



The Institute of Chartered Accountants of Zimbabwe

QUALIFYING EXAMINATION

Part I Professional Paper 1

JANUARY 2011

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.

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 anomalies of converting previous Zimbabwean dollars to US dollars.

QUESTION 1**60 marks**

Mr Alistair Murphy, a widower who is 58 years of age, is a qualified quantity surveyor. He had worked abroad for several years and was then employed by the local government in Bulawayo. With the approval of his employer, he also performed part-time services for another quantity surveyor, Mr A Moyo.

In February 2010, when Mr Moyo reached retirement age, he offered to sell his business to Mr Murphy. As Mr Murphy had to give notice to his employer, it was agreed that the purchase would take place on 1 May 2010.

The terms of the agreement between Mr Murphy and Mr Moyo were that Mr Murphy would register for value added tax (VAT) purposes and acquire Mr Moyo's business on 1 May 2010 as a going concern in his own name.

The agreed values contained in the agreement were as follows:

	\$
Goodwill	40 000
Debtors	33 000
Office equipment	36 500
Residential property (partially used for business purposes and partially used as Mr Murphy's principal private residence, as he had been living in rented accommodation up to May 2010)	120 000
Total purchase consideration (VAT included at 0%)	229 500

Mr Murphy purchased the following assets in May 2010:

	\$
Computer	1 000
VAT on the computer	150
Generator	300
VAT on the generator	45
	1 495

Mr Murphy prepared the following income and expenditure account for the period 1 May 2010 to 31 December 2010 (net of VAT):

INCOME AND EXPENDITURE ACCOUNT FOR THE PERIOD 1 MAY 2010 TO 31 DECEMBER 2010				
Income	Notes	\$	\$	\$
Fees				350 000
Expenditure				
Bad debts			1 397	
Purchased debtors, all irrecoverable		1 220		
Incurred in June 2010, proved to be irrecoverable		177		
Insurance premium			310	
Office and cash in transit		185		
Own life insurance		125		
Legal expenses			210	
Purchase agreement		175		
Debt collection		35		
Medical aid			1 600	
Staff		1 280		
Self		320		
Motor vehicle expenses			1 880	
Staff expenses			36 000	
Staff salaries		32 000		
Cash in lieu of leave paid in December 2009		4 000		
Office expenses	1		7 700	
Rates on purchased property		4 400		
Electricity		3 300		
Telephone	2		860	
Alterations to the property to add another toilet			10 220	
Total expenditure			60 177	
Net profit for the period			289 823	
			350 000	350 000

Notes

- 1 It was agreed with the Zimbabwe Revenue Authority (ZIMRA) that 25% of both these expenses were for business purposes and 75% for private purposes.
- 2 It was agreed with ZIMRA that 80% was for business and the balance for private purposes.

In September 2010 the Botswana government requested Mr Murphy to carry out an assignment in Francistown, for which service he was paid a technical fee equivalent to \$458. He was there for a period of four days and does not have a permanent establishment in Botswana.

Mr Murphy's remuneration for the period January 2010 to 30 April 2010 was as follows:

	\$
Salary	4 500
Bonus paid in March 2010	500
Medical aid	160
Total	5 160

Mr Murphy had the use of a vehicle with an engine capacity of 1500 cc for the period January to April 2010. On the termination of his services he was allowed to purchase this vehicle for \$900. The market value of the vehicle was \$3 750 and the original cost to his employer was the equivalent of \$2 700.

Mr Murphy used this vehicle in his business, and it was agreed with ZIMRA that 30% was for business purposes and 70% was for private use.

Mr Murphy owned a flat in Harare which had been let for the period 1 February 2010 to 31 May 2010. Income received from it was as follows:

	\$
Rent	4 750
Levy	(570)
	4 180

Mr Murphy sold the flat in June 2010 for \$115 000. The flat had been purchased in October 2006 for the equivalent of \$75 000.

Mr Murphy received a Zimbabwe pension which amounted to \$12 250 for the 2010 tax year.

Mr Murphy had invested funds in bank acceptances and interest amounting to \$3 500 accrued to him in the 2010 tax year.

Mr Murphy was diagnosed with cancer and was advised that he required an operation and radio therapy treatment, which was available in South Africa. He therefore decided to close his business at the end of December 2010 and to move to South Africa in the new year.

He was able to sell the house which had been used partially as an office and mainly as his principal private residence for \$167 000 in December 2010.

The other assets were on hand at the year end and Mr Murphy hopes that he will be able to find a buyer for them in the new year.

QUESTION 2

40 marks

Supremo Tankers (Pvt) Ltd ('Supremo') operates a fleet of trucks and trailers to provide logistical services to brick manufacturers in the Mashonaland and Matabeleland provinces. These services mainly entail the transport of bricks on behalf of brick manufacturers to their customers. Supremo owns 100 trucks together with 'flat-bed' trailers. These transport vehicles have loading equipment specially designed to load and unload bricks. The logistical service is offered to customers on one of the following bases:

- An annual contractual basis to transport bricks from the brick manufacturer's premises to specified locations based on a minimum number of loads per week. These contracts provide for a fixed monthly charge subject to changes in diesel fuel prices. Contracts specify that diesel fuel represents 20% of the total charge to customers and Supremo adjusts monthly charges to customers with immediate effect in the event of a change in the retail price of diesel fuel; or
- A per load basis in terms of which Supremo charges an agreed transport fee per kilometre travelled from the brick manufacturer's premises to the delivery destination. These charges also fluctuate depending on diesel fuel prices, based on the principle that diesel fuel costs represent 20% of the total per kilometre charge to customers.

The shareholders in Supremo are Sergio Parisse (70%) and BWI Holdings (Pvt) Ltd ('BWI') (30%). Mr Parisse started Supremo in 1985 and has been instrumental in developing the business into the leading logistics provider to brick manufacturers in the provinces in which it operates. Supremo focuses exclusively on services to brick manufacturers.

Supremo's profitability has declined significantly in the 2009 and 2010 financial years, mainly because of lower activity levels in the brick manufacturing industry. Research by an industry association revealed that sales volumes of brick manufacturers were 25% lower in 2009 than in the previous year and that sales volumes declined by a further 5% in 2010.

The decline in demand for its services that Supremo has experienced has also had an effect on its capacity utilisation. Prior to 2009 Supremo was able to optimise load volumes and to ensure that it carried full loads on most occasions. This changed in 2009 and now many of the trailers are empty on one or more legs of a journey. For example, bricks may be delivered to a destination but the trailer remains empty until the truck reaches the next customer.

DAB Bank is the commercial banker to Supremo. DAB Bank has exclusively financed the acquisition of trucks and trailers by Supremo over the past five years on an instalment sale basis. DAB Bank requires a deposit of 20% of the purchase price of new vehicles when financing Supremo's acquisition of trucks and trailers. The instalment sale is repayable in equal monthly instalments over six years and the capital outstanding bears interest at the prevailing minimum lending overdraft rate (currently 10%).

The bank overdraft balance with DAB Bank at 31 December 2010 was \$28 405 000. As a result of the ongoing operating losses, DAB Bank has informed Supremo that they are required to reduce their bank overdraft balance to \$5 million by 28 February 2011. If this overdraft balance is not reduced then DAB Bank will withdraw the overdraft facilities.

Supremo has historically adopted a policy of trading in or disposing of trucks after five years. Supremo has found that after this period, trucks become very expensive to maintain and repair costs increase exponentially. This does not apply to trailers as Supremo has workshop facilities where it overhauls and cost-effectively maintains trailers to extend their useful life to more than ten years.

The demand for used trucks has declined dramatically over the past two years, which has had an adverse impact on disposal prices. Conditions in the market have also impacted on used truck prices. The trucks that Supremo uses are imported from South Africa and a strengthening rand has resulted in an increase in the cost of new trucks, which in turn affects the resale values of used trucks. Prior to 2009 Supremo generally disposed of trucks at prices which were higher than the carrying values.

The financial results and financial position per the management accounts for the year ended 31 December 2010 are summarised below:

SUPREMO TANKERS (PVT) LTD			
EXTRACTS FROM THE STATEMENTS OF COMPREHENSIVE INCOME			
Year ended 31 December	Notes	2010	2009
		\$'000	\$'000
Revenue	1	102 920	128 650
Cost of sales	2	(66 120)	(76 820)
Gross profit		36 800	51 830
Operating and administrative costs	3	(23 500)	(21 400)
Loss on sale of vehicles		(2 600)	(2 500)
Earnings before interest, tax, depreciation and amortisation (EBITDA)		10 700	27 930
Depreciation		(14 380)	(16 750)
EBIT		(3 680)	11 180
Finance costs		(12 100)	(12 400)
Loss before taxation		(15 780)	(1 220)
Taxation		-	-
Loss after taxation		(15 780)	(1 220)

SUPREMO TANKERS (PVT) LTD
EXTRACTS FROM THE STATEMENTS OF FINANCIAL POSITION

As at 31 December	Notes	2010 \$'000	2009 \$'000
Non-current assets			
Property, plant and equipment	4	157 200	149 200
Current assets		19 225	22 050
Inventories		925	950
Trade and other receivables		18 300	21 100
TOTAL ASSETS		176 425	171 250
Equity		31 970	47 750
Share capital		5 000	5 000
Distributable reserves		26 970	42 750
Non-current liabilities		83 650	86 400
Interest-bearing liabilities	5	80 050	82 800
Deferred taxation		3 600	3 600
Current liabilities		60 805	37 100
Trade and other payables		11 100	12 700
Current portion of interest-bearing liabilities	5	21 300	23 200
Bank overdraft		28 405	1 200
TOTAL EQUITY AND LIABILITIES		176 425	171 250

Notes

- Revenue declined by 10% in the 2009 financial year compared to 2008. Supremo did not increase annual or per kilometre charges to customers in 2009 and 2010 except for changes relating to diesel fuel price fluctuations.
- Details of the cost of sales are set out in the table below:

	2010 \$'000	2009 \$'000
Fixed costs		
Insurance, employee costs (truck drivers and workshop employees), vehicle licenses and workshop fixed overheads	32 920	33 990
Variable costs	33 200	42 830
Diesel fuel	20 580	25 730
Other variable costs (oil, maintenance, tyre replacement costs)	12 620	17 100
Total cost of sales	66 120	76 820

Diesel fuel prices decreased on average by 35% during the 2009 financial year. In 2010, diesel prices increased on average by 8%.

- 3 Operating and administrative costs are mainly fixed costs, with only 5% of these total expenses being variable in relation to revenue and activity levels in the 2009 and 2010 financial years.
- 4 Supremo owns the property in Harare from which it operates. The net book value and tax base of land and buildings at 31 December 2010 was \$17 120 000. The property was acquired in 2002 for \$19 million and a further \$1 million was immediately spent on refurbishing the premises. Buildings are depreciated to a zero residual value on a straight-line basis over 50 years (the depreciation charge for the 2010 financial year was \$360 000). At 31 December 2010 the net book value of the vehicle fleet was \$139 300 000 (2009: \$130 900 000).
- 5 Interest-bearing liabilities represent the balance outstanding on instalment sale agreements.

Reduction of the bank overdraft

The shareholders of Supremo have met to discuss plans of action to reduce the bank overdraft to \$5 million by February 2011. BWI has indicated that it has no cash resources available to subscribe for shares in Supremo or to advance a shareholder's loan to the company. Mr Parisse has in principle agreed to purchase the land and buildings owned by Supremo for \$30 million, which represents the fair market value. He has furthermore agreed to lease the property to Supremo for five years at a market-related rental of \$200 000 per month, subject to annual inflation escalations. The proceeds from the sale of the property will be used to reduce the company's bank overdraft.

QUALIFYING EXAMINATION 2011

PROFESSIONAL PAPER 1

QUESTION 1 REQUIRED		Marks
(a)	Calculate Mr Murphy's taxable remuneration income (not his tax liability) for the tax year ended 31 December 2010. In your solution you should provide brief reasons for the inclusion/exclusion of accruals, even in instances where in your opinion there is no tax effect.	6
(b)	Calculate Mr Murphy's taxable income from business operations (not his tax liability) for the tax year ended 31 December 2010. In your solution you should include brief reasons for the inclusion/exclusion of all accruals and/or expenses for the calculation of taxable income, even in instances where in your opinion there is no tax effect.	30
(c)	State what credits, if any, Mr Murphy is entitled to claim for the tax year ended 31 December 2010.	2
(d)	Calculate Mr Murphy's capital gains tax liability for the tax year ended 31 December 2010	4
(e)	Calculate Mr Murphy's VAT liability from business operations for the tax year ended 31 December 2010.	15
Presentation marks: Arrangement and layout, clarity of explanation, logical argument and language usage.		3
TOTAL MARKS		60
MONTHLY MOTORING BENEFITS		
Engine capacity	\$	
Up to 1500 cc	150	
1500 cc to 2000 cc	200	
2001 cc to 3000 cc	300	
3001 cc and above	400	

QUALIFYING EXAMINATION 2011

PROFESSIONAL PAPER 1

QUESTION 2 REQUIRED		Marks
(a)	Analyse and comment on the revenue and gross profit performance of Supremo in the 2009 and 2010 financial years. Calculate relevant ratios in support of your comments.	20
(b)	Identify and outline at least two possible actions that Supremo could take to return to profitability on a sustainable basis and at least two possible actions that Supremo could take to improve the cash flow generation of the business.	8
(c)	Critically discuss, from the perspective of Supremo, the proposed sale and leaseback of the land and buildings.	9
Presentation marks: Arrangement and layout, clarity of explanation, logical argument and language usage.		3
TOTAL MARKS		40