Zambia Institute of Chartered Accountants

QUESTION AND ANSWER

FOR

MARCH 2020

DIPLOMA IN ACCOUNTANCY PROGRAMME

LEVEL II PAPERS

DIPLOMA IN ACCOUNTING PROGRAMME EXAMINATIONS

LEVEL TWO

DA 8: FINANCIAL REPORTING

MONDAY 16 MARCH 2020

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

INSTRUCTIONS TO CANDIDATES

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

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

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

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

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

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

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

8. Present legible and tidy work.

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

DO NOT OPEN THIS QUESTION PAPER UNTIL YOU ARE INSTRUCTED BY THE INVIGILATOR.

SECTION A

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

QUESTION ONE:

You are provided with the following draft statements of financial position for **Pambwe Co** and **Sepo Co** as at 31 March 2020:

	Pambwe Co	***Sepo Co***
	K'000	K'000
Assets		
Non-current assets:		
Property, plant and equipment (Note 2)	601,600	252,000
Investments in Alinaswe Co at 1 April 2019 (Note 5)	36,000	0
	637,600	252,000
Current assets:		
Inventories (Note 4)	155,200	150,400
Trade receivables (Note 4)	117,600	100,000
Bank	9,600	4,800
	282,400	255,200
Total assets	**920,000**	**507,200**
Equity and liabilities		
Equity		
Equity shares of K1 each	400,000	160,000
Retained earnings - at 1 April 2019	160,000	152,000
- for year to 31 March 2020	128,000	64,000
	688,000	376,000
Non-current liabilities:		
8% Loan note	40,000	0
	40,000	0
Current liabilities:		
Trade payables (Note 4)	192,000	131,200
	192,000	131,200
Total equity and liabilities	**920,000**	**507,200**

The following information is also made available:

1. On 1 January 2020, Pambwe Co acquired 120 million of Sepo Co's equity shares by means of a share exchange of two shares in Pambwe Co for every three Sepo Co shares

acquired. On that date, further consideration was issued to the shareholders of Sepo Co in form of a K100 8% loan note for every 100 shares acquired in Sepo Co. None of the purchase consideration, nor the outstanding interest on the loan notes at 31 March 2020, has yet been recorded by Pambwe Co. At the date of acquisition, the share price of Pambwe Co and Sepo Co was K3·20 and K1·80 respectively.

2. The fair values of Sepo Co's assets at the date of acquisition were equal to their carrying amounts. Sepo Co-operates an extractive industry which requires to be decommissioned in five years' time. No provision has been made for these decommissioning costs by Sepo Co. The present value of the decommissioning is estimated at K32 million, payable in five years' time from date of acquisition. For discounting purposes, assume 8% cost of capital.

3. Pambwe Co's policy is to value the non-controlling interest at fair value at the date of acquisition. Sepo Co's share price at that date can be deemed to be representative of the fair value of the shares held by the non-controlling interest.

4. The inventory of Sepo Co includes goods bought from Pambwe Co for K16.8 million. Pambwe Co applies a consistent mark-up on cost of 40% when arriving at its selling prices. On 28 March 2020, Pambwe Co dispatched goods to Sepo Co with a selling price of K5.6 million. These were not received by Sepo Co until after the year end and so have not been included in the above inventory at 31 March 2020. At 31 March 2020, Pambwe Co's records showed a receivable due from Sepo Co of K24 million, which differed from the equivalent payable in Sepo Co's records due to goods in transit. The intra-group reconciliation should be done by assuming that Sepo Co had received the goods in transit before the year end.

5. The investment in Alinaswe Co represents 30% of its voting share capital and Pambwe Co uses equity accounting to account for this investment. Alinaswe Co's profit for the year ended 31 March 2020 was K48 million and Alinaswe Co paid total dividends during the year ended 31 March 2020 of K16 million. Pambwe Co has recorded its share of the dividend received from Alinaswe Co in investment income.

6. Assume all profits and losses accrued evenly throughout the year.

7. There were no impairment losses within the group for the year ended 31 March 2020.

Required:

Prepare the Consolidated statement of financial position for Pambwe Co as at 31 March 2020. **[Total: 25 Marks]**

QUESTION TWO

The following trial balance relates to Kazembe Ltd, a Public limited liability company as at 31 December 2019.

	K'000	K'000
4% loan note repayable in 2025 (issued in 2017)		7,500
Investment income		900

Ordinary shares of 50 ngwee each		5,000
Share premium		40,700
Retained earnings at 1 January 2019		17,450
Revenue (note i)		154,700
Distribution costs	25,700	
Administrative expenses	17,250	
Purchases	83,450	
Loan note interest paid	100	
Land and buildings cost (includes K3m for land) (note iii)	19,000	
Land and buildings: accumulated depreciation at 1 January 2019		3,200
Plant and equipment: cost	12,900	
Plant and equipment: accumulated depreciation 1 January 2019		6,300
Investment property 1 January 2019	27,400	
Interim dividends paid	300	
Inventories 1 January 2019	22,200	
Trade and other receivables	27,250	
Trade and other payables		21,700
Bank		3,350
Financial asset: equity investment (note iv)	25,250	
	260,800	260,800

The following notes are relevant:

(i) Kazembe's revenue includes K25.6 million for goods sold to a customer on 1 January 2019. The terms of the sale are that Kazembe will incur ongoing service and support costs of K2.4 million per annum for three years after the sale. Kazembe normally makes a gross profit margin of 25% on such servicing and support works. Ignore discounting.

(ii) Closing inventories at 31 December 2019 were valued at K18.5 million.

(iii) The 10 year old land and buildings were revalued for the first time on 1 January 2019 to K37.8 million with land being revalued to K5 million. Kazembe makes no transfer to retained earnings of any revaluation surplus.

(iv) The equity investments had a fair value of K24 million on 31 December 2019. There were no purchases or disposals of any of these investments during the year. Kazembe has not made an election in accordance with *IFRS 9, financial instruments.*

(v) A piece of plant with a carrying amount of K1.1 million on 31 December 2019, after depreciation charge for the year, was tested for impairment on 31 December 2019. Results reviewed that its fair value less costs to sell were K0.85 million. On the same date, the asset was expected to generate annual net income of K0.2 million for the next 5 years at which point the asset would be disposed of for K0.21 million. An appropriate discount rate is 14%.

End of Year	Discount Factor
5	0.519
1 to 5	3.433

(vi) Depreciation of plant and equipment to be included as cost of sales and that of buildings as administration cost. Depreciation on non-current assets to be provided as follows:

- Buildings straight line over 50 years
- Plant and equipment 20% reducing balance method.

(vii) The fair value of investment property at 31 December 2019 was K28.60 million. Kazembe uses the IAS 40 Fair Value Model to account for Investment Properties.

(viii) A provision for income tax for the year ended 31 December 2019 of K1.25 million is required.

(ix) Interim dividends of 3 ngwee per share were paid on 30 September 2019. No final dividend was declared until 20 March 2020 for the year ending 31 December 2019.

Required:

(a) Prepare the statement of profit or loss and other comprehensive income for Kazembe for the year ended 31 December 2019. (9 marks)

(b) Prepare a statement of changes in equity as at 31 December 2019. (3 marks)

(c) Prepare a statement of financial position for Kazembe as at 31 December 2019. (13 marks)

[Total: 25 Marks]

SECTION B

Attempt any TWO (2) questions.

QUESTION THREE

Details of Mukula Plc's draft financial statements, together with other relevant information are shown below:

Statement of Profit or Loss for the Year Ended 31 March 2020

	K'Million
Revenue	946
Cost of Sales	(458)
Gross Profit	488
Distribution costs	(152)
Administrative expenses	(96)
Finance income	12
Finance costs	(34)
Profit before tax	218
Income tax expense	(94)
Profit after tax	124
Dividends paid in the period	64

STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 2020

	2020 K'million	2019 K'million
Non-current assets		
Property, plant and equipment	654	528
Current assets		
Inventories	246	352
Trade receivables	190	174
Short term investments	130	60
Cash at bank and in hand	58	0
	624	586
	1,278	**1,114**
Equity		
Share capital of K1 per share	400	240
Share premium	60	0
Revaluation surplus	132	194
Retained earnings	142	82
Total Equity	734	516
Non-current liabilities		
10% debentures	200	300
Non-current liabilities	344	298
Total liabilities	544	598

Total Equity and liabilities	**1,278**	**1,114**

The following notes are also relevant:

1. During the year ended 31 March 2020, items of Property, plant and equipment which originally cost K80 million were disposed of at a loss of K12 million. These items had a carrying value of K56 million at the date of disposal.

2. The short term investments meet the definition of cash and cash equivalents per IAS 7: Statement of cash flows.

3. Current liabilities consist of the following:

	2020	2019
	K'm	K'm
Bank overdraft	0	44
Trade payables	252	140
Interest payable	14	6
Income tax payable	78	108
	344	298

4. On 1 August 2019, K100 million of 10% debentures was converted into K100 million K1 ordinary shares.

5. The depreciation charge for the year included in the Profit or loss was K86 million.

Required:

(a) Prepare a Statement of cash flows for Mukula plc for the year ended 31 March 2020 using the indirect method. (20 marks)

(b) With specific reference to IAS 7: Statement of cash flows, state examples of material non-cash transactions that need to be disclosed in the financial statements and explain why such disclosure is important. (5 marks)

[Total: 25 Marks]

QUESTION FOUR

(a) *IAS 21 the effects of changes in foreign exchange rates* provides a set of principles for foreign currency translation, specifically how to account for individual transactions initially and subsequently among others.

Required:

(i) Distinguish between functional currency and presentation currency, giving an example in each case. (3 marks)

(ii) Moonga is a Business involved in imports and exports with accounting period ending 31 March 2020. Its functional currency is kwacha (K). On 15 January 2020, it acquired a non-current asset on credit for £100,000 and bought goods on credit for £50,000. On 31 January 2020, 25% of outstanding balance on non-current asset purchase was paid while 50% on goods was paid. The exchange rates on the respective dates were:

15 January 2020	K12.20 = £1
31 January 2020	K12.60 = £1
31 March 2020	K12.50 = £1

Required:

Show the above transactions as they would appear in financial statements of Moonga for the period to 31 March 2020, giving explanation for the figures. (8 marks)

(b) *IAS 2, inventories describes* measurement criteria for inventories.

The reporting date for Musa Ltd is 30 September 2019 and financial statements are set for approval on 25 November 2019.

On 30 September 2019, Musa Ltd.'s inventory count was conducted for its manufactured goods and reviewed the following elements of cost for its inventory:

	K
Direct materials	150,000
Direct labour	200,000
Direct expenses	70,000
Abnormal materials usage	40,000
Production overheads absorbed	15,000
Actual production overheads	20,000
Selling overheads	17,000
Administration overheads	18,000
Storage overheads	7,000

The accountant of Musa Ltd has informed you that shortly after the reporting date, on 8 October 2019, the inventory in question was sold for K365,000 and incurred marketing costs of K15,000.

Required:

Calculate the cost of inventory, based on elements of cost provided above, and recommend to Musa Ltd at which value inventory should be recognized in its financial statements at 30 September 2019. (6 marks)

(c) The following figures have been calculated from the comparative financial statements of Bwalya for the year ended 30 September 2019:

Increase in profit after taxation	80%
Increase in (basic) earnings per share	5%
Increase in diluted earnings per share	2%

Required:

Explain why the three measures of earnings (profit) growth for the same company over the same period can give apparently differing impressions. (4 marks)

(d) The methods by which Accounting Standards are developed differ considerably throughout the world. It is often argued that there are two main systems of regulation that determine the nature of Accounting Standards: a rules-based system and a principles-based system.

Required:

Explain the difference between the two systems and state which system you believe is most descriptive of International Financial Reporting Standards (IFRS). (4 marks)

[Total: 25 Marks]

QUESTION FIVE:

The International Financial Reporting Standards (IFRSs) Framework describes the basic concepts that underlie the preparation and presentation of financial statements for external users. The IFRSs Framework serves as a guide to the International Standards Board (IASB) in developing future IFRSs and as a guide to resolving accounting issues that are not addressed directly in an International Accounting Standard (IAS) or International Financial Reporting Standard (IFRS).

Required:

(a) State how prime users of financial information benefit from the main objectives of general purpose financial reporting. (5 marks)

(b) Explain the five main elements of financial statements. (10 marks)

(c) State the general recognition criteria of the elements of financial statements. (4 marks)

(d) Identify and discuss how the two fundamental qualitative characteristics of financial information benefit users of an entity's financial statements. (6 marks)

[Total: 25 marks]

END OF PAPER

DA8 SUGGESTED SOLUTIONS

SOLUTION ONE

Pambwe Co – Consolidated statement of financial position as at 31 March 2020

	K'000	K'000
Assets		
Non-current assets:		
PPE (601,600 + 252,000 + 32,000 extractive ops – 1,600 depreciation)		884,000
Goodwill (w (i))		88,000
Investment in associate (36,000 + 9,600 (w (iii)))		45,600
		1,017,600
Current assets		
Inventory (155,200 + 150,400 + 5,600 GIT – 6,400 URP (w (ii)))	304,800	
Trade receivables (117,600 + 100,000 – 24,000 intra group)	193,600	
Bank (9,600 + 4,800)	14,400	512,800
Total assets		**1,530,400**
Equity and liabilities		
Equity attributable to owners of the parent		
Equity shares of K1 each (400,000 + 80,000 ((w (i))		480,000
Other equity reserves (share premium) (w (i))	176,000	
Retained earnings (w (iii))	299,120	475,120
		955,120
Non-controlling interest (w (iv))		75,440
Total equity		1,030,560
Non-current liabilities		
8% loan notes (40,000 + 120,000 consideration)	160,000	
Accrued loan interest (w (iii))	2,400	
Environmental provision (32,000 + 640 interest (w (iii)))	32,640	195,040
Current liabilities (192,000 + 131,200 – (24,000 – 5,600 GIT) intra group (w (ii)))		304,800
Total equity and liabilities		**1,530,400**

Workings (figures in brackets are in K'000)

(i) Goodwill in Sepo Co

	K'000	K'000
Controlling interest		
Share exchange (160,000 x 75% x 2/3 = 80,000 x K3·20)		256,000
8% loan notes (160,000 x 75% x 1/100x100)		120,000
Non-controlling interest (160,000 x 25% x K1·80)		72,000
		448,000
Equity shares	160,000	
Retained earnings at 1 April 2015	152,000	
Earnings 1 April 2015 to acquisition (64,000 x 9/12)	48,000	
Fair value adjustments – asset re mine	32,000	
– provision re mine	(32,000)	(360,000)
Goodwill arising on acquisition		88,000

The share exchange of K256 million would be recorded as share capital of K80 million (80,000 x K1) and share premium of K176 million (80,000 x (K3·20 – K1·00)). Applying the group policy to the environmental provision would mean adding K4 million to the carrying amount of the mine and the same amount recorded as a provision at the date of acquisition. This has no overall effect on goodwill, but it does affect the consolidated statement of financial position and post-acquisition profit.

(ii) The inventory of Sepo Co includes unrealised profit (URP) of K4.8 million (16,800 x 40/140). Similarly, the goods-in-transit sale of K5.6 million includes URP of K1.6 million (5.6 million x 40/140).

(iii) Consolidated retained earnings:

	K'000
Pambwe Co's retained earnings	288,000
Sepo Co's post-acquisition profit (13,760 x 75% see below)	10,320
Unrecorded share of Alinaswe's retained profit ((48,000 – 16,000) x 30%)	9,600
Outstanding loan interest at 31 March 2016 (120,000 x 8% x 3/12)	(2,400)
URP in inventory (w (ii))	(6,400)
	299,120
The adjusted post-acquisition profits of Sepo Co are:	
As reported and time apportioned (64,000 x 3/12)	16,000
Interest on environmental provision (32,000 x 8% x 3/12)	(640)
Additional depreciation re mine (32,000/5 years x 3/12)	(1,600)
	13,760

(iv) Non-controlling interest

	K'000
Fair value on acquisition (w (i))	72,000
Post-acquisition profit (13,760 x 25% (w (iv)))	3,440
	75,440

SOLUTION TWO

a) Statement of profit or loss and other comprehensive income for Kazembe for the year ended 31 December 2020.

	K'000
Revenue (154,700 – 6,400 w1)	148,300
Cost of sales (W2)	(88,720)
Gross profit	59,580
Investment income	900
Decrease in fair value of financial asset (24,000 – 25,250)	(1,250)
Increase in fair value of investment property (28,600 – 27,400)	1,200
Distribution costs	(25,700)
Administrative expenses	(18,070)
Operating profit	16,660
Finance costs (4% x 7,500)	(300)
Profit before tax	16,360
Income tax	(1,250)
Profit for the year	15,110
Other comprehensive income:	
Revaluation surplus (w3)	22,000
Total comprehensive income	37,110

b) Kazembe limited's statement of changes in equity as at 31 December 2020.

	Share Capital K'000	Share premium K'000	Revaluation Reserve K'000	Retained Earnings K'000	Total K'000
Balances b/f	5,000	40,700	0	17,450	63,150
Total comprehensive					
Income	-	-	22,000	15,110	37.110
Dividends paid				(300)	(300)
	5,000	40,700	22,000	32,260	99,960

c) Statement of financial position of Kazembe as at 31 December, 2020

Non current assets	K'000	K'000
Prpoperty, plant and equipment (W3)		42,010
Investment property		28,600
Financial asset: equity instrument		24,000
		94,610
Current assets		
Inventories	18,500	
Account trade receivables	27,250	45,750
Total assets		140,360
Equity and liabilities		
Equity share capital		5,000
Share premium		40,700
Retained earnings (answer b)		32,260
Revaluation reserve		22,000
		99,960
Non current liabilities		
4% loan note		7,500
Deferred income		3,200
Current liabilities		
Trade payables	21,700	
Bank overdraft	3,350	

Income tax payable	1,250	
Accrued finance cost	200	
Deferred income	3,200	29,700
Total equity and liabilities		140,360

Workings

1. Revenue

   IFRS 15 Revenue requires that the recognition of revenue for performance obligation satisfied over time be systematic as the performance obligations are being satisfied.

   2 years revenue on service provision would not be recognized as the performance obligation would yet be satisfied, i.e 6,400 (K2,400 x 100/75) x 2 years. This will be deferred to next 2 years hence half current liability and another half non current liability.

2.	Cost of sales	Administration Expenses	distribution costs
	K'000	K'000	K'000
Per trial balance	-----	17,250	27,500
Opening Inventories	22,200	------	------
Purchases	83,450	------	-----
Closing inventories	(18,500)	-------	------
Depreciation:			
Buildings	------	820	------
Plant and equipment	1,320	--------	-------
Plant impairment loss	250	------	--------
	88,720	18,070	25,700

3. Remaining life of building at1.12019

   - Past depreciation p.a(K'000) 3200/10 320
   - Total Life 16000/320 50yrs
   - Remaining life 50-10 40yrs

4. Property, plant and equipment

Land	Buildings	Plant &	Total

			equipment	
	K'000	K'000	K'000	K'000
Cost b/f	3,000	16,000	12,900	31,900
Less accumulated				
Depreciation b/f		(3,200)	(6,300)	(9,500)
Carrying amt. b/f	3,000	12,800	6,600	22,400
Revaluation surplus	2,000	20,000		22,000
Revalued amount	5,000	32,800	6,600	44,400
Depren. charge (w4)	----	(820)	(1,320)	(2,140)
Impairment loss (w5)			(250)	(250)
Carrying amt. c/f	5,000	31,980	5,030	42,010

5. Depreciation:

   Buildings K32,000/40 years = 820 pa
   Plant and equipment 20% x 6,600 (w3) = 1,320 pa

6. Plant and equipment impairment.
   Carrying amount on date of review K1,100
   Fair value less costs to sell K850
   Value in use = 200 x 3.433 =687
   210 x 0.519 = 109
   Total 796
   Therefore, the higher of Fair value less costs and value in use is taken for recoverable amount, i.e K850. As this is less than carrying amount, the asset is impaired by K250 (1,100 -850).

SOLUTION THREE

(a) MUKULA PLC: STATEMENT OF CASH FLOWS FOR YEAR ENDED 31 MARCH 2020

	K'Million	K'Million
Cash flow from operating activities		
Profit before taxation	218	
Adjusted for –		
Loss on disposal	12	
Depreciation	86	
Interest income	(12)	
Interest expense	34	
	338	
Decrease in inventories (246-352)	106	
Increase in trade receivables (190-174)	(16)	
Increase in trade payables (252-140)	112	
Cash generated from operating activities	540	
Interest paid (W2)	(26)	
Income taxes paid (W3)	(124)	
Net cash used from operating activities		390
Cash flow from investing activities		
Purchase of property, plant and equipment (W1)	(330)	
Proceeds from sale of property, plant and equipment (56-12)	44	
Interest received	12	
Net cash used in investing activities		(274)
Cash flow from financing activities		
Proceeds from issuance of share capital (W4)	120	
Dividends paid	(64)	
Net cash from financing activities		56
Net increase in cash and cash equivalents		172
Cash and cash equivalents at beginning of the year		16
Cash and cash equivalents at end of the year		**188**

Workings:

1. Property, plant and equipment

PROPERTY, PLANT AND EQUIPMENT ACCOUNT

	K'm		K'm
Balance b/d (NBV)	528	Revaluation surplus	62
		Depreciation	86
		Disposal	56
Additions (balancing figure)	330	Balance c/d (NBV)	654
	858		858

2. Interest paid

INTEREST PAYABLE ACCOUNT

	K'm		K'm
Bank		Balance b/d	
Balance c/d		Profit or loss	

3. Income taxes paid

INCOME TAXES PAYABLE ACCOUNT

	K'm		K'm
Bank	124	Balance b/d	108
Balance c/d	78	Profit or loss	94
	202		202

4. *Issue of shares*

	K'm
Share capital plus premium at end	460
Share capital at start	(240)
Increase during the year	220
Debentures converted into shares	(100)
Shares issued for cash	120

(b) Examples of material non-cash transactions requiring disclosure in the Statement of cash flows by IAS 7, may include:

- Bonus issues of shares that usually funded from reserves
- Acquisition of non-current assets by way of a lease or financing agreement
- Conversion of debt to equity (e.g. the exercise of an option within convertible loan notes to convert to equity shares).

The statement of cash flows provides information that enables users assess an entity's ability to generate cash and its absorption of cash. This should further enable the assessment of an entity's financial flexibility and liquidity assuming that these are primarily dependant on the entity's cash resources.

However, an entity may be in a position to transact effectively without using cash, that is, carry out non cash transactions. Cash is therefore not as important if the entity is in a position to transact without using it. It is therefore important to disclose material non cash transactions so that users can appreciate the extent to which the entity was able to transact without the need for cash.

SOLUTION FOUR

a) (i) **Functional currency**

It is the currency of the primary economic environment in which the entity operates. It is mostly the local currency in the economy of operation.

It could be seen as a currency that influences sales prices, labour or material costs and other operating costs in the process of doing business.
It could be said to be currency in which funding from issuing debt and equity is generated or currency in which entity maintains its day-to-day financial records.

For example, companies doing business in Zambia, though foreign based are required to quote prices in Kwacha, which is their functional currency. Material or labour costs sourced locally will be in Kwacha as well.

Presentation currency

It is the currency in which the entity presents its financial statements. It could be different from functional currency especially if entity is a foreign subsidiary as it may have to present financial statements in the currency of parent company.

For example, foreign based entities with their head quarters abroad do prepare financial statements in currency of their controlling country. If company headquarters is locally situated, functional currency will be same as presentation currency.

ii)profit and loss extract for year ended 31 March 2020

		K
Purchases	50000x12.2	610,000
Exchange gain on liability for goods purchases (working)		17,500
Net gain on liability for PPE (working)		32,500

Statement of financial position as at 31 March 2020

		K
Payable (to supplier of goods) 50%x50000x12.5		312,500
Payable (to supplier of non current assets)	75%x10000x12.5	937500

Workings – Exchange differences:

	PPE	Inventory
	K	K
Initial Liability (at temporal rate)	1,220,000	610,000
Payment (rate on date of payment)	(315,000)	(315,000)
	905,000	295,000
Exchange loss (balancing figure)	32,500	17,500

Payable to Report at 31.3.20 (at closing rate)	937,500	312,500

Goods bought

Initial recognition will be at £50,000/12.20 = K4,098
Settlement amount should have been at 50% x K4,098 = K2,049
But was [50% x £50,000/£12.60] = K1,984
Gain on settlement = K65

At reporting date, the balance on payables account of K2,049 is retranslated to K2,000 [50% x £50,000/£12.50] giving rise to a further gain of K49 [K2,049 – K2,000]

(b)

An IAS 2 inventory states that inventories must be measured at the lower of cost and NRV. For Musa, cost of inventory will be as follows:

Direct materials	150,000
Direct labour	200,000
Direct expenses	70,000
Production overheads absorbed	15,000
Total cost	435,000

IAS 2 specifically disallows inclusion of non-production costs such as selling, administrative and storage as well as costs due to wastage and other inefficiencies of operations such as materials wastage.

The Net Realizable value of inventory fell to K350,000, which is lower than recorded cost hence as an adjusting even in accordance with IAS 10, the inventory will need to be restated to its NRV of K350,000 at reporting date. The difference between K435,000 and K350,000 will be expensed to reduce profit for the year under review.

c.) Whilst profit after tax (and its growth) is a useful measure, it may not give a fair representation of the true underlying earnings performance. In this example, users could interpret the large annual increase in profit after tax of 80% as being indicative of an underlying improvement in profitability (rather than what it really is: an increase in absolute profit). It is possible, even probable, that (some of) the profit growth has been achieved through the acquisition of other companies (acquisitive growth). Where companies are acquired from the proceeds of a new issue of shares, or where they have been acquired through share exchanges, this will result in a greater number of equity shares of the acquiring company being in issue.

This is what appears to have happened in the case of Bwalya as the improvement indicated by its earnings per share (EPS) is only 5% per annum. This explains why the EPS (and the trend of EPS) is considered a more reliable indicator of performance because the additional profits which could be expected from the greater resources (proceeds from the shares issued) is matched with the increase in the number of shares. Simply looking at the growth in a company's profit after tax does not take into account any increases in the resources used to earn them. Any increase in growth financed by borrowings (debt) would not have the same impact on profit (as being financed by equity shares) because the finance costs of the debt would act to reduce profit. The calculation of a diluted EPS takes into account any potential equity shares in issue.

Potential ordinary shares arise from financial instruments (e.g. convertible loan notes and options) that may entitle their holders to equity shares in the future. The diluted EPS is useful as it alerts existing shareholders to the fact that future EPS may be reduced as a result of share capital changes; in a sense it is a warning sign. In this case the lower increase in the diluted EPS is evidence that the (higher) increase in the basic EPS has, in part, been achieved through the increased use of diluting financial instruments. The finance cost of these instruments is less than the earnings their proceeds have generated leading to an increase in current profits (and basic EPS); however, in the future they will cause more shares to be issued. This causes a dilution where the finance cost per potential new share is less than the basic EPS.

d.) A rules-based accounting system is likely to be very descriptive and is generally considered to be a system which relies on a series of detailed rules or accounting requirements that prescribe how financial statements should be prepared. Such a system is considered less flexible, but often more comparable and consistent, than a principles-based system. Some would argue that rules-based systems can lead to looking for 'loopholes'. By contrast, a principles-based system relies on generally accepted accounting principles that are conceptually based and are normally underpinned by a set of key objectives. They are more flexible than a rules-based system, but they do require judgment and interpretation which could lead to inconsistencies between reporting entities and can sometimes lead to the manipulation of financial statements.

Because IFRSs are based on *The Conceptual Framework for Financial Reporting,* they are often regarded as being a principles-based system. Of course IFRSs do contain many rules and requirements (often lengthy and complex), but their critical feature is that IFRS 'rules' are based on underlying concepts. In reality most accounting systems have an element of both rules and principles and their designation as rules-based or principles-based depends on the relative importance and robustness of the principles compared to the volume and manner in which the rules are derived.

SOLUTION FIVE

(a) How prime users of financial information benefit from the main objectives of general purpose financial reporting

The primary users of general purpose financial reporting are present and potential investors, lenders and other creditors, who use that information to make decisions about buying, selling or holding equity or debt instruments and providing or settling loans or other forms of credit.

The primary users need information about the resources of the entity not only to assess an entity's prospects for future net cash inflows but also how effectively and efficiently management has discharged their responsibilities to use the entity's existing resources (i.e., stewardship).

The IFRS Framework notes that general purpose financial reports cannot provide all the information that users may need to make economic decisions. They will need to consider pertinent information from other sources as well.

(b) A brief explanation of the five main elements of financial statements

- **Asset.** An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

- **Liability.** A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

- **Equity.** Equity is the residual interest in the assets of the entity after deducting all its liabilities.

- **Income.** Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

- **Expense.** Expenses are decreases in economic benefits during an accounting period in form of outflows or depletions of assets or incurrences of liabilities that decrease equity, other than those relating to distributions to equity holders.

(c) *General recognition of the elements of financial statements*

Recognition is the process of incorporating in the statement of financial position and/or statement of profit or loss and other comprehensive income an item that meets the definition of an element and satisfies the following criteria for recognition:

- It is probable that any future economic benefit associated with the item will flow to or from the entity; and

- The item's cost or value can be measured with reliability.

(d) *Fundamental qualitative characteristics of useful financial statements*

Relevance and faithful representation are the fundamental qualitative characteristics of useful financial information, by the IFRS Framework.

(i) Relevance

Relevant financial information is capable of making a difference in the decisions made by users. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value, or both. The predictive value and confirmatory value of financial information are interrelated.

Materiality is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity's financial report.

(ii) Faithful *representation*

General purpose financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only be relevant, but must also represent faithfully the phenomena it purports to represent. This fundamental characteristic seeks to maximise the underlying characteristics of completeness, neutrality and freedom from error. Information must be both relevant and faithfully represented if it is to be useful.

END OF SUGGESTED SOLUTIONS

DIPLOMA IN ACCOUNTANCY PROGRAMME EXAMINATIONS

LEVEL TWO

DA 9: MANAGEMENT ACCOUNTING

MARCH 2020

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

INSTRUCTIONS TO CANDIDATES

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

2. This paper is divided into TWO sections:

   Section A: There are two (2) compulsory questions.
   Section B: There are three (3) questions. Attempt any two (2) questions.

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

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

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

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

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

8. Present legible and tidy work.

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

DO NOT OPEN THIS QUESTION PAPER UNTIL YOU ARE INSTRUCTED BY THE INVIGILATOR.

SECTION A – TWO COMPULSORY QUESTIONS

Attempt both questions in this section.

QUESTION ONE

(a) Gogo plc operates a retail business, buying and reselling assorted footwear. Purchases are later sold at cost plus 25%. The management team are preparing the cash budget for 2019 and have gathered the following data:

1. The budgeted sales (in K) are as follows:

Month	Sales (K)
January	1,000,000
February	900,000
March	1,250,000
April	1,400,000
May	1,325,000
June	1,562,500
July	1,437,500
August	1,187,500
September	1,625,000

2. It is management policy to hold inventory at the end of each month which is sufficient to meet sales demand in the next half month. Sales are budgeted to occur evenly during each month.

3. Suppliers are paid 50% in the month of purchase and the balance in the month after purchase.

4. 15% of the total sales are on cash and the remainder on credit. Credit sales are paid for as follows:

   - Following month after sale 60%
   - Second month after sale 20%
   - Third month after sale 16%
   - Bad debts 4%

5. Labour is 10% of cost of sales and is paid for in the month that it is incurred.

6. Production overheads are cash related and are 70% of labour cost. Overheads are paid 30% in the month they are incurred and the balance the following month.

7. Some property was disposed of on 28 December 2019, and a cash amount of K1,076,800 will be available on 1 January 2019.

Required:

Prepare Gogo's cash budget for the eight (8) months to 31 August 2019.

(17 marks)

(b) Seven months later, on 31 July 2019, management was conducting a review of the performance of the business. The cash budget for the month of July 2019 was selected as the budget control period, with the following actual results on cash basis achieved;

Details	**Actual for July 2019@70% activity level**
Sales receipts	K2,012,610
Materials purchases	(K1,565,900)
Labour payment	(K127,700)
Overhead payment	(K121,512)
Surplus for the month	**K197,498**

The following additional information relating to receipts and payment has been made available:

1. The budgeted cash budget for July 2018 was prepared on the basis of an activity level of 50%.
2. Sales receipts and material payments vary directly to activity level.
3. Labour and overheads payments are 30% and 70% respectively variable, varying directly to activity level with the balance on labour and overheads remaining fixed.

Required:

Prepare a cash budgetary control statement for the month of July 2019.

(8 marks)

[Total: 25 Marks]

QUESTION TWO

Kolopa Limited Manufactures a variety of washing detergent products that removes all dirty and stains. The company operates a standard marginal costing system to monitor and control its costs and a full production cost plus a profit mark up of 37.4% to determine the price.

The following data relates to the production of one of its products called Spotless Clean (SC) detergent.

1Kg of SC detergent requires:

Ingredient X - 0.10Kg @ K4.20 per Kg
Ingredient Y - 0.05Kg @ K5.80 per Kg
Direct Labour 1 hour @ K10 per direct labour hour

Ingredients X and Y are interchangeable. Fixed production overheads are budgeted at K160,000 per month and production is budgeted to be 20,000Kg per month.

During the last month, 19,000Kg of Spotless Clean detergent were produced with the following resource consumption:

Ingredient X - 2,550Kg @ K4.00
Ingredient Y- 855Kg @ K6.60
Director Labour 18,750 hours @ K10.10 per direct labour hour

A recession in the year meant that the market for the Spotless Clean detergent declined by 10% during the last month.

Required:

(a) Calculate the following variances:

- (i) Labour rate and efficiency. (3 marks)
- (ii) Sales volume (2 marks)
- (iii) Planning and operational variances for sales volume (4 marks)
- (iv) Mix and yield variances for each ingredient (6 marks)

(b) Explain four objectives of standard costing for a company like Kolopa Limited. (6 marks)

(c) In relation to decision making, explain the following:

- (i) Relevant cost
- (ii) Avoidable Cost
- (iii) The importance of making decisions based upon contribution per unit of the limiting factor (2 marks)

[Total: 25 Marks]

SECTION B

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

QUESTION THREE

TOP Star Co Ltd. recently developed a new digital receiver and is now considering setting the selling price. A market research conducted by the company has produced the following forecasts of demand at three potential selling prices.

Selling price	**K300**	**K315**	**K360**
Sales units per annum	10,000	8,000	6,000
Fixed costs per annum	K700,000	K500,000	K1,200,000

The company's cost structure is such that 60% of fixed costs are general overheads while the remainder are directly attributable to fixed costs. The variable costs are forecast at K193 per unit at an activity level of a production range of up to 7,000 units. When the production increases above 7,000 and up to 14,000 units, the variable cost reduces to 96% due to the labour learning effect.

Required:

(a) Determine the optimal selling price that would maximise TOP Star's profit. (8 marks)

(b) Calculate the margin of safety as a percentage at the optimal selling price and briefly comment on the meaning of the figure calculated. (3 marks)

(c) Using graph paper, draw and label a simple breakeven chart for the optimal selling price for activity levels between 0 and 14,000 units. Give a comment on the chart drawn. (9 marks)

(d) Define target costing and explain how it could be used by TOP Star in the design, manufacture and sale of the digital receivers. (5 marks)

[Total: 25 Marks]

QUESTION FOUR

Jacaranda Plc. sets prices for its only product by adding 20% mark-up on total cost. So far the cost plus based price has been viewed satisfactory because the resulting demand enables full capacity operation of 25,000 units to be achieved.

The cost structure for this level of activity is as follows:

	K per unit
Direct material	21
Direct labour	20
Variable production overhead	6
Sales commission	9
Total fixed overheads:	
Production	K300,000
Selling and distribution	K150,000
Administration	K 75,000

Mr. Bauze, the director who recently joined Jacaranda Plc. has engaged your management consultancy organization to advise on his company's pricing policy.

As management accountant at the management consultancy organization, you have been asked to investigate the effect on costs and profit of an increase in the selling price. You are provided with the following sales volume estimates achievable at three alternative sales prices under consideration by the marketing department.

Selling price	K105	K120	K135
Annual sales volume (units)	20,000	16,000	11,000

After analyzing the effect changes in sales volume will have on cost behaviour patterns, you have collected the following information:

Direct material cost per unit will increase by 15% for all units produced during the year if activity reduces below 15,000 units per annum due to loss of bulk purchase discounts.

A reduction in activity level below 20,000 units per annum will reduce direct labour cost per unit by 10% due to savings in bonus payments, while fixed production overhead will reduce by K15,000 per annum.

Sales commission will be paid at the rate of 10% of sales price; while there will be no change in unit cost of variable production overhead and total expenditure on administration overhead within the range of activity. Fixed selling price will also remain the same.

No inventory of the product is held due to its high perishable nature.

Required:

(a) Determine the current price and optimum price for Jacaranda Plc's product.

(12 marks)

(b) Calculate the breakeven sales units and margin of safety at:

(i) Current price
(ii) Optimum price (8 marks)

(c) Management accounting systems form an essential part of an organisation management information system.

Outline the steps in the decision making processes. (5 marks)

[Total: 25 Marks]

QUESTION FIVE

You are an accounting technician working at EMW Co, a company that manufactures and distributes clothing. On average the company operates 30 days per month.

You have estimated the following figures for the coming year:

Sales	K5,600,000
Average receivables	K506,000
Gross profit	25% mark up
Average inventories	
Finished goods	K350,000
Work in progress	K550,000
Raw materials	K220,000
Average payables	K210,000

Material costs represent 50% of the total cost of sales.

EMW Co imports most of its materials from overseas countries, especially Persia. The high inflation rates in Persia have meant that the company's cost of materials has risen rapidly over recent years. This has led to a significant deterioration in the company's margins, which, coupled with its increasing liquidity problems, is making the shareholders nervous.

Required:

(a) Calculate the cash operating cycle, to the nearest day. (6 marks)

(b) State four (4) methods of reducing the length of the cash operating cycle. (4 marks)

(c) Discuss:

(i) The significance of trade credit in a firm's working capital cycle. (5 marks)

(ii) The dangers of over-reliance on trade credit as a source of finance. (5 marks)

(d) Explain how the economic order quantity (EOQ) model can assist in reducing inventory costs, and the assumptions it is based on. (5 marks)

[Total: 25 Marks]

END OF PAPER

SUGGESTED SOLUTIONS

SOLUTION ONE
(a)

Gogo Plc
Eight month cash budget to 31st August 2019

Details	**January**	**February**	**March**	**April**	**May**	**June**	**July**	**August**
Receipts (W1)	150,000	645,000	816,500	1,136,500	1,247,650	1,318,125	1,428,150	1,357,075
Payments								
Purchases (W2)	380,000	810,000	960,000	1,075,000	1,122,500	1,177,500	1,125,000	1,087,500
Labour(W3)	80,000	72,000	100,000	112,000	106,000	125,000	115,000	95,000
Production overheads(W3)	16,800	54,320	56,280	72,520	77,140	78,190	85,400	76,300
Total payments	476,800	936,320	1,116,280	1,259,520	1,305,640	1,380,690	1,325,400	1,258,800
Balance	(326,800)	(291,320)	(299,780)	(123,020)	(57,990)	(62,565)	102,750	98,275
Opening cash balance	1,076,800	750,000	458,680	158,900	35,880	(22,110)	(84,675)	18,075
Closing cash balance	**750,000**	**458,680**	**158,900**	**35,880**	**(22,110)**	**(84,675)**	**18,075**	**116,350**

Working 1	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
	K	K	K	K	K	K	K	K
Sales	1,000,000	900,000	1,250,000	1,400,000	1,325,000	1,562,500	1,437,500	1,187,500
Receipts								
credit sales @85%	850,000	765,000	1,062,500	1,190,000	1,126,250	1,328,125	1,221,875	1,009,375
60% next month		510,000	459,000	637,500	714,000	675,750	796,875	733,125
20% two months from sale			170,000	153,000	212,500	238,000	225,250	265,625
16%three months from sale				136,000	122,400	170,000	190,400	180,200
cash sales @ 15%	150,000	135,000	187,500	210,000	198,750	234,375	215,625	178,125
Total Receipts	**150,000**	**645,000**	**816,500**	**1,136,500**	**1,247,650**	**1,318,125**	**1,428,150**	**1,357,075**

Working 2	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
	K	K	K	K	K	K	K	K
Sales	1,000,000	900,000	1,250,000	1,400,000	1,325,000	1,562,500	1,437,500	1,187,500
Cost of sales(Sales/1.25)	800,000	720,000	1,000,000	1,120,000	1,060,000	1,250,000	1,150,000	950,000
Closing stock	360,000	500,000	560,000	530,000	625,000	575,000	475,000	650,000
Opening Stock	(400,000)	(360,000)	(500,000)	(560,000)	(530,000)	(625,000)	(575,000)	(475,000)
Total Purchases	760,000	860,000	1,060,000	1,090,000	1,155,000	1,200,000	1,050,000	1,125,000
50% paid in the month	380,000	430,000	530,000	545,000	577,500	600,000	525,000	562,500
50% paid in the next month	-	380,000	430,000	530,000	545,000	577,500	600,000	525,000
Total payments	**380,000**	**810,000**	**960,000**	**1,075,000**	**1,122,500**	**1,177,500**	**1,125,000**	**1,087,500**

Working 3	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
	K	K	K	K	K	K	K	K
Labour 10% of cost of sales	**80,000**	**72,000**	**100,000**	**112,000**	**106,000**	**125,000**	**115,000**	**95,000**
Overheads 70% of labour;	56,000	50,400	70,000	78,400	74,200	87,500	80,500	66,500
30% paid in month	16,800	15,120	21,000	23,520	22,260	26,250	24,150	19,950
70% paid in the next month		39,200	35,280	49,000	54,880	51,940	61,250	56,350
Total payment	**16,800**	**54,320**	**56,280**	**72,520**	**77,140**	**78,190**	**85,400**	**76,300**

(b)
Modern Ltd
Budgetary control statement

Details	Original Budget 50%	Flexed Budget 70%	Actual Results 70%	Variance Report
	K	K	K	K
Sales receipt	714,075	999,705	1,006,305	6,600(F)
Material	(562,500)	(787,500)	(782,950)	4,550(A)
Labour:				
Variable	(17,250)	(24,150)	(19,155)	4,995(F)
Fixed	(40,250)	(56,350)	(44,695)	11,655(F)
Overheads:				
Variable	(29,890)	(41,846)	(42,529)	683(A)
Fixed	(12,810)	(17,934)	(18,227)	293(A)
	51,375	**71,925**	**98,749**	**26,824(F)**

Workings:

1. Labour
   57,500 x 0.7/0.5 =K80,500
   Variable = 30% of K80,500 = K24,150
   Fixed = 70% of K80,500 = K56,350

2. Overheads
   42,700 x 0.7/0.5 = K59,780
   Variable = 70% of K59,780 = K41,846
   Fixed = 30% of K59,780 = K17,934

SOLUTION TWO

(a) (i) Labour Variances

Labour rate	K	
18,750 hours of labour should cost (x K10)	187,500	
But did cost (18,750 x K10.10)	189,375	
Labour rate variance	1,875	(A)

Labour Efficiency		
19,000Kg should take (x 1 hour)	19,000 hours	
But did take	18,750 hours	
Efficiency variance in hours	250	(F)
X standard labour rate per hour	K 10	
Labour efficiency variance	K2,500	(F)

(ii) Sales volume variance

Budgeted sales volume	20,000 Kg	
Actual sales volume	19,000 kg	
Volume variance in Kg	1,000	(A)
X standard contribution per Kg (W1)	K 15	
Sales volume contribution variance	K15,000	(A)

Workings

(1) Standard contribution per unit

	K	K
Full production cost (W2)		18.71
Profit mark-up (37.4% of K18.71)		6.998
Selling price		25.71
Variable cost (W2)		(10.71)
Contribution per Kg		15.00

(2) Full production cost per Kg

	K
Ingredient X (0.1Kg @ K4.20)	0.42
Ingredient Y (0.05Kg @ K5.80)	0.29
Direct labour (1 hour @ K10)	10.00
Variable production cost per Kg	10.71
Fixed production cost per unit (K160,000/20,000Kg)	8.00
Full production cost per Kg	18.71

(iii) Planning and operational variances for sales volume.

Sales volume planning variance

Original budgeted sales	20,000Kg

Revised budgeted sales (90% of 20,000)	18,000Kg	
	2,000Kg	(A)
X Standard contribution per Kg (W1)	K 15	
Sales volume planning variance	K30,000	(A)

Sales volume operational variance

Revised budget sales (90% of 20,000)	18,000Kg	
Actual sales	19,000Kg	
Operational variance in Kg	1,000Kg	(F)
X Standard contribution per Kg (W1)	K 15	
Sales volume operational variance	K15,000	(F)

(iv) Mix and yield variance for each ingredient

Ingredient mix variance

Ingredient	Actual Mix Kg	Actual in Standard mix Kg	Variance Kg	Standard Price K	Mix Variance K	
X	2,550	2,270	280	4.20	1,176	(A)
Y	855	1,135	- 280	5.80	1,624	(F)
	3,405	3,405	Nil		448	(F)

Working for actual quantity in standard mix□

Total quantity used (2,550+855)	3,405Kg
Standard mix for actual usage: A ($\frac{0.1}{0.15}$ x 3,405)	2,270Kg
B ($\frac{0.05}{0.15}$ x 3,405)	1,135Kg

Ingredient yield variance

Each Kg of spotless Clean detergent requires

	K
0.1Kg of X costing	0.42
0.05Kg of Y costing	0.29
0.15Kg	0.71

3,405Kg should yield (÷ 0.15)	22,700Kg	
But did yield	19,000Kg	
Yield variance in Kg	3,700Kg	(A)
X Standard cost per unit of output	K 0.71	
Ingredient yield variance	K2,627	(A)

(b) **Decision Making**

Standard costing provides a prediction of future costs derived from either traditional or activity based costing systems which can be used for decision making such as pricing decision. These standard costs may be based on the elimination of avoidable inefficiencies making them more preferable future target costs than unadjusted past costs which may incorporate inefficiencies.

Motivation

Standard costing provides challenging targets which individuals are motivated to achieve. Research evidence suggests that existence of a defined quantitative goal is likely to motivate higher levels of performance than would be achieved if no such target was set.

Budgeting and evaluation managerial performance standard costs are valuable for budgeting as they are a reliable and convenient source of data for converting budgeted production into physical and monetary values.

Control

By highlighting those activities that do not conform to plan, managers are made aware of those situations that may be out of control and in need of corrective action. With a standard costing system, variances are analysed in great detail such as by element of cost price and quantity elements. This provides useful feedback in pin pointing the areas where variances have arisen.

(c) (i) Relevant cost is a future incremental cash flow arising as a direct consequence of
a decision. It is a cost which should be taken into account when making a decision since it will affect the decision option chosen. E.g. The decision to sell or continue using a machine will be affected by scrap value.

(ii) Avoidable costs are costs that would not be incurred if any activity or sector of a business did not exist. E.g. In a decision to whether or not shut down a department, if some of the costs will be incurred anyway, they are not avoidable costs and should not be included in the decision data.

(iii) The importance of maximizing contribution per unit of limiting factor.

Limiting factors restrict the activity of an organization, and therefore, its ability to earn contribution. However, in the short run, fixed costs do not change, therefore maximizing contribution will result in maximizing profit. Hence given any limiting factors, an organization must ensure that it earns the biggest contribution possible by choosing products that give the most contribution per unit of the limiting factor. This will result in the maximization of contribution and profit.

SOLUTION THREE

Part (a)

Selling Price	**K300**	**K315**	**K360**
Units produced and sold	10,000 units	8,000 units	6,000 units
	K'000	K'000	K'000
Sales	3,000	2,520	2,160
Variable costs up to 7,000 units	(1,351)	(1,351)	(1,158)
Variable costs above 7,000 units	(555.84)	(185.28)	-
Total gross contribution	1,093.16	983.72	1,002
Less attributable fixed costs	(280)	(200)	(480)
Net contribution	**813.16**	**783.72**	**522**

The optimal price is K300 as this gives the highest net contribution.

Part (b)

Margin of safety = (Sales units – BEP units)/Sales units x 100%

BEP = Fixed costs/contribution per units;

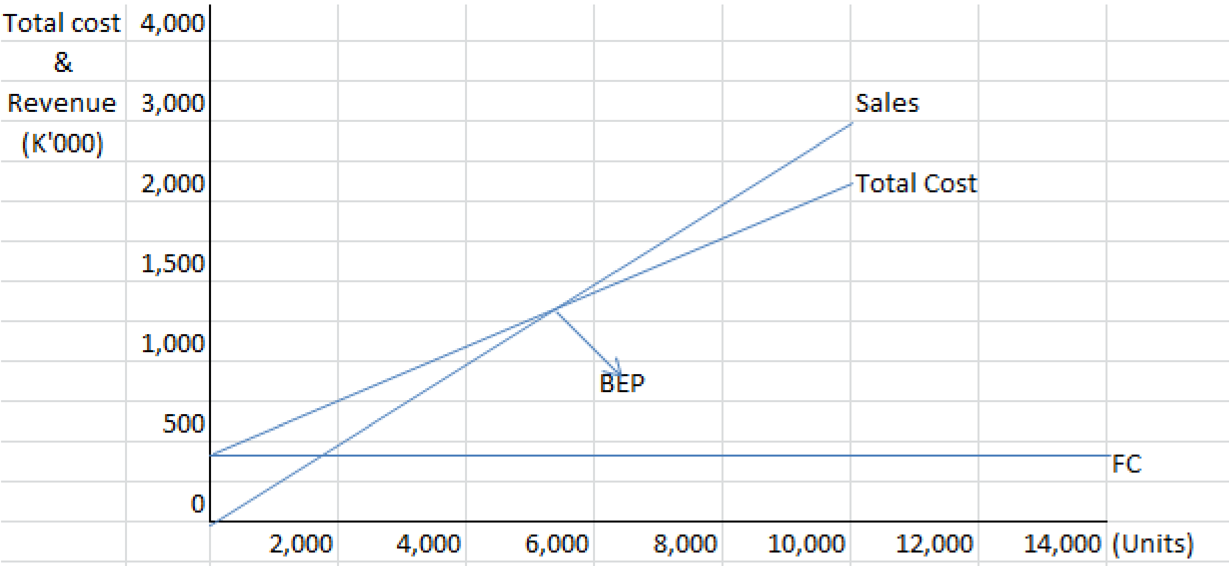
Fixed costs = K700,000 – 280,000 = K420,000

Average net contribution per unit = K813,160/10,000 = K81.316 per unit

BEP = K420,000/81.316 = 5,165 units

Margin of safety = 10,000 – 5,165/10,000 x 100 = 48.35%.

Part (C)



Part (D)

(iii) Target costing involves setting a target cost by subtracting a desired profit margin from a competitive market price. A target cost may be less than the planned initial cost but it is expected to be achieved by the time a product reaches the maturity stage of the product lifecycle.

To use target costing, Top Star Co would need to:

(i) Consider the appropriate product specification for the market (for example battery life, capacity, etc).

(ii) Decide the selling price likely to achieve its desired market share (usually by reference to competitors' prices).

(iii) Decide on the required profit margin for the product, based on a desired return on sales or return on investment.

(iv) Calculate the target cost by subtracting the target profit from the target price.

(v) Produce the required product at the target cost. This is most likely to be successful at the design stage by, for example, reducing the number of components, using standard components, or by using different materials.

SOLUTION FOUR

(a) Current price per unit based on total cost plus 20% mark up.

	K
Direct Material	21
Direct Labour	20
Variable Production Overhead	6
Variable Production cost	47
Fixed Production Overhead (K300+150+75)+4 / 25,000	25
Sales Commission	9
Selling costs	6
Administration	3
Total Cost	77
Profit Mark Up (20% of K77)	15.4
Selling Price	92.4

Option Selling Price

Sales Volume (Units):	25,000	20,000	16,000	11,000
Selling Price	K	K	K	K
	92.4	105	120	135
D. Material	21	21	21	24.15
D. Labour	20	20	18	18
Variable Production Overhead	6	6	6	6
Sales Commission (10% of Price)	9.24	10.5	12	13.5
Variable Cost of Sales	56.24	57.5	57	61.65
Contribution per Unit	36.16	47.5	63	73.35
Total Contribution	904,000	950,000	1,008,000	806,850
Fixed Production Cost	(300,000)	(300,000)	(285,000)	(285,000)
Fixed Selling and Distribution	(150,000)	(150,000)	(150,000)	(150,000)
Administration Overhead (Fixed)	(75,000)	(75,000)	(75,000)	(75,000)
Profit	379,000	425,000	498,000	296,850

While the current price is K97.2, optimum price is K120. Decision was based on profit.

(b) Breakeven sales units and margin of safety.

	Current Price	Optimum Price
Fixed Costs:	K	K
Production	300,000	285,000
Selling and Distribution	150,000	150,000
Administration	75,000	75,000
Total fixed Costs	525,000	510,000
Contribution Per Unit	K34	K63

Breakeven Sales Units		K525,000/34	K520,000/63
	=	15,442	8,095
Margin of Safety (Units)		25,000 – 15,442	16,000 – 8,096
	=	9,558	7,905
As a % of budget	=	38.23%	49.4%

(c) Steps in the decision making process

(i) Identify the objectives. These could be goals or problems.
(ii) Identify alternative courses of action which may contribute towards achieving the objectives.
(iii) Collect and analyse relevant data about each alternative.
(iv) Select the appropriate course of action.
(v) Implement the decision
(vi) Obtain data about actual results.
(vii) Compare actual and planned outcomes and take appropriate action where planned results have not been achieved.

SOLUTION FIVE

Part a)
12 x 30 days per month = 360 days
Cost of sales = K5,600,000 / 1.25 = K4,480,000
Material cost = 50% x K4,480,000 = K2,240,000

Receivables days: K506,000/K5,600,000 x 360 = 32.5 days

Inventory days; Finished goods = K350,000/K4,480,000 x 360 = 28.1 days

WIP = K550,000/K4,480,000 x 360 = 44.2 days

Raw materials = K220,000/K2,240,000 x 360 = 35.4 days

Payables = K210,000/K2,240,000 x 360 = 33.8 days

Cash cycle: 32.5 + 28.1 + 44.2 + 35.4 – 33.8 = 106.4 days or 106

Part b)
The cash operating cycle can be improved (reduced) in the following ways;

i) Reduced receivables
ii) Reduced inventory of Raw materials
iii) Reduced inventory of WIP
iv) Reduced inventory of finished goods
v) Taking more credit from suppliers

Part c)

i) Working capital is the amount of funds required to run the day to day operations of the business. The length of time it takes to convert inventory to sales, collect money from customers and pay suppliers is referred to as the working capital cycle. Many businesses would therefore, prefer to have a shorter cycle.
Trade credit is a key component of working capital. This is because most businesses would like to have a sound liquidity position and therefore, would improve their cash position (cash cycle) by taking credit. Rather than using the money to pay suppliers now, a company that takes credit for say 30 days, is able to invest this money and generate a return on it before paying the supplier. This would therefore help in improving business performance and profitability.
Shortening the Cash conversion cycle is therefore a key aim when considering trade credit for a firm. Therefore to optimise its cash conversion cycle a business would therefore consider;
    - Reducing inventory days
    - Reduce credit to customers
    - Increase credit from suppliers.

ii) Trade credit or payables are a significant source of finance for many businesses such as EMW Co. Some of the reasons why this is the case is that trade credit is a form of interest free borrowing. However, over reliance on trade credit has a number of costs which include;

Effective cost- There are some implied costs of taking too much credit. For example, suppliers charging a higher price per unit for items on credit than on cash. Most business that rely heavily on credit are prone to production interruptions resulting from supplier problems. The switching costs of suppliers also becomes high.

Damaged credit reference could result from too much credit, especially when the credit has been outstanding for a very long time. Poor credit reference could hinder the business from obtaining future credit.

Efficiency and profitability are affected. The high dependence on a supplier that provided goods on credit to the business would mean that the company's production is structured around the supplier. This would make the company's production activity volatile and where fixed costs are high, a small drop in contribution resulting from lack of production could result in losses to the company.

Part d)

The economic order quantity (EOQ) model can be used to decide the optimum order size for inventories which will minimise the costs of ordering inventories plus inventory holding costs.

At the EOQ level, total holding costs per period equal the total ordering costs in the period. Therefore at EOQ, ordering and holding costs are lowest.

The EOQ assumes that there are no bulk purchase discounts for large quantity orders; therefore purchasing costs are the same regardless of the order quantity.
Also, it assume that demand is constant, the lead time is constant or zero and purchase costs per unit are constant.

DIPLOMA IN ACCOUNTANCY PROGRAMME EXAMINATIONS

LEVEL TWO

DA: 10 TAXATION

MARCH 2020

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

INSTRUCTIONS TO CANDIDATES

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

2. This paper is divided into TWO sections:

   Section A: There are two (2) compulsory questions.
   Section B: There are three (3) questions. Attempt any two (2) questions.

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

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

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

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

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

8. Present legible and tidy work.

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

DO NOT OPEN THIS QUESTIO PAPER UNTIL YOU ARE INSTRUCTED BY THE INVIGILATOR.

Taxation Table

Income Tax

Standard personal income tax rates

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

Income from farming for individuals

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

Company Income Tax rates

On income from manufacturing and other	35%
On income from farming	10%
On income of Banks and other Financial Institutions	35%
On income from mineral processing	30%
On income from mining operations	30%
On income from manufacture of products made out of copper cathodes	15%

Mineral Royalty

Mineral Royalty on Copper

Range of Norm Price	Mineral Royalty Rate
Less than US$4,500	5.5% of norm value
From US$4,500 to less than US$6,000	6.5% of norm value
From US$6,000 to less than US$7,500	7.5% of norm value
From US$7,500 to less than US$9,000	8.5% of norm value
From US$9,000 and above	10% of norm value

Mineral Royalty on other minerals

Type of mineral	Mineral Royalty Rate
Base Metals (Other than Copper, Cobalt and Vanadium)	5% of norm value
Cobalt and Vanadium	8% of norm value
Energy and Industrial Minerals	5% of gross value
Gemstones	6% of gross value
Precious Metals	6% of norm value

Capital Allowances

Implements, plant and machinery and commercial vehicles:

Wear and Tear Allowance –	Standard wear and tear allowance	25%
	Used in manufacturing and leasing	50%
	Used in farming and agro-processing	100%

Non- commercial vehicles

Wear and Tear Allowance	20%

Industrial Buildings:

Wear and Tear Allowance	5%
Initial Allowance	10%
Investment Allowance	10%

Low Cost Housing **(Cost up to K20,000)**

Wear and Tear Allowance	10%
Initial Allowance	10%

Commercial Buildings

Wear and Tear Allowance	2%

Farming Allowances

Development Allowance	10%
Farm Works Allowance	100%
Farm Improvement Allowance	100%

Presumptive Taxes

Turnover Tax 4%

Presumptive Tax for Transporters

Seating capacity	*Tax per annum*	*Tax per day*
	K	K
From 64 passengers and over	10,800	29.55
From 50 to 63 passengers	9,000	24.60
From 36 to 49 passengers	7,200	19.50
From 22 to 35 passengers	5,400	15.00
From 18 to 21 passengers	3,600	9.90
From 12 to 17 passengers	1,800	4.95
Less than 12 passengers and taxis	900	2.40

Property Transfer Tax

Rate of Tax on Realised Value of Land, Land and Buildings and shares	5%
Rate of tax on the realized value on the transfer of intellectual property	5%
Rate of Tax on Realised Value on a transfer or sale of a mining right	10%

Value Added Tax

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

Customs and Excise duties on used motor vehicles

	Aged less than 5 years		**Aged 5 years and over**	
Motor vehicles for the transport of ten or more persons, including the driver	**Customs duty**	**Excise duty**	**Customs duty**	**Excise duty**

	K	**K**	**K**	**K**
Sitting capacity of 10 but not exceeding 14 persons including the driver	17,778	22,223	8,889	11,112
Sitting capacity exceeding 14 but not exceeding 32 persons	38,924	0	13,840	0
Sitting capacity of 33 but not exceeding 44 persons	86,497	0	19,462	0
Sitting capacity exceeding 44 persons	108,121	0	43,248	0

	Aged less than 5 years		**Aged 5 years and over**	
Motor cars and other motor vehicles principally designed for the transport of persons including station wagons and racing cars	**Customs duty**	**Excise duty**	**Customs duty**	**Excise duty**
	K	**K**	**K**	**K**
Sedans				
cylinder capacity not exceeding 1000 cc	12,490	10,824	7,136	6,185
Cylinder capacity exceeding 1000 cc but not exceeding 1500 cc	16,058	13,917	8,564	7,422
Cylinder capacity exceeding 1500 cc but not exceeding 2500 cc	16,545	21,508	8,423	10,950
Cylinder capacity exceeding 2500 cc but not exceeding 3000 cc	18,049	23,463	10,528	13,687
Cylinder capacity exceeding 3000 cc	22,561	29,329	12,032	15,642
Hatchbacks				
cylinder capacity not exceeding 1000 cc	10,705	9,278	7,136	6,185
Cylinder capacity exceeding 1000 cc but not exceeding 1500 cc	14,274	12,371	8,564	7,422
Cylinder capacity exceeding 1500 cc but not exceeding 2500 cc	15,041	19,553	8,423	10,950
Cylinder capacity exceeding 2500 cc but not exceeding 3000 cc	16,545	21,508	10,523	13,687
Cylinder capacity exceeding 3000 cc	19,553	25,419	12,032	15,642
Station wagons				
cylinder capacity not exceeding 2500 cc	16,545	21,508	9,024	11,731
Cylinder capacity exceeding 2500 cc but not exceeding 3000 cc	18,049	23,463	13,357	17,598
Cylinder capacity exceeding 3000 cc but not exceeding 2500 cc	22,561	29,329	18,049	23,463
SUVs				
Cylinder capacity not exceeding 2500 cc	21,057	27,374	9,024	11,732
Cylinder capacity exceeding 2500 cc but not exceeding 3000 cc	24,065	31,284	13,357	17,598
Cylinder capacity exceeding 3000 cc	28,577	37,150	18,049	23,463

	Aged less than 5 years		**Aged 5 years and over**	
Motor vehicles for the transport of goods -with compression-ignition internal combustion piston engine (diesel or semi-	**Customs duty**	**Excise duty**	**Customs duty**	**Excise duty**

diesel):

	K	K	K	K
Single cab				
GVW exceeding 1.0 tonne but not exceeding 1.5 tonnes	21,926	9,501	8,770	3,801
GVW exceeding 1.5 tonnes but not exceeding 3.0 tonnes	26,311	11,402	15,348	6,651
GVW exceeding 3.0 tonnes but not exceeding 5.0 tonnes	30,697	13,302	17,541	7,601
Double cabs GVW exceeding 3 tonnes but not exceeding 5 tonnes	30,274	0	24,119	10,452
Double cabs GVW exceeding 3.0 tonnes but not exceeding 5.0 tonnes, **with spark ignition internal combustion piston engine**	30,697	13,302	24,119	10,452
Panel Vans				
GVW exceeding 1.0 tonne but not exceeding 1.5 tonnes	15,348	6,651	8,770	3,801
GVW exceeding 1.5 tonnes but not exceeding 3.0 tonnes	17,541	7,601	15,348	6,651
GVW exceeding 3.0 tonnes but not exceeding 5.0 tonnes	21,926	9,501	17,541	7,601
Trucks				
GVW up to 2 tonnes	21,926	9,501	10,963	4,751
GVW exceeding 2.0 tonnes but not exceeding 5.0 tonnes	28,504	12,352	13,156	5,701
GVW exceeding 5.0 tonnes but not exceeding 10.0 tonnes	24,724	18,955	10,817	8,293
GVW exceeding 10.0 tonnes but not exceeding 20.0 tonnes	30,905	23,694	11,744	9,004
GVW exceeding 20 tonnes	51,898	0	19,461	0
GVW exceeding 20 tonnes, **with spark ignition internal combustion piston engine**	37,086	28,432	13,907	10,662

Surtax

On all motor vehicles aged more than five (5) years from year of manufacture K2,000

Customs and Excise on New Motor vehicles

Duty rates on:

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

   Customs Duty:

   Percentage of Value for Duty Purposes 30%

   Minimum Specific Customs Duty K6,000

Excise Duty:

Percentage of Value for Duty Purposes for Excise Duty Purposes	
Cylinder capacity of 1500 cc and less	20%
Cylinder Capacity of more than 1500 cc	30%

2. Pick-ups and trucks/lorries with gross weight not exceeding 20 tones:

Customs Duty

Percentage of Value for Duty Purposes	15%
Minimum specific Customs Duty	K6,000

Excise Duty:

Percentage of Value for Duty Purposes for Excise Duty Purposes	10%

3. Buses/coaches for the transport of more than ten persons

Customs Duty:

Percentage of Value for Duty Purposes	15%
Minimum Specific Customs Duty	K6,000

Excise Duty:

Percentage of Value for Duty Purposes for Excise Duty Purposes	
Seating Capacity of 16 persons and less	25%
Seating Capacity of 16 persons and more	0%

4. **Trucks/lorries with gross weight exceeding 20 tonnes**

Customs Duty:

Percentage of Value for Duty Purposes	15%

Excise Duty:

Percentage of Value for Duty Purposes for Excise Duty Purposes	0%

SECTION A

Attempt BOTH questions in this section

QUESTION ONE

Kamaka Limited is a Zambian resident company engaged in manufacturing. Kamaka Limited is registered for Value added Tax (VAT). The company prepared the following statement of profit or loss for the year ended 31 December 2019:

		K	K
Gross profit			500,800
Debenture interest received	(Note 1)		39,400
Bank Interest received	(Note 1)		9,350
Royalties received	(note 2)		24,000
			573,550
Less Expense:			
Depreciation		45,600	
Bad debt	(note 3)	11,200	
Motor expenses	(note 4)	49,500	
Professional fees	(note 5)	8,200	
Repairs and renewals	(note 6)	9,600	
General expense	(note 7)	124,300	
			(248,400)
Net profit			**325,150**

Note 1: The figures for Debenture and Bank Interests received represent the actual amount received by the company. Withholding tax had been deducted at source.

Note 2: The gross amount of royalties is shown; withholding tax had been deducted at source.

Note 3: **Bad-debts**

The figures for bad debts is made up of trade debts written off K8,000, a loan to a former employee written off K2,500, an increase in general bad debt provision K1,200 and decrease in specific bad debt provision K500.

Note 4: Motor Car expenses

The figure for motor car expenses include an amount of K5,000 which relates to mileage done by employees while performing the duties of employment. The balance is in respect of mileage done by the Executive Director of the company.

Note 5: Professional Fees

The figures for professional fees include K2,000 for accountancy services, K3,200 for legal fees in connection with defense of the Kamaka Limited’s internet domain name and K3,000 for legal fees incurred in connection with the grant of ten year lease of land used as parking space for employees motor cars.

Note 6: Repairs and Renewals.

The figure for repairs and renewals consist of K3,600 for decorating the Administrative offices and K6,000 for construction of a new wall in order to split a large office into smaller offices to accommodate new employees.

Note 7: General Expenses

The figure for general expenses includes K4,000 for entertaining customers, K3,200 for a staff Christmas party, K5,000 for gifts of the firms calendars bearing the firm's name each costing K82 The balance is made up of revenue expenses which are all allowable for tax purposes.

Note 8: Implements, Plant and Machinery and other assets.

On 1 January 2019 the income tax values of implements, plant and machinery were follows:

Asset	Income Tax Value at January 2019	Original Cost (VAT inclusive)
	K	K
Manufacturing equipment	50,000	116,000
Toyota Hilux van (single cab)	56,250	87,000
Nissan Sunny car (1900cc)	20,880	34,800
Computer	5,625	8,700
Office furniture	16,500	25,520
Toyota Harrier car (3000 cc)	32,016	53,360
Toyota light truck	45,000	69,600

The Nisan Sunny car and Toyota Harrier car were used by the Marketing Director and Finance Director respectively on personal-to-holder basis.

Note 9: Accommodation

The Managing Director is accommodated in a company owned house. The house cost the company K700, 000 to build four (4) years ago. The company pays the director the taxable emoluments of K100,000 per annum.

Note10: Differently abled persons

The company has employed two (2) registered differently abled persons as telephone operators on full time basis. These were employed in January 2019.

Note 11: Provision income tax

The company paid provisional income tax amounting to K120,000 during the tax year 2019.

Required:

(a) Calculate the capital allowances claimable by Kamaka Limited on implements, plant and machinery for the tax year 2019. You are required to show the income tax value carried forward as at 31 December 2019. (8 marks)

(b) Calculate Kamaka Limited's tax adjusted business profit for the tax year 2019. (10 marks)

(c) Calculate the final income tax payable by Kamaka Limited for the tax year 2019. (7 marks)

[Total: 25 Marks]

QUESTION TWO

Mwape Phiri was employed as the Information Technology Manager at Chembe Limited, a Zambian resident company. Mr Phiri was declared redundant on 31 October 2019. His conditions of service provided for the following:

Salary per annum	K300,000
Transport allowance	25% of basic pay
Medical allowance	10% of basic pay

Mr Phiri received a long-term service award on 30 June 2019 which comprised of a Laptop valued at K8,000 and a cheque amounting to K12,200. On 1 May 2019, Mr Phiri received a Labour Day award for exceptional performance of K7,000 in cash and an upright fridge valued at K10,000.

Mr Phiri was accommodated in a company owned house for which he paid no rent. If the house was rented out on commercial basis, the company could have charged monthly rentals of K13,400. The company maintains the house, and for the tax year 2019 utility expenses in connection with the house amounted to K3,800 per month.

On being declared redundant, Mr Phiri received leave pay amounting to K26,700, repatriation pay amounting to K50,000, compensation for loss of office amounting to K62,300, accrued service bonus amounting to K21,900 and pension refund amounting to K320,700.

During the tax year 2019, Mr Phiri paid school fees for his children of K32,700, medical insurance premium of K12,900, relevant professional subscription of K5,200 and tax under the pay as you earn system of K137,773. He has always contributed NAPSA at 5% of basic salary.

Mr Phiri received royalties of K30,600 (net), dividends from a LuSE listed company of K12,000 (gross), rental income of K21,250 (net) and commission of K34,000 (net).

Required:

(a) Calculate the income tax payable by Mwape Phiri for the tax year 2019. (15 marks)

(b) Explain the four (4) powers of the Commissioner General of the Zambia Revenue Authority (ZRA). (4 marks)

(c) Explain the responsibility of the Chief Administration Officer of the Tax Appeals Tribunal as stated in the Appeals Tribunal Act of 1998. (2 marks)

(d) Explain the basis of assessment for employment income. (4 marks)

[Total: 25 Marks]

SECTION B

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

QUESTION THREE

(a) Philip, Mary and John are in partnership sharing profits and losses in the ratio 3:3:2 after allowing for partnership salaries of K80,000 per annum for each partner. John retired from partnership on 30 September 2019. Philip and Mary continued with the partnership business, and with effect from that date the partnership agreement was changed. The profits were to be shared in the ratio 2:1 after annual partnership salaries of K80,000 and K100,000 for Philip and Mary respectively.

For the tax year 2019, the tax adjusted business profit after capital allowances was K480,000.

Required:
Calculate the income tax payable by each partner for the tax year 2019. (15 marks)

(b) Turnover tax is charged at 4% of gross turnover. This tax is payable by all persons whose annual business turnover is less than K800,000.

Required:
Briefly explain any three (3) problems associated with turnover tax from the taxpayer's point of view. (6 marks)

(c) Briefly explain the meaning of current year basis of assessment and preceding year basis of assessment. (4 marks)

[Total: 25 Marks]

QUESTION FOUR

The Government of the Republic of Zambia has proposed to re-introduce sales tax (SGT) to replace VAT in the 2019 budget. Zambia Revenue Authority (ZRA) has highlighted that introduction of sales tax will help create steady cash flow for both the business community and Government compared to value added tax (VAT).

Required:

(a) Briefly explain the circumstances under which a trader can be deregistered for VAT.

(6 marks)

(b) Explain any three (3) advantages and any three (3) disadvantages of voluntary VAT registration. (6 marks)

(c) State the due date for the payment of both Withholding VAT and normal VAT and explain the consequences of submitting the VAT return late. (4 marks)

(d) Explain the conditions that need to be met before a bad debt relief is permitted under Value Added Tax. (4 marks)

(e) Explain the importance of the tax point and the circumstances when the basic tax point can be changed. (5 marks)

[Total: 25 Marks]

QUESTION FIVE

(a) In providing tax services, all accountants must apply the fundamental principles in the code of ethics for professional accountants in order to identify threats to compliance with the principles, evaluate the significance and apply appropriate safeguards to ensure that compliance is not compromised. Accountants are expected to help in reducing tax evasion in the country as providers of tax services.

Required:

(i) Explain the meaning of confidentiality and professional competence and due care as fundamental principles in the code of ethics. (4 marks)

(ii) Explain any four (4) illegal ways which may constitute tax evasion. (4 marks)

(b) Andrew Lukwesa, a sole trader, is engaged in farming and prepares his financial statements to 31 December each year. The statement of profit or loss for the year ended 31 December 2019 was as follows:

	K	K
Gross profit		434,600
Other income (Note 4)		70,000
		504,600
Expenses		
Salaries & wages (Note 1)	40,700	
Rent and rates (Note 2)	24,500	
Depreciation	30,000	
Other operating expenses (Note 3)	122,400	
		(217,600)
Net profit		287,000

The following additional information is relevant:

1. Salaries and wages include K12,300 nominal salary for Andrew. The balance consists of salaries paid to the employees.
2. Andrew Lukwesa and his family live in a rented house. It has been agreed that 30% of the rent & rates relates to Andrew's residence.
3. Other operating expenses include entertaining customers K17,400, increase in general provision for doubtful debts K4,500, loan to former employee previously

written off now recovered K6,500 and legal costs incurred on the purchase of a farm land K8,600. The balance consists of revenue expenses which are all allowable for tax purposes.

4. Other income include bank interest K5,200 (gross), Royalties K60,000 (gross) and dividends K4,800 (gross). Withholding tax has already been deducted at source.

Other Information

On 1 January 2019, the income tax values of implements, plant and machinery were nil. During the year to 31 December 2019, Andrew incurred the following capital expenditure:

	K
Toyota Corolla car	30,000
Toyota light truck	40,000
Furniture and fittings	50,000
Borehole	15,000
Tractor	36,000

It has been agreed with the Commissioner General that the business use in the Toyota Corolla car is 75%.

Required:

Calculate the income tax payable by Andrew Lukwesa for the tax year 2019.

(17 marks)

[Total: 25 Marks]

END OF PAPER

DA10 SUGGESTED SOLUTIONS

SOLUTION ONE

(a) KAMAKA LIMITED
COMPUTATION OF CAPITAL ALLOWANCES FOR THE TAX YEAR 2019

Asset	Cost/ITV	Capital Allowances
	K	K
Manufacturing equipment		
Income tax value b/f	50,000	
Wear and tear K111,600 x 25/29 x 50%	(50,000)	50,000
Income tax value c/d	Nil	
Toyota Hilux van		
Income tax value b/f	56,250	
Wear and tear K87,000 X25/29 X 25%	(18,750)	18,750
Income tax value c/d	37,500	
Nissan Sunny car		
Income tax value b/f	20,880	
Wear and Tear K34,800 x 20%	(6,960)	6,960
Income tax value c/d	13,920	
Computers		
Income tax value b/f	5,625	
W & T K8,700 x25/29 X25%	(1,875)	1,875
Income value c/d	3,750	
Office furniture		
Income tax value b/f	16,500	
Wear and tear K25,520 X 25/29 X 25%	(5,500)	5,500
Income tax value c/d	11,000	
Toyota Harrier car		
Income tax value b/f	32,016	
Wear and tear K53,360 X 20%	(10,672)	10,672
Income tax value c/d	21,344	
Toyota Light truck		
Income tax value b/f	45,000	
Wear and tear K69,600 X 29/25 X 25%	(15,000)	15,000
Income tax value c/d	30,000	

Commercial Building

Cost	6,000	
Wear &Tear @2%	(120)	120
Income tax value c/d	5,880	______
Total capital allowances		108,877

(b) KAMAKA LIMITED

COMPUTATION OF ADJUSTED BUSINESS PROFIT FOR THE TAX YEAR 2019

	K	K
Net profit as per accounts		325,150
Add:		
Depreciation	45,600	
Loans to former employee	2,500	
Increase in general bad debt provision	1,200	
Legal fees in connection with ten year lease	3,000	
Construction of a new wall	6,000	
Entertaining customers	4,000	
Personal to holder: Nissan sunny car	30,000	
Toyota harrier car	40,000	
Accommodation benefit (100,000 x 30%)	30,000	
		162,300
		487,450
Less:		
Debenture interest	39,400	
Bank interest	9,350	
Royalties received	24,000	
Capital allowances	108,877	
Differently abled persons (1,000 x 2)	2,000	
		(183,627)
Tax adjusted business profit		303,823

(c) KAMAKA LIMITED

COMPANY INCOME TAX COMPUTATION FOR THE TAX YEAR 2019

	K
Taxable business profit	303,823
Debenture interest K39,400 x 100/85	46,353
Bank Interest received K9,350 x 100/85	11,000
Royalties received	24,000
Taxable Income	385,176
Tax (K385,176 @ 35%)	134,812
Less:	
Provision tax paid	(120,000)
WHT on rent received K46,353 X 15%	(6,953)
Bank interest K11,000 X 15%	(1,650)
Royalties K24,000 X 15%	(3,600)
Final Income tax payable	2,609

SOLUTION TWO

(a) MWAPE PHIRI

PERSONAL INCOME TAX PAYABLE FOR THE TAX YEAR 2019

	K	K
Salary: K300,000 x 10/12		250,000
Transport allowance: K250,000 x 25%		62,500
Medical allowance: K250,000 x 10%		25,000
Long-term service award		12,200
Utility expenses: K3,800 x 10		38,000
Leave pay		26,700
Accrued service bonus		21,900
		436,300
Investment income		
Royalties: K30,600 x 100/85	36,000	
Commission: K34,000 x 100/85	40,000	
		76,000
		512,300
Less:		
Professional subscription		(5,200)
Taxable income		507,100

Income tax

First K39,600 @0%	0
Next K9,600 @25%	2,400
Next K25,200 @30%	7,560
Balance K432,700 @37.5%	162,263
Income tax liability	172,223
Less:	
PAYE	(137,773)

WHT- Royalties (K36,000 x 15%)	(5,400)
WHT- Commission (K40,000 x 15%)	(6,000)
Income tax payable	23,050

(b) The Commissioner General has powers to:

(i) Request a tax return to be submitted anytime

(ii) Make an assessment in respect of a person who is about to leave the Republic

(iii) Request financial statements and documents to be submitted for examination.

(iv) Search and seize money, documents and property.

(c) The Chief Administration Officer of the Tax Appeals Tribunal has the following responsibility :

(i) Ensuring that notices, summons or other documents are served not less than seven days before the date of hearing.

(ii) Receiving relevant documents on behalf of the Tribunal from appellants.

(d) The basis of assessment for emoluments from employment is the actual receipts basis. i.e emoluments are taxed in the tax year in which they are received by the employee.

Emoluments are deemed to have been received on the earlier of:

(i) The time when the payment is actually made; and

(ii) The time when the employee becomes entitled to the emoluments

SOLUTION THREE

(a) PHILIP, MARY AND JOHN

COMPUTATION OF INCOME TAX PAYABLE FOR THE TAX YEAR 2019

	Total	Philip	Mary	John	
First 9 months	K	K	K	K	
Salaries	180,000	60,000	60,000	60,000 1½	
Balance 3:3:2	180,000	67,500	67,500	45,000 1½	
	360,000	127,500	127,500	105,000	½
Last 3 months					
Salaries	45,000	20,000	25,000	----	1
Balance 2:1	75,000	50,000	25,000	-----	1
	120,000	70,000	50,000	-	½
Total	480,000	197,500	177,500	105,000	1½
Income Tax					
First K39,600 @0%		0	0	0	1½
Next K9,600 @25%		2,400	2,400	2,400	1½
Next K25,200 @30%		7,560	7,560	7,560	1½
Balance K123,100/K103,100					
K30,600 @37.5%		46,163	38,663	11,475	1½
Income tax payable		56,123	48,623	21,435	1½

(b) The following are the problems associated with turnover tax from a tax payer's point of view:

(i) Turnover tax is paid regardless of whether the taxpayer has made a profit or loss. This is so because turnover tax is charged on gross earnings.

(ii) Expenses incurred wholly and exclusively for the purposes of the business are not allowable when calculating the turnover tax.

(iii) The opportunity to claim capital allowances on non-current assets, used wholly and exclusively for business purposes is lost.

(iv) The taxpayer is not allowed to carry forward the loss incurred because turnover tax is charged on gross earnings.

(c) The current year basis is used to make income tax assessments for business profits where accounts are prepared to a date falling between 1 April and 31 December inclusive. And the profits earned in the current year are taxed in the same year.

The preceding year basis is used to make income tax assessments for the business profits where accounts are prepared to a date falling between 1 January and 31 March inclusive. And the profits charged in the current year are those of the preceding year.

SOLUTION FOUR

(a) **A trader can be de-registered in the following circumstance:**

i. If the business is sold or ceases to trade permanently

ii. If there is a change in the legal status of the trader

iii. If a trader had applied for registration before commences trading and that the trader fails to commence trading on the expected date

iv. If the trader submits NIL returns for a period of 12 consecutive standard periods

v. If ZRA is satisfied that the trader is no longer making any taxable supplies, nor intending to make taxable supplies

vi. If the trader voluntarily makes an application for de-registration because of the VAT exclusive turnover is below the registration threshold.

(b) **Advantages of voluntary registration includes:**

i. The trader is able to reclaim recoverable input VAT on expenses
ii. Gives an impression of substantial business being conducted
iii. The business is able to compete with other VAT registered companies

Disadvantages of voluntary registration include the following:

i. Penalties are charged if the taxpayer fails to pay the VAT or fails to submit VAT returns
ii. Non registered customers will experience high cost of inputs. This might lead to reduced sales revenue.
iii. High administration work which may lead to an increase in administration costs.

(c) The due date for the payment of both Withholding VAT and normal VAT and explain the consequences of submitting the VAT return late.

i. The due date for the payment of Withholding VAT (WVAT) is the 16^{th} day following the end of the month to which the VAT and the return relate.

ii. The due date for the payment of normal VAT is the 18^{th} day following the end of the month to which the VAT and the return relate

iii. Late submission of a VAT return attracts a penalty of the higher of: 0.5% of the amount of VAT payable and; 1,000 penalty units (K300).

(d) Three (3) conditions that need to be met before a bad debt relief is permitted under Value Added Tax.

i. Transaction should have been for a consideration or by barter
ii. Output Vat should have been accounted for
iii. The debt has been written off from the traders accounts

iv. At least eighteen (18) months should have elapsed from the date the invoices became due.

(e) The importance of the tax point

i. Determining the tax period in which in which VAT relating to the supply should be accounted for.
ii. Decide on the scheme of the VAT rate which will apply to a supply when there is a change in the VAT rate or scheme.

The basic tax point can be changed in the following situations:

i. A tax invoice is issued or payment is made before the basic tax point
ii. Tax invoice is issued within a period of 14 days after the basic tax point

SOLUTION FIVE

(a) Code of ethics

(i) Confidentiality

This principle states that members shall respect the confidentiality of information acquired as a result of professional and business relationships and' therefore, not disclose without proper and specific authority; nor use the information for the personal advantage of the professional accountant.

Professional Competence and due care

This principle states that members shall maintain professional knowledge and skill at a level required to ensure that a client receives competent professional services based on current developments in practice.

(ii) The following are what may constitute tax evasion:

i. Deliberate concealment of income, including overstatement of tax credits or exemptions and suppression of profits
ii. Deliberate misrepresentation of material fact, manipulation of accounts, disclose of unreal expenses for deductions, showing personal expenditure as business expenses.
iii. Failure to maintain complete records of all the transactions
iv. Hiding relevant documents
v. Not reporting taxes such as pay as you earn and withholding tax. These taxes are collected from others by the taxpayer and held in trust by the business to be reported to Zambia Revenue Authority.

(b) ANDREW LUKWESA

COMPUTATION IF TAXABLE PROFITS FOR THE TAX YEAR 2019

	K	K
Net profit as per accounts		287,000
Add:		
Depreciation	30,000	
Andrew's salary	12,300	
Rent & rates (K24,500 x 30%)	7,350	
Entertaining customers	17,400	
Increase in general provision	4,500	
Legal costs- with purchase of land	8,600	
		80,150
		367,150
Less:		
Loans previously written off now recovered	6,500	
Bank interest	5,200	
Royalties	60,000	
Dividends	4,800	

Capital allowances (w1)	78,000	
		(154,500)
Adjusted farming profit		212,650
Add:		
Royalties		60,000
Total taxable income		272,650

Income Tax

Non-farming income:	
First K39,600 @ 0%	0
Next K9,600 @ 25%	2,400
Balance K10,800 @ 30%	3,240
	5,640
Farming income: K212,650 @ 10%	21,265
Income tax liability	26,905
Less:	
Withholding tax- royalties: K60,000 x 15%	(9,000)
Income tax payable	17,905

Workings

Capital allowances	K
Toyota corolla car: K30,000 x 20% x 75%	4,500
Toyota light truck: K40,000 x 25%	10,000
Furniture & fittings: K50,000 x 25%	12,500
Borehole: K15,000 x 100%	15,000
Tractor: K36,000 x 100%	36,000
Total capital allowances	78,000

END OF SUGGESTED SOLUTIONS

DIPLOMA IN ACCOUNTING PROGRAMME EXAMINATIONS

LEVEL TWO

DA 11: PRINCIPLES OF AUDITING

THURSDAY 19 MARCH 2020

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

INSTRUCTIONS TO CANDIDATES

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

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

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

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

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

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

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

8. Present legible and tidy work.

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

DO NOT OPEN THIS QUESTION PAPER UNTIL YOU ARE INSTRUCTED BY THE INVIGILATOR.

SECTION A

Attempt BOTH questions in this section.

QUESTION ONE

Your firm, Kabibi Associates, has been appointed as the auditor of Bright Computers & Consultancy Plc., a company listed on the Lusaka Securities Exchange (LUSE). The company designs and develops software applications. It also occasionally advises businesses on hardware procurement and installations. The company has a committed audit committee.

The Audit Manager has stated that since this is a new audit, the audit risk could be high, especially if the significant risks are not identified at the planning stage. You are planning the audit for the year ended 31 December 2019. Last year's audit was carried out by another firm of auditors.

Information obtained during the first visit to Bright Computers & Consultancy Plc.'s head office

1. The Engagement Partner of Kabibi Associates owns 1,000 K10 ordinary shares in Bright Computer & Consultancy Plc. These shares were acquired in 2017, when all members of the public were invited to take up an equity stake in the business, through a public offer.

2. On 1 January, 2019, Bright Computers & Consultancy Plc. replaced the manual non-current asset register with a computerized one. You are aware that there have been reliability problems with this software. The internal auditors have already carried out audit tests on the software using Computer Assisted Audit Techniques (CAATs). They have concluded that the carrying amounts of non-current assets are fairly stated. However, you strongly feel substantive tests should be carried out, especially on depreciation computations. The Director of Internal Audit is appointed by the Managing Director and also reports to the Managing Director. The scope of internal audit work is also decided by the Managing Director and the Director of Internal Audit.

3. The non-current assets figure in the draft statement of financial position as at 31 December 2019 is K930 million (2018:K780 million).

4. The Finance Director has stated that the board has finally approved a fee of 5% of turnover for the 2019 audit.

5. Mr. Ngosa, the non-current assets Supervisor has been working for Bright Computers & Consultancy Plc. for the previous eight years, and has excellent knowledge of the non-current assets register. He believes that the audit of the computerized non-current asset register will not provide any major challenges. The software for the non-current asset register was developed by Kabibi Associates' IT department.

6. The Finance Director has requested your firm to prepare the financial statements for this year to ensure that the annual report is not unnecessarily delayed. Currently Kabibi Associates has twenty auditors with the CA Zambia qualification.

Required:

(a) Explain four (4) ethical threats which may affect the independence of Kabibi Associates' audit of Bright Computers & Consultancy Plc. (8 marks)

(b) Explain three (3) limitations of internal audit in Bright Computers & Consultancy Plc. and suggest possible measures to ensure the independence of the internal audit department. (6 marks)

(c) Briefly explain how Computer-Assisted Audit Techniques (CAAT) are used in an audit. (3 marks)

(d) Explain what is meant by the following terms:
   (i) Audit risk (2 marks)
   (ii) Significant risks (1 marks)
   (iii) Audit plan (2 marks)

(e) List three (3) main audit procedures to be carried out when auditing depreciation computations. (3 marks)

[Total: 25 Marks]

<u>QUESTION TWO</u>

Buffalo Limited is an audit client of your firm. The year-end of Buffalo Limited is 31 March and you are planning the audit for the current year.

You have been assigned to carry out the audit for sales, accounts receivables and inventory of Buffalo Limited.

Buffalo Limited has a purchasing department under the responsibility of the Purchasing Manager. The company buys large stocks of raw materials and components from suppliers who respond to their enquiries for supply of goods and materials. When there is a need for supplies, the requesting departments call any of the purchasing officers and inform them of the requirements. Based on the information received from the requesting department, the purchasing officers call any suppliers who deal in the said supplies and make a phone order.

Once a supplier has been identified, the order is recorded in an order book and an official order is raised and sent to the supplier as confirmation of the verbal order. When deliveries are made, the officer who placed the order in the first place is required to check the goods before he directs the supplies to Stores Department whose function is to store the supplies. The only stock record that is maintained are stock cards which are raised by the stores officer who is also responsible for numbering the stock cards.

When supplies are required for use, the user calls the Stores Officer who in turn raises a material issue note which is used to update the stores card.

Supplier invoices are sent directly to Finance department by the suppliers for recording and processing. At the end of the month, payment is processed listing all outstanding invoices and is sent to the Purchasing Officer for endorsement after which payment is made. Reconciliations of supplier accounts are carried out once a year in readiness for the annual audit.

The bulk of the sales of Buffalo Limited are on credit and customers are on average given 30 days credit. In the last six months, the credit days have increased from an average of 30 days to 45 days and this is largely attributed to a relaxation of credit vetting procedures towards the year end.

The receivables ledger is maintained by a team of credit controllers. The receivables ledger is manually maintained and because of the large number of customers there is no age analysis of receivables that is kept and plans are under way to have this done once the company migrates to a computerized accounting system.

At the end of the year a physical inventory count is conducted under the supervision of the Stores Controller. Any discrepancies that are observed during the inventory count are corrected by him and the corrected counts passed on to the management accountant for valuation of inventory.

You are about to commence the audit of Buffalo Limited.

Required:

(a) (i) Identify and explain five (5) internal control weaknesses in the sales cycle of Buffalo Limited. (10 marks)

(ii) Suggest five (5) internal controls for the weaknesses identified in (i) above. (5 marks)

(b) (i) Explain positive and negative form of circularization of receivables. (4 marks)

(ii) State and explain four (4) audit procedures that should be undertaken by your firm on the receivables figure in the financial statements of Buffalo Limited. (6 marks)

[Total: 25 Marks]

SECTION B

Attempt any TWO (2) out of THREE (3) questions in this section.

QUESTION THREE

(a) ISA 320 *Materiality in planning and performing an audit* provides guidance to auditors in this area. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

Required:

(i) Explain what is meant by materiality. (3 marks)

(ii) List four (4) examples of matters an auditor may consider when determining the materiality level. (4 marks)

(b) The audit is primarily a statutory concept, and eligibility to conduct an audit is often set down in statute. Similarly, the rights and duties of auditors can be set down in law, to ensure that the auditors have sufficient power to carry out an effective audit.

Required:

(i) State three (3) rights and three (3) duties of an external auditor. (6 marks)
(ii) Give three (3) examples of persons who are ineligible to act as an external auditor. (3 marks)

(c) ISA 230 Audit documentation states that the auditor shall prepare audit documentation on a timely basis.

Required:

(i) Define audit documentation. (2 marks)
(ii) Explain the importance of preparing audit documentation on a timely basis. (3 marks)
(iii) Explain whether audit documentation could be made available to third parties. (4 marks)

[Total: 25 Marks]

QUESTION FOUR

You are an audit senior in Thrive Chartered Accountants. Silver Limited is a newly acquired client of your firm which has recently recruited new staff members including five audit assistants.

You have been assigned to the audit of Silver Limited and an audit team comprising two existing audit assistants and three newly recruited auditors has been put in place. You have seen an advertisement in one leading newspaper in which Silver Limited has invited for expression of interest from reputable firms of auditors to provide internal audit services to it.

Silver Limited is considering establishing an audit committee of the board of directors on your recommendation. There is resistance by half the board as those opposing to it do not see the benefits of having an audit committee.

The following figures have been extracted from the draft statement of financial position:

Tangible non-current assets (Motor vehicles):

		K'000
01/01/2019	Opening balance (At cost)	2,500
	Additions during the year	600
	Disposals	(300)
31/12/2019	**Balance at end of year (Cost)**	**2,800**

The client has provided your firm with a trial balance as at the end of the year and a schedule giving details of all motor vehicles by registration number.

You are planning for a pre audit meeting with the members of the audit team and you need to brief the team on the need to document the evidence that will be gathered and also discuss the audit procedures that will be required to be undertaken in the audit of motor vehicles.

Required:

(a) State three (3) advantages of the proposed audit committee of the board of Silver Limited. (3 marks)

(b) Explain four (4) reasons why auditors need to document evidence gathered. (4 marks)

(c) Explain the meaning of outsourcing in the context of internal audit and give four (4) benefits accruing to Silver Limited of outsourcing the internal audit service. (6 marks)

(d) State and explain the audit procedures that should be carried out in the audit of motor vehicles to test the following assertions:

- (i) Rights and Obligations. (2 marks)
- (ii) Existence (2 marks)
- (iii) Valuation (2 marks)
- (iv) Completeness (2 marks)
- (v) Accuracy (2 marks)
- (vi) Presentation (2 marks)

[Total: 25 Marks]

QUESTION FIVE

Diamond Ltd is a client of your firm of Chartered Accountants. A review of the draft financial statements of Diamond Ltd has revealed that revenue is a material figure.

The following controls in the sales system of Diamond Ltd were extracted from the information gathered during the planning stage of the audit. A note in the Chairman's report states that Diamond Ltd is a going concern and so the financial statements under review have been prepared on that basis.

1. The taking of orders from customers, the recording of sales and receipting of payment is carried out by different individuals.
2. Sales orders and sales invoices are numerically numbered and accounted for.
3. There is an authorized price list which is used when raising invoices.
4. Changes in customer standing data are required to be authorized in writing by the Credit Controller.

Your firm of Chartered Accountants carries out tests of control on accounting systems in addition to carrying out substantive tests. The procedures carried out enable the firm to gather sufficient appropriate audit evidence which forms the basis of forming the audit opinion.

Required:

(a) Distinguish between internal controls and tests of control giving an example of each of them. (5 marks)

(b) Explain the tests of control that should be carried out for each of the four (4) controls in the sales system of Diamond Ltd. (4 marks)

(c) State and explain four (4) generalizations that may help the auditor to assess the reliability of audit evidence. (4 marks)

(d) Explain the duties of management and the auditor with regards the assumption that Diamond Ltd is a going concern. (4 marks)

(e) Distinguish between modified and unmodified opinions in the auditor's report and explain the forms of modified opinion that the auditor may give. (8 marks)

[Total: 25 Marks]

END OF PAPER

DA 11 SUGGESTED SOLUTIONS

SOLUTION ONE

a) **Ethical threats to Kabibi Associates' independence are:**

- **Financial interest** – the Engagement Partner of Kabibi Associates owns 1,000 K10 ordinary shares in Bright Computer & Consultancy Plc. According to the *International Ethics Standards Board for Accountants (*IESBA) code, the parties listed below are not allowed to own a direct financial interest or a material indirect financial interest in a client:
  - The firm
  - A member of the audit team
  - An immediate family member of a member of the audit team

  The Engagement Partner is a member of the audit team and therefore the issue of materiality does not arise. The Engagement Partner would directly benefit from increases in client profits and would be reluctant to raise any concerns that could adversely affect the performance of Bright Computer & Consultancy Plc. Hence, in order to mitigate the risk to independence that this poses on the audit, the Engagement Partner needs to dispose of the shares or he should be removed from the team. It may also be advisable to inform the audit committee of what has happened.

- **Contingent fees** – the approved fee of 5% of turnover is a contingent fee. Contingent fees are calculated on a predetermined basis relating to the outcome of a transaction or result of the services performed by the firm. The IESBA code does not allow contingent fees, since this has a direct impact on auditor independence. Kabibi Associates in this case may not question overstatements in turnover since these will translate into an increased audit fee. The key estimate in the determination of audit fees is how long the Engagement Partner thinks it will take to do the work, and level of expertise needed. The Engagement Partner should therefore discuss the matter with audit committee and a solution could be found since at least one member of the audit committee should be an accountant.

- **Development of software for non-current assets register** – this would result in self-review threat since Kabibi Associates would review the software as part of the audit. Any weaknesses identified during the audit may not be reported to management or those charged with governance due to the possible negative impact this could have Kabibi Associates' reputation. Kabibi Associates should consider whether the threat to independence could be reduced by appropriate safeguards. Kabibi Associates could include using different staff for the audit. The audit committee should be informed accordingly. Bright Computer & Consultancy Plc. can also be advised to seek independent advice regarding the software.

- **Preparation of financial statements** – there will clearly be a significant risk of a self-review threat if Kabibi Associates agrees to prepare the financial statements. The rules are more stringent when the client is a public interest entity like Bright Computer & Consultancy Plc. Firms should not prepare accounts or financial statements for public interest clients. Kabibi Associates should not agree to prepare financial statements for Bright Computer & Consultancy Plc., even if it means using different staff.

b) Limitations of internal audit in Bright Computer & Consultancy Plc. are:

- **Appointment of Director of Internal Audit** – the Director of Internal Audit is appointed by the Managing Director. Given that Managing Director is responsible for the running of the company, it is possible that there will be bias in the appointment of the Director of Internal Audit; the Managing Director may appoint someone who he knows will not criticize his work or the company. To ensure independence, the Director of Internal Audit should be appointed by the audit committee or at least the appointment agreed by the whole board.

- **Reporting system** – the Director of Internal Audit reports to the Managing Director. This limits the effectiveness of the internal audit reports as the Managing Director will also be responsible for some of the systems that the internal auditor is reporting on. Similarly, the Director of Internal Audit may soften or limit criticism in internal audit reports to avoid confrontation with the Managing Director. To ensure independence, the internal audit should report to the audit committee.

- **Scope of work** – the scope of work of internal audit is decided by the Managing Director in discussion with the Director of Internal Audit. This means that the Managing Director may try and influence the Director of Internal Audit regarding the areas that the internal audit department is auditing, possibly directing attention away from any contentious areas that the Managing Director does not want audited. To ensure independence, the scope of work of the internal audit department should be decided by Director of Internal Audit, with the assistance of the audit committee.

c) Two types of CAATs, and below is how they are used in an audit:

1. Audit software – this consists of computer programs used by the auditors, as part of their auditing procedures to process data of audit significance from the entity's accounting system. It may consist of generalized audit software or custom audit software. Audit software is used for substantive procedures e.g. tracing transactions through the computerized system, performing calculations, sampling.
2. Test data – these are techniques used in conducting audit procedures by entering data (e.g. a sample of transactions) into an entity's computer system, and comparing the results obtained with pre-determined results. Test data is used for tests of controls. To be successful test data should include

both data with errors built into it and data without errors e.g. codes that do not exist, invoices with arithmetic errors.

d) Meaning of audit risk, significant risk and audit plan:

i) Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. It is a function of the risk of material misstatement (inherent risk and control risk) and the risk that the auditor will not detect such misstatement (detection risk).

ii) Significant risks are complex or unusual transactions that may indicate fraud, or other special risks. These will require special audit considerations.

iii) The audit plan converts the audit strategy into a more detailed plan and includes the nature, timing and extent of audit procedures to be performed by engagement team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. The audit plan therefore serves as a set of instructions to assistants involved in the audit and as a means to control the proper execution of the work.

e) The audit procedures for the audit of depreciation calculations include:

- Review depreciation rates applied in relation to asset lives, residual values, replacement policy, past experience of gains and losses on disposal, consistency with prior years and accounting policy, possible obsolescence etc.
- Review non-current assets register to ensure that depreciation has been charged on all assets with limited useful life.
- For revalued assets, ensure that the charge for depreciation is based on the revalued amount by recalculating it for a sample of revalued assets.
- Re-perform calculation of depreciation rates to ensure it is correct.
- Compare ratios of depreciation to non-current assets (by category) with previous years, depreciation policy rates etc.

SOLUTION TWO

a) i. Internal control weaknesses in Buffalo Limited:

1. There appears to be no list of approved suppliers in Buffalo Limited. This could result in the company not getting value for money on its supplies.
2. The purchasing officers have the power to decide from which supplier to purchase materials. This can result in the purchasing officers conniving with the suppliers for personal gain.
3. The purchasing officers who place the orders are the same ones who check goods when received. They may not perform the quality control checks as expected as they are involved in procurement.
4. Stock cards maintained in stores are not pre numbered and instead the stores officer numbers cards as they are used. There is a risk that documents can be destroyed and replaced after falsification of the records.
5. Goods are handed over to the users without evidence of confirmation of receipt by the recipients. This may lead to falsification of stores records where a fraud has taken place.
6. The number of Good Received Notes (GRN) raised by stores is not adequate with a copy retained in stores and the other copy given to the user. This means that payment is made without a copy of the GRN confirming receipt of the goods being paid for.
7. Supplier reconciliations are only carried out at the period end. This could result in disputes with suppliers and subsequently misstatements in the amount of accounts payables.
8. The lack of credit vetting may result in credit being extended to customers with no ability to pay the amounts due.
9. The non-availability of an age analysis of receivables may result in misstatement in the allowance for receivables and the company carrying debts that may be uncollectable.
10. The stores controller is responsible for the inventory count as well as being custodian of the inventory. Records may be falsified to hide any fraud that may take place.

ii. Internal controls for the weaknesses in (i) above:

1. There should be an approved list of approved suppliers from whom purchases should be made.
2. All orders made must be approved by a senior official as a control over the purchasing officers.
3. Checking of goods when received should be by someone else other than the purchasing officers, preferably by the stores personnel.
4. Pre numbered stock cards must be maintained and unused cards should be well secured preferably by another person other than the user.
5. The users of goods drawn from stores should sign for goods received and this should be evidenced by raising a materials issue note.
6. The number of Goods Received Notes raised should be increased to three and one should be sent to the accounts department which will form part of the supporting documents for payments.

7. Supplier reconciliations should be done regularly on a monthly basis and should be independently checked by someone else and this should be evidenced in writing.
8. There should be a credit policy in place clearly spelling out who can give credit and credit limits set up.
9. An age analysis should be prepared monthly to enable prompt follow up of old dates and assist in determining provisions for receivables.
10. The inventory count should be the responsibility of an officer not involved in the custody of stores.

b) i. Positive and negative forms of circularization:

Positive circularization – this is the form of receivables circularization where the customer being confirmed is required to respond to the letter of circularization whether or not they agree with the amount in the letter. There is action expected on the part of the customer to react to the letter.

Negative circularization – In this case the customer is expected to only respond when they do not agree with the amount in the circularization letter. In this case it is assumed that when the customer does not respond then they agree with the balance per the letter of circularization.

ii. Audit procedures for receivables figure:

- Agree the figure on the schedule of receivables to the general ledger control account.
- Cast the schedule of receivables to ensure it is correct.
- Circularize a sample of receivables and reconcile any differences.
- Review post year end receipts from receivables to confirm balances due at the period end.
- Review the receivables age analysis and ensure adequate provisions made for doubtful debts.
- Inquire from management on any long standing unpaid invoices.
- For a number of invoices around the year end inspect the dates and ensure correct cut off.
- Review receivables schedule for credit balances and ensure appropriately disclosed and payables.

SOLUTION THREE

a) Materiality and matters to consider:

i) Materiality is a concept, a threshold, an intangible. What makes misstatements material to one user of the accounts may not be material to another user. The precise definition is as follows:

‘Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.’

ii) The matters to consider when determining materiality level include:

- Elements of the financial statements (e.g. assets, liabilities, equity, revenue, expenses)
- Whether there are items on which users tend to focus
- Nature of the entity, industry and economic environment
- Entity’s ownership structure and financing
- Risk assessment

b) Rights, duties and eligibility of auditors:

i) Rights of external auditors include:

- **Access to records** – a right of access at all times to the books, accounts and vouchers of the company (in whatever form they are held)
- **Information and explanations** – a right to require from the company’s officers such information and explanations as they think necessary for the performance of their duties as auditors
- **Attendance at/notices of general meetings** – a right to attend any general meetings of the company and to receive all notices of and other communications relating to such meetings which any member of the company is entitled to receive
- **Rights to be heard at general meetings** – a right to be heard at general meetings which they attend on any part of the business that concerns them as auditors
- Rights in relation to written resolutions – a right to receive a copy of any written resolution proposed.

Duties of external auditors include reporting on:

- **Compliance with legislation** – whether the financial statements have been prepared in accordance with the relevant legislation
- **Truth and fairness of accounts** – whether the statement of financial position shows a true and fair view of the company’s affairs at the end of the period and the statement of profit or loss (and statement of cash flow) show a true and fair view of the results for that period
- **Adequate accounting records and returns** – whether adequate accounting records have been kept and returns adequate for the audit received from branches not visited by the auditor

- **Agreement of accounts to records** – whether the accounts are in agreement with the accounting records and returns
- **Consistency of other information** – whether the information in the directors' report is consistent with the financial statements
- **Directors' benefits** – whether disclosure of directors' benefits has been made in accordance with the Companies Act

ii) The following are ineligible to be auditors:

- An officer or employee of the company
- A partner or employee of such a person
- A partnership in which such a person is a partner

There may be further rules about connections between the company or its officers and the auditor, depending on local statutory rules.

c) i) Meaning of audit documentation:

Audit documentation is the record of audit procedures performed, relevant audit evidence obtained and conclusions reached. The terms 'working papers' or 'work papers' are also sometimes used. As per ISA 230 *Audit Documentation,* auditors are required to prepare and retain written documentation that provides a sufficient appropriate record of the basis for the audit report; and evidence the audit was planned and performed in accordance with ISAs and other regulatory requirements.

ii) Timely preparation of audit documentation is important because audits are normally conducted under tight deadlines and any delays could impact negatively on the auditors' competence and reputation. In addition, timely supervision and reviews are facilitated if auditors prepare audit documentation on a timely basis.

Important corrective decisions can also be delayed, and this impact can impact negatively on the quality and the effectiveness of the entire audit process. The audit team members are also held accountable. Hence, timely audit documentation does contribute significantly to timely completion of an audit. Information which is not available on time greatly contributes to a manager's inefficient.

iii) Auditors must follow ethical guidance on the confidentiality of audit working papers. By its nature, audit evidence will comprise much sensitive information that is confidential. Hence the auditor's duty of confidentiality should never be compromised without proper and specific authority or unless there is a legal or professional right or duty to disclose. They may, at their discretion, release parts of or whole working papers to the entity, as long as disclosure does not undermine 'the independence or validity of the audit processes. However, it is important to note that information should not be made available to third parties without the permission of the entity or circumstances mentioned above.

SOLUTION FOUR

a) Advantages of the audit committee:

1. Improves the quality of financial reporting by reviewing the financial statements on behalf of the board.
2. Creates a climate of discipline and control which reduces the opportunity for fraud.
3. Is a forum where the Financial Director can raise matters of concern.
4. Strengthens the position of the external auditor in case of disputes with management.
5. Strengthens the position of internal audit in that it will report to the committee and so affords a degree of independence on internal audit.
6. Increases public confidence in the credibility and objectivity of financial statements.

b) Reasons why auditors need to document evidence gathered:

It is a requirement of auditing standards that evidence gathered should be documented. ISA 230 *Audit evidence* gives guidance in this area. Auditors need to document evience for the following reasons:

- Evidence gathered during the audit is the basis upon which the audit opinion is based.
- Documenting evidence allows for planning and coordinating of the work as it enables reviews to be carried out.
- In case of litigation, documented evidence can form a basis for defense to show that the audit was conducted in accordance with international standards.
- Documenting evidence enables the audit team to be accountable for its work.
- Allows record of matters of continuing importance to be retained.
- Enables the conduct of quality control reviews and inspections both internal and external.

c) Meaning of out outsourcing of internal audit services:

Outsourcing internal audit means that the company uses the services of another to carry out its internal audit duties. This involves getting into a contract and agreeing on the cost of the service to be offered.

Benefits of outsourcing:

- The company can have an internal audit department much faster than establishing one in-house.
- The company can benefit from the expertise that the outsourcing company has as they are experts in the field.
- The outsourced service will bring about a level of independence which may be lacking in an internally established internal audit department.
- Company does not need to worry about employing its own internal auditors and the related remuneration. In this case the company need only worry about the contracted amount and no more.

d) Audit procedures to test the following assertions for motor vehicles:

i) Rights and Obligations:

- Inspect the motor vehicle white books to confirm that they are in the name of the client.
- Confirm that the vehicles are used for the client's business.

ii) Existence:

- Sample some motor vehicles from the Fixed Assets register and physically inspect the asset to confirm existence.

iii) Valuation:

- Confirm that the cost of the motor vehicles agrees with the purchasing documents such as the invoice.
- Re-perform the calculation of depreciation to ensure it is correct.
- Scrutinize the draft financial statements to ensure that depreciation policies and rates are disclosed.

iv) Completeness:

- Agree the schedule of motor vehicles prepared by the client with the relevant general ledger accounts.
- For a sample of motor vehicles inspected confirm that they are recorded in the non-current asset register.

v) Accuracy

- Agree the fixed assets opening position to the prior year's financial statements.
- Recalculate any profit or loss on the disposal of motor vehicles during the year.

vi) Presentation

- Review the non-current asset disclosures in the financial statements to ensure that they are in line with the provisions of IAS 16 provisions.
- Inspect the draft financial statements to ensure that depreciation policies and rates are correctly disclosed.

SOLUTION FIVE:

a) Distinction between internal controls and tests of control:

Internal controls are any measures that management puts in place to provide reasonable assurance about the achievement of organizational objectives. They include financial and other controls and aim at prevention and detection of fraud and errors.

An **example** of an internal control is when payment vouchers are prepared, they should be checked by a different person who should evidence the checking by signing.

Tests of controls on the other hand are tests that are carried out by the auditor. These involve the auditor identifying the controls that are in place and then select samples of transactions and test them to confirm on the effectiveness of the controls that have been set.

For **example**, in the case of payment documents being checked and signed by a different person from the originator, the auditor could select samples of paid payment vouchers and check them for confirmation of the checking and ensure it is evidenced in writing.

b) Tests of controls for controls in Diamond Ltd:

1. For a sample of orders executed, examine the documentation to confirm that the taking of orders, recording of sales and receiving of proceeds are all done by different people.
2. Obtain a sample of sales orders and sales invoices that have been executed and confirm they are pre-numbered. For a series of unused sales orders and sales invoices confirm they are pre-numbered.
3. Confirm the existence of the approved price list by examining a copy and confirming authorization. For a sample of executed orders, confirm prices used to authorize the price list.
4. For a sample of used customer data input forms, verify that they have been duly authorized by the designated official.

c) Generalizations on the reliability of audit evidence:

- Original copies of evidence are more reliable than photocopies.
- Written evidence is more reliable than oral evidence.
- Evidence obtained from the client systems is more reliable when the related controls are operating effectively.
- Evidence obtained and generated by the auditor is more reliable than that from the client.
- External evidence is more reliable than that obtained from the entity because it is from independent sources.

d) Management's responsibility with regards going concern:

ISA 570(Revised) *Going concern* gives guidance with regards the going concern assumption of an entity. Management is responsible for assessing that a company is a going concern. This assumption is futuristic and so management has to base this on assumptions to support their conclusion. The assessment should be made to cover at least the next twelve months.

Auditor's responsibility with regards going concern:
The auditors should be alert during the audit for any indicators that the client company is not a going concern. Further, the auditor is required to assess the assumptions by management in their review of the going concern aspect of the company.

The assumptions should be reviewed for reasonableness. The auditors should also ensure that management has made an assessment for a period covering not less than the following twelve months.

e) Unmodified audit opinions:
Guidance on the unmodified opinion is given by ISA 700(Revised) *Forming an opinion and reporting on financial statements.*

This is an opinion issued by the auditor when the auditor concludes that the financial statements have, in all material respects, been prepared in accordance with the applicable financial reporting framework.

The auditor concludes that the financial statements are free from material misstatements and that they show a true and fair view.

Modified audit opinion:
ISA 705(Revised) *Modifications to the opinion in the independent auditor's report* sets out the guidance on modified audit opinions.

This is an opinion issued by the auditor when he has a matter of concern. Such an opinion is issued where the auditor concludes that the financial statements as a whole are not free from material misstatements.

Forms of modified opinions:
Qualified opinion:
This is an opinion which is issued by the auditor in two circumstances.

- When the auditor has obtained sufficient and appropriate audit evidence.
- When there is a limitation of scope and the auditor has not obtained sufficient appropriate audit evidence.

A qualified opinion will be given in either of the above situations and the auditor concludes that there is a matter of concern and the, matter is material but not pervasive.

Adverse opinion:
This is a form of modified opinion which the auditor issues when he has obtained sufficient appropriate audit evidence that the financial statements do not show a true and fair view.

In this case the matter of concern to the auditor is both material and pervasive.

Disclaimer of opinion:
In this case the auditor does not issue an opinion and states that he is unable to form an opinion on the financial statements.

This is issued when there has been a limitation of scope and the auditor has not obtained all the evidence required to make him form an opinion. He will issue a disclaimer of opinion when the matter of concern is material and pervasive.

END OF SUGGESTED SOLUTIONS

DIPLOMA IN ACCOUNTANCY PROGRAMME EXAMINATIONS

LEVEL TWO

DA: 12 GOVERNANCE AND COMPANY LAW

FRIDAY 20 MARCH 2020

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

INSTRUCTIONS TO CANDIDATES

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

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

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

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

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

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

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

8. Present legible and tidy work.

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

DO NOT OPEN THIS QUESTION PAPER UNTIL YOU ARE INSTRUCTED BY THE INVIGILATOR

SECTION A – TWO COMPULSORY QUESTIONS

Attempt both questions

QUESTION ONE

Katiyo Malilo a graduate from the University of Oxford is a director at the Zambia Institute of Chartered Accountants (ZICA) and also a member of the board of directors. He has been working for the said institution for the past 10 years and he knows that as a result of his position, he is under a fiduciary duty. It appears he has always had a challenge to understand the concept of corporate governance and fiduciary duties at his work station. His difficulty was worsened when the institution called an expert from the Chartered Governance Institute of Zambia who gave a presentation on corporate governance entitled ***"The role of the board of directors towards the stakeholders and the risk of poor corporate governance***".

Among the things presented was that:

> *"The law of agency and stakeholders plays an important role in terms of the responsibilities that directors have towards shareholders as their agents."*

Malilo felt shy to ask about his difficulty especially that his subordinates seem to have understood the presentation very well.

Malilo knowing that he is accountable to the shareholders and other stakeholders, he decides to call you for guidance.

Required:

In reference to the above scenario:

(a) Explain how a director acts as the agent of the shareholders. (4 marks)

(b) Explain the meaning of corporate governance . (2 marks)

(c) Explain any five (5) fiduciary duties that Malilo has towards the stakeholders. (10 marks)

(d) Discuss the three (3) examples of poor corporate governance that Malilo as Director needs to avoid. (9 marks)

[Total: 25 Marks]

QUESTION TWO

Macwala, a Director in Mac Construction Company is a young and innovative business person who has been carrying on business for the past 8 years with hardships under a company limited by shares. The company has 4 drivers, 2 secretaries, 4 directors and 17 general workers to mention a few.

Macwala who sourced P.T Accountants to audit the company has just realized that the company is in debts and that the said company may not continue with the current staff.

Among the issues reported in the audit report is that the assets of the company were unable to pay for all the liabilities that the company had even when this is combined with unpaid shares.

Required:

(a) Explain to Macwala on the types of winding up in the event the status of the company remains the same. (10 marks)

(b) Discuss with Macwala on any safeguards as the company is wound up. (4 marks)

(c) State any two advantages of a company limited by shares. (2 marks)

(d) Explain if a sole proprietorship would be better for Macwala . (3 marks)

(e) Assuming Macwala wants to convert this company into a company limited by guarantee, explain what he needs in order to convert the company. (6 marks)

[Total: 25 Marks]

SECTION B

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

<u>QUESTION THREE</u>

(a) A company has both internal and external stakeholders.

(i) Identify two (2) internal and two (2) external stakeholders of a company.

(4 marks)

(ii) Explain how each one of the above in the face of bad corporate governance can affect the company. (6 marks)

(b) Describe the procedure of calling an Annual General Meeting (AGM). (4 marks)

(c) Various bodies have over the years developed various principles based codes for corporate governance practitioners to follow. Although the said codes have a major global influence, they are nevertheless riddled with limitations.

Required:

Outline any five (5) such limitations. (5 marks)

(d) The Organization for Economic Co-operation and Development (OECD) in consultation with member countries has developed a set of principles of corporate governance that countries and companies should work towards achieving.

Required:

Explain any three (3) such principles of corporate governance developed by the OECD. (5 marks)

[Total: 25 Marks]

<u>QUESTION FOUR</u>

(a) The Board of Directors plays an important role in the corporate governance and it is at the heart of good governance. The purpose of the board is to define the purpose of the company and the values by which the company will perform its daily existence and to identify the stakeholders relevant to the business of the company. Therefore, the board must then develop a strategy combining all three factors and ensure management implements that strategy.

Required:

(i) Explain the duty of conflict of interest in relations to directors. (4 marks)

(ii) List any six (6) roles of the Chairman. (6 marks)

(iii) Advise the role of the remuneration committee. (5 marks)

(b) A company to be formed needs someone to incorporate it through the laid down process in the Companies Act and pay all registration fees at Patent and Company Registration Agency. One a company is incorporated, it is regarded as a legal person with the ability to sue and be sued in its own in its own capacity.

This principle was elaborated fully in the case of ***Salomon v Salomon Company Limited (1897).***

Required:

Explain the following:

(i) Perpetual succession (2 marks)

(ii) Limited liability (2 marks)

(iii) Pre-incorporation contracts (2 marks)

(iv) Lifting the veil of incorporation (2 marks)

(v) Articles of Association as a contract (2 marks)

[Total: 25 Marks]

QUESTION FIVE

Kondowe incorporated a public company with the aim of raising capital from the public in case the company wants to do so or when the company is in distress. He also wants to ensure that the capital of the company is never diluted. However, there are several issues he does not really understand.

Required:

(a) Explain to Kondowe on the following:

(i) Nominal and subscribed capital. (4 marks)

(ii) Redeemable shares. (2 marks)

(iii) Reduction of share capital. (3 marks)

(iv) Payment of dividends. (5 marks)

(v) Duty not to make a secret profit. (3 marks)

(b) Explain to Kondowe how a company is not allowed to assist in purchasing of its own shares. (4 marks)

(c) Explain what is meant by accumulated profit. (4 marks)

[Total: 25 Marks]

END OF PAPER

DA12 SUGGESTED SOLUTIONS

SOLUTION ONE

1) From the given facts, Katiyo Malilo who is employed as a director stands as an agent of the shareholders as one of the stakeholders. It is seen that an agent herein called the director was appointed by the principal herein called the shareholders and as such must act on behalf of the shareholders.

   Thus, Malilo stands as an agent of the shareholders.

2) In the given scenario, Malilo as a director and board member is employed to understand corporate governance as a system by which organisations are directed and controlled. Thus, it is a set of relationships between company's directors, its shareholders and other stakeholders. Malilo as a director needs to understand this concept.
3) The statement given in the question brings about agency relationship were fiduciaries duties are created between the agent and the principal. The following are the fiduciary duties:

   i) **Performance**

      The agent who agrees to act as an agent for a reward has contractual obligation to perform his agreed task. An unpaid agent is not bound to carry out his duties. Any agent may refuse to perform illegal acts.

   ii) **Obedience**

      The agent must act strictly in accordance with his instructions provided they are lawful and reasonable. Even if he believes disobedience to be in his principal's best interest, he may not disobey instructions. Only if he asked to commit an illegal act may he do so.

   iii) **To exercise due care and skill**

      An agent will owe a duty to act with reasonable care and skill, regardless of whether the agency relationship is contractual or gratuitous. The level of skill to be exercised, however, should be that appropriate to the agent's professional capacity and this may introduce a distinction in the levels expected of different agents.

iv) To carry out instructions personally

Unless expressly or impliedly authorised to delegate the work, an agent owes a duty to the principal to act personally in the completion of the task. The right to delegate may be agreed expressly by the principal, or it may be implied from customary practice or arise as a matter of necessity. In any such case, the agent remains liable to the principal for the proper performance of the agreed contract.

v) To account

There is an implied duty that the agent keeps proper accounts of all transactions entered into on behalf of the principal. The agent is required to account for all money and other property received on the principal's behalf and should keep his or her own property separate from that of the principal.

vi) No conflict of interest

An agent must not allow the possibility of personal interest to conflict with the interests of his or her principal without disclosing that possibility to the principal. Upon full disclosure, it is up to the principal to decide whether or not to proceed with the particular transaction. If there is a breach of this duty, the principal may set aside the contract so affected and claim any profit which might have been made by the agent.

vii) Not to take a bribe .

This duty may be seen as merely a particular aspect of the general duty not to make a secret profit, but it goes so much to the root of the agency relationship that it is usually treated as a distinct heading in its own right.

viii) **Not to make a secret profit**

An agent who uses his or her position as an agent to secure financial advantage for him or herself, without full disclosure to his principal, is in breach of fiduciary duty. Upon disclosure, the principal may authorize the agent's profit, but full disclosure is a necessary precondition.

ix) Confidence

The agent must keep in confidence what he knows of his principal’s affairs even after the agency relationship has been terminated.

4) Since Zambia Institution of Commissioned Accountant is subject to corporate governance, it may have some poor maladministration by its board of directors.

Thus, examples of poor corporate governance are as stated below:

i) Domination by a single individual

A feature of many corporate governance scandals has been boards dominated by a single senior executive with other board members merely acting as a rubber stamp. Sometimes the single individual may by pass the board to action his own interests. Even in an organisation which is not dominated by one single member, there can still exist other weaknesses. The organisation may be run by a small group centered round the chief executive and chief financial officer, and appointments may be made by personal recommendation rather than a formal, objective process.

ii) Lack of involvement

Boards that meet irregularly or fail to consider systematically the organisation’s activities and risks are clearly weak. Sometimes the failure to carry out proper oversight is due to a lack of information being provided, or the directors lacking the knowledge or skills necessary to contribute effectively.

iii) Lack of supervision

Employees who are not properly supervised by the board can create large losses for the organisation through their own incompetence, negligence or fraudulent activity. The behaviour of employees is paramount to the running of the organisation as one simple mistake can lead to a fall of the entire organisation. One such example is Nick Leeson who made Barings Bank collapse.

SOLUTION TWO

(a) A Company is an artificail person. It cannot dies but it can cease to exist by being dissoved and struck off the register of companies. The disolution of a company is what is callled winding up or liquidation.

Therefore the advise given to Macwala on the types of winding up is as follows:

- **Winding up by the court**
- **Members winding up**
- **Creditors winding up**

Compulsory Winding up

A compulsory winding up otherwise known as winding up by court, is winding up in which the directors of the company do not feel able to make statutory declaration that the company will be able to pay its debts within approximately twelve months. It also occurs where such a statement has been made but the company finds that it is unable pay its debts within the stipulated time. If satisfied, the Court makes an order to wind up the Company.

Examples of the grounds to wind up a company include inability to pay debts, the number of members reducing below two. The entire grounds foe winding up by the court are found in the companies Act.

Voluntary winding up by Members and Creditors

Voluntary winding up maybe be made by the members or creditors. In the case of creditors, winding up occurs where the shareholders resolve to put the company into liquidation but cannot make a declaration of solvency. If a resolution to wind up is passed, shareholders must within 24 hours of passing resolution convene a meeting of the creditors and a liquidator must be appointed. Where members are the ones winding up the Company, the shareholders pass a resolution to wind up and appoint a liquidator. In order for it to be a members voluntary winding up, the directors have to make the declaration of solvency confirming that the company will be able to pay all its debts.

A voluntary winding up enables a company and its creditors to be free to settle their affairs without having to seek the assistance of the Court. A voluntary winding up does not necessarily imply that a company's business is to cease entirely. Where a reconstruction or an amalgamation is desired, a voluntary winding up is often necessary to put this into effect.

The date the resolution to wind up the company voluntarily is recognised as the official date of the commencement of the winding up.

It must be noted that a resolution to wind up voluntarily does not mean that the company immediately ceases to exist, but rather, it still maintains its personality and its powers until it is dissolved. A transfer of shares can only be made without the sanction of the liquidator. Further, any alteration in the status of members cannot be allowed after the commencement of the winding up. A liquidator must be appointed and during the course of winding up, every invoice, order for goods, or business letter issued by the company or the liquidator must contain a stamen that the company is being wound up.

(b) Macwala may put in several safeguards in the certain ciurcumstances. Some of the concerns of the company will still arise from disolving a company by this method. The inability if any of every officer and members of the company whether by the court order, voluntary winding up or by dissolution by the regsitrar could be declared void by the court upon an aplication by an interetsd person includong the company or the liquidater within 2 tears of initial dissolution. If this happens, the proceedings may be taken as though the company hadnot been dissolved.

(c) Advantages

1. Liability extends to the shares held in relation to unpaid shares
2. A company limited by shares can be both a private or public company.

(d) The answer here is dependant on the argument brought forth by the student.

However, the favourable answer we are looking for is that a sole trader would not be a proper entity for Macwala because in a sole trader, once it is in destress there is no distinction given to the sole trader and entity. There is no separability, hence the personal property of the sole trader is at risk. With a company, there is limited liability in terms of the liability of members.

(e) For the conversion of a company limited by shares into limited by guarantee, Macwala must:

1) All members must agree in writing to the conversion
2) There must be no unpaid liability on the shares,
3) members to surrender their shares for cancellation,
4) amend the articles for purposes of the said conversion if the articles does not provide for such.
5) Each member must make a declaration of guarantee.

SOLUTION THREE

a) (i) Internal stakeholders include Employees, management. External stakeholders include the Government, local authorities, the public, civil society. (4 marks)

(ii) In the event of bad corporate governance, employees will lack the requisite motivation which is a recipe for productivity. In the absence of productivity, the company will lose revenue and eventually close. On the part of management, the management will most definitely run the company aground, like it happened in Enron or other such companies. With respect to the government, bad corporate governance will lead to loss of revenue due to closure of the company. In the event of company closures government also will tend to suffer high unemployment ratios and hence, equally high poverty levels. The same effect will be replicated to local authorities and the public. (6 marks)

b) An Annual General (AGM) meeting is a statutory meeting which every body corporate is mandated to hold. By law, within three months of the end of each financial year, an AGM should be held. Two types of AGMs exist; the ordinary AGM and the Extraordinary Annual general Meeting. The procedure of calling the two is pretty much the same.

The starting point is the notice given to members of the unless the articles prescribe otherwise. The notice should specify the place, the day and time of the meeting. Sufficient notice of the meeting need be given, usually 21 days unless the articles provide otherwise. However, depending on circumstances, the length of the notice may fluctuate.

Because all the matters to be discussed at an AGM are considered special business, then the notice also need to specifically state what will be considered at the AGM.

c) Explain the following concepts:

a. Global differences in legal and financial structures, corporate ownership structures, cultural and economic factors makes it difficult to strengthen international codes.

b. They represent the lowest common denominator of general, fairly weak principles.

c. The codes lack legislative power

d. There is no international enforcement mechanism

e. A varied compliance is approach between developed and developing countries

f. Cost implications make smaller local companies shy from the best practices recommended by the codes.

d) The institute of Directors of Zambia (IOD) is a leadership forum, committed to the development of members through education, and training; and exchange of information in order to enhance the quality of leadership and corporate governance in the public and private sectors of Zambia. It was launched on 7^{th} April 2000. It promotes sound corporate governance principles and ethics in order to ensure proper management, control, and accountability for affairs of private and public enterprises in the country and, in the process, preserve and secure the interests of stakeholders. In 2005, the IOD produced the

The main objectives of the IOD are:

1. Promote excellence in corporate governance;
2. Represent interests of directors and facilitate their professional development in support of the economic well-being of the country;
3. Enhance the standard and effectiveness of directors through information and education on their legal, moral, financial and general rights and obligation in respect of their companies, shareholder, employees, management and the community as a whole;
4. Inculcate the highest standards of ethics among directors; and
5. Provide an effective voice for company directors in public affairs and for that purpose take a continuing and affective interest in legislation, economic, and social matters to ensure the preservation of basic commercial freedoms ad to prevent abuse of such freedoms.

SOLUTION FOUR

(a) (i) The duty of conflict of interest in relation to directors as agents of the company has a general duty to avoid a conflict of interest. In particular, the directors must retain their freedom of action and not fetter their discretion by agreeing to vote as some other person may direct. The directors owe a fiduciary duty to avoid a conflict of duty and personal interest. The directors must not obtain any personal advantage from their position as directors without the consent of the company for whatever gain or profit they have obtained.

(ii) Roles of a Chairman

1. Running the board and setting its agenda
2. Ensuring the board receives accurate and timely information
3. Ensuring effective communication with stakeholders
4. Ensuring that sufficient time is allowed for discussion of controversial issues
5. Taking the lead in board development
6. Facilitating board appraisal
7. Encouraging active engagement by all the members of the board
8. Reporting in and signing off accounts

(iii) The role of the remuneration committee is to establish remuneration arrangements. In order to be effective, the committee needs to determine the organisation's general policy on the remuneration of executive directors and specific remuneration packages for each director.
And for this to happens, the UK corporate governance code suggests measures to ensure that the committee is independent, including requiring the committee to be staffed by independent non-executive directors, ensuring that executive directors do not set their own remuneration levels.

(B)

Perpetual succession

This entails that once a company has been incorporated the company has a continuous existence and can outlive its original members. Continuity of the company does not depend on the continuity of its shareholders. They may come and go but the company will live on.

Limited liability

This entails that the liability if the members is limited. This is arguably the most important advantage of incorporation. Limitation of liability is either by way of shares or by guarantee. Where limited by shares, the liability of the members is limited to the unpaid shares if any while id it is limited by guarantee, the limitation is limited to the members who have undertaken to contribute to the assets of the company in case of wound up.

Pre-incorporation contracts

A pre incorporation contract is a contract purported to be made by a company or its agents at a time before the company has been formed. Thus, this contract id binding on the company if the company is able to adopt the said contract and fulfil the conditions outlined in the companies Act.

Lifting the veil of incorporation

This entails to a situation where a shareholder is held liable for its corporate's debts despite the rule of limited liability and this is classified into two i.e lifting the veil by the Judiciary and by statute.

Articles of association

Articles of a company formed a contract between member to company, company to members and members to member.

As the constitution of the company, the articles play a role of the contract on the above groups and it can be enforced in the same ways and manners like an ordinary contract.

SOLUTION FIVE

(a)

i. Nominal capital is the amount of capital registered with the Registrar of Companies. It is also known as registered or authorised capital. It is the amount up to which the company may issue shares or stock while Subscribed capital is the amount of issued capital that has been taken up that is subscribed for by shareholders.

ii. A company with a share capital may, if authorised by its articles, issue redeemable shares, whether ordinary or preference. Redeemable shares may be made redeemable between certain dates at the option of the company's directors. Redeemable shares may be issued only if there are in issue other shares which cannot be redeemed.

iii. Reduction of share capital.

The company may decide to reduce its capital. However, the Companies Act only authorises the reduction of share capital in certain circumstances. A reduction of share capital diminishes creditors' security. To protect the creditors, the Companies Act imposes conditions which the company must fulfil. Reduction may be done through Extinguishing or reducing liability on unpaid share, Cancelling share capital, Paying off paid up share capital, Payment in kind and or Payment of dividends to mention a few.

iv. A dividend is paid out the company's net profit. It is usually distributed or paid out to shareholders in proportion to their shareholdings. It is to reward in the form of a dividend all those who invest in the company.

v. Directors are under a duty not to make secret profits by the use of their power without company's consent, they are liable to make good those profits to the company. Without the consent of the company any profits made during the course of his business must be accounted for. The board may exempt from duty to account by ratifying the act of the director.

(b) A company may not purchase its own shares, as by doing so it will lose its own capital.

The effect is that the company cannot become a member of itself. There is a distinction between the situation when the directors redeem the shares of a holder and the shareholder surrenders shares in the lien of forfeiture. The shareholder is relieved from future calls. He is not taking money out of the company. Even though a company cannot purchase its own shares or be a member to itself, shares or shares of its members can be held by a trustee. The shares held by trustees are acquired by means other than purchase. A company may purchase its own shares under a court order, for example, where it is required to receive oppressed minority shareholders.

(c) The law provides that no dividends shall be paid to shareholders of a company except out of the profits arising or accumulated from the business of the company. The word accumulated means that any losses of previous years must be included in reckoning the current distributable surplus.

END OF PAPER