THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ZIMBABWE

Initial Test of Competence
Professional Paper 2

JANUARY 2016

TOTAL MARKS – 100
READING TIME – 30 minutes
WRITING TIME – 150 minutes

INSTRUCTIONS TO CANDIDATES

1. Enter your examination number on the front of the answer book. Your name must not appear anywhere.
2. You are reminded that answers may **NOT** be written in pencil.
3. The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and the required depth of the answer.
   - **Even if it is not explicitly required, you should show workings and cross-reference them to your answer.**
   - Marks are awarded for appropriate arrangement and layout, clarity of explanation, logical argument and clear and concise language.
4. Working papers must be handed in with scripts.

NOTES

1. **The questions in this paper are not intended to reflect the reality of the Zimbabwean economy. Hence reference to exchange rates, interest rates, return on capital, inflation, etc., are to be taken at face value and there is an assumption that financial instruments such as foreign exchange contracts will be freely available. Unless otherwise stated, an effective tax rate of 25,75% should be used.**
2. Any proposed amendments to tax legislation from the National Budget announced in November 2015 ARE NOT EXAMINABLE in this ITC.

QUESTION 1 **42 marks**

Drumeo Ltd ('Drumeo'), including its subsidiaries and associates, operates as a manufacturer of paper and plastic packaging, supplying its products to the Zimbabwean market as well as to various other countries on the African continent. Drumeo's paper business is one of the largest paper recyclers in Africa, with recycled paper being converted into high-quality industrial container and carton board. The plastics business manufactures a range of plastic packaging products for the food, beverage, personal care and pharmaceutical markets, primarily in Zimbabwe.

The group is currently preparing the consolidated financial statements for the year ended 31 December 2015. The financial director learnt of your technical expertise and approached you for advice on specific matters relating to the financial statements. He provided you with key information about Drumeo and extracts of the draft consolidated financial statements and notes.

The following key information pertains to Drumeo:

- The Drumeo group prepares its financial statements in accordance with International Financial Reporting Standards (IFRS).
- Drumeo is listed on the Zimbabwe Stock Exchange.
- The performance of the plastics business has been disappointing in the 2014 and 2015 financial years ('FY2014 and FY2015'), partly because of strike action in the sector, credit downgrades during the period, interest rate hikes and slowing demand as more environmentally friendly and cost effective alternatives are being sought by consumers.
- The strong economic growth in some central and west African countries, including Ghana and Nigeria, helped Drumeo record a profit for FY2015 in the paper business. Cash collections from customer are, however, problematic in these countries.
- Overall Drumeo recorded a net loss before taxation of $3 million in FY2015 (FY2014: net loss before taxation of $200 000).
- One of the subsidiaries of Drumeo has an assessed tax loss that arose during FY2015.
- Goodwill relates to both the plastics and paper businesses.
- During FY2015 Moody's Investor Service downgraded the credit rating of Drumeo.
- Drumeo has early adopted IFRS 9 *Financial Instruments*.

The following extracts of the draft consolidated financial statements and notes for the year ended 31 December 2015 have been provided:

DRAFT CONSOLIDATED STATEMENT OF FINANCIAL POSITION			
	Note	2015	2014
		$ million	$ million
ASSETS			
Non-current assets			
Property, plant and equipment		374	365
Goodwill	3*	155	155
Investment in associate	4*	58	39
Loan to associate	12	25	25
Unlisted investment	5	41	41
Deferred taxation assets	6	52	–
Total non-current assets		**705**	**625**
Current assets			
Inventories	7*	126	33
Trade and other receivables	8*	261	192
Cash and cash equivalents	9*	281	210
Total current assets		**668**	**435**
TOTAL ASSETS		**1 373**	**1 060**
EQUITY AND LIABILITIES			
Equity			
Stated capital	10*	2	2
Retained earnings		201	205
Foreign currency translation reserve		76	75
Bond equity		286	286
Non-controlling interests		96	67
Total equity		**661**	**635**
Non-current liabilities			
Bond liability		64	82
Deferred taxation liabilities	6	–	38
Total non-current liabilities		**64**	**120**
Current liabilities			
Trade and other payables	14*	648	305
Total current liabilities		**648**	**305**
Total liabilities		**712**	**425**
TOTAL EQUITY AND LIABILITIES		**1 373**	**1 060**

* These notes have been prepared but have been omitted from the extracts provided below and therefore can be accepted as being correct.

EXTRACT FROM THE NOTES TO THE DRAFT CONSOLIDATED FINANCIAL STATEMENTS

1 Accounting policies

1.1 Significant judgements and sources of estimation uncertainty

In preparing the financial statements, management is required to make estimates and assumptions that affect the amounts represented in the financial statements and related disclosures. Use of available information and the application of judgement are inherent in the formation of estimates. Actual results in the future could differ from these estimates and these differences may be material to the financial statements. Management has concluded that the sources of estimation uncertainty for which significant judgements are required relate to impairment testing. There are no other areas of significant judgement, since all other assets and liabilities are accounted for on the historical cost or amortised cost basis.

Impairment testing

- The recoverable amounts of cash-generating units and individual assets are determined based on the higher of value in use and fair value less cost to sell. These calculations require the use of estimates and assumptions. It is reasonably possible that the assumptions may change, which may then have an impact on our estimates and may in turn require a material adjustment to the carrying amount of goodwill and tangible assets.
- In calculating the recoverable amounts of cash-generating units and individual assets, the group projects cash flows for a period of seven years, discounted at the group's weighted average cost of capital of 15% (FY2014: 19%).
- Management anticipated losses in the plastics business in prior years and recorded impairment losses in prior years. No impairment tests were performed during FY2014 and FY2015 as there were no indicators of impairment evident during those years. Accordingly, no impairment losses have been recognised for FY2014 orFY2015.

1.5 Financial instruments

Classification – financial assets

The group classifies financial assets into the following categories:
- Financial assets at fair value through profit or loss
- Financial assets at amortised cost
- Debt instruments at fair value through other comprehensive income
- Equity instruments at fair value through other comprehensive income.

The group classifies financial assets depending on the group's business model for managing its financial instruments and the contractual cash flow characteristics of the instrument. A financial asset is classified at amortised cost only if both the following criteria are met:
- The objective of the group's business model is to hold the asset to collect the contractual cash flows; and
- The contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

If the group holds the asset in a business model with an intention to both hold the asset to collect the contractual cash flows and sell the asset, and the payments comprise solely payments of principal and interest (i.e. debt instruments), the financial instrument is classified as fair value through other comprehensive income. If either one of the two criteria above is not met, the financial instrument is classified as fair value through profit or loss. All equity investments are measured at fair value. Equity investments that are held for trading are measured at fair value through profit or loss. For all other equity investments, the group makes an irrevocable election at initial recognition to recognise changes in fair value through other comprehensive income rather than profit or loss.

Classification – financial liabilities

Financial liabilities comprise bonds, loans from associates, short-term loans and bank overdrafts. All financial liabilities are measured at amortised cost.

5 Unlisted investment

The unlisted investment is a share investment held in a private company. This investment is measured at fair value through profit or loss. No shares were bought or sold during the year. There were no fair value adjustments during the year as the fair value was the same as that determined at 31 December 2014. The fair value of $41 million was determined by a qualified share valuer as follows:

	Carrying amount at 31/12/2015	Fair value hierarchy level	Valuation technique(s) and key input(s)
Unlisted investment	$41 000 000	2	*PE method – the fair value of the investment was estimated using the company's audited earnings figures, making significant adjustments for non-recurring items. An observable PE of a similar listed company was used as the multiple, with significant adjustments for risk specific to the unlisted investment.*

6 Deferred tax assets and liabilities

Deferred tax assets and liabilities are offset when the group intends to settle its tax assets and liabilities on a net basis. The deferred tax asset at year end represents unused tax losses.

The following additional disclosures have been included in the draft consolidated financial statements but have been omitted from these extracts. These are the only other disclosures relating to deferred tax:

- *Major components of tax expense/income (IAS 12.79 – 12.80).*
- *Tax rate reconciliation (IAS 12.81(c)).*
- *Analysis of deferred tax balances at year end and reconciliation of the opening and closing deferred tax balances (IAS 12.81(a) and (g)).*

12 Loan to associate

The loan of $25 million was provided three years ago to Mondeo (Pvt) Ltd ('Mondeo'). The loan bears no interest and is repayable on demand. In view of the zero interest on the loan, the loan to Mondeo is accounted for at historical cost.

15 Financial risk disclosure

The only financial risk to which the group is exposed is liquidity risk. The group manages this risk by managing the maturities of its assets and liabilities to ensure there are no significant timing mismatches.

A maturity analysis of all financial assets and liabilities is provided below:

Financial assets and liabilities: Maturities as at 31 December 2015	Up to one month	One to three months	Four to twelve months	More than 12 months	Total
	$ million	$ million	$ million	$ million	$ million
Assets					
Loans to associate	25	–	–	–	25
Unlisted investment	–	–	–	41	41
Trade and other receivables	203	21	37	–	261
Cash and cash equivalents	281	–	–	–	281
Liabilities					
Bond liability	–	–	–	64	64
Trade and other payables	103	134	83	328	648

16 Segment reporting

The group considers the business to have only one segment, namely the 'packaging segment', and therefore does not prepare a segment report.

17 Contingent liability – events after the reporting period

On 15 January 2016 the Competition Commission concluded an on-going investigation regarding alleged price collusion in the paper and plastics packaging segment. Several large role players had been cited for allegedly forming cartels to control prices in the industry. Drumeo reached a settlement and agreed to pay the Competition Commission an amount of $20 million on 31 January 2016.

QUESTION 2 **58 marks**

Ignore value-added tax (VAT)

Mr Sizwe Umakhi is a 28-year old entrepreneur who has worked part-time in various positions, including as an Ubex driver, a professional model and a real-estate agent. Mr Umakhi has managed to save $350 000 for starting his own business. He plans to acquire ten used vehicles and form partnerships with various Ubex drivers to generate income for himself and the drivers.

Ubex is a global software group that allows users registered with it to use its mobile application ('app') to request transportation from registered Ubex private drivers. The Ubex app is available free of charge and can be downloaded onto most cell phones. Having registered as a user with Ubex and downloaded the app, you can request a driver to collect you at a specified location or use your phone's global positioning system (GPS) to enable the driver to locate you. When registering with Ubex as a user, you are required to provide your credit or debit card details. This enables Ubex to collect and process payment for the fare due to drivers for transporting you to your desired destination. Ubex retains 20% of the fare and pays the rest to the driver. Ubex does not own vehicles nor does it employ drivers. The fares chargeable vary according to the type of service requested. The most commonly available services are UbexBLACK (luxury vehicles such as Mercedes Benz, BMW and Audi vehicles) and UbexX (lower cost vehicles). Ubex sets the fares for rides based on a base fee (minimum fee irrespective of time or distance travelled) plus charges per kilometre and/or minute. When travelling faster than a certain speed, the fare is charged per kilometre. Otherwise the fare is determined per minute travelled.

The following are the key benefits to Ubex users:

- Ease of use – users simply open the Ubex app on their cell phones and request a driver;
- Visibility – users can track where drivers are located using the Ubex app and the estimated time of their arrival is also displayed;
- Transparency – users can access details of the driver, including his/her name, vehicle registration number and rating;
- No cash transactions – fares are deducted via registered debit or credit cards and users do not have to have any cash on them; and
- Record keeping – Ubex emails details of the trip and fare to users after they have used the service.

Mr Umakhi was a registered Ubex driver for two years and is intimately aware of the benefits to drivers. These include the following:

- Flexibility – drivers choose their own working hours and areas to operate in;
- Guaranteed payment – Ubex collects and remits amounts owing for trips;
- No negotiation – Ubex fares are standard (except in peak hours when premium fares are charged) and users are unable to negotiate lower prices;
- Information – Ubex provides regular statistical and informational reports to drivers; and
- Networking – Ubex drivers meet a variety of different people daily.

Vehicle fleet

Mr Umakhi has negotiated the purchase of ten used Volkswagen Polo vehicles from a motor dealership in Avondale. All the vehicles are in excellent condition and have near identical mileage. The purchase price is $170 000 per vehicle which includes a 50 000km service plan for each vehicle (Mr Umakhi does not have to pay for regular services to vehicles for the next 50 000 km travelled).

Each Volkswagen Polo vehicle acquired is to be used by Ubex drivers for the next four years. At the end of the four-year period, it is estimated that the vehicles could be sold for $51 000 each.

Mr Umakhi procured bank financing for the ten vehicles on the following terms:

- A 20% deposit per vehicle ($34 000 each);
- Equal monthly repayments in arrears for 48 months; and
- A fixed nominal annual interest rate of 10%.

Arrangements between Mr Umakhi and the drivers

Mr Umakhi has identified 20 drivers who are prepared to work in partnership with him. All drivers have the necessary credentials, including professional driving permits, to act as Ubex drivers. The intention is that each vehicle will be shared by two drivers. Each driver will have the use of a specific Volkswagen Polo for 12 hours daily to ensure maximum utilisation of vehicles. The agreed terms between Mr Umakhi and the drivers include the following:

- Mr Umakhi will pay for all the monthly operating costs of the vehicles, including fuel, tyre replacement, service and maintenance costs, and insurance;
- Drivers will collect and return vehicles to Mr Umakhi's home in Avondale on a daily basis. There is an outside office at his home that drivers can use should they wish to, to take a break or where they can get refreshments (tea, coffee, water, sandwiches and fruit);
- Drivers have agreed that Ubex will pay the fares directly into a separate bank account established and controlled by Mr Umakhi for the venture;
- Drivers will enter the times that they collect and return vehicles (together with the kilometre readings from the vehicle's odometer at these times) into a log book which is kept at Mr Umakhi's outside office; and
- Mr Umakhi will pay drivers amounts owing to them on a monthly basis as per the agreed profit-sharing arrangement.

Mr Umakhi and the drivers have agreed to a profit-sharing arrangement whereby Mr Umakhi will collect amounts owing to them from Ubex and deduct the following expenses before paying the net amount to drivers:

- Vehicle operating costs (fuel, tyre replacement, service and maintenance costs and insurance);
- Costs for usage of vehicles (this is equivalent to the monthly vehicle loan repayment amount);
- An 'office' fee of $1 000 per month per vehicle in the first year to recover costs of parking at Mr Umakhi's home, use of the outside office, refreshments and monthly administration; and
- A fixed 'profit share' fee of $2 000 per month per vehicle payable to Mr Umakhi in the first year, which amount will escalate by 8% per annum thereafter.

Mr Umakhi suggested the above profit-sharing arrangement based on his experience as an Ubex driver. Mr Umakhi estimates that receiving $2 000 per vehicle per month, in addition to recovering incurred costs, will be sufficient to generate a reasonable return on assets. Drivers will therefore be incentivised to maximise revenue (fares paid for their driving services).

Mr Umakhi has agreed to provide drivers with a monthly report, which summarises the revenue, operating costs, vehicle usage charges, office fee and Mr Umakhi's profit share fee per vehicle. Drivers will share the net profit due to them based on the revenue each of them has generated from their designated vehicle.

Forecast revenue per vehicle

The Volkswagen Polo vehicles to be acquired will operate as UbexX vehicles. The forecast revenue per vehicle below in the first year of operation is based on Mr Umakhi's insights and knowledge of acting as an Ubex driver in the Avondale and surrounding areas of Harare.

Annual revenue forecast per vehicle in year 1	
Average hours annually that vehicle is operated by drivers	4 410 hours
Average number of trips per operational hour	0,8
Average fare per paid trip	$100
Average kilometres travelled per paid trip	10 km

Vehicle operating costs

The forecast costs of operating each vehicle in the first year of operations is set out in the table below. The Volkswagen Polo vehicles use diesel and are expected to be fuel-efficient.

Forecast vehicle operating costs in year 1	
Fuel costs	
Average annual total distance to be travelled per vehicle	50 000 km
Average number of litres to be used per each 100 km travelled	5,5 litres
Average cost per litre of diesel during the year	$12,25
Tyres	
Cost of replacing all four tyres per vehicle after every 25 000 km	$3 200
Insurance costs	
Average annual insurance premium per vehicle	$11 760

Service and maintenance costs were not included in the above table as these will be covered by the service plan to be obtained when purchasing the vehicles. It is estimated that the cost of servicing each vehicle in the first year of operations, had the service plan not been obtained, would have amounted to $6 800, on the assumption that each vehicle needs to be serviced after every 25 000 km travelled.

Monthly reporting and variance analysis

Mr Umakhi aims to provide the drivers with useful information in the monthly reports. Certain vehicle costs, such as insurance costs, vehicle repayments and Mr Umakhi's profit share per vehicle, are expected to remain fixed during the year. As a result, providing variance analysis on these expenses would be a fruitless exercise.

Mr Umakhi would like to provide drivers with an analysis of deviations from forecast revenue and from expected costs, which vary according to distance travelled.

Potential returns from venture

Mr Umakhi is not a finance expert but would like an indication of the expected internal rate of return (IRR) and net present value (NPV) of his investment in the Volkswagen Polo vehicles and the proposed venture with the Ubex drivers. Mr Umakhi's required return on investment is 20% pre tax.

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INITIAL TEST OF COMPETENCE, JANUARY 2016
PROFESSIONAL PAPER 2

QUESTION 1 – REQUIRED	Marks	
	Sub-total	Total
Critically review the extracts of the draft consolidated statement of financial position and notes provided for apparent inaccuracies, inconsistencies, errors in application and non-compliance with IFRS.	40	
• Limit your discussion to the issues for which there is evidence of inaccuracies, inconsistencies, errors in application and non-compliance with IFRS in the extracts provided. • Ignore comparative disclosures. • Detailed disclosure requirements or sample disclosure are not required. • Calculations are not required.		
Communication skills – logical argument; clarity of expression	2	42
Total		**42**

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INITIAL TEST OF COMPETENCE, JANUARY 2016
PROFESSIONAL PAPER 2

QUESTION 2 – REQUIRED		Marks	
		Sub-total	Total
(a)	Calculate the estimated net profit per vehicle that will be available to be shared by the two drivers allocated to each specific vehicle in the first year of operation. Base your calculation on Mr Umakhi's estimates for the first year of operation.	10	10
(b)	Estimate the monthly gross revenue that each vehicle needs to generate in the first year of operation in order to cover the fixed monthly operating costs of that vehicle. Assume that Mr Umakhi's estimates for the first year of operation are accurate.	10	10
(c)	Identify the monthly variances that Mr Umakhi could calculate to provide useful feedback on each vehicle and on each driver's performance. Explain the usefulness to Mr Umakhi and/or the drivers of each variance identified.	14	
	Communication skills – clarity of expression	*1*	15
(d)	Estimate the potential IRR and NPV that Mr Umakhi could realise over a four-year period from investing in the proposed venture with the Ubex drivers.	7	7
(e)	Identify and discuss the key business risks that Mr Umakhi faces from investing and participating in the proposed venture with the Ubex drivers.	14	
	Communication skills – logical argument; clarity of expression	*2*	16
Total			**58**