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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ZIMBABWE

Initial Test of Competence Professional Paper 1

JUNE 2014

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 are not intended to reflect the reality of the Zimbabwean economy. Hence reference to exchange rates, interest rates, return on capital, 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

QUESTION 1 **100 marks**

Ignore Value-Added Tax (VAT).

You are a trainee accountant assigned to the statutory audit of GasCom Ltd ('GasCom') for the reporting period ended 31 December 2013. GasCom was incorporated in Zimbabwe in 1975. It was listed on the Zimbabwe Stock Exchange in 1997, followed by a secondary listing on the Botswana Stock Exchange in 2003. GasCom has established itself as the leading distributor of liquefied petroleum gas (LPG) in and around the Southern African region and supplies a wide range of customers from various sectors, including mining, manufacturing, heavy industry, healthcare and hospitality.

The government considers LPG to be a sustainable and clean alternative cooking and lighting fuel that provides poor communities in Zimbabwe with an opportunity to move away from traditional coal, paraffin and candle fuel and light sources that pose inherent safety risks. Considerable investment is required to introduce LPG throughout the country and for GasCom to obtain sufficient market penetration within these communities.

LPG is a by-product of the oil refining process and GasCom purchases LPG from various refineries across Zimbabwe. When shortages are anticipated, GasCom imports LPG to help stabilise the market and to ensure that customer access to LPG is maintained. Importing LPG is an expensive alternative and is only resorted to in limited circumstances. After purchase, the LPG is stored by GasCom in bulk tanks at their facilities. The LPG, which is stored as a liquid and is measured in kilograms, is then bottled and marketed in cylinders of various sizes (e.g. 4,5kg cylinders, 9kg cylinders and 19kg cylinders).

The senior trainee accountant requested your assistance with the following matters relating to the audit of GasCom:

Sale of LPG

The sale of LPG in Zimbabwe is monitored and regulated by the Department of Energy (DoE). The DoE manages all energy matters in Zimbabwe and is responsible for the setting of selling prices for LPG. The DoE accordingly instituted the following LPG rebate system to govern the revenues generated by gas companies in Zimbabwe:

> *'During the course of each calendar year, gas companies are allowed the discretion to determine the prices at which they wish to sell LPG to consumers during that year. The industry has many suppliers and thus normal market and competitive forces drive the price at which LPG is supplied to consumers.*
>
> *In terms of the rebate system, at the end of that calendar year, the DoE will perform a review of the LPG price and determine an acceptable selling price based on a number of variables, including international crude oil prices, exchange rates and consumer price inflation data. This price is published in the Government Gazette.*
>
> *Consumers of LPG who purchase more than a certain quantity of LPG per annum are able to register with the DoE as registered consumers. Registered consumers who wish to claim rebates under the rebate system are required to retain proof of all LPG purchased from gas companies during the year. If the price paid by the registered consumer exceeds the gazetted price determined at each year end, the consumer will qualify for a cash rebate from the DoE.*

The DoE will recover the cost of these rebates from each gas company as part of that company's annual licence fee for the next year.'

GasCom's policy is to recognise revenue on the basis of actual prices charged to customers and the effect of any rebates is reflected as an expense upon receiving the annual licence fee invoice from the DoE.

GasCom's current selling price of LPG amounts to \$3,50 per kg, which includes a 10% deposit for the returnable gas cylinder. Thus GasCom collects a deposit for each cylinder delivered to the customer and is required to refund this deposit when the cylinders are returned by customers. Experience has shown that 90% of all cylinders are returned by customers. Disruptions in the supply of LPG from the refineries during the 2013 winter months resulted in GasCom only selling and distributing 1 400 000 kg of LPG to customers and subsidiaries in the 2013 financial year ('FY2013').

Table 1 shows some of the expenditure incurred by GasCom during FY2013 year:

Table 1		
Description	**Note**	**\$'000**
Depreciation and impairment – returnable cylinders	1	910
Raw material	2	To be determined
Storage costs	3	470
Depreciation on vehicles and other overheads	4	2 630
Import of pre-filled cylinders	5	580

Notes

1 Returnable cylinders in circulation are recorded as part of property, plant and equipment at cost, net of accumulated depreciation and impairment losses. Returnable cylinders are not derecognised upon the sale of the goods. The stock control of these cylinders is one of the major management requirements of GasCom's business. This is to ensure that there are enough cylinders in circulation and that sufficient back-up stock exists. GasCom continually liaises with its customers about all aspects of cylinder management. Systems were introduced to optimise the efficient management and control of cylinders.

GasCom's internal audit function regularly reviews the company's cylinder management systems. GasCom currently has sufficient cylinders in circulation to bottle approximately 1 650 000 kg of LPG per annum. In addition, it retains a back-up stock of cylinders at its storage sites sufficient to bottle approximately 350 000 kg of LPG per annum.

The costs of the cylinders are depreciated to their residual values over their estimated useful lives. Impairment is recognised against the carrying amounts of the cylinders for breakages and losses that occur during the normal course of business.

2 Raw material comprises LPG sourced from refineries. There were 450 000 kg of LPG in bulk tanks and filled cylinders on hand on 1 January 2013 with a carrying amount of \$1 080 000. Purchases for FY2013 amounted to 1 300 000 kg at \$1,20 per kg. A proportion of LPG is lost in transit from the refinery to delivery at company premises through spillage and leakage. During the 2013 financial year, GasCom's losses through such spillage and leakage were 5% (the industry standard).

3 Storage costs comprise costs to store empty cylinders, filled cylinders and the LPG in bulk tanks:

Description	$'000
Empty cylinders	110
Filled cylinders	70
LPG in bulk tanks	290

4 Depreciation on vehicles relates to tankers and delivery trucks. The tankers transport the gas from the refineries to GasCom's bottling facilities, while delivery trucks are used to transport cylinders to and from customers.

Description	$'000
Depreciation of tankers	950
Depreciation of delivery trucks	230
Bottling overhead costs	1 450

5 To avoid winter shortages, which have occurred for several years, it has become necessary for GasCom to import additional supplies. The company recently invested in 20 000 new 9kg cylinders, most of which were pre-filled to eliminate supply chain bottlenecks. These new pre-filled cylinders were shipped free on board from Australia on 20 December 2013 and arrived at the Harare plant on 13 January 2014. This is expected to improve GasCom's ability to serve its customers in winter, but will result in margin erosion given the increased costs.

The expenditure was made up as follows:

	$'000
LPG content (180 000 kg)	324
Cylinders (20 000 units)	160
Shipping and forwarding costs	96
Total	**580**

At 31 December 2013, GasCom had the following on hand (excluding the imported pre-filled cylinders referred to in note 5):

	Quantity
Empty cylinders on hand	50 000 units
LPG in bulk tanks	150 000 kg
LPG in cylinders	135 000 kg

GasWest

As part of GasCom's strategy to expand its footprint in Africa, the company acquired 100% of a gas distribution company situated in Ghana during the previous financial year. This company, called GasWest Ltd ('GasWest'), is a distributor of LPG in Ghana, and GasCom believes that this investment provides excellent growth opportunities not only in Ghana, but also into the rest of West Africa. GasWest has a functional currency of Ghana Cedi (GHS).

In order to stimulate foreign investment in the group, GasWest issued 100 000 call options on the shares of GasCom on 1 September 2012. The call options were purchased by various local banks in Ghana. In terms of the call option contract the holder of each option has the right to purchase two shares in GasCom in three years' time (on 1 September 2015) for GHS2,00 per share. To ensure that such shares are available to option holders who exercise their rights under the option, GasWest will purchase GasCom shares on the open market.

All the approvals necessary to issue the options and to purchase the shares on exercise of the options have been obtained.

The senior trainee accountant has indicated that he believes the written call options should be accounted for as financial liabilities in the separate financial statements of GasWest and as equity instruments in GasCom's consolidated financial statements.

Investment in the KenyaGas Energy Company

GasCom purchased 80% of the shares in the KenyaGas Energy Company Ltd ('KenyaGas') on 1 January 2012 for 30 million Kenyan shillings (KES), thereby obtaining control over KenyaGas from that date. KenyaGas is a gas distribution company situated in Kenya. GasCom sold 25% of the total number of shares in issue in KenyaGas on 31 December 2013 for KES15 million. At that date the fair value of the remaining 55% shareholding amounted to KES40 million. KenyaGas has a functional currency of Kenyan shillings.

Information about KenyaGas

The annual increases in retained earnings since 1 January 2012 are as follows:

	KES
1 January 2012 to 31 December 2012	13 000 000
1 January 2013 to 31 December 2013	12 500 000

The fair value of the identifiable assets and liabilities was determined as KES32 200 000 on 1 January 2012 in terms of IFRS 3, *Business Combinations*. This fair value includes the liability for the following claim:

- On 30 November 2011 a gas explosion occurred at a restaurant in Nairobi. The owner of the restaurant instituted a claim against KenyaGas, arguing that the KenyaGas cylinder on his premises was defective and caused the explosion.

- The amount of any settlement will be tax deductible in Kenya. The Kenyan general corporate income tax rate is 30%.

- The fair value of the claim was determined as KES4 million on 1 January 2012.

The following occurred after GasCom's acquisition of KenyaGas:

- KenyaGas settled the claim relating to the restaurant explosion on 30 November 2013 for KES7 500 000.

- GasCom extended a loan of $300 000 to KenyaGas on 1 January 2012. The loan is denominated in Kenyan shillings and bears interest at a rate of 11% per annum. This was a market-related interest rate on 1 January 2012. The interest is due annually in arrears on 31 December. The interest payments were settled on their due dates. The loan currently has no repayment date and GasCom considers the loan to be part of its net investment in KenyaGas.
- From 1 December 2012 KenyaGas acquired all its LPG from GasCom. This arrangement is part of GasCom's immediate strategy to obtain a market presence and

also to establish itself as a trusted supplier in Kenya. In the long term, it is envisaged that manufacturing and bottling facilities will be built in Kenya. However, commencement of the construction of these facilities has been hampered by a lack of the necessary infrastructure and local expertise, as well as rising costs. Construction of a facility in Nairobi, the capital of Kenya, has been on hold since March 2013 because the site that was earmarked was close to the area where a multi-storey building under construction collapsed on 29 March 2013.

- Total purchases from GasCom during December 2012 amounted to KES32 million, of which 40% remained unsold on 31 December 2012 (all this LPG had been sold by 31 December 2013). The total cost to GasCom of the LPG sold to KenyaGas during December 2012 amounted to $200 000.

- Total purchases from GasCom throughout the 2013 financial year amounted to KES36 million, of which 25% remained unsold on 31 December 2013. The total cost to GasCom of the LPG sold to KenyaGas during the 2013 financial year was $200 000.

- The following exchange rates apply:

	Average exchange rate USD : KES
1 January 2012	1 : 111
Average for 2012	1 : 107
Average for December 2012	1 : 106
31 December 2012	1 : 105
Average for 2013	1 : 99
31 December 2013	1 : 88

* USD = United States dollar.

- KenyaGas has no reserves other than retained earnings. There have been no movements in the stated capital since 1 January 2012.

- KenyaGas is audited by the Kenyan medium-sized audit firm, Walter & Partners, which has no affiliation with your audit firm.

Additional information

- GasCom uses the weighted average cost formula, calculated on an annual basis, to determine the cost of inventories.

- Overhead costs of GasCom are allocated based on kilograms of LPG.

- GasCom has a functional and presentation currency of United States dollar.

- GasCom elects to carry investments in subsidiary companies in its separate financial statements at cost in terms of IAS 27, *Separate Financial Statements*.

- Non-controlling interest is measured at the proportionate share of the net asset value at acquisition.

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INITIAL TEST OF COMPETENCE, JUNE 2014

PROFESSIONAL PAPER 1

ZL 54

QUESTION 1 – REQUIRED		Marks	
		Sub-total	**Total**
(a)	Draft a memorandum to the senior trainee accountant in charge of the GasCom audit in which you – (i) discuss and conclude whether you agree with the manner in which GasCom accounts for the DoE's LPG licence fee resulting from the consumer rebate; and (ii) discuss the appropriate recognition and measurement of the deposit received from customers in relation to the returnable gas cylinders in the financial statements of GasCom.	15 12	
	Communication skills – logical argument; clarity of expression	2	29
(b)	Calculate the cost of LPG inventories in terms of IFRS as it would appear in the statement of financial position in the separate financial statements of GasCom for the financial year ended 31 December 2013. Your workings should, with regard to each expenditure item as set out in table 1, indicate reasons for your decision to either include or exclude it from the cost of LPG inventories.	19	19
(c)	Discuss whether you agree with the classification of the call options issued by GasWest on 1 September 2012 as equity instruments in the consolidated financial statements of the GasCom group.	7	
	Communication skills – clarity of expression	*1*	8
(d)	Provide the pro forma consolidation journal entries that should be processed by GasCom to account for KenyaGas in its consolidated financial statements for the financial year ended 31 December 2013.	33	
	Communication skills – presentation	*1*	34
(e)	List the audit procedures you would perform to audit the existence and valuation of returnable cylinders reflected in the separate financial statements of GasCom at 31 December 2013. You may assume that the work of the internal audit function can be used for audit purposes, where appropriate.	9	
	Communication skills – clarity of expression	*1*	10
Total			**100**

60 65

>50% 5