



Initial Test of Competence Professional Paper 1

JANUARY 2015

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.

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.

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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, 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 tax rate of 25,75% should be used.
- 2 Any proposed amendments to tax legislation from the National Budget announced in November 2014 ARE NOT EXAMINABLE in this ITC.

QUESTION 1

60 marks

INFORMATION RELATING TO MR TYRONE LANDIS

Mr Tyrone Landis, a 56-year-old Zimbabwe resident, died on 31 August 2014. At the time of his death Tyrone owned the following assets and investments:

- 1 **A loan to the Landis Trust:** On 30 July 2010 Tyrone sold a small block of flats in Borrowdale on loan account to the Landis Trust for \$150 000. This was an arm's length deal at market value at that time. The loan bears interest at a market-related rate of 10% per annum. No repayments of the capital amount of the loan had been made by the Landis Trust. The interest arising on the loan was paid as incurred. In terms of Tyrone's last will and testament, the loan owing by the Landis Trust was waived.
- 2 **Retirement annuity fund:** On 31 July 2014 Tyrone commuted his retirement annuity fund, which he had taken out in 1989, and received \$450 000. He paid his annual contribution to the fund, amounting to \$6 000, in January 2014.
- 3 **Shares in Acacia Ltd, a company listed in Zimbabwe:** Mr Perry Landis, Tyrone's father, acquired these shares at a cost of \$9 000 (accept that this is the converted US\$ value) on 1 December 2001. On the death of Perry in 2004, Tyrone inherited these shares, the estate value of which was \$97 500. The market value of the shares at the date of Tyrone's death was \$126 500. Dividends received in the 2014 year of assessment, up to the date of Tyrone's death, amounted to \$400, after the deduction of the relevant withholding tax. These shares were bequeathed to Tyrone's wife.
- 4 **Shares in Cedar Plc, a company listed in the United Kingdom:** Tyrone acquired these shares at a cost of GBP9 000 on 30 June 2002 from funds he had in the United Kingdom at that time. The shares had a market value of GBP97 500 at the date of his death. On 30 July 2014 Tyrone received a dividend from Cedar Plc in Zimbabwe with an equivalent value of \$16 830, after the deduction of withholding tax of 15%. No further dividends were paid by Cedar Plc. These shares were bequeathed to the Landis Trust.
- 5 **Cash on hand of \$50 000:** The cash on hand (if any), after paying funeral expenses, executor's fees, estate duty and tax liabilities, was bequeathed to the Landis Trust.
- 6 **Family vehicle valued at \$5 000:** This vehicle was bequeathed to Tyrone's wife.
- 7 **Principal private residence:** Tyrone acquired this property on 1 September 2005 for \$85 000 and constructed a swimming pool at a cost of \$15 000 on 1 December 2005. The maintenance of the pool proved to be too costly and Tyrone decided to demolish it in 2009 at a cost of \$4 000. The market value of the property at the date of Tyrone's death was \$375 000. The residence has never been used for trade purposes. The property was bequeathed to Tyrone's wife.
- 8 **Business as a sole trader:** Tyrone had been carrying on business as a sole trader in Gweru under the name of Keen Manufacturing ('Keen') for the last 13 years. The business manufactured fishing equipment which was sold on the local and export market. Tyrone was registered for Value Added Tax (VAT) with a two-month VAT period.

The following information was extracted from the accounting records of Keen for the period 1 January to 2014 to 31 August 2014. All amounts are exclusive of VAT unless stated otherwise:

	\$
Sales	662 000
Cost of sales	(468 000)
Other tax deductible expenditure	(24 000)
Profit before tax and leasing charges	170 000

Additional information

8.1 Cost of sales was calculated as follows:

	\$
Opening trading stock, at cost	215 000
Purchase of raw materials	286 300
Labour costs	240 000
Closing trading stock, at cost	(273 300)
	468 000

8.2 Trading stock has never been valued at below cost and had a market value of \$460 000 on 31 August 2014.

8.3 Apart from expenses with regard to the lease which have not yet been recorded, there were no other expenses.

8.4 In terms of a ten-year lease concluded on 1 January 2007, a monthly rental of \$3 450, excluding VAT, was payable. On inception of the lease, a lease premium of \$11 400, exclusive of VAT, was payable. The lease contract had no market value at 31 August 2014.

8.5 In terms of Tyrone's will, the executor was to sell Keen as soon as possible and the net proceeds were to be inherited by the Landis Trust. Tyrone and his business in the estate, for VAT purposes, are deemed to be one and the same person.

8.6 Subsequent to Tyrone's death, the executor of the estate continued to operate Keen until its sale. The business was sold as a going concern to an unrelated VAT registered person on 30 September 2014 for \$637 000.

8.7 The taxable profit for the one month's trading can be accepted to be \$36 000, excluding expenses, with regard to the lease. No further income accrued to the estate after 30 September 2014 until it was wound up on 31 December 2014.

8.8 The agreement allocated the following amounts to the purchase consideration:

	\$
Trading stock	460 000
Goodwill	177 000

8.9 The lease agreement, with the consent of the lessor, was taken over by the purchaser. The value of goodwill at the date of Tyrone's death was \$170 000.

INFORMATION RELATING TO THE LANDIS TRUST

The Landis Trust was created in Zimbabwe by Perry Landis in 1985 with an initial donation of the equivalent of \$10. The beneficiaries of the Landis Trust were Perry's seven grandchildren (one of whom is Aimee Jackson), who were resident in different parts of Zimbabwe.

On his death in 2002 Perry had bequeathed the following assets to the Landis Trust:

- Commercial property in Bulawayo;
- A flat in Kwe Kwe;
- Shares in Stinkwood (Pvt) Ltd ('Stinkwood'), a Zimbabwe company;
- Shares in Jacaranda Plc, a foreign company.

The following is an extract from the accounting records of the Trust for the year ended 31 December 2014:

	\$	\$
Income		
Rent from the Bulawayo commercial property		54 000
Rent from the block of flats in Borrowdale		17 500
Interest from Agricultural Authority Bills		12 560
Dividend from Stinkwood		18 840
		102 900
Expenditure and distribution		
Allowable maintenance costs for Bulawayo property	24 480	
Allowable maintenance costs for Borrowdale block of flats	9 000	
Audit fees	2 500	
Trustees' remuneration	2 620	
Air tickets for beneficiaries to attend Tyrone's funeral	2 690	
Annuities	10 500	51 790
		51 110

Capital distribution

Property distributed to Aimee Jackson \$48 000

NOTES

The above extract includes all income and expenditure of the Landis Trust except for the interest paid to Tyrone for the period 1 January to 31 August 2014.

The Zimbabwe Revenue Authority has agreed that the trustees' remuneration should be apportioned between taxable and non-taxable income.

In terms of the trust deed, the trustees have the discretion to distribute the income of the Landis Trust on behalf of the beneficiaries. The trustees agreed to a request from some of the beneficiaries that their travel costs to attend Tyrone's funeral be paid out of the income of the Landis Trust.

In terms of Perry's last will and testament, the trustees of the Landis Trust are required to distribute an annuity of \$1 500 to each beneficiary alive at the end of each year of assessment out of the net rentals of the Bulawayo commercial property bequeathed to the Landis Trust. At the end of the 2014 year \$1 500 was distributed to each of the seven beneficiaries.

In terms of Perry's last will and testament, the Kwe Kwe flat was to vest in Aimee Jackson, Perry's favourite grandchild, upon reaching the age of 25. She turned 25 in January 2014, at which date the market value of the property was \$48 000. At the time of Perry's death in 2002, the value was \$13 000. This value was accepted by the Master.

QUESTION 2

40 marks

Ignore value-added tax.

Qualtail Movers (Pvt) Ltd ('Qualtail') a company incorporated in Zimbabwe, was founded on 1 July 2012 when Movers & Shakers Ltd ('Movers & Shakers') approached Hummingbird Ltd ('Hummingbird') to co-invest in a new furniture removal business. Movers & Shakers is a national haulage company and Hummingbird is a general retailer that uses a quality-based strategy to differentiate itself from competitors. The new business allowed Movers & Shakers to combine its expertise in the haulage industry with Hummingbird's existing customer base and reputation for quality.

Key terms of the Qualtail shareholders' agreement

On 1 July 2012 Movers & Shakers contributed \$800 000 in cash to Qualtail for an 80% shareholding and Hummingbird contributed \$200 000 in cash for a 20% shareholding.

The following are the key terms of the shareholders' agreement signed on 1 July 2012 between Hummingbird and Movers & Shakers with regard to their investment in Qualtail:

- 1 Movers & Shakers is responsible for the day-to-day operational and administrative matters of Qualtail.
- 2 Movers & Shakers must provide Hummingbird with quarterly management reports with regard to Qualtail.
- 3 Any strategic decisions require the unanimous agreement of both parties. Any decisions relating to the 'relevant activities' of Qualtail, as defined in IFRS 10 *Consolidated Financial Statements*, are considered to be strategic decisions.
- 4 In the event of negligence or fraud on the part of Movers & Shakers, Hummingbird will assume sole control of the assets and operations of Qualtail.

Qualtail has been correctly classified and accounted for by Hummingbird and Movers & Shakers as a joint venture in accordance with IFRS 11 *Joint Arrangements*.

Fraud complaint and investigation by Hummingbird

On 10 October 2013 the Hummingbird customer services department investigated a complaint from a client who had been blacklisted for unpaid debt to Qualtail, despite having been issued with a receipt for the full amount. Because a management conference was being held at the time, only a junior employee in the finance department of Movers & Shakers could be reached. This employee confirmed that the debt of the customer had been written off as irrecoverable in the accounting records of Qualtail. Further investigations revealed that Movers & Shakers had been systematically underreporting cash receipts from Qualtail's debtors and had written off the differences as irrecoverable.

As a result, Hummingbird invoked its right to assume sole control of Qualtail on 1 November 2013 in terms of the shareholders' agreement. On that date –

- the high court upheld Hummingbird's right to assume sole control and ordered Movers & Shakers to repay the stolen monies to Qualtail;
- the fair value of Hummingbird's interest in Qualtail was \$250 000; and
- Hummingbird appointed forensic experts to conduct a detailed analysis in order to quantify the extent of the fraud committed by Movers & Shakers since the inception of Qualtail.

Forensic investigation results

- The investigation by forensic experts was completed on 10 June 2014 and concluded that –
- Movers & Shakers had defrauded Qualtail of cash receipts amounting to \$53 000 during the year ended 30 June 2013 and a further \$44 500 from 1 July 2013 to 31 October 2013; and
 - the amounts that had been written off as 'irrecoverable' had been credited to the allowance for credit losses account, with the resulting debit entry recognised as bad debts written off.

Movers & Shakers complied with the court order of 1 November 2013 and repaid the cash amounts stolen to Qualtail on 15 June 2014.

Buy-out of Movers & Shakers by Hummingbird

On 30 June 2014 Hummingbird argued before the court that the company's relationship with Movers & Shakers had been irreparably damaged by the events. It further argued that it should be awarded the right to force Movers & Shakers to sell its interest in Qualtail to Hummingbird. The high court agreed and granted Hummingbird the right to purchase the Qualtail shares held by Movers & Shakers for \$920 000.

In view of the negative publicity arising from the court case, Movers & Shakers decided to accept the court's decision rather than to appeal. On 30 June 2014, Hummingbird purchased Movers & Shakers's interest in Qualtail in terms of the court order and the related cash was paid to Movers & Shakers on the same day.

Trial balances and additional information

The following are the trial balances of Qualtail. These trial balances (and the information contained below) were prepared before any adjustments resulting from the findings from the above forensic investigation had been accounted for:

	Twelve months ended 30 June 2013	Four months ended 31 October 2013*
	\$	\$
Property, plant and equipment	750 000	685 000
Trade receivables	280 000	330 000
Allowance for credit losses	(56 000)	(101 000)
Bank	249 870	339 390
Share capital	(1 000 000)	(1 000 000)
Retained earnings – beginning of the period	–	(74 000)
Total liabilities	(149 870)	(120 390)
Profit after tax for the period	(74 000)	(59 000)
Total	0	0

* Unless otherwise stated, assume that these amounts approximate fair value where applicable.

The profit after tax of Qualtail for the period from 1 November 2013 to 30 June 2014 was \$99 000, before reflecting any of the information set out below:

1 Trade receivables

	1 November 2013	30 June 2014
Fair value of trade receivables	\$220 500	\$552 500

The trade receivables at 1 November 2013 exclude any claims by Qualtail against Movers & Shakers to repay stolen monies. 90% of the net outstanding trade receivables balance (excluding any claims by Qualtail against Movers & Shakers to repay stolen monies) per the trial balance on 1 November 2013 had been collected by 30 June 2014.

2 Lease commitment

Qualtail signed an operating lease agreement with an independent third party on 1 July 2012. In terms of this agreement Qualtail is entitled to the use of three warehouses with related office space for a five-year period. Rental of \$6 500 is payable monthly in arrears, starting on 31 July 2012. There is no escalation clause.

As a result of changes in the market for warehouse space, the market-related rental has changed as follows since 1 July 2012:

Market-related rental per month	\$
30 June 2013	6 800
31 October 2013	7 500
30 June 2014	7 500

3 Legal contingency

During the year ended 30 June 2013 a client sued Qualtail for \$10 000, claiming that her furniture had been damaged due to negligence. The client was not aware that the truck transporting this furniture had been involved in an accident en route to the delivery. The law suit was still in progress at 30 June 2014.

The following information about the law suit was compiled by the company's expert legal advisors:

Date	Fair value of claim	Likelihood of success
	\$	
30 June 2013	2 000	Remote
31 October 2013	2 500	Not probable, but no longer remote
30 June 2014	2 500	Not probable, but no longer remote

A successful claim by the client will lead to a tax deduction for Qualtail for the amount paid.

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QUESTION 2 – REQUIRED	Marks	
	Sub-total	Total
Prepare the pro forma journal entries necessary to account for Qualtail in the consolidated annual financial statements of Hummingbird for the year ended 30 June 2014 in accordance with International Financial Reporting Standards.	39	
<i>Communication skills – presentation</i>	1	40
Total		40