COMPETENCE PRACTICE EXAMINATION

NON AUDIT

DECEMBERE 2012

TIME ALLOWED: 5 HOURS

INSTRUCTIONS TO CANDIDATES

1. This paper has Two Questions.

2. You are required to attempt ALL the two questions

3. Each question has Sections:
   Question one has two sections: A and B

   Question two has two sections: A and B

4. All the two questions carry equal marks.

5. The Examination is divided into sessions of $2^1/_2$ hours each. There will be a 30 Minutes break in between the sessions.

6. Please use your Membership number and your National Registration Card number on the front of the answer booklet. You name must NOT appear anywhere on your answer booklet.

7. This is an open book examination.

QUESTION ONE

Auto Equip Ltd (AEL)

1. BACKGROUND

Auto Equip Ltd (AEL) manufactures; markets and sells a wide range of spare parts and equipment for both domestic and commercial use. Electronic and computerized models are manufactured at the Lusaka plant, while the low priced mechanical equipment are sourced from China.

Following the advent of privatisation of state-controlled companies in the early 1990's, AEL directed its efforts towards improving its market orientation. The number of concurrent changes in the company made for a new window of opportunity to redirect the strategic focus on the company. Changes in the organizational structure and routines accompanied the company's claims of a new commitment to think more about the customer and less about the technical features of its products.

2. STAFFING

The managing director of AEL is Mr. Josephat Chenda, a mechanical engineer by profession. His wife, Grace, is in charge of general administration. The finance director, Mr. Teddy Longa and his assistant were dismissed following a number of unexplained queries from the Zambia Revenue Authority.

3. APPOINTMENT AS FINANCIAL ADVISORS

Your name is Kelvin Bwale and you are the managing director of KBO Associates, a firm of management and financial consultants registered with ZICA and licenced to provide accountancy and other related services, except auditing. In search for a financial advisor to assist AEL before a new accounting personnel are employed, Mr. Chenda approached your firm to accept appointment as financial advisors for AEL until further notice.

Subsequently a meeting was held between yourself and Mr. Chenda at which details of the assignment were agreed and a letter of engagement duly signed. This was followed up by an e-mail from Mr. Josephat in which he made specific requests regarding the assignment. The e-mail is copied below:

To : Felix Mate
From : Josephat Chenda
RE : Confirmation of appointment as financial advisors

Felix,
Thanks a bunch for accepting to act as our financial advisors, until such a time that we are able to replace our financial accounting personnel. As I intimated in the meeting last, one of the reason why I was forced to ask the Finance Director and his assistant to leave was because our company has had so many problems with the Zambia Revenue authority in the recent past. Problems have included late submission of tax returns including related penalties.

For the recent tax assessment and tax computations, we have been advised that the estimated penalties are in the region of K50 million. I understand we are entitled to appeal. Kindly advise me how we should proceed, particularly in respect of:

- How the self assessment works
- Penalties and interest
- The appeals procedure

In addition, I am reluctant to submit the tax computation for the 2010/11 for our Lusaka operations (Please find attachment 1). I will appreciate it if you can review it for me. I am not able to reconcile the taxable profit to the accounting profit appearing in the financial statements for the year ended 31 march 2010.

As for the current year, draft financial statements have been prepared but need to be finalized taking into accounting specific matters that have were highlighted by the finance director before he left. The draft financial statements and the related matters are in attachment 2.

Will appreciate prompt response.

Thank you.

Josephat.

4. **Attachment 1 - TAXATION COMPUTATION- Lusaka operations**

The profit for the year ended 31 March 2011 was arrived at after dealing with the following items:

a) Depreciation of plant and machinery amounted to K35.4 million as well as depreciation of land and buildings of K25 million were charged to the income statement

b) General expenses of 16 million. This figure included K10 million being the travelling expenses of staff, including Directors, and K6 million being expenditure incurred on entertaining suppliers

c) Bad debts charged in the profit and loss account were arrived at as shown in the bad debts account below

	Kwacha – Debit		Kwacha – credit
Trade debts written off	12,500,000	Balance b/f:	
Loan to employee written off	8,500,000	General provision	1,850,000
Balance c/f:		Specific provision	2,500,000
General provision	5,800,000		
Specific provision	3,000,000	Profit and loss	25,450,000
	29,800,000		29,800,000

d) Legal and accountancy charges

	Kwacha
Debt collection service	2,000,000
Staff service agreements	5,000,000
Special tax advice	9,500,000
Audit and accountancy fees	10,900,000
	27,400,000
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e) Subscriptions and donations include the following

	Kwacha
Donation to UGG, a political party	8,000,000

Sports facilities for staff	9,850,000
Donation for scientific research at UNZA	9,500,000
Subscription to chamber of commerce	9,900,000
	37,250,000
	=========

f) Repairs and renewals, which were made up as follows:

	Kwacha
Redecorating existing business premises	3,000,000
Renovations to new premises to remedy wear and tear Of previous owner	5,000,000
	8,000,000
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The premises were usable before the renovation were made.

g) A profit on disposal of a motor van of K21million was credited to the income statement

h) Dividend received from another Zambian company of K15 million net, were credited to the income statement

i) Assets which the company owned as at 1 April 2011 were as follows:

I. Motor van

The income tax value at 1 April 2011 was K93.750 million. The original cost as at 30th June 2010 was K125 million. The motor van was sold on 31 December 2011 for K130 million. The company's sales manager had private use of 25% in the Motor Van.

II. Other Assets

Date of purchase	Asset	Original purchase cost K' million
1 May 2003	Industrial building	890
1 August 2005	Motor car (1)	75
1 June 2009	Motor car (2)	126
1 October 2009	Fixtures and fittings	350

5. Attachment 2 - DRAFT FINANCIAL STATEMENTS

a) Income statement – Year ended 31 March 2012

	K'million
Sales revenue (note (ii))	13,700

Cost of sales (note (iii))	(9,200)
Gross profit	4,500
Operating expenses	(2,400)
Loan note interest paid (see financial position)	(25)
Operating profit before tax	2,075
Income tax expense (note (vii))	(55)
Profit for the year	2,020

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b) Statement of financial position as at 31 March 2012

	K'million	K'million
Non-current assets		
Property, plant and equipment (note (iv))		6,270
Investments		1,200
		7,470
Current assets		
Inventory	1,750	
Trade receivables	2,450	
Bank	350	
		4,550
Total assets		12,020

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Equity and Liabilities		
Ordinary shares of K250 each (note (vi))		2,000
Reserves:		
Share premium		600
Retained profits – 1 April 2010	2,990	
Year to 31 March 2012	2,020	
Dividends paid	(500)	
		4,510

		7,110
Non-current liabilities		
10% loan note (issued 2009)	500	
Deferred tax	280	
		780
Current liabilities		
Trade payables		4,130
		12,020
		======

c) Accounting policy note – Investment properties and Plant and equipment

The property, plant and equipment include investment properties. These are carried at revalued amount, i.e. fair value less subsequent accumulated depreciation and any accumulated impairment losses. This is in accordance with IAS 16, *Property, plant and equipment* and IAS 40, *Investment properties*

d) Additional information

The following matters are relevant:

(i) Included in sales revenue is K300 million being the sales proceed of an item of plant that was sold in January 2012. The plant had originally cost K900 million and had been depreciated by K630 million at the date of its sale. Other than recording the proceeds in sales and cash, no other accounting entries for the disposal of the plant have been made. All plant is depreciated at 25% per annum on the reducing balance basis

(ii) The company policy for all depreciation is that it is charged to cost of sales and a full year's charge is made in the year of acquisition or completion and none in the year of disposal

(iii) On 31 December 2011 the company completed the construction of a new of a new warehouse. The construction was achieved using the company's own resources as follows:

	(K'million)
Purchased materials	150
Direct labour	800
Supervision	65
Design and planning costs	20

Included in the above figures are K10 million for materials and K25 million for labour costs that were effectively lost due to the foundations being too close to a nearby property. All the above costs are included in cost of sales. The building was brought into immediate use on completion and has an estimated life of 20 years (straight line depreciation)

(iv) Details of the other property, plant and equipment at 31 March 2012 are

	K'million	K'million
Land at cost		1,000
Buildings at cost	4,000	
Less accumulated depreciation at 31 March 2011	(800)	3,200
Plant at cost	5,200	
Less accumulated depreciation at 31 March 2011	(3,200)	2,070
		6,270
		====

At the beginning of the current year (1 April 2011), AEL had an open market basis valuation of its properties (excluding the warehouse in note (iii) above). Land was valued at K1.2 billion and the property at K4.8 billion. The directors wish these values to be incorporated into the financial statements. The properties had an estimated remaining life of 20 years at the date of valuation (straight-line depreciation is used). AEL makes a transfer to realized profits in respect of excess depreciation on revalued assets.

Note: Depreciation for the year 31 March 2012 has not yet been accounted for in the draft financial statements.

(v) The investments in quoted companies that are carried at their share market values with any gains and losses recorded in the income statement. The value shown in the statement of financial position is that at 31 March 2012. During the year to 31 March 2011, the investments have risen in value by an average of 10%. AEL has not yet reflected the increase in its financial statements.

(vi) On 1st October 2011 there had been a fully subscribed rights issue of 1 for 4 at K600.This has been recorded in the above statement of financial position.

(vii) Income tax on the profits for the year to 31 March 2012 is estimated at K260 million. The figure in the income statement is the under-provision for income tax for

the year to 31 March 2012. The carrying value of AEL's net assets is K1.4 billion more than their tax base at 31 March 2012. The applicable effective rate of income tax rate is 25%

SECTION A

1) **Respond to the e-mail from Mr. Chenda by preparing a briefing paper in which you should**
   a) Explain the operation of the self-assessment system, highlighting the submission provisions (5 marks)
   b) Advise the provisions relating to the late and underpayment of income tax, as well as late submission of returns (10 marks)
   c) Advise Mr. Chenda how he could go about with his intended appeals procedure and his next course of action should this appeal fail (10 marks)

2) **With reference to the matters in attachment relating to the tax computation for the year ended 31 March 2011, explain how each of the items should have been dealt with in computing the taxation payable. (25 marks)**

SECTION B

3) **Discuss the extent to which accounting policy relating to investment properties and plant and equipment complies with applicable international accounting standards. (10 Marks)**

4) **Using the draft financial statements in attachment 2**
   a) Prepare suitable workings and adjustments to account for the matters stated in (i) to (vii) (10 marks)
   b) Prepare a restated statement of comprehensive income for the year reflecting the information in notes (i) to (vii) (10 marks)
   c) Prepare a statement of changes in equity for the year ended 31 March 2012 (5 marks)
   d) Prepare a restated statement of financial position as at 31 March 2012 reflecting the adjustments in (4a) above (15 marks)

QUESTION TWO

TOYO ZAMBIA LIMITED (TZL)

6. BACKGROUND

Toyo Zambia Limited (TZL) is a small manufacturing company located off Kafue road in Chilanga which is about fifteen kilometers from Lusaka Town centre. TZL has been supplying quality fibre cement products and enduring roofing sheets, including pipes for water reticulation. A substantial amount of its inputs are sourced from China. TZL employees an average of 90 employees. More than fifty percent of the workforce is from the communities surrounding Chilanga.

In a small way, TZL has gone further to empower the communities by encouraging former employees to form co-operatives which in turn are given various kinds of work within the company. All initiatives have resulted in these individuals being empowered as they are able to earn a living after leaving the company. All these efforts are aimed at making the individuals more productive and in turn enhance their skills and livelihood.

a) Strategic Objectives

TZL is a business entity whose aim is to maximize profits which in turn will benefit all stakeholders. This has been enhanced by the introduction of a new performance management system.

b) Environmental Management

TZL ensures that it contributes to environmental management. This is evidenced by the measures and programmes put in place to ensure very minimal waste and pollution is generated during the processing products. This is achieved by operating a loop system that ensures that a minimal waste is generated. The dump-site at Mapepe is well managed by ensuring that the land is rehabilitated by planting vegetation including trees. This site is enclosed with a wall fence to ensure no trespassing by the public. The management of the site complies with the requirements set out by the Zambia Environmental Management Agency (ZEMA)

7. MANAGEMENT TEAM

Name	Designation
Pascal Moyo	Chairman and Chief Executive
Patel Bahati	Technical and Production Director
Catherine Mambwe	Finance and Administration Director
Marcel P. Soloti	Management Accountant

8. RESIGNATION OF MANAGEMENT ACCOUNTANT / APPOINMENT OF CONSULTANTS

Due to irreconcilable differences with Chairman and Chief Executive, Marcel P.Soloti the management accountant was allowed to resign on 31 December 2011. As part of TZL social responsibility, the company has undertaken to assist Mr. Soloti with the tax affairs relating to his personal business.

Plans are under way to replace the management accountant. In the meantime your firm, BK Solutions Ltd, has been appointed as consultant to assist with a number of outstanding issues. These issues were attached to an e-mail sent to you by the Finance and Administration Director as follows

a) Attachment 1 - Fraudulent reporting
b) Attachment 2 – Provisions
c) Attachment 3 – Borrowing costs
d) Attachment 3 - Marcel Soloti taxation affairs

Your name is Bright Kasuba and you are the managing director of BK Solutions Ltd, a firm registered with the Zambia Institute of Chartered Accountants.

9. Attachment 1 - FRAUDULENT REPORTING

The following matters arose from the management letter issued by the auditors on the financial statements for the year ended 31 March 2012.

a) Cash transfers

During the year ended 31 march 2012, TZL approached one of its Chinese suppliers to extend 60 day credit facility. The Chinese company agreed on condition that TZL submitted bank statements to show the cash position of the company. In order to ensure that a more favourable cash position was portrayed, TZL delayed delivering some cheques on behalf of local suppliers.

In addition, a substantial amount of money was transferred from the other operations in the country. As soon the credit facility was granted, the cash was given back and cheques to suppliers duly delivered.

b) Inclusion of loan to directors as part of cash and cash and cash equivalents

The financial director included a loan advanced to him as part of the cash and cash equivalents in preparing the statement of cash flows for the year ended 31 March 2012.

c) Non-impairment of non-current assets

The financial director deliberately did not subject the non-current assets to impairment reviews. His argument was based on the fact that the fair values for the non-current assets had been consistently going up.

d) Revenue recognition

For TZL, revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities when those inflows result in increases in equity. The amount of revenue is decided by the agreement between ZTL and its customers. Some of these agreements include return clauses, where the customers are allowed to return the products if not resold within sixty days. However, the directors have always accounted for revenue gross before the expiry of the sixty days and any returns are accounted for as sales returns. There is evidence to suggest that some customers have returned goods before the expiry of the sixty days

10. Attachment 2 - PROVISIONS

TZL prepares its financial statements in accordance with International Financial Reporting Standards. On 25th March 2011, Toyo made a public announcement of a decision to reduce the level of emissions of harmful chemicals from its factories. The average useful lives of the various pieces of plant and equipment on 31st March 2011 (the accounting reference date) were 20 years. The depreciation of the factories is computed on a straight line basis and charged to cost of sales. The directors formulated the proposals for emission reduction following an agreement in principle with the Zambia Environmental Management Agency (ZEMA), reached during the early part of 2011.

Accordingly, the directors prepared detailed estimates of the costs of their proposals and these showed that the following expenditures would be required:

- K300 million on 30 March 2012
- K300 million on 30 March 2013
- K400 million on 30 March 2014

All estimates are for the actual anticipated cash payments. No contracts were entered into until after 1 April 2011. The estimate proved accurate as far as the expenditure due on 31 March 2012 was concerned. When the directors decided to proceed with this project, they used discounted cash flow techniques to appraise the proposed investment. The annual discount rate they used was 8%. TZL has a reputation of fulfilling its financial commitments after it has publicly announced them. TZL included a provision for the expected costs of its proposal in its financial statements for the year ended 31 March 2011

11. Attachment 3 –BORROWING COSTS

On 1 April 2011, Toyo Zambia borrowed K1.5 billion to finance the construction of two additional production facilities, both of which were expected to take a year to build. The loan facility was negotiated with Barclays bank and was drawn on 1 April 2011. The funds were utilised as follows:

	Facility 1	Facility 2
1 April 2011	K250 million	K500 million
1 October 2011	K250 million	K500 million

The remaining funds after 1 April 2011 were invested temporary. The loan rate was 20% and Toyo Zambia could invest surplus funds at 16%

12. Attachment 4 – MARCEL SOLOTI TAXATION AFFAIRS

M.P. Soloti has been married for some years now. In addition to being employed as management accountant for TZL, Mr Soloti also runs a grocery on a part-time basis. The gross annual salary from Toyo Zambia was K144 million.

Other income received from Toyo Zambia included housing allowance of K1,200,000 per month and a medical allowance of K400,000 per month. He also owns two residential properties, one of which he resides in and the other a rented out at K2,550,000 (net) per month. Property expenses paid out by P.M. Soloti totalled K2,400,000 and two thirds (2/3) of these expenses related to the rented out property. Payments made by M.P. Soloti included the following:

	(Kwacha)
NAPSA Pension contribution	4,400,000
P.A.Y.E	42,400,000
Subscriptions to a professional body	1,360,000
Golf club subscriptions	1,440,000
Mortgage interest on his main residence	2,840,000

On his resignation, Mr. Soloti received K92 million as accrued service bonus and repatriation payment of K16 million

Using the terminal dues received from his former employer, he expanded the grocery business in terms of turnover and achieved a profit of K173.4 million for the year ended 31 March 2012, before adjusting for the following expenses:

	(Kwacha)
Depreciation of premises	4,800,000
Mrs. M.P. Soloti nominal salary	36,120,000
Mr. M.P. Soloti nominal salary	65,200,000
Licence renewal fees	880,000
Capital allowance on business assets for the year were	7,740,000

Mrs. M.P. Soloti works in the grocery on a full time basis.

SECTION A

1) **With regard to attachment 1- fraudulent reporting:**
   a) Explain the term fraudulent financial reporting, illustrating your explanations with examples in accordance with guidelines issued by the Zambia institute of Chartered Accountants (ZICA) **(10 marks)**

   b) Discuss the ethical and professional implications associated with fraudulent reporting, as guided by ZICA **(4 marks)**

   c) For each of the following items, comment on the fraudulent reporting implications, taking into account relevant ethical and professional requirements:
      i) Cash transfers
      ii) Inclusion of loan to director as part of cash and cash equivalents
      iii) None-impairment of non-current assets
      iv) Revenue recognition **(16 marks)**

2) **With regard to attachment 2 – provisions:**
   a) Identify and explain the criteria that should be satisfied before a provision can be recognised. **(5 marks)**

   b) Explain to what extent TZL has satisfied this criteria to support the director's decision to recognise the provision in the statement of financial position as at 31 March 2011 **(5 marks)**

   c) Compute the appropriate provision in the statement of financial position in respect of the proposed expenditure at 31 March 2011 and 31 March 2012 **(5 marks)**
   d) Compute the two components of the charge to the income statement in respect of the proposal for the year ended 31 March 2012. You should explain how each component arises and identify where in the statement of comprehensive income each component is required. **(10 marks)**

SECTION B

3) With regard to attachment 3 – Borrowing costs

a) Identify and explain the criteria that should be satisfied before TZl can be allowed to capitalize its borrowing costs, in according with IAS 23, *Borrowing costs*

(3 marks)

b) Calculate the borrowing cost which should be capitalized for each of the assets and consequently the cost of each asset as at 31 March 2012 **(7 marks)**

4) With regard to attachment 4 – Marcel Soloti taxation affairs

a) Calculate Macel Soloti's income tax payable for the year ended 31 Mach 2012

(20 marks)

b) Calculate the grocery business tax that would be paid on the following assumptions:

i) The business was run as Partnership **(5 marks)**

ii) The business was run as a limited company **(5 marks)**

c) Advise the couple on whether to operate the grocery in the future as either a partnership or a limited company based on the year ended 31 March 2012 results

(5 marks)

The following taxation rates should be used were appropriate

ITEM	DESCRIPTION	RATE
	PERSONAL TAX	
1	First K12,000,000	**0%**
2	Next K8,800,000	**25%**
3	Next K29,580,000	**30%**
4	Balance	**35%**
5	Tax on terminal dues	**10%**
	COMPANY TAX	
1	On income from LUSE listed companies	**30%**
2	On income from manufacturing and other companies	**35%**
	WITHHOLDING TAX	
1	Dividends	**15%**
2	Rents	**15%**