



COMPETENCE PRACTICE EXAMINATION

NON AUDIT

JUNE 2009

SUGGESTED SOLUTIONS

QUESTION 1

SECTION A

- 1) **Monica's requests:**
 - a) **Ethical and Professional Matters**
 - b) **Comment on whether firm can comply**
 - c) **Conclusion**

(a) Ethical and professional matter	(b) Comment
<p>Disclosure of Jason's remuneration</p> <p>In a professional appointment, the accountant owes a duty of confidentiality to the client. (i.e. the company not individual shareholders or executives).</p> <p>There is no legal or professional right or duty to disclose client information on an ad hoc basis merely because it is available to the accountant.</p>	<p>It would be a breach of the professional accountant's duty of confidentiality to Sparkles (in acting as advisor) and Jason (in acting as advisor) to disclose the information requested when clearly there is no process of law or "public interest" involved.</p> <p>NFS could only disclose the information to Monica with Jason's consent. This is highly unlikely since Jason has refused to do so. Also, attempting to obtain permission from Jason is likely to result in a breach of the duty of confidence that the NFS owes to Monica.</p> <p>The latest audited financial statements (which are available to Monica in her capacity as a shareholder) may disclose Jason's remuneration for the previous year. Monica will need to wait for this information to be publicly available.</p> <p>As a member of the company (i.e. shareholder), Monica would also be entitled to inspect any relevant documents requested to be held at Sparkles' registered office (e.g. if Jason has a service contract with the company).</p>
<p>Continue to Act as personal advisor</p> <p>A conflict between the interests of Sparkles Ltd (and its continuing directors) and Monica (in a personal capacity) is likely to arise (e.g. over the valuation of Monica's shareholding).</p>	<p>It would be inappropriate for us to act for both parties in certain matters, such as negotiating a share price (in the event of subsequent disagreement) without appropriate safeguards.</p> <p>Valuing Monica's shareholding and</p>

	<p>negotiating her profit-related remuneration may appear to threaten our objectivity of the professional relationship that exists with Sparkles Ltd. Monica may try to exert influence to overstate profits.</p> <p>However, the interest of these clients may not be materially prejudiced in all matters if:</p> <ul style="list-style-type: none"> • adequate disclosure is possible (i.e of all relevant matters to all parties) ; and appropriate safeguards are implemented (e.g. advising one or all clients to seek additional independent advice) • In particular, it may be possible to advise Monica on personal tax matters.
<p>Act as advisor to Spakos Ltd A conflict between the interest of Monica's new company, Spakos Ltd and Sparkles Ltd is likely to arise as the former has been set up in competition with the latter.</p>	<p>There is nothing improper in having both companies as professional clients if there are appropriate safeguards (e.g different reporting directors and teams of staff for each professional engagement).</p> <p>However, even with safeguards, the directors of Sparkles Ltd (the Kapelas in particular) may perceive that the involvement of the company's professional relationship with a competitor (in the capacity of advisor) could materially prejudice their interests. Also, that the new company has been set up with so similar a name suggests that Monica may be quite aggressive in targeting Sparkles Ltd's Car business.</p> <p>In view of the adversarial relationship between Monica and Sparkles Ltd it would be prudent to include in their respective engagement letters a clause reserving the right to act for other clients subject to confidential information being kept secure.</p>

(c) Conclusion

The request to disclose Jason's remuneration must be declined. However, Monica may be directed to alternative sources of information, which may be of use (though not strictly current).

The firm may continue to act as Monica's personal advisor subject to appropriate conditions and safeguards being put in place in respect of matters which may materially prejudice either client. For example:

- the agreement of Sparkles Ltd (and the remaining directors)
- Monica being advised to seek additional independent advice.

However, given the apparent acrimony between Monica and her former associates, it seems unlikely that Sparkles Ltd would agree to such an arrangement.

The appointment to become professional advisors for Spakos Ltd could only be accepted with appropriate safeguards (e.g. reporting directors and other professional staff not involved in the provision of services to Sparkles Ltd). However, even with safeguards, if Monica's appointments are accepted, Sparkles Ltd may decide to discontinue using NFS in future.

2) Value Added Requirements

a) Calculation of VAT payable/ repayable for the month of March 2010

	K	K
Output VAT		
Standard rated sales:		
Total sales		99,950,000
Less exempt sales (10% x K99,950,000)		(9,995,000)
Taxable sales		89,955,000
Less zero rated sales		<u>(12,500,000)</u>
Standard rated sales		<u>77,455,000</u>
VAT (16% x K77,455,000)		12,392,800
Zero rated sales : VAT (0% x K12,500,000)		Nil
Total output VAT		12,392,800
Less recoverable input VAT:		
Purchases	62,800,000	
Less exempt purchases	<u>(15,000,000)</u>	
	47,800,000	
Less purchase from non-registered		
Traders (50% x K47,800,000)	<u>(23,900,000)</u>	
Taxable	<u>23,900,000</u>	

VAT (16% x K23,900,000)	3,824,000	
Bad debt relief		
(16% x K3,250,000)	520,000	
Overheads :		
(16% x K10,600,000) x 90%	1,526,400	
Diesel payable: (4/29x5,650,000)	779,310	(6,649,710)
VAT PAYABLE		<u>5,743,090</u>

b) Date and implications

The due date for payments of the VAT calculated above of K5,740,090 is 21 April 2010.

If the VAT is paid later than 21 April, a daily penalty, taken as the higher of K180,000 and 0.5% of the outstanding VAT would be chargeable on the company. As 0.5% of K5, 743,090 is only K28, 715.45 per day, the daily penalty would be K180, 000.

Interest on overdue tax would be chargeable at the Bank of Zambia discount rate plus 2% for the period by which the VAT would be late.

c) Exempt supplies and zero rated supplies

The main differences between making exempt supplies and making zero rated supplies are as follows:

- When determining whether a trader should register for VAT by reference to the level of turnover, the turnover of exempt supplies is not taken into account while the turnover of zero rated supplies is taken into account.
- A trader who makes only exempt suppliers cannot register for VAT while a trader who makes only zero rated suppliers can register for VAT.
- All the input VAT that is attributed to exempt supplies cannot be recovered while all the input VAT that is attributed to zero rated supplies is recoverable.

SECTION B

3) Briefing paper on matters arising

- a) Identification of applicable accounting standards and explanation of relevant accounting principles
- b) Calculation of relevant figures to be included in the statement of comprehensive income and the statement of financial position

Briefing Paper

To	: The Board	Date: 20 th April 2010
From	: The Finance Director	
Subject	: Matters arising – Financial Statements for the year ended 31 March 2010	

The purpose of this memo is to explain how the accounting matters outstanding for the year ended 31 March 2010 should be accounted for, including relevant figures as appropriate. The explanations are based on the requirements of the IASB's *Framework* and the International Financial Reporting Standards.

a) Sale and Repurchase agreement with Investment Trust bank

Off balance sheet finance is the funding or refinancing of a company's operations in such a way that, under legal requirements and existing accounting conventions, some or all of the finance may not be shown on its balance sheet.

Common forms of off balance sheet finance include sale and repurchase agreements such as the one between Sparkles and Investment Trust bank.

The problem with the practice of off balance sheet finance is that the users of financial statements do not have a proper or clear view of the state of the company's affairs. In order to overcome this problem, the IASB *Framework* requires that the principle of substance over form should be applied. Substance over form is the principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

The main considerations from the transaction with Investment Trust Bank are that:

- i) At the time of perceived sale the fair value of the field of sugar cane is K4 billion and this is far more than the K1.5 billion sales price to Investment Trust Bank. Why would Sparkles choose to sell at such a lower price?
- ii) Sparkles has the option to buy back the field in three years time at K2 billion. In three year's time, the expected fair value of the field is assessed at K6 billion. Why would Investment Trust accept to sell at such a lower price?
- iii) During the three year period, Sparkles will be responsible for the care and maintenance of the field. Why should this be the responsibility of Sparkles if they sold the field to Investment Trust bank?

From the above scenario, it can be concluded that:

- Sparkles is likely to exercise the option to buy back the field in three years' time

- Sparkles has retained the risks and rewards associated with the field of sugar cane
- The substance of the transaction is that Sparkles has borrowed K1.5 from Investment Trust bank and the difference between K2 billion and K1.5 billion is that should be allocated in the income statement over the three year period. The field of sugar cane is provided as security.
- The figures that should be in the financial statements of Sparkles for the year ended 31 March 2010 are as follows:

Statement of Comprehensive income

Interest (K0.5billion *3/36)	K0.042billion
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Statement of Financial Position

Current Assets

Inventories	K0.9 billion
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Non-Current Liabilities

Loan	K1.5 billion
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b) Sale and lease back transaction

The sale and lease back appears to create a finance lease because:

- The lease term is for a major part of the economic life of the asset,
- The present value of the minimum lease payments is equal to substantially all of the fair value of the asset.
- Gains or losses from changes in the fair value of the residual value of the asset accrue to the lessee.

According to IAS 17, the plant should remain in the books of Sparkles at carrying value and the sale proceeds of K330 million should be shown as a liability representing the finance lease obligation. As payments are made they are to be treated as repayment of the liability and partly as a finance lease charge against income.

c) Non-current assets held for sale

For a non-current asset or disposal group to be classified as held- for-sale, the asset must be available for immediate sale in its present condition and its sale must be highly probable. In addition, the asset must be currently being marketed actively at a price that is reasonable in relation to its current fair value.

The other conditions are that:

- The sale should be completed, or expected to be so, within a year from the date of the classification.
- The actions required to complete the planned sale will have been made, and it is unlikely that the plan will be significantly changed or withdrawn.
- For the sale to be highly probable, management must be committed to selling the asset and must be actively looking for a buyer.
- It is possible that the sale may not be completed within one year. In this case, the asset could still be classified as held for sale if the delay is caused by events beyond the entity's control and the entity is still committed to selling the asset.

Based on above conditions, the asset is not available for immediate sale mainly because the price is in excess of the current market value, and especially that the market conditions have deteriorated significantly. The asset should not be classified as held for sale.

d) Related Party Transactions

Each of the transactions should be examined in order to determine whether they would warrant disclosure as related party transaction under IAS 24.

- (i) Notwithstanding the fact that Sparkles purchases all cars from Japanese Exports (JE) and is dependent on it, JE does not automatically become a related party. Thus for the purpose of IAS 24, purchases from JE are not considered related party transactions.
- (ii) Seventy percent of the sales are to an entity owned by a director (i.e., an entity controlled by a key management person), and 30% of the sales are made to an entity that Sparkles appear to have “significant influence” over. Thus both sales are to related parties as defined in IAS 24 and would need to be disclosed as such.
- (iii) The lease of the warehouse although at arm’s length has been entered into with the wife (a “close member of the family”) of a “director” (a key management person) and thus needs to be disclosed as a related party transaction.

I trust that the above should help to resolve the matters outstanding so that the financial statements for the year ended 31 March 2010 could be finalised

J Nkuta
Managing Consultant

4) Accounting for planned acquisitions:

a) Malido Farms Ltd

With this acquisition, Sparkles will own 80% of the equity share capital of Malido Farms. Therefore Sparkles clearly will **control** Malido, making it a subsidiary. The remainder 20% will be the Non-controlling interest.

Where the **investor controls the investee**, the controlling entity (the parent) and the controlled entity (the subsidiary) form a group. **Consolidated financial statements** are prepared for the group. The gains, losses, assets, liabilities and cash flows of the parent and the subsidiary are aggregated in order to present the financial performance and position of the group as a **single economic entity**. This treatment is required by IFRS 3, *Business Combinations* and IAS 27 *Consolidated financial statements*

b) Fresh Produce Ltd

With this planned acquisition, Sparkles will own 40% of the equity share capital of Fresh produce Ltd. This is **not sufficient to control** Fresh Produce Ltd, but the fact that there

are no other major shareholdings indicates that Sparkles will be able to **exercise significant influence** over the policies adopted by Fresh Produce. Therefore Fresh Produce Ltd is an **associate** of Sparkles

Where the **investor does not have control but exerts significant influence** over the investee's operating and financial policies of the investee, the investee is an associate and the **equity method is used**, as required by IAS 28 *Investment in associates*. The investor's share of the results and net assets of the investee are not combined with the investor's own activities and resources, but are brought into its financial statements on a single line in the income statement (Share of profit after tax) and balance sheet (Cost of investment plus share of post acquisition profits of associate) respectively. This treatment recognises the investor's share of the results and net assets, but does not misrepresent the extent of its influence over the investee.

c) Kalimba Cars Ltd

With this planned acquisition Sparkles will own 31.25% of the equity shares of Kalimba Cars Ltd. Where an investor holds 20% or more of the voting rights, it is normally presumed that the investor can exercise significant influence (and therefore has an associate). However another investor holds 62.5% of the equity share capital and clearly exercises control in practice (by making Kalimba Cars Ltd adopt policies that do not meet with the approval of Sparkles). Therefore Kalimba Cars Ltd is a simple **non-current asset investment**

Where the investor **does not exercise control, joint control or significant influence** the only amounts recognised in the consolidated financial statements are the **investment at cost** (as required by IAS 39 *Financial Instruments: Recognition and measurement*) and **any investment income**

QUESTION 2

SECTION A

5) Special requests by Mr. Kapindele

a) Ethical and Professional Matter	b) Action to take
<p>Employment of Son – Due skill, diligence and competence – relationships.</p> <p>As professional accountants, we have a duty to maintain professional knowledge and skill at the level required to ensure that our client receive competence professional services based on current developments in practice, legislation and techniques. It is not clear to what extent Mr Kapindele's Son is qualified and competent.</p>	<p>Accordingly, this request should only be considered if the son fits the profile of the required education, skill and back ground. However, employing Mr. Kapindele's Son extends our familiarity threat/close relationships with the Kapindeles and therefore should be declined on professional grounds.</p>
<p>Tax – burden – Tax evasion and tax avoidance</p> <p>Mr. Kapindele's request would seem to imply that the tax burden should be reduced at all costs – whether legal or not.</p> <p>Whereas there is nothing wrong with tax avoidance, tax evasion is illegal and would expose us to circumstances and publicity in form of advocacy threat.</p>	<p>We should explain this matter to Mr Kapindele that tax can only be avoided through prudent taxation and financial planning. The illegality associated with tax evasion should be emphasised. We hope that Mr Kapindele would choose to avoid tax and not the evasion route. Any attempt to evade tax would put us in a position where we may have to consider our confidentiality obligations and also seriously question the integrity of Mr Kapindele. This would force us to consider resigning from the assignment.</p>
<p>Bonus – Fee determination</p> <p>Basing the fee on the extent of tax liability reduction is similar to charging fees on a contingency basis. ZICA's position is that fees should not be charged on percentage, contingency or similar basis. Fees should be based:</p> <ul style="list-style-type: none"> • Seniority of the accountant to be engaged on the work • The time to be spent • The degree of risk, urgency and 	<p>We should explain to Mr Kapindele the basis on which fees are determined. It will also be necessary to ensure that the letter of engagement signed with Petwe Holdings very clear on this matter.</p>

importance of the work to the client	
Transfer pricing – possible money laundering There appear to be intent to gain a benefit by evading a tax liability. This may be regarded as a criminal activity bordering on money laundering. Professional requirements provide that the professional accountant should report such incidences to the relevant authority.	Money laundering is illegal and the implications of this request should be clearly explained to Mr Kapindele. If Mr. Kapindele insists on using this , this will serious concerns relating to: <ul style="list-style-type: none"> • Legality that may require us to disclose information to the relevant authority • Integrity of Mr Kapindele As these issues are too serious, we would consider resigning from the position as professional advisors

6) Sweeney Investments

Key Points for the answer

Redeemable shares are classified as liabilities, so the dividend on them is presented within finance costs, rather than as a deduction from retained earnings. Surpluses and deficits on investment properties are accounted for under fair value model and are recognized in the statement of income, not other comprehensive income. IAS 16 revaluation surpluses on PPE are recognized in other comprehensive income, however. The plan held for sale must not be depreciated but written down if fair value less costs to sell is less than carrying value.

(a) Sweeney Investments Statement of comprehensive income for the year ended 31 March 2010

	K'million
Revenue	213,800
Cost of sales (W1)	<u>(152,000)</u>
Gross profit	61,800
Operating expenses	<u>(22,400)</u>
Investment income	1,200
Loss on investment property (16,000 – 13, 500)	<u>(2,500)</u>
Finance costs (5,000 – 3,200 ordinary dividend)	<u>(1,800)</u>
Profit before tax	36,300
Income tax expenses (W2)	<u>(6,400)</u>
Profit for the period	29,900

Other comprehensive income

Gain on property revaluation	<u>21,000</u>
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Total comprehensive income for the period	<u>50,900</u>
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(b) Sweeney Investments Statement of Financial Position at 31 March 2010

	K'million	K'million
Non-current assets		
Property, plant and equipment (Note c)		76,600
Investment property		<u>13,500</u>
		90,100
Current Assets		
Inventories (10,500 – 300 (W1))	10,200	
Trade receivables	<u>13,500</u>	
	23,700	
Assets held for sale	<u>5,700</u>	
		<u>29,400</u>
Total assets		<u>119,500</u>
Equity and liabilities		
Ordinary share capital		20,000
Revaluation reserve		21,000
Retained earnings (17,500 + 29,900 – 3,200 ordinary dividend)		<u>44,200</u>
		85,200
Non – current liabilities		
Deferred tax (W2)	3,600	
10% Redeemable preference shares of	<u>10,000</u>	
		13,600
Current liabilities		
Trade payables	11,800	
Current tax	8,000	
Bank overdraft	<u>900</u>	
		<u>20,700</u>
Total equity and liabilities		<u>119,500</u>

Workings

	K'million
(W1) Cost of Sales	
Per question	143,800
Inventory write down (800-(950-450))	300
Depreciation	
-building (48,000/15)	3,200
-plant (W3)	2,400
Write down of plant held for sale (6,000 x 95% -8,000)	<u>2,300</u>
	<u>152,000</u>
(W2) Tax Deferred Tax	
Balance b/f	5,200
Balance c/f(12,000 x 30%)	<u>3,600</u>
Written back	1,600
Current tax	<u>8,000</u>
	<u>(6,400)</u>
(W3) Property, plant and equipment	
	K'million
Plant	
Cost b/f	36,000
Accumulated depreciation b/f	<u>16,800</u>
Carrying amount	19,200
Depreciation charge for year – 12.5%	<u>(2,400)</u>
Carrying amount c/f	16,800
Land and building (63,000 – 3,200(W1))	<u>59,800</u>
Carrying amount	<u>76,600</u>

SECTION B

1) Tax computation and calculation of taxation payable

Lusaka Traders Limited

Company Income Tax Computation for the year ended 31 March 2009

	K	K	K
Net profit as per accounts			125,000,000
Add			
Entertaining suppliers		6,000,000	
Parking fines		9,500,000	
Donation to political party		8,000,000	
Depreciation:			
Plant and machinery		35,400,000	
Land and Buildings		25,000,000	
Loan to employee w/off		8,500,000	
Increase in general provision (5, 800, 000 – 1, 850, 000)		<u>3,950,000</u>	
			<u>96,350,000</u>
			221,350,000
Less:			
Profit on disposal		21,000,000	
Dividends received		15,000,000	
Capital allowances:			
Motor van;			
ITV b/f	93,750,000		
Proceeds (limited to cost)	<u>(125,000,000)</u>		
Capital recovery	<u>(31,250,000)</u>		
Motor car (1)	Nil		
Motor car (2)			
20% x K126,000,000)	25,200,000		
Fixtures and fittings			
25% x K350,000,000	87,500,000		
Industrial Building			
5% x K890,000,000	44,500,000		
		125,950,000	
			<u>(161,950,000)</u>
Final Taxable Income			<u>59,400,000</u>
Company Income Tax Payable			
35% x K59,400,000			<u>20,790,000</u>

2) Tax advice for Mrs Kapindele – Employing Kido either as an employee or as a Partner

In this question Mrs Kapindele wishes to run a business with her son, Kido, who may be engaged as a partner or employee. If Kido were engaged as a partner, all payments to him would not be tax deductible whereas if he were engaged as an employee, all payments to, and on his behalf would be tax deductible.

The better, alternative is determined by comparing the family's net income under each of the two alternatives.

- a) Kido is brought into the business as a partner,
- b) Kido is brought into the business as an employee

1. Calculation of Income Tax under the two alternatives.

Personal Income tax computations if Kido was a partner for 2008/09

	Total	Mrs Kapindele	Kido
	K	K	K
Partnership salary	38,000,000	20,000,000	18,000,000
Balance (3:2)	<u>57,000,000</u>	<u>34,200,000</u>	<u>22,800,000</u>
Total income	95,000,000	54,200,000	40,800,000
Less tax free income		(7,200,000)	(7,200,000)
Final taxable income		47,000,000	33,600,000

	K	K
Income Tax payable		
25% x K7,620,000	1,905,000	1,905,000
30% x K33,180,000 / K25,980,000	9,954,000	7,794,000
35% x K6,200,000	<u>2,170,000</u>	<u>0</u>
Income Tax payable	<u>14,029,000</u>	<u>9,699,000</u>

(ii). Mrs Kapindele

Personal Income Tax Computation for 2008/09 if Kido is employed

	K	K
Original adjusted profit		95,000,000
Less		
Kido's salary	18,000,000	
Employer's NAPSA		
(5% X K18,000,000)	900,000	
		<u>(18,900,000)</u>
		76,100,000
Less tax free income		<u>(7,200,000)</u>
Taxable income		68,900,000
		K

Income Tax:		
25% X K7,620,000		1,905,000
30% X K33,180,000		9,954,000
35 % X K28,100,000		<u>9,835,000</u>
Income tax payable		<u>21,694,000</u>

Kido

Personal income tax computation for 2008/09 if Kido is employed

	K
Salary from employment	18,000,000
Less NAPSA Contribution	<u>(900,000)</u>
	17,100,000
Less tax free income	<u>(7,200,000)</u>
Final taxable income	<u>9,900,000</u>
	K
Income tax	
25% X K7,620,000	1,905,000
30% X K2,280,000	<u>684,000</u>
Income Tax payable	<u>2,589,000</u>

c) Beneficial option:

If Kido is engaged as a partner, the net income for the family is:

	K
Total profit	95,000,000
Less:	
Income tax for Mrs Kapindele	(14,029,000)
Income tax for Kido	<u>(9,699,000)</u>
Net Income	<u>71,272,000</u>

If Kido is engaged as an employee, the net income for the family is:

	K
Total Income	95,000,000
Less:	
Income tax for Mrs Kapindele	(21,694,000)
Income tax for Kido	(2,589,000)
Kido's NAPSA (5% x K18,000,000)	(900,000)
Employer's NAPSA	<u>(900,000)</u>
Net Income	<u>68,917,000</u>

If Clement was engaged as a partner, the family's net income would be higher by:

$$K71,272,000 - K68,917,000 = 2,355,000$$

Based on this analysis, it is beneficial for Mrs Kapindele to engage Kido as an equal partner, rather than as an employee.

END OF SOLUTIONS