DIPLOMA IN ACCOUNTING PROGRAMME EXAMINATIONS

LEVEL TWO

DA 8: FINANCIAL REPORTING

MONDAY 11 DECEMBER 2017

TOTAL MARKS – 100; TIME ALLOWED: THREE (3) HOURS

INSTRUCTIONS TO CANDIDATES

1. You have fifteen (15) minutes reading time. Use it to study the examination paper carefully so that you understand what to do in each question. You will be told when to start writing.

2. This paper is divided into TWO sections:
   Section A: There are two (2) compulsory questions.
   Section B: There are three (3) questions. Attempt any two (2) questions.

3. Enter your student number and your National Registration Card number on the front of the answer booklet. Your name must **NOT** appear anywhere on your answer booklet.

4. Do **NOT** write in pencil (except for graphs and diagrams).

5. **Cell Phones** are **NOT** allowed in the Examination Room.

6. The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and depth of the answer.

7. All workings must be done in the answer booklet.

8. Present legible and tidy work.

9. Graph paper (if required) is provided at the end of the answer booklet.

SECTION A- TWO COMPULSORY QUESTIONS

Both Questions in this Section are compulsory and must be attempted.

QUESTION ONE:

The following Trial balance for Profed Co was extracted after preparing a draft Statement of profit or loss for the year ended 31 March 2016:

	K'000	K'000
Equity shares of K1 each	-	250,000
Retained earnings as at 1 April 2015	-	17,500
Profit before interest and tax for year ended 31 March 2016	-	150,000
6% convertible loan notes (note (1))	-	200,000
Leased property (original life 25 years) - at cost (note (2))	375,000	-
Plant and equipment – at cost (note (2))	360,500	-
Accumulated depreciation at 1 April 2015: Leased property	-	75,000
Plant and equipment	-	140,500
Trade receivables (note (3))	140,000	-
Other current assets	46,500	-
Current liabilities	-	88,500
Deferred tax (note (4))	-	16,000
Interest payment (note (1))	12,000	-
Current tax (note (4)	3,500	-
	937,500	**937,500**

The following information is also available:

1. Profed Co issued 2 million; K100, 6% convertible loan notes on 1 April 2015. Interest is payable annually in arrears on 31 March each year. The loans can be converted to equity shares on the basis of 20 shares for each K100 loan note on 31 March 2018 or redeemed at par for cash on the same date. An equivalent loan without the conversion rights would have required an interest rate of 8%.

2. Profed directors decided to revalue the leased property to K331.5 million on 1 October 2015. The company policy is **not to** make an annual transfer from the revaluation surplus to retained earnings to reflect the realisation of the revaluation gain; however, the revaluation will give rise to a deferred tax liability at the company's tax rate of 20%.

   The leased property is depreciated on a straight-line basis and plant and equipment is depreciated at a rate of 15% per annum using the reducing balance method. No depreciation has yet been charged on any non-current assets for the year ended 31 March 2016.

3. In September 2015, the directors of Profed Co discovered a fraud. In total, K3.5 million which had been included as receivables in the above trial balance had been stolen by an employee. Of this amount, K2.25 million related to the year ended 31 March 2015, with the rest relating to the current year. Profed directors are hopeful that 50% of the current year losses can be recovered from the company's insurers and on 31 March 2016, it was virtually certain the estimated amount would be recovered as Profed had received confirmation of the approval of the insurance claim they made prior to the reporting date.

4. A provision of K13.5 million is required for current income tax on the profit of the year to 31 March 2016. The balance on current tax in the trial balance is the under/over provision of tax for the previous year. In addition to the temporary differences relating to the information in note (2), at 31 March 2016, the carrying amounts of Profed Co.'s net assets are K60 million more than their tax base.

5. The present values of K1 receivable at the end of each year, based on discount rates of 6% and 8%, are:

		6%	8%
End of year	1	0·94	0·93
	2	0·89	0·86
	3	0·84	0·79

Required:

(a) Prepare a schedule of adjustments required to the draft Profit before interest and tax, in the above trial balance, to give the profit or loss of Profed Co for the year ended 31 March 2016 as a result of the information in notes (1) to (5) above. (5 marks)

(b) Prepare the Statement of financial position of Profed Co as at 31 March 2016. (15 marks)

Note: A Statement of changes in equity and the notes to the Statement of financial position are not required.

(c) The generally acceptable principle of accounting for Property, plant and equipment involves distinguishing between capital and revenue expenditure, measuring the cost of assets, determining how they should be depreciated and dealing with problems of subsequent measurement and subsequent expenditure.

IAS 16: Property, plant and equipment aims at improving consistency in these areas.

Required:

Explain how initial cost of property, plant and equipment should be measured in the financial statements of a reporting entity. (5 marks)

[Total: 25 Marks]

QUESTION TWO

Hugos, a listed company on the Lusaka stock exchange acquired 180,000 of the equity shares of Sugar, another listed company on the same stock market for cash of K377, 950 on 1 October 2016, when Sugar's retained earnings were K38,400. On the same date, Hugos acquired 30,000 of Apple's equity shares for K82, 000 when Apple's retained earnings were K124, 950. Hugos exercises significant influence over all aspects of Apple's operational and other decisions.

The statements of financial position of Hugos Company and its investee companies, Sugar and Apple as at 30 September 2017 are provided below:

	Hugos	Sugar	Apple
	'K'	'K'	'K'
Non-current assets			
Property, Plant and Equipment	251,950	287,950	206,350
Investments:			
180,000 ordinary shares in Sugar at cost	377,950		
30,000 ordinary shares in Apple	82,000		
Loan to Sugar	63,000		
Total non-current assets	774,900	287,950	206,350
Current assets			
Inventory	50,800	72,050	51,300
Trade receivables	157,000	66,000	59,700
Bank	6,300	18,000	17,900
Total current assets	214,100	156,050	128,900
Total assets	989,000	444,000	335,250
Equity and Liabilities			
Equity shares of K1 each	630,000	240,000	120,000
Retained earnings	132,500	78,000	144,000
Shareholders' funds	762,500	318,000	264,000
Non-current Liabilities			
Long term borrowings	163,500	63,000	59,000
Current liabilities			
Trade payables	63,000	63,000	12,250
Total equity and liabilities	989,000	444,000	335,250

Additional Information

(i) The fair value of Sugar's property, plant and equipment on 1 October 2016 exceeded its carrying amount by K6,500. This excess was attributed to buildings owned by Sugar, which at the date of acquisition had a remaining life of 20 years. Hugos depreciates buildings on straight line basis.

(ii) In addition, Hugos advanced a 10 year loan of K63,000 on 1 October 2016 to Sugar. At 30 September 2017, K270 loan interest was due on the loan but had not been paid. Both Hugos and Sugar had accrued the interest at the year end.

(iii) Hugos occasionally trades with Sugar. In September 2017, Hugos sold goods to Sugar for K24,000. Hugos uses a markup of 25% on cost on all its sales. On 30 September 2017, all goods in the sale were included in Sugar's closing inventory.

(iv) Prior to the sale in the year to 30 September 2017, Hugos has traded with Sugar and resulting receivable and payable balances are K50,000 receivable from Sugar and K36,000 payable to Hugos. These are included in the respective receivable and payable balances above.

(v) Sugar dispatched a cheque for K14,000 on 29 September 2017 to Hugos which did not arrive until 7 October 2017.

(v) Hugos values NCI using fair value method and the NCI fair value on the date of acquisition was K7, 000.

(vi) The Goodwill in Sugar is impaired by 10% and the investment in Apple is impaired by K1,250.

Required:
Prepare the consolidated statement of financial position for Hugo's group as at 30 September 2017.

[Total: 25 Marks]

SECTION B
There are THREE (3) questions in this section. Attempt any TWO (2) questions.

QUESTION THREE
Kindo is a Public listed manufacturing company. Its summarized financial statements are shown below:

Statements of financial position for Kindo as at:

	31 December 2016	31 December 2015
	K'000	K'000
Non-current assets		
Property, plant and equipment	45,000	45,150
Current assets		
Inventory	5,250	4,500
Trade account receivables	3,150	2,700
Cash and cash equivalents	930	450
Total current assets	9,330	7,650
Total assets	54,330	52,800
Equity and liabilities		
K0.50 ordinary shares	18,000	9,000
Share premium	7,500	3,000
Revaluation reserve	9,000	9,000
Retained earnings	5,103	3,000
Total shareholders' funds	39,603	24,000
Non-current liabilities		
Interest bearing loan note	7,200	21,000
Deferred tax	1,620	1,350
Total non-current liabilities	8,820	22,350
Current liabilities		
Trade and other payables	3,000	4,200
Current tax payable	2,727	2,250
Provision	180	-
Total current liabilities	5,907	6,450
Total equity and liabilities	54,330	52,800

You have also been provided with the statement of profit or loss for the year ended 31 December 2016 as follows:

	K'000
Revenue	48,000
Cost of sales	(30,000)
Gross profit	18,000
Administrative expenses	(6,000)
Distribution costs	(3,600)
Operating profit	8,400
Finance cost	(1,800)
Profit before tax	6,600
Income tax expense	(2,997)
Profit for the year	3,603

The following information is to be taken into account:

(i) On 31 March 2016, Kindo issued 4,000,000 bonus shares, followed by a rights issue, utilizing the share premium reserve for the bonus issue.

(ii) During the year, Kindo sold plant for K180, 000. At the date of sale, it had a carrying amount of K105,000. The profit on this sale has been included in operating profit for the year ended 31 December 2016.

(iii) The trade and other payables balance includes interest payable of K990,000 and K1,800,000 at 31 December 2016 and 31 December 2015 respectively.

(iv) Kindo repaid part of its interest bearing loan of K13,800,000 on 30 September 2016.

(v) Depreciation expense for the year amounts to K3,330,000. This has been included in cost of sales.

(vi) Kindo has been advised by its lawyers that it is probably going to lose a court case and has provided K180,000 for the estimated cost of the case. This is included in administration expenses.

Required:

(a) Prepare Kindo's statement of cash flows for the year ended 31 December, 2016 in accordance with **IAS 7 Statement of Cash Flows** using the indirect method. (16 marks)

The following details relate to operating activities:

(b) Prepare the operating activities up to the item cash generated from operations using the direct method given that:

Administrative expenses include:	K'000
Wages paid	4,500
General administrative expenses paid	2,120
Rent received	(455)
Profit on disposal	(75)
Provision	180
Other operating non cash income	(270)
	6,000
Other non-administrative expenses paid	5,700

(6 marks)

(c) Explain the importance of cash flow information compared to profit information.

(3 marks)

[Total: 25 marks]

QUESTION FOUR

Nkisu Plc is listed on the Lusaka Stock of Exchange and one of the conditions for listing is the company must comply with use of IFRSs in the preparation of its financial statements. The following transactions have arisen for Nkisu and you have been approached as a Financial Reporting consultant to advise on the accounting treatments. Nkisu has an accounting period ending 31 December each year.

Situation one

(i) On 1 January 2015, Nkisu issued a 7% loan note with a nominal value of K560,000 at a discount of 4%. Issue costs amounted to K2, 500.
The loan note will be redeemed on 31 December 2017 at par. Interest is paid annually in arrears and the effective interest rate is 9%.
(7 marks)

(ii) Additionally, Nkisu had convertible loan notes that on 1 January 2015 had been split as
follows:

	K'000
Liability component	313,588
Equity component	16,412
Total proceeds	330,000

The convertible loan note had 8% nominal interest and 10% effective interest rate.

Required:

Show the effect of the transactions (i) and (ii) above on the financial statements of Nkisu for the years ending 31 December 2015, 2016 and 2017. Explanation for the figures is required.

(7 marks)

Situation two

(i) On 1 January 2015, Nkisu owned a building that it acquired 5 years before, for K800,000. The building was then estimated to have a life of 20 years and has a carrying amount of K525,000 on 1 January 2015.This carrying amount is after revision for an impairment loss suffered after an impairment review on 31 December 2014 of K75,000.
On 31 December 2015, a professional valuer engaged by Nkisu's Board of Directors advised that the building had a fair value of K750,000 and hence revalued it to same amount. (5 marks)

(ii) As Nkisu has plans to expand to take account of business growth prospects, the company applied for government grant with a view to purchase non current assets for production and for the employment of 300 extra workers. 20% of the cost of plant of K200,000 was received as grant to finance the purchase. Plant is

depreciated at 15% reducing balance method.
The employment of 300 extra workers grant is premised on the fact that the workers will remain employed over the next three years. Assume this is highly probable. Nkisu's employment budget has been drafted and shows it will employ 100 workers in the year ended 31 December 2015; 150 in the following year and final 50 workers in the year to 31 December 2017.
A grant in connection with employee recruitment of K300,000 was received on 1 January 2015.
It is Nkisu's policy to account for grant related to income and assets using the deferred income method.

Required:
Explain the accounting treatment of the transactions (i) and (ii) for the year ending 31 December 2015, in accordance with the provisions of IAS 16 Property, plant and equipment and IAS 20 Accounting for government grants and disclosure of government assistance.

(6 marks)
[Total: 25 marks]

QUESTION FIVE

Public sector entities have different objectives, different operating environments and different other characteristics from those of private sector entities.

(a) Describe the contents of a complete set of financial statements as required by IPSAS 1 for a public sector entity. (3 marks)

(b) Explain the requirements of IPSAS 1 with regard to minimum line items to be presented:

- (i) On the face of the Statement of financial position, (5 marks)
- (ii) In the Statement of financial performance, (3 marks)
- (iii) In the analysis of revenue and of expenses and (3 marks)
- (iv) In the notes to the financial statements. (3 marks)

(c) Explain major differences between the financial statements of a public sector entity prepared in accordance with IPSAS 1 and the financial statements of a profit-making entity prepared in accordance with IAS 1. (8 marks)

[Total: 25 Marks]

END OF PAPER

DA 8: FINANCIAL REPORTING SOLUTIONS

SOLUTION ONE

(a) PROFED Co - Schedule of adjustments to profit for year ended 31 March 2016

		K'000
Draft Profit before interest and tax per trial balance		150,000
Adjusted for:		
Note (1)	Convertible loan note finance costs (w (i))	(15,117)
Note (2)	Amortisation of leased property (7,500 + 8,500 (w (ii)))	(16,000)
	Depreciation of plant and equipment (w (ii))	(33,000)
Note (3)	Current year loss on fraud (3,500 – 2,250 see below)	(625)
Note (4)	Income tax expense (13,500 + 3,500 – 4,000 (w (iii)))	(13,000)
Profit for the year		**72,258**

The K2.25 million fraud loss in the previous year is a prior period adjustment (reported in the statement of changes in equity). The current year loss of K1,250 (3,500 -2,250) is divided in two, i.e 50% receivable from insurers to be recognized as asset and the other 50% to be expensed, ie 625.

(b) PROFED Co - Statement of financial position as at 31 March 2016

	K'000	K'000
Assets		
Non-current assets		
Property, plant and equipment (323,000 + 187,000,400 (w (ii)))		510,000
Current assets		
Trade receivables (140,000 – 3,500 fraud)	136,500	
Other current assets per trial balance (46,500 +625)	47,125	183,625
Total assets		**693,625**
Equity and liabilities		
Equity		
Equity shares of K1 each		250,000
Other component of equity (w (i))	11,040	
Revaluation surplus (39,000 – 7,800 (w (ii)))	31,200	
Retained earnings (w (iv))	87,508	129,748
		379,748
Non-current liabilities		
Deferred tax (w (iii))	19,800	
6% convertible loan notes (w (i))	192,077	211,877
Current liabilities		
Per trial balance	88,500	
Current tax payable	13,500	102,000
Total equity and liabilities		**693,625**

(c) An explanation of how initial cost of PPE is measured by IAS 16

IAS 16 states that an acquired item of property which qualifies for recognition as an asset must initially be measured at cost. Cost comprises the following components:

(1) Purchase price, less any trade discounts or rebates, but not settlement discounts,
(2) Import duties and non-refundable purchase taxes,
(3) Directly attributable costs of bringing the asset to working condition for its intended use. These include the cost of site preparation, initial delivery and handling costs, installation costs and professional fees. Also included is the estimated cost of removing the asset and restoring the site, to the extent that it is recognised as a provision under IAS 37 Provisions, contingent liabilities and contingent assets.

Certain costs which will not normally be part of the cost of property, plant and equipment must instead be expensed. These are administration costs, start-up costs and initial operating losses.

In the case of self-constructed assets, the principles are the same as for acquired assets. This may include labour costs of the entity's own employees; while abnormal costs such as wastage and errors are excluded.

Workings (monetary figures in brackets are in K'000)

(i) 6% convertible loan notes

The convertible loan notes are a compound financial instrument having a debt and an equity component which must both be quantified and accounted for separately:

Year ended 31 March	Outflow	8%	Present value
	K'000		K'000
2016	12,000	0·93	11,160
20X7	12,000	0·86	10,320
20X8	212,000	0·79	167,480
Debt component			188,960
Equity component (balancing figure)			11,040
Proceeds of issue			200,000

The finance cost will be K15.115 million (188,960 x 8%) and carrying amount of the loan notes at 31 March 2016 will be K38.415 million (188,960 + (15,115 – 12,000)).

(ii) Non-current assets

Leased property

The gain on revaluation and carrying amount of the leased property is:

	K'000
Carrying amount at 1 April 2015 (375,000 – 75,000)	300,000
Amortisation upto revaluation (1 Oct 2015) (375,000/25 x 6/12)	(7,500)
Carrying amount at revaluation	292,500
Gain on revaluation (balancing figure)	39,000
Revaluation at 1 October 2015	331,500
Amortisation to 31 March 2016 (66,300/19·5 yrs x 6/12)	(8,500)
Carrying amount at 31 March 2016	323,000

Annual amortisation is K15 million (375,000/25 years); therefore accumulated amortisation at 1 April 2015 of K75 million represents five years' amortisation. At revaluation (1 Oct 2015), there will be a remaining life of 19·5 years. Of the revaluation gain, K31.2 million (80%) is credited to the revaluation surplus and K7.8 million (20%) is credited to deferred tax.

Plant and equipment

	K'000
Carrying amount at 1 April 2015 (360,500 – 140,500)	220,000
Depreciation for year to 31 March 2016 (15% reducing balance)	(33,000)
Carrying amount at 31 March 2016	187,000

(iii) Income tax

Provision required at 31 March 2016(current)		13,500
Revalued property and other assets (39,000 + 60,000) x 20%)	19,800	
Less Provision at 1 April 2015 (deferred)	(16,000)	
Add under provision b/f	3,500	
Less Revaluation of land and buildings (39,000 x 20%)	(7,800)	
to profit or loss	13,000)	

(iv) Retained earnings

Balance at 1 April 2015	17,500
Prior period adjustment (fraud)	(2,250)
Adjusted profit for year (from (a))	72,258
Balance at 31 March 2016	87,508

SOLUTION TWO

Hugos group

Consolidated Statement of financial position as at 30 September 2017

	'K'	'K'
Non current assets		
Property, Plant and Equipment (251,950 + 287,950 + 6,175)		546,075
Goodwill (W2)		90,045
Investments in Apple (W4)		85,513
Total non current assets		721,633
Current assets		
Inventories (50,800 + 72,050 – 4,800)		118,050
Receivables (157,000 + 66,000 – 14,000 – 36,000 - 270)		172,730
Bank (6,300 + 18,000 + 14,000)		38,300
Total current assets		329,080
Total assets		1,050,713
Equity and liabilities		
Share capital		630,000
Retained earnings (W5)		153,165
Non controlling interest (W6)		14,318
		797,483
Non current liabilities		
Long term borrowings		163,500
Current liabilities		
Trade and other payables (63,000 + 63,000 – 36,000 - 270)		89,730
Total equity and liabilities		1,050,713

WORKINGS

1. Hugos

Date acquired 1.10.16

180,000/240,000 = 75%

1.10.16

30,000/120,000 = 25%

Date acquired

Sugar

Apple

Therefore, Sugar is a subsidiary of Hugos and Apple is an associate of Hugos.

2. **Goodwill in Subsidiary**

Purchase consideration:		'K'
Cash		377,950
Fair value of NCI		7,000
		384,950
Less fair value of net assets acquired:		
Share capital	240,000	
Pre-acquisition retained earnings	38,400	
Fair value adjustment (W3)	6,500	(284,900)
Gross goodwill		100,050
Impairment loss		(10,005)
Net Goodwill		90,045

3. Fair value adjustment

	At acquisition	movement	At reporting
	'K'	'K'	'K'
Buildings	6,500	325	6,175

Additional depreciation:6,500/20years = 325.

4. Carrying amount of investment in Apple at 30 September 2017

	'K'
Cost of investment	82,000
Plus group share of Apple's post acquisition retained earnings (W5)	4,763
Less Impairement loss	(1,250)
Carrying amount of investment	85,513

5. Consolidated Retained Earnings

	Hugos		Sugar	Apple
	'K'		'K'	'K'
Per question	132,500		78,000	144,000
Less pre-acquisition R.E			(38,400)	(124,950)
Less additional depreciation			(325)	19,050
Less PUP	(4,800)		39,275	
Group share of Sugar:				
(75% x 39,275)	29,456			
Group share of Apple:				
(25% x 19050)		4,763		
Group share of Impairment loss:				
(75% x 10,005)	(7,504)			
Impairment of investment	(1,250)			
Group retained earnings	153,165			

6. Non controlling interest

	'K'
Fair value of NCI at acquisition	7,000
NCI share of post acquisition retained earnings (25% x 39,275)	9819
NCI share of impairment loss (25% x 10,005)	(2,501)
NCI at reporting	14,318

7. Unrealized profit

   Sales 24,000 x 25/125 = 4,800.

SOLUTION THREE

a) Kindo's statement of cash flows for the year ended 31 December 2016

		K'000
Cash flows from operating activities		
Profit before tax		6,600
Provisions		180
Depreciation expense		3,330
Interest expense		800
Less profit on disposal (w1)		(75)
Cash generated from operations before working capital		11,835
Adj. for working capital movements:		
Increase in inventory (5,250 – 4,500)		(750)
Increase in receivables (3,150 – 2,700)		(450)
Decrease in payables (2,400 – 2,010)		(390)
Cash generated from operations		10,245
Interest paid (w3)		(2,610)
Tax paid (w4)		(2,250)
Net cash inflow generated from operating activities		5,385
Cash flows from investing activities		
Cash paid to acquire PPE (w5)	(3,285)	
Proceeds from sale of PPE	180	
Net cash outflow on investing activities		(3,105)
Cash flows from financing activities		
Proceeds from share issue (w6)	13,500	
Loan note repaid	(13,800)	
Dividends paid (w7)	(1,500)	
Net cash outflow on financing activities		(1,800)
Net increase in cash and cash equivalents		480
Add cash and cash equivalents on 1 January 2016		450
Equals cash and cash equivalent at 31 December 2016		930

b) Kindo's statement of cash flows for the year ended 31 December 2016 – Direct method

	K'000
Cash received from customers (w8)	47,550
Cash paid to suppliers (w9)	(25,440)
Cash paid to employees	(4,500)
Other administrative costs	(2,120)
Rent received	455
other non administrative exp paid	(5,700)
Cash generated from operations	10,245

c) Importance of statement of cash flows compared to profit or loss include:

- It enables users assess debt and solvency
- It helps indicate problems early
- Cash flows are an objective means to assessing performance than profit
- It helps highlight where cash is being generated, whether from core activities or non core activities.
- It helps users assess financial adaptability, ie how able entity is to alter its cash flows in response to any unexpected events.
- It is also easier to audit cash flow information than profit information.

WORKINGS (all figures are in K'000) unless otherwise indicated.

1. Profit on disposal of plant

Proceeds from sale	180
Carrying amount	(105)
Profit on sale	75

2. Trade payables

Trade payables	2016	2015
Payables per SFP	3,000	4,200
Less interest payable	(990)	(1,800)
Trade payables	2,010	2,400

3. Interest paid:

Accrued interest b/f	1,800
Add profit and loss charge	1,800
Less accrued c/f	(990)
Interest paid	2,610

4. Tax paid

Deferred tax accrued b/f	1,350
Current tax accrued b/f	2,250
Add charge to profit or loss	2,997
Less deferred tax c/f	(1,620)
Less current tax c/f	(2,727
Tax paid	2,250

5. Cash paid to acquire PPE

PPE Carrying amount c/f	45,000
Plus CA of disposed PPE	105
Plus depreciation charge	3,330
Less CA of PPE b/f	(45,150)
Cash paid to acquire PPE	3,285

6. Proceeds from the issue of shares

	2016	2015
Share capital	18,000	9,000
Share premium	7,500	3,000
	25,500	12,000

Total difference 13,500 (25,500 – 12,000)
Value of bonus shares = K0.50 x 4,000,000 shares = K2,000
A K2,000 increased share capital and reduced share premium which must be added and subtracted to/from the difference of K13,500. Leaving us with net proceeds of K13,500.

7. Dividends paid

Retained earnings b/f	3,000
Plus profit for the year	3,603
Less retained earning c/f	(5,103)
Dividends paid	1,500

8. Cash received from customers:

Receivables b/f	2,700
Plus revenue	48,000
Less receivables c/f	(3,150)
Cash received	47,550

9. Cash paid to suppliers:

Payables b/f	2,400
Plus purchases (w10)	27,450
Less payables c/f	2,010
Cash paid	25,440

10. Purchases:

Closing inventory	5,250
Plus cost of sales	30,000
Less depreciation	3,300
Less opening inventory	4,500
= purchases	27,450

SOLUTION FOUR

i) Statement of profit or loss extract 'K' Statement of financial position

Year ending 31.12.15			
Interest expense	48,159	Financial liability	544,059
Year ending 31.12.16			
Interest expense	48,965	Financial liability	553,824
Year ending 31.12 17			
Interest expense	45,376	financial liability	--

ii) Statement of profit or loss extract 'K' Statement of financial position

Year ending 31.12.15			
Interest expense	31,359	financial liability	318,547
		Equity option	16,412
Year ending 31.12.16			
Interest expense	31,855	financial liability	324,002
		Equity option	16,412
Year ending 31.12.17			
Interest expense	32,402	financial liability	330,000
		Equity option	16,412

Workings

Situation one

i. Y/e 31 December 2015

Balance b/f[(96% x 560,000) – 2,500]	535,100
Interest expense (9% x 535,100)	48,159
Interest paid (7% x 560,000)	(39,200)
Balance b/f 1 January 2016	544,059
Year ending 31 December 2016:	
Interest expense (9% x 544,059)	48,965
Interest paid (7% x 560,000)	(39,200)
Balance b/f 1 January 2017	553,824
Year ending 31 December 2017	
Interest expense (9% x 553,824) bal fig.	45,376
Interest paid (7% x 560,000)	(39,200)
Balance c/f 31 December 2017	560,000

IFRS 9, financial instruments requires that if the bond is issued at a discount and there are issue costs, these be deducted to arrive at the net proceeds on which an effective interest rate is applied to ascertain the interest expense for the year, i.e 560,000 – 2,500 – [4% x 560,000] = 535,100.

However, the nominal rate used to calculate actual interest paid is applied on the face value of the debt in this case 39,200 [7% x 560,000]

ii.

Liability component b/f at 1 January 2015	313,588
interest expense at 10%	31,359
interest paid	(26,400)
liability at 31 December 2015	318,547
interest expense @ 10%	31,855
interest paid	(26,400)
liability at 31 December 2016	324,002
interest expense @ 10% (bal fig)	32,402
interest paid	(26,400)
liability at 31 December 2017.	330,000

Situation two

i) Statement of profit or loss extract for year ending 31 December 2015

Reversal of decrease of value (impairment)	75,000
Other comprehensive income:	
Revaluation surplus (260-750	185,000

Statement of financial position extract as at 31 December 2015

Non current assets	
Property, plant and equipment	750,000

Explanation of accounting treatment

Nkisu's building has been revalued upwards as at 31 December 2015, giving rise to revaluation surplus of K260,000. This however followed a previous revaluation decrease of K75,000 on 1 January 2015. According to IAS 16 Property, Plant and equipment, a revaluation surplus that follows a previous decrease must first go to reverse the decrease before being credited to reserve, that is, to the extent of the decrease, reverse. The double entry for the above will then be as follows:

Dr Non current asset	260,000
Cr profit and loss (reversal)	75,000
Cr revaluation surplus	185,000

ii) Profit and loss extract for years ending:

31 December 2015

Grant income (100 + 3)	103,000
Depreciation expense	(30,000)

For completeness sake, figures for the following two years would be as follows:

31 December 2016

Grant income (150 + 5.50)	155,500
Depreciation expense	(25,500)

31 December 2017

Grant income (50 + 4.718)	54,718
Depreciation expense	(21,675)

Statement of financial position extract as at:

31 December 2015

PPE (85% x200)	170,000
NCL deferred income (40,000- 8,550) + 50,000	81,450
CL deferred income (150,000 + 5,550)	155,550

Again, for completeness sake, the figures for the following two years would be as follows:

31 December 2016

PPE (85% x 170)	144,500
NCL deferred income(40,000- 12,668)	27,332
CL deferred income (4,718 + 50,000	54,718

31 December 2017

PPE (85% x 144,500)	122,825
NCL deferred income (40,000 – 16678)	23,322
CL deferred income	4,010

Explanation of accounting treatment

Asset related grant accounted for using deferred income method requires grant amount to be calculated using method of depreciation, in this case 15% reducing balance method. The grant to be allocated in year one to be prorated based on months in accounting period when grant acquired. As this was on 1 July 2015, amount of grant for year ending 31 December 20 15 is K3,000 [15% x 20% x 200,000] x 6/12. The grant balance at end of year one is therefore K37,000 divided between current and non current portions.

For income related grant, it needs to be allocated systematically based on the employment numbers each year. For example 100/300 employees x

K300,000 to be recognized in the first year while the balance get deferred.

Working (i)

Original cost at 1 January 2015	800,000
Accumulated dep'n. at 1 January 2015	
(800,000/20 years x 5 years)	(200,000)
Carrying amount at 1 January 2015	600,000
Impairment loss	(75,000)
Impaired value at 1 January 2015	525,000
Depreciation expense for the year to 31.12.15	
[525,000/15 years]	(35,000)
Carrying amount at 31.12.15	490,000
Revaluation surplus	260,000
Revalued amount	750,000

Working (ii)

Asset related grant

Grant amount on NCAs 20% x 200,000 = 40,000
Grant allocation:
Year ending 31 December 2015 – 15% x 40,000 = 6,000 x 6/12 = 3,000
Year ending 31 December 2016 – 15% x 34,000 = 5,100
Year ending 31 December 2017 – 15% x 28,900 = 4335
Year ending 31 December 2018 – 15% x 24,565 = 3,685

Income related grant

Year ending 31 December 2015: 100/300 x K300,000 = K100,000
Year ending 31 December 2016: 150/300 x K300,000 = K150,000
Year ending 31 December 2017: 50/300 x K300,000 = K50,000

SOLUTION FIVE

(a) A complete set of financial statements as required by IPSAS 1 consists of:

- A statement of financial position,
- A statement of financial performance,
- A statement of changes in net assets/equity,
- A cash flow statement,
- A comparison of budget and actual amounts (when the entity makes its approved budget publicly available) and
- Notes, including a summary of significant accounting policies

(b) IPSAS 1 requires the following minimum disclosure on the:

i. *face of the statement of financial position*:
- Property, plant and equipment
- Investment property
- Intangible assets
- Financial assets
- Investment accounted for using the equity method
- Inventories
- Recoverables from non-exchange transactions (taxes and transfers)
- Receivables from exchange transactions
- Cash and cash equivalents
- Taxes and transfers payable
- Payables under exchange transactions
- Provisions
- Financial liabilities
- Minority interest, presented within net assets/equity
- Net assets/equity attributable to owners of the controlling entity.

ii. *face of the statement of financial performance:*
- Revenue
- Finance costs
- Share of the surplus or deficit of associates and joint ventures accounted for using the equity method
- Pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to discontinuing operations
- Surplus or deficit

Additionally IPSAS 1 requires the following allocations of surplus or deficit to be disclosed on the face of the statement of financial performance:
- Surplus or deficit attributable to minority interest
- Surplus or deficit attributable to owners of the controlling entity.

iii. *IPSAS 1 requires an analysis of total revenue, classified in an appropriate manner, either on* the face of the statement of financial performance or in the notes.

IPSAS 1 requires an analysis of expenses based either on the nature of expenses or their function within the entity, whichever provides information that is reliable and more relevant. This analysis can either be presented on the face of the statement of financial performance or in the notes, but IPSAS 1 encourages entities to include this analysis on the face of the statement of financial performance.

If an entity choses to present expenses analysed by function, then IPSAS 1 requires additional disclosure on the nature of expenses, including depreciation, amortisation and employee benefits expenses. This is because information on the nature of expenses is useful in predicting future cash flows.

iv. *IPSAS 1 states that the notes should:*

- Provide information about the basis on which the financial statements were prepared and which specific accounting policies were used
- Disclose any information, not shown elsewhere in the financial statements, which is required by IPSASs
- Show any additional information that is relevant to understanding which is not shown elsewhere in the financial statements.

(b) A major difference between IPSAS 1 and IAS 1 is the requirement to include a comparison of budget and actual amounts in the financial statements where the entity makes its approved budget publicly available. This comparison can be presented either as a separate additional financial statement or as a budget column in the financial statements, or by disclosing that the budgeted amounts have not been exceeded, or, if there are any instances where this is not the case, adding a footnote to the financial statements.

Although IPSAS 1 allows for other formats for the statement of financial position (SOFP), the illustrative example given in IPSAS 1 arranges the statement so that assets less liabilities equal equity (capital). Under IAS 1 the SOFP is usually arranged as assets equal equity plus liabilities. The equity/net assets section of an SOFP prepared under IPSAS 1 is often different from that seen in the equity section of an SOFP prepared under IAS 1 due to the absence of share capital. Net assets/equity is made up of amounts contributed by other entities (for example, government grants) and amounts contributed by the public (for example, taxes), less amounts used to deliver services or to fulfill the entity's other objectives.

Another major difference of financial statements prepared under IPSAS 1 compared to IAS 1 is that the statement used to report on financial performance is known as the 'Statement of performance' which reports the surplus or deficit for the year, rather than as the 'Statement of profit or loss' as per IAS 1. This difference reflects the fact that the main aim of a public sector entity is to deliver services to the public rather than to make profits and generate a return on equity for investors.

Furthermore, a profit making entity’s income comes only or mainly from sales. A public sector entity’s revenue (income) may come from many different sources, and so IPSAS 1 requires an analysis of total revenue, either on the face of the statement of financial performance, or in the notes.

END OF SOLUTIONS

DIPLOMA IN ACCOUNTING PROGRAMME EXAMINATIONS

LEVEL TWO

DA 9: MANAGEMENT ACCOUNTING

TUESDAY 12 DECEMBER 2017

TOTAL MARKS – 100; TIME ALLOWED: THREE (3) HOURS

INSTRUCTIONS TO CANDIDATES

1. You have fifteen (15) minutes reading time. Use it to study the examination paper carefully so that you understand what to do in each question. You will be told when to start writing.

2. This paper is divided into TWO sections:
   Section A: There are two (2) compulsory questions.
   Section B: There are three (3) questions. Attempt any two (2) questions.

3. Enter your student number and your National Registration Card number on the front of the answer booklet. Your name must **NOT** appear anywhere on your answer booklet.

4. Do **NOT** write in pencil (except for graphs and diagrams).

5. **Cell Phones** are **NOT** allowed in the Examination Room.

6. The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and depth of the answer.

7. All workings must be done in the answer booklet.

8. Present legible and tidy work.

9. Graph paper (if required) is provided at the end of the answer booklet.

SECTION A-TWO COMPULSORY QUESTIONS

Attempt both questions in this section

QUESTION ONE

Yavuta, a premium food manufacturer, is reviewing operations for a three month period of 20X3. The company operates a standard marginal costing system and manufactures one product, ZP for which the following standard revenue and cost data per unit of product is available:

Selling price	K12.00
Direct material A	2.5kg at K1.70 per kg
Direct material B	1.5kg at K1.20 per kg
Direct labour	0.45hrs at K6.00 per hour

Fixed productions overheads for the three month period were expected to be K62, 500.

Actual data for the three-month period was as follows:

Sales and production	48,000 units of ZP were produced and sold for K580, 800
Direct material A	121, 951 kg were used at a cost of K200, 000
Direct material B	67,200kg were used at a cost of K84, 000
Direct labour	Employees worked for 18,900 hours, but 19,200 hours were paid at a cost at a cost of K117, 120
Fixed production overheads	K64, 000

Budgeted sales for the three-month were 50, 000 units of product ZP.

Required:

(a) Calculate the following variances.

(i) Sales volume contribution and sales prices variances

(ii) Price, mix and yield variances for each material

(iii) Labour rate, efficiency and idle time variances. (10 marks)

(b) Mention possible causes for each of the following variances.

(i) Material price, mix and yield variances for material A

(ii) Labour rate, labour efficiency and idle time variances.

(6 marks)

(c) Explain what is meant by basic standard and ideal standards and their effect on employee motivation (4 marks)

(d) Compare and contrast between financial accounts and management accounts.

(5 marks)

[Total 25 marks]

QUESTION TWO

(a) Mwaiseni Limited manufactures several products including product M. Each product uses same direct materials and same type of direct labour but in different quantities. The company currently uses a cost plus basis to determine the selling prices for its products based on full cost using an overhead absorption rate per direct labour hour.

The company's budgeted fixed production overhead for next year is K5,720,000.00.

Having attended a seminar on modern management accounting techniques and pricing strategies; the Managing Director is now concerned that the Company may be losing sales because of it's approach to setting prices. The Managing Director feels an Activity Based Costing would be more appropriate.

As the Company's Assistant Management Accountant, you have ascertained Mwaiseni Limited's budgeted fixed production overheads as follows:-

Activity	K	Cost driver	Cost driven quantity
Set-up costs	2,000,000	No. of setups	800
Inspection/quality control	1,200,000	No. of quality tests	400
Stores receiving	2,520,000	No. of purchase requisitions	1,800
	5,720,000		

Machines are reset after each batch. Quality tests are carried out after every second batch.

Budgeted data for product M for next year are:

Direct materials	K45.40 per unit
Direct labour	0.5 hours per unit @ K20 per hour
Batch size	150 units
Number of purchase requisitions	85
Budgeted production	15,000 units

Required:

Calculate the full cost per unit of product M using activity based costing and the selling price based on a 20% mark up. (10 marks)

(b) Management accounting systems form a key component of an organisation's Management Information System.

Required:

(i) Explain three (3) types of management decision levels and the type of management information it requires. (6 marks)

(ii) Discuss the relevance of feedback in a Management Accounting System. (9 marks)

[Total 25 marks]

SECTION B

There are THREE (3) questions in this section. Attempt any TWO (2) questions

QUESTION THREE

Twalumba specializes in the manufacture of solar panels. It is planning to introduce a new slimline solar panel specially designed for small houses. Development of the new panel is to begin shortly and Twalumba is in the process of determining the price of the panel. It expects the new product to have the following costs.

	Year 1	**Year 2**	**Year 3**	**Year 4**
Units manufactured and sold	2, 000	15, 000	20, 000	5, 000
R & D costs	K1,900,000	K100,000	-	-
Marketing costs	K100,000	K75,000	K50,000	K10,000
Production cost per unit	K500	K450	K400	K450
Customer service cost per unit	K50	K40	K40	K40

The Marketing Director believes that customers will be prepared to pay K500 for a solar panel but the Financial Director believes this will not cover all of the costs throughout the lifecycle.

Required:

(a) Calculate the cost per unit looking at the whole life cycle and comment on the suggested price by the Marketing Director. (10 marks)

(b) Explain any five (5) factors that influence the price of a product. (10 marks)

(c) Describe the following pricing strategies:

(i) Complementary product pricing

(ii) Psychology pricing

(iii) Price discrimination

(iv) Premium pricing

(v) Product line pricing (5 marks)

[Total: 25 Marks]

QUESTION FOUR

Bupilo Limited produces and sells two products A and B. The company is now in the process of preparing its budgets for the first quarter of 2018.

Sales forecasts:

Sales manager has just concluded the sales forecasts as follows:

A 35,000 units
B 56,000 units

It is expected that inventory of finished goods at 31 December, 2017 will be 5,000 units and 10,000 units for product A and B respectively. However, at the end of the first quarter of 2018, inventory of A will increase by 20% while that of B will reduce by 20%.

Past records show that 10% of total production for each product is defective and can neither be rectified nor sold.

The company uses two types of material; X and Y and two grades of labour, skilled and semi-skilled. The quantities required of each material and grade of labour to produce one unit of the finished product and purchase prices and labour rates are shown in the table below:

	X	Y	Skilled Labour	Semi-Skilled Labour
Product A	8Kg	4Kg	0.5 hours	0.8 hours
Product B	4Kg	3Kg	0.3 hours	0.4 hours
Purchase Price per Kg.	K1.25	K1.80		
Budgeted Opening Inventory	30,000Kg	20,000Kg		
Labour Rate per Hour			K20	K14

The company plans to hold inventory of raw materials at the end of the quarter of 8% of the quarter's material usage.

The budgeted productivity ratio for skilled and semi-skilled labour is 100% and 80% respectively.

Required:

(a) Prepare the following budgets for the first quarter of 2018

(i) Production budget (in Units) (4 marks)
(ii) Material usage budget (in Kg) (3 marks)
(iii) Material purchases budget (in Kg and K) (4 marks)
(iv) Labour budget (in Hours and K) (5 marks)

(b) Explain the importance of the human factor in the budgeting process. (9 marks)

[Total 25 marks]

QUESTION FIVE

The King Kong manufacture company makes an adapter for use on a range of heating equipment. Sales for 2017 were K4m, with each adapter being sold for K10. During the year, the firm operated at 80% of its maximum capacity and there are proposals being considered to enable the firm increase sales. Details of the cost structure are as follows:

Prime cost	**K4 per unit**
Variable overheads:	
Production	K40,000
Selling	K80,000
Distribution	K60,000
Fixed overhead:	
Production	K160,000
Selling	K90,000
Distribution	K40,000
Administration	K720,000

In addition to these costs, a commission of 5% on sales value is paid to agents who sell these products.

Required:

(a) Calculate the break-even point in sales revenue (3 marks)

(b) Prepare statements to show revenue, costs and profits at:

(i) The present level of sales (3 marks)

(ii) If the unit selling price is reduced by 5% which should increase sales volume by 12.5% (3 marks)

(iii) If the unit selling price is reduced by 10% which should increase sales volume by 25%. (3 marks)

(c) Comment on any problems that the firm might encounter if it operated at the level that gives the greatest profit.
(2 marks)

The following information is for Part (d) only

(d) The King Kong is deciding whether or not to proceed with a special order contract. This order contract will require the following:

(i) Materials P and Q will be used for the contract. 100 tonnes of material P will be needed and sufficient material is in inventory because the material is in common use in the company. The original cost of the material in inventory is K10 per tonne but it would cost K12 per tonne to replace if it is used for this contract. The material Q required is in inventory as a result of previous over purchasing. This material originally cost K5,000 but it has no other use. The material is toxic and if it is not used on this contract, then King Kong must pay K2,800 to have it disposed.

(iii) The contract requires 200 hours of labour at K50 per hour. Employees possessing the necessary skills are currently employed by the company but they are idle at present due to a lull (break) in the company's normal business.

(iv) Overhead will be absorbed by the contract at a rate of K100 per labour hour, which consists of K70 for fixed overhead and K30 for variable.

(v) The contract will require the use of a storage unit for three months. King Kong is committed to rent the unit for one year at a rental of K500 per month. The unit is not in use at present. A neighbouring business has recently approached King Kong offering to rent the unit from them for K700 per month.

(vi) Total fixed overheads are not expected to increase as a result of the contract.

Required:

Use the details above to determine the relevant cost of the order contract, including an explanation of the reason for including or excluding a cost in the relevant cost schedule (11 marks)

[Total 25 marks]

END OF PAPER

DA 9: MANAGEMENT ACCOUNTING SOLUTIONS

SOLUTION ONE

(a) Variances

Standard sales price		12.00
Material A	K1.70 x 2.5	4.25
Material B	K1.20 x 1.5	1.80
Labour	K6.00 x 0.45	2.70
Standard contribution		**3.25**

Sales volume contribution variance

Budgeted sales volume	50,000 units
Actual sales volume	48,000 units
Sales volume variance in units	2,000 units (A)
X standard contribution per unit (K3.25)	x3.25
Sales volume variance	K6, 500 (A)

Sales price variance

	K
Sales revenue for 48,000 units should have been (x K12)	576, 000
But was	580, 000
Selling price variance	4,800 (F)

Direct material price variances

	K
121,951 Kgs of (A) should have cost (x 1.70)	207, 317
But did cost	200,000
Material A price variance	7,317 (F)

	K
67,200 Kgs of (B) should have cost (K1.20)	80,640
But did cost	84,000
Materia B price variance	3,360(A)

Material mix variances

		Kg
Total quantity used (121,951 + 67,200) kg		189, 151
Standard mix for actual use	2.5/4 A	118,219
	1.5/4 B	70,932

Material	actual quantity Standard mix	actual quantity actual mix	variance	per kg	variance
	Kg	Kg	Kg	K	K
A	118,219	121,951	3,732(A)	1.70	6,344 (A)
B	70.932	67,200	3,732(F)	1.20	4,478 (F)
	189,151	189,151	-		1,866(A)

Material yield variances in total

		K
Each unit of product Yavuta requires	2.5kg of A costing	4.25
	1.5kg of B costing	1.80
	4.0 kg	6.05
189,151 kg should have yielded (÷ 4kg)		47,288 units
But did yield		48,000 units
Yield variance in units		712 units (F)
X standard cost per unit of output		x K6.05
Yield variance		K4, 308

For individual materials

Material	Quantity standard mix	actual standard mix	variance	standard per Kg	variance
	Kg	kg	kg	K	K
A	120,000	118,219	1,781(F)	1.70	3,028 (F)
B	72,000	70,932	1,068(F)	1.20	1,282 (F)
	192,000	189,151	2,849 (F)		4,310 (F)

Labour rate variances

	K
19,200 hours of work should have cost (K6 per hr)	115,200
But did cost	117,120
Labour rate variance	1,920 (A)

Labour efficiency variance

48,000 units of Yavuta should have taken (x0.45 hrs)	21,600 hrs
But did take	18,900 hrs
Efficiency variance in hours	2,700 hrs (F)
X standard rate per hour	x K6
Efficiency variance	K16,200 (F)

Idle time variance

18,900 hours were worked but 19,200 hours were paid for.
Idle time variance = 300 hours (A) x K6 = K 1,800 (A)

(b)

i) The favorable material A price variance shows that it cost less than standard. This could have been because of out of date standard, price changes by the supplier or perhaps a discount.

   The adverse mix variance shows that more was used as output than has been expected, maybe because it was cheaper.

   The favorable material A yield variance indicates that more output was produced than expected. This could be due to better operating processes or a superior workforce.

   It should be noted however that any explanations of the mix and yield variances for material A cannot really be discussed in isolation from those for material B.

ii) The adverse labour rate variance is because staff were paid more per hour than expected. This may have been because more skilled staff were employed, or there may have been a pay increase since the standard was developed

   The favorable labour efficiency variance shows that few hours were worked than was expected, maybe as employees benefited from a learning curve effect or additional training.

   The adverse idle time variance maybe due to process problems such as machine breakdowns.

(c)

An ideal standard is one which can be attained under perfect operating conditions: no wastage, no inefficiencies, no idle time and no breakdowns.

A basic standard is a long-term standard which remains unchanged over the years and is used to show trends.

Ideal standards can be seen as long-term targets but are not very useful for day-to-day control purposes as they cannot be achieved. It is claimed that they provide employees with an incentive to be more efficient. However, they may have an under favorable effect on employee motivation as variances will always be adverse.

Basic standards may have an under favorable effect on motivation as employees discover over time that they are easily able to achieve the standards.

(d)

i) Financial accounts are prepared for individuals external to an organization: shareholders, customers, suppliers, tax authorities, employees.

ii) Management accounts are prepared for internal of an organization.

Financial accounts	Management accounts
Financial accounts detail the performance of an organization over a defined period and the state of affairs at the end of that period	Management accounts aid management to record, plan, control the organization's activities and help the decision-making process
Limited liability company must, by law, prepare financial accounts	There is no legal requirement to prepare management accounts
The format of published financial accounts is determined by local law, by international Accounting Standards and International Financial Reporting Standards. In principle the accounts of different organizations can therefore be easily compared	The format of management accounts is entirely at management discretion: no strict rules govern the way they are prepared or presented. Each organization can devise its own management accounting system and format of reports
Financial accounts concentrate on the business as a whole, aggregating revenues and costs from different operations and are in an end in themselves	Management accounts can focus on specific areas of an organization's activities. Information may be produced to aid a decision rather than to be an end product of a decision
Most financial accounting information is of a monetary nature	Management accounts incorporate non-monetary measures. Management may need to know, for example tons of aluminum produced, monthly machine hours or miles travelled by salesmen
Financial accounts present an essentially historic picture of past operations	Managements accounts are both historical record and a future planning tool

SOLUTION TWO

(a) Cost Driver Rates

Set-up Costs:	K2,000,000 / 800 set-ups	=	K2,500/Set-up
Inspection/Quality Control:	K1,200,000 / 400 quality tests	=	K3,000/Quality test
Stores receiving:	K2,520,000 / 1,800 purchase requisition	=	K1,400/Purchase requisition

Cost Driver Quantities for Product M

Number of batches (15,000 units/150 units per batch) = 100 batches

Number of set-ups = 100 machines are set after each batch

Number of quality tests (100/2) = 50 tests quality tests are done on the second batch

Number of purchase requisitions = 85

Activity Based Cost

	K
D. material: K45.40 x 15,000 units	681,000
D. material: 0.5 hrs x 15,000 units x K20	150,000
Set-up costs: 100 set-ups x K2,500	250,000
Inspection/quality costs: 50 tests x K3,000	150,000
Store receiving: 85 requisitions x K1,400	119,000
Activity based cost	1,350,000
Total budgeted production	15,000 units
Activity based cost per unit	K 90
Profit markup $(\frac{20}{100} \times K90)$	K 18
Selling price	K108

(b) (i) **Tactical Level Decisions/Middle Management decisions**

These are budgeting decisions usually for a year. Information required include activity levels, input quantities and costs, output quantities and revenues, resource utilization and constraints.

Operational Level decisions /Short term decisions

Included here were price, output level, product mix, inventory levels and decisions to do with whether or not to accept special orders. Possible management information would be relevant costs, contributions from alternative courses of action and breakeven analysis.

Strategic Level decisions/Long term decision

These involve investment decisions and policy or strategic decisions. Both external and internal information would be necessary to assist in the target settings, investment appraisals and create models to test out the effect of alternative strategies.

M&E /Control decisions

They cover monitoring the performance of managers, products and departments. Standard costing and budgetary control systems need to be set. Divisional performance is highlighted using variance analysis

(ii) Feed back describes both the process of reporting back control information to management and the control information itself. It is the information produced from within the organization with the purpose of helping management and other employees with control decisions.

The following reasons explain the relevance of feedback in a management accounting system.

Control

Managers can only control their activities if there is feedback of actual results. Differences between planned and actual performance is highlighted in the feedback reports and corrective action taken if necessary. Stating out in the right direction calls for effective planning but control keeps the organization in the right direction. This requires regular feedback of actual results for comparison with plan.

Regular monitoring

If a system is not monitored regularly it may drift so far out of control that corrective action becomes difficult or impossible. Effective feedback operates as a continuous process so that managers can identify variances as soon as possible and take early corrective action.

Attention directing

Feedback can help management to concentrate their efforts in the most useful areas. By highlighting those activities which are not proceeding according to plan a feedback report can direct management's attention and avoid them wasting time on areas that are under control. This is known as management by exception.

Motivation

Feedback of information has been identified by management theorists as an essential component of an intrinsically motivating job, Individuals will not be motivated to achieve their performance targets if they are kept in ignorance of how well or badly they are performing.

SOLUTION THREE

a)

Pungwa Mukolwe

R&D cost 1,900 + 100	2,000
Marketing costs 100 + 75 + 50 + 10	235
Production 500 x 200 + 6,750 + 800 + 2,250	1,800
Customer service costs (50 x 2,000 +	1,700
Disposal of spec	300
	2223
Number of units	4,200
	529

Comment; The financial director is correct, the cost will be more than the selling price of K500

Advice; Ways of reducing the cost such as marketing, Pungwa Mukolwe etc.

b) **Factors influencing the price of a product**

i. Price perception; is the way customers react to prices.
ii. Quality; sometimes a price change might indicate improved quality.
iii. Intermediaries; when the organization sells goods to agents that later sell to the public. The agents might be charging customers their own prices.
iv. Competitors; before pricing a product, it is important to find out prices charged by other companies
v. Suppliers; if the organizations suppliers notices an increase in organization's product price, they might also want to increase their prices.
vi. Inflation; prices may need to be adjusted in situations where inflation is to increase.
vii. Product life cycle; this is when the product is at different stages which is growth, maturity, saturation and decline

    Prices are different at each stage e.g at growth stage it might be high compared to other stages

c) **Other pricing methods**

i. Market skimming; involves changing prices when a product is first handed and spending heavily on advertising and sales and sales promotion to obtain sales. The aim of market skimming is to gain high unit profits early in the product's life.

ii. Market penetration; a policy of low prices when the product is first launched to obtain sales volume and market share.
iii. Premium pricing; making a product appear different so as to justify a premium price it is different in terms of quality, reliability, durability.
iv. Price discrimination; when a company can sell into two or more separate markets, it might be able to charge a different price in each market.
v. Psychological pricing; timing of people's minds e.g pricing strategies include pricing a product at 1.99 instead of 20
vi. Product-line pricing; most organizations sell not just one product but a range. Focus is placed on the profit from the whole range rather than the profit on each single product.
vii. Complementary product pricing these products are sold separately but are used together. One product would tend to be priced competitively which attracts demand for complementary product.
viii. Special order; this is done using relevant costs.
ix. Loss leaders; particularly useful in retailing a very low price for one product which is intended to make consumers buy additional products in the range that carry higher profit profit.

SOLUTION FOUR

(a) (i) Production Budget (Units)

	A	B
Sales forecast	35,000	56,000
Closing Inventory (W1)	6,000	8,000
Opening Inventory	(5,000)	(10,000)
Good production units	36,000	54,000
Defective production (W2)	4,000	6,000
Production units	40,000	60,000

Workings:.

(1) Closing Inventory

Product A increases by $\left(\frac{20}{100} \times 5{,}000\right)$ = 1,000 units

Closing inventory of product A (5,000 + 1,000) = 6,000 units

Product B reduces by $(\frac{20}{100} \times 10{,}000)$ = 2,000 units

Closing inventory of product B (10,000 – 2,000) = 8,000 units

(2) Defective Production

Product A $(\frac{10}{90} \times 36{,}000)$ = 4,000 units

Product B $(\frac{10}{90} \times 54{,}000)$ = 6,000 units

(ii) Material Usage Budget (Kg)

	Material X		**Material Y**
Product A (8Kg x 40,000)	320,000	(4Kg x 40,000)	160,000
Product B (4Kg x 60,000)	240,000	(3Kg x 60,000)	180,000
	560,000		340,000

(iii) Material Purchases Budget

	Material X	Material Y
Usage (Kg)	560,000	340,000
Closing Inventory (Kg)	44,800	27,200
Opening Inventory (Kg)	(30,000)	(20,000)
Material Purchases (Kg)	574,800	347,200
Purchase Price per Kg (K)	1.25	1.80
Cost of Material Purchases	718,500	624,960

(iv) Labour Requirement Budget in Hours and Value

	Skilled Labour	Semi-Skilled Labour
Product A (40,000 @0.5:0.8 hrs)	20,000	32,000
Product A (60,000 @ 0.3:0.4 hrs)	18,000	24,000
Standard hours required	38,000	56,000
Productivity ratio (100%:80%)	-	14,000
Actual labour hours required	38,000	70,000
Labour rate per hour (K)	20.00	14.00
Cost of labour	760,000	980,000

(b) Budgeting is far more than just a mathematical technique as the process involves some human factor or behavioural aspects. Some of the notable behavioural aspects of budgeting are:

(i) Motivation
(ii) Participation
(iii) Performance evaluation
(iv) Feedback
(v) Budget slack
(vi) Politics

Motivation

Budgets should by achievable but challenging and achievement of them recognized. This would motivate managers to work towards the organizational goals resulting in goal congruence.

Participation

Participation in the budgeting process improves motivation resulting in improved quality of budget decisions and individual efforts to achieve their budget targets.

Performance Evaluation

Information about how actual results are progressing and how they compare with target is a critical course of motivation. A budgeting system will never succeed if individuals are kept in dark about their performance.

Feed Back

Negative feedback should be constructively presented as much as possible to achieve positive action. It should also be given to the individual responsible for the budget in question in order to encourage appropriate remedial action.

Budgetary Slack

When managers set budgets, there is a temptation to set them at low level to make them easy to achieve possibly to increase chances of bonuses. Unintentional errors may also be included in the budget. This disadvantages managers or departments who have not built slack into their budgets.

A more comparatively strict attitude by the budget committee when finally budgets are approved such as cutting all budgets submitted by some percentage.

Secondly and possibly, the more accurate solution is to ensure that input information is as specific as possible so as to identify slack immediately and that flexibility is built into the system to enable budgets reset when slack is identified.

Politics

Political elements exists in all organizations. It is particularly evident during the budgeting process. Managers with 'power' will ably negotiate a higher than necessary budget level for their department.

QUESTION FIVE

Part (a)
The sales volume is 400,000 units (K4m divided by K10m per unit).
Because it is easier to work per unit first of all, calculate a unit cost which will be:

	K	
Prime cost	4.00	
Variable overhead	0.45	(calculated as K180,000 divided by 400,000 units)
Commission	0.50	
Total variable cost	4.95	
Selling price	10.00	
Unit contribution	5.05	

The fixed costs are K1,010,000 so divide this by K5.05 to give a break-even quantity of 20,000 units of K200,000.

Part (b)

	Present		increased by 12.5%		increased by 25%	
Volume	400,000		450,000		500,000	
Selling price	K10		K9.50		K9	
	K	K	K	K	K	K
Total Revenue	400,000		4,275,000		4,500,000	
Prime Cost	1,600,000		1,800,000		2,000,000	
Variable Overhead	180,000		202,500		225,000	
Commission	200,000		213,750		225,000	
Total Variable Cost	1,980,000		2,216,250		2,450,000	
Contribution	2,020,000		2,058,750		2,050,000	
Fixed Cost		1,010,000		1,010,000		1,010,000
Profit		1,010,000		1,048,750		1,040,000

Clearly we can see that the middle column is the volume and selling price that gives the best profit reward to the company.

(c)
Before accepting this reduction in the selling price to K9.50 the firm will need to consider what moves may be made by competitors. It also needs to be very sure of its costs because an increase in revenue brings with it a relatively small increase in profits. It also means that the company is operating at 90% of its full capacity.

Part (d)
(a) The relevant cost of a material that is used regularly is its replacement cost. Additional inventory of the material will need to be purchased for use in this contract. The relevant cost of material P is therefore K1.20 per tonne.
Material Q has a'negative'cost if used for the contract. That is, there is a relevant saving made from not having to pay the disposal cost of K280.
(b) The relevant cost of labour is zero. The labour cost is being paid anyway and no extra cost will be incurred as a result of this contract.
(c) The fixed overhead is not relevant because we are told that fixed overheads are not expected to increase. The relevant variable overhead cost is: K 3 per hour x 200 hours = K 600.
Even if you are not specifically told that fixed overheads will remain unaltered, it is usual to

assume that they will not increase, stating the assumption clearly.
(d) The rental cost of K 50 per month is not relevant because it will not be affected by the contract. The relevant cost of using the storage unit is the forgone rental income of K 70 per month.

Summary of relevant costs

	K
(i) Material P	120
Material Q	(280)
(ii) Labour	–
(iii) Variable overhead	600
(iv) Rent forgone	210
Total relevant cost	**650**

END OF SOLUTIONS

DIPLOMA IN ACCOUNTING PROGRAMME EXAMINATIONS

LEVEL TWO

DA: 10 TAXATION

THURSDAY 14 DECEMBER 2017

TOTAL MARKS – 100; TIME ALLOWED: THREE (3) HOURS

INSTRUCTIONS TO CANDIDATES

1. You have fifteen (15) minutes reading time. Use it to study the examination paper carefully so that you understand what to do in each question. You will be told when to start writing.

2. This paper is divided into TWO sections:
   Section A: There are two (2) compulsory questions.
   Section B: There are three (3) questions. Attempt any two (2) questions.

3. Enter your student number and your National Registration Card number on the front of the answer booklet. Your name must **NOT** appear anywhere on your answer booklet.

4. Do **NOT** write in pencil (except for graphs and diagrams).

5. **Cell Phones** are **NOT** allowed in the Examination Room.

6. The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and depth of the answer.

7. All workings must be done in the answer booklet.

8. Present legible and tidy work.

9. Graph paper (if required) is provided at the end of the answer booklet.

Taxation Table

Income Tax

Standard personal income tax rates

Income band	Taxable amount	Rate
K1 to K39,600	first K39,600	0%
K39,601 to 49,200	next K9,600	25%
K49,201 to K74,400	next K25,200	30%
Over K74,400		37.5%

Income from farming for individuals

K1 to K39,600	first K39,600	0%
Over K39,600		10%

Company Income Tax rates

On income from manufacturing and other	35%
On income from farming	10%

Mineral Royalty

Mineral Royalty on Copper

Range of Norm Price	Mineral Royalty Rate
Less than US$4,500	4% of norm value
From US$4,500 to less than US$6,000	5% of norm value
From US$6,000 and above	6% of norm value

Mineral Royalty on other minerals

Type of mineral	Mineral Royalty Rate
Base Metals (Other than Copper)	5% on norm value
Energy and Industrial Minerals	5% on gross value
Gemstones	6% on gross value
Precious Metals	6% on norm value

Capital Allowances

Implements, plant and machinery and commercial vehicles:		
Wear and Tear Allowance –	Plant used normally	25%
	Used in Manufacturing and Leasing	50%
	Used in farming and agro-processing	100%
Non- commercial vehicles		
Wear and Tear Allowance		20%
Industrial Buildings:		
Wear and Tear Allowance		5%
Initial Allowance		10%
Investment Allowance		10%
Low Cost Housing	**(Cost up to K20,000)**	
Wear and Tear Allowance		10%
Initial Allowance		10%
Commercial Buildings		
Wear and Tear Allowance		2%
Farming Allowances		
Development Allowance		10%

Farm Works Allowance	100%
Farm Improvement Allowance	100%

Presumptive Taxes

Turnover Tax

Monthly turnover	**Turnover Tax per month**
K1to K4,200	3% of monthly turnover above K3,000
K4,200.01to K8,300	K225 per month+3% of monthly turnover above K4,200
K8,300.01 to K12,500	K400 per month+3% of monthly turnover above K8,300
K12,500.01 to K16,500	K575 per month+3% of monthly turnover above K12,500
K16,500.01 to K20,800	K800 per month+3% of monthly turnover above K16,500
Above K20,800	K1,025 per month+3% monthly of turnover above K20,800

Annual turnover	**Turnover Tax per annum**
K1to K50,400	3% of annual turnover above K36,000
K50,400.01to K99,600	K2,700 per annum+3% of annual turnover above K50,400
K99,600.01 to K150,000	K4,800 per annum +3% of annual turnover above K99,600
K150,000.01 to K198,000	K6,900 per annum+3% of annual turnover above K150,000
K198,000.01 to K249,600	K9,600 per annum+3% of annual turnover above K198,000
Above K249,600	K12,300 per annum +3% of annual of turnover above K249,600

Presumptive Tax for Transporters

Seating capacity	Tax per annum K	Tax per day K
From 64 passengers and over	7,200	19.70
From 50 to 63 passengers	6,000	16.40
From 36 to 49 passengers	4,800	13.00
From 22 to 35 passengers	3,600	10.00
From 18 to 21 passengers	2,400	6.60
From 12 to 17 passengers	1,200	3.30
Less than 12 passengers and taxis	600	1.60

Property Transfer Tax

Rate of Tax on Realised Value of Land, Land and Buildings and shares	5%

Value Added Tax

Registration threshold	K800,000
Standard Value Added Tax Rate (on VAT exclusive turnover)	16%

Customs and Excise

Duty rates on:

1. Motor cars and other motor vehicles (including station wagons) principally designed for the transport of less than ten persons, including the driver:

Customs Duty:

Percentage of Value for Duty Purposes	30%
Minimum Specific Customs Duty	K6,000

Excise Duty:

Percentage of Value for Duty Purposes for Excise Duty Purposes

Cylinder capacity of 1500 cc and less	20%

	Cylinder Capacity of more than 1500 cc	30%
2.	**Pick-ups and trucks/lorries with gross weight not exceeding 20 tones:**	
	Customs Duty	
	Percentage of Value for Duty Purposes	15%
	Minimum specific Customs Duty	K6,000
	Excise Duty:	
	Percentage of Value for Duty Purposes for Excise Duty Purposes	10%
3.	**Buses/coaches for the transport of more than ten persons**	
	Customs Duty:	
	Percentage of Value for Duty Purposes	15%
	Minimum Specific Customs Duty	K6,000
	Excise Duty:	
	Percentage of Value for Duty Purposes for Excise Duty Purposes	
	Seating Capacity of 16 persons and less	25%
	Seating Capacity of 16 persons and more	0%
4.	**Trucks/lorries with gross weight exceeding 20 tonnes**	
	Customs Duty:	
	Percentage of Value for Duty Purposes	15%
	Excise Duty:	
	Percentage of Value for Duty Purposes for Excise Duty Purposes	0%
5.	**Surtax**	
	On all motor vehicles aged more than five (5) years from year of manufacture	K2,000

SECTION A-TWO COMPULSORY QUESTIONS

Attempt BOTH questions in this section

QUESTION ONE

Alex, who had been employed by Kasafu Ltd since 2000, was retrenched on 31 May 2017. Alex was entitled to an annual salary of K271,200, housing allowance of 20% of basic salary and transport allowance of 10% of basic salary. The company had always paid Alex a monthly medical insurance premium allowance of K950. On retrenchment, Alex received a pension of K570,000, repatriation pay of K33,000 and leave pay amounting to K27,050.

Alex has always contributed NAPSA at 5% of his basic salary. The pay as you earn deducted from his salary for the tax year 2017 amounted to K77,186. He also paid trade union contributions of K400, professional subscription of K5,280 and School fees for his children amounting to K12,360.

Alex received the following investment income during the tax year 2017:

	K
Dividends from Munushi mining company	4,200
Dividends from Bongwe plc, a LuSE listed manufacturing company	23,250
Dividends from Chifinsa Ltd	21,250
Interest on Government bonds	12,750
Rent from letting of property	40,500
Royalties	51,000
Interest from bank deposit account	2,700

The above amounts of investment income represent the actual amounts received by Alex.

Upon being retrenched, Alex commenced a business on 1 June 2017 using his terminal benefits, and prepared his first accounts for seven (7) months to 31 December 2017 reporting a profit of K280,700 from a turnover of more than K800,000. The net profit was arrived at after deducting the following expenses:

(i) Wages and salaries amounting to K70,000 which included Alex's nominal salary of K20,000

(ii) Professional fees amounting to K120,000 consisting of K52,400 for accountancy services, K50,000 for trade debt collection and K17,600 for computation of income tax on his retrenchment package.

(iii) Motor car running expenses amounting to K12,000 in respect of his private motor car which is used 70% for business purposes. The motor car was acquired on 10 June 2017.

(iv) General expenses of K180,000. This amount includes K10,200 for a fine in respect of breach of safety regulations, K6,700 donation to a political party, K22,250 depreciation of non-current assets, K110,000 for shop repairs and K30,850 advertising expenses.

(v) Property expenses amounting to K15,000. He lives in a flat situated above the shop, and it has been agreed with the Commissioner General that one-third of these expenses relate to the flat.

Other information

(i) During the period to 31 December 2017, he took goods costing K3,000 out of the business for personal use without paying for them, and no entry has been made in the books to record this. He charges a mark-up of 20% on cost of sales.

(ii) Capital allowances on Alex's assets including the motor car in note (iii) above have been calculated as K67,800.

(iii) Provisional income tax paid amounted to K65,123.

Required:

(a) Calculate the total withholding tax paid by Alex for the tax year 2017. You should clearly show the amount of withholding tax paid on each type of investment income. (6 marks)

(b) Calculate the taxable business profit for the tax year 2017. (6 marks)

(c) Calculate the income tax payable by Alex for the tax year 2017. (13 marks)

[Total: 25 Marks]

<u>QUESTION TWO</u>

(a) Katanga plc is a Zambian resident company engaged in manufacturing. Katanga plc is registered for Value Added Tax. In the tax year 2012, when the company listed its shares on the Lusaka Stock Exchange, it issued over 35% of its shares to indigenous Zambians and has since then, over 35% of the shares have continued being held by indigenous Zambians who will continue holding the shares for the foreseeable future.

The company prepares its accounts to 31 December every year. In the financial year ended 31 December 2017, the company made a Profit after tax of K1,200,000.

The following are the expenses and income included in the above profit figure for the year:

(i) On 1 January 2017, the company sold a Toyota Hilux van which was acquired in 2015 at a cost of K70,000 (VAT exclusive) making a profit on disposal of K20,000. The income tax value on that date was K35,000 while the disposal proceeds were K55,000 (VAT exclusive).

On the same date the company sold an Isuzu Van (single cab) which was also acquired in 2015 at a cost of K80,000 (VAT exclusive) making a loss of K25,000. The income tax value was K40,000 while the disposal proceeds were K15,000 (VAT exclusive).

(ii) The income tax expense charged in the statement of profit or loss, which is also the amount of provisional income tax paid in the tax year 2017, amounted to K250,000.

(iii) The depreciation on non-current assets charged in the statement of profit or loss for the year was K125,000.

(iv) The salaries and wages amounted to K1,900,000. Included in this figure are the emoluments of the two (2) directors who were accommodated in company owned houses, which were acquired in 2011 at a cost of K680,000 in total. The emoluments for each director is K264,000. The rest of the salaries and wages related to all other employees.

(v) The bad debts for the year amounted to K45,000 which included a decrease in general provision during the year amounting to K12,000.

(vi) The legal expenses for the year included legal cost relating to the issue of shares amounting to K4,800 and legal costs relating to the acquisition of land amounting to K1,500.

(vii) Expenses incurred in entertaining customers and suppliers on the official opening of the newly constructed building amounted to K49,600.

(viii) The motor vehicle running expenses amounted to K86,000.

(ix) In the year ended 31st December 2017 the company received debenture interest of K34,000 (gross), bank interest of K17,000 (net) and dividends from a non-mining company of K22,500 (gross).These were the only investment incomes received in the tax year 2017.

Additional information:

(i) In the year ended 31 December 2017, the company acquired two (2) Toyota Prado cars each with a cylinder capacity of 2900cc, at a cost of K90,000 (VAT inclusive) each. These cars are used on personal to holder basis by the directors.

(ii) During the current financial year, the company also acquired a Mitsubishi Light truck at a cost of K145,000 (VAT inclusive) and a Fuso Fighter truck at a cost of K174,000 (VAT inclusive).

(iii) During the year ended 31 December 2017, the company constructed a building which was brought into use on 1 November 2017. The cost was made up of:

	K
Land	180,000
Administration offices	320,000
Factory	900,000
Showroom	980,000
Total cost	2,380,000

Required:

(a) Calculate the maximum capital allowances claimable on implements plant and machinery and the buildings for Katanga plc for the tax year 2017. (12 marks)

(b) Calculate the tax adjusted business profit for Katanga plc for the tax year 2017. (9 marks)

(c) Calculate the income tax payable by Katanga plc for the tax year 2017. (4 marks)

[Total: 25 marks]

SECTION B
There are THREE (3) in this section. Attempt any TWO (2) questions.

QUESTION THREE

(a) Sue, an upcoming young Entrepreneur established and registered a company known as Hejonata Ltd on 1 January 2017 dealing with food and health care.
Her budget for the year ended 31 December 2017 showed that the turnover for the year would be K644,000.

The turnover was broken into K30,500 per month for the first two months, K48,000 per month for the next three months, K55,000 per month for the next four months and K73,000 per month for the last three months of the year.

Required:

Calculate the turnover tax payable by Hejonata Ltd for tax year 2017. (4 marks)

(b) Mabvuto imported a four seater saloon car with a cylinder capacity of 980cc from Japan at a cost of $350.This car was 12 years old from the date of its first Manufacture. He paid insurance charges of $100 and transportation costs of $1,100. Both the insurance charges and the transportation costs cover the saloon car up to Livingstone border post. Once cleared, the registration cost for the car in Lusaka has been estimated at K250, and the comprehensive insurance charge has been estimated at K800.
The car reached Livingstone border post on 22 January 2017 and all the import taxes were paid. The Commissioner General had advised that for the period from 16 January 2017 to 30 January 2017, the exchange rate to be used was K9.80 per dollar. However, the Kwacha depreciated around 22 January 2017 and on that date, the exchange rate quoted in one of the Bureau De Changes was K10.10 per dollar.

Required:

(i) Calculate the Customs Value (Value for Duty Purposes) of the saloon car. (2 marks)

(ii) Calculate the total amount of import taxes paid, including the surtax, at Livingstone border post on the saloon car. (5 marks)

(c) Sable Limited is a Value Added Tax registered company that has provided the following information in respect of the month ended 30th September 2017:

1. Sales invoices totaling K75,000 were issued to customers in respect of standard rated sales. The company offers its customers a discount of 6% for prompt payment, and all the customers take up this discount. Exempt sales for the month were K25,000. Sales returns on standard rated sales were K2,000
2. The company received an advance deposit of K15,000 in respect of a contract that was due for completion in November 2017. The contract has a total value of K60,000. Both of these figures are VAT exclusive.
3. The standard rated purchases were K50,000 and the purchase returns amounted to K8,000.
4. Standard rated expenses amounted to K24,200 (VAT inclusive). Included in this figure is a sum of K4,000 (VAT inclusive) incurred on entertaining customers. All the standard rated expenses are deductible for VAT purposes where appropriate.
5. The company wrote off a bad debt amounting to K10,000 on 30 September 2017. The bad debt arose from two invoices of K5,000 each in respect of which payment was due in June 2015 and in December 2016.

6. The company bought a motor car at a cost of K40,000 (VAT inclusive). The company bought diesel for use in the car during the month of September 2017. The total cost of the diesel was K1,588 (VAT Inclusive).
7. Input Value Added Tax that was attributed to neither the taxable nor the exempt supplies was K1,850.
8. All the above figures are VAT exclusive unless stated otherwise.

Required:
Calculate the amount of VAT payable by Sable Limited for the month of September 2017. (11 marks)

(d) Sable Ltd paid the VAT due for September 2017 on the 25th of October 2017.
(i) Calculate the penalty payable. (1 mark)
(ii) Calculate the interest on the overdue VAT assuming that the Bank of Zambia discount rate is 14% per annum. (1 mark)

(iii) If sable Ltd submitted the VAT return for the month of September nine (9) days after the due date, state the penalty due.
(1 mark)
[Total: 25 marks]

QUESTION FOUR

(a) Income from farming and fishing may be averaged if the farmer has made the irrevocable election to average the income. A farmer may claim a farm improvement allowance in respect of qualifying capital expenditure incurred in any tax year.

Required:

(i) Explain the circumstances under which a farmer may be allowed to make the irrevocable election to average income from farming and fishing. (3 marks)

(ii) Explain the basis of claiming the farm improvement allowance in respect of farm dwellings. (2 marks)

(b) MNT Ltd is a company engaged in farming activities and for the year ended 31 October 2017 the company had the following statement of profit or loss:

	K	K
Livestock sales		1,116, 800
Produce sales		1,043,200
Poultry sales		745, 200
Dividends from HGT Ltd		30,500
		2,935,700
Expenses were:		
Livestock	132,000	
Salaries and wages	110,000	
Seed	114, 900	
Fertilizer	110, 450	
Depreciation	82 ,850	
Diesel	23,000	
Repairs and maintenance	43, 250	
Petrol	47, 200	
Entertaining customers	61,500	

Insurance	127,200	
Loan to former employee written off	81,800	
General farming expenses	106,200	
		1,040,350
Net profit		1,895,150

Notes:

(1) The company listed its shares on the Lusaka stock exchange in the tax year 2017 and also issued 25% of its shares to indigenous Zambians.

(2) Included in general farm expenses are the following amounts:

	K
Subscription to the national farmers union	4,000
Subscription to farming journals	6,000
Donation of farm produce to unapproved institutions	55,000
Accountancy and Audit fees	8,000
Other tax allowable expenses	33,200
	106,200

(3) The company had farming losses brought forward of K90,000.

(4) The company received investment income, which has not been included in the statement of profit or loss shown above, comprising of Royalties of K68,000 (gross), Treasury Bill interest of K17,000 (net), Rent amounting to K25,000 (net) and bank interest of K25,500 (gross).

(5) At 1 January 2017, the income tax values of implements plant and machinery were zero. The company incurred the following expenditure in the tax year 2017:
Construction of five (5) houses for farm workers at a cost of K22,000 each.
Purchase of farming implements at a total cost of K50,000.
Purchase of fencing material at a total cost of K60,900.
Sinking of four (4) boreholes at a total cost of K90,000.
Purchase of three (3) seed- drills at a total cost of K150,400.
Purchase of two (2) combine harvesters at a total cost of K585,000.

(6) The company paid provisional income tax of K70,000 for the tax year 2017.

Required:

(i) Calculate the total capital allowances the company will claim for tax year 2017. (7 marks)

(ii) Calculate the tax adjusted farming profit for the company for year ended 31 December 2017. (5 marks)

(iii) Calculate the tax payable by the company for tax year 2017. (8 marks)

[Total: 25 marks]

QUESTION FIVE

(a) Professional code of ethics for the accountancy profession is designed to guide the individual behavior of professional accountants.

Required:

(i) Explain the importance of the code of ethics to tax and financial consultants. (2 marks)

(ii) Briefly explain the meaning of Integrity, Objectivity and Professional competence and due care as fundamental principles as outlined in the code of ethics. (6 marks)

(iii) Explain the meaning of tax avoidance, and what the Government can do in order to discourage its practice. (3 marks)

(b) Maputo and Kaputo are in partnership running a farming business, sharing profits and losses in the ratio 2:1 after allowing for annual partnership salaries of K60,000 and K72,000 respectively. An extract from the statement of profit or loss showed a farming profit of K720,000 for the year ended 31 December 2017. This profit is after all the necessary adjustments but before capital allowances.

The only assets owned by the business are two (2) motor cars which were acquired on 3 July 2017 at a cost of K140,000 each, an irrigation equipment which was acquired on 22 August 2017 at a cost of K180,000, and a Light truck which was acquired two (2) years ago at a cost of K250,000. The motor cars are used by Maputo and Kaputo for both business and private purposes. It has been agreed with the Commissioner General that the business use in each motor car is 70% in the tax year 2017.

Neither Maputo nor Kaputo has any other income apart from their farming profits.

Required:

Calculate the income tax payable by Maputo and Kaputo for the tax year 2017. (14 marks)

[Total: 25 marks]

END OF PAPER

D10: TAXATION SOLUTIONS
SOLUTION ONE

(a) ALEX

WITHHOLDING TAX FOR THE TAX YEAR 2017

	K
Dividends from Munushi mining company	0
Dividends from Bongwe plc- a manufacturing company	0
Dividends from Chifinsa ltd: K21,250 x 15/85	3,750
Interest on Governemnt bonds: K12,750 x 15/85	2,250
Rent from letting of property: K40,500 x 10/90	4,500
Royalties: K51,000 x 15/85	9,000
Interest from bank deposit account	0
Total withholding tax	19,500

(b) ALEX

TAX ADJUSTED BUSINESS PROFIT FOR THE TAX YEAR 2017

	K	K
Net profit as per accounts		280,700
Add:		
Alex's nominal salary	20,000	
Computation of tax on retrenchment package	17,600	
Motor car expenses: K12,000 x 30%	3,600	
Fine for breach of safety regulations	10,200	
Donation to political party	6,700	
Depreciation	22,250	
Property expenses: K15,000 x 1/3	5,000	
Goods drawn for personal use: K3,000 x 120%	3,600	
		88,950
		369,650
Less: Capital allowances		(67,800)
Adjusted business profit		301,850

(c) ALEX

INCOME TAX PAYABLE FOR THE TAX YEAR 2017

	K	K
Business profits		301,850
Salary: K271,200 x 5/12		113,000
Housing allowance: K113,000 x 20%		22,600
Transport allowance: K113,000 x 10%		11,300
Medical insurance premium: K950 x 5		4,750
Leave pay		27,050
		480,550
Investment income		
Royalties: K51,000 x 100/85		60,000
		540,550

Less:		
NAPSA (K113,000 x 5%)- restricted	3,060	
Professional subscription	5,280	
		(8,340)
Taxable income		532,210

Computation

Amount	Tax rate%	Tax
39,600	0	Nil
9,600	25	2,400
25,200	30	7,560
457,810	37.5	171,679
532,210		181,639
Less:		
PAYE		(77,186)
Provisional income tax paid		(65,123)
WHT- Royalties K60,000 x 15%		(9,000)
Income tax payable		30,330

SOLUTION TWO

(a) KATANGA PLC

COMPUTATION OF CAPITAL ALLOWANCES FOR THE TAX YEAR 2017

	Cost/ITV	CAP ALL.
Toyota Hilux van	K	K
ITV b/f	35,000	
Disposal proceeds	(55,000)	
Balancing charge		(20,000)
Isuzu van		
ITV b/f	40,000	
Disposal proceeds	(15,000)	
Balancing allowance		25,000
Toyota Prado 1		
Cost	90,000	
Wear &tear@20%	18,000	18,000
ITV c/f	72,000	
Toyota Prado 2		
Cost	90,000	
Wear&tear@20%	18,000	18,000
ITV c/f	72,000	
Mitsubishi Light truck		
Cost (145,000x 25/29)	125,000	
W & T @25%	31,250	31,250
ITV c/f	93,750	

Fuso Fighter truck		
Cost (174,000 x 25/29)	150,000	
W & T @25%	37,500	37,500
ITV c/f	112,500	
Factory		
Cost	900,000	
Initial allowance @10%	(90,000)	90,000
Investment allowance @10%		90,000
Wear &tear allowance @5%	(45,000)	45,000
ITV c/f	765,000	
Show room		
Cost	980,000	
Wear&tear @2%	19,600	19,600
ITV c/f	960,400	
Administration offices		
Cost	320,000	
Wear&tear @2%	(6,400)	6,400
ITV c/f	313,600	
Total capital allowances		360,750

Qualifying expenditure of the buildings

	K
Total cost	2,380,000
Less cost of land	(180,000)
	2,200,000

10 % x K2,200, 000 = K220,000

The cost of the showroom and the administrative offices exceed the above amount and will therefore not be classified as industrial buildings. Only the cost of the factory qualifies as an industrial building.

(b) KATANGA PLC

COMPUTATION OF ADJUSTED BUSINESS PROFITS FOR THE TAX YEAR 2017

	K	K
Profit after tax		1,200,000
Add		
Loss on disposal	25,000	
Income tax expense	250,000	
Depreciation	125,000	
Accommodation benefit		
(K264,000 x 2 x 30%)	158,400	
Legal expenses-land	1,500	
-shares	4,800	
Entertaining customers &suppliers	49,600	
Presonal to holder Car benefit		
(2 x K40,000)	80,000	
		694,300
		1,894,300

Less		
Profit on disposal	20,000	
Decrease in general provision	12,000	
Dividends received	22,500	
Debenture interest received	34,000	
Bank interest received	17,000	
Capital allowances (a)	360,750	
		(466,250)
Tax adjusted business profit		**1,428,050**

(iii) KATANGA PLC

COMPUTATION OF INCOME TAX PAYABLE FOR THE TAX YEAR 2017

		K	K
Tax adjusted business profit			1,428,050
Add			
Gross debenture interest rec	34,000		
Gross bank interest (17000 x 100/85)		20,000	54,000
Total taxable income			1,482,050
Income tax liability			
35%-5%=30%x1,552,050			444,615
LESS			
Provisional income tax paid		250,000	
WHT debenture interest (34,000 x15%)		5,100	
WHT bank interest (20,000 x 15%)		3,000	
			(258,100)
FINAL INCOME TAX PAYABLE			186,515

SOLUTION THREE

(a) HEJONATA LTD

COMPUTATION OF TURNOVER TAX FOR THE TAX YEAR 2017

	K	**K**
First two months @ K30,500 per month		
Fixed turnover tax for 20800	1,025	
Add extra turnover tax		
(30,500 - 20,800) x 3%	291	
Total per month	1,316	
Total for two months is: (1,316 x 2)		2,632
Next 3 months@K48,000 per month		
Fixed turnover tax for 20,800	1,025	
Add excess turnover		
(48,000-20800) x 3%	816	
Total per month	1,841	
Total for three months: (3 x 1,841)		5,523
Next 4 months @K55,000 per month		
Fixed turnover tax for 20,800	1,025	
Add excess turnover		
(55,000-20800)x3%	1,026	
Total per month	2,051	
Total for four months: (4 x 2,051)		8,204

Last three (3) months @K73,000		
Fixed turnover tax for K20,800	1,025	
Add excess turnover tax		
(73,000-20,800) x 3%	1,566	
Total per month	2,591	
Total for last three months: (2,591 x 3)		7,773
TOTAL TURNOVER TAX FOR THE YEAR		18,950

(b) CUSTOMS AND EXCISE

(i) MABVUTO COMPUTATION OF VALUE FOR DUTY PURPOSE AND IMPORT DUTIES FOR IMPORTED CAR IN JANUARY 2017

	VDP IN $	
Cost	350	-
Insurance	100	-
Freight	1,100	
VDP in $	1,550	
Exchange rate	K9.80	
VDP in K	15,190	

(ii) IMPORT DUTIES

	K	
Customs duty (K15,190 x 30%)= K4557 the minimum will be paid	6000	
Excise duty (15,190 + 6,000) x 20%		4,238
Import VAT (15,190 + 6,000 + 4,238) x 16%	4,068	
Add surtax	2,000	
TOTAL IMPORT DUTIES INCLUDING SURCHARGE		16,306

(c) (i) SABLE LTD

COMPUTATION OF VAT PAYABLE OR REFUND FOR THE MONTH OF SEPTEMBER 2017

	K	K
OUTPUT VAT		
Standard-rated sales (K75,000 x 94% x 16%)		11,280
Less sales returns (K2,000 x 16%)		(320)
Sales on deposits (K15,000 x 16%)		2,400
		13,360
INPUT VAT		
Standard rated purchases		
(K50,000 x 16%)	8,000	
Less purchase returns		
(K8,000 x 16%)	(1280)	
Standard rated expenses		
(K24,200 - K4,000) x 4/29	2,786	
Bad debt relief (K5,000 x 16%)	800	
Diesel (K1,588 x 4/29 x 90%)	197	
Non attributable vat		
K1,850 x K75,000/K100,000	1,388	
		11,891
VAT PAYABLE		1,469

(ii) (1)_ The penalty for late payment of VAT due is :
K1,469 x 0.5% x 9 days = K66.11

(2) The interest on the overdue VAT payable is :
14%+ 2%= 16%
16% x 9/365 x K1,469 = K5.80

(3) The penalty for late submission of VAT return is:
2000 penalty units (K600) per day i.e K600 x 9 = K5,400.

SOLUTION FOUR

(a) (i) A farmer can be only allowed to average the profits for two (2) consecutive tax Years if:

(i) There is a loss in one year, and a profit in another consecutive year, and
(ii) The profit for one year is substantially lower than the profit for the other consecutive tax year.

(ii) Farm improvement allowance

A farm improvement allowance is given on the cost of farm improvements which are all permanent works including a farm dwelling and fencing appropriate to farming and any building constructed for and used for the welfare of employees in relation to farming land owned or occupied by the farmer claiming that allowance for ascertaining their profit.

(b) (i) MNT LTD
COMPUTATION OF FARM CAPITAL ALLOWANCES FOR TAX YEAR ENDED 2017

	K	K
Farm implements plant and machinery		
Farming implement	50,000	
Seed drills	150,400	
Combine harvesters	585,000	
Allowance at 100%		785,400
Farm Improvements		
Workers houses (K20,000 x 5)	100,000	
Farm fencing	60,900	
Allowance at 100%		160,900
Farm Works		
Boreholes	90,000	
Allowance at 100%		90,000
Total capital allowances		1,036,300

(b) (ii) MNT LTD
COMPUTATION OF TAX ADJUSTED FARMING PROFIT FOR THE YEAR ENDED 31ST DECEMBER 2017.

	K	K
Net profit as per farm accounts		1,895,150
Add back		
Depreciation	82,850	
Entertaining customers	61,500	
Loans to former employee	81,800	
Donations	55,000	
		281,150

		2,176,300
Less		
Capital allowances	1,036,300	
Dividend from HGT LTD	30,500	
		1,066,800
Tax Adjusted farming profit		1,109,500
Total marks obtainable is		

(b) (iii) MNT LTD

COMPUTATION OF INCOME TAX PAYABLE FOR TAX YEAR 2017

	Non farming income	farming income
	K	K
Adjusted farming profit	-	1,109,500
Less farm loss b/f	-	(90,000)
		1,019,500
Investment incomes		
Gross royalties	68,000	-
Gross bank interest	25,500	-
Gross treasury bills (17,000x100/85)	20,000	-
Total assessable incomes	113,500	1,019,500
Income tax liability		
Non farming income		
35%-2%=33% x 113,500		37,455
Farming income		
10%-2%=8%x 1,019,500	-	81,560
Income tax liability		119,015
LESS		
WHT royalties (K68,000 x 15%)	10,200	
Wht T.bills (K20,000 x 15%)	3,000	
WHT Bank interest (K25,500 x 15%)	3,825	
Provisional income tax paid	70,000	
		(87,025)
Final income tax payable		31,990

SOLUTION FIVE

(a) (i) The professional ethics are very important guidelines for the following reasons:

Professional Accountants, Professional Auditors, Tax Consultants are a group of people who are always in contact with different stakeholders in the society .they are therefore responsible and accountable to them in their daily conduct of business .They act in public interest and are there to solve a wide range of problems. Different stake holders usually rely on reports produced by this group of professionals.

The public interest is considered to be the collective wellbeing of the community of people and institutions the professional tax consultant serves, who rely on their work.

(a) (ii) The following are the fundamental principles that govern the ethical code of conduct expected of professional tax consultants and financial consultants:

Integrity

The principle of honesty and integrity impose an obligation on the practitioner to ensure straightforwardness, fair dealing, a commitment not to mislead or deceive and truthfulness.

This means that a member providing tax services shall ensure that their own personal tax obligations and those of any associated entities for which the member is responsible are properly discharged.

Objectivity

Members shall not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

Members shall be impartial and not allow prejudice or bias, conflict of interest or the influence of others to override their objective judgment in relation to tax matters

Professional competence and due care

This means that members engaged in providing tax services shall maintain professional competence and take due care in the performance of their work.

To achieve this, members shall remain continuously aware of developments in the tax profession and tax legislation to ensure that they have the requisite knowledge related to such developments, including an awareness of relevant national pronouncements and other relevant statutory requirements and regulations.

(iii) Tax avoidance can be defined as acting within the law, sometimes at the hedge of legality, to minimize, eliminate or defer tax that would otherwise be legally owed, by taking advantage of the loopholes or weakness and mismatches in the tax law to minimize or defer tax liabilities thereby obtaining a tax advantage that was not intended by the tax legislation.

Tax avoidance is legal and not an offence, but it defeats the intention or purpose of the law and, therefore, to discourage its practice, the government may issue anti-avoidance tax legislation.

(a) MAPUTO AND KAPUTO
INCOME TAX PAYABLE FOR THE TAX YEAR 2017

	K	K
Adjusted farming profit before capital allowances		720,000
Less:		
Capital allowances:		
Motor cars: K140,000 x 2 x 20% x 70%	39,200	
Irrigation equipment: K180,000 x 100%	180,000	
Light truck: K250,000 x 25%	62,500	
		(281,700)
Taxable profit		438,300

	TOTAL **K**	**MAPUTO** **K**	**KAPUTO** **K**
Salaries	132,000	60,000	72,000
Balance 2:1	306,300	204,200	102,100
Total	438,300	264,200	174,100
Computation			
First K39,600 @0%		0	0
Balance: K224,600 @10%		22,460	
K134,500 @10%			13,450 ½
Income tax payable		22,460	13,450 2

END OF SOLUTIONS

DIPLOMA IN ACCOUNTING PROGRAMME EXAMINATIONS

LEVEL TWO

DA 11: PRINCIPLES OF AUDITING

THURSDAY 14 DECEMBER 2017

TOTAL MARKS – 100; TIME ALLOWED: THREE (3) HOURS

INSTRUCTIONS TO CANDIDATES

1. You have fifteen (15) minutes reading time. Use it to study the examination paper carefully so that you understand what to do in each question. You will be told when to start writing.

2. This paper is divided into TWO sections:
   Section A: There are two (2) compulsory questions.
   Section B: There are three (3) questions. Attempt any two (2) questions.

3. Enter your student number and your National Registration Card number on the front of the answer booklet. Your name must **NOT** appear anywhere on your answer booklet.

4. Do **NOT** write in pencil (except for graphs and diagrams).

5. **Cell Phones** are **NOT** allowed in the Examination Room.

6. The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and depth of the answer.

7. All workings must be done in the answer booklet.

8. Present legible and tidy work.

9. Graph paper (if required) is provided at the end of the answer booklet.

SECTION A-TWO COMPULSORY QUESTIONS

Attempt **BOTH** questions in this section.

<u>QUESTION ONE</u>

(a) External auditors design audit procedures in order to obtain evidence to test whether the financial statement assertions made by management hold true.

Required:

Explain the meaning of financial statement assertions and give an example under each category. (3 marks)

(b) Your firm of Chartered Accountants is the auditor of High Tech Electronics Limited. High Tech Electronics Limited imports and sells a wide range of electronic equipment including cellular phone handsets, computers and accessories.

The company has enjoyed a monopoly over the years and has recorded high sales and profitability. Over the last few years, the company has experienced a rapid increase in new high tech equipment coming onto the market resulting in most of the items having a short life span. As a result, the company sells any items considered obsolete at huge discounts.

In an effort to reduce losses as a result of large discounts, Hi Tech Electronics Limited has adopted a policy of giving extended credit to individuals as long as they can prove that they are in gainful employment and show this by presenting a recent pay slip. Due to high staff turnover, the company has experienced problems in following up individual credit customers especially those employed in the private sector.

In order to support the importation of new lines of products, High Tech Electronics Limited has borrowed $300 000.00 from its bankers and as one of the loan conditions the company has given the building hosting its offices as collateral.

The government has relaxed laws relating to import and exercise duties on imported electronic equipment. This has seen a rapid increase in members of the public and corporate customers importing electronic equipment from sources such as e Bay and Amazon.

At the end of each financial year, the Chief Accountant makes an estimate of the debt that may not be collected and this is the figure that is accrued for as allowance for receivables.

You have been assigned to lead a team of auditors to identify the risks of material misstatement inherent in High Tech Electronics in line with the provisions of ISA 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment.*

Required:

(i) Explain THREE (3) methods that can be used in identifying the risk of material misstatement of High Tech Electronics Limited.

(6 marks)

(ii) Identify and explain the audit risks in High Tech Electronics Limited. (10 marks)

(iii) Explain why accounting estimates in the financial statements of a client are a risky area for the auditor and give FOUR (4) examples of accounting estimates. (6 marks)

[Total: 25 Marks]

QUESTION TWO

Clearbase Limited is a computer games company. All administrative processes are conducted at its Head Office. However, all other functions are sited at four other locations in order to ensure optimum cost efficiency of the research and production functions in terms of staff, facilities, travel, etc. All locations are networked together with a server placed at each location to enable fast direct communication and data transfer. Access to all files on the head office server is permitted by each of the other locations, although it is the responsibility of the site manager to restrict this access as he considers appropriate.

All staff are paid on a salary basis. There is currently ten staff at the Head Office with five at each of the locations. The payroll is managed at Head Office who relies on monthly input from each of the site managers.

All employees have to submit a timesheet at the end of each month showing hours worked during the month. If they have worked less than the minimum of Thirty hours then a reason for this has to be given by the employee and approved by the site manager. If such absence was not supported by a valid reason, then the appropriate deduction is made from the salary. The timesheet should also record sicknesses, holidays or other approved absences. At the end of each month, the site manager had to complete a summary form detailing any sicknesses, holidays or other absences. All absences must be supported by a form explaining reasons and authorised by the manager. All sicknesses must be supported by a doctor's certificate if appropriate. The site Manager is also responsible for recruitment of new staff, and informs the Office Manager of all such instances so that the personnel records can be updated. Recruitment of new staff should only take place following authorisation from the Managing Director who is located at Head Office. All monthly input to the Head of Office is via email from each of the site Managers and from the individual employees.

The Managing Director of Clearbase Limited had attended a stakeholders meeting organized by ZICA to sensitive them on the need for companies to have an external auditor for the sake of transparency and accountability. However, some of the stakeholders felt that there was no need to have independent auditors while others were against the abolishment of audits especially for small companies such as Clearbase Limited. Furthermore, some of the shareholders expressed their concern over the high rate of staff turnover and replacements. This caused a lot of changes to the payroll. The company also failed to comply with the minimum wages Act. Previous inspectors had raised a query on the same issue and warned management of punitive measures for non-compliance. Clearbase Limited is equally in huge debt.

The previous year's working papers were disposed of. The engagement partner explained the importance of safe custody and the duration of keeping working papers. During the audit of the payroll, the engagement partner had reminded all involved audit staff to observe professional ethics. The major challenge was the disclosure of certain details on the payroll to unauthorized persons. Furthermore, it came to the attention of the engagement partner that some of the audit staff had obtained oral evidence regarding a payroll query over suspected fraud.

Some of the members on the audit team were not sure of how they could apply certain audit concepts regarding reporting in accordance with the revised ISA 706 emphasis and other matter paragraphs. The problem related to circumstances which gave rise to the two paragraphs (emphasis of matter and other paragraphs) in the auditor's report.

You are an audit senior working for Rolfe, a small firm of Chartered Accountants on the audit of Clearbase Limited and have been asked by the Audit Manager to complete the audit of salaries. Management has also indicated that they could also engage your firm in an attestation engagement as well as direct reporting engagements. You have one junior auditor assisting you with the audit testing.

Required:

(a) Explain the following concepts in relation to the audit of Clearbase Limited.

   (i) Accountability (2 marks)

   (ii) Stewardship (2 marks)

(b) Explain the directors' responsibility with regards to internal controls in the payroll of Clearbase Limited. (6 marks)

(c) Describe the procedures necessary for safe custody and retention of working papers. (5 marks)

(d) Identify FIVE weaknesses in the internal controls in relation to payroll in Clearbase Limited (5 marks)

(e) Distinguish between the roles of internal and external auditors regarding Clearbase Limited. (5 marks)

[Total: 25 marks]

SECTION B

There are THREE (3) questions in this section. Attempt any TWO (2) questions.

QUESTION THREE

You have recently been promoted as Training Manager in your firm of Chartered Accountants. You are planning for training of newly recruited audit managers and audit seniors. The main focus of the training is to deal with matters concerned with the rights of the auditor and professional ethics.

The following information relates to one of your firm's recently acquired audit clients. Your firm has been providing accounting services to this client for the past three years. It is a family owned company whose shares are absolutely owned by the family. The company has experienced rapid growth and decision has been made to list the shares on a recognized stock exchange and the requirement now is that its financial statements must be audited by external auditors.

One of the Firm's audit managers, Harry, was in charge of the provision of accounting services to this client. He has wide experience in the operations of the company. At its first annual general meeting, the company voted that your firm becomes the first statutory auditors and have also demanded that Harry should be assigned as engagement partner on this audit. The client believes that this will save costs in terms of audit fees.

The client has suggested that being the first year of audit; your firm continues to prepare the financial statements while the company looks for a qualified accountant to become financial controller. To this effect, the company has asked your firm to recruit a suitably qualified accountant to fill the position. The Managing Director has stated that the company does not have a human resources department capable of recruiting qualified staff.

In view of the fact that the family will no longer hold a majority of the shares, they have arranged a number of events to mark the end of their control over the company. Among the events that have been lined up is a trip to the Lower Zambezi Game park and they have invited their major customers as well as all members of the audit team who were involved in the provision of accounting services.

Management of this client has suggested that the audit fee should be based on the profit that the company will make. Further, the current Managing Director has indicated that there will be selective disclosure of information to the audit team until such time that new management is put in place.

Among the resources that you wish to use in the training is the Company's Act of 1994 and the Accountants Act of 2008. You are preparing the notes to be used in the forthcoming training and these should cover the information in the requirement.

Required:

(a) (i) Explain the rights of the auditor as detailed in the Companies Act of 1994 s 173. (4 marks)

(iii) Explain the regulation of auditors in Zambia and state Four (4) matters that are considered important in the regulation of auditors. (4 marks)

(b) (i) Explain the fundamental principle of confidentiality and explain exceptions if any. (9 marks)

(ii) Identify and explain the ethical matters in the new client and state the safeguards that must be put in place by your firm. (8 marks)

[Total: 25 Marks]

QUESTION FOUR

(a) Explain what is meant by statistical sampling. (3 marks)

(b) You are the Audit Senior responsible for the audit of Mateo Enterprises Limited, a company that runs a chain of retail stores. You are aware that ISA 500 *Audit evidence* requires auditors to design and perform audit procedures that are appropriate in the circumstances for the purposes of obtaining sufficient audit evidence. Audit evidence can be obtained by inspection, observation, inquiry and confirmation, re-calculation, re-performance and analytical procedures.

Your firm, Serge Accountants, generally uses statistical sampling when carrying out audit tests to collect sufficient appropriate audit evidence. During the audit of non-current assets, a sample with a total value K1, 000,000 was selected statistically from a population having a total value of K10, 000,000. Misstatements valued at K1, 000 were discovered during the audit test. The Audit Manager has instructed you to project the misstatements.

Required:

(i) Explain any TWO (2) methods of sample selection apart from random selection. (4 marks)

(ii) Briefly explain the importance of projecting misstatements, and use the figures given in the scenario to project the misstatements as instructed by the Audit Manager. (6 marks)

(b) Explain any SIX (6) audit procedures used for gathering audit evidence, giving any appropriate example for each technique. (12 marks)

[Total: 25 Marks]

QUESTION FIVE

(a) Identify and explain any SIX (6) elements of a standard audit report (unmodified auditor's report) as outlined in ISA 700 *Forming an Opinion and Reporting on Financial Statements*. (9 marks)

(b) Charles and Francis are in partnership operating a chain of small retail outlets. The audit for the year ended 31 March 2017 is nearing completion. You are the Audit Manager and the following additional matters have come to your attention:

1. One of the payables balance is materially misstated according to a statement obtained from the supplier. However, Charles and Francis have provided satisfactory evidence that the difference is due to cash in transit. The Audit Senior is proposing that an adverse opinion should be given.

2. Land and buildings represent a substantial portion of the financial statements. However, the valuation is materially misstated and Charles and Francis have refused to make the necessary adjustment. The Audit Senior is proposing that a disclaimer of opinion should be given.

3. An immaterial misstatement in the balance for inventory has been identified. This has been communicated to the Chief Accountant but no adjustment has been made. The Audit Senior is proposing that an unmodified opinion should be given.

Required:

(i) State four (4) advantages of having partnership accounts audited. (4 marks)

(ii) Explain, with reasons, whether the Audit Senior's proposals in the above matters are correct, and suggest appropriate opinions where necessary. (12 marks)

[Total: 25 Marks]

END OF PAPER

DA 11: PRINCIPLES OF AUDITING SOLUTIONS

SOLUTION ONE

a) Meaning of financial statement assertions:

Financial statement assertions are representations embodied in the financial statements. Management is making claims concerning the figures in the financial statements.

Financial statement assertions are in three categories as follows:

Assertions about classes of transactions – these relate to transactions contained in the income statements.

An example of an assertion about classes of transactions is accuracy implying that the figures contained are accurate and not materially misstated.

Assertions about account balances – these assertions relate to the balances in the statement of financial position.

For example the assertion of existence relating to tangible non-current assets implying that the non-asset concerned does exist at the period end.

Assertions about disclosure – these relate to the disclosures in the financial statements which form part of the financial statements.

For example, the assertion of completeness relating to the accounting policies in relation to depreciation of Non-current assets in the financial statements

b) High Tech Limited

i. Methods that can be used to gain an understanding of High Tech Limited:

There are various methods that an auditor can use in gaining an understanding of a client company such as High Tech Limited with a view to identify and assess the risks in the company.
ISA 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment, sets* out the methods that the auditor shall use

Examples of such methods include:

Inquiry of management and other staff:

The auditors will enquire about a company and its operations from various people within the organization. These will include the staff, management and those charged with governance.

Analytical procedures:

Analytical procedures are useful at the planning stage of the audit particularly in gaining an understanding of a client company.

This largely involves an evaluation of financial information through analysis of plausible relationships amongst both financial and non-financial data and making conclusions as appropriate. Analytical procedures also involve the computation of ratios and analyzing them.

Observation and inspection:

This involves the auditor observing the operations of the company and also reading through materials contained in say the operations manual and involves meeting staff.

Other sources that can be included:

- The client permanent audit file contains a lot of important information about a client.
- The audit file for the previous financial period will also have a lot of useful information that is useful in the planning of future audits.
- Where the client has a website there is a lot of information that auditors can get through browsing the client website.
- Industry information that is available either on a website or agency which compiles industry information.

ii. The risks of audit risks in High Tech Limited:

1. Obsolescence of inventory:
The fact that High Tech Limited deals in electronic equipment runs the risk of holding obsolete stocks. This is because of rapid changes in technology. There is a risk that inventory at the period end may be misstated and valued at cost instead of the net realizable value which is likely to be lower.

2. Increased imports of electronic equipment:
The increase in imported electronic equipment could lead in reduced sales volumes and margins for High Tech Limited. This has going concern implications for the company as it may be distressed due to shortage of cash.

3. Huge discounts given:
Giving of huge discounts with the view to increase sales may affect the liquidity of the company and hence its ability to continue as a going concern. Further, it may be that some items may end up being sold for less than cost and have implications in the valuation of year-end inventory.

4. Extended credit:
Extended credit to customers will affect the liquidity of the company and could also result in the company failing to collect some debts and hence misstatement of the receivables balances.

5. Default on loan conditions:
In the event that the company defaults on its loan obligations and fails to pay either interest or the principal amount, the bank may enforce its security resulting in the company being unable to continue operating.

6. **Disclosure of outstanding loan:**
   There is a risk of the company not disclosing the amount due on the loan between short term amount and long term amount due as required. Disclosure may therefore not be in line with accounting requirements.

7. **Allowances for receivables:**
   The Chief Accountant bases the provision for receivables on his judgment which may be subjective. This should be based on the age analysis of the receivables. There is, therefore, a risk that the receivables balance may be misstated.

iii. Why accounting estimates are a high risk:

Accounting estimates are amounts that are determined by methods other than where there is a supporting document for the amount. These are usually based on the judgment of management. Since judgment is subjective, there really is no correct figure and reliability of the amounts involved depends on the assumptions made.

The fact that there is subjectivity involved in determining accounting estimates makes them a risk area for the auditor.

Examples of accounting estimates:

- Allowances for receivables.
- Inventory obsolesces
- Warranty obligations that a company may have.
- Depreciation method or the asset useful life
- Outcome of a legal case.
- Outcome of long term contracts.

SOLUTION TWO

(a) (i) Accountability is the state of being accountable, that, is being required to justify and decisions .It suggests an obligation or willingness to accept responsibility for one's actions. In this case, the management of clear base need to a new for the challenges that the company faces as it is there responsibly to do so**.**

(ii) Stewardship-refers to the duties and obligations of a person who manages another person's property. In this case management as agents have a duty to safeguard assets of Clearbase LIMITED**.**

(b) **Directors responsibilities:**

(i) The company's system of internal controls lies with the board of directors who sets procedures for internal controls and monitoring that the system operates properly.
(ii) Assessing risks facing the business so that those risks are avoided. Common risks are fraud and misappropriation of assets.
(iii) They are responsible for reviewing to ensure the organisation meets its objectives. Some of the objectives that the company can fail to achieve are sales growth, increase in market share and increase in profitability up to a certain percentage point.

(c) ISA 230 requires that auditors must not delete or discard documentation of any nature before the end of its retention period. ISQC 1 requires that the firm establishes policies and procedures for the retention of engagement documentation. It states that the retention period for audit for audit engagement is no shorter than five years from the date of the auditor's report. In addition auditors must follow ethical principles regarding confidential of working papers unless the disclosure do not undermine validity of the audit process.

(d) Identifying five weaknesses in the salaries system of Clear base Limited.

(i) Access to company files is permitted to all employees. This makes the payroll system vulnerable as employees may end up changing standing data on the files.

(ii) Employees are allowed to submit their own timesheets-there is a possibility that they can add the number of hours that they actual did not work for.

(iii) The company policies have allowed employees to give their own reasons as to why they were absent. This is a weakness as they can end up giving wrong reasons when in actual fact they were absent for no reasoning the end the company will end up paying for the time workers were not supposed to be pay

(iv) Site managers have been allowed to recruit from site on their own-the problem with this system is that site manager can inflate the numbers by including ghost workers .The Company will end up paying employees who actually do not exist.

(v) Inputs into the payroll being made via e-mail can be intercepted and details changed. They can also be prone to wrong entries being sent via emails. Further they can be read by other employees since all workers have access to company files.

(vi) Site mangers completing details of employees sickness and absence-this is wrong as the site manager will not be the right person to deal with personnel matters. Furthermore, there could be some elements of favoritism.

(e) Distinction between the roles of internal and external auditors.

(i) Internal auditors' objective is to design internal controls so that they can add value to the organization. External auditors carry out an audit to enables auditors to express an opinion on the financial statements.

(ii) Internal auditors report to the board of directors or the audit committee or those charged with governance while eternal editors report to shareholders members of a company on the truth and fairness of the accounts

(iii) Internal auditors are employees of the organization while external auditors are independent of the company and its management and are appointed by shareholders**.**

SOLUTION THREE:

a) i. Rights of the external auditor under CA 1994:

- The right to attend the annual general meeting at which audited accounts will be considered.
- Right to receive notice of any meeting at which term of office would have ended.
- Right to speak at the annual general meeting on any matters relating to the financial statements.
- Right to access records of the client.
- Right to information and explanations from the client as the auditor will determine as necessary.

ii. Regulation of auditors in Zambia:

The regulation of auditors in Zambia is by the Zambia Institute of Chartered

Accountants (ZICA) and the regulations are contained in the Accountants Act of 2008.

The institute issues practicing certificates to qualifying members. These certificates are renewable subject to fulfilling minimum requirements.
Further, ZICA has the mandate to 'audit' the auditor with a view to confirm that the auditors conduct their audits in line with International Standards on Auditing (ISAs).

The institute has the power to revoke a license or deny the issuance of the license. As per requirements of the Accountants Act of 2008, all accountants including auditors are required to be members of the Zambia Institute of Chartered Accountants. It is only in this way that ZICA can regulate the auditors.

b) Confidentiality and ethical matters to consider:

i. Confidentiality:

Confidentiality is one of the fundamental principles of professional ethics that accountants are required to observe.

This states that the accountant (auditor) should not disclose information that comes to them by virtue of their employment or relationship to third parties without the permission of the employer or the client. Further, there should be no conflict of interest arising from privileged information the accountant or auditor has**.**

There are exceptions to the general rules above as follows:

1. In a situation where the auditor is protecting his interest such as where fees have remained unpaid he may make disclosure to appropriate authorities.
2. In the event that it is in the public interest that the auditor should make such disclosures.
3. Where the client or employer is involved in illegal activities such as money laundering or treason, disclosure to competent authorities may be made without prior approval.
4. When the auditor is required by court to give evidence in a case involving the client.
5. When the accountant or auditor is required to disclose information by a competent authority such as the Anti-Corruption Commission (ACC) or the Drug Enforcement Commission (DEC). In this case, the auditor or accountant should establish under which legal provision the competent authority wishes to get the information it requires.
6. Disclosure is permitted by law.

ii. **Ethical matters to be considered and related safeguards:**

The demand by the client that Harry who previously offered non audit services to this client should take up the role of engagement partner gives rise to a self-review threat. He will be reviewing most of the work carried out by him as well as financial statements and systems he was involved in preparing and setting up.

Safeguard:
Harry should not be assigned engagement partner on this audit. Someone else who was not involved with this client should be appointed engagement partner.

Since Harry was involved in the offering of non-audit services to this client this may create a familiarity threat. He is most likely familiar with staff in this client.

Safeguard:
Not to assign Harry on this assignment.

The request by management that the firm should continue to prepare the financial statements of the client and also conduct the audit, gives rise to self-interest and self-review threats.

Safeguard:
Unless the threat can be reduced to acceptable levels, the preparation of financial statements should not be undertaken. Alternatively, different teams should be assigned to take up the two roles.

The suggestion that the firm recruits a financial controller gives rise to self-interest to the firm. This will be the person whom they would have recruited and so may not be objective in dealing with this person.

Safeguard:
The role of the firm should end at shortlisting candidates for the client. The client should make the final selection.

The invitation of the firm's senior staff members on a leisure trip to the Lower Zambezi gives rise to a familiarity threat to the auditor. The auditors will lose their objectivity in dealing with the client as a result thereof.

Safeguard:
The invitation should be declined unless it is clearly insignificant. In this case, a visit to Lower Zambezi does not appear insignificant and so should be declined.

Basing the audit fee on profit that is attained is a contingent fee. This is not allowed as it will give rise to self-interest of the auditor. The higher the profit made the higher the fee.

Safeguard:
Audit fees should be based on the time spent on the audit as well as the level of staff. Usually, these are based on hourly rates which are determined in advance by the auditors.

SOLUTION FOUR

(a) Statistical sampling means any approach to sampling that uses:

- Random selection of samples; and
- Probability theory to evaluate sample results.

Any approach that does not have both these characteristics is considered to be non-statistical sampling.

(b)
(i) Sample selection methods, apart from random selection include:

- **Systematic selection** – this involves selecting items using a constant interval between selections, the first interval having a random start. When using systematic selection auditors must ensure that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population.
- **Haphazard selection** may be an alternative to random selection provided auditors are satisfied that the sample is representative of the entire population. This method requires care to guard against making a selection which is biased, for example towards items which are easily located, as they may not be representative. It should not be used if auditors are carrying out statistical sampling.
- **Block selection** – this may be used to check whether certain items have particular characteristics. For example, an auditor may use a sample of 100 consecutive orders to test whether orders are signed by authorized signatories rather than picking 100 single orders throughout the year. Block sampling may, however, produce samples that are not representative of the population as a whole, particularly if errors only occurred during a certain part of the period, and hence the errors found cannot be projected onto the rest of the population.
- **Monetary Unit Sampling** – this is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts. This is a selection method which ensures that every K1 in a population has an equal chance of being selected for testing. The main advantages of this selection method are that it is easy when computers are used, and that every material item will automatically be sampled.

(ii)
Projecting misstatements means estimating the probable misstatement in the population by extrapolating the misstatements found in the sample. This is important because it enables the auditor to obtain a broad view of the scale of the misstatement. The total of the projected misstatement and anomalous misstatements is the auditor’s best estimate of misstatement in the population. If the total exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population.
Projection of sample misstatement is as follows:

Population size	K10, 000,000
Sample size	K1, 000,000
Sample misstatement	K1,000

Projected misstatement = $\frac{K1,000}{K1,000,000} \times K10,000,000 = \underline{\underline{K10,000}}$

(c) The audit procedures used to obtain audit evidence are:

1. **Inspection of assets** – this is the physical inspection of tangible assets that are recorded in the accounting records in order to confirm existence. For example, auditor attending physical asset verification exercise or physical inventory counts.
2. **Inspection of documentation or records** – this is the examination of documents and records, both internal and external, in paper, electronic or other forms. This procedure provides evidence of varying reliability, depending on the nature, source and effectiveness of controls over production (if internal). For example, verification of asset valuation to valuation certificate.
3. **Observation** – this involves watching a procedure or process being performed (for example, post opening). It is of limited use, as it only confirms the procedure took place when the auditor was watching, and because the act of being observed could affect how the procedure or process was performed.
4. **Inquiry** – this involves seeking information from client staff or external sources. Strength of evidence depends on the knowledge and integrity of source of information. Inquiry alone does not provide sufficient audit evidence to detect a material misstatement at assertion level nor is it sufficient to test the operating effectiveness of controls. For example, inquire of management about warranty obligation issues.
5. **Confirmation** – this is the process of obtaining a representation of information or of an existing condition directly from a third party. For example, confirmation from bank of bank balances.
6. **Recalculation –** this consists of checking the mathematical accuracy of documents or records and can be performed through the use of IT. For example, recalculate profit or loss on asset disposal.
7. **Re-performance** – this is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control. For example, re-perform arithmetic bank reconciliations.
8**. Analytical procedures** – evaluating and comparing financial and/or non-financial data for plausible relationships. Also include the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. For example, compare the current year balances of trade and accruals to the previous year.

SOLUTION FIVE

(a) Elements of the standard audit report are as follows:

- Title – the auditor's report must have a title that clearly indicates that it is the report of the independent auditor. This signifies that the auditor has met all the ethical requirements concerning independence and therefore distinguishes the auditor's report from other reports.
- Addressee – the addressee will be determined by law or regulation, but is likely to be shareholders or those charged with governance.
- Opinion paragraph – this shall identify the entity being audited, state that the financial statements have been audited, identify the title of each statement that comprises the financial statements being audited, refer to summary of significant accounting policies and other explanatory notes, and specify the date or period covered by each statement comprising the financial statements.

  If the auditor expresses an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the opinion shall use one of the following equivalent phrases:

    - The financial statements present fairly, in all material respects...in accordance with [the applicable financial reporting framework]; or
    - The financial statements give a true and fair view of… in accordance with [the applicable financial reporting framework].
- Basis of opinion – this shall state how the audit was conducted and make specific reference to compliance with auditing standards (e.g. International Standards on Auditing – ISAs) and ethical requirements, including obtaining sufficient appropriate evidence as a basis for the audit opinion given.
- Key Audit Matters – this shall state matters which were of most significance in the audit of the financial statements of the current period.
- Other Information – this shall state management is responsible for other information and that the audit opinion on the financial statements does not cover the other information.
- Responsibilities of Management and Those Charged with Governance for the Financial Statement – this part of the report describes the responsibilities of those who are responsible for the preparation of the financial statements and states the oversight role of those charged with governance.
- Auditor's Responsibilities for the Audit of the Financial Statements – this describes the responsibilities of the auditor. For example, to issue an audit report that includes an opinion.
- Report on Other Legal and Regulatory Requirements – the form and content will depend on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation, or national auditing standards.
- Auditor's signature – the report must contain the auditor's signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction.
- Auditor's address – the audit report should name a specific location, which is normally the city where the auditor maintains the office that has the responsibility for the audit.
- Date of the report – the report must be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements.

(b)
(i) Advantages of having partnership accounts audited include the following:

- It can provide a means of settling accounts between the partners.
- Where audited accounts are available, this may make the accounts more acceptable to the taxation authorities when it comes to agreeing an individual partner's liability to tax.
- The sale of the business or the negotiation of loan or overdraft facilities may be facilitated if the firm is able to produce audited accounts.
- An audit on behalf of a 'sleeping partner' is useful since generally such a person will have few other means of checking the accounts of the business or confirming the share of profits due to him or her.

(ii)
1. **Payable balance**

The adverse opinion proposed is wrong because satisfactory evidence has been provided by Charles and Francis. Adverse opinion is expressed when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements are both material and pervasive to the financial statements. In this case, there is in fact no misstatement since the difference is cash in

transit and satisfactory evidence has been provided.
The appropriate opinion in this case is an unmodified opinion.

2. **Land and buildings**

A material misstatement exists in the value for land and buildings and this could have a pervasive effect since land and buildings represent a substantial portion of the financial statements. An opinion must be disclaimed when the auditor cannot obtain sufficient appropriate audit evidence on which to base the opinion and concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. In the case of this audit, however, sufficient appropriate audit evidence exists that the value is materially misstated. Hence, a disclaimer is not appropriate.
The appropriate audit opinion could be a qualified or adverse opinion. Since the issue is material and pervasive, the suitable opinion is therefore an adverse opinion.

3. **Inventory balance**

An unmodified opinion is the opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all **materia**l respects, in accordance with the applicable financial reporting framework. Since the misstatement is immaterial, the unmodified opinion is appropriate. The Audit Senior’s proposal is therefore correct.

END OF SOLUTIONS

DIPLOMA IN ACCOUNTING PROGRAMME EXAMINATIONS

LEVEL TWO

DA: 12 GOVERNANCE AND COMPANY LAW

FRIDAY 15 DECEMBER 2017

TOTAL MARKS – 100; TIME ALLOWED: THREE (3) HOURS

INSTRUCTIONS TO CANDIDATES

1. You have fifteen (15) minutes reading time. Use it to study the examination paper carefully so that you understand what to do in each question. You will be told when to start writing.

2. This paper is divided into TWO sections:
   Section A: There are two (2) compulsory questions.
   Section B: There are three (3) questions. Attempt any two (2) questions.

3. Enter your student number and your National Registration Card number on the front of the answer booklet. Your name must **NOT** appear anywhere on your answer booklet.

4. Do **NOT** write in pencil (except for graphs and diagrams).

5. **Cell Phones** are **NOT** allowed in the Examination Room.

6. The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and depth of the answer.

7. All workings must be done in the answer booklet.

8. Present legible and tidy work.

9. Graph paper (if required) is provided at the end of the answer booklet.

SECTION A - TWO COMPULSORY QUESTIONS

Attempt both questions

QUESTION ONE

Minsale Sugar Ltd is a company whose sole business is the production and processing of sugar. At its Annual General Meeting (AGM) held on 31st March 2017, the shareholders voted in Chisanga, Kambanji and Mukuni to constitute its Board of Directors. The newly appointed Board of Directors had their first meeting on 7th April, 2017 at which Kambanji was appointed managing director of Minsale Sugar Plc for a term of one year. The terms of appointment were that, the Board of Directors will have power to review or terminate his appointment as Managing Director.
On 1st July, 2017, whilst attending a golf tournament in Chipata Town, Kambanji met with his old schoolmate Nyambe Phiri who runs a fleet of trucks hauling all kinds of commodities across the country and abroad. The duo entered into a contract whereby Nyambe Phiri would provide transport for the delivery of sugar to all the depots and customers of Minsale Sugar Ltd. The secret terms are that Nyambe Phiri shall pay Kambanji a 5% commission only, on each truckload of sugar delivered by his fleet of trucks. On arrival from Chipata, Kambanji's statement to the Board of Directors is 'To increase our efficiency, I have chosen Nyambe Phiri to be our sole provider of transport services for all our products. This is my final decision as Managing Director'. The two other directors Chisanga and Mukuni are concerned and have come to you for help.

(a) (i) Identify three fiduciary duties, if any, that Kambanji has breached. (3 marks)
(ii) Explain to Chisanga and Mukuni the duties you have identified in (a) (i) above. (12 marks)

(b) Discuss three (3) ways by which Kambanji's appointment as a director can be terminated. (6 marks)

(c) It has come to light that Kambanji was one of the founding shareholders of Minsale Sugar Ltd. When incorporating the company, shareholders inserted a clause in the articles of association that 'should Kambanji become a managing director of the company, he shall be immune from any civil court action arising from his duties as a director whatsoever'.
Explain whether or not he can rely on this clause? (4 marks)

[Total: 25 Marks]

QUESTION TWO

(a) A company is a business entity that exists separate from its owners. This was established in the case of Salomon **v Salomon [1897]**.

Explain the various characteristics that a company enjoys once it is incorporated apart from separate legal personality. (15 marks)

(b) Differentiate between share capital and loan capital. (5 marks)

(c) Explain two reasons why a company may reduce its share capital. (5 marks)

[Total: 25 Marks]

SECTION B

There are THREE (3) questions in this section. Attempt any TWO (2) questions.

QUESTION THREE

(a) Explain the Accountant's Professional liability according to the Accountants Act 2008.

(4 marks)

(b) Explain the characteristic of the following types of business associations:

(i) Sole proprietorship (6 marks)

(ii) Cooperatives (6 marks)

(c) Hachitwa, Nakandu, Fashion and Kaleza were very good friends all aged at 97 years old and former civil servants. They were sad as their benefits had delayed gravely. When their package was finally out, they sat and agreed to incorporate a company so as to sustain themselves and most importantly their families. A problem arose among themselves because they thought once they die, the business will also die.
As a diploma student in Governance and Corporate law, you are called to explain to them one characteristic of incorporation that can resolve their problem.
Advise the parties on their concern. (5 marks)

(d) Explain the function of the board of directors. (4 marks)

[Total: 25 Marks]

QUESTION FOUR

Sabi Fisheries Ltd's Statement of Financial Position (Balance Sheet) as at 31st October, 2017 showed the following assets and liabilities:

Assets

(Machinery, Premises, Stock of fish, Cash at bank) ---------------------- K190, 000

Liabilities

(Bank Loans, Debentures, Creditors for fish feed and chemicals) ------ K250, 000

The Directors had a meeting to consider among other things the 'declaration of solvency' which they failed to do and the creditors have now appointed Mr. Kesa Kabaso a renowned liquidation lawyer to oversee the activities of the company until they get their money in full.

Sabi Fisheries Ltd's shareholders have protested over the decision of the creditors and are of the view that they must apply to court to reduce the company's capital and consequently reduce what the company will have to pay to the creditors.

(a) Explain five(5) duties that Mr. Kesa Kabaso will perform in his new role. (10 marks)

(b) State whether the shareholders will succeed or fail. Give reasons for your answer.

(5 marks)

(c) What is the difference between a debenture and a share? (4 marks)

(d) Explain what 'floating' and 'fixed' charges are. (6 marks)

[Total: 25 Marks]

QUESTION FIVE

(a) Discuss the contents of the Directors' report. (9 marks)

(b) ABK Company has been in business for the past thirty years. At inception, ABK appointed Mr Bwembya as solicitor; who inscribed in the articles of ABK Company to always be appointed as solicitor. At the time Mr Bwembya was engaged as solicitor, he was not yet a member of ABK Company. Subsequently, he bought shares in the company and became a member.
At its Annual General Meeting, the company passed an ordinary resolution to appoint a new director Mr. Kajina. Mr. Bwembya is displeased with this development and wishes to sue the company.

Explain whether or not Mr. Bwembya will succeed. (10 marks)

(c) Identify the three (3(main officers of a company**.** (6 marks)

[Total: 25 Marks]

END OF PAPER

DA12: GOVERNANCE AND COMPANY LAW SOLUTIONS

SOLUTION ONE

(a) (i) The three duties Kambanji breached as a director are:

- Duty not to have conflict of interest
- Duty to act honestly
- Duty not to make a secret profit
- Duty to exercise power for the benefit of the company
- Duty to act legally and honestly
- Duty to act with care

(ii) The breached duties are explained below:

(i) *Duty not to have conflict of interest* – A director must always act for the best interest of the company. Personal interest must not take precedence. In *Regal (Hastings) Ltd v. Gulliver (1942)* it was held that directors must account for any secret profit they must have made whilst standing in a fiduciary relationship. This Kambanji failed to do by accepting a bribe.

(ii) *Duty to exercise power for the benefit of the company* – A director must act for the benefit of the company at all times. Their interest must not collide with those of a company as seen in *Coronation Syndicate Ltd v. Lilienfield and New Fortuna (1903).* By seeking a bribe and single sourcing the transporter without consulting his colleagues, and bringing in a friend from whom he would benefit, he breached this duty.

(iii) *Duty to act honestly, Legally and within powers* – Directors are not supposed to do anything detrimental to the interests of shareholders (company). This was the decision in *Coronation Syndicate Ltd v. Lilienfield and New Fortuna (1903).* They must act within their powers, legally and with all honesty required of the office of director. By the act of a bribe and not allowing his two colleagues to have a say, he acted outside his powers.

(iv) *Duty not to make secret profit* – Directors are under a duty not to make secret profit using their position in the company – *Boston Deep Sea Fishing Co. v. Answell (1888); and Regal (Hastings) Ltd v. Gulliver (1942).* The commission of 5% is a secret profit which Kambanji shouldn't have received.

(v) *Duty to act with care and skill* – Directors need to act with care and skill. However, they do not need to exhibit greater skill than may reasonably be expected from a person of his knowledge and experience and must act with care, not recklessly *Re City Equitable Fire and Insurance Co. Ltd (1925).* Kambanji put his personal interests above those of a company, therefore, he acted carelessly.

(vi) *Duty to account for any Secret Profit and duty to declare interest* – A direct has a duty to account to the company any secret profits made in the course of his position as director. In an event that he has interest in a particular matter, he must delay his interest beforehand and failure to do is a ground for disqualification. *Boston Deep Sea Fishing Co. v. Answell (1888); and Regal (Hastings) Ltd v. Gulliver (1942).* Kambanji did not account for the secret profit of 5% from every truckload, thus he must account.

(b) (i) *Resignation* – He can resign from his position giving written notice to the company.

(ii) *Disqualification* – A director can be disqualified from office if she is

- absent from meetings for more than 6 months without consent of the other directors,
- uses her office for secret profits,
- fails to disclose her interest in a contract, etc.

(iii) *Retirement* – A director may retire due to old age or as provided for in the company's articles of association.

(iv) *Removal* – Can be removed by the shareholders when he does something wrong, contrary to the ethics of a company.

(v) *Expiry of Contract or term of office* – A director can vacate office when her contract comes to an end or expiry of the time during which she is to work as a director

(vi) *Death* – Director will leave the office upon death.

(vii) *Court Order* – Director will leave office upon being ordered so by the court. For example if in the office illegally, has committed a crime, is disqualified, etc.

(viii) *Liquidation of a company* – When a company is liquidated and a liquidator is appointed, the director vacates his office.

(c) Kambanji cannot rely on the clause in the articles of association because the articles of association are simply a contract between the company and members, and between members. Therefore, as a third party, Kambanji cannot rely on the articles of association, except in his capacity as a shareholder not as a director. This was the holding in *Eley v. Positive Government Securities Life Assurance Ltd (1876).*

SOLUTION TWO

(a) A person possesses legal rights and is subject to legal obligations. In law, the term person is used to denote two categories of legal persons. An individual human being is a natural person; the law also recognizes artificial persons in the form of corporations. A corporation once incorporated enjoys a number of attributes discussed below:

(a) **Perpetual Succession** - Once incorporated, the company has perpetual succession i.e. the company has a continuous existence and can outlive its original members. The continuity of the company does not depend on the continuity of the shareholder. They may come and go, but the company will live on.

(b) **Can Own Property in its Own Name -** As a legal person, a company can own property in its own name, enjoy such property and dispose of it. The property of the Company will not be considered as the joint property of the shareholders.

(c) **Limited Liability -** An important attribute of incorporation as a company is that the liability of the members is limited. This is arguably the main advantage of incorporation. Limitation of liability is either by way of shares or by guarantee. Where limited by shares, the liability of the members is limited to the amount unpaid if any on the shares they hold. Where the company is limited by guarantee, the liability of the members is limited to such amount as the members will have undertaken to contribute to the assets of the company in the event it is wound up.

(d) **Transferability of Shares -** The shares of a company are freely transferable and can be sold and purchased in the share market. This is another advantage over e.g. partnerships. S. 57 of the Companies Act "Share or other interest of a member of a company shall be personal estate and movable property transferable by a written transfer in a manner prescribed by the articles of the company." This, shares are: (a) personal and movable property and (b) transferable as such.

(e) **Common Seal** - A company, being an artificial person, cannot sign its name on any document. A common seal of the company is thus used in place of a signature. S.195 states every company shall have a common seal bearing the Company's name and the words "common seal". A rubber stamp may not satisfy the requirements of s.195 of the Act.

(f) **Capacity to Sue and Be Sued** - As a legal person with independent existence, a company can file suits against other persons in its own name and similarly it can be sued in its own name. No action can be maintained in a company's name without the authority of the company nor can a director or shareholder be a proper plaintiff or defendant to an action to redress wrongs committed by or against the company.

(b) A company's capital is the funds it has available for use in the business, representing its assets. Some part of the capital employed in the business of a trading company maybe provided under short-term commercial arrangement such as purchase of goods or equipment on credit or hire purchase terms, bills of exchange and other short-term credit or it may represent profits of the business retained to finance its expansion. But some of the capital is provided by members of the company subscribing for shares and this is known as share capital or by lenders who provide loan capital by taking debentures or debenture stock and this is known as loan capital. Dividends are paid to shareholders while interest is paid for any loan obtained. Share capital and, so lesser extent, loan capital are elaborately regulated by company law.

(c) A company may wish to reduce its capital for one or more of the following reasons:

(a) The company has suffered a loss in the value of its assets and it reduces its capital to reflect that fact.

(b) The company wishes to extinguish the interests of some members entirely. (In **House of Fraser Plc v ACGE Investments Ltd 1987** preference shareholders who were not allowed to vote at general meetings could not prevent the cancellation of their shares at a premium).

(c) The capital reduction is part of a complicated arrangement or capital which may involve, for instance replacing share capital with debt capital.

SOLUTION THREE

(a) The Accountants Act of 2008 under section 30 provides for professional liability.

The Act makes it clear that a chartered accountant shall not incur any liability for expressing, or not expressing an opinion on the accounts unless the opinion was given negligently.

Where it is proved that an expressed opinion was made negligently, the chartered accountant shall only incur liability if a third party suffered financial loss as a result of having relied on it. To be liable, it must be proved that the chartered accountant knew, or could in the particular circumstances be reasonably expected to know when the negligence occurred, that a third party could have or would have relied on the opinion to enter into a specific transaction.

Take note that the student need not mention section 30.

(b) Explain the characteristic of the following types of business associations

Sole proprietorship

Sole proprietorships are also loosely (but erroneously) called "one-man companies". They include businesses such as retail trading, transport business (especially passenger transport), bottle stalls, barbershops, tailoring shops and farms. Although run commercially, a sole proprietorship is normally conducted on a personal basis. It is usually owned by an individual, who operates it with the assistance of family members. Sole proprietorships are easy to form and they are operated very informally. Sole proprietorships must comply with various laws, including tax laws and licensing legislation and must also comply with the Registration of Business Names Act (discussed below). The most significant disadvantage of a sole proprietorship is that it has no separate existence from its owner. In the event of failure to pay the debts of the business, the owner's personal assets are at risk from creditors, that is there is no limited liability. Similarly, the continuance of the business may be placed in jeopardy when the owner dies. It has no perpetual succession.

Cooperatives

A cooperative is a form of business association. The cooperative idea however is not a single idea but a number of ideas and concepts. A cooperative is often conceived as a communal group of mutually dependent individuals who come together for the purpose of exploiting their strength of numbers to achieve a set economic goal. Cooperatives are often set up by persons seeking to improve their position in areas such as agriculture and marketing. The current law governing cooperatives is the Cooperative Societies Act No. 20 of 1998. It sets out provisions on formation, registration and organization.

(C) Advise Hachitwa, Nakandu, Fashion and Kaleza

The parties must be advised that one of the characteristics of incorporating a company is Perpetual Succession. Once incorporated, the company has perpetual succession i.e. the company has a continuous existence and can outlive its original members (Hachitwa, Nakandu, Fashion and Kaleza). The continuity of the company does not depend on the continuity of the shareholder. They may come and go but the company will live on. So the concern of the parties on their. This, however does not suggest that once incorporated, a company will never come to an end. A company's life comes to an end up to when it is wound up or struck off the register in accordance with the Companies Act. Where a shareholder of a company dies, the legal representative of the deceased shareholder becomes entitled to the shares by transmission. This is provided for in section 71 of the Companies Act.

(c) Explain the role of the board of directors

The role of the board of director is to define the purpose of the company and the values by which the company will perform its daily existence and to identify the stakeholders relevant to the business of the company. The board must then develop strategies which should be followed without fail.

Or can be summarized as

a) The board is collectively responsible for promoting the success of the company by directing and supervising the company's affairs.
b) The board's role is to provide entrepreneurial leadership of the company, within a framework of prudent and effective controls which enable risk to be assessed and managed.
c) The board should set the company strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance.
d) The board should set the company's values and standards and ensure that its obligations to its stakeholders and others are understood and meet.

SOLUTION FOUR

Any five duties

(a) (i) Duties of notice of his appointment
(ii) Duty to keep financial and administrative records
(iii)Duty to hold meetings
(iv) Duty to provide information
(v) Duty to examine officers of the company
(vi) Duty to get in and distribute property of the company

(b) The shareholders will most unlikely succeed as, the law always places the creditors' interests first in event of insolvency. Therefore the priority of the court will be first to liquidate all debt owed by the company then take note of shareholders' interest later.

(c) Share is property in terms of capital an investor owns in a company and is entitled

to earn a dividend equal to the shareholding possessed. Debenture is an instrument or document showing the debt a company owes towards an external party that is, a person or company that does not own shares in the company. A debenture is therefore an acknowledgment of debt.

(d) Floating and fixed charges relate to a company’s indebtedness. They are charges related to the debtor’s ability to dispose of its assets. Fixed charges are limited in ability to dispose of the debtor’s assets so as to raise capital while a floating charge gives the debtor the flexibility to dispose of the assets in the course of ordinary business.

SOLUTION FIVE

(a) **Directors' report**

S.176 of the Companies Act requires directors to include as part of the annual accounts a report with respect to the company's affairs. The key elements of the report include:

The report should deal with any changes that occurred in the financial year in:

The nature of the business of the company or its subsidiaries

The classes of business in which the company has an interest

The report should also disclose:

The principal activities of the company and its subsidiaries

Any changes in activities during the year

Particulars of important events that have occurred during the year

Indications of likely future developments

Indications of research and development activities

(b) **The articles as a contract**

A company's articles form the basis of its constitution and legally binds the members to company, the company to members and the members to members. It does not bind the company to third parties and applies only to rights and obligations which affect members in their capacity as members.

Articles as a contract between members

The articles in effect are a contract made between (a) the company and (b) its members individually. It can also impose a contract on the members in their dealings with each other.

Elley v Positive Government Security Life Assurance Co (1876)

E, a solicitor drafted the original articles and included a provision that the company must always employ him as its solicitor. E became a member of the company some moths after its incorporation. He later sued the company for breach of contract in not employing him as its solicitor. **Held**: E could not rely on the article since it was a contract between the company and its members and he was not asserting any claim as member.

Advise to Mr. Bwembya: Relying on the above authority; Mr. Bwembya may not succeed as at the time of drafting the articles and he was not yet a member and therefore, not bound by the articles.

In administration of companies, there are three main officers of the company are as follows:

(a) **Directors:** The management of the business of a company is entrusted to the directors. The Companies Act defines a director as 'A person appointed by the company to direct and administer the business of the company, whether or not he is called a director.

(b) **Company secretary:** Every public company must have a company secretary, who is one of the officers of a company and may be a director. Private companies are not required to have a secretary. Every public company must have a company secretary, who is one of the officers of a company and may be a director. Private companies are not required to have a secretary.

(c) **Auditor:** Every company (except a dormant private company and certain small companies) must appoint auditors for each financial year.

END OF SOLUTIONS