NON-AUDIT JUNE 2017

QUESTION 1

BACKGROUND

Kandwa Plc was incorporated in Zambia, on 3 April 2007, and was listed on the Lusaka Stock Exchange on 1 January 2017. It buys and distributes various pineapple drinks (which are standard rated), throughout the Republic of Zambia. It has also developed its own drinks. Mr. Francis Chinanazi owns 4% of the ordinary share capital, and he is the Chief Executive Officer (CEO).

Kandwa Plc is a successful company, and its success is based on a very innovative distribution network, with very competitive prices. However, the CEO has questioned the amount of detail contained in the financial statements. He feels this is simply 'noise' to most users, especially non – financial experts who comprise 32% of Kandwa Plc's shareholding. He has heard about the conceptual framework but doubts its relevance. He has also heard about the independent tax system, which he thinks is significantly at variance with the African culture.

Recently, the CEO decided to engage your firm, MEW Associates, to prepare financial statements and give professional advice on the following issues:

- Legal suit involving an arrestable offence.
- Tax disputes involving VAT and PAYE.
- Donations to charities.
- Management trainees.
- E – Commerce.
- Non - executive directorship appointment.

The company is yet to develop a detailed dividend policy, which is expected to address the various concerns of stakeholders. However, the signal for future demand for the company's products is not certain. This will definitely affect the expected future distributions.

LEGAL SUIT

Kandwa Plc has not been servicing their diesel propelled trucks regularly and as such the emissions currently exceed the recommended rate of 3%, by more than 12%. Kandwa Plc and the directors were sued by Zambia Environmental Management Agency (ZEMA). A respected legal expert advised the company to settle the matter out of court, and Kandwa Plc paid a fine of K100,000 as stipulated in the law.

The land used by Kandwa Plc, as a parking place for the company vehicles is contaminated. ZEMA has requested for some information from MEW Associates, regarding the findings by an environmental expert engaged by Kandwa Plc. ZEMA has already sued Kandwa Plc and the directors following serious disagreements over the issue. A conviction regarding non-compliance with environmental regulations could result in a number of sanctions and the directors being imprisoned for three (3) years.

On 19 December 2017, the directors of Kandwa Plc were told by ZEMA legal advisers that ZEMA was willing to drop the case provided the directors signed a legally enforceable undertaking stating that when Kandwa Plc ceases using the land in 4 years time, it will have to pay environmental cleanup costs of K6,000,000 as per legislation which was virtually certain to be passed. The legislation was duly passed on 3 February 2018. The relevant discount rate is 17%. The relevant discount factors at 17% are:

	Present factors	Cumulative discount factors
Year 4 at 17%	0.534	2.743

TAX DISPUTES

Much of the increased tax disputes have come from increased imports. The VAT inspectors have queried a number of VAT refunds. However, the Finance Director of Kandwa Plc suspects that their clearing agent, Asycuda Logistics, has been conniving with some customs officers to manipulate documentation. All tax issues in Kandwa Plc are currently handled by an accounts assistant who only has ZiCA technician membership.

Kandwa Plc is duly registered for VAT, and the Zambia Revenue Authority (ZRA) has requested the company to amend the VAT return submitted for the month of February 2017, using the following details which were agreed to supporting documentation:

1. Standard rated sales amounted to K3,200,000 (VAT exclusive). Kandwa Plc offers its customers a 12% discount for payment within 13 days, and this was taken by 60% of the customers. The consideration is strictly in the form of money.

2. Standard rated purchases and expenses amounted to K1,200,000. This figure includes:

	K
• Petrol expenses (VAT exclusive)	200,000
• Diesel expenses (VAT inclusive)	300,000
• Customer entertainment (VAT inclusive)	18,000
• Motor car (VAT inclusive)	90,000
• Office printer (VAT exclusive)	28,000

The balance of the expenditure consists of standard rated purchases and the figure is VAT inclusive. All the input VAT for the balance is recoverable.

3. On 28 February 2017, Kandwa Plc wrote off bad debts of K40,000 and K20,000 in respect of invoices which were due for payment on 1 August 2015 and 30 September 2015 respectively. Kandwa Plc had accounted for and paid the respective VAT amounts. The figures are VAT inclusive.

4. On 20 February 2017, a major customer paid a cash deposit of K120,000 (VAT exclusive) towards the purchase of drinks. The drinks were delivered on 18 March 2017, and the balance of K125,000 was paid on 5 April 2017.

ZRA PAYE inspectors have also questioned the status of some of the members of staff who have been classified as Consultants (self-employed) by Kandwa Plc.

DONATIONS TO CHARITIES

Kandwa Plc has made various donations to charitable organizations. The donations are in line with the company's policy on corporate social responsibility (CSR). An accounts assistant has charged the total expenditure of K180,000 incurred on donations to administration cost as advised by the Financial Reporting Officer. However, he is ignorant of the tax treatment. The Accounts Supervisor also lacks knowledge in taxation and the company does not offer any training support to its staff.

MANAGEMENT TRAINEES

The Chairman of the Board of Kandwa Plc suggests that the company should immediately consider recruiting five (5) management trainees, who should be seconded to MEW Associates for at least 2 years. He wants the trainees to be ready for ZiCA non-audit practice certification on completion of their secondments. The levels of incompetence, especially in the accounts department remain unacceptable. He wants MEW Associates to provide the eligibility criteria for the certification before a final decision could be made.

E – COMMERCE

The Board has recruited an Information Technology (IT) expert to develop the company's website and maintain it. The board wants MEW Associates to assist in:

- Recruiting sufficient IT experts, who should continue developing and maintaining the website. At the moment the company is solely dependent on one person.
- Procuring appropriate IT hardware and software, from credible suppliers.
- Acting as a change agent.

NON-EXECUTIVE DIRECTORSHIP APPOINTMENT

Mr. Francis Chinanazi was recently appointed as a non-executive director of RF Ltd, a privately owned company, which produces and supplies coal to the entire brewing industry. This is his first private appointment and he would like your advice on what is needed for someone to be an effective non-executive director.

RF Ltd's monthly turnover has collapsed by 35% as a result of continued load-shedding which has badly hit its coal plant in Maamba. The Managing Director has stated that the continued conflicting statements over load-shedding are not assisting. The company has started relocating some of its operations to another country, fleeing from shortage of energy in the country.

FINANCIAL STATEMENTS

The Finance Director, Mr. Matthews Musa, has prepared the list of account balances as at 31 December 2017:

K'000

Bank overdraft	630
Inventories 1.1.2017 (Inventories at cost 31.12.2017 K620,000)	400
Purchases	25,600
Ordinary share capital (K1.00 each fully paid)	12,000
Land and buildings 1 January 2017 (at cost)	31,450
Sales	49,250
Share premium	5,300
8% Loan stock	7,200
Administration costs	6,560
Revaluation surplus	5,510
Suspense account	11,450
Receivables	4,635
6% Redeemable preference shares (25 ngwee each)	2,200
Distribution costs	3,500
Plant and machinery 1 January 2017	26,250
Payables	5,289
Accumulated depreciation 1 January 2017	
Plant and machinery	80
Building	965
Motor vehicles	500
Interest expense	576

Cash in hand	73
Motor vehicles 1 January 2017	1,800
Retained earnings	470

Additional information

1. Depreciation for the year is to be charged as follows:

Plant and machinery - 10% on reducing value – charged to cost of sales.

Building – 5% on straight-line – 70% charged to cost of sales

- 30% charged to administration

Motor vehicles – 25% on reducing value – 80% charged to distribution costs

- 12% charged to cost of sales
- 8% charged to administration costs

2. Included in the value of land and buildings is K200,000 for land. This land was revalued three years ago, from K250,000 to the current value of K200,000. The loss was taken as an expense in profit or loss. During 2017, the land was revalued at K300,000. This has not been taken into account.

3. Amortisation of development cost should be charged to cost of sales, while that of patents should be charged to administration expenses.

4. All inventories held on 31 December 2017 were sold for K550,000 on 15 January 2018.

5. The company made a 2 for 3 rights issue on 1 June 2017 at a price of K1.60. The market value on the last day of quotation with rights was K1.80. The issue was fully subscribed. The proceeds were posted to the suspense account. The EPS for 2016 was 50 ngwee.

6. During the year, the company spent K412,000 on developing new pineapple drinks, which were approved by the Zambia Bureau of Standards on 1 November 2017. The drinks are proving to be commercially successful, based on the market responses received so far. The directors expect the project to be in profit within 10 months of the approval date. The patent was registered on 1 November 2017. It cost K120,000 and remains in force for five years. All the costs have been posted to the suspense account.

7. Income tax on operating profits has been estimated as K900,000. In the previous year 2016, income tax on 2016 operating profits had been estimated as K834,000 but was subsequently agreed at K852,000. The under provision has been posted to the suspense account. Income tax relating to land revaluation is K3,000.

8. An interim dividend of 4 ngwee per ordinary share was paid on 30 September 2017. This was posted to the suspense account. A final dividend of 6 ngwee per ordinary share was declared by the directors on 31 March 2018.

INDEPENDENT TAX SYSTEM

Mr Charles Mbewe who is married to Bibi Ngosa Mbewe was employed by Kandwa Plc until 1 August 2017, when his three (3) year contract came to an end. His annual salary was K240,000. In addition, he was entitled to the following allowances:

	K
Fuel allowance per month from 1 April 2017	
to the end of the contract	1,000
Leave pay	31,600
Bonus	5,000

Mr. Charles Mbewe received royalties of K25,500 in the charge year 2017.

Kandwa Plc provided Charles Mbewe with a company owned house worth K2,500,000, and a company owned Ford Explorer car for both business and private use. The car had a cylinder capacity of 3000cc. Private use has been agreed with the Commissioner General at 30%. If the house was let, the net rent payable after 10% WHT would have been K9,000 per month.

Mr. Charles Mbewe was paid the following on the expiry of his contract:

	K
Leave pay	31,600
Gratuity (35% of cumulative basic pay)	145,000
Repatriation pay	16,000
Pension	600,000

The expenses that Mr. Charles Mbewe incurred in the charge year 2017, in respect of which he wishes to make a claim for deduction are:

	K
NAPSA	7,000
Contribution into employer's approved pension scheme	3,500
Donation to Political party	1,000
Donation to approved charity	2,000
PAYE	38,400

Mrs. Bibi Ngosa Mbewe started running a business on 1 January 2017, selling various household items. She expects her turnover in the next three years to be as follows:

	K
2018	450,000
2019	575,000
2020	700,000

The turnover for 2017 was K180,000 and the net profit was K15,800. The net profit figure was arrived at after charging the following expenses:

	K
Salary for Mrs. Bibi Ngosa Mbewe	20,000
Depreciation	4,000
Motor car expenses for Mrs. Bibi Ngosa Mbewe	10,000
(Private use 60%)	
Entertaining customers	2,000
Salaries for two full-time employees	16,000

SECTION A

1. a) Explain the importance of a conceptual framework for financial reporting.

[4 marks]

b) Discuss two (2) common misconceptions about the purpose and effects of depreciation. [4 marks]

2.a) Prepare the statement of profit or loss for Kandwa Plc for the year ended 31 December 2017. (Work to the nearest K'000)

[17 marks]

Ignore the legal suit.

b) Prepare the statement of financial position for Kandwa Plc as at 31 December 2017. (Work to the nearest K'000)

Ignore the legal suit. [15 marks]

c) Calculate the earnings per share (EPS) in ngwee for 2017, and restate the 2016 EPS. [4 marks]

d) Explain the consequences of infringement of dividend rules. [6 marks]

[Total: 50 marks]

SECTION B

3. a) Identify and explain ethical and professional issues raised in respect of the following:

   (i) Legal suit

   (ii) Tax disputes

   (iii) Donations

   (iv) Management Trainees

   (v) E-commerce

   (vi) Non-executive directors

[12 marks]

b). Explain the accounting treatment of the legal suit. [4 marks]

c) Calculate the figures (if any) to be included in the financial statements for the year ended 31 December 2017, using the details given in respect of the legal suit. Comment on the possible impact on 2017 profits.

[3 marks]

4. Discuss the importance of distinguishing employment and self-employment in taxation. [6 marks]

5. a) Calculate the final income tax payable by Mr. Charles Mbewe for the tax year 2017. [10 marks]

b) Briefly explain independent tax system, and state whether it generally results in higher tax assessments. [2 marks]

c) Calculate the tax payable by Mrs. Bibi Ngosa Mbewe for tax year 2017, giving appropriate justification for your answer. [3 marks]

6. Compute the value added tax (VAT) payable for the month of February 2017 and state the due date. [10 marks]

[Total: 50 marks]

QUESTION TWO

BACKGROUND

Chikupe Ltd is a large VAT registered company which was established twenty (20) years ago. Its founder, Mr. Oscar Mwenge, is the Chairman and Chief Executive Officer (CEO) of a recently acquired subsidiary, Sioma Ltd. Mr. Oscar Mwenge is responsible for running the organisation's business and ensuring that the board focuses on strategic matters. This has significantly minimized unnecessary conflicts between board members and the senior management team.

Mr. Oscar Mwenge is among a few respected senior citizens in the country. He is an engineer with over thirty (30) years practical experience. Chikupe Ltd manufactures various steel products under the brand name 'Chikupe', which are mainly used in the mining industry. Mr. Oscar Mwenge was instrumental in the acquisition of Sioma Ltd. He is a strong believer in diversification and multi-skilling. For him, diversification has a direct impact on performance because it involves the deployment of the company's resources into new products and new markets.

Sioma Ltd is an insurance company, which is relatively profitable, with a high degree of match in terms of strategic direction, and Chikupe Ltd's senior management team has the capabilities and experience to add value by providing the support required by Sioma Ltd. The board is currently considering a number of changes in the accounting policies used by Sioma Ltd.

Chikupe Ltd has constructed a K7 million plant in the Lusaka-South Multi-Facility Economic Zone (LSMFEZ). The facility is expected to create more than 1,000 jobs. Government has provided a tax holiday for ten (10) years, since it is supportive of investments that create decent jobs for Zambians. The company already has three (3) plants in Ndola, Solwezi and Choma. The investment was significantly financed by selling two (2) of the five (5) large commercial plots owned by Chikupe Ltd; even though the sale resulted in huge losses. The overall expansion programme has been successful mainly due to a change in the remuneration structure for directors, which was approved by the company's board three years ago.

Chikupe Ltd has engaged KJC, a firm registered with ZiCA to provide non-audit services. KJC has three (3) partners, five (5) managers and ten (10) accountants at various levels, including three (3) support staff. The partners are:

- Mr. Mundia Tembo – a ZiCA Chartered Accountant with eighteen (18) years experience. He was recently appointed to sit on the board of Chikupe Ltd, and was elected Chairman of the audit and remuneration committee due to his wide experience. He is the Managing Partner.
- Mr. Christopher Mweemba – a ZiCA Chartered Accountant with ten (10) years experience. He is in charge of human resource and quality control.
- Mrs. Rosette Mwansa – a UK Chartered Accountant with twelve (12) years experience in the provision of non-audit services. She in charge of the firm's operations.

Mr. Oscar Mwenge sits on the board of KJC. This has made the KJC board balanced in terms of skills and experience, since KJC has a number of clients in the engineering sector.

You are Jason Kanyama, a newly-qualified Manager in KJC. You have been appointed by the partners to lead a team on the Chikupe Ltd and Sioma Ltd assignments. The partners want you to clearly identify any financial statements risks at the planning stage. To gain further understanding of the companies you held meetings with the finance directors of both companies.

<u>CHIKUPE LTD</u>

The Finance Director, Mrs. Ruth Lufina joined the company on 3 April 2017 and tendered her resignation letter on 10 August 2017. Her last working day was 28 November 2017. She has had serious disagreements with the CEO, Mr. Fred Mokambo over a number of proposed changes to accounting policies and window dressing transactions and activities. He has appointed an unqualified person as the Finance Director. However, the CEO wants KJC to prepare the financial statements for the year ended 31 December 2017.

The audit and remuneration committee at Chikupe Ltd is responsible for reviewing directors' remuneration packages. The current package is very attractive and Chikupe Ltd has the best package in the industry. The package includes a profit-related bonus which is payable to all directors.

The fee for the assignment has been agreed as 9% of the profit after tax. The current company income tax rate is 40% but the directors have told KJC to use 30%, which was recently announced in the budget speech by the Minister of Finance, when calculating deferred tax. They have also suggested that last year's underprovision of company income tax should be written off against retained earnings brought forward.

Mr. Fred Mokambo's wife rents a building owned by Chikupe Ltd, for her steel retail business. She has been running her business for the past five years. Her profit margins are 40% above the industry average. She uses cost leadership strategy for the business to remain highly profitable.

The directors of Chikupe Ltd recently agreed to change inventory valuation to Last In, First Out (LIFO) for the most expensive type of steel, mainly due to the reduction in inflation from 22% to 6.8%. The directors also agreed to continue using First In, First Out (FIFO) for valuing other inventories. They believe this will result in the financial statements showing a true and fair view.

The following items of other inventories are yet to be valued:

Item of inventory	Quantity (Units)	Cost per unit K (Based on FIFO)	Net Realisable Value (NRV) K
A	1,000	10	12
B	3,000	8	5
C	2,500	13	10
D	6,000	4	6
E	500	7	12
F	1,700	3	2
G	600	21	25
H	7,430	2	4

KJC assisted Chikupe Ltd with a loan of K500,000 to complete the construction of the Lusaka plant. This will be repaid in five equal quarterly installments, once the plant becomes operational. Chikupe Ltd has been charged a minimal interest rate of 3%.This has further strengthened the business relationship between the two organizations.

The details of assets disposed of during the year under review were as follows:

Assets disposed of	Cost (K)	Carrying Amount (K)	Proceeds (K)
Commercial plot of land (1)	4,000,000	6,200,000	5,000,000
Commercial plot of land (2)	2,000,000	4,000,000	1,500,000
Toyota Truck	300,000	100,000	170,000

The proceeds of K170,000 for the sale of the Toyota Truck have been credited in the statement of profit or loss as other income. The open market values for the assets disposed of were as follows:

	K
• Commercial plot of land (1)	4,500,000
• Commercial plot of land (2)	1,800,000
• Toyota Truck	120,000

The company is being investigated for tax evasion involving underdeclaring income. The directors expect KJC to resolve the issues with the Zambia Revenue Authority (ZRA). The Zambia Revenue Authority (ZRA) has requested KJC to provide information relating to income.

At a recent meeting with the audit and remuneration committee, KJC was requested to suggest elements which could strengthen the control environment in Chikupe Ltd. They strongly think the current control environment is undermining the effectiveness of controls.

The company spends huge sums of money to protect the 'Chikupe" brand and minimise any reputational risks, and continue consolidating its recent gains in market share. KJC has been instructed to prepare financial statements which show recent gains in market share, failure to which it risks being removed. The 'Chikupe' brand is shown in the statement of financial position. The advertising expenditure has been rising at a rate of 40% per annum.

A theft is reported to have occurred on 31 August 2017 at the Choma plant. The opening inventory at the beginning of the financial year was K525,000. During the 8 months to 31 August 2017, cost of production was K17,982.000. Sales during the same period was K23,945,000. Chikupe Ltd's gross profit margin average 30%. The cost of the inventory which was not stolen was K33,000. The company uses a manual inventory management and control system.

Chikupe Ltd is considering registering as a group for VAT purposes.

For the year ending 31 December 2017, the company's actual results showed a total taxable profit of K12,206,000, which included Rental income of K36,000 (gross) and Royalties of K170,000 (net). The estimated taxable business profit was K908,000.

SIOMA LTD

Sioma Ltd is also VAT registered and now employs ten (10) permanent and thirty (30) part-time staff. The CEO has directed the marketing director to seriously consider e-marketing, and start using the internet as a major selling medium. He is confident that the internet will be used as a low cost method of collecting marketing information about customer perceptions of products and services. This will eventually assist in:

- 'Re-selling' similar products to previous sales.
- 'Cross selling' closely related products.
- 'Up selling' more expensive products etc.

The company has an internal audit department and the Chief Internal Auditor reports to the CEO. The CEO always ensures audit issues are attended to by all senior managers and taken into account when appraising respective senior managers' performances. He also ensures that the internal audit department is adequately resourced.

The board consists of three (3) executive directors and three (3) non-executive directors (NEDs). The NEDs are appointed by the Chairman of the board who also fixes the remuneration for both the executive and non-executive directors. The non-executive directors form the audit committee. The NEDs are engaged on five (5) year contracts to ensure they contribute effectively.

The CEO and the Finance Director appoint external auditors to avoid unnecessary delays in the audit of financial statements. The majority of the shareholders are happy with this arrangement.

The board has a formal charter and regularly monitors key performance drivers. Procedures exist whereby NEDs may take independent advice, at the company's expense if necessary. The Company Secretary is accountable to the board through the Chairman.

Sioma Ltd imported a 26 seater minibus from UK in July 2017 at a cost of $5,300. The company paid insurance of $600 and freight of $1,200. Other incidental costs paid by the company were $500.

The minibus arrived at Nakonde border post on 5 October 2017 and all import taxes were paid by the company on that date. The Commissioner General had advised that for the period from 1 October 2017 to 15 October 2017, the exchange rate to be used was K9.80 per $. However, the kwacha appreciated around 5 October 2017 and on that date, the exchange rate quoted in one of the Bureau De Changes was K9.67 per $.

The company further incurred K1,000 on the registration of the car in Lusaka, and K4,500 for comprehensive insurance.

SECTION A

(1) (a) Identify and explain any five (5) ethical issues in Chikupe Ltd and suggest the necessary safeguards for each issue.
(10 marks)

(b) Explain eight (8) financial statement risks in Chikupe Ltd.
(12 marks)

(c) Write a report to the audit and remuneration committee of Chikupe Ltd, clearly recommending any four (4) elements which may contribute towards strengthening the control environment.
(10 marks)

(2) (a) Describe the five-step model for accounting for revenue.
(10 marks)
(b) Advise the board of Sioma Ltd on changes in accounting policies (apart from disclosure requirements) for an insurer.
(6 marks)
(c) Calculate the value of the given inventory for Chikupe Ltd as at 31 December 2017. (4 marks)

(3) (a) Advise Chikupe Ltd on the intended Group VAT registration. (4 marks)

(b) Compute the provisional tax paid by Chikupe Ltd and state the due date(s). (4 marks)

(c) Calculate the final company income tax payable by Chikupe Ltd for the charge year 2017. (8 marks)
(d) State the due date(s) for the filing of the self assessment income tax return and payment of the final company income tax for the tax year 2017. (2 marks)

(Total: 70 marks)

SECTION B

(4)(a) Explain six (6) weaknesses in corporate governance in Sioma Ltd.

(6 marks)

(b) Recommend one (1) appropriate action to be taken for each governance weakness identified in (a) above. (6 marks)

(5) (a) Calculate the missing inventory figure, in Chikupe Ltd. (3 marks)

(b) Explain two (2) main advantages of computerizing the inventory management and control system and two (2) main advantages of e-marketing from customers' perspectives. (4 marks)

(6) (a) Calculate property transfer tax (PTT) for the various transfers made by Chikupe Ltd. (4 marks)

(b) State the person responsible for paying PTT . (1 mark)

(c) (i) Explain the clearance procedure for motor vehicles. (3 marks)

(ii) Calculate the import taxes that were paid by Sioma Ltd. (3marks)

(Total: 30 marks)