
Volume 2020

# Applied Accountancy FOCUS

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## *Inside this issue*



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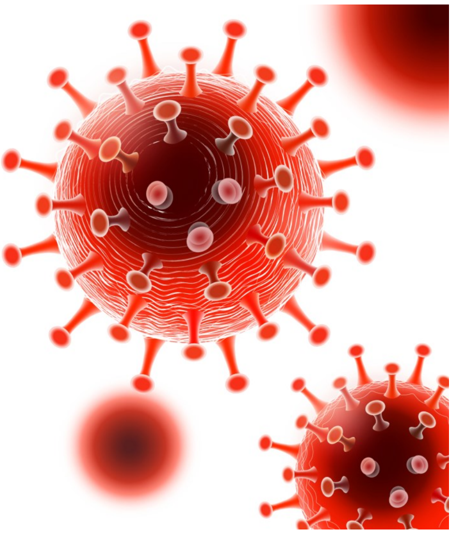
Open Rubric

COVID-19
CORONAVIRUS
NOVEL CORONAVIRUS




# A media reflection on the socio-economic impact of COVID-19

*(by Annette Becker)*

*(Photo: Shutterstock)*

South Africa is a developing country with high levels of inequality (Keeton, 2014:26). The OECD (2015:16) states that the receipt of enough tax revenue by government is an absolute necessity in many developing countries as these countries often struggle to alleviate poverty, demonstrate high levels of inequality, have poor delivery of public services and have trouble to build their own infrastructure. It follows that fiscal authorities in South Africa require enough sustainable revenue to balance the basic needs of its citizens and its fiscal budget, through the levying of various taxes.

At the end of 2019, a highly infectious pandemic started in China, aptly named COVID-19. COVID-19 is part of a larger family of coronaviruses that may cause illness in animals or humans. Infections increased world-wide from 3.66 million people on 6 May 2020 to 25,390 million on 31 August 2020 of whom 850 630 people has died (WHO, 2020). On 31 August 625 056 people in South Africa has been infected and to date, 14 028 deaths. On 15 March 2020 South Africa's government declared a national state of disaster in which all citizens went into lockdown except for certain essential services (Government Gazette). This had a disastrous socio-economic impact on the citizens of South-Africa.

According to Hilary Joffe (Sunday Times, 2020):

- More than 7 million citizens will join the ranks of unemployment and more than 2.5 million jobs are at risk (currently the unemployment rate is already 29% and can thus jump to 48%),
- National Treasury had to source R500 billion to provide for an economic stimulus package, to compensate for the decrease in revenue earned,
- Economic researchers project an economic contraction of 5% but if disruption is extended it could be as high as 16%.
- Household income, specifically middle-income earners will carry the brunt as this group do not receive social grants from government.

> *"Low-income countries such as South Africa are being pushed back into poverty due to the Covid-19 containment."*

Covid-19 has had a serious economic and social impact on most countries in the world, also putting severe constraints on the economy of South Africa, where the legacy of inequalities still linger. Poverty in South Africa has drastically increased, and citizens are fending for themselves as the bottom falls out for the middle class in in South Africa in the form of debt and jobs lost. We will have to reinvent and change our socio-economic behavior to survive. Low-income countries such as South Africa are being pushed back into poverty due to the Covid-19 containment. Dr Imtiaz Sooliman of Gift of the Givers informed BizNews on 28 August 2020 that citizens' need for food was possibly the highest he has ever seen since he started the organisation in 1992 in South Africa.

**The Covid-19 impact:**

***How does Covid-19 death rates compare to other illnesses?***

Flu: "Every year across the globe, there are an estimated 1 billion cases, of which 3 to 5 million are severe cases, resulting in 290 000 to 650 000 influenza-related respiratory deaths." (World Health Organization, 2019)

Malaria: "Estimated that 435 000 deaths due to malaria had occurred globally." (World Health Organization, 2017)

In South Africa lockdown (level 5) was implemented on 27 March 2020 in an attempt the spread of the coronavirus (Bloomberg, Businesstech 12 August 2020). It is described by the media as one of the most severe lockdowns in the world as the country went immediately into a total halt of all economic and social activity except for emergency services. The response of president Ramaphosa was no different from other governments in the world, whose initial response was also for the application of different levels of lockdown.

In South Africa there is however an enormous difference to the socio-economic reality and a genuine desire "to provide relief to the public" (Jeff Rudin: OPINIONISTA: Ways of understanding Ramaphosa's bizarre declaration of war against Covid-19). On 12 August the media reported that president Ramaphosa is preparing to move South Africa to level 2 lockdown, which was finally announced effective from 18 August 2020.

**Reflection:**

It will be a long time before South Africa will recover from the socio-economic impact of Covid-19. Not only is there no money left in the fiscal coffers but the economic decline had a direct impact on the citizens of South Africa, bringing many South Africans to the brink of starvation. We all need to have a social compact with each other to turn the economy around and better the livelihood of our fellow South Africans.

This article is a short reflection on the socio-economic impact of the lockdown on the citizens of South Africa, as reflected by daily emails received from a digital newspaper, The Daily Maverick (Media Connect: noreply@digitalnewspaper.co.za) for the first four months of lockdown and is summarized in the table on the pages hereafter. *AAF*

**References**

BIZNEWS : noreply@digitalnewspaper.co.za. [Accessed 31 August 2020]

The Daily Maverick : noreply@digitalnewspaper.co.za.


*(Photo: Shutterstock)*

| Date | Summary of report | Economic impact | Social impact |
|---|---|---|---|
| **2 June 2020**<br>Logistical problems have led to no test kits for coronavirus infections being delivered to Eastern Cape laboratories where test results are lagging by up to three weeks by Estelle Ellis | In the Eastern Cape the testing for coronavirus infections slowed down to an alarming pace because of a lack of tests (National Health Laboratory Services. The Department of Health reported that more than 21,000 test results are outstanding with a current waiting period of more than two weeks. | Clinics closed as health care workers refused to work if they have not received their results.<br><br>Economic Result:<br>Lack of leadership jeopardizes the provision of services in the Health care sector. | Healthcare workers are left angry as they were exposed to the risk of infections by the lack of efficiency of leadership in the province. Health care workers refused to work. |
| **5 June 2020**<br>Analysis: SA's economy after the Covid-19 - an iron fist in the ANC's velvet glove by Marianne Merten | Governing party agreed to expand their role in its economic reconstruction, "capacity, inherent authority and capabilities in leading society for the recovery" after the Covid-19 lockdown. | Plans are made for a new economy that must be more inclusive and sustainable. Plans are proposed for a $20.5-billion infrastructure spend on networks like rail and ports, broadband, and basic services like water and sanitation and housing. | The cornerstone of the new economy will be social to "overall lift and create a new, inclusive economy" on national level. Social compacting in energy transition, mining and telecoms is needed to unlock investments and create jobs. |
| **11 June 2020**<br>Nompumelelo Runji in her article in the OPINIONISTA: "Only a vibrant civil society will protect democracy during Covid-19" | The lockdown placed the issue of what is meant with a civil society in the centre of our democracy. | Lockdown added economic mismanagement of relief funds. Abuse of power, procurement irregularities, mismanagement of relief funds, maladministration and corruption and fraud all affect the most vulnerable communities. Lockdown caused economic damage, joblessness and bankruptcy. | Lockdown affects the rights of the most vulnerable groups and communities. Communities face economic pressure and anxiety. A swift response from government is needed to alleviate hunger and preserve social stability. Swift response is important because if local government is unresponsive to their community grievances, frustration could lead to other avenues of activism in an open civil society in the form of protests and demonstrations. |
| **15 June 2020**<br>Covid-19 is busy crashing the capitalist system – time for a rethink and a reboot by Dakota Legoete | The capitalist system has failed citizens and needs to be reimagined to combat the socio-economic effects of Covid-19. | According to the World Bank, the global financial crisis, triggered by Covid-19, is the worse in 150 years and they predict that 90% of the world's 183 formalised economies will go into recession in 2020. | Poverty is the biggest threat to mankind. The middle class has been the worst affected as many has lost jobs in the formal sector. Social grants will have a minimal impact on poverty, unemployment and inequality. |

| Date | Summary of report | Economic impact | Social impact |
|---|---|---|---|
| **17 June 2020**<br>Fighting Covid-19: We need clear and open communication from our government by Judith February | Consistent communication from government is requested as the president has communicated last with the nation three weeks ago. | Large parts of the economy reopened but not all parts were treated equal: churches could allow 50 people to gather but the entertainment sector stayed closed with no logical reason provided. The reopening of the economy and society is our collective responsibility but government should be held accountable, and be consistent and open about their decisions. | Minister of Health, the honorable Mr. Mkhize called for a "grassroots" fight against Covid-19 and he launched the Ministerial Advisory Committee (MAC) on Social Behavioural Change. |
| **23 June 2020**<br>Tough week of politics policy and finance as Mboweni-tables Covid-19 emergency-budget by Marianne Merten | Finance Minister Tito Mboweni tabled the Covid-19 emergency Budget., based on a grim outlook of a debt-to-gross domestic product (GDP) at 80.5%. | Economic growth is forecast to contract to -7.1%. This is exasperated by power outages due to a severely constrained power grid. Joblessness is reported in the midst of a record lows in business confidence. | Joblessness before the Covid-19 hard lockdown was short of 40% according to Statistics SA for the period of January to March 2020 |
| **24 June 2020**<br>We must develop governance game changer –for a post Covid-19 post-Zuma recovery By Tania Ajam, Pascal Moloi, Pali Lehola and Ivor Chipkni | Hope that the Covid-19 pandemic will establish a new, revitalised economic "normal", to combat poverty, unemployment and inequality, as well as the lessening of our carbon footprint. | Five changes are hoped for:<br>1.Changes to the Electoral Act to allow independent candidates to stand as members of Parliament and the provincial legislatures;<br>2.The Political Party Funding Act compels political parties to make their funding more transparent;<br>3.The Public Audit Amendment Act 2018, gives the Auditor-General authority to combat corruption and gross negligence of public accounting officers;<br>4.The NPA could finally prosecute some high-profile corruption cases to rebuilt the legitimacy lost during the Zuma era;<br>5.Some cities were incentivized to innovate: Gauteng took the lead in terms of 4IR; the City of Cape Town won in court to secure renewable energy independently of Eskom. | |
| **30 June 2020**<br>Get on with it: Mboweni on post Covid-19 lockdown opportunities by Marianne Merten | Minister Tito Mboweni urged everyone to 'just get out and get on with it' — to support entrepreneurs and do things differently. On the cards is inheritance tax, solidarity tax and wealth tax ahead of the February 2021 Budget, but nothing's concluded. | There is a fiscal deficit of R304.1-billion due to a shortfall in tax collection. In addition, the Special Adjustment Budget on 24 June adds an extra R40 billion that needs to be raised through taxes over the next four years. The Minister of Finance urged that "We should talk more about growing the economy' and that innovative entrepreneurs be sourced and assisted. | |

View from the old lighthouse at Cape Point, overlooking large rocks and dangerous seas (Photo: Janelle Verster)

# Steering towards calmer waters

## Direct costing as a possible decision-making aid in troubled conditions

*(by Janelle Verster)*

### A distorted reflection

When I used to study, I did not really ponder on the implications of what I am learning. It was more (sometimes only) about passing the subject; about storing information in my short-term memory just to "survive" another topic. Not that I did not enjoy Management Accounting, it was my favourite subject, but I basically kept my studies in isolation from common knowledge, logic and common sense. Also, it was not that important to me (and probably not important to my neighbour at all), whether I calculated the standard costing variance as R100 000 unfavourable instead of R10 000 favourable, or the product cost as R200 or R150 – as long as I got the final mark that I aimed for. No-one was placed on a performance improvement plan if I made a mistake in my calculations and incorrectly reported severe underperformance due to a zero too many: I was simply going to lose a mark. And the business was not really going to sell a product at the wrong price based upon my recommendation and end up making a loss due to either insufficient sales volumes as a result of overpricing, or pricing goods or services at below cost. The ever-popular XYZ Limited was simply a fragment of the imagination.

What is not imagination, however, is that we find ourselves in a very uncertain space amid the effects of the COVID-19 virus. The virus has affected the economy in such a way that even a quick drive through town may reveal many closed doors when it comes to businesses that were once thriving. One would hope to think that the doors are closed only temporarily, but unfortunately the sad reality seems to be that some of these doors will not open for their previous business again. ("Reality seems"... can you sense the uncertainty?) There seems to be a high demand for "for sale" signage these days, but for the businesses instead of their goods and services.

> *"From this uncertain position, the real-life questions come into play, whether I have my own business or to potentially help someone who has a business."*

From this uncertain position, the real-life questions come into play, whether I have my own business or to potentially help someone who has a business. I may now have to really start thinking about what I have learnt, especially when it comes to critical contexts like, "Can I save the business?" or "Can I save jobs?" I would like to use the analogy of a boat to illustrate how direct costing principles can potentially assist in making business decisions in these difficult times.

The boat in my story is passing (or sailing around) Cape Point, a headland of the Cape Peninsula that stretches into the Atlantic Ocean not far from the Cape of Good Hope, the most southwestern point of the African continent and which was originally referred to as the Cape of Storms. (Cape Point forms part of the Table Mountain National Park - please do view a map of South Africa on the Internet or elsewhere to see where Cape Point is situated on the eastern side of the southwestern "corner" of the country.) Cape Point is infamous for the vast number of shipwrecks that occurred in its vicinity over the years, being part of an extremely dangerous coastline with currents, swells and rocks that pose extreme dangers to man and vessel alike. Like a skipper and his crew, a business has to make the best decisions given the circumstances and risks – it is not always clear what the "correct" or "perfect" decision would be, but one cannot just blindly select an Eeny Meeny Miny Moe option and hope for the best. There are no guarantees of staying afloat in waters of turmoil, but I would at least like to back myself by steering the boat in a direction where I could have a chance to survive in dangerous times like these.

> 90% of CFOs believe the COVID-19 crisis will have an impact on their revenues and/or costs.
>
> 70% of companies are changing their financial plans and/or forecasts they share with investors
>
> [PwC's COVID-19 CFO Pulse Survey, 2020]

### In deep water

As I have alluded to before, I would like to elaborate on this analogy of a boat to try and suggest that consideration should also be given to direct costing principles in making business decisions in these risky and uncertain times. I am not suggesting that direct costing is the be-all and end-all of business decision-making; in fact, there are indeed also disadvantages to direct costing. But I would just like to demonstrate that direct costing principles could potentially play an important role in deciding what to do.

### What is direct costing?

Direct costing is a cost determination method that includes only variable manufacturing costs in inventory valuation. It is often used in management decision-making, especially over the short-term. Direct costing differs from the absorption costing ("full costing") method that is used for the purposes of inventory valuation for external reporting purposes in terms of IFRS® Standards. Over and above the variable manufacturing costs (direct costing), the absorption costing method also includes fixed manufacturing overheads in inventory at a predetermined overhead rate if IAS 2 Inventories is applied.


A view of the Cape of Good Hope (Photo: Janelle Verster)

### A fixed cost as opposed to a variable cost

In total, a fixed cost remains constant despite changes in activity level (e.g. the number of units manufactured). On the contrary, a variable cost, in total, will increase proportionately as activity levels increase (e.g. cost incurred only if unit is manufactured).

### In principle, why is a predetermined overhead rate calculated in absorption costing?

In the calculation of the fixed manufacturing overhead (FMO) rate, the numerator is the budgeted FMO for the period. One reason why we use the budgeted FMO is that the actual FMO will only be known at the end of the period under consideration. Decision makers cannot wait until the end of the period to take decisions based on full until the end of the period to take decisions based on full costing. So, in simple terms, we use an estimate of the per-unit amount of FMO in determining the cost of our product or service when absorption costing principles apply.

*"...fixed costs are usually irrelevant over the short term and could potentially obscure the real view of what is happening right here and right now."*

**The "old" lighthouse: absorption costing**

Let's now apply the boat analogy to this. An old lighthouse used to direct boats and ships around the Cape Point. The lighthouse provided a warning that land was near and that caution should be taken in decision-making. Unfortunately, the position of this old lighthouse on the highest point of the Point was of such a nature that mist often obscured the light of the tower, resulting in dire consequences for some.

A new lighthouse had to be constructed in a position lower down where mist was not (as much of) an issue. The old lighthouse, however, was not simply brought out of use – it was still a beacon providing those ships far away from the shore, on their way to the West Coast, a valuable indication of where they found themselves on their longer-term journey.

Absorption costing may be seen as the old lighthouse; although it does provide very important information in general and over the long-term, using it as a gauge to determine product costs for short-term decisions, might not be advisable.

**Looks can be deceiving**

Some of the "rocks" may have been hidden under the surface at the time we prepared our budget or an unexpected storm could arrive in an instant. If the budget was prepared before there was even a hint of a virus outbreak or another unforeseen event of this magnitude, it could result in actual FMO being vastly different from budgeted FMO and/or an overhead rate that is not representative of the actual FMO per unit. Including FMO at an "unreliable" rate in the cost of a product or service and basing short-term decisions, e.g. selling price on such information, could potentially be disastrous. Including these FMO in our product costs may not always be an accurate representation of the actual cost to manufacture or supply the product or service or of its profitability.

Furthermore, FMO allocation is often arbitrary and will potentially not result in an accurate indication of the cost of individual products and this could result in suboptimal decisions in terms of e.g. cost-plus pricing or product line discontinuation. In addition, fixed costs are usually irrelevant over the short term and could potentially obscure the real view of what is happening right here and right now.

A view from the new lighthouse that is in a much better position to guide those coming close to shore
(Photo: Tinus le Roux)

**The "new" lighthouse: direct costing**

Direct costing, however, as the "new" lighthouse, could provide a better indication of what needs to be done in the short-term to maximise profits (or, more realistically, in difficult times, to minimise losses). I am not referring to direct costing as "new" because it is a new concept or a recent development (which, by the way, it is not) – just maybe a different approach.

To determine a suitable cost-plus price or product profitability in the long-term would probably require full (absorption) costing to be applied; however, to determine whether to accept a "special order" at a given price or what price to ask for a product or service over the short-term, direct costing may be more suitable.

*"Yes, maybe one can argue that it can have a damaging effect on the `brand value` if the product or service is available at a lower price than normal, but will there even be a business over the long-term if the fixed costs cannot be covered now?*

### Contribution: an important concept

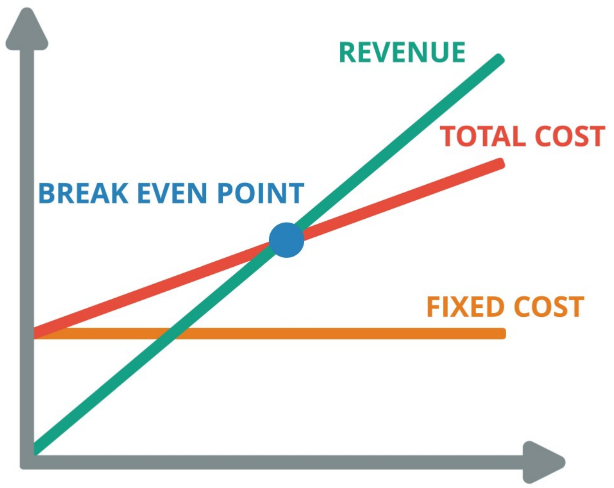
Closely related to direct costing principles is the concept of contribution, which is sales less all variable costs. Both our variable product costs and our variable selling and admin costs will be deducted from sales to determine contribution. The contribution concept has a long list of potential applications, including but not limited to the following:

- ◊ Calculation of break-even quantities or quantities to sell to reach our profit target;
- ◊ Determining the optimal product (or service) mix when there are limiting factors like rationed resources;
- ◊ Calculation of the margin of safety;
- ◊ Performance management;
- ◊ Pricing;
- ◊ Sensitivity analysis;
- ◊ (Other) budgeting and planning activities; and
- ◊ Deciding about the addition/removal of product lines.

Contribution is the contribution towards covering the fixed costs of the business, and over the short-term whilst one maybe does not have the luxury of cutting on any of the fixed costs (e.g. due to being bound by a lease), it may be better to sell at a lower price to cover some of the fixed costs than to keep selling at the "long-term" price and not selling anything or selling very little, and being sunk by the unavoidable fixed costs.

An example: a bed and breakfast establishment that usually asks R800 per room per night. Assuming a total variable cost (for matters like washing and cleaning, consumables, etc.) of R200 per night that a room is occupied and a FMO rate of R330, the full cost would be R530 per night. As an example, say someone is able to pay R500 per night for the room during a difficult or quiet period where there are barely any occupants, should this potential business be turned away as R30 less than the full cost is earned? You will probably agree that over the long-term it is not feasible to set the price per night at R500. However, over the short-term, the R500 exceeds the R200 variable cost and will help to cover some of the fixed costs. Accepting the R500 results in a contribution of R300 towards the fixed costs, whereas refusing it and having the room empty does not help to cover the unavoidable fixed costs at all. The decision does not even consider the cash inflow that will improve liquidity over the short-term.

Yes, maybe one can argue that it can have a damaging effect on the "brand value" if the product or service is available at a lower price than normal, but will there even be a business over the long-term if the fixed costs cannot be covered now?




*(Photo: Shutterstock)*

### Into the open waters

Now we are no longer in a simulator, manoeuvring an imaginary boat, we are actually in the "boat", having to safely steer it around a dangerous point in time. Despite the popularity of the term "virtual reality" in these times, some realities are no longer only virtual.

We don't know what the future holds, but, depending on the position we find ourselves in, we need to try to stay afloat in the storm or direct one another safely around this point in time. Maybe we can use direct costing principles now to help us steer towards calmer waters, from where we can continue our long-term journeys. *AAF*

*(Photo: Shutterstock)*

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***Did you know?***

In a book published by Elsevier/CIMA, it was found that: *"...virtually all the (management accounting) techniques developed since the late nineteenth century, and evident in the historical literature, are still in use today*." The book continued to state that: ."*Direct costing was sold as simpler and more informative than absorption costing*." and ended the section with "*`old' methods have not died: they are still taught, examined and used*"
Dugdale, D., 2005. Contemporary management accounting practices in UK manufacturing. Elsevier.


(Photo: Shutterstock)

# ISA 701 Communicating Key Audit Matters in the Auditor's Report as it relates to COVID-19

*(by Sameera Abed)*

We can all agree that the recent developments due to COVID-19 and the related lockdown restrictions have caused an unprecedented level of uncertainty regarding the economy, causing resultant restructuring of companies, retrenchments and financial market volatility. ISA 701's relevance is increased during this time as it allows for greater transparency and communication of useful information to company investors and other stakeholders through the auditor's report.

The current challenges impact on the financial reporting cycle at companies as well as on the practical manner that an audit may be conducted. The current challenges that may impact an auditor during these times are limited access to staff, the client and physical documentation, restrictions on travel (that impacts audit assurance procedures such as attendance of inventory counts) and technological challenges, to name just a few.

Auditors are therefore forced to use alternative methods to obtain sufficient and appropriate evidence as well as reconsidering audit risk. These challenges are exacerbated with the expectation of users of financial statements whom require increased transparency through disclosures relating to the material effects of the COVID-19 pandemic.

In March, the Independent Regulatory Board for Auditors (IRBA) issued guidance relating to the Implications of the COVID-19 Outbreak on Audits and Auditors as well as guidance on the Impact of COVID-19 on the Auditor's Report: Going Concern. This guidance sought to address some implications and considerations regarding audits and audit risks, and specifically highlighted considerations around KAMs in the auditor's report.

Considering the importance of key audit matters (KAM), this article is aimed at increasing the awareness and understanding of KAMs by discussing what is a KAM, how to determine if a matter represents a KAM and also how to disclose KAMs in the auditor's report.

*"These challenges are exacerbated with the expectation of users of financial statements whom require increased transparency through disclosures relating to the material effects of the COVID-19 pandemic."*

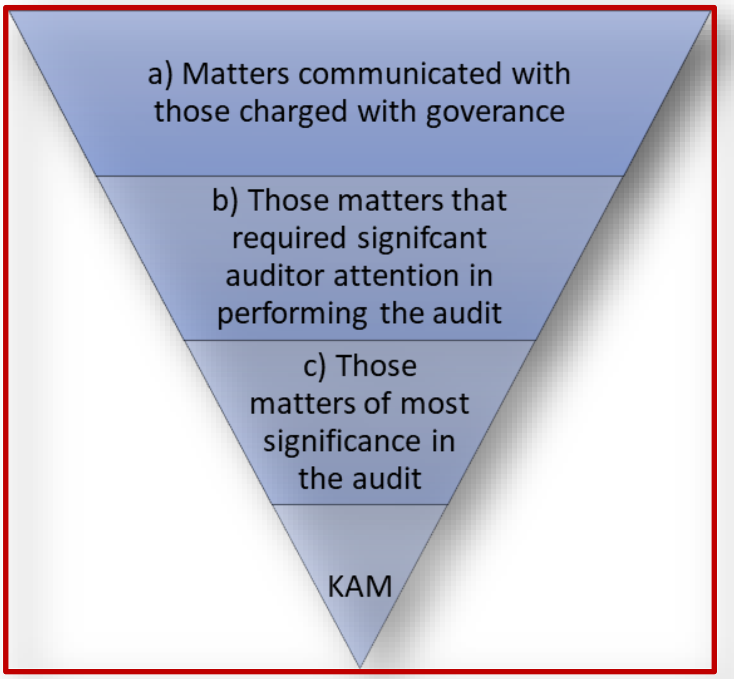
### What is a KAM?

KAMs are defined as those matters that, in the auditor's professional judgement, were of **most significance in the audit** of the **financial statements** of the current period. KAMs are selected from matters **communicated** to those charged with governance.

sufficiently **important to draw to the attention of users of the financial statements** and communicate in the auditor's report. To be useful to the reader, auditors differentiate the value add of their services by providing sufficient information in the auditor's report which pertains to KAMs, to enable the user to better understand the **specific challenges** which the auditor encountered during the audit, and how the auditor **adapted their audit procedures** to respond to those challenges.

### How are KAMs determined?

KAMs are determined using the below diagram:




Source: Adapted from https://www.accountancysa.org.za/analysis-focus-on-key

### How to disclose KAMs:

KAMs are included as a separate section of the auditor's report with the heading 'Key Audit Matter''. SAAPS 3 (revised May 2019) requires the KAMs section to be placed below the Basis of opinion paragraph. Each key audit matter should be described by: (i) stating why the matter was considered a key audit matter; (ii) how the matter was addressed in the audit; and (iii) including a reference to the related disclosures (if applicable). KAMs should give investors and users of financial statements greater insight into the conditions under which the audit was performed and how the resulting audit risks were dealt with by the auditor.

The description of how the matter was addressed in the audit may include the following:

- ◊ Aspects of the auditor's response or approach
- ◊ A brief overview of procedures performed
- ◊ An indication of the outcome of the auditor's procedures
- ◊ Key observations with respect to the matter

Considering the current circumstances and challenges, the audit report should disclose KAMs including the challenges experienced due to COVID-19 and the lockdown, and indicate how the auditor addressed these challenges. These can include the assessment and response to additional audit risks, in areas such as valuations, accounting estimates and events which occurred after the financial reporting date.

### Matters that are not KAMs:

ISA 701.15 further guides auditors of matters that by nature may seem as a KAM such as:

- ◊ A matter giving rise to a modified opinion in accordance with ISA 705 (revised);
- ◊ A material uncertainty relating to events or conditions that may cast doubt on the ability of the entity to continue as a going concern in accordance with ISA 570 (revised);

but which should be **separately** described within the Basis for Qualified (Adverse) Opinion or the Material Uncertainty Related to Going Concern Sections in the Key Audit Matters section of the audit report.

In conclusion, KAMs are especially relevant today and the auditor should aim to respond to increased transparency expectations by providing the auditee stakeholders' with useful information in the audit report. *AAF*

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ACCOUNTANCYSA: ANALYSIS: FOCUS ON KEY AUDIT MATTERS Available here.

# *Reporting & disclosure considerations following COVID-19*

*(by Dr Leana Esterhuyse & Prof Debbie Scheepers)*


*(Photo: Shutterstock 1080405278 )*

In the aftermath of the COVID-19 pandemic, it is safe to say that every global citizen has been impacted directly or indirectly. More so, the effects of this global pandemic were severely felt in developing countries. South Africa already experienced economic turmoil with a downgrade by Moody's to sub-investment status, at the time of the national lockdown announced by President Ramaphosa in March 2020 and talk about a recession in the country due to the strict lockdown requirements, was inevitable.

*"These challenges are exacerbated with the expectation of users of financial statements whom require increased transparency through disclosures relating to the material effects of the COVID-19 pandemic."*

Fortunately, the fatality rate in South Africa was lower than expected, but the impact on our health care system and the poorest of the poor, who experienced major job losses from the lockdown's debilitating effect on businesses, are reminders that our country cannot continue with a "business as usual" attitude.

The King IV Report on Corporate Governance requires a stakeholder-based approach to corporate governance, including reporting on all capitals available to entities in an integrated manner (IoD, 2016). The International Integrated Reporting Framework refers to integrated thinking as 'the active consideration by an organization of the relationships between its various operating and functional units and the capitals that the organisation uses or affects' (IIRC, 2013: 2). An integrated thinking mindset should therefore be applied to corporate reporting on the effect of the COVID-19 pandemic that reflects the social and environmental effects of the pandemic on all stakeholders, not only on the providers of financial capital. Inputs and outputs from all capitals, including impacts on all business aspects must be evaluated holistically rather than in isolation. It is imperative to balance performance across social, relationship, human, intellectual, manufactured and natural capitals to create and conserve value for business entities over the short-, medium- and long-term following the COVID-19 pandemic. The aim of the article is therefore two-fold namely, to provide some considerations that could affect mandatory reporting as well as those voluntary reporting considerations that relationship, human, intellectual, manufactured and natural capitals to create and conserve value for business entities over the short-, medium- and long-term following the COVID-19 pandemic.

The aim of the article is therefore two-fold namely, to provide some considerations that could affect mandatory reporting as well as those voluntary reporting considerations that businesses should provide to mitigate uncertainties and improve information symmetry for the entity's affected stakeholders.

Below is a summary of some mandatory reporting considerations proposed by the International Federation of Accountants (IFAC) and the Financial Reporting LAB (FRL) to assist discussion and consideration when preparing financial statements of entities:

◊ Due to curtailment of business activities and cash flow pressures, entities should recognise the influence of the pandemic on the going concern assumption when preparing financial statements. The potential breaching of debt covenants and operational challenges faced could force entities into bankruptcy. Material uncertainty about the continuation of an entity as a going concern must be disclosed.
◊ The possibility of asset impairments as well as current and non-current debt re-classification should be considered.
◊ Due to market volatility and low activity, the appropriateness of fair value measures should be reviewed.
◊ Although the depreciation of non-financial assets may not be suspended due to the lockdown, the residual values and useful lives of the assets must be re-evaluated.
◊ Entities must consider if their contracts, including leases, have become onerous and provision must be made for penalties where contracts have been breached.
◊ Financial guarantees must be evaluated to determine if a provision need to be raised in the statement of financial position.
◊ Requirements for retrenchments and restructuring must be considered but future operating losses should not be recognised.
◊ Caution should be exercised on the use of historical information to estimate expected credit losses and entities should consider the incorporation of forward-looking expectations.
◊ Inventory must be written down to lower of cost or net realisable value and the enforceability of sale contracts at potentially depressed market prices, considered.
◊ Due to cash flow pressures, it may be prudent to suspend the payment of dividends.

(FRL, 2020; IFAC, 2020)


*(Photo: Shutterstock)*

King IV recommends that the governing body of an organisation should be 'kept apprised of the current state of the relationships between the organisation and its stakeholders' (IoD, 2016: 5). Report preparers should thus move beyond mandatory IFRS reporting (aimed at the financial capital providers) to consider other stakeholders' interests as well. Please see a short reading list at the end for free sources that can be consulted on what other disclosures relating to the impacts of the COVID-19 pandemic would be useful to non-financial stakeholders of the entity. We selected a few that we consider relevant and recommend that entities voluntarily disclose some of the following information:

◊ How did the entity accommodate and support employees that were at home during the lockdown? Information can include leave arrangements, ICT support provided, working from home, mental wellness, online training provided.
◊ As staff returned to the entities' premises (and for the essential workers), what safety measures are in place regarding personal protective equipment (PPE), screening etc.?
◊ How does the sustainability of the entity as a going concern affect job security? Are there discussions with organised labour, or were wages and salaries curtailed?
◊ In a showing of solidarity, did top management curtail their remuneration?
◊ Outreach projects engaged in during the pandemic, e.g. supporting soup kitchens, donating PPE to communities or health care workers?
◊ Did the entity receive any government (i.e. PAYE holidays) or private sector (i.e. Sukuma Relief Programme funded by the Rupert family) funding or assistance to ease cash flow constraints?
◊ Was there any reduction in air (e.g. carbon emissions) or water pollution due to curtailed operations? Was this offset by increased waste disposal of PPE and other plastic materials?

Financial stakeholders might also be interested in voluntary information that speaks to the long-term survival of the entity (see short reading list at the end for sources that provide more details):

◊ Were R&D spending, advertising, licence fees etc. reduced to conserve cash flow? Did it or will it affect the entity's market share?
◊ Did supply chain interruptions during the lockdown result in any technological innovations towards production or processes that can be maintained into the future?
◊ Did new selling/distribution channels emerge, e.g. online sales?
◊ Are major customer relationships properly managed where interruptions or delays in delivery/service occurred?
◊ How does the entity manage their critical supply chains? Are there alternatives?
◊ Was the physical infrastructure properly secured, maintained and serviced during lockdown and low levels of operation?

Covid-19 caused considerable uncertainty about entities' survival. Communicating, and not merely 'reporting', with all the entities' stakeholders are important in fostering trust and loyalty, thus contributing to the long-term sustainability of the entity to the benefit of all of its stakeholders.

For further reading on recommendations for voluntary disclosure on stakeholder and strategic impacts of the COVID-19 pandemic, please click on the following links:

◊ Sustainability Reporting and Early Lessons from COVID-19
◊ Accountancy SA COVID-19 HUB – Business Implications
◊ COVID-19: As your company steps up…speak up
◊ COVID-19 – Resources, action, the future. Reporting in times of uncertainty

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IFAC (2020). Summary of Covid-19 Financial Reporting Considerations, Available online here (Accessed 30 September 2020)

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*(Photo: Shutterstock)*

# Disclosure of risk
*(by Ayesha Ravat)*

Enterprise risk refers to the internal and external factors that affect the ability of a company to meet its corporate objectives. While risks are present in most companies' activities, stakeholder value can be protected and created through the process of risk management. This would entail employing risk management tools and techniques to address the risk.

However, in order to assure investors that risks are effectively managed, companies would require more than a risk management system; they would also need to effectively communicate the risks impacting the company and the management of these risks.

**Risk disclosure**

Stakeholders expect companies to employ risk management tools and techniques to manage the associated risk. This should include providing stakeholders with information relating to the risk by means of risk disclosures. In addition to stakeholder requirements, various standards and guidelines relating to risk disclosure have been published, thus regulating the nature and extent of such risk disclosures.

Despite the increasing importance of and emphasis on enterprise risk management and the disclosure thereof in recent years, research conducted by Linsley & Shrives (2000) revealed that investors and other external parties to the company might have a limited knowledge regarding the risks facing the company. This was further emphasised by the global financial crisis and recent corporate failures which highlighted the need for enhanced risk disclosure.

According to Solomon, Solomon, Norton & Joseph (2000), the conduit for companies' risk management strategy is formal public disclosure to its stakeholders and narrative risk disclosures could represent a key mechanism to reduce this gap (Khlif & Hussainey, 2016).

Based on the existence of a knowledge gap regarding the quality of risk disclosure, this author conducted a recent study to address this gap, to some extent, by identifying a specific risk, which was significant at the time of commencement of the study, and to analyse the extent of companies' disclosure thereof. The study entailed creating a risk disclosure checklist based on various mandatory and voluntary risk disclosure requirements and guidelines. The risk disclosures of the JSE top 40 companies (excluding financial companies) were benchmarked against the checklist by means of analysing the sampled companies' integrated reports.

***Voluntary risk disclosure as an earnings prediction?***

Moumen, Othman and Hussainey (2015) found that the market can better anticipate the future earnings changes for the next two years for an entity that provides higher levels of voluntary risk disclosure than an entity with low levels of voluntary disclosures.

**Results of the quality of risk disclosure study**

The results indicated that companies within most industries tend to limit their risk disclosures to information relating to risk identification, impact, and mitigation, thereby omitting various voluntary disclosures.

*"...companies within most industries tend to limit their risk disclosures..."*

Some of the voluntary disclosures include strategy and resource allocation plans (taking into account the risks), challenges and uncertainties relating to the risk and evaluation of the performance of the company in terms of risk management.

The impact of COVID-19 has increased the risks already faced by companies and introduced additional risks not considered before. Greater emphasis should be placed on providing voluntary risk disclosure. *AAF*

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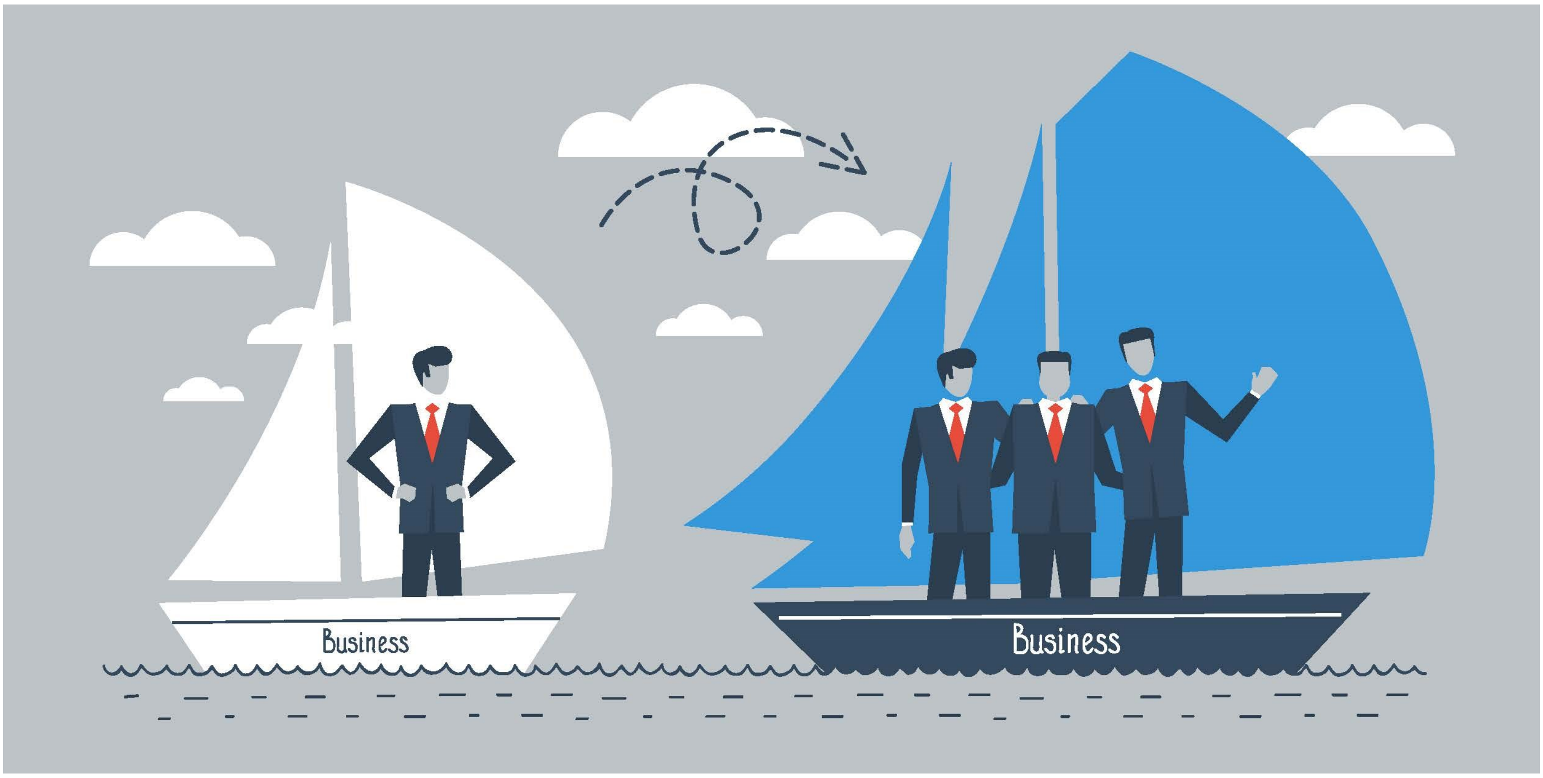


*(Photo: Shutterstock)*

# What changed with Business Combinations during 2020?

*(by Tosca van Mourik)*

Business Combinations was first introduced as an accounting standard in 1983 as IAS 22 Business Combinations. After various revisions, the International Accounting Standards Board (the Board) replaced IAS 22 with the IFRS 3 Business Combinations in 2004. The objective of this new standard was the improvement of the quality of the accounting for business combinations as well as to obtain an international convergence on the accounting of business combinations.

The first phase of this amendments were published in December 2002 as an Exposure Draft (ED) 3 Business Combinations, where the Board proposed amendments to IAS 36 Impairment of Assets and IAS 38 Intangible Assets. In March 2004 the new IFRS 3 Business Combinations and the amended IAS 36 and IAS 38 were issued simultaneously. In this amended IFRS 3 the main aim of the Board was the use of one accounting method for all business combinations, namely the acquisition method. The second phase of IFRS 3 included guidance on the application of the acquisition method. During June 2005, the Board issued an ED to amend IAS 27 Consolidated and Separated Financial Statements. In January 2008 the amended IFRS 3 and IAS 27 were issued.

The last and the most recent amendment of IFRS 3 was in October 2018. The Board amended IFRS 3 to narrow and clarify the definition of a business, and to permit a simplified assessment of whether an acquired set of activities and assets is a group of assets rather than a business. This new simplified assessment is called the "concentration test".

**What is IFRS 3, in a nutshell?**

IFRS 3 establishes principles and requirements for how an acquirer in a business combination:

- ◊ Recognises and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree;
- ◊ Recognises and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and
- ◊ Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

The core principle in IFRS 3 is that an acquirer of a business recognises the assets acquired and the liabilities assumed at their acquisitions-date fair values and discloses information that enables users to evaluate the nature and financial effects of the acquisition.

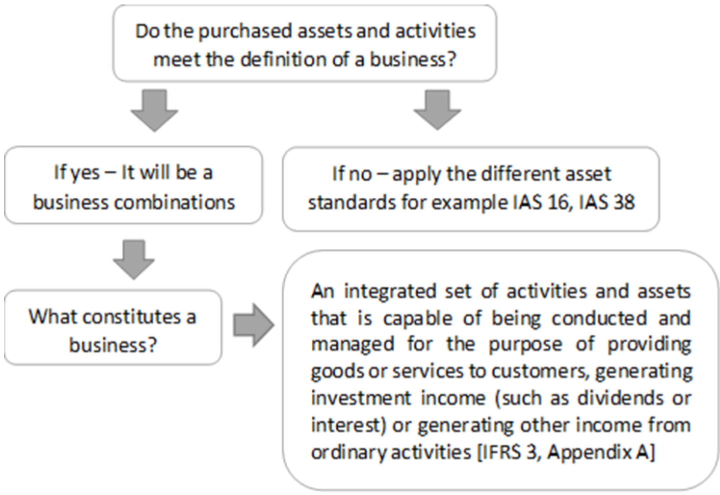
**What is the concentration test all about?**

The principles in IFRS 3 relating to a business combination have not changed. What changed is the definition of a business, as a post-implementation review of IFRS 3 identified that companies have some difficulties in determining whether they acquired a business or only a group of assets.

**What is the main question to ask?**

Paragraph B7A of IFRS 3 Business Combinations sets out the optional test to permit a simplified assessment of whether an acquired set of activities and assets is not a business. This is not an accounting policy choice. The company may elect to use the concentration test for each transaction or event.

This concentration test is a negative test, meaning that if the company meets the requirements of the concentration test, the company did not acquire a business, but only a group of assets. The contrary is also true, if the company does not meet the requirements, then a full assessment needs to be performed to identify if it is indeed a business combination.

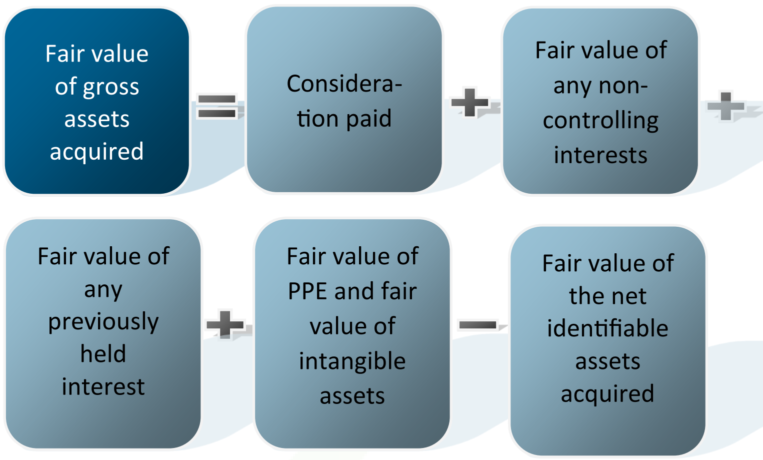



According to paragraph B7B of IFRS 3, the concentration test will be met if substantially all of the fair value of the gross assets required is concentrated in a single identifiable asset or group of similar assets. If that is the case – the company did not acquire a business.

**What additional considerations are applicable to the concentration test?**

| Gross assets exclude: | Fair value of gross assets include: |
|---|---|
| Cash and cash equivalents | Any consideration transferred |
| Deferred tax assets | Fair value of any non-controlling interest |
| Goodwill resulting from deferred tax liabilities | Fair value of PPE and fair value of intangible assets |
| | Fair value of any previously held interest |
| In excess of the fair value of net identifiable assets acquired | |

The fair value of the gross assets acquired is calculated as follows:



**What is a single asset/group of assets [IFRS 3.B7B]?**

The following are identified as a single asset or a single group of assets:

- ◊ Any asset or group of assets that would be recognised and measured as a single identification asset in a business.
- ◊ A tangible asset that is attached and cannot be physically removed and used separately from another tangible asset, without incurring significant cost
- ◊ When assessing similar assets, the company must consider the nature of each asset and the risks associated with managing and creating outputs from these assets.

The following assets are not considered as similar assets:

- ◊ A tangible asset and an intangible asset
- ◊ Tangible assets in different classes (i.e. inventory, manufacturing equipment) unless they are considered a single identifiable asset.
- ◊ Identifiable intangible asset in different classes (i.e. brand names and licenses)
- ◊ Financial assets and non-financial assets. Also financial assets in different classes
- ◊ Identifiable assets that are within the same class but has significantly different risk characteristics

**What are the elements of a business?**

IFRS 3.B7 defines a business as:

"A business consists of *inputs* and *processes* applied to those inputs that have
the ability to contribute to the creation of *outputs*."

- ◊ Inputs include non-current assets, licenses, material and skilled/ knowledgeable and experienced employees.
- ◊ A process is substantive if, when applied to the inputs, the process has the ability to continue producing outputs (not considered unique or scarce) and the employees are capable of performing the process.
- ◊ Outputs created includes the provision of goods or services to customers, to generate investment income or other income from ordinary activities.

**What is the effective date?**

The revised IFRS 3 standard is effective for business combinations for which the acquisition date is on or after the first reporting period beginning on or after 1 January 2020. Early adoption is permitted. AAF

**References**

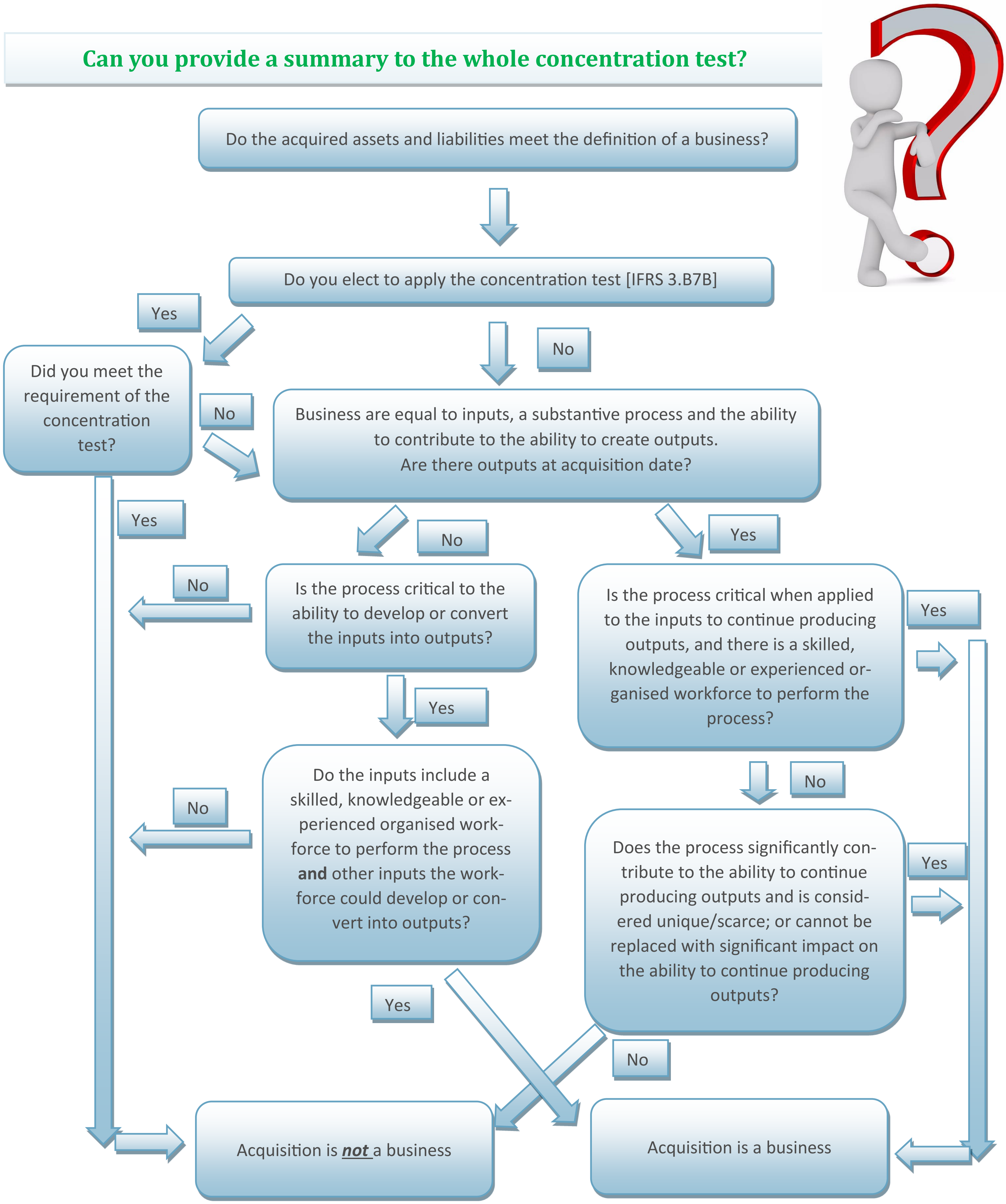

Presentation on SAICA Update 2019 done by SAICA and W.consulting

e-IFRS website on IFRS 3 Business Combinations


SAICA has developed the following educational material on the application of IFRS Standards in light of the Coronavirus Disease (Covid-19) uncertainty. (Source: SAICA and can be accessed here)

| Title | Title |
|---|---|
| Events after the reporting period (IAS 10) | IAS 2 Inventories |
| Going Concern considerations in light of COVID-19 | Issued financial guarantee contracts within the scope of IFRS 9 |
| Disclosure of judgements and sources of estimation uncertainty: Application of IAS 1 | IFRS 9 –Change in held-to collect business models |
| Borrowing Costs IAS 23 | IFRS 9 – measurement of expected credit losses on trade receivables |
| IFRS 15 – Revenue from Contracts with Customers | IFRS 9 - Modifications of financial liabilities |
| Onerous contracts IAS 37 | Government Grants IAS 20 |
| Potential implications on contingent consideration in a business combination (IFRS 3) where all conditions may not be met by year end due to COVID- 19 | |

## Can you provide a summary to the whole concentration test?



# Standard costing: 5 top tips you need to know

*(by Antoinette Combrink)*


*(Photo: Shutterstock)*

1st and foremost you need to determine *if standard costing is appropriate* for your entity by answering the following three questions:

*1. Why do we implement standard costing?*
For planning or budget purposes, to control costs and to evaluate managements' performance.

*2. Who implements standard costing?*
Entities with numerous repetitive operations and where the input required to produce each unit of output can be specified. Therefore, standard costing is often used in *manufacturing entities.*

*3. When to implement standard costing?*
As the implementation of standard costing is expensive, labour intensive and time consuming it should only be implemented *after determining that the benefits exceed the costs.* Standard costing is, therefore, often more appropriate for *large manufacturing entities* than for small entities.

2nd top tip: After determining that standard costing is appropriate, you need to understand *how normal and abnormal losses are treated*

Here it is important to remember that a normal loss is unavoidable (expected) and part of the production process. For example water that evaporates as a normal part of the production process. An abnormal loss on the other hand, is avoidable (unexpected) and not part of the normal production. For example wastage of water.

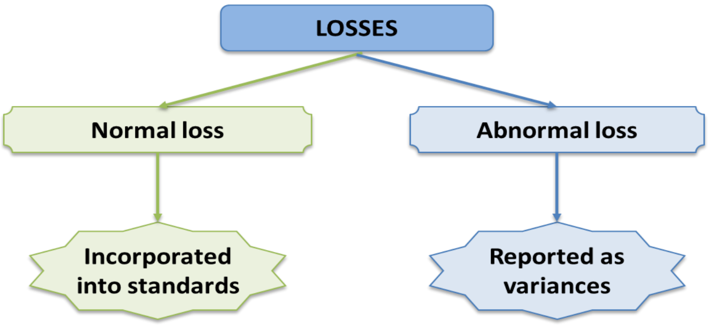
*During times of economic uncertainty "Standard costing remains an important part of any decision making toolkit but it should not be the whole answer. " (KPMG LLP, 2010)*

***Standard costing and COVID-19***

When standard costs are set the anticipated economic environment is used to set targets. But when the economic environment conditions change drastically due to an economic crisis such as COVID-19, standard costs should be revised to reflect the COVID-19 conditions (i.e. an ex post "after the fact" variance analysis).

Standard costs are determined based on expectations, normal losses are therefore already incorporated into the standard. A manager's performance will thus *not* be evaluated based normal losses expected in the operating environment.

Abnormal losses are avoidable (unexpected) and recognised as standard costing variances. A manager's performance will thus be evaluated based on *abnormal losses within the manager's control*.

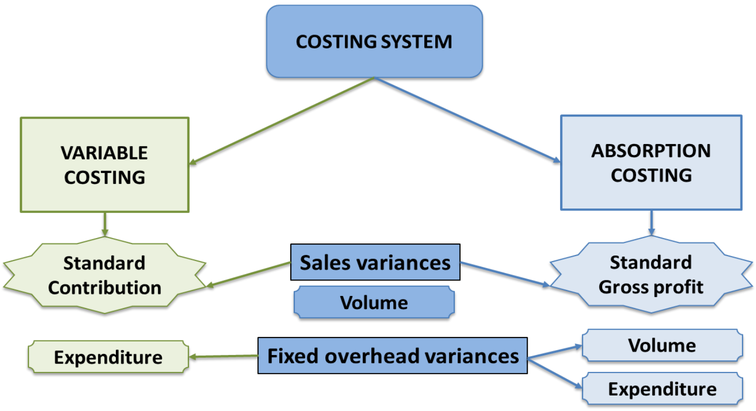



3rd top tip: Determine if a standard *variable* costing, or *absorption* costing system is being used. This must be determined as the calculation methods of *sales volume* variance and *fixed overheads* variances differ depending on which operating system is used.

What is the difference? *For sales volume variances*; the variable costing system uses the standard contribution and the absorption costing system uses the standard gross profit. For fixed overhead variances; the variable costing system only has an expenditure variance, whereas the absorption costing system has an expenditure and volume variance.

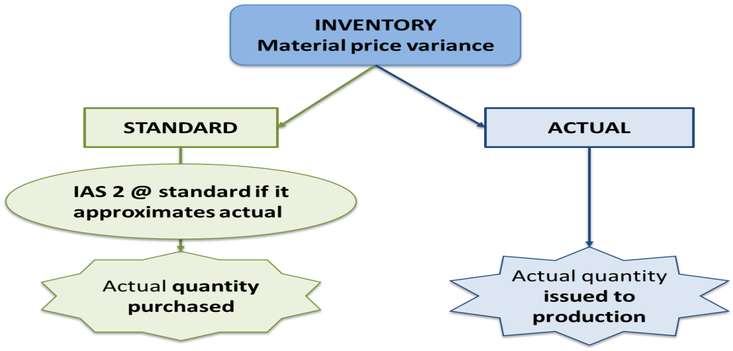
The reason for the difference is due to the treatment of fixed overhead costs. The variable costing system does not absorb fixed overhead cost into production as cost of sales and therefore fixed costs are not included as part of the inventory. Whereas the absorption costing method absorbs the fixed overhead cost into cost of sales and inventory using the budgeted fixed overhead allocation rate.

4th top tip: As IAS 2 (Inventory) allows for inventory to be held at standard cost if it approximates the actual cost, it is important to




Remember that the sales price variance and fixed overhead expenditure variance is the same irrespective of the costing system.

determine if inventory is held at standard cost or at actual cost. Why is it important? If inventory is held at standard cost, the material price variance will be based on *actual quantity purchased*. Whereas for inventory held at actual cost the material price variance will be based on *actual quantity issued to production*.




5th and final top tip: Volume variances are sometimes split further into mix, or quantity, or yield variances. When is the volume variance split further? This happens only when we sell more than one product or use more than one material input in production.

These five easy tips can go a long way to ensure that your standard costing foundation is tops! *AAF*

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*(Photo: Shutterstock)*

# What does the future hold for the auditing profession?

Questions around competition, resilience, conflicts of interest, regulatory weakness and the nature of audit itself have contributed to a crisis of trust in the auditing profession. In their second report on corporations and economic crime, Open Secrets exposed the role of the Big Four audit firms (PwC, KPMG, Deloitte and EY) in some of the most egregious examples of economic crime.

Consequently, the auditing profession globally is facing regulatory reviews, inquiries and criticism. Examples abound: in Australia, a Parliamentary Joint Committee inquiry into the regulation of audit; in the United Kingdom (UK), the Competition and Market Authority's study on competition and resilience, the Brydon review on the effectiveness of audit, the Kingman review on regulation, and the Business, Energy and Industrial Strategy Committee's inquiry to examine how the other three reviews in the UK complement each other, ensuring a coherent framework for auditing in the future.

*"These recommendations come alongside wider calls for a stronger regulator of the auditing profession, greater transparency for audit firms and expanding the scope of an audit. ."*

In South Africa, the minister of finance announced in the 2020 budget speech the establishment of a ministerial panel for the review of the auditing profession. Additionally, the Auditing Profession Amendment Bill aims to, inter alia, strengthen the governance of the Independent Regulatory Board for Auditors (IRBA) and its investigating and disciplinary processes.

These independent reviews into the auditing profession already culminated in the following recommendations in the UK: an operational split of audit and non-audit services, with a structural split to be considered if this is deemed ineffective after three years; piloting joint audits between a Big Four audit firms and a challenger audit firm in the 'upper reaches' of the FTSE 100, in conjunction with a cap on the market share of individual audit firms.

These recommendations come alongside wider calls for a stronger regulator of the auditing profession, greater transparency for audit firms and expanding the scope of an audit. However, a report by the International Federation of Accountants (IFAC), the Association of Chartered Certified Accountants (ACCA), and Chartered Accountants Australia and New Zealand (CA ANZ) emphatically states that breaking up the Big Four audit firms is not the answer to improving audit quality, as multidisciplinary firms have advantages when it comes to meeting expectations of an increasingly broad scope of audit work.

However, even before these independent reviews were commissioned, various regulators, oversight bodies, accounting and auditing professional bodies and audit firms were advocating for stronger audit quality frameworks to strengthen the public's confidence in audits. For example, the International Auditing and Assurance Standards Board (IAASB) initiated projects on audit evidence, professional skepticism and quality management at both audit firm and engagement level, including engagement quality reviews to enhance the robustness of audit firms' systems of quality control[1].

[1] Resulting in the following exposure drafts: Quality Management at Firm Level - ISQM 1; Engagement Quality Reviews - ISQM 2; and Quality Management at Engagement Level - ISA 220.

CA ANZ developed a 15-point plan including a range of measures to future-proof audit quality, while IRBA released a report on audit quality indicators. This report details audit quality indicators related to audit firms to be used by the audit committee of a client or future client, in transparency reports[2] and for regulatory purposes.

[2] Transparency reports were introduced in 2015 by the IAASB as part of their project on Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits.

These indicators include independence, tenure, internal firm quality review processes, workload of partners and audit managers, span of control, technical resources, and training. The IRBA also encourages those audit firms that audit public interest entities to submit transparency reports (albeit on a voluntary basis), detailing the firm's leadership, culture and ethics; risk management practices; relationship with staff and service providers; independence; and addressing external and internal inspection and monitoring results.

It is envisaged that these reports will be used in the tendering process for audits in complying with the mandatory audit firm rotation[3] requirement effective from 1 April 2023 for all companies whose audit firm tenure is ten years or more on that date.

[3] At the end of April 2020, 25% of JSE-listed entities have rotated audit firms ahead of the 2023 deadline with rotations not limited to changing between the Big Four audit firms but some partnering between Big Four and Non-Big Four audit firms.

Furthermore, the South African Auditing Profession Trust Initiative (SAAPTI) has been established by the South African auditing profession to recommend an appropriate responsive plan that will lead to rebuilding trust in the profession, and to ensure that the plan is appropriately executed. SAAPTI has subsequently issued a discussion document on considerations to address the key challenges facing the South African auditing profession, namely, audit quality, ethics, governance, independence, public interest role and expectation gap, market concentration and transformation.


Audit quality indicators

The auditing profession has consensus that the business environment has become so complex that the scope of an audit needs to evolve if an audit still wants to add value. Providing assurance on the historical financial statements is no longer enough – investors want to know about fraud and misconduct, cybersecurity and data privacy issues, consumer protection in financial services, whether the company uses its resources in an environmentally sustainable way, and even the sustainability of the business model.

Accordingly, the IAASB is taking cognisance of the increasingly complex business environment, including the impact of technology, networks and use of external service providers in the audit quality standards resulting from their project on audit quality management. Furthermore, to remain business relevant, auditors need to reposition and upskill themselves in whatever context they find themselves, as the fourth industrial revolution impacts not only on markets and professions but also on jobs.

Nevertheless, one of the biggest challenges remaining over the years is that the public's understanding of what auditors do is very different to the actual scope of their role. This challenge is compounded every time a company collapses, and the auditor is blamed for not preventing the impending disaster – instead of management and, ultimately, the board. Thus, CA ANZ recommends that a government review is warranted of not only auditors but all 'seven lines of defence', namely, management; compliance and risk; the internal audit function; the board; the auditor; regulators; and institutional investors. Such a review will go a long way in restoring public trust in the auditing profession and regaining its relevance and reputation in the future. *AAF*

***Did you know?***

Due to the highly publicized accounting failures, the IAASB has issued a discussion paper for public comment on 15 September 2020 namely Fraud and Going Concern in an Audit of Financial Statements: Exploring the Differences Between Public Perceptions About the Role of the Auditor and the Auditor's Responsibilities in a Financial Statement Audit. The information can be accessed here.

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# Will you recognize fraud when it comes knocking at your door?

***(by Carmen Wright)***


*(Photo: Shutterstock)*

It is a known fact that fraud and corruption are rife in South Africa. According to the 2019 Corruption Watch annual report, South Africa has a serious corruption problem with bribery being the most prominent form of corruption. This was confirmed by the PwC's Global Economic Crime and Fraud Survey of 2020 published in March of this year.

Although we all agree fraud and corruption is wrong, costing the country millions and that perpetrators should be prosecuted, we should also ask: What is our responsibility in combating fraud and corruption?

**Did you know you have to report fraud or corruption?**

A person in a position of authority, such as a public officer, partner in a partnership, member of a closed corporation, CEO or equivalent or a director of a company, have a duty to report (among other things) fraud and/or corruption of R100 000 or more to a member of the Directorate for Priority Crime Investigation (also known as the HAWKS). The reporting duty is also applicable if the person should reasonably have known or even if the person only suspect fraud and/or corruption.

If you don't report, you may be guilty of a criminal offence that carries a penalty of a fine or up to 10-year jail time. It is therefore in your best interest to have a good understanding of what qualifies as fraud or corruption.

***Did you know?***

The relevant information and forms relating to section 34 of the Prevention and Combating of Corrupt Activities Act, 2004 (Act 12 of 2004) can be accessed here.

**What is fraud and corruption?**

Most accountants are familiar with the International Standard on Auditing (ISA) 240 definition of fraud. ISA 240 defines fraud as: "An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage."

The problem is that the common law offence of fraud's definition is much wider than the auditing standard's definition. The common law offence of fraud is defined as: "The unlawful and intentional making of a misrepresentation which causes actual prejudice or which is potentially prejudicial to another."

The Association of Certified Fraud Examiners profiled a typical fraudster based on global fraud cases they investigated in their 2020 report.

*"...even if no actual advantage was obtained by the perpetrator, he/she can still be guilty of fraud."*

Therefore, even if no actual advantage was obtained by the perpetrator, he/she can still be guilty of fraud. For example, if the organization's accountant tried to process fictious revenue transactions to ensure a profit to secure a performance bonus, he/she committed fraud even if the accountant was not successful in processing the fictious revenue transactions.

Corruption on the other hand is defined in the Prevention and Combating of Corrupt Activities Act (PRECCA). The act's definition is quite extensive but was summarized by the National Anti-Corruption Forum as follows: "Corruption occurs when one party gives another party anything of value with the purpose of influencing them to abuse their power." Thus, both the person offering a bribe and the person receiving the bribe is guilty of corruption. Thinking of your past experiences, you might be seeing some red flags right now. But the people we work with are all good guys with good intentions, right?

***Interested in Forensic Auditing?***

If you are interested in fraud and corruption and would like to know more, Unisa offers a Postgraduate Diploma in Forensic Auditing. Visit the Unisa website here.

**What does a fraudster look like?**

It may be easy to identify the bad guy robbing a bank in his balaclava with a gun pointing and shouting at customers. However, as fraud become ever more sophisticated, so do the fraudsters. The PwC's Global Economic Crime and Fraud Survey of 2020 states that 41% of fraud perpetrators are employees of the organisation they defrauded and a further 21% of fraud is perpetrated by collusion between employees and external individuals in South Africa.

The typical fraudster was:

- An employee;
- Male;
- 31 to 45 years old;
- Works in operations or the accounting/finance department;
- Has a university degree; and
- Employed by the company for six years or more.

Know anyone who might fit the profile?

**Other legislation to consider**

PRECCA is not the only legislation that includes a reporting duty when fraud and/or corruption (among other) is suspected. Other legislation that also include a reporting duty include:

- The Financial Intelligence Centre Act;
- The Public Finance Management Act;
- The Municipal Finance Management Act;
- The Companies Act; and
- The Audit Professions Act.

Based on your current employment, it will be wise to familiarize yourself with the applicable legislation and code of conduct that is applicable to you and your possible reporting duties.

**In conclusion**

As a society who reads daily about theft, bribery and corruption in our country, we run the risk of being desensitized to fraud and corruption. We might even get accustomed to paying kick-backs, stating that this is how we conduct business and the only way to secure a tender or a contract. However, turning a blind eye to fraud and corruption is not an option. We should all take responsibility and comply with our reporting duty. *AAF*


*(Photo: Shutterstock)*

# The rationale behind the tax exemption of PBOs

*(by Marié Ungerer)*

Whenever scandals erupt around the misappropriation of money by public benefit organisations (PBOs)[1], for example churches[2], it is quickly followed by threats from all and sundry that the tax exempt[3] status of these organisations should be reconsidered. In the minds of most honest, hard-working, tax-paying citizens it seems that it must be unfair that everybody does not pay tax fair and square. While this may be a natural human reaction to news about fraud and thievery, it does raise the following question: Why in fact are PBOs and many other non-profit organisations (NPOs) exempt from paying income tax? Why can't they pay tax just like everybody else?

*"Why can't they pay tax just like everybody else?"*

Accountants, tax practitioners and even the public are generally aware of the fact that registered PBOs[4] are tax exempt and that a further subset of these organisations[5] may also receive donations that are deductible for income tax purposes in the hands of the donor[6]. The question, "why are PBOs/NPOs tax-exempt" have, however, challenged academics for many years and to such an extent that even today there is still not one perfect explanation for the tax-exempt status of these organisations, but only a number of rather very well thought through theories. Before diving into these very interesting and compelling theories, some background should be provided on NPOs and the non-profit sector and some terminology needs to be explained. This will be followed by a brief summary of the normative theories currently justifying the tax-exemption of NPOs within a historical timeline.

Studies about NPOs and the non-profit sector not only spans many disciplines, which includes economic, management, accounting, political and social sciences as well as law, but it invariably touches on the concept (and sometimes emotive debate) of civil society, what it is and how it operates. NPOs and PBOs somehow become equated with civil society and therefore, in recent scholarship it was submitted that the concept of civil society needs to be divided into two, namely a structural "third sector" concept to be used in empirical studies about NPOs and PBOs and a normative "civil society" concept to be used by theorists studying the nature of civil society[7]. For purposes of this article it can be accepted that NPOs mainly operate in a sector apart from the market place (private sector) and the state/ government (public sector), the so-called third or non-profit sector, while keeping in mind that the blending and blurring of sectors also occur. The third sector or non-profit sector is further and invariably also referred to as the independent, tax-exempt, voluntary or charity sector.

The term NPO refers to a wide range of organisations that include non-governmental organisations (NGOs), community-based organisations, civil society organisations, faith-based organisations, charities, grass-roots organisations, recreational and sporting clubs, professional and business associations, labour unions, etc. The various types of NPOs are divided into two broad categories, namely organisations that provide broad social benefits to the public[8] and organisations that provide mutual benefits[9] to its members.

*"a trust, company or other association of persons – (a) established for a public purpose; and (b) the income and property of which are not distributable to its members or office-bearers except as reasonable compensation for services rendered"*[12]. South Africa follows a so-called light -handed approach to the regulation of NPOs.

***Did you know?***

There are currently 233 725 registered NPOs on the Department of Social Security's database. SARS does not provide the number of registered PBOs, however, they do provide a list of approved PBOs that may issue section 18A certificates. There are currently in excess of 24 000 of these PBOs on SARS' register. More information on SARS's Tax Exemption Unit can be obtained here.

A qualifying entity in South Africa may voluntarily register at the Department of Social Development to become a registered NPO, however, to be officially tax exempt, a NPO needs to register at the South African Revenue Service (SARS) either as a PBO[13], a recreational club[14] or

*"...to be officially tax exempt, a NPO needs to register at the South African Revenue Service..."*

Political organisations are placed into its own third separate category. In addition, NPOs exhibit a number of distinguishing characteristics in that they are: (1) organised (institutionalised to some extent), (2) private (separate from government), (3) self-governing (equipped to control their own activities), (4) voluntary[10] (involving some meaningful degree of voluntary participation) and last but not least (5) non-profit distributing[11]. Interestingly to note that the term non-profit is somewhat of a misnomer, in that NPOs may have a "profit", but this "profit" may not be distributed by way of dividends. This so-called non-distribution constraint forms the basis of many of the tax exemption theories, as will become clearer further on.

A word on the regulation of NPOs in South Africa; the Non-profit Organisations Act provides for a legal definition of a NPO in South Africa and defines a NPO as:

an association (including trade unions and chambers of commerce)[15], etc. This is not a comprehensive list, but sufficient for purposes of this article. It is not a requirement that an entity that intends to register as a PBO, a recreational club or an association also register as a NPO. Traditionally there are three main groups of theories as to why NPOs are and should be exempt from tax: (1) the historical theory, (2) tax base theories, and (3) subsidy theories.

The historical theory makes for interesting reading as it seems that since the beginning of history itself religious entities specifically were tax exempt. Around 1 200 B.C., during the reign of Ramses III, tax exempt temples owned fifteen percent of the cultivable land in ancient Egypt[16]. In Genesis 47:26[17] it is stated that: *"… Joseph made it a law over the land of Egypt to this day, that Pharaoh should have one-fifth, except for the land of the priests only, which did not become Pharaoh's*".

And further in Ezra 7:24[18] it is commanded that: *"… it shall not be lawful to impose tax, tribute, or custom on any of the priests, Levites, singers, gatekeepers, Nethinim, or servants of this house of God*". The historical theory is also referred to as the "sovereignty view" and in this regard Brody[19] states that: "*Charities go untaxed because Caesar should not tax God*".


(Photo: Shutterstock)

However, in earlier times, the non-profit sector was relatively small and NPOs were mainly engaged in religious activities or activities only of a charitable nature. Today the non-profit sector makes a substantial contribution to many countries' economies and they are also expanding into other industries. It is for this reason that the rationale for the tax exemption of NPOs are theorised[20].

In 1976 Bittker and Rahdert[21] developed what would become known as a tax base theory for tax exemption of NPOs. They explained that a NPO is a mere conduit through which funds move from the donor to the ultimate beneficiaries. NPOs therefore do not realise income in the ordinary (or taxable) sense of the word and is therefore excluded from the tax base.

There are multiple arguments explaining tax exemption of NPOs as a deliberate subsidy by government, the so-called subsidy theories. Some of the main proponents of these theories are: Hansmann[22], Steinberg[23], Atkinson[24] and Colombo and Hall[25]. Subsidy theories are based on the fact that NPOs provide goods and services deemed to be good for the public, e.g. health care and education. NPOs also provide goods and services to those who are recognised as especially needy, e.g. food and shelter to the poor.

Subsidy theories further posits that tax exemption of NPOs may be justified by the fact that due to their altruistic characteristics they may tend to better service a specific group in society, e.g. the poor, or that a government, through subsiding NPOs with tax exemption, promotes altruism and volunteerism in society. The tax exemption of NPOs can also correct market failure, e.g. difficulties that NPOs face in raising capital due to the non-distribution constraint[26].

NPOs are also not always fully tax exempt. In many countries, including South Africa, NPOs are allowed to receive income from trading activities, however, such income may then not necessarily be tax exempt. Broadly speaking, any trading income that is not integral and directly related to the main purpose of the NPO and result in unfair competition to trading entities, becomes taxable income in the hands of a NPO and is taxed at the corporate tax rate. This is generally referred to as unrelated business income tax (UBIT). Scholars are not all in agreement regarding UBIT in NPOs and also in some countries, NPOs are not allowed to receive any trading income and may forfeit their tax exempt status if they do.

The two principles, namely the non-distribution constraint and UBIT, plays a significant role in a fairly recent theory on the rationale behind the tax exemption of NPOs.

In his theory, Rushton[27] advances two hypotheses. The first is that the exemption of NPOs from corporate income tax (CIT) is attributable to the fact that the income of a NPO is not ultimately owned by any individual (due to the non-distribution constraint) whereas CIT ensures that individual income does not escape tax by being earned behind the corporate veil.

With the second hypothesis, Rushton provides a justification for the UBIT, however, that falls outside the scope of this article. Rushton also considers the principles of economic efficiency[28] and fairness (equity)[29] in tax policy design and states that the question on whether NPOs should be exempt from tax is not a fairness issue, but rather an efficiency issue.

Rushton leaves scholars with much food for thought as he states: "*To explain why nonprofits are exempt from the CIT, scholars should begin by asking why there is a CIT at all rather than by asking what is so special about nonprofits*". AAF

**References:**

[1]PBOs forms a subset of non-profit organisations (NPOs).

[2]The terms NPOs and PBOs may be used interchangeably.

[3]The practice of religion is a "public benefit activity" as defined in section 30 of the Income Tax Act and therefore a church may register as a PBO.

[4]Tax exempt here refers to being exempt from paying "normal tax" in the South African context.

[5]Income tax Act 58 of 1962 (as amended) (Income Tax Act): section 30 read with PART I of the Ninth Schedule to the Income Tax Act.

[6]PART II of the Ninth Schedule to the Income Tax Act.

Income Tax Act: section 18A.

[7]Viterna, J., Clough, E., & Clarke, K. 2015. Reclaiming the "Third Sector" from "Civil Society." Sociology of Development, 1(1), 173–207 available here and Salamon, L. M. 2010. Putting the civil society sector on the economic map of the world. Annals of Public and Cooperative Economics, 81(2), 167–210 available here.

[8]Includes charitable, educational, scientific, religious and social welfare organisations.

[9]Includes social and sporting clubs, consumer cooperatives, labour unions and business associations.

[10]These five characteristics are generally accepted in scholarship, however, the aspect of voluntarism may not always be present in some tax-exempt institutions.

[11]Salamon, L. M., & Anheier, H. K. 1997. Toward a common definition. In L. M. Salamon & H. K. Anheier (Eds.) Defining the nonprofit sector: a cross-national analysis. (pp. 29–50). New York: St. Martin's Press.

[12]Nonprofit Organisations Act 71 of 1997 (NPO Act): section 1(1)(x).

[13]Income Tax Act: section 30 read with section 10(1)(cN).

[14]Income Tax Act: section 30A read with section 10(1)(cO).

[15]Income Tax Act: section 30B read with section 10(1)(d).

[16]Colombo, J.D. & Hall, M.A. 1995. The charitable tax exemption. Westview Press.

[17]The Holy Bible. 1982. New King James Version. Thomas Nelson.

[18]See 17 above.

[19]Brody, E. 1998. Of sovereignty and subsidy: Conceptualizing the charity tax exemption. Journal of Corporation Law. 23(4)585-630.

[20]Hansmann, H., 1981. The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation. The Yale Law Journal. 91(1)54-100. doi:10.2307/795849.

[21]Bittker, B.I. & Rahdert, G.K. 1976. The exemption of nonprofit organizations from federal income taxation. The Yale Law Journal. 85(3)299-358.

[22]See 20 above.

[23]Steinberg, R. 1997. Overall evaluation of economic theories. Voluntas. 8(2)179–204 available here.

[24]Atkinson, R. 1997. Theories of the Federal Income Tax Exemption for Charities : Thesis, antithesis, and syntheses. Stetson Law Review. 600(Fall)395–432.

[25]See 16 above.

[26]Meaning that investors would not want to invest in NPOs as there will be no return on the investment in terms of dividends received.

[27]Rushton, M. 2007. Why are nonprofits exempt from the corporate income tax? Nonprofit and Voluntary Sector Quarterly. 36(4)662-675 available here.

[28]Efficiency means that tax should not unduly influence economic decision making.

[29]Fairness means that individuals who are in similar economic circumstances should pay similar amounts of tax.


*(Photo: Shutterstock)*

# Management Accounting and Finance in SAICA's ITC: Jan 2013 – Jan 2020

*(by Mandlenkosi M. Kabini )*

This article provides an analysis and insight into the composition of the Management Accounting and Finance (MAF) subject field as examined in the ITC. The author analysed trends from the first ITC exam session in January 2013 up to the exam session in January 2020 (15 ITC exam sessions in total) to provide a holistic view of the MAF component of the ITC over the 15 exam sessions.

The South African Institute of Chartered Accountants (SAICA) Initial Test of Competence (ITC) exam, previously known as Part 1 of the Qualifying Exam (QE1), was offered in two exam sessions per year for the first time in January 2013 (SAICA, 2013). The ITC examines technical competence in four subject fields – namely, Auditing, Financial Accounting, Management Accounting and Finance (MAF), and Taxation. Each ITC exam session is over two days, consisting of four papers of 100 marks each. There are now two ITC exam sessions per year, normally in January and June. The exams for 2020 and 2021 have been affected by the COVID-19 epidemic, thus the June 2020 and January 2021 exams will be held in November 2020 and March 2021 respectively.

According to the current SAICA Competency Framework (SAICA, 2018), MAF is split into three subject areas; Financial Management (FM), Management Decision Making and Control (MDMC), and Strategy, Risk Management and Governance (SRG).

**Management Accounting and Finance Subject Areas**

In the 15 exam sessions analysed over the period under review; MDMC has the highest marks contribution (37,5%) in the total MAF marks, closely followed by FM (35%). There is a higher contribution of discursive marks (61,5%) compared to marks for calculations (38,5%). This may be due to the SRG component being predominantly discursive, while there are also discursive aspects in FM and MDMC.

FM has, on average, slightly higher average marks per question (20,3 marks), closely followed by SRG (18,7 marks). MDMC has been examined more often (in terms of the number of MDMC questions in the exam sessions), although, with a lower average mark per question than the other two MAF subject areas (FM and SRG). Overall, at least two of the subject areas were examined in each of the 15 exam sessions.

Table 1: Overall View of Management Accounting and Finance in the ITC: Jan 2013 to Jan 2020

| ITC: Management Accounting and Finance (MAF) Jan 2013 to Jan 2020 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Subject Area** | **Total Marks** | **%** | **Calc Marks[1]** | **Disc Marks** | **Calc % Total Marks** | **Disc % Total Marks** | **Number of Times Examined** | **Average Marks per question** |
| **FM** | 711 | 35,0% | 378 | 333 | 53,2% | 46,8% | 35 times | 20,3 marks |
| **MDMC** | 763 | 37,5% | 384 | 379 | 50,3% | 49,7% | 46 times | 16,6 marks |
| **SRG** | 560 | 27,5% | 22 | 538 | 3,9% | 96,1% | 30 times | 18,7 marks |
| **Total** | **2 034** | **100,0%** | **784** | **1 250** | **38,5%** | **61,5%** | **111 times** | **18,3 marks** |
| | | **100,0%** | **38,5%** | **61,5%** | | | | |

[1] The split between calculation and discussion marks is made in accordance with the mark plan as per the required and solutions from the SAICA website (SAICA, 2020). In cases where there is no clear split given; the author assesses whether an equal split will be a fair allocation of marks. If this is not the case; largely calculative questions are allocated two-thirds of the marks to the calculation portion and largely discursive questions allocated two-thirds of the marks to the discussion portion. The allocation of calculation marks is limited to the maximum available calculation marks. Communication marks are allocated as per the requirement of the question. For example: marks for layout are allocated to a calculation and marks for clarity

***What benefits do SAICA members enjoy?***

*Per their website (available here), they enjoy the following:*

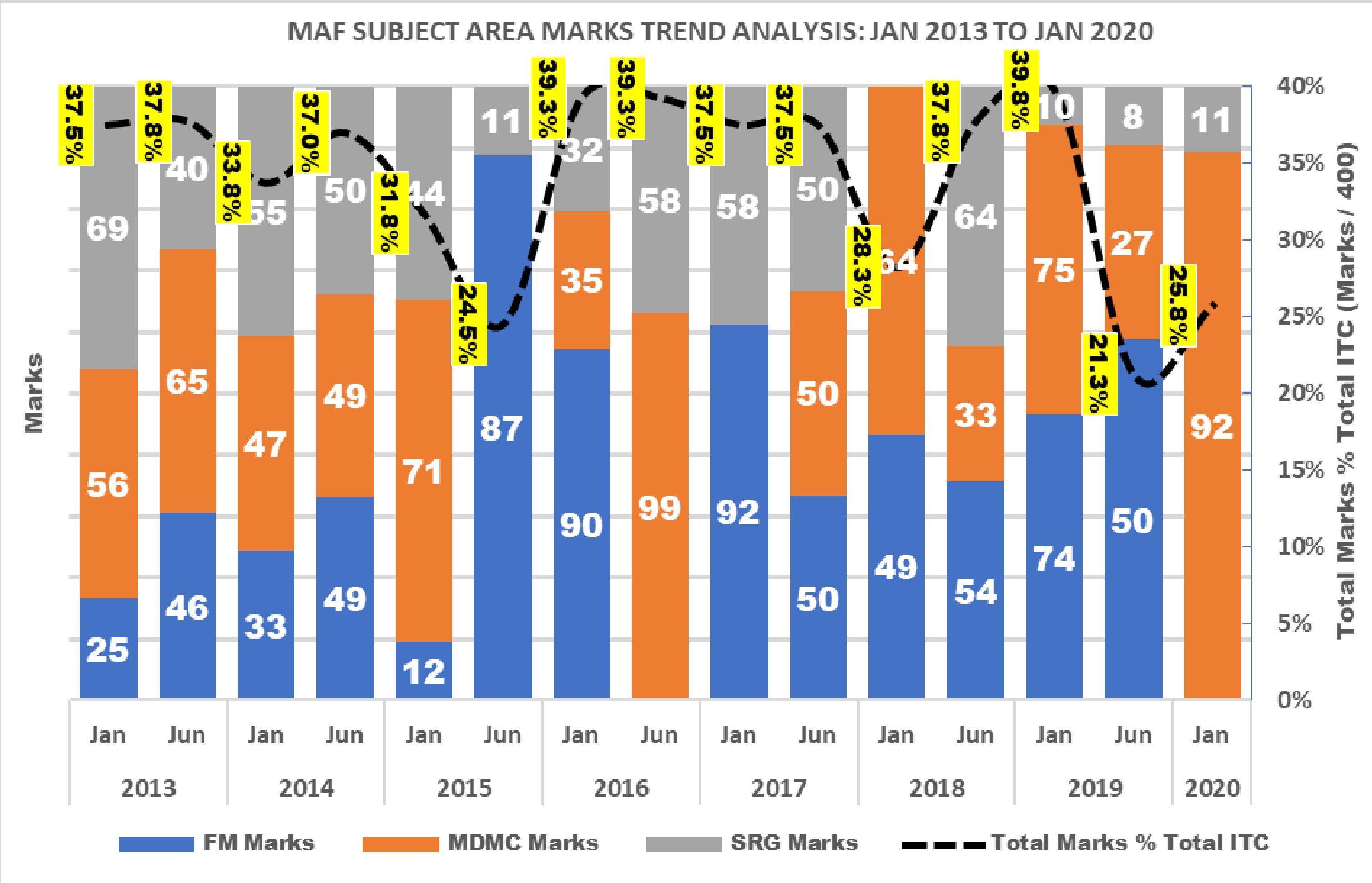
- *"The value of the designation, by being the first-choice financial advisor or employee within the business community at large;*
- *Acceptability for financial/accountancy positions within business in South Africa;*
- *Access to relevant financial/accountancy information in electronic and print formats;*
- *Advice on ethical and technical issues;*
- *Access to continuing professional education;*
- *Membership of one of the leading accountancy institutes in the world;*
- *Networking opportunities, such as a large number of functions and annual dinners, as well as contact with local structures and special interest committees (eg the Commerce and Industry Committee)*
- *Access to an up-to-date information centre; and*
- *Interactive communication with SAICA through the SAICA website."*

**Trend Analysis per Subject Area**

Below is the analysis of the three MAF subject areas' composition in the ITC from January 2013 to January 2020, in the primary axis are the 100% stacked columns containing marks for each subject area and the secondary axis presents a line representing the MAF percentage in the ITC exam session:

It is interesting to note that it was only in the June 2017 and June 2014 exam sessions where the three subject areas were equally examined in terms of marks per MAF subject area.

Figure 1: MAF Subject Areas Marks Trend Analysis: Jan 2013 to Jan 2020




The average contribution of MAF to the total ITC marks per exam session (of 400 marks) has been an average of 33,9% (135,6 marks) over the 15 ITC exam sessions. The number of marks contributed by MAF ranged between 21,3% (June 2019: 85[1] / 400 marks) and 39,8% (Jan 2019: 159[2] / 400 marks) of the total marks per exam session.

There are also exam sessions where one of the subject areas is not examined (i.e. MDMC in June 2015 and January 2017, FM in June 2016 and January 2020, and SRG in January 2018).

[1] 85 MAF marks = 50 FM + 27 MDMC + 8 SRG = Jun 2019 marks as presented in Figure 1; and

[2] 159 MAF marks = 74 FM + 75 MDMC+ 10 SRG = Jan 2019 marks as presented in Figure 1.

**Topics Diversity**

Examiners of MAF have a wide variety of topics to choose from the three subject areas when setting the MAF exam in the ITC. This is evidenced by how unpredictable and diverse the topic mix in the ITC exam has been over the years. The stylized composition and explanation of MAF topics that make up the MAF subject areas is presented in Table 2: MAF Subject Areas Topics below:

Table 2: MAF Subject Areas Topics Examined in the ITC: Jan 2013 – Jan 2020

| Subject Area | Topic Ref | Topic Description | Marks |
|---|---|---|---|
| FM: Financial Management | CIA | Capital Investment Appraisal | 141 |
| | COC | Cost of Capital | 51 |
| | FIA | Financial Information Analysis (includes analysis of ESG) | 171 |
| | Leas | Leasing | 20 |
| | MACS | Mergers and Acquisitions and Corporate Restructuring (includes business rescue and businesses in difficulty in MAF questions) | 55 |
| | SOF | Sources of Finance (excludes Leasing) | 25 |
| | TRTY | Treasury (includes International Finance and MAF Risk Management using Derivative Financial Instruments) | 13 |
| | VAL | Valuations | 195 |
| | WCM | Working Capital Management | 40 |
| MDMC: Management Decision Making and Control | CACS | Absorption Costing | 37 |
| | SBPC | Budgeting, Planning and Control | 32 |
| | SCVP | Cost Volume Profit Analysis | 37 |
| | CSTA | Costing (not classified to a costing system) | 81 |
| | CDCS | Direct Costing | 6 |
| | PMDP | Divisional Performance Analysis | 97 |
| | CJCS | Joint and By-product Costing | 17 |
| | CPCS | Process Costing | 14 |
| | SRel | Relevant Information for Decision Making (includes all forms of Relevant Costing for decision making [product decisions (optimal pricing, product mix), product line decisions (continue or amend?), special order, make or buy, sell or further process, decision impact analysis, etc)] | 337 |
| | CSTD | Standard Costing (includes variance analysis) | 51 |
| | PMTP | Transfer Pricing | 54 |
| SRG: Strategy, Risk Management & Governance | CGov | Corporate Governance (CGov only MAF questions, excludes Auditing Governance) | 80 |
| | ETH | Ethics (Ethics only in MAF questions) | 39 |
| | RisM | Risk Management | 299 |
| | S&BM | Strategy and Business Models (includes stakeholder management and sustainability, lest classified under RiSM) | 142 |
| MAF | MAF | Management Accounting and Finance | 2 034 |

Source: Recreated from the Topics in Financial Management (Correia et al., 2016), Management and Cost Accounting (Drury, The exam sessions with most MAF topics (i.e. the Jan 2013, Jan 2016, Jun 2017, and Jun 2018 sessions had the similar number of questions with the sessions that had the lowest number of topics (2015 Jan and June, and 2020 Jan).

*"The topic mix is quite diverse and cannot be `spotted` or predicted with accuracy or certainty. "*

The top examined topics based on marks are Relevant Information for Decision making (SRel), Risk Management (RisM), Valuations (VAL), Financial Information Analysis (FIA), Strategy and Business Models (S&BM), and Capital Investment appraisal (CIA).

However, these six topics only contributed to 63% of the total MAF marks over the 15 exam sessions. As discussed previously, there were exam sessions where one of the three subject areas were not examined, indicating that these top six topics are not examined in every exam session. Therefore, trying to `spot` which topics will be examined in a particular ITC exam session can be very disastrous to candidate performance.


**Conclusion:**
The trend analysis of the three subject areas' marks show that Management Accounting and Finance contributes to a relatively large portion of the ITC Exam (about a third of the total marks, on average). The topic mix is quite diverse and cannot be `spotted` or predicted with accuracy or certainty. ITC candidates must be well prepared in all MAF subject areas and topics in order to increase their chances of success.

It is pleasing to note that the Management Accounting and Finance portion of the ITC exam is not only calculative in nature, but has a large element of discussion, thus requiring high-order thinking skills and the application of knowledge in a real-life contextualised scenario to demonstrate technical competence in the subject field. *AAF*

**References:**

Correia, C., Flynn, D., Wormald, M., & Dillon, J. (2016). Financial Management (C. Correia (ed.); 8th ed.). Juta and Company Ltd.

Drury, C. (2019). Management and Cost Accounting (10th ed.). Cengage Learning.

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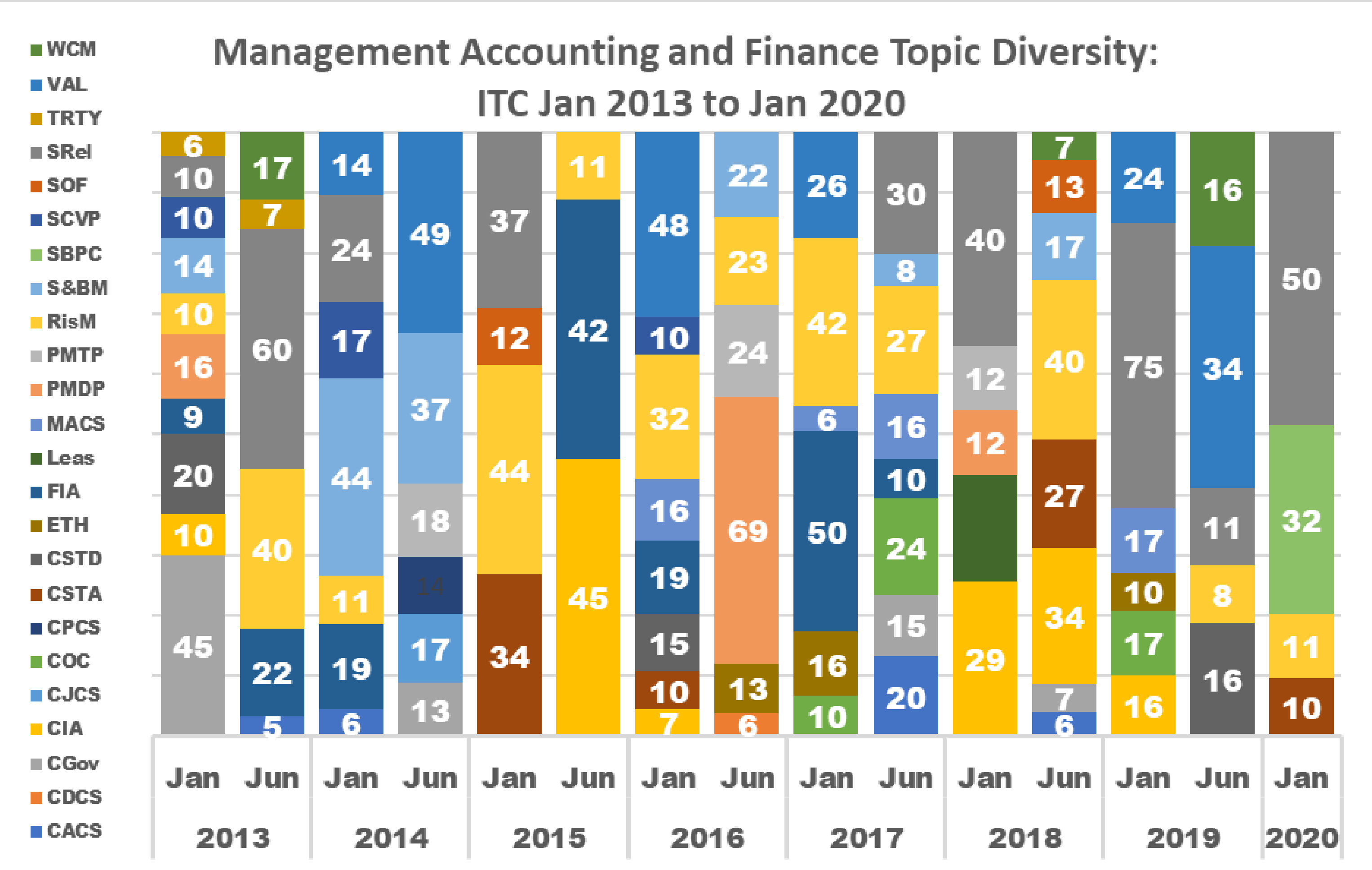
SAICA. (2020, April 25). Initial Test of Competence: Past Exam Papers. Available here.

These topic references were used to construct a graph in Figure 2 below.

MAF topics are highly malleable to fit within a question.

Figure 2: Management Accounting Topics Diversity: ITC Jan 2013 to Jan 2020




The graphical representation of topics overall has more than three times the colours of a rainbow. This shows how unpredictable the topics of the MAF component in the ITC exam can be. The unpredictability of the topic mix is because in MAF it is easier to integrate various topics, tools and techniques in order to solve problems presented in a scenario.

This is shown by the varied number of topics for the same number of questions in the sessions with the greatest number of topics and those with the lowest number of topics being set in two to three questions as shown in Table 3 below:

Table 3: Sessions with Most and Least number of Topics, yet have the same number of questions

| Sessions with the Greatest number of topics | | | | Sessions with the Lowest number of topics | | | |
|---|---|---|---|---|---|---|---|
| Exam | Topics | Questions | Marks | Exam | Topics | Questions | Marks |
| 2013 Jan | 10 | 2 | 150 | 2015 Jan | 4 | 2 | 127 |
| 2016 Jan | 8 | 2 | 157 | 2015 Jun | 3 | 3 | 98 |
| 2017 Jun | 8 | 3 | 150 | 2020 Jan | 4 | 3 | 103 |
| 2018 Jun | 8 | 3 | 151 | | | | |


*(Photo: Shutterstock)*

# Home office expenses for employees and its tax deductions

*(by Maretha Pretorius)*

The COVID-19 pandemic has necessitated many employees to work from home during the lockdown period. This trend towards working from home and at home is expected to gain momentum in the wake of the coronavirus crisis and there is an expectation that remote working will become the norm for a large number of salaried employees.

As a result, many employees have over the last few months incurred additional expenses that they would not have ordinarily incurred had they continued to work from the employer's office. The question then arises whether employees will qualify to claim a deduction for home office expenditure? The answer to this question is not a simple yes or no. In order to determine whether you would qualify to claim a deduction, the requirements that must be met must first be discussed.

## General requirements

A general deduction needs to meet the requirements of section 11(a) and section 23(g) to be allowed as a deduction. This means that only expenses incurred in the "production of income" will be permitted. The above two sections also only permit expenditure that is not of a capital nature.

## Specific requirements

Section 23(b) prohibits the deduction of private or domestic expenditure and although home office expenditure is permitted under section 23(m), this section prohibits the deduction of expenditure related to income from employment, unless the income is earned mainly from commission or other variable remuneration. There are, however, requirements listed in section 23(b) that will enable employees to deduct a portion of the expenses relating to their home office if all these requirements are met. These requirements are:

- ◊ The area used as a home office is specifically equipped for purposes of the taxpayer's trade only; **and**
- ◊ Regularly and exclusively used for such purposes; **and**
- ◊ Either the employee's income must consist mainly of commission or other variable payment or the employees' duties must be mainly performed in the home office. Mainly is considered to be more than 50%.

The above implies that the dining room table or a desk in your bedroom will not suffice and will not be exclusively used for the purpose of earning an income. In addition, only employees who work from home for at least 6 months (or 187 days) of the year, will meet the last requirement. The onus of proof will also be on the taxpayer to prove the facts, should SARS query the tax deduction.

If the above requirements are met, what would qualify as a home office expense?

## What constitutes home office expenses?

Home office expenses will include rental paid in respect of your home or interest on your mortgage bond. Rates and taxes or levies and cost of repair to the property. Office equipment, stationary, internet and telephone costs, electricity and insurance as well as cleaning expenses will be included.  Wear and tear allowances in respect of assets used for purposes of the home office may also be claimed.

A taxpayer would be able to claim a pro-rata percentage of these home office expenses. This pro-rata percentage is calculated based on the floor space occupied by your home office. For example, if your home office is 5% of the total area of your house, you will be able to claim 5% of the expenses listed above.

Any expenses that is of a capital nature, for example building on an additional room, may not be deducted as home office expenditure for tax purposes.

*"A taxpayer would be able to claim a pro-rata percentage of these home office expenses."*

## Capital gains tax consequences

*(Photo: Shutterstock)*

When deciding to claim home office expenses in their tax calculation, employees should take note of the adverse future capital gains tax consequences.

If a taxpayer claims the tax deduction, the home office is now a place of trade and will no longer form part of the taxpayer's primary residence.

When the primary residence is sold, the taxpayer is entitled to a R2 million exclusion on the capital gains tax calculation, known as the primary residence exclusion. The taxpayer is now required to apportion the primary residence exclusion to only the portion of the house that was used for domestic use. If the taxpayer claimed 5% of office expenses (e.g. rental/interest on bond) based on the floor space utilised, the taxpayer will only be entitled to the floor space utilised, the taxpayer will only be entitled to 95% of the primary residence exclusion when selling the primary residence.

## Conclusion

The rules for claiming home office expenses are very strict and employees who have been working from home on a temporary basis and on a short term will in all likelihood probably not qualify to deduct their home office expenses.

Should an employee, decide to claim the home office expenses in their tax return, the taxpayer must comply with the relevant sections of the Income Tax Act and be able to prove that all the requirements have been met when the South African Revenue Services (SARS) asks for evidence. *AAF*

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Your feedback is welcomed and appreciated; is there a specific issue that you want to know more of? Queries and comments can be addressed to Herman Combrink at combrha@unisa.ac.za.