

CAM's Copy



Initial Test of Competence Professional Paper 3

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

QUESTION1

100marks

You are a trainee accountant at Zimbabwe Auditors ('Zima'), a medium-sized firm of Registered Auditors. Early in 2013, Zima acquired and implemented new sophisticated auditing software, ElecAud/IT, on which you have been trained, to ensure that Zima delivers audits of high quality.

You are a member of the team assigned to the audit of Zimbabwe Green Energy Ltd ('Zimgel'), a dominant player in the wind energy industry in Zimbabwe, for the year ended 31 December 2013. Mr Victor Shabangu is the senior audit manager, Mr Kobus Lubbe is the engagement director and Mr Alwyn Light is the engagement quality control reviewer. Zimgel became a client of Zima for the first time early in 2013.

Mr Shabangu recently forwarded the following to you:

- 1 An email that Mr Light sent to Mr Lubbe;
- 2 An electronic work paper related to the auditor's understanding of Zimgel (work paper A100); and
- 3 An article relating to Zimgel which was published in *The Times on Sunday*, 1 December 2013.

These three documents are attached below.

To: Victor.Shabangu@Zima.co.zw
From: Kobus.Lubbe@Zima.co.zw
Date: 15 January 2013
Subject: <Forward> Zimbabwe Green Energy Ltd 2013 audit

For your information.

Best wishes, Kobus

To: Kobus.Lubbe@Zima.co.zw
From: Alwyn Light@Zima.co.zw
Date: 15 January 2013

Dear Kobus

Well done on winning Zimgel's Audit Committee over and getting them to appoint Zima as the new Registered Auditor for the company's 2013 financial statements. This is a massive contract and we can sure do with the extra revenue, especially after Zima lost the audit of Elect (on which you were the engagement partner for the past four years). With hindsight, it is a pity that Zima had let go of so many staff after losing the Elect audit – we could surely use them now!

This contract will give our firm's revenue a nice boost despite the lower than usual audit fee that you offered to Zimgel. I must compliment you on taking the initiative to ensure that our quote is so competitive – it's certainly going to pay off in the future.

I know you are currently under tremendous pressure with your large client portfolio, so don't worry too much about getting the engagement letter issued to Zimgel and signed. It's just a formality that can be attended to later. I know Mike Moller (CEO of Zimgel) very well and I will speak to him regarding this. He is married to my wife's sister☺.

Our firm's CEO told me that Zima's executive committee members (Zima Exco) were not impressed with the fact that Elect had fired us, especially after we had cut our costs so drastically to meet their budget for audit fees. Apparently Elect's CEO hinted in the press that the entity changed auditors due to dissatisfaction with the professional services provided by their outgoing auditors. I think he is simply ungrateful. They could have used our firm's deep understanding of the energy industry to help Elect in a significant way with their business strategies and growing their renewable energy business.

Luckily, you can now use your knowledge of Elect's planned business strategies and of the energy industry to help Zimgel to attain a competitive advantage. At the same time, you will be able to reduce audit hours as you will know where to scratch and where to turn a blind eye. In the process you will be able to change the Zima Exco's perceptions of your value to the firm – remember the Zima Exco is really emphasising that we have to cut costs and increase our firm's profits. Also remember that the Zima Exco hinted that lucrative bonuses will be paid to all directors of the firm based on efficiencies in audit time and an increase in the firm's profit.

Regards, Alwyn

Quality Assurance Director: Zimbabwe Auditors

We guarantee success in everything we do, at the best prices ...

Consider the environment before printing this email.

2 ELECTRONIC WORK PAPER

| Understanding the entity and its environment | | | A100 |
|---|--|--|-------------|
| Client: Zimbabwe Green Energy Ltd | Prepared by: James Nkosi | Original date prepared: 15 March 2013 Updated date prepared: 10 January 2014 | |
| Year ended: 31 December 2013 | Reviewed by: Victor Shabangu | Original date reviewed: 10 December 2013 Updated date reviewed: 15 January 2014 | |

2.1 Background information / company vision

Zimgel is a Zimbabwean incorporated company which is listed on the Zimbabwe Stock Exchange. Zimgel specialises in the generation of electricity from renewable sources, which is then sold to Zimbabwean customers. Zimgel's vision is to position itself as a world leading renewable energy supplier by the end of 2020, with a Zimbabwean market share of 85% of the renewable energy supply.

Zimgel is a leader in the area of research and development of renewable energy sources in Zimbabwe. Renewable energy generation is still underdeveloped in Zimbabwe due to the huge research and construction costs that have to be incurred and the possible adverse effects wind farms could have on bird life. Zimgel is the only company in Zimbabwe that has a fully operational wind farm, situated at Shurugwi. Zimgel generates 95% of the wind powered electricity in Zimbabwe at this wind farm. This amounts to 1 000 megawatts (MW) of electricity per year.

The industry in which Zimgel operates is highly competitive and heavily regulated. The directors have acknowledged that they do not have in-depth knowledge of the legislation that applies to the industry.

Wind farms utilise wind to produce electricity. Numerous wind turbines are spread over a large area of land. The turbine blades are turned by the wind, which then turns an electrical generator, generating electricity. The minimum wind speed needed to generate electricity is 16km/h.

Globally, market participants in the energy sector are experiencing significant pressure to decrease their carbon footprint and to participate in the research and development of alternative sources of electricity.

2.2 Governance

(a) Ownership

The issued share capital of Zimgel is held as follows:

- 49% by UK Green Energy Plc. ('UGE'), a company that is listed and incorporated in the United Kingdom;
- 15% by Zimbabwe Government SOC Ltd ('Zimsoc'), a state-owned company incorporated in Zimbabwe;
- 10% by the Zimbabwe Green Trust, a community trust registered in Zimbabwe; and

- 26% by Zimbabwe Renewable Green Energy (Pvt) Ltd ('Zimgreen') a consortium of experts dedicated to providing clean, renewable energy to the people of Zimbabwe.

(b) Members of the board of directors

- Mr Mike Moller (chief executive officer and chairperson of the board);
- Ms Louise Naidoo (company secretary);
- Mr Gerhard Butler (chief financial officer);
- Mr Frik Eloff (human resource director);
- Dr Gerhard van Jaarsveld (non-executive director and deputy chairperson of the board); and
- Three independent non-executive directors:
 - Ms Riki Mholato;
 - Ms June Madibo; and
 - Ms Kate Middleton.

(c) Audit Committee members

- Ms Riki Mholato (chairperson);
- Mr Ismail Mohammed;
- Ms June Madibo; and
- Ms Kate Middleton.

Ms Middleton is a CA(Z) and sister-in-law of Mike Moller. She advised the board that co-opted members of the Social and Ethics Committee, who are not directors of Zimgel, will not be able to attend the company's general shareholders' meeting (to be held on 10 January 2014). Mr Moller agreed with her.

2.3 Financial information

| | 31/12/2013 | 31/12/2012 |
|-------------------------|----------------------------|-------------------|
| | Management accounts | Audited |
| | \$ | \$ |
| Current assets | 4 750 000 | 115 875 000 |
| Current liabilities | (286 234 272) | (86 520 548) |
| Net loss after taxation | 302 683 219 | 71 852 740 |

Zimgel is experiencing liquidity problems and is reliant on large amounts of loan funding from its investors and bankers. The liquidity problems are mainly due to the large capital amounts (of close to \$100 million) which were paid out of the company's overdraft facility. Management pointed out that the company is still in its growth phase. Management has no formal plan in place to decrease losses other than to complete the new Chegutu wind farm. Feasibility studies have shown that the Shurugwi and Chegutu wind farms will each make a profit over the 20 years of their lifespans. Wind farms generally only become profitable after ten years' of operation.

2.4 Capital expenditure

(a) Shurugwi wind farm

The Shurugwi wind farm consists of 400 wind turbines across 182 km² which is currently running at full capacity. Each wind turbine has the capacity to generate 2,5 MW of electricity per year. Additional wind turbines have to be constructed to increase capacity. The Shurugwi wind farm was completed at the end of December 2011 and was financed by means of a loan from UGE. The loan is subject to the following condition: For the duration of the loan, the current ratio of Zimgel, at each financial year end, may not be less than 1:1. UGE has entered into a subordination agreement with Zimgel in respect of this loan.

(b) Chegutu wind farm

Since December 2011 Zimgel had been searching for a suitable site south of Harare to use as a wind farm. On 3 April 2013 Zimgel purchased 95 km² of land in the area from the Darlington Family Trust for \$15 million, despite it having a market value of only \$12 million (as determined by an independent valuer appointed by Zimgel).

The trustees of the Darlington Family Trust are Mr Mike Moller and Ms Simphiwe Louw. The beneficiaries are Mr Mike Moller's wife, Ms Zelda Moller and Dr Gerhard van Jaarsveld (father of Ms Zelda Moller). The purchase of the land was approved at the directors' meeting held on 28 March 2013. Mr Moller and Dr van Jaarsveld did not vote on this transaction as they disclosed their links with the Darlington Family Trust before the transaction was approved.

To construct the wind farm, Zimgel has been importing all the turbines from a Chinese supplier and has contracted R&M Constructions (an unrelated third party) to undertake the necessary construction work on site. Construction on the Chegutu wind farm commenced on 19 April 2013, after approval for this was granted by the Department of Energy on 10 April 2013.

Zimgel is currently undertaking research into the production of solar energy in Zimbabwe on the Chegutu wind farm. The research commenced on 7 May 2013 and management capitalised these costs as an intangible asset.

According to the CFO, the following capital expenditures were incurred on the Chegutu wind farm during the 2013 financial year:

| | \$'000 |
|--|-----------|
| Land | 15 000 |
| Construction of 50 of the planned 200 imported wind turbines | 250 000 |
| Cost of turbines | 200 000 |
| Construction costs – R&M Constructions | 50 000 |
| Less: Government grant | (30 000) |
| Security fencing around the farm | 14 800 |
| Research costs | 16 000 |
| | 265 800 |

Energy Watch International, an environmental organisation, has said that the production delays at the Elect coal-fired power plant indicate that Zimbabwe desperately needs to focus its energy production on renewable sources. Elect announced last Monday that the plant would not be productive in 2014 as planned and pushed back the operational date to 2018. A shortfall in electricity supply is anticipated due to this delay.

This comes after municipalities across Zimbabwe expressed their willingness to buy a minimum base load of 3000 MW per year from renewable energy source companies in Zimbabwe, at above market prices, in order to cut out unreliable electricity supply from Elect. This should encourage other market participants to enter the market, in the process eliminating the monopoly that Elect has in Zimbabwe.

'It is time for the authorities and Elect to rethink the entire electricity paradigm, and begin the transition away from coal towards renewable energy and energy efficiency. This is the only sustainable path towards ensuring access to electricity for all Zimbabweans,' announced Greenpeace Africa in reaction to Elect announcement of the delays.

Renewable energy production is growing

rapidly around the world and will be the second biggest source of electricity, after coal, by 2016, according to a five-year outlook published by the *International Energy Agency*.

Internationally, renewable energy demand is expected to increase annually by 60% during the next five years.

On a visit to Zimbabwe on Tuesday, officials from a number of East European countries outlined agreements that will result in those countries investing \$30 billion in Zimbabwe, to be used exclusively for renewable energy research, development and production.

In 2013, Zimbabwe produced 82 472 MW of electricity from various sources, of which wind power was the smallest contributor. Electricity demand in Zimbabwe will increase every year from 2014 to 2020.

Large capital investment is required by market participants to stimulate growth in renewable energy sources. The Zimbabwe government indicated that Zimbabwe Green Energy Ltd could potentially be in line for a significant portion of these funds, because this firm has great potential and is one of only a handful of companies in Zimbabwe focusing on renewable energy sources.



INITIAL TEST OF COMPETENCE, JUNE 2014

PROFESSIONAL PAPER 3

The required section of this question consists of two parts. Answer each part in the correct answer book.

| PART II – REQUIRED | | Marks | |
|--------------------------|--|-----------|------------|
| | | Sub-total | Total |
| (b) | Discuss, with reasons, the impact of the information contained in Mr Light's email on the likely quality of Zima's audit of the 2013 financial statements of Zimgel. | 10 | |
| | <i>Communication skills – logical argument</i> | 1 | 11 |
| (c) | Prepare a memorandum to the Audit Committee of Zimgel in which you describe any non-compliance and potential non-compliance by Zimgel with the King Code of Governance, and the King Report on Governance. | 15 | |
| | <i>Communication skills – presentation</i> | 1 | 16 |
| (d) | Describe the substantive procedures that Zima should perform in respect of all the capital expenditures incurred by Zimgel in 2013 on the Chegutu wind farm. | 34 | |
| | You should ignore audit procedures relating to – <ul style="list-style-type: none"> • depreciation or impairments of the capital expenditures; and • taxation. <i>Communication skills – clarity of expression; presentation</i> | 2 | 36 |
| Total for part II | | | 63 |
| TOTAL | | | 100 |



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PROFESSIONAL PAPER 3

The required section of this question consists of two parts. Answer each part in the correct answer book.

| PART I – REQUIRED | | Marks | |
|-------------------------|--|-----------|-----------|
| | | Sub-total | Total |
| (a) | Identify and describe Zimgel’s key strengths, weaknesses, opportunities and threats. | 35 | |
| | <i>Communication skills – clarity of expression; layout and structure</i> | 2 | 37 |
| Total for part I | | | 37 |

Continued



INITIAL TEST OF COMPETENCE, JUNE 2014
PROFESSIONAL PAPER 3

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