THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF ZIMBABWE

Initial Test of Competence
Professional Paper 3

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

Ignore Value-Added Tax (VAT).

Developers Ltd ('Developers') is a company listed on the Zimbabwe Stock Exchange (ZSE). Its primary business is the development of residential properties that the company sells or leases to unconnected third parties. The company has two wholly-owned subsidiaries:

- Equipment Ltd ('Equipment') (a Zimbabwean resident company that manufactures and sells home appliances locally and in the region and holds an investment portfolio); and
- Cleaners Ltd ('Cleaners') (a company registered and effectively managed in Mauritius that provides cleaning services to customers). It derives its income from a foreign business establishment in Mauritius.

The Developers group could have established Cleaners in either Zimbabwe or Mauritius, but chose Mauritius based on its 'favourable financial and business environment'. All three companies have a 31 December year end. The functional currency of all three companies, as determined in accordance with IAS 21 *The Effects of Changes in Foreign Exchange,* is the USD.

Shortly before the finalisation of the group annual report for the year ended 31 December 2014 ('FY2014'), the financial manager, Mr Jack Cash, had to be rushed to hospital for a medical emergency. The only outstanding matter that he had to attend to in the financial statements was the finalisation of the income tax expense note. The Developers group elected to present its tax rate reconciliation in the percentage format required in paragraph 81(c)(i) of IAS 12 *Income Taxes.*

Miss Suzie Nerves, a junior staff member in the finance department, was asked to complete the tax rate reconciliation, using the information in Mr Cash's file.

Miss Nerves has prepared the following draft tax rate reconciliation note:

	Note	**%**	**Miss Nerves's calculation**
Effective tax rate according to Mr Cash	1.1	**18,96%**	
Effective tax rate according to Miss Nerves			
Corporate statutory tax rate	1.2	25,75	
Reconciling items			
Temporary differences	1.3	1,38	(210 000 – 14 500) x 0,2575 / 3 643 000
Non-taxable capital gain (land)	1.3	(0,14)	20 000 x 0,2575 / 3 643 000
Foreign profits taxed at lower rate	1.4	(5,90)	2 000 000 x (0,15 – 0,2575) / 3 643 000
Withholding tax on dividends declared	1.5	1,37	500 000 x 0,10 / 3 643 000
Dividends and foreign interest received – exempt	1.6	(0,24)	34 000 x 0,2575 / 3 643 000
Depreciation on own office building – non-deductible item	1.8	0,10	14 400 x 0,2575 / 3 643 000
Effective tax rate		**22,32**	
Difference		**3,36%**	

1 Notes from Mr Cash's file

You may assume that all the information contained in Mr Cash's file is correct.

1.1 The group's profit before tax is $3 643 000 and the related income tax expense is $690 712 (correctly calculated), resulting in an effective tax rate for the group of 18,96%.

1.2 The 'applicable tax rate' for the group in terms of paragraphs 81(c)(ii) and 85 of IAS 12 is the Zimbabwean domestic corporate tax rate of 25,75%.

1.3 The companies in the group have the following temporary differences and assessed losses (correctly calculated):

	Developers	Equipment	Cleaners
	$	$	$
31 December 2013			
Other net taxable temporary differences	680 000	57 500	0
Assessed loss	0	(63 000)	0
	680 000	(5 500)	0
31 December 2014			
Other net taxable temporary differences	890 000	43 000	20 000
Assessed loss	0	0	0
	890 000	43 000	0
Movement in other net taxable temporary differences	210 000	(14 500)	20 000

Cleaners has a piece of vacant land situated 500 metres from its head office building in Mauritius. The company uses the land as parking space for employees. During the current financial year the land was re-valued by $20 000 (increase) to reflect current market prices of similar property in the same area. This revaluation was correctly accounted for within the accounting records of Cleaners. Capital gains are not taxable in Mauritius.

On 31 December 2013 there was some uncertainty about the future profitability of Equipment and it was not probable that future taxable profits would be available against which unused tax losses could be utilised.

1.4 An amount of $2 million from Cleaners is included in the group's profit before tax. Mauritius has a corporate tax rate of 15%. All the services were rendered in Mauritius.

1.5 Developers paid a gross dividend of $500 000 in cash to its shareholders on 28 December 2014. All the shareholders are natural persons resident in Zimbabwe.

1.6 During FY2014 Equipment received the following gross dividends and foreign interest from its investments:

Received from	$
Dividends from XYZ Ltd, a Zimbabwean resident company, in cash	3 000
An inventory dividend in specie from ABC Ltd, a Zimbabwean resident company	25 000
Dividends from DEF Plc, a company listed on the New York Stock Exchange (NYSE)	2 000
Interest from GHI Ltd, a company resident in South Africa	4 000
	34 000
Note: None of the foreign dividends and interest was subject to a withholding tax.	

1.7 On 31 December 2007 Developers commenced with the construction of residential properties that the company intended to sell as inventory.

1.8 On 14 September 2012 Developers commenced with the construction of its own office building. This building was funded from surplus cash and it was brought into use on 1 April 2013 at a total cost of $360 000 (which is not less than the arm's length price of the building). No further capital costs were incurred in respect of this building before it was sold.

On 1 September 2014 Developers decided to sell its own office building and to rent office facilities from an unconnected third party. Management were of the opinion that it could probably sell the building at a substantial profit, given the rising prices of office buildings. Accordingly, the building was actively marketed and advertised from 1 September 2014. After receiving numerous offers, the building was eventually sold for a cash amount of $500 000 on 15 December 2014. Allowable selling costs amounted to $25 000.

Management consulted senior counsel specialising in tax who confirmed in writing that the sale of this office building would not constitute gross income in terms of section 8.1 of the Income Tax Act. Furthermore, if Developers promptly submitted the computation of capital gains tax, the Zimbabwe Revenue Authority (ZIMRA) would waive the automatic 15% withholding tax on the proceeds of the sale.

On 1 September 2014 the carrying amount of the building was lower than its fair value less cost to sell.

The following information relates to Developers' own office building:

	$
Depreciation from 1 January to 31 August 2014	14 400

In 2008 Developers had also sold its previous owner-occupied office building, for a similar reason.

1.9 Developers received gross interest income of $20 000 from a Zimbabwean financial institution at a market-related rate.

1.10 Equipment recorded the following items of expenditure for the year ended 31 December 2014:

	$
Expenses at a trade fair in Paris aimed at soliciting business	12 000
Advertising for the sale of goods outside Zimbabwe	15 000
Bringing prospective foreign buyers to Zimbabwe	5 000
Providing samples of goods to persons in regional countries for potential export	10 000
Local management travel expenses to Mauritius to attend Cleaners' board meetings	5 000

2 Additional information

The Developers group has won awards from the Zimbabwe Investment Authority for its export performance and from ZIMRA for the administration of its PAYE and VAT responsibilities.

However, shortly after the group's year end, the following headline appeared in the business media: '*Leading listed group does not pay its fair share of taxes.*'

QUESTION 2 **40 marks**

Ignore Value-Added Tax (VAT).

You have recently been appointed as the assistant financial manager of Glasgow Ltd ('Glasgow'). In this role you have been allocated the responsibility for the preparation of the consolidated annual financial statements for the financial year ended 30 September 2014 ('FY2014'). Glasgow was incorporated in Zimbabwe in 1963 and it listed on the Zimbabwe Stock Exchange in 2002. Glasgow has established itself as the leading manufacturer, distributor and recycler of glass products in and around sub-Saharan Africa and supplies a wide range of customers.

The chairman of Glasgow's remuneration committee, Mr Severus Brickett, has drafted a revised group remuneration policy in the hope of motivating, attracting and retaining talent throughout the Glasgow group. In order to implement the revised remuneration policy, Glasgow entered into several transactions during the course of the financial year. These transactions have been summarised below to assist you in finalising the consolidated annual financial statements for FY2014.

The following is an extract from the preliminary consolidated statement of comprehensive income of the Glasgow group for FY2014:

	$'000
Profit before tax	2 520
Income tax expense	(706)
Profit for the period	**1 814**
Attributable to	
Equity holders of the parent	1 325
Non-controlling interest	489
	1 814

1 An overview of Glasgow's share register on 30 September 2013 revealed that its issued share capital consisted of 2 million ordinary shares of 10 cents each.

2 The impact of the transactions in notes 3 and 4 below are not reflected in the preliminary consolidated statement of comprehensive income figures provided above.

3 Group share incentive scheme

The following emerged from an overview of the minutes of Glasgow's annual general meeting of shareholders held on 15 January 2014:

3.1 The shareholders approved the establishment of an employee share option scheme for the 15 executive directors of Glasgow. On 1 February 2014, 10 000 ordinary share options, with a strike price of $3,00 per option, were granted to each of the executive directors. This was conditional upon them remaining in the employ of Glasgow until 31 January 2017. On grant date, Glasgow determined the fair value per share option to be $1,50. The terms of the options do not create an entitlement to a strike price adjustment in the event of a rights issue by Glasgow.

3.2 Glasgow purchased 150 000 of its own ordinary shares on 15 March 2014. Glasgow will use these shares to settle the share options upon exercise.

3.3 The weighted average market price of Glasgow's ordinary shares from grant date to year end was $4,20 per share. On 30 September 2014 the remuneration committee approved a reduction in the strike price per option from $3,00 to $2,50 to compensate the executive directors for their non-participation in the rights issue (see par. 5). The service condition remained unchanged. No further approval was required for these changes. Glasgow estimated the fair value per share option at 30 September 2014 to be as follows:

Fair value (original terms)	**Fair value (revised terms)**
$0,90	$1,20

3.4 One executive director resigned during July 2014. No further resignations are expected for the foreseeable future.

4 Investment in Greentech

On 1 October 2013 Glasgow obtained an 80% shareholding (comprising 1 200 000 shares) in and control over Green Technologies (Pvt) Ltd ('Greentech'). The purchase consideration was agreed as follows:

4.1 $500 000 paid in cash on 1 October 2013.

4.2 The purchase agreement stipulates that should the profit after tax of Greentech increase by at least 5% per annum for each of the three years following the acquisition, the seller would receive 200 000 ordinary shares in Greentech in three years' time.

4.3 Greentech's profit after tax was as follows:

	Profit after tax
Year ended 30 September	**$**
2011	60 500
2012	65 000
2013	71 000
2014	75 000

5 Rights issue

On 1 August 2014 Glasgow issued 462 500 ordinary shares as a result of a one for four rights issue at $3,20 per share. Glasgow did not exercise its rights with regard to the purchased treasury shares. The fair value per share on the date of the rights issue (and immediately prior to the rights issue) was $3,78.

6 Other information

The closing market price of Glasgow's ordinary shares as at 30 September 2014 was $3,50 per share.

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PROFESSIONAL PAPER 3

QUESTION 1 – REQUIRED		Marks	
		Sub-total	Total
(a)	Assuming that senior counsel's opinion is correct (see note 1.8), discuss, with reference to relevant case law, whether the receipt of $500 000 from the sale of Developers' own office building on 1 September 2014 is of a capital nature in terms of the gross income definition in section 8.1 of the Income Tax Act.	13	
	Ignore the recoupment of the amounts previously deducted in terms of the Fourth Schedule of the Income Tax Act.		
	Communication skills – clarity of expression; logical argument	2	15
(b)	Prepare a corrected consolidated tax rate reconciliation of the Developers group for the year ended 31 December 2014 in terms of IAS 12. Provide a brief explanation for each reconciling item included in your reconciliation and for each reconciling item in Miss Nerves's draft tax reconciliation excluded from your reconciliation.	40	
	Assume that the proceeds on the sale of Developers' own office building is a receipt of a capital nature for tax purposes and ignore the effects of the recoupment of the amounts previously deducted in terms of the Fourth Schedule of the Income Tax Act.		
	Communication skills – presentation; layout and structure	2	42
(c)	Discuss whether in your opinion the Developers group's effective tax rate for the year ended 31 December 2014 supports or contradicts the headline that appeared in the business media.	3	3
Total			**60**

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QUESTION 2 – REQUIRED	**Marks**	
	Sub-total	**Total**
With regard to the Glasgow group's consolidated annual financial statements for FY2014 – • calculate the basic earnings per share; • calculate the diluted earnings per share; and • provide the required reconciliations in terms of paragraphs 70(a) and 70(b) of IAS 33 *Earnings per share.*	38	
Communication skills – presentation	2	40
Total		**40**

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