THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ZIMBABWE

Initial Test of Competence
Professional Paper 4

JUNE 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.

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, 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 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 **54 marks**

Jonathan Small and his wife Elizabeth are married out of community of property. Jonathan is 50 years old and Elizabeth is 47 years old. They have two children – their daughter Sarah is a 22-year-old student, and their son Herbie is 15 years old and is still in school. All family members are ordinarily resident in Zimbabwe.

In 1998 Elizabeth founded Dream Design (Pvt) Ltd ('Dream Design'), an interior decorating company, of which she was the sole shareholder. Elizabeth is the managing director, and employs a staff of three decorators and a general administrator. Dream Design has a December year end and is a registered operator in terms of the *Value-Added Tax Act*, Chapter 23:12, as amended.

In 2002 Jonathan and Elizabeth paid an independent accountant, Mr Chris Hosking, to assist them in setting up the Small Family Trust. Mr Hosking runs his own accounting practice as a sole practitioner. He is not a value-added tax (VAT) registered operator. Jonathan and Elizabeth were appointed as trustees, together with Mr Hosking. The trustees are mandated to administer the assets of the Trust, and to provide for the financial needs of Jonathan, Elizabeth and their children from the income of the Trust at the discretion of the trustees.

On the day the Trust was formed Elizabeth sold all her shares in Dream Design to the Trust at market value. The purchase was funded by way of a loan account. This loan account was settled in full in December 2009 with dividend income received from Dream Design. Since then the income of the Trust has consisted of dividends from these shares together with interest income on the amounts not distributed by the trustees. However, on 31 December 2015 the trustees had distributed all amounts accrued to or received by the Trust to that date.

Jonathan is a very successful plastic surgeon who is employed by a local private hospital. Jonathan owns the family home. This home was originally financed by a mortgage bond from Second Divisional Bank, but it had been paid off by 2012. In that year Jonathan took out a second mortgage bond secured against the family home to purchase a block of flats as a long-term investment for $3 million. He has included the rent received each year in his gross income. However, since the deduction he claimed for interest paid on the mortgage bond was almost equal to the rental income, the effect on his taxable income was minimal.

Jonathan wanted to minimise future estate duties and protect his personal assets from professional claims. He accordingly transferred ownership of his block of flats into the name of the Small Family Trust for no consideration on 1 January 2015. The market value of the property was $5 500 000 on that date. The second mortgage bond over the family home was retained in Jonathan's name. As there was no cash available in the Trust, Jonathan also paid the transfer duty and transfer costs on behalf of the Trust. The Trust is obliged to repay these costs to Jonathan.

During the course of the 2015 year of assessment amongst others the following transactions took place in the Trust's bank account:

	$
Dividends from Dream Design The dividend was declared on 1 October 2015 and paid on 15 October 2015. This was the only dividend for the year.	700 000
Rent income	325 000
Interest on its cash balances $9 000 of this interest income is attributable to dividend receipts retained in the Trust's bank account.	16 000
Monthly fees for trustee services of $2 000 to Mr Hosking for the period October 2015 to December 2015	
Market-related interest charge on the loan of the transfer duty and transfer costs This charge was paid out of the dividend income received.	14 000
Rates and taxes on the block of flats	60 000
There were no rental amounts outstanding on 31 December 2014 as the Trust did not own the flats on this date. Rent of $5 000 was outstanding on 31 December 2015.	

The trustees, acting within their mandate, vested the following amounts in the beneficiaries on 31 December 2015:

- From rental income: $150 000 to Jonathan, and $25 000 each to Sarah and Herbie; and
- From dividend income: $200 000 to Elizabeth.

On 1 October 2015 Dream Design, on the instruction of the trustees, paid the outstanding monthly trustees fees of $18 000 due to Mr Hosking for the period 1 January 2015 to 30 September 2015. The Trust will not be required to repay this amount to the company. Dream Design did not have a valid Tax Clearance Certificate (ITF263) on hand for Mr Hoskins at 30 September 2015.

During the year Dream Design contracted a USA resident company, WebInc, to design its website. The terms of the contract provided for a 10% down payment and the balance to be settled at completion of the project and presentation of a final invoice. The project was satisfactorily completed in late October 2015 and an amount of $5 000 in respect of the full fee was invoiced on 1 November 2015 by WebInc. The initial deposit was paid on 1 October 2015 but due to the introduction of certain monitoring activities on foreign payments by the Reserve Bank of Zimbabwe, the final amount owing had not been settled by 31 December 2015.

In July 2015 Dream Design downloaded an interior decorating software suite, called Virtualroom, from the website of the developer, Virtualworld Ltd ('Virtualworld'). The software is protected by international copyright. The licence agreement allows for a free trial period of one month. After the trial period, a licence to activate the full version would be required and provided upon payment of an annual fee of $1 000, payable in advance. The software automatically locks out users without a valid licence. Dream Design made payment of the $1000 in full by means of a telegraphic transfer on 1 August 2015 and the licence key was activated on 3 August 2015. Virtualworld is resident in Italy.

Dream Design exhibits every year at the Zimbabwe Design Indaba. Dream Design was approached by the organisers of the Indaba with the following proposal: If Dream Design were to provide its services to the Indaba free of charge to assist with the theme, décor and planning of the event, the Indaba would waive its standard fee of $50 000 for providing Dream Design with a stand at the event. The organisers of the Indaba agreed to the proposal, which was carried out as planned. Dream Design estimates that it could have charged $40 000 for the services it provided to the Indaba. At year end Dream Design had not received or issued any invoices in respect of the transaction. The company's accountant is of the view that the transaction effectively has a net balance of zero and therefore has no income tax or VAT consequences. He does not intend pursuing the matter further.

Jonathan Small is in the process of completing his tax return for the 2015 year of assessment. His calculations are as follows:

	$
Salary from employment	660 000
Rental income received from the Trust	150 000
Interest expense in respect of the second mortgage bond	(160 000)
Estimated taxable income for normal tax purposes	650 000
Donations made during the year	–
Capital loss for capital gains tax purposes on the transfer of the flats to the Trust	(3 000 000)

Jonathan has an assessed capital loss of $20 000 brought forward from his 2014 year of assessment.

Jonathan submitted his taxable income calculation and supporting documents to Ms Amara Singh (CA(Z)), who helps him to compile his annual tax returns. She called him shortly after receiving it and said: 'You should never have transferred the flats to the Trust for no consideration.'

QUESTION 2

46 marks

Angora Natural Fibres (Pvt) Ltd ('ANF') has two operating divisions. The processing division treats mohair obtained from Angora goats and processes this into yarn. The weaving division further processes the yarn into woven rugs and carpets. Until the beginning of the current financial year, all of the yarn processed by the company was sold to external customers. ANF started a weaving division to convert yarn into rugs and carpets on 1 January 2015, thereby adding more value to its existing activities. The weaving division currently purchases all its yarn from the processing division.

Divisional structure and performance management system

With its expansion of operations into weaving, ANF implemented a divisional performance management structure on 1 January 2015. The company's operations are now split into the processing, weaving and support divisions. The support division is responsible for providing administrative, procurement, finance, marketing and sales support to both operating divisions.

The processing and weaving divisions operate as investment centres while the support division is a cost centre. A divisional manager heads up each division and is solely responsible for its performance. Performance bonuses equivalent to 50% of their annual salaries are paid to divisional managers who meet their annual performance targets. In addition, the divisional manager who is judged to be the best performing manager in a particular financial year receives a further $250 000 as a cash bonus. As a result there is strong competition between the divisional managers.

The processing and weaving divisional managers' performance targets are to obtain at least a 30% operating profit margin, calculated as profit before interest, taxation and any bonuses due to divisional managers, divided by the gross revenue for their division. The support divisional manager's performance target is that the support division's total actual costs are lower than budget.

Processing division

Mohair is sold at auction twice a year. ANF purchases mohair at these auctions to ensure it has raw material to process throughout the year.

The processing of mohair involves the following steps:

1. The raw mohair is washed in heated water to remove the natural grease and soil. This is done in big tubs that are fitted with rakes that gently move the mohair. Each batch of mohair is washed three times, followed by a final rinse. The washed mohair is then dried. The soapy water needs to be disposed of in an effluent dam in accordance with environmental regulations.
2. The second step entails first blending the various types of mohair and straightening the fibres so that they all lie in the same direction. This is done by passing the mohair through a system of rollers.
3. The final step involves spinning the processed fibre into yarn. During the spinning process, the mohair is mixed with sheep wool to enhance the yarn's attributes and to reduce the cost of the final yarn. ANF does not process raw sheep wool but purchases sheep wool that is ready to be spun from external suppliers. The final yarn contains 50% mohair and 50% sheep wool.

A 50% loss in weight of mohair is expected during steps 1 and 2. No loss of mohair or sheep wool is expected during the spinning process.

The plant and equipment used by the processing division is fully depreciated and requires significant on-going repairs and maintenance. The division will probably need to replace the existing plant and equipment within the next three years at a considerable cost to improve processing efficiency and reduce repairs and maintenance expenditure.

Weaving division

The weaving division obtains its yarn from the processing division. Yarn is woven into rugs and carpets for sale to external customers.

No loss of yarn is expected during the weaving process.

Financial and operational information

The following divisional financial information relates to the year ended 31 December 2015 and is presented before the determination of any bonuses to be paid to divisional managers.

	Notes	Processing division $'000	Weaving division $'000
Revenue	1	405 000	112 500
Raw mohair purchased	2	(120 000)	–
Sheep wool purchased	2	(36 000)	–
Dye and soap used		(3 780)	–
Yarn purchased		–	(50 625)
Salaries and wages	3	(48 275)	(13 725)
Repairs and maintenance costs	4	(10 500)	(1 200)
Water used	5	(2 400)	–
Water disposal costs	6	(9 600)	–
Depreciation	7	–	(1 170)
Other overheads		(4 360)	(580)
Sales commission paid	8	(3 544)	(1 125)
Allocated support division costs	9	(40 805)	(11 335)
Operating profit		125 736	32 740
Operating profit margin		31,0%	29,1%

Notes

1 During the year the processing division produced and sold 600 000 kg of yarn. Of this, 75 000 kg were transferred internally to the weaving division at the same price as that charged to external customers. The sales price of yarn remained constant at $675 per kg throughout the 2015 financial year ('FY2015'). The processing division could have sold a total of 575 000 kg of yarn to external customers in 2015 if it had not supplied the weaving division.

The weaving division produced and sold 25 000 m^2 of woven rugs and carpets during FY2015. The weaving division has significant spare capacity, which would enable it to take advantage of expansion possibilities in the future.

There were no inventories of raw mohair, sheep wool, processed yarn or woven carpets and rugs on 1 January 2015 and 31 December 2015.

2 During the year 600 000 kg of raw mohair was purchased and processed. The washing and blending process resulted in 300 000 kg of processed mohair being combined with 300 000 kg of sheep wool to produce 600 000 kg of yarn. The processing division has a capacity to produce 600 000 kg of yarn annually.

3 Each divisional manager was paid $1 million per annum before bonuses in 2015 and these costs have been included in the processing and weaving divisions' salary and wage costs. All staff employed by ANF are full-time employees.

4 Repairs and maintenance costs are largely fixed in nature as ANF regularly maintains plant and equipment to ensure minimal disruptions to manufacturing activities.

5 The vast majority of ANF's water is consumed during the washing of the raw mohair and therefore the full water costs are allocated to the processing division. The breakdown of the water costs and raw mohair washed during the year is as follows:

	Mohair washed	**Total water costs**
	Kg	**$**
January	37 500	152 500
February	50 000	200 000
March	55 000	219 000
April	45 000	181 000
May	52 500	209 500
June	52 500	209 500
July	57 500	228 500
August	52 500	209 500
September	55 000	219 000
October	55 000	219 000
November	52 500	209 500
December	35 000	143 000
	600 000	2 400 000

The fixed portion of water costs on a monthly basis remained constant throughout the financial year.

6 ANF outsources the disposal of soapy water after the washing of raw mohair to an independent contractor. The contractor collected the soapy water from ANF's premises, treated it and disposed of it in an effluent dam for a fixed fee of $9 600 000 in FY2015.

7 Plant and equipment is depreciated over ten years on a straight-line basis. New plant and equipment was purchased for the weaving division at the beginning of 2015.

8 Sales representatives are employed within the support division and earn fixed monthly salaries. In addition, sales commission is paid to sales representatives at a rate of 1% of gross revenue in respect of external sales. However, sales representatives do not receive any commission on sales from the processing division to the weaving division.

9 The support division's costs are allocated to the processing and weaving divisions in full based on their relative gross revenue as a percentage of total ANF gross revenue.

The budgeted and actual costs of the support division for FY2015 were as follows:

	Budget $'000	Actual $'000
Salaries and wages	6 950	6 950
Sales and marketing expenses	20 250	19 270
Rental of premises	9 000	9 000
Electricity	15 000	15 890
Other overheads	1 200	1 030
Total support division costs	52 400	52 140

The support divisional manager's annual salary before bonuses of $1 million has been included in salaries and wages in the above table. No provision has been made yet for any potential bonus due to the support divisional manager. The sales and marketing expenses comprise the fixed salaries paid to sales representatives and the cost of advertising and sponsorships.

All three divisions operate from the same premises.

Transfer pricing between the processing and weaving divisions

Transfers of yarn from the processing division to the weaving division took place at the same price as that charged to external customers. The processing divisional manager argued that his performance is measured based on his division's operating profit margin. Hence, he is reluctant to charge the weaving division a lower price than what the processing division could achieve by selling to external customers.

The weaving divisional manager is presently disputing the transfer price. She believes the processing divisional manager is unfairly benefitting from sales to the weaving division at market-related prices. She believes that she is at an immediate disadvantage for the award of best divisional manager. She has threatened to purchase her yarn from an external provider so that she is not unfairly prejudiced for the award. She has recommended that the transfer price from the processing division be the price charged to external customers less 10%. She argued that this will still enable the processing divisional manager to meet his operating profit margin target and this would also allow her to achieve her performance target.

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PROFESSIONAL PAPER 4

QUESTION 2 – REQUIRED		**Marks**	
		Sub-total	**Total**
(a)	Calculate the variable cost per kilogramme of yarn produced and sold by the processing division during FY2015.	6	6
(b)	Calculate the impact on ANF's operating profit (after full provision for any divisional manager bonuses) for FY2015 if the weaving division had purchased 75 000 kg of yarn from external suppliers instead of from the processing division.	14	14
(c)	Discuss the factors that ANF should consider in deciding upon a fair transfer price for yarn purchased by the weaving division from the processing division.	9	
	Communication – clarity of expression	*1*	10
(d)	Critically discuss the allocation of the support division's operating expenses to the processing and weaving divisions.	7	
	Communication – logical argument	*1*	8
(e)	Outline the pitfalls of the current incentivisation scheme for the processing and weaving divisional managers from the perspective of ANF.	8	8
Total			**46**

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INITIAL TEST OF COMPETENCE, JUNE 2016
PROFESSIONAL PAPER 4

QUESTION 1 – REQUIRED		Marks Sub-total	Marks Total
(a)	Calculate Jonathan's income tax payable on income from trade and investment as well as any capital gains tax payable for the 2015 year of assessment. Start your income tax calculations with Jonathan's estimated taxable income of $650 000 and ignore any potential capital allowances or recoupments.	17	17
(b)	Critically discuss Ms Singh's comments to Jonathan.	8	
	Communication skills – logical argument	*1*	9
(c)	Discuss the tax consequences for Dream Design of the payment made to Mr Hosking by the company. Ignore VAT.	5	5
(d)	(i) Discuss, with reasons, what obligations arise under the Income Tax Act in the hands of Dream Design with regard to the transactions entered into with WebInc and Virtualworld.	15	
	(ii) Discuss, with reasons, the consequences for Dream Design of entering into the arrangement with the Zimbabwe Design Indaba with regard to VAT.	7	
	Communication skills – logical argument	*1*	23
Total			**54**