa. Afrique entered into a six-month contract with the Overland 4x4 Fitment Centre on 1 June 2010 to modify the SUV Bush Cruiser vehicles with the necessary accessories in order to ensure that they are "bush ready". Twenty percent (20%) of the contract amount relates to 20 new mud terrain tyres for the SUV Bush Cruiser vehicles. The following are details of the abovementioned transactions:

	<b>Date</b>	<b>Amount</b>
Purchase second-hand SUV Bush Cruisers	1 May 2010	R120 000 each
Overland 4x4 Fitment Centre contract (6 months)	1 June 2010	R500 000 (four vehicles)

The Overland 4x4 Fitment Centre delivered the completed vehicles to Afrique on 1 December 2010 after receiving the outstanding contract amount of R500 000.

Afrique paid R15 000 to *GO Magazine* for advertisement cost. *GO Magazine* included advertisements in their June 2010 to December 2010 issues, introducing the SUV Bush Cruiser vehicles of Afrique to prospective tourists.

The SUV Bush Cruisers had an estimated useful life of 10 years, with no residual value. Afrique estimates that the mud terrain tyres will need to be replaced after 50 000 km has been travelled. Afrique depreciates its tyres according to the distance-travelled method. Under this method of depreciation, the depreciation of the tyres is calculated based on the number of kilometres travelled during the reporting period divided by the total estimated kilometres. Each vehicle travelled the following number of kilometres from 1 December 2010 to 28 February 2011:

	<b>Number of kilometres</b>
Vehicle 1 *	2 500 km
Vehicle 2 *	4 000 km
Vehicle 3	0 km
Vehicle 4	0 km

\*None of the spare tyres on the vehicles was used.

### 3. Building under construction

The company decided to build a new office building in Johannesburg during 2010 on a piece of vacant land. This land was acquired on 1 March 2010 for R1 000 000 and the company will use the building after completion to operate from.

Afrique was granted a mortgage bond of R5 000 000 with a nominal interest rate of 12% annually, compounded annually. Since the mortgage bond was an access bond, the company was able to draw funds out of the bond only as and when it was required. The building contractor invoiced the company for R4 000 000 on 26 June 2010 and the company made its first withdrawal from the bond on 30 June 2010 in order to make this first payment. The company withdraw the balance of R1 000 000 on 31 August 2010 in order to make the second payment which was invoiced to them on 26 August 2010.

The balance of the building cost incurred after 28 February 2011 and the office building will be completed on 30 September 2011. The remainder of the building cost will be funded by the company's general borrowing facilities.

### 4. Land and buildings

Afrique owns a small office building in Cape Town, from which the company operates. The Cape Town office was purchased on 1 March 2008. Afrique decided to move its offices to Johannesburg on 1 November 2010. Afrique held the Cape Town office building for capital appreciation purposes from 1 November 2010. The following information about the Cape Town office is available:

	<b>Land R</b>	<b>Building R</b>
Purchase price (1 March 2008)	500 000	900 000
Market value (28 February 2010)	530 000	1 200 000
Market value (1 November 2010)	525 000	1 150 000
Market value (28 February 2011)	550 000	1 160 000
Depreciation rate (straight-line method)	-	2%
SARS building allowance (no apportionment)	-	20 years

Afrique has revalued its land and buildings on 28 February 2010 to ensure that the carrying amount does not differ materially from the amount that would be determined using the fair value at the reporting date. Afrique engages Surveyors & Co, an accredited independent valuer, to determine the fair value of its land and buildings. The market values are determined with reference to prices in an active market. Depreciation for the year should be based on the most recent valuations as at the end of that specific year. Revalued assets are disclosed at the net replacement cost and revaluation surpluses will only be realised when the related assets are sold or disposed of. Investment properties are accounted for by means of the fair value model. It is the policy of the company to disclose land and buildings as separate classes.