



# **COMPETENCE PRACTICE EXAMINATION**

**NON AUDIT**

**JUNE 2009**

**SUGGESTED SOLUTIONS**

## SECTION A

### Question 1

The ethical in this situation is not difficult to identify – Is it ethical for Brian to work hours and not record them as hours worked in this situation? There are typically more people affected in situations in which ethical dilemmas occur than might be expected. The following are the key persons involved in this situation

Who	How affected
Brian Chanda	<ul style="list-style-type: none"><li>• Being asked to violate firm's policy</li><li>• Hours of work will be affected</li><li>• Pay will be affected</li><li>• Performance evaluations may be affected</li><li>• Attitude about the firm may be affected</li></ul>
Martha Kombe	<ul style="list-style-type: none"><li>• Same as Brian Chanda</li></ul>
Charles Lengwe	<ul style="list-style-type: none"><li>• Success on engagement and in firm may be affected</li><li>• Hours of work will be affected</li></ul>
Zulu Accounting Services Ltd	<ul style="list-style-type: none"><li>• Stated policy is being violated</li><li>• May result in underbilling clients in the current and future engagements</li><li>• May affect the firm's ability to motivate and retain employees</li></ul>
Staff assigned to Kalundu Holdings in the future	<ul style="list-style-type: none"><li>• May result in unrealistic time budgets</li><li>• May result in unfavourable time performance evaluations</li><li>• May result in pressures to continue practice of not charging for hours worked</li></ul>
Other staff in the firm	<ul style="list-style-type: none"><li>• Following the practice on this engagement may motivate others to follow the same practice on other engagements</li></ul>

**Faced with the same situation, possible alternative actions include:**

- Refuse to work additional hours
- Perform in the manner requested
- Inform Charles that he will not work the additional hours or will charge the additional hours to the engagement
- Talk to another senior member of staff about Charles' request
- Refuse to work on the engagement
- Quit working for the firm

Only Brian can decide the most appropriate option to select in the circumstances after considering his ethical values and likely consequences of each option. At one

extreme, Brian can decide that the only relevant consequence is the potential impact on his career. In accordance with strict professional requirements, this action would be unethical. At the other extreme, Brian can decide to refuse to work for a firm that permits even one supervisor to violate firm policies. Others may consider such an extreme action as naive.

## Question 2

### Schedule of Adjustments

#### i) Finance Leases

In accordance with *IAS 17 Leases*, the finance lease has been incorrectly treated as an operating lease. Treating it as a finance lease gives the following figures:

	(K'million)
Cash price/recorded cost	1,120
First instalment (reversed in Statement of Comprehensive Income)	(320)
	-----
Capital outstanding at 1 April 2008	800
Interest @ 10%	80

The capital outstanding of 800 million should be split between current and non-current liabilities. The second instalment of K320 million payable on 1 April 20X9 will contain K80 million of interest ( $800 \times 10\%$ ), therefore the capital element in this payment will be K240 million ( $K320 - K80$ ) and this is a current liability. This leaves K560 million ( $K800 - K240$ ) as a non-current liability.

#### ii) Non-current assets depreciation

	(K'million)
Buildings ( $K13,000 \times 2\%$ )	260
Non-leased plant ( $K11,000 \times 20\%$ )	2,200
Leased plant ( $1,120 \times 25\%$ )	280

#### iii) Investment Property

In accordance with *IAS 40 Investment Properties*, where the fair value model is adopted for investment properties, resulting gains and losses should be immediately recognised in the income statement.

	(K'million)
Carrying value	1,500
Revaluation	1,240
	-----
Loss to be debited to the income statement	260

**iv) Damaged and slow moving inventories**

The damaged and slow moving inventory should be written down to its estimated realisable value. This is K360 million (K400 m less sales commission at 10%). Therefore the required write down is K240 million (K600 million less K360 million). This in accordance with *IAS 2 Inventories*

The unrecorded invoice of K50 million would be an addition to purchases therefore a deduction from profit.

**v) Provision for future overhaul costs**

A provision for a future major overhaul does not meet the definition of a liability in *IAS 37 Provisions Contingent Liabilities and Contingent Assets* and must be reversed; this will increase the current year's profit and the previous year's profit by K600 million each

**vi) Deferred tax provision**

	(K'million)
Balance brought down	1,870
Balance carried down	2,250
	-----
Increase in provision	380

The increase in deferred taxation of K380 million will be debited to the income statement and the balance provision of K2,250 million reported in the statement of financial position as a non-current liability. This is in accordance with *IAS 12 Income Taxes*

**vii) Suspense Account - Issue costs**

International accounting standards require issue costs, discounts on issue and premiums on redemptions of loan instruments to be included as part of the finance costs. The net proceeds are K1,410 million (K1,500 million x 95% less K15 million issue costs) per the suspense account. The finance cost and liability amounts computed as:

	(K'million)
Initial carrying value	1,410
Interest @ 6% for first six months	85
	-----
	1,495

Of this K60 million ( $K1,500 \text{ million} \times 8\% \times 6/12$ ) is represented by the cash payment to be made on 1 April 2009 (current liability) and the K1,435 million ( $K1,495 \text{ million}$  less K60 million) remainder is non-current liability

## SECTION B

### Question 3 (a)

#### Adjustments to accumulated retained earnings for the year ended 31 March 2009

	(K'Million)	(K'Million)
Retained profits as at 1 April 20X8		5,250
Reversal of provision for plant overhaul {Adjust (v)}		600
		-----
		5,850
Profit for the year to 31 March 2009	4,750	
Lease rental added back {adjustment (i)}	320	
Lease interest {adjustment (i)}	(80)	
Depreciation {adjustment (ii)}:		
Building	(260)	
Owned Plant	(2,200)	
Leased Plant	(280)	
Loss on investment property {adjustment (iii)}	(260)	
Write down of inventory {adjustment (iv)}	(240)	
Unrecorded payable {adjustment (iv)}	(50)	
Reversal of provision for overhaul {adjustment (v)}	600	
Increase in deferred tax {adjustment (vi)}	(380)	
Interest {adjustment (vii)}	(85)	
	-----	1,835
		-----
Adjusted accumulated retained earnings		7,685
		-----

**Question 3 (b)****Statement of Financial Position for Kalundu Holdings as at 31 March 2009**

	(Adjustment Reference)	(K'Million)	(K'Million)
<b>Non-current assets</b>			
Freehold property (12,600 – 260)	(ii)		12,340
Plant – owned (11,000 – 2,200)	(ii)		8,800
Plant - Leased (1,120 – 280)	(ii)		840
Investment property	(iii)		1,240
			-----
			23,220
<b>Current asset</b>			
Inventory (6,040 – 240)	(iv)	5,800	
Trade receivables and prepayments		3,120	
Bank		1,380	
		-----	
			10,300
			-----
<b>Total assets</b>			33,520
			=====
<b>Equity and Liabilities</b>			
Ordinary shares of K1 each			15,000
Share premium		1,000	
Retained earnings – ( as adjusted)	(3a)	7,685	
		-----	
			8,685
			-----
			23,685
<b>Non-current liabilities</b>			
Deferred tax –	(vi)	2,250	
Finance lease obligations	(i)	560	
8% Loan note	(vii)	1,435	
		-----	
			4,245
<b>Current liabilities</b>			
Trade payables (4,740 +50)	(iv)	4,790	
Accrued loan note	(vii)	60	
Finance lease obligation	(i)	320	
Taxation		420	
		-----	
			5,590
			-----
<b>Total equity and liabilities</b>			33,520
			=====

## Question 4

### Accounting policies

An accounting policy is the particular method selected by an organisation to measure and financial statement elements. These accounting policies should be based on allowed methods by the International Financial Reporting Standards and should be applied consistently from one period to another

#### 1) Tangible Non-Current Assets

Tangible property, plant, and equipment are recognized as assets if and only if it is probable that future economic benefits associated with the assets will flow to the entity; and the cost of the items can be measured reliably. The fair value model of valuation is followed for investment properties. In accordance with *IAS 40 Investment Properties*, where the fair value model is used, gains or losses arising from changes in fair value should be recognised in the income statement and not to be carried forward as stated.

In addition, where fair valuation is selected for other tangible assets, *IAS 16 Property Plant and Equipment* requires that the entire class of assets must be revalued to avoid “cherry-picking” and a mixture of valuation basis. Tangible assets revalued should also be subjected to depreciation.

#### 1) Intangible assets

By definition, an asset is resource controlled by an entity as a result of past transactions, from which future economic benefits are expected to flow to the entity. Kalundu Holdings does not have total control on the members of staff receiving specialised training. Where as it should be expected that such training should produce benefits in the future, this cannot be guaranteed and would be difficult to measure.

As for advertising, the benefits depend on a whole range of factors outside the control of Kalundu Holdings. Accordingly, both expenditures should be written off as incurred. This is in accordance with *IAS 38 Intangible Assets*.

#### 2) Provision for asset replacement

In accordance with *IAS 37 Provisions, Contingent Liabilities and Contingent Assets*, provisions should be recognized if, and only if, **all** of these conditions are met:

- An entity has a **present obligation** resulting from a past event;
- It is **probable** that an outflow of resources embodying economic benefits would be required to settle the obligation; and
- A **reliable estimate** can be made of the amount of the obligation

Not all obligations would make it incumbent upon an entity to recognize a provision. Only present obligations resulting from a **past obligating event** give rise to a provision.

An obligation could either be a legal obligation or a constructive obligation. A **legal obligation** is an obligation that could:

- Be contractual; or
- Arise due to a legislation; or
- Result from other operation of law.

The company operates some heavy excavating plant which requires a major overhaul every three years. Unless the major overhaul is a legal requirement, there is no obligating event. According such provisions are not permitted.

### 3) Inventories

In general, inventories are valued at the “lower of cost and net realizable value.” The cost of inventories comprises all

- a) Costs of purchase
- b) Costs of conversion
- c) “Other costs” incurred in bringing the inventories to their present location and condition

Techniques for measurements of costs such as the standard cost method and the retail method may be used if results more or less equal actual costs. In cases of inventories that are not most ordinarily interchangeable and goods or services produced and segregated for specific project, costs shall be assigned using the **specific identification** of their individual costs.

In all other cases, the cost of inventories should be measured using **either**

- The FIFO (first-in, first-out) method; or
- The weighted-average cost method

LIFO is specifically not allowed



### Question 5

Date : 20<sup>th</sup> May 2009

**a) Employee Bonus and salary**

**b) Employee Benefit in kind**

### c) Share Option Scheme

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#### **d) Pension Schemes**

A pension scheme could be provided, or an existing one improved. This is highly tax efficient and should give employees long term security. Contributions to an approved pension scheme are partially allowed as tax deductible expenses. An equivalent of the Employee's 20% of Emoluments is allowed as a deduction for Tax purposes in respect of the Employer's pension contribution to an employee's pension scheme.

#### **Choice of business medium**

The principal effect of choosing a company as the medium for a new business venture is that the owners of the business will be employees or office-holders of the company. The withdrawal of sums as remuneration will thus have PAYE implications, and NAPSAs implications.

Corporate status may sometimes be preferred for reasons of prestige, or making the business seem larger than it is. The fact that a company can be set up with limited liability should not be seen as a persuasive reason for preferring corporate status however. This is because the company's major creditors (i.e. the banks) will invariably seek personal guarantees from the company's directors for any funds advanced to it. In most cases therefore, limited liability is an illusion. Other factors to consider between using partnership or incorporate as a medium include:

- a) Sole traders and partnerships bear a higher marginal rate of tax, where as the rate applicable to corporate entities is fixed
- b) Salaries and drawings attract a higher rate of tax compared to dividends
- c) Where start-up losses are anticipated, the drawback of corporate status is that those losses will only be relievable against the company's profits.
- d) Aside from tax reasons, the most common motivation for incurring the cost of setting up a corporation is the recognition that the shareholder is not legally liable for the actions of the corporation. This is because the corporation has its own separate existence wholly apart from those who run it.
- e) Unlike proprietorships and partnerships, the life of the corporation is not dependent on the life of a particular individual or individuals. It can be continued indefinitely until it accomplishes its objective, merges with another business, or goes bankrupt. Unless stated otherwise, it could go on indefinitely.
- f) In an incorporated entity it is possible to for the ownership interest you have in a business can be readily sold, transferred, or given away to another family member.
- g) It is usually much easier to attract new investors into a corporate entity because of limited liability and the easy transferability of shares. Shares of stock can be transferred directly to new investors, or when larger offerings to the public are involved, the services of brokerage firms and stock exchanges are called upon.

## **QUESTION 2**

### **SECTION A**

#### **Question 1(a)**

**Comment on the basis of charging professional fees and the expected role to ensure that Thandiwe pays as little as possible**

There are two issues. Firstly Thandiwe is of the view that professional fees are charged on a contingent basis and secondly there is a mistaken understanding that the professional accountant is supposed to do anything to make sure that she pays as little tax as possible

- **Basis of charging professional fees**

Professional fees should be charged taking into the account the following:

- a. Qualification and experience of staff allocated to the assignment
- b. Time
- c. Charge out rates for staff allocated to the assignment as determined by the firm
- d. Complexity of the assignment
- e. Any special reporting requirements
- f. A proportion of other attributable overheads

Contingent fees are prohibited

- **Responsibility to reduce tax**

It is not the responsibility of Facts and Figures to ensure that Thandiwe pays as little tax as possible. However, Facts and Figures may help Thandiwe to plan her tax affairs in such a way that she minimises her tax obligations. There is nothing wrong with avoiding tax through legitimate tax planning. Tax evasion is illegal.

#### **Question 1(b)**

**Arguments for and against accepting to provide professional services**

- i) **Against**

Before accepting an engagement, the professional accountant is supposed to carry out preliminary procedures to ensure that they are not associated negative publicity and also that they are competent and professional to provide required services. In the case of Thandiwe, the following reservations should be taken into account:

- As she was suspected of being involved in fraudulent activities, this brings into question her integrity

- If Thandiwe was to appear in court, any association with her would be considered unfavourably
- There is high risk of financial statements being misstated due to incomplete records and intermingling of personal and business assets
- Issuing invoices for goods not sold suggests money laundering activities and is illegal. Associating with such client exposes the professional to very high levels of engagement risk
- As Thandiwe seems to be responsible for everything, this apparent lack of segregation of duties exposes the professional accountant to risk
- There is likely going to be misunderstanding in the role of the professional as Thandiwe expect that fees are charged in relation to the amount of tax saved.

**ii) For**

On the other hand, there are valid reasons why such an engagement should be accepted. These include:

- This is an opportunity to provide accountancy services, including related training.
- There is no doubt that Thandiwe would benefit from other recommendations relating to internal controls
- As Thandiwe's business is small, this is compatible with the size of Fact and Figures Accountancy Services Ltd.

**Question 2 (a) and (b)**

(a) POTENTIAL WEAKNESS IN THE RECEIPTS AND BANKING SYSTEM	(b) RECOMMENDED CONTROL PROCEDURE
viii) The cash book is written from deposit slips	The cash book should be written up from receipts and not deposits. Alternatively, the deposits should be reconciled to the receipts. In addition, there should be a requirement that deposits are made within 24 hours of receipting.
ix) The banking of receipts and bank reconciliations are done by the same person with no check	Segregation of duties requires that activities relating to authorisation, recording and custody should be segregated. The assistant is handling receipts, banking them and recording and reconciling the cash book. A different person should be introduced to perform bank reconciliations.
x) Lack of supervisory controls as Thandiwe does not have the necessary skills and qualification to do so	If Thandiwe is not able to check the deposits and bank reconciliations, she must employ another qualified person to do so. Alternatively, she could request an accountant from Facts and Figures to assist her.
xi) Bank reconciliations are not done on a monthly basis	Bank reconciliations should be performed at least every month. At any time during the month, interim statement should be obtained from the bank and comparisons made between receipts and bankings
xii) Unusual reconciling items appearing on the bank reconciliation statement	The bank reconciliation should only contain two reconciling items, being unpresented cheques and uncredited deposits. These should be verified by reviewing bank statements in the subsequent period. Any other reconciling items should be regarded as an error and is potential for fraud.
xiii) Existence of significantly higher cash book balances compared to the bank balance	Periodic analytical reviews and comparisons between cash book balance and bank balance.

### Question 3

#### Investigative Procedures

##### i) Physical Quantities

A reconciliation of physical quantities would provide reliable evidence of maximum potential fraud as follows:

Opening inventory of trophies	X
Trophies made during the period under investigation	X
	-----
	X
Less closing inventories	(X)
	-----
Total sales	X

The total sales multiplied by the selling price should give an indication of the possible total sales during the investigation period. This should be compared with receipts and total deposits. It is likely that the deposits would be much less.

##### ii) Comparisons between receipts and deposits during the investigation period

As the cash book is written up from deposit slips, follow up all receipts to deposits would highlight the discrepancies between receipts and deposits.

##### iii) Analytical reviews of cash book between receipts and payments

Since a separate account is maintained for sales of trophies, a review of receipts and payments and comparison with the bank balance would provide evidence for potential fraud, especially that the cash book is written up from deposits.

##### iv) Follow up bank reconciliations

Following up unusual reconciling items on the bank reconciliation would also provide evidence leading to discovery of fraud

##### v) Life style of assistant responsible for banking and bank reconciliations

It is likely that the assistant's life style may have changed over time, probably leading a more expensive lifestyle not proportionate to income levels. Changes in eating habits, dressing and other financial dispositions should excite the suspicion that the assistant was getting more money than the salary offered.

## **SECTION B**

### **Question 1 (a)**

#### **Tax evasion and tax avoidance**

It is true that the difference between tax avoidance and evasion is important due to the legal implications.

#### **Tax Evasion**

The term tax evasion summarises any action taken to evade taxes by illegal means. The main points of tax evasion are:

- i) Suppressing information, e.g. failing to declare taxable income to ZRA
- ii) Submitting false information, e.g. claiming expenses that have not been incurred

Tax evasion is an illegal activity and carries a risk of criminal prosecution, including fines and imprisonment

#### **Tax Avoidance**

Tax avoidance is using the taxation regime to one's advantage by arranging your affairs to minimise your tax liability. It is legal and does not entail misleading ZRA. The term is also used to describe tax schemes that utilise loopholes in the tax legislation

#### **Implications of the two actions**

Changing the timing of the sale of an item so as to delay the tax charge is tax avoidance. Individuals may also do this to take advantage of capital gains tax allowances that are given each year.

Altering paperwork is tax evasion as it amounts to submitting false information.

### **Question 1 (b)**

#### **Obligations of Thandiwe after she has registered**

All supplies who have been registered for VAT are required to do the following:

- i) Display their VAT registration certificate.
- ii) Submit VAT Returns and make payments as required.
- iii) Provide Tax invoices.
- iv) Maintain sufficient records and retain them for a minimum of 5 years for VAT purposes.
- v) Advise ZRA of any change in business (name, address, telephone number, ownership, cessation of business, etc.)
- vi) Allow Officers of ZRA to enter their business premises and examine their goods and records.

## Question 2 (a)

### Cash flow forecast for six months to December 2009-05-25

<b>Sales quantities</b>	<b>250</b>	<b>275</b>	<b>275</b>	<b>310</b>	<b>330</b>	<b>270</b>	<b>1,710</b>
	(K'000)	(K'000)	(K'000)	(K'000)	(K'000)	(K'000)	(K'000)
	July	August	Sept.	October	Nov.	Dec	Total
<b>Receipts</b>							
Sales	17,500	19,250	19,250	21,700	23,100	18,900	119,700
Capital invest	25,000						25,000
Loan							
<b>Total receipts</b>	<b>42,500</b>	<b>19,250</b>	<b>19,250</b>	<b>21,700</b>	<b>23,100</b>	<b>18,900</b>	<b>144,700</b>
<b>Payments</b>							
Rent for premises	3,000	3,000	3,000	3,000	3,000	3,000	18,000
Machines	12,000						12,000
Manger's Salary	7,500	7,500	7,500	7,500	7,500	7,500	45,000
Office Furniture	8,000						8,000
Computer	9,500						9,500
Wages	6,000	6,000	6,000	6,000	6,000	6,000	36,000
Raw materials	700	700	700	700	700	700	4,200
Advertising	400	400	160	160	160	160	1,440
Consultancy fee	2,500						2,500
Telephone			500			500	1,000
Insurance	2,500						2,500
Other Overheads	900	900	900	900	900	900	5,400
<b>Total payments</b>	<b>53,000</b>	<b>18,500</b>	<b>18,760</b>	<b>18,260</b>	<b>18,260</b>	<b>18,760</b>	<b>145,540</b>
<b>Net cash flow</b>	<b>(10,500)</b>	<b>750</b>	<b>490</b>	<b>3,440</b>	<b>4,840</b>	<b>140</b>	<b>(840)</b>
<b>Balance b/d</b>	<b>0</b>	<b>(10,500)</b>	<b>(9,750)</b>	<b>(9,260)</b>	<b>(5,820)</b>	<b>(980)</b>	<b>0</b>
<b>Closing balance</b>	<b>(10,500)</b>	<b>(9,750)</b>	<b>(9,260)</b>	<b>(5,820)</b>	<b>(980)</b>	<b>(840)</b>	<b>(840)</b>
=====							



**Question 2(b)****Suggested actions to improve the cash flow position:**

- She could consider paying for such items as the computer and consultancy fees in instalments
- Machines could be bought on hire purchase or under a finance lease
- Thandiwe could reduce her salary in the first three months
- Take out a loan for the shortfall
- Restructure the wages so that employees are paid on a commission basis with a smaller fixed salary

**END OF SOLUTIONS**