

## NON-AUDIT

### QUESTION ONE

Your name is Baptista Longwe, senior manager in Buupe & Buupe Associates, a firm of Chartered Accountants registered with the Zambia Institute of Chartered Accountants (ZiCA). The firm is specialised in the provision of accounting, taxation and advisory services to mainly the small to medium size companies.

You have recently been approached by Mr. Lee Chin, a Chinese national who is the managing director of Huango Holdings to accept appointment as accounting and tax advisors for the group. With annual turnover of around K75 million, the group is diversified with operations in the construction, engineering, farming as well as real estate sectors. The company's previous advisors recently resigned. Mr. Chin states that this was due to "a disagreement on the accounting treatment of revenue from contracts with customer, and because they thought that as managing director, I was involved in too many operations and needed to consider more segregation of duties."

You have also become aware that Mr. Chin has been investigated by the Anti-Corruption Commission on suspicion of being involved in money laundering and two other corrupt related offences.

Apart from providing advice on a wide range of issues, your firm will be required to report on the cash and profit forecasts for the group. Mr. Chin has also requested that as accounting and taxation advisor, you will be expected to accompany him to a meeting with the bank where a new loan will be discussed, and the cash flow and profit forecasts reviewed. Mr. Chin has hinted that if you do not accompany him to the meeting, he will consider approaching another professional firm.

Other services to be provided relate to:

- Preparation of cash flow and profit forecasts
- Financial Reporting Framework
- Review of financial statements and Accounting treatment of specific items
- Rental income
- Value Added Tax(VAT) dispute with ZRA – Mungwe farms

#### **1) Reporting on the cashflow and profit forecasts**

Mr. Chin has requested that your firm report on the cash flow forecast prepared for the purpose of securing a bank loan. Mr. Chin understands that an engagement to report on the cash flow and profit forecasts does not constitute an audit. Due to the uncertainty surrounding forecasts

and projections, and due to the limited nature of the procedures performed during the accountant's review, only limited assurance can be offered for such engagements

## **2) Financial Reporting Framework**

The Zambia Institute of Chartered Accountants has the mandate to regulate and govern the conduct of its members in the practice of their business and profession. Arising from this mandate, the Institute has powers to develop, promote and enforce internationally comparable practice standards (i.e. accounting, auditing and ethics) in Zambia.

In line with this mandate, the Institute on 15th December 2010 adopted the use of the Three Tier Financial Reporting Framework for entities in Zambia. Mr. Chin is not sure which framework applies to Huango Holdings

## **3) Review of financial statements and Accounting treatment of specific items**

Mr. Chin is very keen that Huango Holdings adopts the full IFRS Financial Reporting Framework. Accordingly, your firm has been requested to review the financial statements and advise on the accounting treatment to be applied to the following items:

- a) Construction revenue
- b) Accounting for farm assets
- c) Investment properties
- d) Environmental legislation

### **a) Construction Revenue**

Huango Holdings entered into a contract on 1 April 2016 to construct a block making machine on a customer's premises for a promised consideration of K1,500,000 with a bonus of K100,000 if the machine is completed within 24 months. At the inception of the contract, Huango Holdings correctly accounted for the promised bundle of goods and services as a single performance obligation in accordance with IFRS 15. At the inception of the contract, Huango Holdings expected the costs to be K800,000 and concluded that it was highly probable that a significant reversal in the amount of cumulative revenue recognised would occur. Completion of the block making machine was highly susceptible to factors outside of Huango Holdings's influence, mainly issues with the supply of components.

At 31<sup>st</sup> March 2017, Huango Holdings had satisfied 65% of its performance obligation on the basis of costs incurred up to that date and concluded that the variable consideration was still constrained in accordance with IFRS 15. However, on 4 April 2017, the contract was modified with the result that the fixed consideration and expected costs increased by K110,000 and K60,000 respectively. The time allowable for achieving the bonus was extended by six months with the result that Huango Holdings concluded that it is highly probable that the bonus would be achieved and that the contract still remained a single performance obligation.

**b) Environmental legislation**

Huango Holdings owns a warehouse. Chemco has leased the warehouse from Huango Holdings and is using it as a storage facility for chemicals. The government through the Zambia Environmental Management Agency (ZEMA), has announced its intention to enact environmental legislation requiring property owners to accept liability for environmental pollution. As a result, Huango Holdings has introduced a hazardous chemical policy and has begun to apply the policy to its properties. Huango Holdings has become aware that the chemicals have contaminated the land surrounding the warehouse. Huango Holdings has no recourse against Chemco or its insurance company for the clean-up costs of the pollution. At 31<sup>st</sup> March 2017, it is virtually certain that draft legislation requiring a clean- up of land already contaminated would be enacted shortly after the year end.

**c) Investment properties**

Huango Holdings wishes to create a credible investment property portfolio with a view to determining if any property may be considered surplus to the functional objectives and requirements of Huango Holdings. The following portfolio of property is owned by Huango Holdings.

- Huango Holdings owns several plots of land within Lusaka province. Some of the land is owned by Huango Holdings for capital appreciation and this may be sold at any time in the future. Other plots of land have no current purpose as Huango Holdings has not determined whether it will use the land to provide services such as those provided by national parks or for short-term sale in the ordinary course of operations.
- Huango Holdings supplements its income by buying and selling property. Huango Holdings regularly sells part of its housing inventory in the ordinary course of its operations as a result of changing demographics. Part of the inventory, which is not held for sale, is to provide housing to low-income employees at below market rental. The rent paid by employees covers the cost of maintenance of the property.

#### **d) Accounting for farm assets – Mungwe Farms**

Huango Holdings also owns Mungwe Farms. On 1 April 2016, Mungwe Farms had a herd of 100 cows, all of which were 2 years old. At this date, the fair value less point of sale costs of the herd was K1 million. On 1 October 2016, the farm purchased 20 cows (each two and half years old) for K6,000 each.

As at 31 March 2017, three- year old cows sell at market for K9,000 each.

Market auctioneers have charged a sales levy of 2% for many years.

#### **4) Rental income**

As part of its real estate business, Huango Holdings rents out a number of premises. The Zambia Revenue Authority (ZRA) have recently warned both tenants and property owners to comply with applicable requirements. Mr, Chi has provided the following information relating to rental agreements and obligations:

##### **Agreement between tenants and Huango Holdings**

###### Tenants Obligations

- A withholding tax return should be given to Huango Holdings within 30 days
- Deduct withholding tax from rentals payable on instruction from Huango Holdings
- Pay such withholding tax to ZRA by the end of the following month following the month of payment of rentals
- In case of cash flow problems, priority should be given to paying the rentals to Huango Holdings
- Keep receipts and certificate of deduction securely

###### Hungo Holdings obligations

- Huango Holdings will register all tenants with ZRA
- The registration of the tenants will also act as automatic registration for Huango Holdings
- No separate returns are required from Huango Holdings to declare rental income receivable
- If the property expenses exceed the net rental income, no return is required to be declared to ZRA

#### **5) Value Added Tax (VAT) dispute with ZRA - Mungwe Farms**

Mungwe farms also distributes cotton and other raw materials to blanket manufacturing companies. The company is registered for VAT. The following information has been extracted from the management accounts for the month of March 2017:

	K
Sales	149,925
Cost of sales	<u>(93,975)</u>
Gross profit	55,950
Expenses Depreciation	(1,875)
Bad debts written off	(9,750)
General overheads	(15,900)
Operating expenses	<u>(18,450)</u>
profit	9,975

**Additional information**

- 1) Exempt supplies taken as a proportion of total sales amount to 10%. Included in the remainder are zero rated supplies of K18,750.
- 2) 15% of the standard rated sales were made to customers who are not registered for VAT.
- 3) Included in cost of sales are purchases totalling K94,200. These include exempt purchases whose value was K22,500. The remainder of the purchases are standard rated for VAT purposes. 20% of the standard rated purchases were from non-value Added Tax registered traders.
- 4) The bad debts were written off on 31<sup>st</sup> March 2017. The figure consists of two invoices of K4,875 each in respect of which payment was due on 1 October 2015 and 1 January 2016.
- 5) The general overheads are all standard rated supplies for VAT purposes.
- 6) The figure for operating expenses are inclusive of VAT at the standard rate and are made up of:

	K
Entertaining suppliers who are VAT registered	
3,975	
Telephone bills	
6,000	
Petrol	
8,475	

Unless stated otherwise, all the above figures are VAT exclusive.

There was a dispute on the VAT return submitted for the month of March 2017, in respect of Mungwe Farms. Mr. Chin would like your firm to compute the VAT payable or repayable based on the management accounts for the month of March 2017.

**REQUIREMENTS:**

- 1) In relation to the invitation to accept the invitation to act as accounting and taxation advisors,**
  - a) Identify and evaluate FIVE ethical and other professionals that arise (10 marks)
  - b) For each issue, recommend the action that your firm should take (5 marks)
  
- 2) List and briefly describe the matters that should be considered in undertaking to report on the cashflow and profit forecasts (12 marks)
  
- 3) With regard to Financial Reporting Framework**
  - a) Describe Financial Reporting Framework adopted by ZiCA stating clearly how it applies to different categories of entities (6 marks)
  - b) Advise and justify the Financial Reporting Framework applicable to Huango Holdings (4 marks)
- 4) Assuming that full IFRS is adopted for Huango Holdings, advise on the accounting treatment to be applied to the following items, including any financial statements extracts**
  - a) Revenue – accounting treatment up to 4<sup>th</sup> April 2017 (10 marks)
  - b) Environmental provision – accounting treatment for the year ended 31 March 2017 (7 marks)
  - c) Investment properties – accounting treatment for the year ended 31 March 2017 (10 marks)
  - d) Biological assets – accounting treatment for the year ended 31 March 2017 (6 marks)
- 5) In respect of the rental agreements**
  - a) Evaluate the obligations of the tenants (8 marks)
  - b) Evaluation the obligations of the Landlord, Huango Holdings (8 marks)
  
- 6) In respect of Mungwe farms and the VAT dispute with ZRA, advise the amount of VAT payable or repayable for the month of March 2017. The VAT rate applicable is 16%. (14 marks)

**Total Marks**

**(100 Marks)**

## **QUESTION TWO**

Your name is Chisanga Kombe, director in HLP Accountants, a firm of Chartered Accountants registered with the Zambia Institute of Chartered Accountants (ZiCA) specialised in the provision of accounting, taxation and advisory services to mainly small to medium size companies.

For the current year, you have been assigned to undertake the following assignments:

- a) Mico Insurance – Suspected fraud
- b) Gazi Global Internet Services – Review of financial statements
- c) Gazi Global Internet Services -Reconstruction of specific balances
- d) Mr. Elephant Njovu – Taxation and Investment advice

### **a) Mico Insurance**

Mico Insurance is a provider of a range of insurance services within Zambia and within the region. In the recent past, it has embarked on a marketing and promotion strategy to introduce a new range of products and services. This has resulted in extended travelling by various brokers and other insurance sales agents.

The finance director of Mico Insurance Jack Phiri contacted you this morning, saying:

I was alerted yesterday to a fraud being conducted by members of our sales team. It appears that several sales representatives have been claiming reimbursement for fictitious travel and client entertaining expenses and inflating actual expenses incurred. Specifically, our internal auditor has alleged that the sales representatives have claimed on expenses for items such as gifts for clients and office supplies which were never actually purchased, claimed for business-class airline tickets but in reality had purchased economy tickets, claimed for non-existent business mileage and used the company credit card to purchase items for personal use. I am very worried about the scale of this fraud, as travel and client entertainment is one of our biggest expenses. All of the alleged fraudsters have been suspended pending an investigation which I would like your firm to conduct. We will prosecute these employees to attempt to recoup our losses if evidence shows that a fraud has indeed occurred,

so your firm would need to provide an expert witness in the event of a court case. Can we meet tomorrow to discuss this potential assignment?’

**b) Gazi Global Internet Services (Gazi)**

**Background**

Gazi has positioned itself as the internet service provider of first choice and has located its outlets in all busy shopping malls around the country. Started by Mr. Gazi five years, it has grown its revenues by more than 40% by the end of 2016 and now employs 45 members of staff. Even though Gazi may be considered a small company, Mr. Gazi has deliberately decided to adopt the Full IFRS accounting reporting framework as prescribed by ZiCA.

Gazi automated its accounting systems using the PASTEL accounting software package. The accounting is centralised with all the accounting being done in Lusaka by the chief accounting. Returns are received online from various outlets on a monthly basis.

**Virus attack**

Unfortunately, the PASTEL system was brutally attacked by a virus shortly after preparing the draft financial statements for year ended 31 March 2017. Most of the information was deleted and the chief accountant has started the process of reconstructing the financial statements from available records. For now, only the opening statement financial positions as at 1<sup>st</sup> April 2016 is available, as well as the cash flow statement for the year ended 31<sup>st</sup> March 2017 and supporting notes. These were printed out before the virus attack and are provided below

**Opening statement of financial position as at 1<sup>st</sup> April 2016**

**Gazi Global Internet services**

**Statement of financial position as at 1 April 2016**

	<b>K'000</b>	<b>K</b>
<b>'000</b>		
<b>Non-current assets</b>		
Land and buildings (at valuation of K49.2m less Accumulated depreciation of K5.0m)		44,200
Plant (at cost K70m less accumulated depreciation of K22.5m)		47,500
Investment at cost		16,900
		-----
		108,600
<b>Current assets</b>		
Inventories		57,400
Trade receivables		28,600



Bank		<u>1,200</u>
		87,200
		-----
		195,800
		=====
<b>Capital and Liabilities</b>		
Share capital (K1 each)		25,000
Share premium		5,000
Retained profits		70,300
Revaluation reserve		<u>12,000</u>
		87,300
		-----
-		112,300
<b>Non-current liabilities</b>		
8% loan note		43,200
<b>Current liabilities</b>		
Trade payables	31,400	
Taxation	<u>8,900</u>	
		40,300
		-----
		195,800
		=====

Following the virus attack, Mr. Gazi is not sure that these financial statements fully comply with International Financial Reporting Standards. He is particularly concerned about the new values placed on non-current assets. He is also surprised at the level of trade payables as decision was made to source most of the supplies in cash. He has therefore requested your firm to review the opening statement of financial position as at 1<sup>st</sup> April 2016 to determine whether it complies with the applicable reporting framework. Mr. Gazi understands that such a review does not constitute an audit

**Gazi Global Internet services**

**Cash flow statement for the year ended 31 March 2017**

	K'000	K
<b>'000</b>		
<b>OPERATING ACTIVITIES</b>		
Profit before tax		15,600
Add back depreciation on land and buildings		1,800
Add back depreciation on plant		26,600
Less loss on sale of plant		(4,200)
Decrease in inventories		14,100
Increase in receivables		(21,800)

Decrease in payables	(4,700)
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<b>Cash generated from operations</b>	<b>35,800</b>
Interest paid	(1,400)
Taxation paid	(10,000)
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	24,400

#### **INVESTING ACTIVITIES**

	<b>K'000</b>	<b>K '000</b>
Purchase of land and buildings		(7,100)
Purchase of plant		(38,100)
Investment income		400
Proceeds on sale of plant		7,800
Proceeds on sale of investment		<u>11,000</u>
<b>Net cash outflow from investing activities</b>	<b>(26,000)</b>	

#### **FINANCING ACTIVITIES**

Loan repaid	(3,400)
Proceeds from issue of new shares	28,000
Dividends paid	<u>(26,100)</u>
<b>Net cash used in financing activities</b>	<b>(1,500)</b>

Net decrease in cash and cash equivalents for the year	(3,100)
Cash and cash equivalents as at 1 April 2016	1,200
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Cash and cash equivalents as at 31 <sup>st</sup> March 2017	(1,900)
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#### **Supporting notes for the cash flow statement**

- i) In preparing the cash flow statement, investment in government treasury bills was included as part of cash and cash equivalents
- ii) There were no disposals of land and buildings during the year. The increase of K6 million in the valuation reserve was entirely due to the revaluation of the company's land
- iii) Plant with a net book value of K12 million (cost K23.5 million) was sold during the year for K7.8 million. The loss on sale has been included in the profit before interest and tax
- iv) Investments with a cost of K8.7 million were sold during the year for K11 million. There were no further purchases of investments. These investments are all in unquoted companies and therefore their fair values cannot be readily estimated
- v) On 10 October 2016, a bonus issue of 1 for 10 ordinary shares was made utilising the share premium account. The remainder of the

increase in ordinary shares was due to an issue of 22,500 shares for cash on 31 October 2016

- vi) The balance on the taxation account is after settlement of the provision made for the year ended 31 March 2016, A provision for the current year has not been made.

In the absence of the closing balances for the year ended 31<sup>st</sup> March 2017, Mr. Gazi has requested your firm to assist in the determination of specific balances using the opening position as at 1<sup>st</sup> April 2016 and the cash flow statement as at 31<sup>st</sup> March 2017. You have assisted Gazi in the preparation of financial statements in the past and you have been satisfied that the PASTEL system is adequate to produce required information.

**c) Mr. Elephant Njovu – tax computation and tax advice**

**Tax computation**

Elephant Njovu has worked for Tulux Paints Ltd for many years as a Distribution Director. He retired on 31 August 2016, when he was 55 years old. His annual salary has been K264,000 in the tax year 2016. Upon retiring on 31 August 2016, Elephant received his repatriation pay of K45,000, severance pay of K30,000 and a pension from an approved fund of K580,000.

In the tax year 2016, he was also entitled to a housing allowance of K3,500 per month, medical allowance of K6,000 per annum, school children's allowance of K8,000 per annum per child and a fuel allowance of K1,200 per month.

Elephant has three (3) school going children. The school children's allowance was payable at the start of each term in January, May and October in equal instalments each year.

During the tax year 2016, Elephant received a long-term service award in the form of cash of K3,000 and a gold wrist watch valued at K8,500. This was in recognition of his twenty- year service in the company. This award was made on 30 April 2016.

On 3 May 2016, he received a labour day award which was made up of a laptop worth K4,800 and K2,600 cash.

Tulux Paints received a national award as the best Paint Company for the first half of the year 2016. To recognise the employees' hard work, the company declared a bonus that was paid on 31 August 2016. Elephant's bonus was K9,000.

In addition to the above, Elephant also received royalties of K25,500 (net) during December 2016.

Pay As You Earn deducted from his emoluments during the tax year 2016 amounted to K35,000. His other payments in the tax year 2016, included:

- Subscriptions to the Institute of Directors amounting to K3,400
- NAPSA contributions of K8,800
- School fees for children of K 9,000
- A donation to a local approved charity K1,080.

Apart from a payslip showing total income and total tax deducted, Mr. Njovu is not sure how his final pay was computed. He has approached your firm to provide him with a detailed computation of his final pay and the tax due

### **Investment advice**

Upon retiring, Mr Njovu has partnered with a group of foreign investors wishing to invest in the agricultural and manufacturing sectors of the Zambian economy. The investment in each sector will require an estimated capital injection of over K1billion, excluding investment in land and buildings, with the expected annual turnover from each investment being in excess of K100 million. It is anticipated that each investment will create over 1,000 job opportunities for the local Zambian community.

Mr. Njovu has approached your firm for investment advice

## **REQUIREMENTS**

### **1) In relation to the invitation to take part in the fraud investigation in Mico Insurance**

- a) Assess THREE ethical and professional issues raised by the request for your firm to investigate the alleged fraudulent activity.  
(6 marks)
- b) For each issue, recommend the action that your firm should take  
(6 marks)
- c) Explain the matters that should be discussed in the meeting with Jack Phiri in respect of planning the investigation into the alleged fraudulent activity.  
(10 marks)

### **2) Review of historical financial statements**

- a) Explain with examples the difference between an assurance engagement, an engagement to review financial statements and agreed upon procedures (6 marks)
- b) In deciding on the scope of the review, state the matters relevant to Gazi Global that should be considered (6 marks)
- c) State the procedures that should be carried out on the following elements of the statement of financial position as at 1<sup>st</sup> April 2016:
  - (i) Land and buildings (5 marks)
  - (ii) Inventories (3 marks)
  - (iii) Trade receivables (3 marks)
  - (iv) Trade payable (3 marks)

**3) Gazi - In relation to the destroyed records and cash flow statement**

- a) Recommend recovery procedures that Gazi should put in place to mitigate against such disasters in future (5 marks)
- b) Evaluate whether investment in government treasury bills should be included as part of cash and cash equivalents (3 marks)
- c) Using the opening statement of financial position as at 1 April 2016 and the cash flow statement for the year ended 31<sup>st</sup> March 2017, reconstruct the closing carrying value of the following balances as at 31<sup>st</sup> March 2017
  - i) The net carrying value for Land and Buildings (4 marks)
  - ii) The net carrying value for plant and equipment (5 marks)
  - iii) The closing value of share capital (3 marks)
  - iv) The closing carrying value of share premium (3 marks)
  - v) The closing carrying value of revaluation reserves (2 marks)
  - vi) The closing value of investments at cost (2 marks)

**4) In relation to the requests from Mr. Njovu**

- a) Calculate the total amount of Income Tax payable by Elephant Njovu for the tax year 2016. (17 marks)
- b) Advise Mr. Njovu of the tax incentives which will be available to the proposed businesses in each of the following sectors:
  - i) Agriculture (4 marks)
  - ii) Manufacturing (4 marks)

**Total Marks (100 Marks)**

## **APPLICABLE TAXATION RATES**

<i>Personal Income tax rates</i>		<i>Chargeable income</i>
<i>Rate (%)</i>	<i>(Kwacha)</i>	
<b>First</b>	<b>36,000</b>	<b>0</b>
<b>Next</b>	<b>9,600</b>	<b>25</b>
<b>Next</b>	<b>25,200</b>	<b>30</b>
<b>Excess over</b>	<b>70,800</b>	<b>35</b>
 <i>Income from farming for individuals</i>		
<b>First</b>	<b>36,000</b>	<b>0</b>
<b>Excess over</b>	<b>36,000</b>	<b>10</b>
 <i>Gratuity (Qualifying)</i>		
<b>First</b>	<b>36,000</b>	<b>0</b>
<b>Over</b>	<b>36,000</b>	<b>25</b>
 <i>Terminal benefits</i>		
<b>First</b>	<b>35,000</b>	<b>0</b>
<b>Over</b>	<b>35,000</b>	<b>10</b>