



Initial Test of Competence Professional Paper 3

JANUARY 2019

**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 style, clarity of expression layout and structure, logical argument and presentation.
- 4 Working papers must be handed in with scripts.

Disclaimer clause: All names of persons, places and business entities mentioned in this examination paper are fictitious and any resemblance to real persons, living or dead, places and business entities are purely coincidental.

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, revenue and expenditure figures, 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. Where necessary, an effective income tax rate of 25,75% should be used.
- 2 Any proposed amendments to tax legislation from the National Budget announced in November 2018 **ARE NOT EXAMINABLE** in this ITC.

QUESTION 1

100 marks

All amounts include value-added tax (VAT), unless specifically stated otherwise. Assume a VAT rate of 15%.

TellMeMore (Pvt) Ltd ('TellMeMore') is an internet service provider whose aim is to provide affordable access to the internet to all its Zimbabwean customers. The company was founded in 1998 by Dr Henry Jones, an Australian-born mathematician. TellMeMore pioneered internet access over fibre (a method for connectivity that enables very fast data transmission) to homes in Zimbabwe. This move resulted in a substantial increase in revenue for TellMeMore over the past few years. Henry's vision is to provide the best high-speed internet access at an affordable rate with no limit on the amount of data that can be used per month (thus uncapped).

TellMeMore is an entrepreneurial business that relies on venture capital to fund expansions. Henry decided from incorporation of the company to prepare TellMeMore's financial statements in terms of International Financial Reporting Standards (IFRS) and to have the financial statements audited. TellMeMore has a June financial year end and is a registered category B VAT operator. TellMeMore is not an appointed VAT withholding tax agent.

SGT Auditors ('SGT') have been the auditors of TellMeMore since inception of the company and Ms Tsitsi Moyo has been the audit partner for the last seven years. Over time, Tsitsi has become good friends with the Financial Director at TellMeMore, Ms Cindy Smith, and now occasionally their families go on holiday together. During the most recent holiday, Cindy told Tsitsi that TellMeMore expected a drastic reduction in its audit fee, rather than an increase, otherwise it would have to put the audit out to tender. TellMeMore is a significant customer for SGT and as a result Tsitsi is under pressure to reduce the number of people on the audit to keep the audit fees low.

Fibre-to-the-home technology

Zimbabwe has been lagging behind developed countries in terms of internet speed and cost. Zimbabwe has, however, seen an increased investment in fibre-to-the-home technology in recent years. Several established and new companies are rolling out fibre-to-the-home networks across cities and towns.

There are two types of players involved in bringing fibre technology to homeowners:

- 1 **The infrastructure provider:** Providers, such as for example M-Fibre (Pvt) Ltd ('M-Fibre'), are responsible for providing the fibre infrastructure to the homes. Internet service providers can obtain access to this type of infrastructure, and pay for using the line.
- 2 **The internet service provider:** Internet service providers, such as TellMeMore, provide internet access to customers over the fibre infrastructure developed by the infrastructure providers. Internet service providers offer customers a variety of internet packages with different prices, to suit different needs.

TellMeMore contracts

The following information pertains to entering into contracts with customers:

- TellMeMore is paperless and therefore concludes its contracts electronically with customers.
- After a customer has completed an order enquiry online on the TellMeMore website, a company sales representative visits the customer to assess the customer's needs and

explain the different packages and the installation process. Once the contract has been signed electronically, it is emailed to the customer. The contract captures all the particulars of the customers together with the contract option he/she chose.

- Customers can choose between four different types of contracts based on their data needs. These options are advertised on TellMeMore's website, with different contract prices being dependent on the download and upload speed.
- M-Fibre is the infrastructure provider that provides the customer with the fibre infrastructure.
 - M-Fibre separately charges the customer a once-off installation cost of \$1 500 for the installation of the fibre infrastructure.
 - Once a customer has signed the contract, M-Fibre schedules the fibre installation in the customer's home to connect the fibre.
- TellMeMore is responsible for the provision of the internet service to the customer and pays a fixed monthly fee of \$500 000 per month to M-Fibre for using the fibre infrastructure to service its customers.
- TellMeMore provides the user (customer) with a free router.
 - The router is a standard type routinely sold by online merchants at \$599. The router costs TellMeMore \$375 (excluding VAT).
 - The router becomes the property of the customer when the contract is signed and thus can be used with any internet service provider.
- As the contracts are for 12 months, background credit checks are performed on the customers to make sure they are able to honour the terms and conditions of the contract.
- Customers who sign the contract are bound by the terms and conditions that are set out on TellMeMore's website and this is deemed to be legally enforceable.

Import, export and sale of routers

TellMeMore imports its routers from Taiwan. The company imported a consignment of 3 000 routers during May 2018, amounting to a dollar equivalent of \$1 050 000. The routers were loaded at origin during May 2018. Control passed to TellMeMore from the time that the routers were loaded onto the ship. The routers arrived in Zimbabwe in early June 2018 and were cleared by Customs on 8 June 2018. The market value disclosed on the import documents was accepted from a customs and excise perspective to be \$1 050 000. Import duties amounted to \$75 000.

TellMeMore exported 500 of these routers to a Namibian company at a total selling price of \$250 000 in June 2018.

TellMeMore allows employees to each acquire one router free of charge in any three-year period. Two employees made use of this benefit:

- Ms Lebo Lephoto acquired a router in May 2018.
- Ms Sipha Mandela acquired a router in June 2018 from old stock, which only had a market value of \$300.

The accountant journalised the transactions, which excluded VAT, as follows:

| | Dr. | Cr. |
|-------------------------|-----|-----|
| | \$ | \$ |
| Salaries: Lebo Lephoto | 375 | |
| Inventory | | 375 |
| Salaries: Sipha Mandela | 375 | |
| Inventory | | 375 |

Cloud-based accounting software

TellMeMore uses accounting software called Naught™, a cloud-based accounting software specifically designed for small and medium-sized businesses. From a tax residency perspective, The supplier of Naught is a non-resident company. From a VAT perspective the software program is regarded as an electronic service. Henry found out about Naught when it featured in *Innovation Magazine*. Naught was described as the emerging global leader of online accounting software that connects small businesses to their advisors. This sounded perfect for TellMeMore as Henry considered the business to be straight-forward and was looking for a simple accounting software solution.

The cloud-based software means that one version of the software is used by everyone and from any location, including mobile devices. New features become available automatically. Collaboration between accountants, bookkeepers, auditors and third-party software is easy. Another key feature of Naught is its ability to connect seamlessly with more than 700 applications for a complete solution. Naught is an innovative product that continues to grow at an unprecedented pace, and the software has won numerous awards during its relatively short lifetime to date. Innovation such as automation, machine learning and artificial intelligence are now part of the software package.

TellMeMore has subscribed to the software at \$5 000 per month since 2014 and uses the software as its accounting system.

Accounting for contracts using Naught software

The following illustrates how TellMeMore uses the Naught accounting system to account for a Tell10/10 contract option. The basic terms of this contract are as follows:

| Tell10/10 contract terms |
|---|
| \$649 per month |
| 10 megabits per second download/upload speed |
| Uncapped data |
| Free router |
| 12-month contract |
| Includes TellMeMore's payment of the M-Fibre line monthly fee |

- TellMeMore uses the SignMeApp app for signing contracts with customers:
 - When a customer orders a product on the website, the customer's data is transferred to the application and a new contract is created;
 - The sales representative visits the customer with an electronic tablet (on which the SignMeApp app is loaded) and the contract is completed and signed on the representative's electronic tablet; and
 - The application sends a copy of the contract to the email address of the customer.
- TellMeMore pays a subscription of \$150 per month for the SignMeApp app, which is supplied by a registered Zimbabwean VAT operator.
- The SignMeApp app works seamlessly with Naught to transfer key data from the contract to Naught. A copy of the contract is also stored in the Naught contracts database.
- Naught receives the key information of the contract and automatically sets up an invoicing schedule. Customers are invoiced monthly in arrears. Naught automatically creates, saves

and emails the recurring invoices. For example, in the case of a Tell10/10 contract, Naught will send invoices for \$649 per month at the end of each month, for a period of 12 months.

- When the invoices are created and emailed to customers at the end of a month, Naught debits the customer's account and credits a revenue suspense account in the ledger with the invoiced amount, as illustrated below:

| | | | Dr. | Cr. |
|------------|--|--------------|-----|-----|
| Date | | | \$ | \$ |
| DD/MM/YYYY | Dr Trade receivable (Customer xxxx) Cr Revenue suspense <i>Subscription DD/MM/YYYY for Customer xxxx</i> | SoFP SoFP | 649 | 649 |

- 'Pay here' options are included on the invoices, which allow customers to choose how to pay the invoices. Options include –
 - paying via the electronic link on the invoice with a debit or credit card; or
 - paying via an electronic funds transfer or cash into TellMeMore's bank account using an individualised reference number.
- Payment terms are 30 days from invoice date.
- TellMeMore has set up direct bank feeds from its bank accounts to Naught. Data from the bank is fed to Naught daily and Naught matches the deposits against the invoices. When deposits are matched, Naught debits the bank account and credits the customer's account in the ledger. Naught at the same time recognises revenue and debits the revenue suspense account created at the time of invoicing and credits the revenue account in the ledger. Naught creates an exception report, which must be reviewed for deposits that cannot be matched. The journal entries resulting from matching the deposit to the invoice are illustrated below:

| | | | Dr. | Cr. |
|------------|--|--------------|-----|-----|
| Date | | | \$ | \$ |
| DD/MM/YYYY | Dr Bank Cr Trade receivable (Customer xxxx) <i>Subscription DD/MM/YYYY for Customer xxxx</i> | SoFP SoFP | 649 | 649 |
| DD/MM/YYYY | Dr Revenue suspense Cr Revenue <i>Recognition of revenue for DD/MM/YYYY services</i> | SoFP P/L | 649 | 649 |

TellMeMore payments to M-Fibre and administration of documents

- M-Fibre also uses Naught and submits its monthly invoices to TellMeMore for payment via Naught.
- Daily bank feeds allow Naught to match the payments made by TellMeMore against the invoices. When payments are matched, Naught debits the trade payable account and credits the bank account in the ledger. Naught creates an exception report that must be reviewed for payments that cannot be matched.
- All documents and invoices received related to invoice payments and expenses are emailed to the file's inbox at Naught for safe record-keeping. In the case of suppliers that use Naught invoicing, Naught is able to automatically read the details of the invoice and add as much

detail as possible to an expense dashboard. The details include the name of the supplier, the amount, invoice number, etc. Further, for some expenses, Naught is able through artificial intelligence and machine learning to classify the expenses correctly. In these cases, Naught debits the relevant expense account and credits a trade payable account in the ledger.

- Because everything is stored online in the cloud, these invoices can be accessed at any time, and anywhere. In the case of invoices that are received manually, a photo is taken on a smartphone device and emailed to the Naught file's inbox. Invoices that cannot be 'read' by Naught are placed on a dashboard for user intervention and processing, after which Naught processes the relevant entries in the ledger.
- As the data is processed real-time, financial reports can be extracted instantly. Henry can view the company's statement of financial position, statement of profit and loss and other comprehensive income, statement of changes in equity and cash flow statement in real-time and instantly.

Financial year-end considerations

- At the financial year end, Mr Azhar Daniels CA(Z), who is an independent service provider engaged to provide accounting services to TellMeMore, uses the 'Collaborate' function in Naught to remotely review sales contracts, invoices generated, invoices received, and other documents stored in the database. Azhar seldom makes or processes any further adjustments and 'signs off' a trial balance from which the IFRS compliant financial statements are prepared. A time stamp on the Collaborate function shows that he spends no more than ten minutes on reviewing and signing off the trial balance. However, Azhar's invoice reflects that four hours' work were done. TellMeMore's most recent financial year end was 30 June 2018 (FY2018).
- For TellMeMore's VAT returns, Azhar merely performs a basic VAT output payable and VAT input claimable calculation on a bi-monthly basis. The calculation is based only on the revenue and expense accounts that reflect through the statement of profit or loss. In other words, VAT output is calculated by using the tax fraction for revenue accounts and VAT input by using the tax fraction for expenditure accounts. Azhar told Henry that he prefers to do the VAT calculation in this basic manner, as this saves time.
- At the 30 June 2018 financial year end, the auditors provided Henry with a schedule of journal entries that needed to be processed to the ledger. Some of the journal entries affected revenue.

Development of an application

Henry recently attended an IFRS update course and realised that the revenue amount that he views daily actually differs from the revenue amount in his IFRS financial statements at the financial year end. He realised that the Naught data needed to be adjusted to reflect the correct revenue amount at any point in time. Henry set out to determine a way to resolve this problem. He decided to develop and sell an application that could integrate with Naught and recognise the journal entries correctly in the ledger. The application would be available online to Naught's million plus active subscribers, of whom more than 100 000 are Zimbabwean tax residents.

Henry discussed the application idea with Azhar on 1 August 2018, who agreed that to his knowledge no such application existed. They were both of the opinion that there was a market for such an application, especially for customers who had sales contracts with complex arrangements. Henry contacted another Naught expert who estimated that 1% of Naught's active

users would be interested in the application. If marketed at an initial price of \$50 per month, TellMeMore could make at least \$500 000 per month.

- On 5 August 2018 Henry therefore engaged an application developer to conceptualise and plan the application for an amount of \$250 000.
- At 31 October 2018 a concept version of the design of the application, called 'ContractAccount', was completed. TellMeMore approved the design and gave the go-ahead to complete the development of the application at a cost of \$800 000 per month, payable to the application developer. A pro-rata payment is made for part of a month.
- On 15 November 2018 an independent application consultant was brought in at a cost of \$35 000 to test the application development to date and it was found that the application was technically up to standard, although some minor changes had to be made.
- The ContractAccount application was completed and launched on 15 December 2018. In January 2019 a bug that was causing the application to crash in some circumstances was discovered and an additional \$15 000 was spent on a solution to resolve this problem. Since then, the application has been performing well and up to January 2019 TellMeMore had signed up 1 000 customers. Apart from regular updates that would have to be made, TellMeMore considers that ContractAccount will have an indefinite useful life.

Additional information

- TellMeMore early adopted IFRS 15 *Revenue from Contracts with Customers* as from 1 July 2017 and correctly concluded that no significant benefit of financing exists in its contracts with customers.
- All amounts are material.



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PROFESSIONAL PAPER 3

This question consists of two parts. Answer each part in a separate answer book.

| QUESTION 1 PART I – REQUIRED | | Marks | |
|--|---|-----------|-------|
| | | Sub-total | Total |
| All amounts include VAT, unless specifically stated otherwise. | | | |
| (a) | <p>With reference to the example of a Tell10/10 contract and to IFRS 15 –</p> <ul style="list-style-type: none"> ○ critically evaluate and discuss the journal entries in the scenario processed by the Naught accounting software; and ○ provide the journal entries, together with dates and supporting calculations, that should have been processed by the Naught accounting software to ensure that IFRS compliant financial information had been provided by TellMeMore for FY2018. <p>Assume that the Tell10/10 contract was signed on 1 May 2018, that the customer pays via an electronic funds transfer, and that the customer paid the May invoice on time but had not paid the June invoice by the financial year end.</p> <ul style="list-style-type: none"> • Correcting journal entries are not required. • Journals for any direct expenses are required as far as the available information permits. • Ignore any transactions relating to the import and export of routers. • Round amounts to the nearest dollar. • Ignore current and deferred tax. • Do not discuss presentation. <p><i>Communication skills – presentation; clarity of expression</i></p> | 32 | |
| | | 2 | 34 |
| (b) | <p>Calculate, based on the information in the scenario and supported by reasons, the VAT payable/claimable by TellMeMore for the VAT period ended 30 June 2018.</p> <p>For the purpose of this calculation, assume that the invoiced amounts for internet package contracts (the consideration) amounted to \$4 million for the VAT period ended 30 June 2018.</p> <ul style="list-style-type: none"> • Provide a brief reason for the transactions where no tax implications arise. • Round amounts to the nearest dollar. | 13 | |
| | | | 13 |

Continued

| QUESTION 1 PART I – REQUIRED | | Marks | |
|------------------------------|--|-----------|-----------|
| | | Sub-total | Total |
| (c) | Discuss the accounting recognition and measurement of all aspects that relate to the development of the ContractAccount application in the IFRS compliant financial statements of TellMeMore for FY2019. | 25 | |
| | <ul style="list-style-type: none"> • Do not discuss presentation and disclosure. • Ignore all taxation. | | |
| | <i>Communication skills – clarity of expression; appropriate style</i> | 2 | 27 |
| Total for part I | | | 74 |



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PROFESSIONAL PAPER 3

This question consists of two parts. Answer each part in a separate answer book.

| QUESTION 1 PART II – REQUIRED | | Marks | |
|-------------------------------|---|-------------|------------|
| | | Sub-total | Total |
| (d) | Discuss the key factors that TellMeMore should have considered in evaluating whether or not to develop the ContractAccount application from both a strategic and operational point of view. <i>Communication skills – logical argument</i> | 15 1 | 16 |
| (e) | Discuss any concerns you may have regarding the professional conduct of Tsitsi (the audit partner) and Azhar (the independent service provider engaged to provide accounting services). | 10 | 10 |
| Total for part II | | | 26 |
| TOTAL FOR THE QUESTION | | | 100 |