NON – AUDIT

SUGGESTED SOLUTION

SOLUTION ONE

SECTION A

(1) (a)

The financial reporting process is concerned with providing information that is useful in the business and economic decision making process. Therefore a conceptual framework will form the **theoretical basis** for determining which events should be accounted for, how they should be measured and how they should be communicated to the user.

Although it is theoretical in nature, a conceptual framework for financial reporting has highly practical final aims.

The danger of not having a conceptual framework is demonstrated in the way some countries' standards have developed over recent years; standards tend to be produced in a **haphazard and firefighting approach**. Where an agreed framework exists, the standard-setting body act as an architect or designer, rather than a fire-fighter, building accounting rules on the foundation of sound, agreed basic principles.

The lack of a conceptual framework also means that fundamental principles are tackled more than once in different standards, thereby producing **contradictions and inconsistencies in basic concepts** such as those of prudence and matching. This leads to ambiguity and it affects the true and fair concept of financial reporting.

Another problem with the lack of a full conceptual framework has become apparent in the USA. The large number of **highly detailed standards** produced by the Financial Accounting Standards Board (FASB) has created a financial reporting environment governed by specific rules rather than general principles. FASB has 'concept statements' but a full conceptual framework would be better.

A conceptual framework can also **bolster standard setters against political pressure** from various 'lobby groups' and interested parties. Such pressure would only prevail if it was acceptable under the conceptual framework.

A framework cannot provide all the answers for standard setters. It can provide basic principles which can be used when deciding between alternatives, and can **narrow the range of alternatives** that can be considered. In the UK, Statement of Principles has provided definitions that have formed the basis of definitions in accounting standards, as has the IASB's conceptual framework in areas such as financial instruments and provisions. A framework can also **provide guidance in the absence of an accounting standard**. For example, there is no IFRS dealing specifically with off balance sheet finance, so the IASB Conceptual Framework must form the basis for decisions.

(Award 1 mark for each relevant point – Maximum 4 marks)

(b)
The need to depreciate non-current assets arises from the **accrual assumption.** If money is expended in purchasing an asset then the amount must at some time be charged against profits. If the asset is one which contributes to an enterprise's revenue over a number of accounting periods it would be inappropriate to charge any single period (e.g. the period in which the asset was acquired) with the whole of the expenditure. Instead, some method must be found of **spreading the cost** of the asset over its useful economic life.

This view of depreciation as a process of allocation of the cost of an asset over several accounting periods is the adopted by **IAS 16**. The two common misconceptions about the purpose and effects of depreciation are:

- It is sometimes thought that the **net book value (NBV) of an asset is equal to its net realizable value** and that the object of charging depreciation is to reflect the fall in value of an asset over its life. This misconception is the basis of a common, but incorrect, argument which says that freehold properties (say) need not be depreciated in times when property **values are rising**. It is true that historical cost statements of financial position (balance sheets) often give a misleading impression when a property's NBV is much below its market value, but in such a case it is open to a business to incorporate a revaluation into its books, or even to prepare its accounts based on current costs. This is a separate problem from that of allocating the property's cost over successive accounting periods.

- Another misconception is that depreciation is provided so that an asset can be **replaced** at the end of its useful life. This is not the case.
    - If there is **no intention of replacing** the asset, it could then be argued that there is no need to provide for any depreciation at all.

- If **prices are rising**, the replacement cost of the asset will exceed the amount of depreciation provided.

(Award 1 mark for each valid point – Maximum 4 marks)

(2)

(a)

KANDWA PLC
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2017

	K'000	K'000	**Marks**
Revenue		49,250	**½**
Cost of sales (W1)		(29,214)	**5**
Gross profit		20,036	**½**
Distribution costs (W1)		(3,760)	**2**
Administration expenses (W1)		(7,009)	**2**
Finance costs (W5)		(708)	**1**
Profit before tax		8,559	**½**
Income tax expense (W6)		(915)	**1**
Profit for the year		7,644	**½**
Other comprehensive income:			
Gain on land revaluation	50		**½**
Income tax relating to gain on land revaluation	(3)		**½**
Other comprehensive income, net of tax		47	**½**
Total Comprehensive Income for the year		7,691	**½**

(Award marks as shown above and up to 2 marks for presentation – Maximum 17 marks)

(b)

KANDWA PLC
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2017

	K'000	
ASSETS		
Non-current assets		**Marks**
Property, plant and equipment (W2)	53,550	**3**
Intangible non-current asset (W4)	514	**1 ½**

Current assets		
Inventories	550	½
Trade receivables	4,635	½
Cash	73	½
Total Assets	59,322	

EQUITY AND LIABILITIES		
Equity		
Ordinary share capital (W1)	20,000	**1**
Share premium	10,100	**1**
Retained earnings (470 + 7,644 – 800)	7,314	**1**
Revaluation surplus	5,557	**1**
Non-current liabilities		
8% loan stock	7,200	½
6% redeemable preference shares	2,200	½
Current liabilities		
Trade payables	5,289	½
Bank overdraft	630	½
Income tax	900	½
Redeemable preference dividend	132	½
Total equity and liabilities	59,322	

(Award marks as shown above and up to 2 marks for presentation – Maximum 15 marks)

Workings

1. Expenses

	Cost of sales	Distribution costs	Administration costs
	K'000	K'000	K'000
Opening inventories	400		
Per Balance listing		3,500	6,560
Purchases	25,600		
Revaluation gain			(50)
Depreciation on buildings (W2)	1,094	0	469
Depreciation on plant and mach.	2,617	0	0
Depreciation on motor vehicles	39	260	26
Amortisation of development costs	14	0	0

Amortisation of patents			4
Closing inventories (620 – 70)	(550)	0	0
Total	29,214	3,760	7,009

2. Property, plant and equipment

	Land	Buildings	Plant & mach.	Motor vech.	Total
Cost	K'000	K'000	K'000	K'000	K'000
b/d	200	31,250	26,250	1,800	59,500
Additions	0	0	0	0	0
Disposals	0	0	0	0	0
Revaluations	100	0	0	0	100
c/d	300	31,250	26,250	1,800	59,600
Depreciation					
b/d	0	965	80	500	1,545
5% x (31,450 – 200)		1,563			1,563
10% x (26,250 – 80)			2,617		2,617
25% x (1,800 – 500)				325	325
c/d	0	2,528	2,697	825	6,050
Carrying amount					
At 31 Dec. 2017	300	28,722	23,553	975	53,550
At 1 Jan. 2017	200	30,285	26,170	1,300	57,955

Depreciation charge for the year is split as follows:

	Cost of sales	Distribution costs	Administration expenses
	K'000	K'000	K'000
Buildings			
1,563 x 70%	1,094		
1,563 x 30%			469
Plant & machinery			
2,617 x 100%	2,617		
Motor vehicles			

325 x 12%	39		
325 x 80%		260	
325 x 8%			26
Total	3,750	260	495

4. Intangible non-current assets

	Development costs	Patents	Total
	K'000	K'000	K'000
Expenditure	412	120	532
Amortisation (2/60)	(14)	(4)	(18)
Carrying amount	398	116	514

5. Finance cost

	K'000
Per balance listing	576
Redeemable preference dividends (6% x 2,200,000)	132
Total	708

6. Income tax expense

	K'000
Current year	900
Income tax relating to revaluation surplus	(3)
Previous year under provision	18
Total charge	915

7. Suspense Account

	Debit (K'000)		Credit (K'000)
Ordinary share capital	8,000	b/d	11,450
Share premium	4,800	Development costs	412
		Interim dividend	800
		Patent	120
		Previous year tax under provision	18
Total	12,800	Total	12,800

(c)

EPS for 2016

EPS = 1.72/1.80 x 50 = 48 ngwee

EPS for 2017

EPS = K7,644,000/16,899,225 = 45 ngwee

(Award up to 2 marks for each correct EPS calculation – Maximum 4 marks)

Workings

1. Theoretical ex-rights price (TERP)

	Number	Price	Value
	'000	K	K'000
Before rights issue	12,000	1.80	21,600
Rights issue			
12,000/3 x 2	8,000	1.60	12,800
After rights issue	20,000		34,400

TERP = 34,400/20,000 = K1.72

OR

	Number	Price	Value
		K	K
Before rights issue	3	1.80	5.40
Rights issue			
	2	1.60	3.20
After rights issue	5		8.60

TERP = 8.60/5 = K1.72

2. Number of shares:

Before the rights issue	12,000,000 x 5/12 x 1.80/1.72	5,232,558
After the rights issue	20,000,000 x 7/12	11,666,667
Total		16,899,225

(d) Infringement of dividend rules

If a dividend is paid otherwise than out of distributable profits of the company, the directors and the shareholders may be involved in making good the unlawful distribution.

The directors are held responsible since they either recommended to members in general meeting that a dividend should be declared or they declare interim dividends. The directors are liable if:

- They declare a dividend which they know is paid out of capital.
- Without preparing any accounts, they declare or recommend a dividend which proves to be paid out of capital. It is their duty to satisfy themselves that profits are available.
- They make some mistake of law or interpretation of the constitution which leads them to recommend or declare an unlawful dividend. However in such cases the directors may well be entitled to relief if their acts were performed 'honestly and reasonably'.

The directors may however honestly rely on proper accounts which disclose an apparent distributable profit out of which the dividend can properly be paid. They are not liable if it later appears that the assumptions or estimates used in preparing the accounts, although reasonable at the time, were in fact unsound.

The position of members is as follows.

- A member may obtain an injunction to restrain a company from paying an unlawful dividend.
- Members voting in general meeting cannot authorize the payment of an unlawful dividend nor release the directors from their liability to pay it back.
- The company can recover from members an unlawful dividend if the members knew or had reasonable ground to believe that it was unlawful.

- If the directors have to make good to the company an unlawful dividend they may claim indemnity from members who at the time of receipt knew of the irregularity.
- Members knowingly receiving an unlawful dividend may not bring an action against the directors.

If an unlawful dividend is paid by reason of error in the accounts the company may be unable to claim against either the directors or the members. The company might then have a claim against its auditors if the undiscovered mistake was due to negligence on their part.

(Award 1 mark for each valid point – Maximum 6 marks)

SECTION B

(3) (a)

(i) Legal suit

Members should be straightforward and honest in all professional and business relationships (integrity). It would be a criminal offence for MEW Associates to act positively, without lawful authority or reasonable excuse (if MEW Associates knows or suspects that Pandwa Plc has committed a wrongful act), in such a manner as to impede with intent the arrest or prosecution of the directors whom MEW Associates knows or believes to have committed an 'arrestable' offence.
Although, MEW Associates should respect the confidentiality of information acquired as a result of professional and business relationships, MEW Associates should give careful thought to its own position.
Hence, MEW Associates could provide the requested findings depending on the legal advice given.

(ii) Tax dispute

In many jurisdictions, accountancy firms may be asked to provide taxation services to its client. These encompass a wide range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. The provision of taxation services is generally not seen to threaten independence.

According to the tax laws in Zambia, Tax advisors may also be liable to a fine and/ or imprisonment if they are knowingly involved in, or facilitates the fraudulent evasion of tax. Hence, if MEW Associates as Tax advisors become aware of a material non-compliance or tax evasion of Pandwa Plc, whether perpetrated by the clearing agent, Asycuda logistics or not, they should report this fact to Pandwa Plc to rectify the position and request that they report it to Commissioner General. Hence, MEW Associates will be required to follow the tax laws when handling the dispute with Zambia Revenue Authority (ZRA). This will also apply to the 'consultant' classification which has been queried by ZRA.

The Zambia Institute of Chartered (ZiCA) provides the code of ethics for all the chartered accountants in Zambia and any member who may have aided a client to evade tax may be subjected to disciplinary action.

(iii) Donation

Members have a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques. Members should act diligently and in accordance with applicable technical and professional standards when providing professional services. It is unfortunate that Pandwa Plc does not provide any training.

According to the Income Tax Act, amounts paid to a charitable, ecclesiastical, research or educational or for national amateur sporting purposes are allowed if:

- The payment is made in money or in kind
- The payment is made for no consideration whatsoever
- The institution has been approved by the Minister of Finance

The maximum amount that is allowed is 15% of the taxable profits of the business.

Pandwa Plc must recruit a qualified person to handle tax issues and avoid wrong doing which may result in penalties and interests, and ensure staff training is adequately supported.

(iv) Management trainees

Appropriate training must be availed to trainees. To be eligible to obtain a non audit practising certificate, a member shall have

- been certified by a professional body or a body recognized under section 13 of the Accountants Act 2008 to have complied with the education and training requirements;
- obtained competence to practice over a period of more than seven (7) years between the date of complying with the education and training requirements and date of the application;
- passed the competence practice examination set by the institute and

The experience must be of a wider and deeper nature than that required for membership and should cover any of the following areas: Financial Reporting, Taxation (Personal, Corporate and other related areas), Management Accounting, Financial Management, and Strategic and Risk Management. The experience must be confirmed by a supervisor(s).

It is crucial to any professional to have not only a sound theoretical knowledge but also to apply that knowledge competently while working. The practical experience, primarily in the area of audit and accountancy, must be approved and properly supervised in a suitable professional environment.

(v) E-commerce

The most generic description of e-commerce is trading on the internet, buying and selling products and services. This normally results in serious security concerns about hackers and electronic fraud. The requirement for appropriate software and hardware from a reliable source is cardinal. In addition, selling drinks over the internet could have its own challenges.

MEW Associates involvement in this area could compromise their independence and objectivity. MEW Associates may not have appropriate competencies to give the required professional advice. In addition, this can involve significant sums of money and the partners of MEW Associates may recommend their friends for the various procurements, whose performance could prove to be substandard.

Accountants have a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. MEW Associates should not undertake this assignment unless they have the necessary Information Technology (IT) resources.

(vi) Non- executive directors

Non-executive directors are directors who do not have day-to-day operational responsibility for the company. They are not employees of the company or affiliated with it in any way. To be effective, the following are some of the important issues for Mr. Francis Chinanazi:

- Independence – free thinking, avoids conflicts of interest
- Preparedness – knows key staff, organization and industry, aware of statutory and fiduciary duties
- Practice – participates actively, questioning, insists on obtaining information, undertakes professional education
- Committee work – understands process of committee work, exhibits ideas and enthusiasm
- Development of the organization – makes suggestions on innovation, strategic direction and planning, helps win the support of outside stakeholders

(Award up to 2 marks for each well explained issue – Maximum 12 marks)

(b) Accounting treatment

IAS 37 Provisions, contingent liabilities and contingent assets, gives detailed accounting guidance in this area. The standard states that a provision should be recognized as a liability in the financial statements when:

- An entity has a present obligation (legal or constructive) as a result of a past event
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation
- A reliable estimate can be made of the amount of the obligation

Kandwa Plc should therefore recognize a provision for estimated costs of making good the site because:

- It has a present obligation to incur the expenditure as a result of a past event. In this case the obligating event occurred when it became virtually certain that the legislation would be passed. Therefore the obligation existed at 31 December 2017, and
- An outflow of resources embodying economic benefits is probable, and
- It is possible to make a reliable estimate of the amount.

(Award up to 1 mark for each valid point – Maximum 4 marks)

(c) For the year ended 31 December 2017, the figures to be included are as follows:

- A provision of K3,204,000 (6,000,000 x 0.534) is reported as a liability.
- A non-current asset of K3,204,000 is also recognized. The provision results in a corresponding asset because the expenditure gives the company access to an inflow of resources embodying future economic benefits; there is no effect on profit or loss for the year.

(Award 1 mark for correct liability figure, 1 mark for correct non-current asset figure and 1 mark for no effect on profits – Maximum 3 marks)

(4)

It is important to distinguish employment from self-employment because of the different tax treatments which may assist in minimising tax liabilities. In general, most taxpayer could prefer being treated as self-employed so as to avoid paying more tax. The main issues regarding tax treatment are as follows:

- An employee does not have to account for income tax payable personally. The employer is responsible for handling the employee's tax affairs. An employee cannot suffer any tax penalties.
- A self employed individual must account for income tax on his or her earnings personally. In case of failing to comply with some obligations under the Income Tax Act, the self-employed individual will suffer tax penalties.
- For the employee, income tax is payable under the PAYE system immediately the emoluments are paid. This means, the employee cannot receive the gross earnings and pay income tax later on.

  A self-employed individual with annual turnover in excess of K800,000 pays income tax based on provisional income during the tax year. The final balance of income tax is payable by the 21st June after the end of the tax year. Assuming the profits are equal to cash, a self-employed person will be able to invest that cash and earn additional income before 21st June following the end of the tax year.

- Employees must pay contributions to NAPSA, with the employer also making a contribution on behalf of employees. In addition, employees can also pay contributions into another pension scheme.

  The self employed are free to make their own pension arrangements. They must pay contributions to NAPSA on behalf of their own employees, if they have any.

- Deductions from emoluments for tax purposes are quite rare. Only a few statutory deductions are allowed. In some cases, the amount that can be deducted is restricted. For example, the pension contributions paid to approved funds is not wholly deductible. The deductible amount is restricted to 15% of emoluments or K3,060 per year, whichever is lower.

  For the self-employed all revenue expenses incurred wholly and exclusively for the purposes of a business, are deductible. In many cases, there are no restrictions as to the maximum amount that can be deducted.

- An employee cannot register for VAT and will bear all VAT on supplies received as a final consumer.

  A self-employed individual may be able to register for VAT if he or she makes taxable supplies. He or she can then not bear VAT on all supplies received, unless the VAT relating to them is irrecoverable.

(Award up to 1 mark for each well-explained point – Maximum 6 marks)

5. (a) Charles Mbewe

Personal Income Tax Computation for the tax year 2017

	K	K	**Marks**
Earned income			
Emoluments from employment			
Salary (240,000 x 7/12)		140,000	**1**
Fuel allowance (1,000 x 4)		4,000	**1**
Leave pay		31,600	**½**
Bonus		5,000	**½**
		180,600	
Investment income			
Royalties (grossed-up) (25,500 x 100/85)		30,000	**1**
		210,600	
Deductions			
NAPSA (maximum)	3,060		**½**
Donation to approved charity	2,000		**½**
		(5,060)	
Taxable income		205,540	**½**
Income tax			
39,600 x 0%		0	**½**
9,600 x 25%		2,400	**½**
25,200 x 30%		7,560	**½**
131,140 x 37.5%		49,178	**½**
		59,138	
Less tax already paid			
PAYE		(38,400)	**½**
WHT on Royalties (15% x 30,000)		(4,500)	**½**
Final income tax payable		16,238	

Notes

1. Gratuity and repatriation pay are exempt, since they are pension benefits. **½ mark**

2. WHT on dividends from a Zambian company is a final. Hence no further assessments apply. **½ mark**

3. The contributions to the other pension scheme has not been deducted because of the limitation of allowable deductions to a maximum of K3,060 per annum, which has been fully utilized by NAPSA. The National Pension Scheme Authority (NAPSA) is given priority over any other approved fund. **½ mark**

(Award marks as shown above – Maximum 10 marks)

(b)

Independent taxation system is a system whereby married couples are not taxed as a single individual. Each spouse is taxed individually. Since each spouse has his or her own tax free amount of K39,600, and lower rates of 25% and 30%, it simply means the tax payable is significantly reduced. This is why it is usually advisable for couples to operate a business venture through a partnership.

(Award 1 mark for each valid point – Maximum 2 marks)

(c) Mrs. Bibi Mbewe

The taxable turnover does not exceed K800,000 and as such she will have paid turnover tax, not the usual income tax. The monthly turnover tax will have been based on the monthly turnover category. **1 mark**

Monthly turnover = 180,000/12 = K15,000 **½ mark**

Monthly turnover tax:

	K	
Presumptive amount	575	
Plus 3% x (15,000 -12,500)	75	
Monthly turnover tax	650	**1 ½ marks**

The profit figure given is irrelevant.

(Award marks as shown above – Maximum 3 marks)

5. Kandwa Plc

Computation of VAT payable for the month of February 2017

	K	K	**Marks**
Output VAT			
Standard rated sales (3,200,000 x 16% x 88%)		450,560	**2**
Deposit (120,000 x 16%)		19,200	**1**
Total output VAT		469,760	
Input VAT			
Purchases and expenses (balance) (564,000 x 4/29)	77,793		**2**
Petrol (VAT not recoverable)	-		**1**
Diesel (300,000 x 4/29 x 90%)	37,241		**1**
Office printer (28,000 x 16%)	4,480		**1**
Bad debt relief (40,000 x 4/29)	5,517		**1**
Total input VAT (recoverable)		(125,031)	
VAT payable		344,729	**½**

Due date: 16 March 2017. **½**

(Award marks as shown above – Maximum 10 marks)

END

SUGGESTED SOLUTIONS AND MARKING KEY

SOLUTION TWO

SECTION A

(1) (a)

Ethical threat	Explanation	Safeguards
1. Fees for the assignments, and bonus for all directors based on the level of profitability.	There is a possibility that KJC could manipulatively overstate profitability in order to get higher fees, and the directors may not even question this since their bonuses are also linked to profitability.	KJC should act with integrity and honesty, although the level of self interest is significant. The feasible safeguard is to ensure the fees and the bonus, are no linked to profitability. In fact, contingent fees are prohibited by ZiCA. Chikupe Ltd should consider using the balanced scorecard when determining the bonus. This could remove the self-interest.
2. Instruction to prepare financial statements which shows the recent gains in market share, failure to which KJC will be removed. The Finance Director, Mrs. Ruth Lufina resigned due to proposed changes to accounting policies and window dressing transactions and activities.	KJC need to be able to prepare information honestly and with objectivity. However, in this situation, KJC is being pressured into producing information which may be incorrect, simply to show what the directors want, for whatever reason. The instruction gives rise to an intimidation threat and may encourage dishonesty.	KJC should consult with any committee charged with governance (e.g. the audit committee or ethics committee) or if necessary take advice from ZiCA. If after these discussions, the situations cannot be resolved, KJC may have to consider resignation.
3. Cross directorships in that Mr. Oscar Mwenge, Chairman and Chief Executive Office of Sioma Ltd (he is the founder of Chikupe Ltd) sits on the board of KJC, while Mr. Mundia Tembo, Managing Partner of KJC also sits on the board of Chikupe Ltd. He is the Chairman of the audit and remuneration committee.	Cross directorships represent a threat to the efficient working of governance committees such as the audit remunerations committees. A cross directorship is said to exist when two (or more) directors sit on the boards of the other. In practice, such arrangements also involve some element of cross-shareholdings which further	Cross directorships and cross shareholding arrangements are explicitly forbidden by many corporate governance codes of best practice, including ZiCA guidance. Mr. Mundia Tembo should consider resigning his position as a director of Chikupe Ltd.

	compromises the independence of the directors involved. The danger is that cross directorships will undermine the roles of the audit and remunerations committees. Mr. Mundia Tembo may not be independent when deciding on Mr. Oscar Mwenge's remuneration , since he may in who, in turn, play a part in deciding Mr. Mundia Tembo's remuneration. This is a clear conflict of interest. Neither director involved in the arrangement is impartial and so a temptation would exist to act in a manner other than for the benefit of the shareholders of the company on whose remunerations committee they sit.	
4. Confidentiality	KJC has a duty of confidentiality to Chikupe Ltd, and KJC and its staff must ensure that they do not breach their duty of confidentiality when dealing with the Zambia Revenue Authority (ZRA). However, this may be complicated by the fact the company is suspected of underdeclaring income. This is effectively then an investigation into the crime of money laundering, in which case, KJC may have legal duties of disclosure that are not subject to subject to the duty of confidentiality and for which they have protection under qualified privilege. Members are entitled to make disclosures to defend themselves and their professional reputation, and if	KJC should take legal advice on disclosures that they are required to make and disclosures that they are not permitted to make before they make any disclosures to the tax authorities in the course of this investigation.

	the investigation includes members of the tax department of firm personally, they may need to make disclosures in their own interests.	
5. KJC loan to Chikupe Ltd.	A loan between KJC and Chikupe Ltd creates a self-interest threat to independence. The Code specifically states that firms should not enter into any loan arrangement with a client that is not a bank or similar institution.	No safeguard would reduce the self-interest to an acceptable level. KJC resign.

(Award ½ mark for each identification, up to 1 mark for each explanation and ½ mark for each relevant safeguard – Maximum 10 marks)

(b) Financial statement risks

Financial statement risks	Explanation
• Inventory valuation	LIFO is not an acceptable method of valuing inventory under IAS 2. If used, there is a risk that the inventory will be overstated and profits will be overstated as well, since inflation is decreasing. This could be one of the strategies directors want to use to increase their bonus.
• Proceeds from sale of Toyota truck credited to statement of profit or loss as other income	There is a risk that the profit on disposal is overstated since the carrying amount of Toyota truck has not been deducted. In addition, the carrying amount of non-current assets will also be overstated.
• Related party transactions	A related party transaction has occurred by virtue of the Managing Director's wife renting the building owned by the company. The rent is not mentioned but high profits earned by the wife may suggest that she pays minimal rentals and is able to buy steel from Chikupe Ltd at significantly discounted prices. IAS 24 defines a related party transaction as 'a transfer of resources, services or obligations

	between a reporting entity and a related party, regardless of whether a price is charged. There is a risk of non-disclosure of this related party transaction, contrary to the requirement of IAS 24.
• Deferred tax and the accounting treatment of underprovision of last year's tax	IAS 12 requires that deferred tax is calculated at a rate of tax that is 'substantively enacted' and expected to apply to the period when the deferred tax is to be settled. Substantively enacted generally means that it has been made into law, not merely suggested or announced. In this instance, therefore, the directors are proposing to apply a lower tax rate that is not substantively enacted, but has merely been announced by the Minister of Finance. There is a risk that the deferred tax will be understated and profits overstated. The underprovision of last year's tax should not be written off against retained earnings. If this is done, the current year's profit will be overstated. The underprovision should be part of the current year's tax.
• Resignation of the Finance Director and appointment of an unqualified person.	There is a risk that reliable financial information required for the preparation of financial statements showing a true and fair view may not be available. The Managing Director, Mr. Fred Mokambo wants to manipulate the financial statements by changing accounting policies and engaging in window dressing transactions and activities. This will also affect consolidated financial statements. The oversight on the preparation process may be compromised.
• Accounting estimate and bonuses	The existence of profit-based bonuses for directors represents an inherent risk of manipulation, with income and profit being overstated, and expenses being understated. The fact that the Finance Director, Mrs. Ruth Lufina left after disagreement over a number of proposed changes to accounting policies and window dressing transactions and activities may indicate that Mr Fred Mokambo and other directors have indeed attempted to manipulate the financial statements. There is a risk that IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors may not be adhered to, for instance if change in accounting policy has been mistaken for a

	change in accounting estimate.
• Disposal of commercial plots of land at significant losses	The significant losses made on the sale of the two commercial plots of land should be separately disclosed in the statement of profit or loss. There is a risk that this may not be done. The losses made on land sold also suggest that the land currently recognized at cost in the statement of financial position may be impaired.IAS 36 Impairment of assets requires an impairment review to be carried out in this case, and that any impairment losses are recognized. There is a risk of this not happening, overstating both non-current assets and profit.
• Internally generated brands	'Chikupe' is an internally generated brand name, which as per IAS 38 Intangible Assets cannot be capitalized unless it has a readily ascertainable market value. There should be no non-current asset in the financial statements in respect of this brand. There is also a risk that some of the advertising expenditure made has been recognized as an asset. This would be an overstatement of non-current assets.

(Award ½ mark for each identification – Maximum 4 marks; and award up to 1 mark for each well-explained financial risk – Maximum 8 marks)

(c) **REPORT**

To: The Audit and Remuneration Committee – Chikupe Ltd

From: Manager - KJC

Subject: **Suggested elements of the control environment**

Date: 15 July, 2015

1.0. **<u>Introduction</u>**

Further to our meeting, I set out below suggested elements of the control environment.

2.0. **<u>Suggested elements of the control environment</u>**

The following are the suggested elements of the control environment which could contribute towards strengthening the control environment in Chikupe Ltd:

- Human resource policies and practices – Chikupe Ltd must develop and implement suitable human policies and practices. These should include recruitment, orientation, training, evaluating, counseling, promoting, compensation and remedial actions.
- Commitment to competence – The management of Chikupe Ltd must seriously identify and implement suitable competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
- Management's philosophy and operating style – Appropriate training is required for all levels. The attitudes and actions towards financial reporting must change and be aligned to best practices, recommended in most corporate governance codes.
- Assignment of authority and responsibility – Clear procedures must be put in place for assigning of authority and responsibility. The reporting relationships and authorisation hierarchies must be established. Assignments must be based on merit. The appointment of an unqualified person as the Finance Director falls short of recommended practice.

3.0**. Conclusion**

The suggested elements will definitely contribute towards addressing the lapses identified in the control environment. If you require any further information on this matter, please do not hesitate to contact me.

Signed: Manager

(Award up to 2 marks for format and up to 2 marks for each valid suggestion – Maximum 10 marks)

(2)

(a)

Revenue is income arising in course of an entity's ordinary activities. The core principle of IFRS 15 is that an entity will recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This core principle is delivered in a five-step model framework:

Step 1: Identify the contract with customer

A contract with a customer will be within the scope of IFRS 15 if all the following conditions are met:

- the contract has been approved by the parties to the contract;
- each party's rights in relation to the goods or services to be transferred can be identified;
- the payment terms for the goods or services to be transferred can be identified;
- the contract has commercial substance; and
- it is probable that the consideration to which the entity is entitled to in exchange for the goods or services will be collected.

If a contract with a customer does not yet meet all of the above criteria, the entity will continue to re-assess the contract going forward to determine whether it subsequently meets the above criteria. From that point, the entity will apply IFRS 15 to the contract.

Step 2: Identify the performance obligations in the contract

At the inception of the contract, the entity should assess the goods or services that have been promised to the customer, and identify as a performance obligation:

- a good or service (or bundle of goods or services) that is distinct; or
- a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Step 3: Determine the transaction price

The transaction price is the amount to which an entity expects to be entitled in exchange for the transfer of goods and services. When making this determination, an entity will consider past customary business practices.

Step 4: Allocate the transaction price to the performance obligations in the contracts

Where a contract has multiple performance obligations, an entity will allocate the transaction price to the performance obligations in the contract by reference to their relative standalone selling prices. If a standalone selling price is not directly observable, the entity will need to estimate it. IFRS 15 suggests various methods that might be used, including:

- Adjusted market assessment approach
- Expected cost plus a margin approach
- Residual approach (only permissible in limited circumstances)

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation

Revenue is recognized as control is passed, either over time or at a point in time.

Control of an asset is defined as the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. This includes the ability to prevent others from directing the use of and obtaining the benefits from the asset. The benefits related to the asset are the potential cash flows that may be obtained directly or indirectly. These include, but are not limited to:

- using the asset to produce goods or provide services;
- using the asset to enhance the value of other assets;
- using the asset to settle liabilities or to reduce expenses;
- selling or exchanging the asset;
- pledging the asset to secure a loan; and
- holding the asset.

(Award up to 2 marks for each well described step – Maximum 10 marks)

(b)

IFRS 4 exempts an insurer temporarily (until completion of Phase II of the Insurance Project) from some requirements of other IFRSs, including the requirement to consider IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors in selecting accounting policies for insurance contracts.

IFRS 4 permits an insurer to change its accounting policies for insurance contracts only if, as a result, its financial statements present information that is more relevant and no less reliable, or more reliable and no less relevant. In particular, an insurer cannot introduce any of the following practices, although it may continue using accounting policies that involve them:

- measuring insurance liabilities on an undiscounted basis
- measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current market-based fees for similar services using non-uniform accounting policies for the insurance liabilities of subsidiaries.

The IFRS permits the introduction of an accounting policy that involves remeasuring designated insurance liabilities consistently in each period to reflect current market interest rates (and, if the insurer so elects, other current estimates and assumptions). Without this permission, an insurer would have been required to apply the change in accounting policies consistently to all similar liabilities.

An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it should not introduce additional prudence.

There is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts.

When an insurer changes its accounting policies for insurance liabilities, it may reclassify some or all financial assets as 'at fair value through profit or loss'.

(Award 1 mark for each valid point – Maximum 6 marks)

(c) The value of the inventory is as follows:

Item of inventory	Quantity (units)	Cost per unit K	Net Realisable Value (NRV) K	Lower of cost and NRV K	Total value K
A	1,000	10	12	10	10,000
B	3,000	8	5	5	15,000
C	2,500	13	10	10	25,000
D	6,000	4	6	4	24,000
E	500	7	12	7	3,500
F	1,700	3	2	2	3,400
G	600	21	25	21	12,600
H	7,430	2	4	2	14,860
Total					108,360

(Award ½ mark for each correct inventory figure – Maximum 4 marks)

(3)

(a) Group registration for VAT means members of the group are allowed to register as a single entity for group VAT. Any supply of goods or services by a member of the group to another member of the group is disregarded for VAT purposes. Effective 2017, it is no longer possible to register as a group for VAT in Zambia. Abolition of the VAT Group Registration Scheme is intended to remove the challenges in risk profiling of individual members of the group.

(Award 1 mark for each valid point – Maximum 4 marks)

(b) **Chikupe Ltd**

Provisional Tax already paid = 35% x K908,000 = K317,800

Provisional tax will have been paid in four instalments as follows:

Each instalment = 317,800/4 = K79,450

Instalment	Amount K	Due date
1st	79,450	31 March 2017
2nd	79,450	30 June 2017
3rd	79,450	30 September 2017
4th	79,450	31 December 2017

(Award 1 mark for the correct provisional tax, 1 mark for correct installment figure and ½ mark for each correct due date – Maximum 4 marks)

(c) The final company income tax payable is as follows:

Chikupe Ltd

Company Income tax computation for the tax year 2017

K

Business profit (W1)		12,000,000	**3 marks**
Royalties (gross up)	170,000 x 100/85	200,000	**1 mark**
Taxable income		12,200,000	
Company income tax			
	35% x 12,200,000	343,000	**1 mark**
Less tax already paid:			
Withholding tax 15% x 200,000		(30,000)	**1 mark**
Provisional Income tax		(317,800)	**1 mark**
Company income tax payable		23,700	**1 mark**

(Award marks as shown above – Maximum 8 marks)

Working

1. Business profit

	K
Total taxable income	12,206,000
Less:	
Rental income	(36,000)
Royalties	(170,000)
Taxable business profits	12,000,000

(d) The self assessment income tax return must be filed by 21 June 2018, and the final company income tax of K23,700 should also be paid by 21 June 2018.

(Award 1 mark for each due date – Maximum 2 marks)

SECTION B

(4) (a) and (b)

Weakness in Corporate Governance	Recommended action
• Mr. Oscar Mwenge is both Chairman and Chief Executive Officer (CEO).	Appointing another individual to the role of CEO will satisfy corporate governance

This provides a fertile ground for abuse of power in the company.	requirements as well as allowing Mr. Oscar Mwenge to limit any perceived abuse of power in the company. The Chairman of the board is responsible for managing the board of directors, while, the CEO is responsible for the executive management. Both roles are generally demanding and separation could ensure effective performance.
• Appointment of external auditors done by directors	Appointment should be done by the members in general meeting following recommendation of the audit committee.
• Inexperienced non-executive directors are likely to be appointed by the Chairman since there is no nomination committee. This limits their effectiveness.	The company should appoint non-executive directors with appropriate experience and training to be able to make an active contribution to board discussions. A nomination committee should be established.
• The Chief Internal Auditor reporting to the CEO. He may not be critical of the CEO. The CEO may have vested interests in not taking any action on the internal auditor's reports.	The Chief Internal Auditor should report to the Audit Committee. This will ensure that the report is heard by the Non-executive directors (NEDs) and recommendations implemented by management.
• Service contracts for NEDs of 5 years. The NEDs may become too familiar with the operations of the company and therefore not provide the necessary external independent scrutiny that they are supposed to do.	Service contracts for NEDs normally last for a maximum of 3 years, with appointment for a third term being classed as unusual. This also allows the board to refresh with new NEDs.
• Lack of remuneration committee – Directors may be receiving remuneration packages that shareholders consider unwarranted and clearly beyond what it is desirable.	A remuneration committee should be set up, which will be responsible determining the directors' remuneration. Remuneration should be dependent upon organization and individual performance.

(Award 1 mark for each well - explained weakness – Maximum 6 marks; and 1 mark for each valid recommendation – Maximum 6 marks)

(5)

(a) Missing inventory figure:

	K
Sales (100%)	23,945,000
Gross profit (30%)	7,183,500

Cost of goods sold (70%)	16,761,500	**½ mark**

	K	
Opening inventory, at cost	525,000	
Plus purchases	17,982,000	
	18,507,000	
Less closing inventory, at cost	(33,000)	
Equals cost of goods sold and missing inventory	18,474,000	**2 marks**

Cost of goods sold and missing inventory	18,474,000	
Cost of goods sold	(16,761,500)	
Cost of missing inventory	1,712,500	**½ mark**

(Award marks as shown above – Maximum 3 marks)

(b)
Main advantages of computerized inventory management and control include:

- It usually gives more reliable up to date information. For example, Radio frequency identification (RFID) offers real-time inventory tracking that allows companies to monitor and control inventory supply at all times.
- It is able to give more flexible reporting which is cardinal in decision-making. For example, management information system (MIS) can transform data from underlying inventory transaction processing systems (TPS) into summarized files that can be used as a the basis for various management reports.

(Award 1 mark for each well explained advantage – Maximum 2 marks)

Main advantages of e-marketing from customers' perspective include:

- Prices are easy to compare on the internet (greater transparency) so there is more pressure on businesses to be competitive. Customers are therefore assured of getting value for their money.
- Traditional media are mainly 'push' media – the marketing message is broadcast from business to customer – with limited interaction. In e-marketing it is usually a customer who seeks information on a web – it is a 'pull' mechanism. The customer has a direct voice in the functioning of the supply.

(Award 1 mark for each well explained advantage – Maximum 2 marks)

(6)

(a)

- Sale of Commercial plot of land (1)

The realized value of the Commercial plot land is the actual price charged of K5,000,000 as it is more than the open market value of K4,500,000. The amount of property transfer tax paid is 5% x K5,000,000 = K250,000.

- Sale of Commercial plot of land (2)

The realized value of the Commercial plot of land is the open market value of K1,800,000 as it is more than the actual price charged of K1,500,000. The amount of property transfer tax paid is 5% x K1,800,000 = K90,000.

- Sale of Toyota truck

The definition of property for the purposes of property transfer tax does not include chattels. Motor vehicles are not property for the purposes of property transfer tax. Therefore, property transfer tax will not be payable on the disposal of the truck.

(Award 1 ½ marks for Commercial plot of land (1), 1 ½ marks for Commercial plot of land (2) and 1 mark for Truck – Maximum 4 marks)

(b) Property transfer tax (PTT) is payable by the transferor of property. It is not payable by the transferee.

(Award 1 mark for correct answer – Maximum 1 mark)

(c)

(i) Complete Customs clearance of a motor vehicle is granted only after all the requirements under the Customs law and other related laws have been fulfilled. This includes:

- Presentation of genuine import documents;
- Revaluation by customs, if necessary;
- Payment of customs duty, VAT and processing fee; and
- Processing of the declaration in form CE 20 by Customs

Motor vehicles allowed to be cleared at inland ports are removed under bond (RIB) from the entry ports and are taken/driven straight to the appointed customs area where they are kept until they are finally cleared.

All imports, including motor vehicles, must be cleared within 30 days after importation otherwise interest for late clearance/payment of duty is charged.

(Award ½ mark for each correct point – Maximum 3 marks)

(ii)

The Customs Value is:

	$	
Cost	5,300	
Insurance	600	
Freight	1,200	
Incidental	500	
C.I.F.	7,600	**½ mark**

Value for Duty Purposes: $7,600 x K9.80 = K74,480 **½ mark**

Computation of import taxes paid:

	Values	Taxes	
	K	K	
Value for Duty Purposes (VDP)	74,480		
Customs Duty @ 15%	11,172	11,172	**½ mark**
	85,652		
Excise Duty @ 0%	0	0	**½ mark**
	85,652		
Value Added Tax @ 16%	13,704	13,704	**½ mark**
	99,356		
Total import taxes paid		24,876	**½ mark**

(Award marks as shown above – Maximum 3 marks)

END