ACCOUNTING 4 – 2015

FINAL ASSESSMENT OPPORTUNITY
OCTOBER 2015

FIRST EXAMINER: MR. M VAN WyK
INTERNAL MODERATOR: PROF. D. COETSEE
EXTERNAL MODERATOR: MRS. E DU TOIT

TIME: 120 MINUTES
MARKS: 100 MARKS

INSTRUCTIONS:

1. This paper consists of seven (7) pages. If your paper does not contain all the pages, please put up your hand so that a replacement paper can be handed to you.
2. Answer all the questions.
3. You will have twenty (20) minutes of reading time. Thereafter you will have a hundred and twenty (120) minutes to answer the required section.
4. No calculators may be used during the reading time.
5. Calculate the time that you should spend on each question by multiplying the number of marks for each question by 1.2 to determine the time, in minutes, available for each question. Adhere to these time constraints in order to finish the paper in the given time.
6. Delete all open spaces on your answer sheets with pen. Pages on your answer sheets that contain open spaces will be marked as such and those pages will not be eligible for a remark.
7. No tippex or pencil may be used on your answer sheets. Pages on your answer sheets that contain pencil or tippex will be marked as such and will not be eligible for a remark.
8. All the examination regulations of the UJ and the policy document for students of the Department of Accountancy will apply during this assessment.
9. The neatness and presentation of your answers will be taken into account when marking your paper.
QUESTION 1

Big Brands Group Ltd (Big Brands) is an integrated food services business encompassing franchised brands, logistics and manufacturing.

As a leading quick service and casual dining restaurant franchisor, Big Brands’ franchise network comprises over 2,000 restaurants across South Africa and countries in the rest of Africa. The brand portfolio comprises an extensive array of mainstream restaurant brands ranging from Bimpy, Luigi’s Pizza, Bean Fresh and pub brand O’Reilly’s, amongst others.

The Group also manufactures and supplies its franchisees and South African supermarkets with a wide range of sauces, spices, ice cream, fruit juice, coffee and other hot beverage products.

Big Brands Ltd owns three fully owned subsidiaries namely Bean Fresh (Pty) Ltd (which includes the Bean Fresh franchise and outlets), Calgro Logistics (Pty) Ltd and Supreme Foods (Pty) Ltd (manufacturer of foods and beverages mentioned above). The group structure can be illustrated as follows:

![Group Structure Diagram]

You are the Financial Manager of the Group and you are currently busy with the financial reporting pack for the annual audit. The CFO, only recently appointed, requested your assistance on certain financial matters that will affect the financial statements for the reporting period ended 30 June 2015.

PART 1 32 MARKS

The CFO of Big Brands Ltd sent you an email regarding two lease agreements, the Parkview Restaurant and a Roasting Machine. The CFO mentioned that one of the accountants completely misunderstood the accounting treatment of the lease agreements. The detail of these lease agreements were included in the email of which the extracts are given below:

**Parkview Restaurant**

Big Brands struggled to obtain finance for one of their new franchises, “The Perk-Spot”. On 1 January 2015, Big Brands entered into a twenty-year sale and leaseback agreement with Jenkins Ltd on an empty restaurant building located in Parkview, Johannesburg which was owned by Big Brands before entering into the agreement.
QUESTION 1 (CONTINUED)

The lease was correctly classified as a finance lease. The annual lease instalments amounted to R200 000 and are payable in arrears on 31 December of which the first instalment will be on 31 December 2015. The carrying amount of the restaurant building on 1 January 2015 was R5 520 000. The restaurant building was originally constructed for a total cost of R10 200 000. Big Brands Ltd sold the restaurant building for R15 000 000 which was considered to be the market value on 1 January 2015. At the end of the lease term, the title of ownership will pass back to Big Brands Ltd. You may ignore VAT and deferred tax implications.

The CFO made the following comment in the email:

“The accountant recognised a profit of R9 480 000 directly in profit or loss, but something is bothering me regarding the treatment of the profit. My detailed knowledge of IAS 17 isn’t what it used to be. Will you please look into it?”

Roasting Machine

On 1 July 2014, Big Brands entered into a lease agreement with one of its subsidiaries, Bean Fresh (Pty) Ltd (Bean Fresh). The lease agreement was entered into to lease-out a newly purchased roasting machine to Bean Fresh. The terms of the lease agreement are as follows:

<table>
<thead>
<tr>
<th>Original Purchase Price:</th>
<th>R394 396 (Incl. VAT)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease term:</td>
<td>5 years</td>
</tr>
<tr>
<td>Annual Lease Payments (payable in arrears on 30 June):</td>
<td>R90 000 (Excl. VAT)</td>
</tr>
<tr>
<td>Guaranteed Residual:</td>
<td>R15 000 (Excl. VAT)</td>
</tr>
<tr>
<td>Interest Rate Implicit to the Lease</td>
<td>10.50% pre-tax rate</td>
</tr>
<tr>
<td>Economic Useful life of the Roasting Machine</td>
<td>6 years</td>
</tr>
<tr>
<td>Title of ownership of the Roasting Machine will not transfer over to Bean Fresh at the end of the lease term.</td>
<td></td>
</tr>
</tbody>
</table>

The CFO made the following comment in the email:

“The accountant did not recognise this lease agreement in either of the companies’ books because in his opinion nothing really happened on group level and therefore did not see the need to recognise it. Will you please go through the agreement and ensure that the accounting treatment is in line with IAS 17?”

Big Brands did not finance the VAT as part of the lease agreement. A corporate tax rate of 28% is applicable. Depreciation on roasting machinery is based on the straight line method over its useful life. The roasting machine has a zero residual value. The machine qualified for a section 12C allowance from SARS when it was newly purchased on 1 July 2014. As per section 12C, Big Brands qualifies for a 40% allowance in the first year and 20% for subsequent years (40:20:20:20).
Employee share incentive scheme

Big Brands has recorded impressive growth in their earnings over the past few years and the board of directors decided to reward employees through an employee incentive scheme. This would align the interests of the employees with the company’s and shareholders’ interests. The incentive scheme was also implemented to assist in retaining skilled staff in key positions within the company’s operations.

In light of this, Big Brands issued 1,000 share options to each of the 500 key employees on 1 July 2012 to acquire ordinary shares when vesting conditions are satisfied. The strike price of these options is R55 per share which is equal to the fair value of a Big Brands Ltd ordinary share on 1 July 2012. The employees will receive benefit of future growth of the share price.

The share options vest on 30 June 2017 provided both of the following vesting conditions are satisfied:

**Condition A:** The employee has remained in the employment of Big Brands throughout the vesting period.

**Condition B:** The market price of Big Brands ordinary shares maintain a 10% growth until 30 June 2017.

<table>
<thead>
<tr>
<th>Date of estimation</th>
<th>Expected Cumulative number of employees leaving during the vesting period</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 June 2013</td>
<td>70</td>
</tr>
<tr>
<td>30 June 2014</td>
<td>85</td>
</tr>
<tr>
<td>30 June 2015</td>
<td>99</td>
</tr>
</tbody>
</table>

The fair values of the options were determined as follows:

<table>
<thead>
<tr>
<th></th>
<th>Before adjusting for any of the vesting conditions</th>
<th>After adjusting for the market conditions only</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rand</td>
<td>Rand</td>
</tr>
<tr>
<td>1 July 2012</td>
<td>17.01</td>
<td>15.00</td>
</tr>
<tr>
<td>30 June 2013</td>
<td>19.85</td>
<td>12.44</td>
</tr>
<tr>
<td>30 June 2014</td>
<td>16.33</td>
<td>0.70</td>
</tr>
<tr>
<td>30 June 2015</td>
<td>12.05</td>
<td>11.70</td>
</tr>
</tbody>
</table>
QUESTION 1 (CONTINUED)

Due to an economic recession in the 2014 reporting period and weakening commodity prices Big Brands shares made losses along with the JSE All Share index. The result thereof was that Big Brands’ shares were trading at R53 on 30 June 2014. Using a binominal option pricing-model, the fair value of the share options on 30 June 2014 were estimated to be R0.70 given the fall of the share price.

On 1 July 2014, the Board of Directors of Big Brands decided to lower the strike price of the options to R40 which increased the fair value of the share options with R5.25 on 1 July 2014.

PART 3

The Bean Fresh franchise had a number of innovative marketing campaigns to improve the growth of their turnover. However, this has led to confusion under the Big Brands finance team on how to account for the revenue transactions that derived from these campaigns as they were complex in nature. The CFO sent you an email requesting your assistance on the revenue recognition with regards to the “Expresso Initiative”.

Expresso Initiative

The highly sought after Expresso Coffee Machine was stocked in all the Bean Fresh outlets across South Africa since March 2015. In order to maximise the movement of inventory, Big Brands decided to include a free service as part of the sale of Expresso Coffee Machines which expires 12 months after invoice date. Included in the free service is technical assistance from technicians by calling the “Technician Centre” and a maintenance service.

The above deal was advertised for R2 999 (Incl. VAT) and sold from the Bean Fresh outlet stores without any deliveries. Due to popular demand, Big Brands managed to sell 20 000 units through this deal up until 30 June 2015.

The fair value of the Expresso Coffee machine is considered to be R1 800 (Excl. VAT). The cost price of each Expresso Coffee machine is R1 710 (Excl VAT). It is determined that it will take ten hours for a technician to service a single machine over the 12 month agreement. A technician charges R75 per hour for his/her labour.
QUESTION 1 (CONTINUED)

PART 4 10 MARKS

Big Brands entered into a number of financial instruments on 30 June 2015 and the CFO asked your advice on the accounting treatment of these instruments.

*Investment in London Coffee (Pty) Ltd*

As per the original terms of the investment, Big Brands purchased 300 000 R10 10% redeemable debentures from London Coffee (Pty) Ltd on 1 July 2013. The investment was purchased at a discount of 10%. Interest is payable annually on 30 June and the debentures are redeemable on 30 June 2016 at a premium of 25%.

*Foreign exchange contract transaction*

Due to the appreciation of the United States Dollar (US$), Big Brands entered into a forward exchange contract (FEC) on 30 June 2015 to purchase US$1 000 for R12 500 in three months’ time. The US$: ZAR forward exchange rate for the remaining term of the contract as at year-end is US$ 1: ZAR 12.40. This contract will be net-settled in cash and requires no initial net investment as it is in substance a forward contract.

PART 5 10 MARKS

As part of obtaining additional finance for the new “The Perk-Spot” franchise, Big Brands issued 1 000 000 R5 10% convertible preference shares on 30 June 2015 at par. Interest is payable annually in arrears at a nominal annual interest rate of 10%. Big Brands have the option to convert the preference shares into 2 ordinary shares for every preference share held at 30 June 2020, which is the maturity date as per the agreement. If not converted into ordinary shares, the preference shares will be redeemed at a premium of 20% on 30 June 2020.

On 30 June 2015, the market interest rate for similar debt with conversion options is 12.15%. The market interest rate for similar debt instruments without conversion options is 11.08%.
Winchester United Football Limited (United) is a professional football club based in Old Trafford, England. United currently plays in the Premier League, the top flight of English football. United was the world's third most valuable football club in 2013.

On 8 March 2014, United’s football manager (Alex Featherstone) who managed Winchester United from 1986 announced his retirement as manager, leaving the team in the hands of his successor, David Moses. Since then, the team has been experiencing a dismal season that has seen the reigning Premier League champions to slump down to seventh in the premier league table.

This has led United to consider entering into new player contracts in an effort to better their position in the league. The following table illustrates the player contracts that were acquired in the current reporting period ended 31 December 2014.

<table>
<thead>
<tr>
<th>New Contracts Acquired</th>
<th>Acquisition Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Memphis Depaar</td>
<td>£25,000,000</td>
</tr>
<tr>
<td>Matteo Darmia</td>
<td>£12,700,000</td>
</tr>
<tr>
<td>Mathew Schneiderlin</td>
<td>£24,000,000</td>
</tr>
<tr>
<td>Basta Schweinsteiger</td>
<td>£14,400,000</td>
</tr>
<tr>
<td><strong>Total Acquisition Fee</strong></td>
<td><strong>£76 100 000</strong></td>
</tr>
</tbody>
</table>

In trading with player contracts, there were also a number of player contracts sold to other clubs which resulted in total proceeds of £55 250 000. This isn’t considered to be uncommon in the Premier League.

Apart from the new players being highly skilled, these contracts will also increase the sale of official Winchester United merchandise such as jerseys and other club clothing. Winchester United’s management is optimistic about the potential of the investment based on the high level of skills the new players possess which will hopefully lead to cup and league success.

After taking the above into consideration, the United is of the opinion that the new player contracts should be recognised as an intangible assets in the statement of financial position.