The Institute of Chartered Accountants of Zimbabwe

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QUALIFYING EXAMINATION

Part I
Professional Paper 2

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 and historical 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

You are an audit trainee on the audit of EZ-Appliances Holdings Ltd ('EZA'). Your firm was appointed as auditors on 31 March 2010 at the annual general meeting for the 2009 financial year. The financial year of the group ends on 30 September and the audit report for the year ended 30 September 2010 should be issued no later than 15 February 2011. All planning and field work on the EZA audit have been completed except for the audit procedures related to investments. You have been requested by the audit senior to audit investments and the following working papers, information and documentation have been provided to you to assist you:

A – 2 Extracts from 'Understanding the entity and its environment'

A – 3 Audit materiality

B – 1 Media release – *Reserve Bank of Zimbabwe (RBZ) closes the operations of Investa*

C – 1 Extracts from the investigator's report to RBZ

D – 1 Letter from Fortune Ltd's chief financial officer to the investigator of Investa

E – 1 Calculation of impairment losses of investments by EZA's financial director

Entity name: *EZA*	Prepared by: *C Lerk*	Year end: *30/09/10*	A-2
	Reviewed by: *S Enior*	Date: *06/04/10*	
Extracts from 'Understanding the entity and its environment'			

Nature of the entity

EZA is the holding company of a group of companies that sells and repairs appliances. It has three wholly owned subsidiaries:

- A low cost appliances business;
- An appliances maintenance business; and
- A top of the range appliances business.

For the year ended 30 September 2009 the group reported $100 million profit after tax. This was mainly attributable to an increase in revenue in the appliances maintenance business. During September 2009, the Audit and Risk Committee recommended to the board that $50 million should be invested through a fund manager in anticipation of future growth. Shortly thereafter EZA appointed Investa (Pvt) Ltd ('Investa'), a fund manager, to invest the funds on behalf of EZA. All investments are made in the name of EZA. On 1 October 2009, $50 million was invested through Investa. EZA will account for the underlying investments individually, and not as a portfolio. EZA has no other investments.

To establish a balance between risk and growth in investments, EZA gave Investa a specific mandate to invest in a range of instruments ranging from low to high risk instruments. The board, on recommendation of the Audit and Risk Committee, was very specific in stating that Investa may only invest in bonds, the money market and listed equity shares.

Entity name: *EZA*	Prepared by: *C Lerk*	Year end: *30/09/10*	A-3
	Reviewed by: *S Enior*	Date: *09/04/10*	
Audit materiality			

Audit materiality

The planning and final materiality figures were set at $3 million.

<table>
<tr><td>Entity name: EZA</td><td>Prepared by: C Lerk</td><td>Year end: 30/09/10</td><td rowspan="3">B-1</td></tr>
<tr><td></td><td>Reviewed by: S Enior</td><td>Date: 08/10/10</td></tr>
<tr><td colspan="3">Extract from media release</td></tr>
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MEDIA RELEASE

Monday 13 September 2010

Reserve Bank of Zimbabwe closes the operations of Investa

The Reserve Bank of Zimbabwe (RBZ) appointed Tick and Company as investigators into the affairs of Investa.

Investa was an authorised financial services provider in terms of the RBZ rules to provide certain specified services. However, on 1 September 2010 an investigation by the RBZ showed that the company had invested client funds outside the terms of its licence and beyond the scope of the mandates received from clients.

The RBZ consequently appointed Tick and Company to carry out a full investigation with the purpose of realising investors' investments as soon as possible with the minimum amount of loss to the investors.

Entity name: *EZA*	Prepared by: ***C Lerk***	Year end: ***30/09/10***	C-1
	Reviewed by: ***S Enior***	Date: ***04/01/11***	
Extracts from investigator's report			

EXTRACTS FROM THE INVESTIGATOR'S REPORT
TO THE RESERVE BANK OF ZIMBABWE CASE NO: 2875/10

INVESTA (PVT) LTD
REPORT OF THE INVESTIGATOR **15 December 2010**

We , Tick and Company, appointed as investigators to the abovementioned company under the abovementioned case number by the Reserve Bank of Zimbabwe, do hereby report as follows:

The following information relates to the cost (on investment date) of the instruments in which Investa (Pvt) Ltd invested on behalf of clients, as well as the latest information available for these instruments.

Investments invested in on behalf of EZ-Appliances Holdings Ltd:

Instrument	Cost of the instrument $	Notes
ZSE listed shares		1
• AB Ltd (110 000 shares)	10 936 000	
• CD Ltd (30 000 shares)	3 592 000	
Property investment company	19 000 000	2
Money market	2 000 000	3
Bonds in Fortune Ltd	14 472 000	4
Total	**50 000 000**	

Notes

1 The market value on 10 December 2010, before taking 2% transaction costs into account, was: AB Ltd: $105 per share and CD Ltd: $115 per share.

2 EZA has a 15% interest in an unlisted property investment company, which is currently developing a shopping mall in Harare. The property investment company has no other assets and is debt free. The mall is expected to be completed on 30 September 2012. On this date the property will be sold and the property investment company will be liquidated. The appointed valuator has indicated that she expects the property to realise $119 million when sold. She also stated that the fair return on similar investments is 10% per annum. The property currently generates no rental income. The valuator's report is available on request.

3 The balance as at 30 September 2010 was $2 200 000, confirmed telephonically with the financial institution.

4 At acquisition the bonds had a nominal value of $15 million. The cost price of the bonds was $14 400 000 and transaction costs of 0,5% were incurred. The coupon rate was 6% per annum and interest was payable on 30 September each year in arrears. The bonds were bought at a discount on 1 October 2009 because the coupon rate of 6% was slightly less than the fair market rate. These bonds were redeemable at par on 30 September 2014. Also see the attached letter (D-1) from Fortune Ltd for the latest information regarding these bonds.

Entity name: *EZA*	Prepared by: *C Lerk*	Year end: *30/09/10*	D-1
	Reviewed by: *S Enior*	Date: *04/01/11*	
Letter from Fortune Ltd			

FORTUNE LTD

15 October 2010

Dear Investigator, Tick and Company

RE: INTEREST PAYMENT NOT RECEIVED ON 30 SEPTEMBER 2010

Due to the economic crisis and cash flow problems experienced during the last few months, Fortune Ltd has been forced to take action. We are proposing to our bond holders to revise the terms of the bonds. The revised terms have been discussed with the majority of the bond holders who have indicated their support in principle.

The proposed arrangement has the following impact on the five year bonds of Investa (Pvt) Ltd (held on behalf of EZ-Appliances Holdings Ltd):

- The interest coupon of $900 000 that was due on 30 September 2010 will only be payable on 30 September 2011 (together with the other interest coupon due on 30 September 2011);
- From 1 October 2010 the coupon rate has been reduced to 3% per annum, payable at the end of each year (30 September) until the revised expiry date;
- The redemption date of the bonds has been postponed until 30 September 2019; and
- The bonds will be redeemable at a discount of 10% on the nominal value.

We will circulate the appropriate documentation to approve and implement this proposal in due course.

We trust that you will understand our current crisis. Please do not hesitate to contact us should you need any further information.

Mr J P Sadley

Chief Financial Officer
Fortune Ltd

Entity name: *EZA*	Prepared by: *C Lerk*	Year end: *30/09/10*	E-1
	Reviewed by: *S Enior*	Date: *04/01/11*	
Calculation of impairment losses			

EZ-APPLIANCES HOLDINGS LTD
Calculation of impairment losses of investments as at 30 September 2010
(Prepared by Mr A Count (financial director))

Instrument	Carrying amount before impairments	Current value	Difference	Notes
	$	$	$	
ZSE listed shares				1
• AB Ltd (110 000 shares)	9 350 000	11 319 000	1 969 000	
• CD Ltd (30 000 shares)	3 300 000	3 381 000	81 000	
Unlisted property investment company	19 000 000	17 850 000	(1 150 000)	2
Money market	2 200 000	2 200 000	–	3
Bonds in Fortune Ltd	14 472 000	13 717 494	(754 506)	4
Total	**48 322 000**	**48 467 494**	**145 494**	5

Notes

1 All listed shares are classified at fair value through profit or loss. The carrying amounts are the market values at 30 September 2010. The current values are the market values at 10 December 2010.

2 This investment is classified as available-for-sale. The current value was determined on the basis of the valuator's report referred to in the investigator's report dated 15 December 2010.

3 The funds in money market are available on demand, with no penalty clauses.

4 EZ-Appliances Holdings Ltd classified the investment in the bonds as held-to-maturity. The carrying amount is the cost of the bonds (including transaction costs). Please refer to the letter from Fortune Ltd (D-1) dated 15 October 2010 received by the investigator. The current value was determined by discounting all future cash flows over the revised remaining term at 3%, as indicated in the letter from Fortune Ltd.

5 The $145 494 impairment calculated above has been recorded in the profit or loss of EZA.

All the above investments have been measured at their 'current value' as per the table above in the financial statements for the year ended 30 September 2010.

Audit working paper note

Mr A Count has indicated that, as he believes his calculation of the impairment loss is correct, he is not willing to make any further adjustments in the final trial balance in respect thereof.

QUESTION 2 **40 marks**

Joule Ltd ('Joule'), a manufacturer and distributor of electric cars, is based in Zimbabwe. Joule has a dollar ($) functional currency. Joule has a foreign subsidiary, Watt Ltd ('Watt'), based in South Africa (SA), which is a retailer of electric cars. Watt has a SA rand (R) functional currency. Both companies have a 31 December financial year end.

Joule acquires ordinary shares of Watt

In the hope of penetrating the SA market, Joule purchased 1 600 000 of the 2 million issued ordinary shares of Watt for R7 million on 1 January 2008.

Following this acquisition, Watt was contractually required to exclusively sell electric cars manufactured by Joule. At the date of acquisition, Watt's inventory of electric cars had been purchased from another supplier. As Watt was not allowed to sell these electric cars, they were duly scrapped in Watt's financial records on 31 January 2008 at a negligible cost.

On 1 January 2008 –

- all Watt's identifiable assets and liabilities, with the exception of its inventory of electric cars, were fairly valued and recognised in its financial statements;
- (which is the date of acquisition), Watt's inventory was reflected at R2 240 000 in its records;
- the trade value (price at which the electric cars could be sold to another retailer) of the inventory of electric cars was R3 220 000. The retail value (price at which the electric cars could be sold to consumers) of this inventory was R3 430 000;
- Watt's share capital amounted to R280 000; and
- the non-controlling interest in Watt had a fair value of R1 610 000

Transactions between Joule and Watt

Joule began selling electric cars to Watt on 2 January 2008. All sales were for cash and were made at a 15% mark-up on cost. Joule sold electric cars to Watt for R7 245 000 in 2008 and R11 830 000 in 2009.

Details of sales of electric cars to Watt	Year ended 31 December 2008	Year ended 31 December 2009
	R	R
Opening inventory of electric cars acquired from Joule	–	869 000
Sales to Watt	7 245 000	11 830 000
Closing inventory of Watt	869 000	3 549 000*

*All inventories on hand at 31 December 2009 were sold during January 2010.

Joule sells ordinary shares in Watt

On 1 January 2010 Joule's management decided to reduce their interest in Watt due to insufficient demand for electric cars in SA. On 31 January 2010 Joule sold 1 million of its ordinary shares in Watt for R8 400 000 to Edison Plc. The 600 000 ordinary shares that Joule continued to hold had a fair value of R5 040 000 on 31 January 2010.

Watt issues preference shares

On 1 July 2010 Watt issued 3 000 redeemable cumulative preference shares at R7 000 each to third parties. The preference shares pay a coupon of 4% per annum and have a redemption value of R7 000 each. If declared, preference dividends are paid annually in arrears. On redemption any undeclared dividends are added to the redemption price including interest on the undeclared dividends at 4% per annum.

Other information

From 2008 to 2010 Joule and Watt had the following retained earnings balances and profits / (losses) in their individual company financial statements:

	Joule	Watt
	$	R
Retained earnings at 1 January 2008	321 000	6 860 000
Profit/(loss) for the year	(8 500)	2 170 000
Retained earnings at 31 December 2008	312 500	9 030 000
Profit/(loss) for the year	13 000	280 000
Retained earnings at 31 December 2009	325 500	9 310 000
Profit/(loss) for the year	144 000*	3 780 000**
Retained earnings at 31 December 2010	469 500	13 090 000

* An amount of $1 089 000 profit on the disposal of shares in Watt is included in the profit for the year.

** The profit for the year is stated before taking into account the preference dividends on the redeemable cumulative preference shares.

The following spot exchange rates were applicable (R : US $1):

1 January 2008	6,20
31 January 2008	6,40
31 December 2008	6,50
30 November 2009	6,70
31 December 2009	6,80
31 January 2010	7,20
31 December 2010	7,00

The following average exchange rates were applicable (R : US $1):

1 January 2008 to 31 December 2008	6,60
1 January 2009 to 31 December 2009	6,60
1 January 2010 to 31 January 2010	7,10
1 February 2010 to 31 December 2010	7,30
1 July 2010 to 31 December 2010	7,30

The following additional information is applicable:

- Both Joule and Watt earned all their profits evenly throughout each year;
- Neither Joule nor Watt declared any ordinary dividend between 1 January 2008 and 31 December 2010;
- Joule accounts for investments in subsidiaries at cost in its separate financial statements;

- Both Joule and Watt comply with International Financial Reporting Standards (IFRS);
- Joule applied IFRS 3 (revised 2008) to its acquisition of Watt. Joule elected to measure the non-controlling interest in Watt at fair value at the date of acquisition;
- The group's presentation currency is dollars;
- Goodwill arising on the acquisition of Watt has not been impaired; and
- The income tax rate is 25,75% in Zimbabwe and 28% in SA.

You may ignore the effect of deferred tax on the foreign currency translation reserve.

QUALIFYING EXAMINATION 2011

PROFESSIONAL PAPER 2

QUESTION 2 REQUIRED		**Marks**
(a)	Discuss and calculate the amount at which Watt's electric cars on hand at 1 January 2008 should initially be measured in the consolidated financial statements of the Joule group of companies.	7
(b)	With regard to the year ended 31 December 2010 – (i) calculate the total group profit or loss on the sale of its shareholding in Watt; and (ii) calculate the profit for the year that would appear in the group's consolidated statement of comprehensive income.	 19 12
Presentation marks: Arrangement and layout, clarity of explanation, logical argument and language usage.		2
TOTAL MARKS		**40**

QUALIFYING EXAMINATION 2011

PROFESSIONAL PAPER 2

QUESTION 1 REQUIRED		Marks
(a)	Describe the risks of material misstatement arising from the impairment calculation in respect of EZA's investment in Fortune Ltd bonds.	6
(b)	Prepare a memorandum to the partner in which you discuss and calculate the appropriate carrying amount of the Fortune Ltd bonds in the statement of financial position of EZA at 30 September 2010. Your memorandum should also discuss the proposed presentation following from this valuation of the bonds in the statement of financial position and statement of comprehensive income of EZA at 30 September 2010. For the purposes of preparing the memorandum your name is **A Trainee**.	20
(c)	Discuss the substantive audit procedures that the audit team should perform to assess the carrying amounts of the investments for impairment, the related statement of comprehensive income impacts and related disclosures. You should not discuss any audit procedures to be performed on the carrying amounts before impairments, as these have already been satisfactorily completed.	15
(d)	Discuss the obligations of the auditor with regard to communicating the issues identified in the audit of investments. Your solution should include a description of the content of the communication and to whom it should be addressed.	8
(e)	Calculate the uncorrected misstatements resulting from the audit of investments that you would include in your schedule of audit differences. In preparing your answer, consider inter alia the adjustments already recorded by Mr Count to the carrying amounts of investments at 30 September 2010.	7
Presentation marks: Arrangement and layout, clarity of explanation, logical argument and language use.		4
TOTAL MARKS		**60**