



COMPETENCE PRACTICE EXAMINATION

NON-AUDIT

DECEMBER 2011

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 2½ 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. Your name must NOT appear anywhere on your answer booklet.
7. This is an open book examination.

QUESTION ONE
LUSAKA TOOLING LTD

A. BACKGROUND

Lusaka Tooling Ltd (LT) manufactures a range of highly specialised cutting tools for the engineering industry. It also acts as an exclusive agent for three complementary product ranges manufactured in South Africa. LT has been in the machine tools for 15 years and is still largely family owned. Mr. Sylvester Tembo has been their principal engineer for the last 10 years. During his time, Mr. Tembo has generated several innovative ideas to improve and sustain the profitability of LT. However, Mr Tembo resigned at the beginning of 2010 following a bitter disagreement with one of the key family members. As an outsider, Mr. Tembo felt he was not being fairly recognised for his contributions.

Following the resignation of Mr. Tembo, LT drifted into a rather sleepy and vulnerable position with regard to its competitors. Its turnover reduced by 10% and profitability continues to fall. At the same time, its competitors are cutting deep into its market. LT Ltd has not made any efforts to replace Mr. Tembo.

In the mean time, Mr Tembo set up his own firm – Tembo Engineering Solutions Ltd (TES). He commenced trading with effect from 1st July 2010. With a diagnostic tool called TECHSPAN, Mr. Tembo is able to quickly diagnose client problems and determine specific solutions.

Mr. Robinson Julu, the Executive chairman of LT has approached Mr. Tembo to re-consider working with LT either as an employee or self employed.

Mr. Tembo as a self-employed to enter into a strategic relationship with LT Ltd where:

- i. Mr. Tembo will continue to service other clients independent of LT. Mr. Tembo has generated a good profile of clients that pay him fees on a monthly basis.
- ii. Mr. Tembo will be expected to use his technologies in meeting the requirements of LT. Lt will pay him an agreed amount of fees at the end of each month. The amount will be based on time, level of expertise and machine utilisation.
- iii. LT will treat Mr. Tembo as self-employed and no tax will be deducted from the payments to be made to him.
- iv. This arrangement will be effective 1 April 2011.
- v. It is planned that Mr. Tembo will be accommodated in the same office that he used when he was employed by LT.
- vi. Mr. Tembo will be spending almost half his time at LT.

However, the executive chairman is not sure whether this arrangement may also be construed as an employment contract.

Mr. Tembo will be employed as Director of Projects under the following conditions:

- i. The employment contract is a three-year renewable contract commencing on 1 April 2011.

- ii. Mr. Tembo will be paid a starting annual basic salary of K240 million. The salary will be payable monthly in arrears on the last day of each month. At the beginning of each year, Mr. Tembo will receive an annual increment of K12 million. He will receive a re-settling allowance of 10% of starting annual basic salary after six months.
- iii. The gratuity payable at the end of the three-year contract is 20% of his cumulative basic pay for the contract term.
- iv. Mr. Tembo will be accommodated in a house leased by the company. He will not pay any rent. All maintenance costs including the cost of electricity, water and general cleaning will be paid by the company.
- v. The company will re-imburse all medical fees incurred by Mr. Tembo and members of his family.
- vi. Mr. Tembo is a member of the Lusaka Squash Club. LT Ltd will pay annual subscriptions every year. The amount involved is K500,000 per annum.
- vii. Mr. Tembo is a member of the Engineering Institute of Zambia (EIZ). He pays annual subscriptions to the institute every year. The amount of the annual subscription is K1.2 every year.
- viii. Mr. Tembo will be paying contributions to the National Pension Scheme Authority according to the regulations of the Scheme at 5% of his basic salary.

B. APPOINTMENT AS TAX AND ACCOUNTING CONSULTANTS

For the second year running, your firm MDM Consulting Ltd, has been retained by LT Ltd as professional advisers in accounting and taxation matters. You have been specifically retained to provide advice:

- a) On the nature of the strategic business relationship that should be negotiated with Mr. Tembo.
- b) On the deferred tax implications of LT Ltd, especially in relation to its revaluation of property and equipment.

You have accepted this appointment and you have proceeded to plan the work. Your name is Biswell Nkole and you are managing director of MDM Consulting Ltd.

This re-appointment has been very welcome because your firm has suffered a reduction in fee income due to increasing competition and low liquidity levels in the economy. Your Business Development Director has proposed the following ways in which the firm can increase its income;

- a) Obtain a list of SME's companies and plan to visit each chief executive officer in order to seek new business. In practice, this is called "cold calling". The strategy will include an offer to provide them with free consultancy services on a range of key topical issues, including tax implications of the forthcoming budgetary pronouncements.
- b) Displaying business cards alongside those of local tradesmen and service providers in supermarkets and libraries. The cards would read:

*"MDM ZICA Associates
For PROFESSIONAL Accountancy, Business Consultancy
and Taxation Services at Competitive rates.
Money back guarantees"*

- c) Placing an advert in the ZICA accountancy journal and to include the following excerpt:
“If you have an asset on which a large chargeable gain is expected to arise when you dispose of it, you should be interested in the best tax planning advice. However your gains might arise, there are techniques you can apply, MDM Consulting Ltd can ensure that you consider all the alternative fact presentations so that you minimise the amount of tax you might have to pay. No tax saving – no fee”

C. DEFERRED TAXATION

The Financial statements of LT Ltd always contain a note explaining the relationship between taxable income and accounting profit. This takes the form of a numerical reconciliation between the tax expense and the product of accounting profit multiplied by the applicable tax rate. Mr. Julu is not quite sure why this is necessary.

According to LT Ltd records, temporary differences of K2 billion had arisen because of differences between the carrying amount of non-current assets and their tax base. These had arisen because LT Ltd had exercised its right to claim accelerated capital allowance in the earlier years of the asset lives

At 1 April 2010 the temporary differences attributable to non-current assets were K2.3 billion. The tax rate has been 35% in the past. The directors have since been advised that the rate of tax would decrease to 30% by the time the temporary differences on the non-current differences reversed.

The estimated tax charge for the year ended 31 March 2011 was K400 million. The estimated charge for the year ended 31 March 2010 has been agreed with the Zambia Revenue Authority and settled without adjustment.

Mr. Robinson Julu is also concerned that if LT Ltd re-values the company's land and buildings there will be a deferred tax liability on the gain, even though there is very little chance of the gain being realised and the related tax ever crystallising.

SECTION A

- 1) **In relation to the proposals by your Business Development Director to increase your income, list and briefly describe ethical and professional matters raised by each of the proposals** (20 marks)
- 2) **Using the terms of engagement as a self employed:**
 - a) **Discuss the factors that should be taken into account in determining whether Mr. Tembo is an employee or self employed** (14 marks)
 - b) **Indicate which of these matters are likely to show that Mr. Tembo is an employee of LT Ltd** (8 marks)
 - c) **Indicate which of those matters show that Mr. Tembo is self-employed** (8 marks)

SECTION B

- 3) **Assuming Mr. Tembo was re-engaged as an employee**
 - a) **Explain the taxation implications of each of Mr. Tembo's proposed terms of employment, and of his payments** (20 marks)
 - b) **Support your explanations with appropriate calculations** (5marks)
- 4) **Using the information on deferred tax**
 - a) **Explain the relevance of the note supporting the deferred taxation** (5 marks)
 - b) **Compute the deferred taxation balance for the year and prepare the financial statement extracts** (15 marks)
 - c) **Discuss the logic of creating a deferred tax liability in relation to the revaluation of the land and buildings** (5 marks)