THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF ZIMBABWE

The Institute of Chartered Accountants of Zimbabwe

QUALIFYING EXAMINATION

Part I
Paper 2

JANUARY 2010

TOTAL MARKS – 200 **TIME – Five hours**

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.

NOTE: The questions in this paper reflect currencies and comparative figures in US dollars to make a meaningful comparison of financial performance possible, with no account being taken of the mathematics of converting previous Zimbabwean dollars to US dollars.

QUESTION 1 **60 marks**

Amounts in the question exclude VAT, except where indicated.

WorldCup (Pvt) Ltd ('WorldCup') was incorporated on 1 January 2000. WorldCup manufactures and sells high-quality sports equipment. The company's annual financial reporting period ends on 31 December.

Information about group companies

Protea (Pvt) Ltd

WorldCup invested in Protea (Pvt) Ltd ('Protea') on 1 January 2008 by acquiring an 80% controlling interest in its share capital for US $11 600 000. On 1 January 2008, Protea's equity consisted of the following:

	US $
Share capital	100 000
Share premium	400 000
Retained earnings	14 500 000

Protea has not issued any additional shares since that date. Protea specialises in the hosting of major international sporting tournaments in Zimbabwe.

Protea acquired land during the 2003 financial reporting period at a total cost of US $7 million. Following the major success of a number of tournaments held in Zimbabwe in 2007, Protea required funding for purposes of expansion and therefore entered into a sale-and-leaseback agreement for the land with WorldCup.

In terms of the agreement, WorldCup settled its obligation under the sale agreement in cash. Protea correctly classified the leasing element of the sale-and-leaseback agreement in terms of IAS 17, *Leases,* as an operating lease.

The following information relates to the sale-and-leaseback transaction:

Selling price	US $10 million
Date of disposal and commencement of lease agreement	1 February 2008
Lease instalments	US $200 000, payable monthly in arrear
Lease term	60 months

The following information relates to the land that is the subject of the sale-and-leaseback transaction:

	1 January 2008	**1 February 2008**
	US $	**US $**
Fair value of land	9 000 000	9 000 000
Base cost to Protea of land for capital gains tax purposes	7 000 000	7 000 000
Carrying amount of land in Protea's records	7 000 000	7 000 000

Warriors (Pvt) Ltd

On 1 January 2008 WorldCup invested in Warriors (Pvt) Ltd ('Warriors') when WorldCup acquired a 90% controlling interest in its share capital for US $12 800 000. On 1 January 2008, the equity of Warriors consisted of the following:

	US $
Share capital	200 000
Share premium	800 000
Retained earnings	11 000 000
Mark-to-market reserve (relating to available-for-sale financial assets)	1 000 000

Warriors has not issued any additional shares since that date. The main operations of Warriors involve the manufacture and assembly of low-cost soccer equipment.

During the 2008 financial reporting period, the management of Warriors approached the directors of WorldCup regarding a potential 'management buy-out' of Warriors. After extensive negotiations between relevant parties, a deal was concluded with the management of Warriors. In terms of the agreement, WorldCup sold a portion of its holding in Warriors for US $12 million cash on 1 July 2009, resulting in WorldCup retaining a 40% ownership interest in Warriors. WorldCup was able to exert significant influence over the financial and operating policies of Warriors as from 1 July 2009.

The fair value of available-for-sale financial assets held by Warriors increased by US $1 800 000 (after tax) between 1 January 2009 and 30 June 2009. Warriors's profit for the year accrued as follows for the year ended 31 December 2009:

	1/1/2009 to 30/6/2009	**1/7/2009 to 31/12/2009**
	US $	**US $**
Revenue	9 000 000	11 000 000
Cost of sales	(4 500 000)	(5 500 000)
Operating costs	(2 772 000)	(2 094 400)
Profit before tax	1 728 000	3 405 600
Income tax expense	(650 100)	(890 500)
PROFIT FOR THE YEAR	**1 077 900**	**2 515 100**

Additional information

Except where noted, the carrying amounts of net identifiable assets of all group companies approximated their fair values at the dates on which WorldCup invested in these companies.

The share capital of all companies in the WorldCup group consists of ordinary shares with a par value of US $1,00 per share.

It is the accounting policy of all companies in the WorldCup group to subsequently measure –

- investment properties according to the cost model in terms of IAS 40, *Investment Properties*; and
- items of property, plant and equipment according to the cost model in terms of IAS 16, *Property, Plant and Equipment.*

It is the accounting policy of WorldCup to measure investments in subsidiaries and associates at cost in its separate financial statements in accordance with IAS 27, *Consolidated and Separate Financial Statements.*

WorldCup has elected to measure any non-controlling interests at fair value at acquisition dates. Fair values are determined with reference to acceptable valuation techniques on the relevant dates.

WorldCup elected to apply IFRS 3, *Business Combinations (revised 2008)*, with effect from 1 January 2008.

The fair values (per share) of shares in group companies were as follows at the respective dates:

	Fair value (per share)	
	Protea	**Warriors**
1 January 2008	US $148,00	US $67,00
1 July 2009		US $110,00

Separate or individual statements of changes in equity of group companies

The following information represents the draft separate statements of changes in equity of companies in the WorldCup group for the year ended 31 December 2009:

WorldCup					
	Share capital	**Share premium**	**Retained earnings**	**Mark-to-market reserve**	**Total equity**
	US $'000	**US $'000**	**US $'000**	**US $'000**	**US $'000**
Balance at 1 January 2009	700	2 300	24 605	1 800	29 405
Changes in equity for 2009					
Profit for the year	–	–	16 360	–	16 360
Other comprehensive income	–	–	–	900	900
Dividends paid (31 December 2009)	–	–	(3 500)	–	(3 500)
Balance at 31 December 2009	700	2 300	37 465	2 700	43 165

Protea					
	Share capital	**Share premium**	**Retained earnings**	**Mark-to-market reserve**	**Total equity**
	US $'000	**US $'000**	**US $'000**	**US $'000**	**US $'000**
Balance at 1 January 2009	100	400	18 900	800	20 200
Changes in equity for 2009					
Profit for the year	–	–	4 742	–	4 742
Other comprehensive income	–	–	–	100	100
Dividends paid (31 December 2009)	–	–	(2 600)	–	(2 600)
Balance at 31 December 2009	100	400	21 042	900	22 442

Warriors					
	Share capital	**Share premium**	**Retained earnings**	**Mark-to-market reserve**	**Total equity**
	US $'000	**US $'000**	**US $'000**	**US $'000**	**US $'000**
Balance at 1 January 2009	200	800	12 800	3 100	16 900
Changes in equity for 2009					
Profit for the year	–	–	3 593	–	3 593
Other comprehensive income	–	–	–	1 300	1 300
Dividends paid (31 December 2009)	–	–	(1 500)	–	(1 500)
Balance at 31 December 2009	200	800	14 893	4 400	20 293

REQUIRED

		Marks
(a)	Provide the pro forma consolidation journal entries that should be processed by WorldCup (Pvt) Ltd for the year ended 31 December 2009 to correctly account for Protea (Pvt) Ltd in its consolidated annual financial statements. Journal entries relating to deferred taxation are also required.	38
(b)	Provide the pro forma consolidation journal entries that should be processed by WorldCup (Pvt) Ltd for the year ended 31 December 2009 to correctly account for Warriors (Pvt) Ltd in its consolidated annual financial statements. Journal entries relating to deferred taxation are not required.	20
Presentation marks:	Arrangement and layout, clarity of explanation, logical argument and language usage.	2

QUESTION 2 **40 marks**

Elton Shumba is the financial director of Wonderland (Pvt) Ltd. He is also a director of Neverland (Pvt) Ltd, which is the holding company of Wonderland (Pvt) Ltd.

Elton is 60 years of age. He had contracted polio during his youth and is confined to a wheelchair.

For the period 1 February 2009 to 31 December 2009 Elton received the following remuneration from the company, which was all paid in foreign currency. (Elton was on unpaid leave for the month of January and received no remuneration.)

	Note	US $
Salary		60 000
Director's fees, voted for on 30 September 2009		2 000
Medical aid contributions paid by the company		3 600
Medical expenses paid by the company in July 2009		1 000
Entertainment allowance	1	2 400
		69 000
Elton's pension fund contributions to the company's approved pension fund for the period 1 February to 31 December 2009		3 575
PAYE deducted for the period 1 February to 31 December 2009		22 700

Notes

1 During the 2009 tax year Elton entertained clients at a cost of US $950.

Additional information

- For the period January 2009 to September 2009 he had the use of a company vehicle with an engine capacity of 1500 cc. In October 2009 the company sold the vehicle to Elton for US $2 000. The market value of the vehicle was US $3 500 and the cost to the company was US $5 450.
- In September 2009 Elton exercised an option to acquire 200 shares in Wonderland (Pvt) Ltd at US $2 per share. At that date the market value of these shares was US $3 per share. The option had been offered in February 2007 when the market value of the shares was the equivalent of US $3,50 per share.
- Elton owns two flats, one of which is his principal private residence and another, which was let throughout the year for US $9 600. The monthly levy of US $500 per month was paid by Elton. Elton enclosed the balcony of the rented flat in September 2009 at a cost of US $1 800.
- Elton received a pension of US $200 per month from an approved pension fund from his previous employer.

- On 30 September 2009 Neverland (Pvt) Ltd paid Elton director's fees amounting to US $500 less US $100 withholding tax.

- In September 2009 Elton invested funds in bankers' acceptances. Interest on these bankers' acceptances amounted to US $4 000 for the year.

REQUIRED

	Marks
You are required to calculate Elton's tax liability for the year ended 31 December 2009. Provide detailed explanations to support your calculations whenever necessary.	37
Presentation marks: Arrangement and layout, clarity of explanation, logical argument and language usage.	3

INDIVIDUAL TAXATION EMPLOYMENT INCOME RATES OF TAX EARNED IN FOREIGN CURRENCY FOR THE YEAR ENDED 31 DECEMBER 2009			
Period **1 February 2009** **to 31 December 2009**	**Segment of monthly income**	**Rate of tax within segment**	**Cumulative monthly income tax liability ***
	US $	**%**	**US $**
	0 – 150	–	–
	151 – 500	20	70,00
	501 – 1 000	25	195,00
	1 001 – 1 500	30	345,00
	1 501 – 3 000	35	870,00
	3 001 and above	37,5	

* Plus 3% levy.

QUESTION 3 **100 marks**

Amounts in the question exclude VAT, except where indicated.

ElectriBolt Ltd ('ElectriBolt') is an independent electricity supplier with various power-generation operations throughout Zimbabwe. ElectriBolt is listed on the Zimbabwe Stock Exchange. The company's most recent financial reporting date was 31 December 2009.

Background

On 1 January 1999, ElectriBolt entered into a unique hydro-electricity supply licence agreement with the Zimbabwe government ('the government'). The licence agreement entitled ElectriBolt to install three turbines at the Nyangombe Waterfall, which is situated in the Nyangombe National Park, and generate and supply electricity for a period of 15 years. The licence agreement provides that –

- ElectriBolt is required to pay the government a fixed instalment of US $800 000 annually in arrear for the right to use the site to generate electricity; and
- the agreement is not renewable at the end of the 15-year term.

ElectriBolt decided to grant the right of use of the abovementioned supply licence, from the inception date of the agreement with the government (1 January 1999), to PowerSmart Ltd ('PowerSmart'), a large electricity supplier, for a period of 15 years. All licensing rights granted to ElectriBolt by the government were transferred to PowerSmart in exchange for a fixed annual instalment of US $1 million, payable in arrear to ElectriBolt. By law the final operator of an electricity supply business is solely responsible and liable for any related environmental site rehabilitation. PowerSmart may not transfer or sell the supply licence to any other party. A cancellation penalty of US $900 000 is payable by PowerSmart to ElectriBolt should PowerSmart at any stage unilaterally decide on the early cancellation of the agreement.

On 1 January 1999, ElectriBolt did not recognise any assets or liabilities in respect of the hydroelectricity supply licence with the government and the right of use of the licence granted to PowerSmart. The US $800 000 per annum for the supply licence is expensed on an annual basis and the US $1 million per annum receipt from PowerSmart is recognised as revenue on an annual basis. This accounting policy is acceptable in terms of International Financial Reporting Standards.

Feasibility study on PowerSmart's Nyangombe operations

ElectriBolt recently established that PowerSmart is underperforming at the Nyangombe site and believes that significantly more electricity can be generated during the last four years of the supply licence. The major reason for PowerSmart's disappointing performance is the regular labour disputes experienced at the Nyangombe operation. ElectriBolt conducted a feasibility study in December 2009 to evaluate the possible acquisition of PowerSmart's Nyangombe operations. Following this feasibility study, ElectriBolt proposed acquiring the PowerSmart Nyangombe division as a going concern, including all assets and liabilities of this division except for cash and cash equivalents and taxation liabilities. The licensing agreement between ElectriBolt and PowerSmart would be terminated as part of the acquisition.

The Chief Financial Officer (CFO) of ElectriBolt prepared the following cash-flow projections, following a detailed review of historic financial information of the Nyangombe division of

PowerSmart and its budgets for the next four years, for the purposes of valuing the Nyangombe division:

Year ending 31 December	Notes	2010	2011	2012	2013
		US $	US $	US $	US $
Turnover	1	18 000 000	18 000 000	18 000 000	18 000 000
Operating costs	1	(4 500 000)	(4 500 000)	(4 500 000)	(4 500 000)
Opportunity cost	2	(1 000 000)	(1 000 000)	(1 000 000)	(1 000 000)
Supply licence agreement instalments		(800 000)	(800 000)	(800 000)	(800 000)
Operating cost savings	3	300 000	300 000	300 000	300 000
Cost of helicopter lease	4	(480 000)	(480 000)	(480 000)	(480 000)
Depreciation: Turbines		(700 000)	(700 000)	(700 000)	(700 000)
Interest on long-term loan	5	(897 536)	(712 469)	(503 344)	(267 032)
Environmental site rehabilitation costs	6	–	–	–	(2 500 000)
Pending legal claim	7	–	–	–	–
Taxation	8	(2 778 290)	(2 830 109)	(2 888 664)	(2 254 831)
Net cash flows		7 144 174	7 277 422	7 427 992	5 798 137

Related calculations	Notes	
Weighted average cost of capital (WACC)	9	23,00%
Net present value of the future cash flows of the Nyangombe division of PowerSmart	9	US $17 143 393

Notes to the cash-flow projections

1 Projected turnover includes a conservative estimate of the additional electricity that ElectriBolt could generate and supply, assuming it acquired control of the operations. Operating costs exclude annual supply licence payments due by PowerSmart to ElectriBolt.

2 Opportunity cost represents annual instalments in terms of the supply licence agreement, to which ElectriBolt will no longer be entitled.

3 PowerSmart incurred research and development costs during the period 2007 to 2009 aimed at improving operating efficiency. As a result thereof, PowerSmart expects a possible annual operating cost saving of US $300 000 from 2010 to 2013. The CFO of PowerSmart is of the opinion that the cost saving is only 45% probable, resulting in the development costs not meeting the recognition criteria in terms of IAS 38, *Intangible Assets,* for recognition as an intangible asset. It follows that development costs were immediately expensed when incurred.

4 PowerSmart leases an executive helicopter from Fly-with-Me Airways (Pvt) Ltd at a fixed instalment of US $360 000, payable annually in arrear. The lease agreement was correctly classified as an operating lease in terms of IAS 17, *Leases.* The lease agreement

commenced on 1 January 2008 and ends on 31 December 2012. On 31 December 2009, it was reliably established that similar executive helicopters can be leased at a market-related fixed instalment of US $480 000, payable annually in arrear.

5 PowerSmart obtained a long-term loan of US $15 million on 1 January 1999 to finance this particular operation. The long-term loan is repayable in 15 equal annual instalments, which commenced on 31 December 1999. The loan bears interest at a fixed rate of 13% per annum. The loan agreement provides that the loan cannot be repaid earlier than the agreed repayment profile. On 31 December 2009, long-term loans with a similar risk profile and remaining maturity were available at a fixed rate of 12% per annum.

6 This amount has been reliably estimated by an independent environmental rehabilitation expert.

7 Labour unrest increased after the recent dismissal of a number of PowerSmart's employees as a result of increased operational inefficiency. The trade union to which these employees belong has instituted a legal claim against PowerSmart on behalf of the employees on the grounds of unfair dismissal. The legal advisers of PowerSmart are of the opinion that –

- the dismissed employees have a valid claim against PowerSmart for unfair dismissal;
- the trade union will not be able to prove the claim for unfair dismissal in court, due to a lack of evidence; and
- it is possible but not probable that the court will require PowerSmart to make a financial settlement to the dismissed employees.

The CFO did not include any amount relating to the legal claim in the forecast cash flows. Should such a claim be successful, any amount paid by PowerSmart will not be deductible for tax purposes. The fair value of the legal claim at 31 December 2009, as reliably determined by an experienced actuary, is US $450 000.

8 All items in the cash-flow budget have been assumed to be taxable or deductible for income tax purposes, except as per point 7 above. (It is assumed that the tax payable is the actual cash outflow for the respective years.)

9 The nominal WACC of ElectriBolt is 23% and the forecast cash flows have been discounted using this rate.

Financing alternatives

On 31 December 2009 the Nyangombe division of PowerSmart was acquired by ElectriBolt as a going concern, including all assets and liabilities of the division except for cash and cash equivalents and taxation liabilities. The purchase consideration of US $16 million was paid by ElectriBolt on 31 December 2009. It was correctly established that the transaction between ElectriBolt and PowerSmart constitutes a 'business combination' as defined in IFRS 3, *Business Combinations.*

ElectriBolt is considering various financing alternatives for the business combination transaction:

- Payment out of existing cash reserves of US $16 million; or

- Obtaining a US $16 million medium-term loan from ElectriBolt's bankers. The loan is to bear interest at 1% above the prevailing minimum lending rate. This is the company's incremental cost of borrowing. The loan is to be repaid in one bullet payment at the end of four years. Interest is to be calculated and compounded annually in arrear, and capitalised into the outstanding loan balance. Transaction costs of 1% of the principal amount will be payable at the inception of the medium-term loan. The interest to be incurred on such a long-term loan is deductible for taxation purposes; or

- The issue of compulsory convertible preference shares with a par value of US $16 million. Preference shareholders will be entitled to an annual dividend calculated as 80% of the prevailing minmum lending rate multiplied by the par value of shares held. ElectriBolt is required to pay preference dividends annually in arrear and has no discretion with regard to declaring these dividends. Each preference share will automatically convert into one ordinary share after four years. Analysts predict that the value of the converted shares at the end of year four will amount to US $17 800 000.

Draft statement of financial position of the Nyangombe division of PowerSmart as at 31 December 2009

The information below represents an extract from the **draft** statement of financial position of the Nyangombe division of PowerSmart as at 31 December 2009, which contained *inter alia* the following:

	Notes	US $
ASSETS		
Non-current assets		
Property, plant and equipment	1	9 750 000
Current assets		
Inventories	2	750 000
Trade receivables	3	300 000
Cash and cash equivalents		250 000
LIABILITIES		
Non-current liabilities		
Long-term borrowings	4	5 480 535
Deferred tax	5	653 535
Long-term provisions	6	–
Current liabilities		
Trade payables	7	435 000
Current portion of long-term borrowings	4	1 423 590
Zimbabwe Revenue Authority (ZIMRA)		115 000

Notes

1 Items of property, plant and equipment are subsequently measured according to the cost model in terms of IAS 16, *Property, Plant and Equipment.* The market value of the property, plant and equipment as at 31 December 2009 was US $14 million.

2 The fair value of inventories was reliably determined at US $800 000 as at 31 December 2009.

3 The balance of net trade receivables comprised the following as at 31 December 2009:

	US $
Gross trade receivables	480 000
Less: Allowance for doubtful debts*	(180 000)
	300 000

* ZIMRA agreed to a tax deduction of 25% of the allowance for doubtful debts for taxation purposes.

The fair value of trade receivables as at 31 December 2009 was reliably determined at US $400 000.

4 Long-term borrowings are subsequently measured according to the amortised cost model in terms of IAS 39, *Financial Instruments: Recognition and Measurement*. Long-term borrowings consisted of the following as at 31 December 2009:

	US $
Long-term loan	6 904 125
Less: Current portion of long-term borrowings	(1 423 590)
	5 480 535

5 The deferred tax balance as at 31 December 2009 was calculated as follows:

Asset/liability	**Carrying amount**	**Tax base**	**Temporary difference**
	US $	**US $**	**US $**
Property, plant and equipment	9 750 000	7 500 000	2 250 000
Inventories	750 000	750 000	–
Trade receivables	300 000	435 000	(135 000)
Long-term loan	6 904 125	6 904 125	–
Trade payables	435 000	435 000	–
Taxable temporary differences			2 115 000
Deferred tax calculated at 30,9%			653 535

6 No provision has been recognised in the statement of financial position of PowerSmart in respect of the environmental site rehabilitation. 70% of the damage caused to the environment occurred when the turbines were installed, while the remaining 30% of the damage to the environment is caused evenly over the duration of the contract. No environmental rehabilitation activities had been undertaken by 31 December 2009 and the CFO therefore holds the opinion that no provision should be recognised in the statement of financial position until the electricity supply operation ceases. ZIMRA will allow the amount incurred in respect of environmental rehabilitation costs as a deduction for taxation purposes when it is actually paid.

7 The fair value of trade payables as at 31 December 2009 was reliably determined at US $500 000.

8 The supply licence, the use of which was granted by ElectriBolt, had a fair value of US $4 500 000 at 31 December 2009 based on the terms of the licensing agreement between ElectriBolt and PowerSmart. If a similar right with payments at market rates were granted at 31 December 2009, it would have a fair value of US $5 million.

Additional information

Where appropriate and unless stated otherwise, ZIMRA accepts the acquisition date fair values of assets and liabilities for taxation purposes.

The current minimum lending rate is 10% per annum, nominal and pre-tax.

REQUIRED

PART A – to be answered in a separate book

		Marks
(a)	Identify, with reasons, any errors in and omissions from the cash flow forecasts and discounted future cash flows of the Nyangombe division of PowerSmart Ltd as prepared by the CFO of ElectriBolt Ltd.	16
(b)	Identify and describe any advantages and disadvantages of ElectriBolt Ltd settling the purchase consideration due to PowerSmart Ltd using its own cash resources.	6
(c)	With regard to ElectriBolt Ltd evaluating the financing of the acquisition of the Nyangombe division of PowerSmart Ltd through obtaining the medium-term loan or through the issue of the preference shares –	
	(i) calculate and determine which instrument will be more cost effective for ElectriBolt Ltd to use; and	10
	(ii) discuss any other factors ElectriBolt Ltd should consider in deciding which instrument to use.	6
Presentation marks:	Arrangement and layout, clarity of explanation, logical argument and language usage.	2

PART B – to be answered in a separate book

		Marks
(d)	Prepare a report to the CFO of ElectriBolt Ltd in which you discuss, with reasons, the following items at the acquisition date of the acquired operations and net assets of the Nyangombe division of PowerSmart Ltd:	
	(i) The recognition of the pending court case between PowerSmart Ltd and the trade union;	5
	(ii) The recognition of the provision, if any, for environmental site rehabilitation; and	7
	(iii) The recognition and measurement of the compulsory convertible preference shares if these are issued as consideration for the acquisition.	8
(e)	Prepare the journal entries that should be processed by ElectriBolt Ltd on 31 December 2009 in respect of the acquisition of the Nyangombe division of PowerSmart Ltd on 31 December 2009. Your solution must include the workings of the deferred taxation consequences of all recognised assets and liabilities.	36
Presentation marks:	Arrangement and layout, clarity of explanation, logical argument and language usage.	4