

NON-AUDIT QUESTION ONE

A. BACKGROUND

Budget Equipment Limited (BEL) is one of the leading support services companies in Zambia, which focuses on the building industry. Additionally, the company manufactures and sells building equipment on which it gives a standard one year warrant to all customers. BEL operates an integrated computerised accounting system designed to keep track of all warranty claims, in sufficient detail to provide BEL with a reasonable basis for making any provisions.

The company is controlled by Mr. Ray Pappino, who owns 80% of the share capital. Mr. Pappino provides the overall oversight on strategic management and corporate governance matters.

B. MR. JOHN FEROUK – CONSULTING ENGINEER

Mr J Ferouk has been engaged by BEL as a consulting mechanical engineer. He only came to Zambia in June 2013 and he has worked for BEL since then, employed on a three year contract. He was born in 1965 and he is originally from Turkey. He had lived in Turkey from the time of birth until the end of May 2013 when he came to Zambia.

A recent audit from the immigration department has determined that:

- a) Mr. Ferouk does not have a valid permit to work in Zambia
- b) Mr. Ferouk is paid a dollar-based salary which is externalised to his account in Turkey. This is not reflected on his payroll for the purposes of computing PAYE, as according to Mr. Papponi, tax agreements between Zambia and Turkey allows this
- c) Mr. Ferouk is partly engaged to run a casino owned by Mr. Pappino, the principal shareholder of BEL.
- d) Mr. Pappino has previously been implicated in pyramid schemes in three countries in Europe.

C. FINANCIAL STATEMENTS – NOTES TO THE FINANCIAL STATEMENTS

The chief accountant for BEL has drafted financial statements for the year ended 31 December 2014. As reflected in the following notes to these financial statements, there are several matters that need further attention

BUDGET EQUIPMENT LTD

Notes to the Financial Statements – 31st December 2014

1. REPORTING FRAMEWORK

BEL has adopted the “Full IFRS” mode of preparation and presentation of financial statements. This requires BEL to fully comply with all International Financial Reporting Standards applicable. There are no specific requirements or modifications relating to the building industry

2. NON-CURRENT ASSETS

The property, plant and equipment of BEL include the following items:

- a) Property, plant and equipment held for use in operating leases: At 31st December 2014 the company has plant with a carrying value of K1.5 million of plant. This plant had been leased out on operating leases. These leases have now expired. The company is undecided as to whether to sell the plant or lease it to customers under finance leases. The fair value less selling costs of the plant is K1 million and the fair value in use is estimated at K3.5 million
- b) Property, plant and equipment acquired under finance leases.
- c) Plant with a carrying value of K750,000 at 31st December 2014 had ceased to be used because of a downturn in the economy. BEL had decided to maintain the plant in workable condition in case of a change in economic conditions. The plant was subsequently sold by auction on 20th February 2015 for K450,000 net of costs. The financial statements were signed by the directors on 28th February 2015.

3. WARRANTIES

Apart from the one year standard warrant, BEL has now extended the warranty to two years for certain major customers and has insured against the cost of the second year of the warranty. The warranty has been extended at nil cost to the customers. Past experience has shown that 80% of the building equipment will not be subject to warranty claims in the first year, 15% will have minor defects and 5% will require major repair.

BEL estimates that in the second year of the warranty, 20% of the items sold will have minor defects and 10% will require major repair

In the year to 31st December 2014, the following information is relevant:

	Standard warranty (units)	Extended warranty (units)	Selling price per unit (both) (K250,000)
Sales	200	500	
		Major repair	Minor defect
Cost of repair (average)		K20,000	K4,000

For accounting purposes, all potential claims during the year are assumed to arise on 31st December 2014 and any warrant claims are accounted for on 31st December each year. A risk adjusted discount rate of 20% is assumed.

4. FINANCIAL INSTRUMENTS- TREASURY BILLS

BEL invested in a K2 million bond instrument issued by the Livingstone City Council (LCC) on 1st January 2013. The investment is primarily held for collection of interest and capital throughout the bond period. Additionally the cash inflows received consist solely of repayment of interest and capital. The bond has therefore been designated to be measured at amortised cost. The effective and stated interest rate for this bond was 25% and BEL has no intention of invoking the fair value option. Interest is payable by LCC at the end of each year and the bond is repayable on 31st December 2016. As at the year-end

31st December 2014, it was reported that LCC was facing financial difficulties and was undergoing a financial re-organisation following the change in government administration. The directors now estimate that they will only receive K1.5 million on 31st December 2016, when the bond matures. The bond was originally expected to be redeemed at a premium of K576,560. Although the Interest for the year ended 31st December 2014 had been received, no further interest is expected in 2015 and 2016. Normally, annual interest receivable is based on 20% of K2million.

5. TAXATION

5.1. CURRENT TAX

For the year ended 31st December 2014, the company's profit after taxation in the profit and loss account was K20.125million

The profit of K20.125 million was arrived at after dealing with the following items:

- a) K1.250million incurred on restoration costs to the warehouse was charged as an expense. The warehouse was purchased on 1st November 2014 in a damaged state. The warehouse could not have been used in the state it was at the time of purchase
- b) Depreciation of non-current assets charged to the profit and loss was K3.125 million
- c) Entertainment expenditure charged in the accounts was as follows:

	(K'000)
Christmas party for staff	487.5
Entertaining special customers	1,312.5
Entertaining potential customers	<u>575.0</u>
Total charge to profit and loss	<u>2,375.0</u>
- d) Bad debts written off were arrived at as follows:

	(K'000)
Bad debts written off	1,625.0
Increase in specific provision for bad debts	305.5
Decrease in general provision for bad debts	(247.5)
Bad debts previously written off now recovered	<u>(312.5)</u>
Charge to the profit and loss	<u>1,370.5</u>
- e) The amount of dividend received from TEC Limited, a fellow Zambian Company and credited to the profit and loss account was K1.3million (net). BEL did not pay any dividend in the year ended 31st December 2014
- f) The provision for income tax on profits charged in the profit and loss account was made up as follows:

	(K'000)
--	----------------

Non-audit – December 2015

Provision for tax on profits	6,462
Over-provision of previous year's tax on profits	(312)

Tax charge in the profit and loss account	6,150
	=====

g) Capital allowances for the year were K3.560 million.

6. INVENTORY VALUATION – ACCOUNTING ERROR

During the inventory count conducted on 31st December 2014, it was discovered that some pieces of equipment were incorrectly labelled during the count for the year ended 31st December 2013, resulting an overstatement of closing inventories of K1.5 million as at 31st December 2013. The impact of this overstatement is considered material and fundamental to the financial statements. The management accountant has decided to write off the K1.5million against cost of sales; in three years starting from the current year ending 31st December 2014. The balance is treated as a deferred asset included in other receivables.

D. RETENTION OF LUNTE ACCOUNTING SOLUTIONS LIMITED (LASL)

You are the managing director of Lunte Accounting Solutions and your firm has been retained as financial and business consultants for the third year running. You have been retained to assist management with the preparation and presentation of financial statements for the year ended 31st December 2014, in accordance with International Financial Reporting Standards.

In the past years your services have included other related services including:

- Compilation engagements
- Agreed upon engagements
- Engagements to review historical financial statements

As in previous years, your retention as financial consultants was endorsed by Mr. Pappino, on condition that the fees remained within the budgetary requirements of BEL. Mr. Pappino has also invited you to review the “gambling system” at the casino and suggest improvements.

During the course of your providing services to BEL, you received the following requests:

Immigration department

- Request to furnish more details relating to the employment of Mr. John Ferouk

Anti-Corruption Commission

- Possible corrupt and money laundering practices relating to Mr. Pappino

Labour Office

- To confirm allegations of unfair treatment of employees

REQUIREMENTS

1) ZICA requires that practitioners are guided by the ethical code of fundamental principles.

- a) State your responsibility to share information about BEL with third parties
(4 marks)
- b) Recommend the action that should be taken in relation to the requests from:
 - (i) Immigration department (3 marks)
 - (ii) Anti-corruption Commission (ACC) (6 marks)
 - (iii) Labour office (3 marks)
- c) Identify and explain FIVE other ethical issues that arise from your continued association with BEL. (10 marks)

2) BEL has requested you to assist them with the preparation and presentation of financial statements

- a) Distinguish between a compilation engagement and an engagement to review historical financial statements (5 marks)
- b) The practitioner is required to obtain an understanding of the specific matters sufficient to be able to perform a compilation engagement. Describe SIX matters relating to BEL that you should be considered in planning and performing the compilation engagement (9 marks)

3) In relation to the compilation of the financial statements for BEL for the year ended 31st December 2014, discuss how the following should be treated:

- a) Note 2 (a) – Non-current assets (4 marks)
- b) Note 2 (c) – Non-current assets (4 marks)
- c) Note 3 – Warranties (4 marks)
- d) Note 4 – Financial instruments (4 marks)
- e) Note 6 – Inventory valuation (4 marks)

You should support your answer with appropriate computations and reference to relevant International Financial Reporting Standards (10 marks)

4) In relation to the tax information and the tax implications of employing Mr. John Ferouk

- a) Calculate BEL's company tax payable for the charge year 2014 (16 marks)
- b) As for Mr. John Ferouk:
 - i) Explain the criteria that should be used to determine whether an individual is liable to income tax in Zambia (5 marks)

- ii) Explain whether Mr. Ferouk is liable to Zambian income tax in the given circumstances\

(4 marks)

- iii) Comment on the acceptability of Mr. Ferouks externalised payments not being subjected to PAYE, on account of double taxation relief (DTR) (5 marks)

Grand total

(100 marks)

NON-AUDIT – QUESTION TWO

A. LITANA ACCOUNTANTS LIMITED

Your name is Ashley Bwembya and you are a manager in the business advisory department of Litana Accountants Limited (LAL).

Following poor financial and operational performance in the previous years, LAL had proposed and undertaken a number of promotional and marketing activities, summarized below:

a) Encouraging members of staff to approach existing and potential clients for business

Many of the employees are members of social clubs such as golf and football clubs, some of whom serve as committee members. For examples one of the employees is a chairperson of the local golf club.

b) Distributing promotional leaflets at Soweto market and other main markets in each Lusaka, Kitwe and Livingstone

This involved local boys to distribute the leaflets, including bus drivers and their conductors/assistants.

c) Advertising on radio and in the press

The adverts were placed in the post newspapers and other press publications, whilst advertising messages will be transmitted through local radio stations. Wherever possible, local languages was used

d) Offer substantial discounts for new services

LAL introduced a number of new services relating to taxation and investment and financing consultancy. In order to penetrate the market, it was proposed that the initial fees would be charged at a discount of at least 30%

Following the various marketing and promotional activities undertaken in the last one year, a number of companies have since approached your firm for various professional engagements. Two of these companies are:

- a) Events Management Professionals Ltd (EMPL)
- b) Unique Styling Enterprises (USE)

B. EVENTS MANAGEMENT PROFESSIONALS LIMITED (EMPL)

Events Management Professionals Ltd (EMPL) is a private company, whose business activity is events management, involving the organization of conferences, meetings and celebratory events for companies and individuals. The business also includes the selling and hiring of tents. EMPL was founded 10 years ago by Mr. Danny Situmbeko and his sister, Natalie, who still own the majority of the company's shares. The company has grown rapidly and now employs more than 40 people staff in offices in each of the major towns of Zambia.

Your firm has just been engaged to

- a) To assist in the finalization of financial statements for the year ended 31 December 2014 to support the re-submission of tax returns
- b) To advise EMPL on a number of recent income tax changes announced by the Zambia Revenue Authority (ZRA)

C. FINALISATION OF FINANCIAL STATEMENTS

The following matters have remained outstanding in relation to the finalization of financial statements for the year ended 31 December 2014:

- a) Included in sales revenue is K3.5 million, which relates to the sale of tents to customers under sale or return agreements. The expiry date for the return of the tents was 31 January 2015. EMPL has charged a mark-up of 25% on cost for these sales.
- b) A lease rental of K502,000 was paid on 1 January 2014. It is the first of five annual payments in advance for the rental of air conditioners that have a cash price of K1.8million. The auditors of EMPL have advised that this is a finance lease and have calculated the implicit interest rate in the lease @20% per annum. Leased assets should be depreciated on a straight-line basis over the life of the lease
- c) On 1st January 2014, EMPL acquired new musical and audio equipment at cost of K10million. The depreciation on the equipment should be calculated on a straight line basis over 20 years. The new equipment replaced the existing one that was sold on the same date for K4.6million. It had cost K2.5million and had a carrying value of K4million at the date of sale. The profit on this sale has been correctly calculated. However no depreciation was provided on the new equipment because the directors consider that:
 - The equipment is likely to increase in value
 - The resulting depreciation would not be material
- d) EMPL had incurred K5million on developing the reputation of the "EMPL brand". This expenditure is capitalized and included in the statement of financial position as an intangible asset. The amount includes:
 - Training costs
 - Advertising costs
 - Cost of opening up new selling outlets

It is expected that the EMPL brand will result in increased in loyalty of customers and the retention of customers. As at 31 December 2014, it was not possible to assess how many customers had been retained as a result.

D. RECENT INCOME TAX CHANGES

During the year Danny had the fortune of winning a house worth K2.5million through a promotion conducted by Airtel. At the same time, Danny won a family holiday package to Mauritius by participating in a tournament at the Lusaka Golf Club. The package comprised:

- K20,000 accommodation and food
- K8,000 air tickets
- K2,000 incidentals

Danny is aware that new tax changes have since been introduced relating to winnings from gaming, betting and lotteries.

E. UNIQUE STYLING ENTERPRISES

In addition to being a director in EMPL, Natalie also runs a boutique in Lusaka called Unique Styling Enterprises, as a sole trader. Natalie has run the boutique for several years and is duly registered for Value Added Tax.

Natalie has heard that it may be more tax beneficial to incorporate her business as a limited company. Natalie is now considering the following strategic option:

- Incorporate the boutique into a limited company from 1st January 2016
- Natalie will own 80% of the shares and 20% to be held by her son Benjamin
- Natalie and Benjamin will be the first executive directors of the company. Benjamin is presently studying in Australia and is not involved in the operations of the boutique

In order to facilitate the decision in this matter, Natalie has produced the following estimated results for the years ended 31 December 2015 and 2016, as below:

Year ended 31 December 2015

The tax adjusted business profit for the year ended 31 December 2015, is expected to be K712,500. She will withdraw K225,000 of this profit as drawings. The profit figure is before estimated capital allowances. The only assets held by the business qualifying for capital allowances during this year include fixtures and fittings and a motor van.. The fixtures and fitting were acquired at a cost of K70,000 and had an income tax value of 35,000 on 1 January 2015. The motor van was acquired at a cost of K80,000 and had an income tax value of K60,000 at 1 January 2015. Natalie has private use of 40% in the motor van. The market values of the fixtures and motor van at 31 December 2015 will be K30,000 and K50,000 respectively

Year ended 31 December 2016

After incorporation on 1 January 2106, Natalie will continue preparing accounts to 31 December each year and all the business assets will be taken over by the newly incorporated company. Her private use in the motor van will continue at 40%. In the year ended 31 December 2016, she expects the company to make taxable profits of K825,000 before capital allowances and any withdrawal of profits by both Natalie and Benjamin.

It is anticipated that Natalie and Benjamin will withdraw K270,000 and K120,000 of the profits respectively in the year ended 31 December 2016, as either dividends or director emoluments. Regardless of whether profits are drawn as directors' emoluments or as dividends, they would in addition to the amounts drawn, draw out a further K130,000 each, as interest free loans made by the company to themselves to help them finance the purchase of personal motor vehicles. These loans can either be written off at some time in the future by the company, or can be repaid to the company either partly or in full by Natalie and Benjamin.

NAPSA contributions payable where applicable, should be taken to be 5% of the relevant income per annum

REQUIREMENTS

- 1) Prepare a briefing memo in which you should advise your firm on the professional requirements relating to advertising professional services as prescribed by the Zambia Institute of Chartered Accountants (ZICA) **(10 marks)**
- 2) **Identify and evaluate the ethical and other profession issues relating to the proposals by managing director to improve your firm's market share:**
 - a) Encouraging members of staff to approach existing and potential clients for business **(6 marks)**
 - b) Distributing promotional leaflets at Soweto market and other main markets in each Lusaka, Kitwe and Livingstone **(5 marks)**
 - c) Advertising on radio and in the press **(5marks)**
 - d) Offer substantial discounts for new services **(6 marks)**
- 3) **In relation to the finalization of financial statements for the year ended 31 December 2014, discuss how the accounting treatment should be applied to the following items. Support your answer by reference to relevant accounting standards:**
 - a) Sales on sale or return **(4 marks)**
 - b) Lease of equipment **(6 marks)**
 - c) The non depreciation of the new property **(6 marks)**
 - d) The EMPL brand **(4 marks)**

For the purpose of answering question (4) and (5), you should assume that today is 1 December 2015 and the earnings for the purpose of NAPSA contributions should be taken to be K190,092 per annum
--

- 4) **With regard to the planned incorporation of the boutique: Individual implications**

- a) Advise Natalie of the taxation implications of incorporating her business and compute the final assessable profits for the tax year 2015, explaining the basis of assessment for the profits to be generated by the business in the years ending 31 December 2015 and 2016. Assuming that the tax rates for 2014 are also applicable to 2015 and 2016

(10 marks)

- b) Calculate the Income Tax and NAPSA contributions payable by Natalie and Benjamin in the tax year 2016 if:

- i) Gross directors emoluments of K270,000 and K120,000 are drawn by Natalie and Benjamin.

(4 marks)

- ii) Gross dividends of K270,000 and K120,000 are drawn by Natalie and Benjamin respectively.

(4 marks)

5) With regard to the planned incorporation of the boutique: Company implications

- a) Calculate the company Income Tax, Withholding Tax and NAPSA contributions payable by the company for the tax year 2016 if:

- i) Gross directors emoluments of K270,000 and K120,000 are drawn by Natalie and Benjamin respectively

(3 marks)

- ii) Gross dividends of K270,000 and K120,000 are drawn by Natalie and Benjamin respectively

(3 marks)

- b) Assuming Natalie and Benjamin drew gross emoluments of K270,000 and K120,000 respectively,

- i) Advise them of the taxation implications if, in addition to the emoluments, they were to also draw K130,000 each, as interest free loans.

(3 marks)

You should further advise them of the taxation implications if:

- ii) The loans were to be subsequently written off at some time in the future by the company,

(3 marks)

- iii) The loans were to be subsequently repaid to the company by each individual either partly or in full at some time in the future.

(3 marks)

- c) Based on your calculations in parts 4(b) and 5(a) above only, advise Natalie and Benjamin whether to draw the profits as director's emoluments or as dividends.

(5 marks)

6) The income tax Act was amended in 2014 to deal with winnings from gaming, betting and lotteries:

- a) State the Income Tax amendments relating to winnings from gaming, lotteries and betting.

(4 marks)

- b) Advise how:

- i) The house on promotion should be accounted for (3 marks)
ii) The holiday package should be accounted for (3 marks)

TAXATION RATES TO BE USED

1) Income tax

	Chargeable income	Rate (%)
Personal Income tax rates (Kwacha)		
First	36,000	0
Next	9,600	25
Next	25,200	30
Excess over	70,800	35

2) Company Tax rates

On income from manufacturing and other	25
--	----

3) Capital Allowances

Implements, plant and machinery and commercial vehicles:

Wear and tear allowance: Used normally 25%

NON-AUDIT QUESTION ONE – SUGGESTED SOLUTIONS

5) ZICA ETHICAL CODE OF PRINCIPLES.

a) Responsibility re confidentiality

According to the ZICA ethical code, members should respect confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper or specific authority or unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional or business relationships should not be used for the personal advantage of members or third parties.

b) Recommended action:

i) Immigration department

- Immigration is not one of the authorities to which the practitioner has a duty to report.
- Accordingly the request should be referred to the client

- The practitioner should discuss the issue with the client to find out how the client intends to deal with it.

ii) Anti-corruption Commission (ACC)

- These issues border on money laundering.
- If the practitioner has reasonable evidence to suggest that there is money laundering, the practitioner has a duty to report to the required authority
- However before responding to the request, the practitioner should:
 - Be satisfied that there is sufficient evidence
 - The evidence is in good faith
 - Seek legal advice
 - Reporting to those charged with corporate governance – assuming they are not involved
- The practitioner is also encouraged to consider resigning from such an engagement as ZICA ethical codes warn members from associating with such risky clients

iii) Labour office

- Labour office is not one of the authorities to which the practitioner has a duty to report.
- Accordingly the request should be referred to the client
- The practitioner should discuss the issue with the client to find out how the client intends to deal with it.

c) Other Ethical Issues

i) Money laundering

There are suspicious circumstances surrounding BEL that might suggest possible money laundering. Mr. Ferouk is partly engaged to run a casino owned by Mr. Pappino, the principal shareholder of BEL. Casinos are recognised as typical targets for money laundering. Additionally, Mr. Pappino has previously been implicated in pyramid schemes in three countries in Europe.

Continued association with the client exposes the firm to negative publicity. In addition, money laundering imposes a duty to report to an appropriate authority

ii) Tax evasion

Not subjecting Mr. John Ferouk's salary to PAYE amounts to tax evasion. Breaching of laws and regulations questions the integrity of management and may bring about negative publicity that will have an adverse impact on the reputation of LASL

iii) Review of the "gambling system" in the casino

LASL should carefully consider this request as it may not have the skill, knowledge and experience with such systems. ZICA ethical guidelines require that a member should not take assignments for which they are not competent.

iv) Possible intimidation

Mr. Pappino has indicated that the engagement fees should be within the budgetary requirements of BEL. This may constitute intimidation threat. Fees should be determined

based on the practitioners' assessment of time, expertise and other resources required on the assignment

v) Dominance of control by Mr. Pappino

Dominance of control by Mr. Pappino opens BEL to possible abuse, given the background of Mr. Pappino. This will lead to possible error and fraud in the financial statements. This questions the reliability of records and other information that will be provided in the process of compiling financial statements.

6) COMPILATION ENGAGEMENT

a) Distinction between compilation engagement and review of historical financial information

Compilation engagement

According to the *International Standard on Related Services (ISRS) 4410 (revised)*, a compilation engagement is an engagement in which a practitioner applies accounting and financial reporting expertise to assist management in the preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework, and reports as required by ISRS 4410.

Reporting

An important purpose of the practitioner's report is to clearly communicate the nature of the compilation engagement, and the practitioner's role and responsibilities in the engagement. However, the practitioner's report is not a vehicle to express an opinion or conclusion on the financial information in any form.

Review of historical information

According to the *International Standard on Review engagements (ISRE) 2400 (revised)*, the review of historical financial statements is a limited assurance engagement, as described in the *International Framework for Assurance Engagements* (the Assurance Framework). In a review of financial statements, the practitioner expresses a conclusion that is designed to enhance the degree of confidence of intended users regarding the preparation of an entity's financial statements in accordance with an applicable financial reporting framework. The practitioner's conclusion is based on the practitioner obtaining limited assurance.

Reporting

The practitioner's report includes a description of the nature of a review engagement as context for the readers of the report to be able to understand the conclusion. The practitioner performs primarily inquiry and analytical procedures to obtain sufficient appropriate evidence as the basis for a conclusion on the financial statements as a whole, expressed in accordance with the requirements of the ISRE 2400.

b) Planning and performing the compilation engagement

According to the *International Standard on Related Services (ISRS) 4410 (revised)*, the practitioner should obtain an understanding of the following matters:

i. Business - The size and complexity of BEL's operations.

Budget Equipment Limited (BEL) is one of the leading support services companies in Zambia, which focuses on the building industry. Additionally, the company

manufactures and sells building equipment on which it gives a standard one year warrant to all customers.

ii. Operations and governance

The level of development of BEL's management and governance structure regarding management and oversight of the entity's accounting records; and the financial reporting system that underpin the preparation of financial information of the entity. For BEL, the oversight and control is in the hands of Mr. Ray Pappino

iii. Accounting system - The level of development and complexity of the entity's

BEL operates an integrated computerised accounting system designed to keep track of all warranty claims, in sufficient detail to provide BEL with a reasonable basis for making any provisions.

iv. Accounting records – The nature of BEL's assets, liabilities, revenues and expenses. As per the statement of financial records:

- The assets of BEL include leased assets and plant and equipment held for use in operating leases.
- BEL's revenue is mainly generated from sale of building equipment as well as from hire of equipment under operating leases
- BEL's non-current assets include financial instruments

v. Reporting framework

BEL has adopted the "Full IFRS" mode of preparation and presentation of financial statements. This requires BEL to fully comply with all International Financial Reporting Standards applicable.

vi. Application of the reporting framework to BEL's industry

There are no specific requirements or modifications relating to the building industry

7) Discussion and treatment of items

a) Note 2 (a) – Non-current assets

Matter

The fact that the company is undecided as to whether to sell the plant or lease it to customers under finance leases questions the recoverability and valuation of the asset. This is an indication that impairment may have taken place. It is also not clear whether the company has decided to sell the plant or not.

Discussion and reference accounting standards

According to **IAS 36, Impairment**, an impairment review should be undertaken since there is an indication that the asset may have suffered impairment. According to IAS 36, impairment is the amount by which the carrying value of an asset exceeds its recoverable amount. The recoverable amount is taken to be the greater of the fair value or net realisable and the value in use computed as the net present value of inflows expected from the asset.

Non-audit – December 2015

	K'000	K'000
Carrying value		1,500
Fair value	1,000	
Value in use	3,500	
Recoverable amount		3,500

The assets are not impaired because the value in use is above the carrying value.

According to **IFRS 5, Asset Held For Sale**, to qualify as held for sale, the sale must be highly probable and generally must be completed within one year. In the case of the operating lease assets, they will not qualify as held for sale assets as at 31st December 2014 as the company has not made a decision as to whether they should be sold or leased. The asset should therefore, be shown as non-current assets and depreciated.

b) Note 2 (c) – Non-current assets

Matter

The plant ceased to be used implying that BEL was considering selling it or putting it to alternative use. The auction sale may be regarded as a subsequent event as it took place before the financial statements were signed.

Discussion and reference accounting standards

According to **IFRS 5, Asset Held For Sale**, the plant would not be classified as a held for sale asset at 31 march 2014 even though the plant was sold at auction prior to the date the financial statements were signed. The decision to sell is not clear and the other held for sale criteria were not met at the date of the reporting period. IFRS 5 prohibits the classification of non-current assets as held for sale if the criteria are not met after the end of the reporting period and before the financial statements are signed. The company should disclose relevant information in the notes to the financial statements for the year ended 31st December 2014.

Additionally, According to **IAS 17, Subsequent events**, the fair value appear to have fallen from K750,000 to K450,000. This may be considered to be an adjusting event indicating a possible impairment of the asset. On this basis, an impairment of K300,000 (K750,000 – K450,000) should be accounted for

c) Note 3 – Warranties

Matter

This matter deals with provisions and the criteria to be met for recognition and measurement purposes

Discussion and reference accounting standards

According to **IAS 37, Provisions, Contingent Assets and Contingent Liabilities**, a provision is a liability of uncertain timing or amount. A liability is defined as an existing obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. An entity must recognise a provision under IAS 37 if, and only if:

Non-audit – December 2015

- a) A present obligation (legal or constructive) has arisen as a result of past event (the obligating event)
- b) It is probable ('more likely than not') that an outflow of resources embodying economic benefits will be required to settle the obligation
- c) The amount can be estimated reliably

Expected cash flows should be discounted to their present values, where the effect of the time value of money is material using a risk adjusted rate.

For BEL, the past event which causes the obligation is the initial sale of the equipment with the warrant given at the time.

Year 1 – See workings below

The initial estimated provision is K1,120,000 reduced to K933,296 after discounting

Year 2 - See workings below

The initial estimated provision is K1,400,000 reduced to K972,160 after discounting

80% * 700			nil			
Minor = 700*15% @ K4,000			420			
Major = 700*5% @ K20,000			700			
			-----		-----	
			1120	0.8333	933.296	
			-----		-----	
Year 2 Warrant						
Total units sold eligible = 500						
70% * 500			nil			
Minor = 500*20% @ K4,000			400			
Major = 500*10% @ K20,000			1000			
			-----		-----	
			1400	0.6944	972.16	
			-----		-----	

d) Note 4 – Financial instruments

FINANCIAL INSTRUMENT

Matter

This is a financial instrument that should be accounted for in accordance with the type of financial asset that it is – equity instrument, derivative or financial asset meeting specified criteria

Discussion and reference accounting standards

Non-audit – December 2015

According to **IFRS 9, Recognition and measurement of Financial Instruments**, this instrument should be accounted for using amortised cost because:

- It is a business model to receive interest and principal only in future
- BEL has no intention of invoking the fair value option

Additionally, the instrument appear to have suffered impairment as LCC is experiencing financial difficulties and only K1.5 million is expected to be received on 31st December 2016, when the bond matures. Accordingly, **IAS 36, Impairment**, also applies

	(,000)							
			Interest		Interest			
	Year	Opening	Effective	Sub	received @	Closing		
	end	Balance	rate @ 25%	total	20% of K2mil	Balance		
	2013	2,000.00	500.00	2,500.00	-400.00	2,100.00		
	2014	2,100.00	525.00	2,625.00	-400.00	2,225.00		
	2015	2,225.00	556.25	2,781.25	-400.00	2,381.25		
	2016	2,381.25	595.31	2,976.56	-2,976.56	0.00		
		In 2016 the receipt is made up of(K400+576.56+2,000)						

As at 31st December 2014 BEL only expects to receive K1.5million in 2016. The net present of K1.5million is K960,000 ($K1.5\text{million} \times 1/1.5625$). This gives an impairment of K1.265 ($2.225 - 0.960$) . The table after impairment is as follows:

	(,000)							
			Interest		Interest			
	Year	Opening	Effective	Sub	received @	Closing		
	end	Balance	rate @ 25%	total	20% of K2mil	Balance		
	2013	2,000.00	500.00	2,500.00	-400.00	2,100.00		
	2014	2,100.00	525.00	2,625.00	-400.00	960.00		
	2015	960.00	240.00	1,200.00	0.00	1,200.00		
	2016	1,200.00	300.00	1,500.00	-1,500.00	0.00		

Journal Entry

	Debit	Credit
DR – Profit and loss	K1.265million	
CR – Financial instrument		K1.265
Being accounting for impairment of financial instruments		

e) Note 6 - Inventory valuation

Matter

This matter affects the valuation of inventories and the treatment of fundamental errors

Discussion and reference accounting standards

Non-audit – December 2015

According to **IAS 2, Inventories**, inventories should be valued at the lower of cost and net realisable value. Writing off the error over three years implies that inventories are stated at above cost in the first year and below cost in years ending 2013 and 2014.

According to **IAS 8, Accounting policies, Changes in Accounting Estimates and Errors**, the correction fundamental should be done retrospectively and accounted for as a prior year adjustment. Accordingly, the total overstatement should have been written off in 2013.

Journal Entry

	Debit	Credit
DR – Retained profits brought forward	K1.5million	
CR – Cost of sales		K0.5million
CR - Deferred Asset		K1.0million
Being reversal of error wrongly carried as deferred asset and written off in the current year instead of being treated as a prior year adjustment		

8) Budget Equipment Limited

a) Budget Equipment Limited - Company Income tax computation for the year 2014

	K'000	K'000
Profit after tax as per accounts		20,125
Add back:		
- Initial repairs on warehouse	1,250	
- Depreciation on fixed assets	3,125	
- Entertaining special customers	1,312	
- Entertaining potential customers	575	
- Tax charge in the profit and loss account	6,150	
	-----	12,412

		32,537
Less:		
- Decrease in general provision	247.50	
- Dividend received	1,300.00	
- Capital allowances	3,560.00	
	-----	-5,107.50

Taxable profits		27,430
		=====
Company tax payable (27,430 *35%)		9600.325
		=====

b) As for Mr. John Ferouk:

i) Criteria to determine whether an individual is liable to income tax in Zambia

- An individual is resident in Zambia for income tax if that individual is resident and is ordinarily resident in Zambia.
- An individual is resident in Zambia for income tax purposes for any tax year, if that individual is physically present in Zambia in that tax year for a period of at least 183 days.
- Ordinary residence has not been defined. However, individuals who normally live in Zambia are residents and ordinary resident in Zambia.
- Individual who come to Zambia with the intention of remaining here for more than 12 months are deemed to be resident and ordinary resident in Zambia; from the date of arriving in the country.
- It is usually considered that residence is not casual and uncertain, but the person held to reside does so in the ordinary course of his life

ii) Possible tax liability of Mr. Ferouk

- Based on the information available and the criteria referred to above, Mr. John Ferouk is liable to Zambian income tax.
- He is resident in Zambia and by virtue of the fact that he is employed by a Zambian company on a three year contract
- He seems to have intentions of remaining in Zambia for a period extending one tax year.
- As the income he is deriving has a Zambian source, that income is the income that will be chargeable to income tax in Zambia in addition to any income from outside Zambia that he may be entitled to.

iii) Double taxation relief

Double taxation relief (DTR) is given to eliminate the effects of double taxation in cases where income that has suffered tax in one country is also subjected to tax in another country. DTR is given in one of the following ways

- Treaty relief – This may provide full recovery of any foreign tax covered by the agreement
- Unilateral relief – To ensure that the amount of foreign tax available for credit does not exceed the Zambian tax on that foreign income
- Unilateral expense relief – Where applicable, only the amount of foreign income, net of foreign taxes paid is what may be subjected to tax in Zambia.

None of this applies to Mr. John Ferouk. The external emoluments are earned in Zambia and should be subjected to PAYE. What BEL has done is tantamount to tax evasion

