THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ZIMBABWE

The Institute of Chartered Accountants of Zimbabwe

QUALIFYING EXAMINATION

Part I
Professional Paper 4

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.

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 **68 marks**

Gateway Ltd ('Gateway') is a Zimbabwe company listed on the Zimbabwe Stock Exchange. The company develops, manufactures and markets a range of navigation, communication and information devices and applications, which are enabled by means of global positioning system (GPS) technology.

The company's mission is 'innovation and versatility through adversity' and it has continued to generate healthy margins despite the recent financial crisis and the impact it has had on the discretionary spending of its customer base.

The company operates in two markets:

- Fitness products: The main products include touch-screen outdoor handsets with integrated digital cameras, wireless workout courses and fitness watches designed for casual runners to elite tri-athletes; and
- Marine products: High-definition radar and transceiver systems for boats of all sizes.

The fitness products are mainly sold through a network of independent dealers and distributors in three geographical areas, namely Zimbabwe, the Middle East and North America, and account for approximately 50% of Gateway's revenue. The marine products are sold primarily to government agencies in Africa and the Middle East and account for 40% of Gateway's revenue (the remaining 10% consists of interest and dividend income).

Each geographical area reports to the relevant managing directors of the fitness and marine markets on that market's products. The two managing directors report financial and operating information of each market separately to Gateway's chief executive officer, who has been identified as the chief operating decision maker for the purpose of evaluating the performance and allocation of resources to the fitness and marine markets. There are no inter-market transfers or sales.

The board of directors of Gateway decided not to present segmental information in accordance with IFRS 8, *Operating Segments,* in the company's annual financial statements for the financial year ended 31 December 2010. The reason for the directors' decision was that they are of the opinion that the company has only one segment, namely 'the development, manufacture and marketing of a range of navigation, communication and information devices and applications'. Therefore, as this aggregated information is already presented in the annual financial statements, no additional segmental information needs to be provided.

You are completing your training contract as a trainee accountant with Gateway. You are assisting Gateway's chief financial officer, a qualified CA(Z), with the finalisation of the annual financial statements of Gateway for the year ended 31 December 2010.

The annual financial statements are to be presented to Gateway's Audit Committee on Monday 28 March 2011.

Additional information

1 Gateway has a functional currency of dollars ($).

2 Investments

2.1 Bear Ltd debentures

- Gateway acquired 2 000 Bear Ltd ('Bear') 10% debentures of $145 each on 1 January 2009 at a price of $140 each. The debentures are redeemable at par on 31 December 2012. Even though Gateway has the intention of holding these instruments until their maturity (or conversion) date, it has elected to classify the investments as available-for-sale in accordance with IAS 39, *Financial Instruments: Recognition and Measurement*.

  The following applies to the debentures:

Date	Fair value of each debenture	Market-related interest rate (the effective interest rate)
	$	%
1 January 2009	140,00	11,0
31 December 2009	67,12	13,0
31 December 2010	143,24	10,5

- Bear defaulted on the coupon payment due on 31 December 2009 because of liquidity problems which arose during December 2009 and which became public knowledge only with the default of the company's coupon payment.

- As these liquidity problems are likely to continue into the foreseeable future, Gateway considered the debentures to be impaired. On 5 January 2010 (prior to authorising Gateway's 2009 annual financial statements), Gateway and Bear agreed to restructure the remaining cash flows. Consequently the annual coupon receipt was reduced to $7 per debenture (amounting to a total reduced coupon receipt of $14 000)) at 31 December 2010 and the capital amount due on 31 December 2012 was reduced to $70 per debenture (amounting to a total reduced capital outstanding of $140 000).

- On 31 December 2010 Bear paid the reduced coupon of $7 per debenture owing on that date. On the same date the company announced that it had resolved its liquidity problems thanks to a recapitalisation by its parent company during 2010. It would accordingly resume payment of the original coupon of $15 per debenture ($30 000 in total) on 31 December 2011 and committed itself to redeeming the debentures at their original par value of $145 per debenture ($290 000 in total) on 31 December 2012.

- The value of Gateway's investment in Bear Ltd debentures at 31 December 2010 would have been $284 000 if carried at amortised cost and if no impairment loss had been recognised in the past.

3 Manufacturing equipment

3.1 Decision to construct a new machine (machine Z)

- On 20 December 2009 the directors of Gateway approved a decision to construct a new production machine. The construction of the machine was to be outsourced to Channel Plc ('Channel'), but ownership of the machine would vest in Gateway throughout the construction, assembly and testing period.

- Channel is a company based in the United Kingdom (UK) and therefore has a functional currency of pounds sterling (£). It is a world leader in the construction of specialised equipment of this nature.

- Gateway is able to view the specification of raw materials available from Channel, assemble them and integrate its own components into the design by means of computer-aided design software. This means that the company is able to construct a virtual prototype of its machine. This process design is delivered through a free web service and will inform the ultimate construction of the machine by Channel.

- The directors of Gateway are also aware of environmentally friendly components which are produced by Green Technologies Plc ('Green Tech') and which would be suitable for construction of a new production machine. These components would help to reduce Gateway's carbon footprint over time. Green Tech has a functional currency of £.

3.2 Construction of machine Z by Channel

On 1 January 2010 Gateway entered into the contract with Channel, in terms of which Channel would –

- construct, install and test the machine on Gateway's premises for a fixed price of £3 600 000, to be paid in two instalments:
  - An advance payment of £2 500 000 on 1 February 2010; and
  - The balance of £1 100 000 on the date that the machine is ready for use;

- commence construction once the environmentally friendly components have been received from Green Tech;

- as part of constructing the machine, be responsible for transporting the environmentally friendly components from their port of departure to Gateway's premises in Zimbabwe; and

- have completed the testing of the machine's readiness for use by 31 October 2010.

The payments to Channel were funded by means of a loan of £3 600 000 negotiated and drawn down fully on 1 February 2010. The loan (together with any interest owing) was repaid in full on 31 December 2010 and bore interest at a market-related rate of 5,8% per annum. Gateway was able to invest surplus funds in a UK bank account for a period of nine months at a rate of 2,5% per annum. Capital and interest on the invested surplus funds is receivable on maturity. If Channel had funded the loan in Zimbabwe, it would have incurred net financing costs (interest cost less interest income on surplus funds) of $373 300.

3.3 Cost schedule of Channel

Channel provided Gateway with the following cost schedule:

Costs	Cost incurred	Profit margin	Total amount	Notes
	£	£	£	
Raw materials (excluding the components purchased from Green Tech)	2 300 000	200 000	2 500 000	Incurred on 1 February 2010
Transportation costs of components purchased from Green Tech	20 000		20 000	Incurred on 15 February 2010
Labour costs and overheads to construct, assemble and test machine Z	980 000	100 000	1 080 000	Incurred evenly over the period 15 February 2010 to 31 October 2010
	3 300 000	300 000	3 600 000	

3.4 Components imported from Green Tech

On 1 January 2010 Gateway placed a non-cancellable order with Green Tech to purchase the environmentally friendly components. The components were shipped and risks and rewards transferred on 1 February 2010 and arrived at Gateway's premises on 15 February 2010. The cost of the components, amounting to £450 000, was paid on 1 February 2010 as per the order agreement.

a. Further information related to manufacturing equipment

- Gateway applies the cost model to manufacturing equipment.
- Machine Z is a qualifying asset in terms of IAS 23, *Borrowing Costs*.
- Machine Z was ready for use on 31 October 2010. At that date the machine was expected to have a useful life of ten years, with a residual value of $1 140 000.
- Gateway started using machine Z in its production processes on 1 December 2010.
- The company's policy is to include foreign exchange gains or losses only on foreign loans in financing costs.
- The impact of discounting creditors is immaterial.
- The following exchange rates were applicable:

Date	Spot rate 1£ : $
1 January 2010	1,50
1 February 2010	1,54
15 February 2010	1,53
31 October 2010 and 1 November 2010	1,60
31 December 2010	1,57
Average:	
• 1 February 2010 to 31 October 2010	1,56
• 15 February 2010 to 31 October 2010	1,55
• 1 November 2010 to 31 December 2010	1,58

4 Fleet vehicles of Gateway

The financial accountant of Gateway prepared the following depreciation schedule for the fleet vehicles (you may assume that the calculations are correct):

Fleet vehicles	$
Cost	360 000
Accumulated depreciation and impairment losses	(64 800)
Carrying amount at beginning of the year	295 200
Depreciation: 1 January to 30 June 2010 [(360 000 – 36 000/5 x 6/12]	(32 400)

There is no limitation on the recognition of deferred tax assets, as the company is expected to make sufficient taxable profit into the foreseeable future against which deductible temporary differences can be utilised.

The fleet of vehicles was purchased on 1 January 2009 at exchange rates approved by the Zimbabwe Revenue Authority (ZIMRA) for the purposes of calculating tax allowances. Depreciation is provided at 20% per annum using the straight-line method. The residual value was originally estimated and continues to be estimated at $36 000. ZIMRA granted a special initial allowance (SIA) of 50% in the year of purchase and a 25% wear and tear allowance on original cost in subsequent years.

On 1 July 2010 the fleet vehicles were sold and leased back for $288 000 (their fair value) in terms of a finance lease agreement. At the end of the 42-month term of the sale and leaseback agreement, ownership will be transferred to Gateway. The original estimated useful life of the asset remained unchanged. Lease instalments amounting to $8 400 are payable monthly in arrears, starting on 31 July 2010, at a nominal interest rate of 11,5% per annum.

The only entries that were passed in respect of this transaction were as follows:

	Debit	**Credit**
	$	**$**
Bank	288 000	
Lease liability		288 000
Receipt of cash on sale and leaseback		
Lease liability ($8 400 x 6)	50 400	
Bank		50 400
Lease instalment paid		

QUESTION 2 **32 marks**

You are a tax consultant and one of your clients is Midlands (Pvt) Ltd ('Midlands'), a Zimbabwe registered company, which owns a licensed hotel.

Midlands entered into a contract with another Zimbabwe registered company, Nashen (Pvt) Ltd ('Nashen'), to provide accommodation and meals on a bed and breakfast basis to some of its employees for a six-month period.

During September 2010 these employees, after having stayed at the hotel for only two months, absconded after causing extensive damage to the hotel rooms that they had occupied.

Midlands sought legal advice on the matter and based on this advice, threatened to sue Nashen unless it settled a claim for damages amounting to $600 000.

This claim consisted of the following:

	$
Meals and accommodation	170 000
Damage to the hotel rooms	230 000
Loss of goodwill which Midlands had suffered as a result of the events that led to the claim	200 000
Total claim	600 000

On 15 November 2010 the parties agreed to settle the matter out of court and Nashen paid Midlands $300 000. In return, Midlands undertook to abandon first any rights it may have had for damages and second any pending or contemplated court action against Nashen.

The parties agreed that the $300 000 represented 50% of each of the three items in the original claim.

During the year ended 31 December 2010 Midlands had the following additions to its fixed assets:

	$
A second-hand Toyota Venture vehicle purchased in May 2010 to be used as a courtesy car, costing	12 000
An industrial washing machine which was delivered on 31 December 2010 but was only connected in the laundry on 3 January 2011, costing	1 320
A tennis court constructed in April 2010 at a cost of	5 200

All other assets owned by the company had been fully depreciated and had a nil income tax value on 1 January 2010.

The company presented the following income and expenditure account for the year ended 31 December 2010 to you:

	Notes	$	$
Income			
Revenue from accommodation, meals and liquor sales			2 250 000
Payment from Nashen			300 000
Dividend from a local company			1 200
Expenditure			
Allowable expenditure, electricity ,water, rates, salaries, wages, etc.		550 000	
Entertainment	2	2 670	
Provision for specific bad debts which had all been incurred during the year		5 675	
Provision for specific directors' fees to be voted in January 2011		4 000	
Provision for additional repairs to be carried out in 2011		36 220	
Provision for plumbing costs		145	
Legal fees	3	550	
Repairs to rooms damaged by Nashen's employees		112 000	
Loan interest	1	2 860	
Total expenditure		714 120	
Profit for the year		1 837 080	
		2 551 200	2 551 200

Notes

1 The interest on loans was used as follows:

	$
To fund general working capital	1200
To pay a dividend declared to shareholders	600
To purchase shares in a local company	1060
	2860

2 Entertainment

	$
Entertainment allowance paid to managing director	1440
Entertainment of overseas travel agents	1230
	2670

3 Midlands incurred legal expenses, occurred while obtaining advice on the Nashen claim:

	$
Claim for meals, accommodation and damage to property	300
Claim for goodwill lost	250
	550

QUALIFYING EXAMINATION 2011

PROFESSIONAL PAPER 4

QUESTION 1 REQUIRED		**Marks**
(a)	Indicate, with supporting reasons, whether the decision by the board not to produce a segmental report in its annual financial statements ended 31 December 2010 is appropriate.	7
(b)	Calculate the amounts to be included in the statement of comprehensive income of Gateway for the financial year ended 31 December 2010 relating to – (i) the investment in Bear Ltd debentures; and (ii) machine Z and its related funding. • Assume that Gateway presents a single statement of comprehensive income as allowed by IAS1.81(a), *Presentation of Financial Statements*. • Clearly differentiate between items affecting profit or loss and those affecting other comprehensive income (if any). • Ignore comparative figures and all forms of taxation.	41
(c)	Prepare an extract of the statement of financial position of Gateway for the year ended 31 December 2010 for all the applicable line items in connection with the fleet vehicles. • Ignore comparative figures. • You are not required to disclose the current tax payable and cash and cash equivalents. • In your answer you should consider the impact of income tax.	15
Presentation marks:	Arrangement and layout, clarity of explanation, logical argument and language usage.	5
TOTAL MARKS		**68**

QUALIFYING EXAMINATION 2011

PROFESSIONAL PAPER 4

QUESTION 2 REQUIRED		Marks
(a)	Discuss, in the form of a list and with reference to case law and legislation, whether the payment from Nashen is wholly or partially subject to income tax.	7
(b)	Prepare an income tax computation for the year ended 31 December 2010, commencing with profit for the year of $1 837 080, and calculate the company's normal tax liability, if any. In your solution you should give brief reasons for the inclusion/exclusion of accruals and expenditure.	19
(c)	State the dates when any tax liability should have been paid.	4
Presentation marks: Arrangement and layout, clarity of explanation, logical argument and language usage.		2
TOTAL MARKS		**32**