NOVEMBER 2019

FINAL STAGE

Q & A

C1 - Corporate Reporting

C2 - Auditing and Assurance Services

C3 - Business and Corporate Finance

C4 - Advanced Taxation

NATIONAL BOARD OF ACCOUNTANTS AND AUDITORS

NOVEMBER 2019
Q & A

FINAL LEVEL

Contents

EXAMINATION	**:**	**FINAL LEVEL**
SUBJECT	**:**	**CORPORATE REPORTING**
CODE	**:**	**C1**
EXAMINATION DATE	**:**	**WEDNESDAY, 30TH OCTOBER, 2019**
TIME ALLOWED	**:**	**THREE HOURS (9:00 A.M. – 12:00 NOON)**

GENERAL INSTRUCTIONS

1. There are **TWO** Sections in this paper. Sections **A** and **B** which comprise of **SIX** questions.
2. Answer question **ONE** in Section **A.**
3. Answer **ANY THREE** questions in Section **B.**
4. In total, answer **FOUR** questions.
5. Show clearly all your workings in the respective answers where applicable.
6. Calculate your answers to the nearest one decimal point where necessary.
7. This question paper comprises **13** printed pages.

SECTION A
Compulsory question

QUESTION 1

(a) Mangi Ltd. is a company that operates in the services sector. Mangi has business relationships with Boza Ltd. and Hai Ltd. All three entities are public limited companies. The draft statements of financial position of these entities as at 30th November 2018 are as follows:

	Mangi	Boza	Hai
	TZS. million	TZS. million	TZS. million
ASSETS			
NON-CURRENT ASSETS			
Property, plant and equipment's	920	300	310
Investment in subsidiaries			
- Boza	730		
- Hai		320	
Investment in Puttin	48		
Intangible assets	198	30	35
Total non-current assets	**1,896**	**650**	**345**
Current assets	895	480	250
Total assets	**2,791**	**1,130**	**595**
EQUITY AND LIABILITIES			
Share capital	920	400	200
Other component of equity	73	37	25
Retained earnings	895	442	139
Total equity	**1,888**	**879**	**364**
Non-current liabilities	495	123	93
Current liabilities	408	128	138
Total equity and liabilities	**2,791**	**1,130**	**595**

The following information is relevant to the preparation of the group financial statements:

1. On 1st December 2016, Mangi acquired 70% of the equity interests of Boza. The purchase consideration was settled in cash TZS.730 million. At acquisition, the fair value of the non-controlling interest in Boza was TZS.295 million. On 1st December 2016, the fair value of the identifiable net asset acquired was TZS.835 million and retained earnings of Boza were TZS.319 million and other components of equity were TZS.27 million. The excess in fair value is due to non-depreciable land.

2. On 1st December 2017, Boza acquired 80% of the equity interests in Hai for a cash consideration of TZS.320 million. The fair value of a 20% holding of the non-controlling interest was TZS.72 million; a 30% holding was TZS.108 million and a 44% holding was TZS.161 million. At the date of acquisition, the identifiable net assets of Hai had a fair value of TZS.362 million, retained earnings were TZS.106 million and other components of equity were TZS.20 million. The excess in fair value is due to non-depreciable land.

   It is the group's policy to measure the non-controlling interest at fair value at the date of acquisition.
3. Both Boza and Hai were impairment tested at 30th November 2018. The recoverable amounts of both cash generating units as stated in the individual financial statements at 30th November 2018 were: Boza, TZS.1,425 million and Hai, TZS.604 million. The directors of Mangi felt that any impairment of assets was due to the poor performance of the intangible assets. The recoverable amount has been determined without consideration of liabilities which all relate to the financing of operations.
4. Mangi acquired a 14% interest in Puttin, a public limited company, on 1st December 2016 for a cash consideration of TZS.18 million. The investment was accounted for under *IFRS 9 Financial Instruments* and was designated as financial assets at fair value through other comprehensive income. On 1st June 2018, Mangi acquired an additional 16% interest in Puttin for a cash consideration of TZS.27 million and achieved significant influence. The value of the original 14% investment on 1st June 2018 was TZS.21 million. Puttin made profits after tax of TZS.20 million and TZS.30 million for the year to 30th November 2017 and 30th November 2018 respectively. On 30th November 2018, Mangi received a dividend from Puttin of TZS.2 million, which has been credited to other components of equity.
5. Mangi purchased patents of TZS.10 million to use in a project to develop new products on 1st December 2017. Mangi has completed the investigative phase of the project, incurring an addition cost of TZS.7 million and has determined that the product can be developed profitably. An effective and working prototype was created at a cost of TZS.4 million and in order to put the product into a condition for sale, a further TZS.3 million was spent. Finally, marketing costs of TZS.2 million were incurred. All of the above costs are included in the intangible assets of Mangi.
6. Mangi intends to dispose of a major line of the parent's business operations. At the date the "held for sale" criteria were met, the carrying amount of the assets and liabilities comprising the line of business were:

	TZS. million
Property, Plant and Equipment (PPE)	49
Inventory	18
Current liabilities	3

It is anticipated that Mangi will realise TZS.30 million for the business. No adjustments have been made in the financial statements in relation to the above decision.

REQUIRED:

Prepare the Consolidated Statement of Financial Position for Mangi Group as at 30th November 2018. **(20 marks)**

(b) IFRS 11 – *Joint Arrangements* was issued in May 2011. It establishes the principles for accounting for business arrangements that are controlled jointly by two or more parties. The standard classifies joint arrangements into two types. Joint Operations and Joint Ventures. In relation to this, the following transactions are available:

1. On 1st August 2018, Songolo Marine Plc, a company that owns a shipyard, is asked to construct a passenger liner for a customer. The customer requires special capabilities that require a specially designed propulsion system. The shipyard enters into a contract with an engine manufacturer whereby the total price of the ship will be TZS.100 million to be split 80% to the shipyard and 20% to the engine manufacturer. Under the agreement, Songoro Marine Plc will complete the structure of the ship, and the engine manufacturer will design and supply the engine. During the year ended 31st July 2019 the ship was completed on schedule and the agreed consideration was paid. Costs incurred by Songolo Marine Plc were TZS.62 million.
2. On 1st August 2018, Songolo Marine Plc entered into an arrangement with another company to develop a more modern shipyard. The two companies set up a new entity to build the shipyard, and invested TZS.130 million each into the new entity. They agreed to manage the resulting asset jointly. During year ended 31st July 2019 the shipyard was completed and generated a profit for the year of TZS.4 million.
3. Songolo Marine Plc has a 50% equity interest in another entity, Marine Service Company Ltd. Marine Service Company Ltd runs a shipping line, and had assets of TZS.50 million and liabilities of TZS.48 million at 1st August 2018. The trading loss for the year ended 31st July 2019 was TZS.4.8 million. The other 50% equity interest is held by another entity, but day-to-day management decisions are made by Songolo Marine Plc. Songolo Marine Plc has appointed four directors to the 5-person board of Marine Services Company Ltd.

REQUIRED:

(i) Distinguish between the two types of joint arrangement described by IFRS 11 – *Joint Arrangements*. **(3 marks)**

(ii) Explain the accounting method required for reporting an entity's interest in a joint venture. **(4 marks)**

(iii) In the case of transactions 1, 2, and 3 above, discuss the accounting treatment required by IFRS. Give reasons for your answer and show any necessary journal entries in the books of Songolo Marine Plc. **(7 marks)**

(c) The general requirements of IFRS 10 is that entities should consolidate their financial statements when they have subsidiaries. However, different requirements exist for investment entities:

REQUIRED:

(i) Explain the meaning of an "investment entity". **(3 marks)**

(ii) Discuss the accounting requirements for an investment entity. **(3 marks)**
(Total: 40 marks)

SECTION B

There are **FIVE** questions. Answer any **THREE** questions

QUESTION 2

(a) You are the financial controller of Shamu Plc ('Shamu'), a diversified group operating in several business sectors. The Finance Director has asked you to investigate the required accounting treatment under IFRS 15: *Revenue From Contract with Customers*, for the following material transactions/agreements for the year ended 31st December 2018.

(i) Goods, which cost TZS.280,000,000 were sold to QQ Bank Plc for TZS.320,000,000 on 30th June 2018. Shamu has an option to repurchase the goods from QQ Bank Plc at any time within the next two years. The repurchase price will be TZS.320,000,000 plus interest charged at 10% per annum from the date of sale to the date of repurchase. QQ Bank Plc has an option to require Shamu to repurchase the goods at the end of the two years period for price of TZS.387,200,000.

(ii) Shamu manufacturers precision machine tools to customer specification. On 15 April 2018 a customer placed an order for a machine tool costing TZS.810,000,000. The customer paid the normal 10% deposit on placing the order. Work started on the order during December 2018.

(iii) On 1st September 2018, Shamu received subscriptions in advance of TZS.240,000,000. The subscriptions are for 24 monthly publications of magazine produced by Shamu. At the year end, Shamu had produced and dispatched three of the 24 publications. The cost of producing each edition of the magazine is broadly similar.

REQUIRED:

Prepare notes for a meeting with the Finance Director to discuss these transactions/agreements. **(10 marks)**

(b) (i) Tango enters into a contract with a customer to sell an existing printing machine such that control of the printing machine vests with the customer in two years' time. The contract has two payments options. The customer can pay TZS.240,000 when the contract is signed or TZS.300,000 in two years' time when the customer gains control of the printing machine. The interest rate implicit in the contract is 11.8% in order to adjust for the risk involved in the delay in payment. However, Tango's incremental borrowing rate is 5%. The customer paid TZS.240,000 on 1st December 2017 when the contract was signed.

(4 marks)

(ii) Tango enters into a contract on 1st December 2017 to construct a printing machine on a customer's premises for a promised consideration of TZS.1,500,000 with a bonus of TZS.100,000 if the machine is completed within 24 months. At the inception of the contract, Tango correctly accounts for the promised bundle of goods and service as a single performance obligation in accordance with IFRS 15. At the inception of the contract, Tango expects the costs to be TZS.800,000 and concludes that it is highly probable that a significant reversal in the amount of cumulative revenue recognized will occur. Completion of the printing machine is highly susceptible to factors outside the control of Tango, mainly issues relating to the supply of components.

At 30th November 2018, Tango has satisfied 65% of its performance obligation on the basis of costs incurred to date and concludes that the variable consideration is still constrained in accordance with IFRS 15. However, on 4th December 2018, the contract is modified with the result that the fixed consideration and expected costs increased by TZS.110,000 and TZS.60,000 respectively. The time allowable for achieving the bonus is extended by six months with the result that Tango concludes that it is highly probable that the bonus will be achieved and that the contract still remains a single performance obligation. Tango has an accounting year end of 30th November.

REQUIRED:

Discuss how the above two contracts should be accounted for under IFRS 15. (In the case of (b) (i), the discussion should include the accounting treatment up to 30th November 2019 and in the case of (b) (ii), the accounting treatment up to 4th December 2018).

(6 marks)
(Total: 20 marks)

QUESTION 3

(a) You have been hired as an analyst for Nyumbani Bank and your team is working on an independent assessment of Misosi Bado Foods Inc. (MBF Inc.) MBF Inc. is a firm that specializes in the production of freshly imported farm products from France. Your assistant has provided you with the following data for MBF Inc. and their industry:

Ratio	2018	2017	2016	2018 – Industry Average
Long-term debt	0.45	0.40	0.35	0.35
Inventory Turnover days	62.65	42.42	32.25	53.25
Depreciation/Total Assets	0.25	0.014	0.018	0.015
Day’s sales in receivables	113	98	94	130.25
Debt to Equity	0.75	0.85	0.90	0.88
Profit Margin	0.082	0.07	0.06	0.075
Total Asset Turnover	0.54	0.65	0.70	0.40
Quick Ratio	1.028	1.03	1.029	1.031
Current Ratio	1.33	1.21	1.15	1.25
Times Interest Earned	0.9	4.375	4.45	4.65
Equity Multiplier	1.75	1.85	1.90	1.88

In the annual report to the shareholders, the CEO of MBF Inc. wrote, “2018 was a good year for the firm with respect to our ability to meet our short-term obligations. We had higher liquidity largely due to an increase in highly liquid current assets (cash, account receivables and short-term marketable securities)”.

REQUIRED:

Be as complete as possible and use only relevant information from the given figures to answer the following questions:

(i) Evaluate the CEO’s statement. **(2 marks)**

(ii) Comment on the firm’s assets management. **(2 marks)**

(iii) Provide the shareholders with an assessment of the firm’s solvency and leverage. **(2 marks)**

(b) The following is the summarized Statement of Financial Position of a concern as at 31st December 2018:

ASSETS	**TZS. '000'**
Goodwill	20,000
Land and buildings	250,000
Machinery	175,000
Furniture	10,000
Stock	90,000
Debtors	21,000
Cash at bank	5,000
Cash in hand	4,000
	575,000

CAPITAL AND LIABILITIES	
6% Preference share capital	150,000
Equity share capital	250,000
General reserve	20,000
P& L	15,000
5% Debentures	100,000
Creditors	28,000
Bills payable	12,000
	575,000

Other information:
Total sales worth TZS.400,000,000, 20% of which is made on credit. Gross profit and profit after tax for the year ended amounted to TZS.80,000,000 and TZS.20,000,000 respectively.

REQUIRED:

Comment on the financial condition of the company, on investments' structure, credit terms, profitability and liquidity **(8 marks)**

(c) In the 21st century, Corporate Social Responsibility (CSR) is an emerging field in the accounting and finance industry. Sustainability is understood as having environmental, social, and economic components. CSR has received several classifications, including "UN Global Compact Principles, OECD Guidelines for Multinational Enterprises, GRI, ISO 26000, AA1000, ISO 14001 and SA88000. In the global market, about 95% of the largest 250 companies issue CSR reports and follow CSR compliance guidelines. Typically, the CSR report covers important areas such as the company's goals and objectives, environmental performance, and the human impact.

REQUIRED:

Briefly explain the importance of CSR in Financial Reporting Standards.

(6 marks)
(Total: 20 marks)

QUESTION 4

(a) A company received the following grants in the year to 31st May 2019. TZS.60 million related to the purchases of new machinery that cost 300 million. The machinery was acquired in the current year and is being depreciated straight line over 8 years with a full year's charge in the year of acquisition. Under the terms of the grant the company must keep the asset for 5 years and spend TZS.40 million towards training cost for the year to 31st May 2019 and 2020.

During the year ended 31st May 2019, TZS.15 million was spent on the training. The company's budgeted training costs for 2020 are TZS.29 million. If total training costs are not at least TZS.40 million by the end of May 2020 the grant is repayable pro-rata. The company was set up in 2017 and in the current year a grant of TZS.5 million relating to start-up costs of the company was received. No amount had been accrued for this as at 31st May 2018 as there was no reasonable assurance that the grant would be received at that date. In addition to the above grants received, the company is considering installing new energy efficiency boilers that use renewable fuel. The boilers would cost TZS.15 million and currently grants of 15% are available.

REQUIRED:

Explain how the above items should be dealt with in the financial statements of the company for the year ended to 31st May 2019 and prepare necessary journal entries relating to grants. **(10 marks)**

(b) IAS 16 – Property, Plant & Equipment sets out the accounting requirements for most tangible non-current assets. It requires that an annual charge be made to profit or loss reflecting the amount of economic benefit associated with the asset consumed during the period. IAS 16 also permits non-current assets to be revalued to fair value, should a reporting entity choose the fair value model. In relation to IAS 16, the following information has been extracted from the financial records of MPANGA KIPENGELE, a Public Limited Company dealing with Wildlife Management in the United Republic of Tanzania as at 31st December 2018:

i. Installation of electricity in Selous, Swagaswaga, Lukwika, Lumesule and Kijereshi Game Reserves amounting to TZS.159,790,000. the installation involved electrical and other cable materials.
ii. For the purpose of improving access roads in its game reserves, the company incurred TZS.84,000,000. In this case, expenditure on diesel were TZS.23,000,000; perdiem TZS.4,000,000 and the remainder were incurred on aggregates and road surfacing materials.
iii. Installed water supply system at BehoBeho and Tagalala campsites, MCT Arusha and APU Manyoni for TZS.16,000,000.
iv. Rehabilitated 32 staff houses in Kalulu and Mulele for TZS.158,000,000. the components of the expenditure were diesel TZS.8,000,000; casual laborers TZS.2,000,000; perdiem TZS.5,000,000 and the balance was used on acquisition of building materials.

v. For effective and efficient administration purposes, the company procured motor vehicles, computers, equipment and other related facilities for TZS.33,431,600,000. These were paid for on 12th December 2018 and they were received from respective suppliers on 12th January 2019.

vi. Facilitated five staff to participate in tender evaluation of various bid documents for TZS.6,880,000. This comprises sitting allowances TZS.5,400,000; conference cost TZS.1,200,000 and ground transport TZS.280,000.

vii. The company incurred TZS.168,000,000 as staff training cost on IPSASs, Taxation, Financial Management for non-finance managers, Public Procurement and Natural Resources Management.

viii. Prepared funding proposal for capacity building to its staff for TZS.11,520,000.

ix. Started construction of 60 signposts on 12th October 2018 at Saanane Islands, Matembwe, KDU Bunda, Maswa and Moyowosi. Cost incurred as at 30th December 2018 was TZS.141, 000,000. The construction was completed on 24th March 2019. The total construction cost amounted to TZS.241,000,000.

x. TZS.15,345,900 was spent for the acquisition of Smart TV Sets and TZS.23,000,000 for the office furniture and fittings. The payments were effected on 11th November 2018 and the Smart TV Sets were received on 11th February 2019 while the office furniture and fittings were delivered on 29th December 2018.

REQUIRED:

Draft a report to the Chairman of the Audit Committee of MPANGA KIPENGELE PLC explaining the accounting treatments of each of the above transactions as per the requirement of IAS 16 Property, Plant and Equipment's for the year ended 31st December 2018. **(10 marks)**

(Total : 20 marks)

QUESTION 5

(a) IAS 37 *Provision, Contingent Liabilities and Assets* sets out the accounting treatment and disclosures for these transactions and events. The standard discusses general principles of recognition, measurement and presentation as well as specific application guidance for certain issues. This guidance aims to assist preparers of financial statements in applying IAS 37.

The following situation have arisen during the preparation of the draft financial statements of Horse Power Plc for year ended 31st July 2019:

(i) On 1st August 2016, Horse Power Plc acquired a nuclear power plant at a cost of TZS.20,000,000,000. Part of the arrangement was that the plant be dismantled and the site restored after its useful economic life of 20 years had passed. The cost of restoration was estimated on 1st August 2018, after discounting to present value, to be TZS.4,000,000,000. This amount reflected an appropriate discount rate of 6%, (75% of this estimate related to the dismantling of the plant, and 25% to the removal of waste fuel). At 31st July 2019, due to regulatory and other obstacles, no power had yet been produced, hence, no waste fuel had been generated.

(ii) During the year ended 31st July 2019, Horse power Plc decided to close both its coal burning power generating plants in October 2019. This decision has been announced publicly and detailed formal plan prepared. The plan proposes to make 75 employees redundant, retrain 25 other staff to work in the nuclear plant, and sell the coal-fired plants in their current condition. It is anticipated that the redundancy costs will amount to TZS.750,000,000, and the retraining will cost TZS.100,000,000. The coal plants will be disposed of for zero consideration as the new owner will be expected to dismantle the plants and clean up the sites. The carrying value of these plants is TZS.1,200,000,000 at 31st July 2019.

REQUIRED:

Propose appropriate accounting treatment of the above matters for the year ended 31st July 2019, applying IAS 37 and other relevant standards. **(10 marks)**

(b) Kimemeshi Ltd is engaged in the business of importation and distribution of electronic appliances. The financial statements for the year ended 30th September 2019 are being finalized and are expected to be authorized for issue on 15th November 2019, ready for the company's annual general meeting to be held on 2nd December 2019.

The following events has taken place between 1st October 2019 and now.

(i) On 15th October 2019, one of Kimemeshi's competitors announced launching of an upgraded version for DVD players. Kimemeshi's inventory at 30th September 2019 include a big stock of DVD players costing TZS.450,000,000. The draft financial statements show a value of TZS.210,000,000 in respect of this stock, being at net realizable value estimated after a declining demand observed during the year. As a result of the launch, the net realizable value of the stock is now estimated to be TZS.82,500,000.

(ii) On 18th October 2019 Kimemeshi announced final dividend for the year ended 30th September 2019. The dividend comprised of TZS.65,200,000 cash dividend and a bonus share dividend of 1 share for each 10 shares held. The fair value of the company shares stood at TZS.3,250 at the announcement date, and the nominal value is TZs.1,000.

(iii) On 20th October 2019, LED TV sets valued at TZS.650,000,000 were stolen from a warehouse. These sets were included in Kimemeshi's inventory as at 30th September 2019.

(iv) On 29th October 2019, a customer announced voluntary liquidation. This customer owed TZS.80,000,000 on 30th September 2019 and, learning from the delays in payment, a specific allowance for doubtful debts on this customer was created at 30th September 2019 amounting to TZS.25,000,000. Correspondence with the liquidator after the announcement indicate that Kimemeshi can only recover 15% of this receivable.

REQUIRED:

Referring to the requirements of IAS 10: *Event after the reporting period*, describe how each of the above transaction should be treated in the financial statements of Kimemeshi Ltd. for the year ended 30th September 2019. Where relevant, show the computations and appropriate journal entries. **(10 marks)**

(Total: 20 marks)

QUESTION 6

(a) Dealing amongst related parties are a common feature of commercial life. The objective of IAS 24: *Related Party Disclosures* is to ensure that financial statements contain the necessary disclosures to make users aware of the possibility that financial statements may have been affected by the existence of related parties. In relation to this, Hombolo, a public listed company owns two subsidiary companies. It owns 100% of the equity shares of Vikonje and 55% of the equity shares of Ihumwa. During the year ended 30th September 2019 Ihumwa made several sales of goods to Vikonje. These sales totaled TZS.150 million and had cost Ihumwa TZS.140 million to manufacture. Ihumwa made these sales under the instruction of the Board of Hombolo. It is known that one of the directors of Ihumwa who is not a director of Hombolo, is unhappy with the parent company's instruction as he believes the goods could have been sold to other companies outside the group at the far higher price of TZS.200 million. All directors within the group benefit from a profit sharing scheme.

REQUIRED:

(i) Describe the main circumstances that give rise to related parties **(2 marks)**

(ii) Explain why the disclosure of related party relationships and transactions may be important. **(3 marks)**

(iii) Describe the financial effect that Hombolo's instruction may have on the financial statements of the companies within the group and the implications this may have for the other interested parties. **(5 marks)**

(b) On 1st January 2017 Kambili Ltd sold a property it owned to Kibarabara bank for TZS.300,000,000. The carrying value of the property on 1st January 2017 was TZS.200,000,000, of which TZS.120,000,000 was depreciable. The remaining economic life of the depreciable element was 30 years from 1st January 2017.

Kambili Ltd continued to occupy the property and took responsibility for its security and maintenance. The market value of the property on 1st January 2017 was TZS.500,000,000 and it is considered unlikely that this will fall significantly in the foreseeable future.

Kambili Ltd measures all its property, plant and equipment under the cost model and depreciates its property on straight line basis.

The terms of sale allowed Kambili Ltd an option to re-purchase the property from the bank as follows:

- On 31st December 2017 for TZS.330,000,000
- On 31st December 2018 for TZS.363,000,000
- On 31st December 2019 for TZS.399,300,000

REQUIRED:

Describe how the transaction relating to the property will be reflected in the financial statements for the year ended 31st December 2017 and 31st December 2018, by clearly showing the relevant journal entries and extracts of financial statements. **(10 marks)**

(Total: 20 marks)

EXAMINATION	**:**	**FINAL LEVEL**
SUBJECT	**:**	**AUDITING AND ASSURANCE SERVICES**
CODE	**:**	**C2**
EXAMINATION DATE	**:**	**TUESDAY, 29TH OCTOBER, 2019**
TIME ALLOWED	**:**	**THREE HOURS (9:00 A.M. – 12:00 NOON)**

GENERAL INSTRUCTIONS

1. There are **TWO** Sections in this paper**.** Sections **A** and **B** which comprise a total of **SIX** questions.

2. Answer question **ONE** in Section **A.**

3. Answer **ANY THREE** questions in Section **B.**

4. In total answer **FOUR** questions.

5. Marks are shown at the end of each question.

6. Presentation, clarity of expression, logic of arguments and the use of lucid English will be taken into account in the assessment of candidates' performance.

7. This question paper comprises **9** printed pages.

SECTION A
Compulsory question

QUESTION 1

(a) Air Citizen has been given an exclusive right by the Tanzania Civil Aviation Authority (TCAA) to provide direct flights between Kampala and Dodoma twice a week. The introduction of this service has been well advertised in national newspapers and is expected to be efficient and timely.

The journey time between Kampala and Dodoma is expected to be significantly reduced, so as to encourage tourism and business development opportunities in Dodoma. Air Citizen operates a refurbished 35-years old Aircraft which is leased from an international Airline and registered with the TCAA. The TCAA requires that engines be overhauled in every two years. Engine overhauls are expected to put the aircraft out of commission for several weeks. The Aircraft is configured to carry 15 First Class, 50 Business Class and 76 Economy Class passengers. The Aircraft has a package to reserve holding capacity for Dodoma's numerous horticultural growers (groundnuts, grapes and other fruits) and general cargo.

The two-hour journey offers an in-flight movie, a meal, hot and cold drinks and tax free shopping. All meals are prepared in Kampala under a contract with an airport catering company. Passengers are invited to complete a 'satisfaction' questionnaire which is included with the in-flight entertainment and shopping guide. Responses received show that passengers are generally least satisfied with the quality of the food especially on the Dodoma to Kampala flight. Air Citizen employs ten full time cabin crew attendants who are trained in air-stewardship including passenger safety in the event of accident and illness. Flight personnel (the captain and co-pilots) are provided under a contract with the international airline from which the aircraft is leased. At the end of each flight the captain completes a timesheet detailing the crew and actual flight time.

Air Citizen was incorporated in Tanzania, whose capital city is Dodoma on 1st March, 2019 and now operates in Uganda whose capital city is Kampala. Ticket sales are done by Air Citizen and travel agents in Tanzania and Uganda. On a number of occasions, tickets on economy class have been over-booked. Customers who have been affected by this have been accommodated in business class as there is much less demand for this, and even lesser for first class. Ticket prices for each class depend on many factors, for example, whether the tickets are refundable/non-refundable, exchangeable/non-exchangeable, one way or return, week days or weekend, and the time of booking. Aircraft's insurance cover includes passenger liability, freight/baggage and compensation insurance. Premiums for passenger liability insurance are determined on the basis of passenger miles flown.

You have been appointed to lead an audit team to conduct of Air Citizen.

REQUIRED:

(i) Identify and explain any six (6) business risks facing Air Citizen. **(6 marks)**

(ii) Describe how the risk identified in (i) above could be managed and maintained at an acceptable level by Air Citizen. **(6 marks)**

(b) ISA 320: *Materiality in Planning and Performing an Audit* provides guidance on the concept of materiality in planning and performing an audit.

REQUIRED:

Explain the meaning of materiality and determine how the level of materiality is assessed. **(5 marks)**

(c) DARUBINI Co. designs and manufactures luxury motor vehicles. The company employs 2,500 staff and its shares are held by 15 individuals, most of them from the same family. The maximum shareholding is 15% of the share capital.

The Executive Directors are drawn mainly from the shareholders. There are no Non-Executive Directors because the company legislation in DARUBINI Co.'s jurisdiction does not require any. The Executive Directors are very successful in running DARUBINI Co. partly from their training in production and management techniques, and partly from their 'hand-on approach providing motivation to employees.

The board is considering a significant expansion of the company. However, the company's bankers are concerned with the standard of financial reporting as the Financial Director (FD) has recently left DARUBINI Co. The board is delaying provision of additional financial information until a new FD is appointed.

DARUBINI Co. has an Internal Audit Department, although the Chief Internal Auditor frequently comments that the board of DARUBINI Co. does not understand his reports and do not provide sufficient support for his department for the internal control systems within DARUBINI Co. The board of DARUBINI Co concur with this view of the Chief Internal Auditor. Anders & Associates, the external auditors have also expressed concern in this area and the fact that the Internal Audit Department focuses most of its work on control systems, rather than on financial reporting. Anders & Associates are appointed by and report to the board of DARUBINI Co.

The board of DARUBINI Co. considering a proposal from the Chief Internal Auditor to establish an Audit Committee. In his proposal the Chief Internal Auditor recommended the committee to consist one Executive Director, the Chief Internal Auditor as well as three new appointees. One appointee should have a non-executive seat on the board of directors.

REQUIRED*:*

Discuss the benefits to DARUBINI Co. forming an audit committee. **(6 marks)**

(d) BASIC Insurance Company Ltd. prepares its annual financial statements to 31st December each year. Due to the larger number of the transactions, interim financial statements for each half year are prepared at the end of June every year. This is done to facilitate the early completion and audit of the annual financial statements. Kiteka & Associates are the independent auditors of BASIC Insurance Co. Ltd. This year's interim financial information has been prepared and are ready for review.

You are the senior audit of Kiteka & Associates, the auditing firm selected to be the auditors of BASIC Insurance Co. Ltd. You have been appointed to head the audit team to carry out the review of the interim financial information.

REQUIRED:

Suggest the procedures you would use to carry out the review of the interim financial information. **(6 marks)**

(e) The National Board of Accountants and Auditors (NBAA) is organizing a Continuous Professional Development (CPD) seminar on the code of conduct for members and other relevant issues pertaining to audit. You are the audit partner of HALAUMIKI & Associate a firm of Certified Public Accountants, and you have been invited to present a paper in the Seminar, which is to cover among other things, the topic on advantages of independence of the auditors and the inherent limitations of auditing.

REQUIRED:

(i) Explain any four (4) advantages of independent audit. **(4 marks)**

(ii) Explain the meaning of the phrase *"the auditor must be seen to be independent both in fact and appearance"*. **(3 marks)**

(iii) Explain any four (4) inherent limitations of auditing. **(4 marks)**

(Total: 40 marks)

SECTION B

There are **FIVE** questions. Answer **ANY THREE** questions

QUESTION 2

(a) SUNCHE Co. is a new client of Count and Partners an audit firm. SUNCHE Co. runs a spa trading under the name of SUNCHE. The spa is open to non-members and members. Members pay an annual membership fee that entitles them to 50% off spa rates for individual treatments and sessions. The spa employs lifeguards, masseuses, beauty therapist and nursery nurses for its crèche facilities. In addition, there is also administrative staff, including a finance controller, who reports to the Managing Director, Machoge Wambecha, who is also the major shareholders.

The spa has been in business for five years, but this is the first time it has required an audit services. Its major local competitor is Revitalise, a large members-only spa, which started business two years ago. Count and Partners has just been invited to tender for the audit of the company which owns Revitalise.

The finance controller at SUNCHE is Pamela Chogo, who was employed 18 months ago. Since she was employed, Pamela has done the following:

1. Instituted control procedures outlined in a controls manual:
2. Formalized a budgeting system so that budgets are now prepared and approved annually; and
3. Recommended the need for an audit services to the Managing Director, Machoge Wambecha.

Pamela introduced Count and Partners to Mr Wambecha through her husband, Anthony Chogo, who is a manager at Count and Partners. The audit engagement partner assigned to SUNCHE is Saida Lamb. Since the agreeing audit terms with Count and Partners Mr Wambecha has:

1. Requested Saida to advertise to the employees of Count and Partners, an offer of a staff membership rate, which is 50% of standard membership rates and then entitles the member to 75 off spa rates.

2. Asked Saida if she could sit in the board of directors at SUNCHE Co. as a non-executive director.

3. Asked Saida if the audit firm will confirm the figures on an insurance claim to be submitted in respect of a fire in the treatment centre just prior to the year end.

REQUIRED:

(i) Explain the ethical threats which may affect the independence of Count and Partners audit of SUNCHE Co; and for each threat explain how it might be avoided. **(8 marks)**

(ii) Explain five (5) procedures you would carry out to obtain an understanding of SUNCHE Co. in order to conduct the first year audit. **(5 marks)**

(b) Most auditor's reports are positive and with a statement expressing the auditors' opinion that the financial statements show a true and fair view and comply with statutory requirements. However, some auditors express this opinion with reservations or express a conversed opinion.

REQUIRED:

Explain the conditions that can lead to qualification of audit report. **(7 marks)**
(Total: 20 marks)

QUESTION 3

(a) Upon the completion of the audit of Zombwe company Ltd the engagement partner reviewed the audit working papers and came across the following:

- There was material consistency between the financial statements and other information in documents containing the financial statements and the auditor's report thereon. The material inconsistency has been traced to the financial information but management has refused to effect any change when requested to do so.
- Inventory worth TZS.50 million were valued at cost in financial statements. The review of the post balance sheet events indicated that not all the inventory could be sold in the normal course of business. Some were damaged and some have been obsolete and slow moving. The total assets of the company is TZS.200 million. If inventory were valued at net realizable value the value would be reduced by TZS.2 million. The directors have refused to allow the inventory to be valued at lower of cost and net relizable value and value all the inventory at cost.
- Management refused to allow auditors to carry out circularization of debtors. The receivables figure was material in the financial statements. In addition, the auditors have not received reply to the letter of enquiry sent to the company's solicitors in respect of a major litigation affecting the company. The auditors assessed that the effect of the two items is both material and pervasive.
- Subsequent events indicated that a major debtor has become insolvent. The amount involved was material. The directors refused to recognize the provision for a write off of amount.

REQUIRED:

(i) For each of the above issues, recommend the type of audit opinion to be raised. **(8 marks)**

(ii) Consider the actions that the auditor should take in view of management refusal to accept the recommendations and/or to allow the auditor to carry out the necessary audit procedures. **(2 marks)**

(b) P & K Mining company operaties in Geita. The youth of the area surrounding the mining had been opposing the activities of the company. Mr. Ngosha, the Managing Director of P & K Mining approached VIVA & Associates, an audit firm to accept and attest engagement to examine and report on the environmental issues of P & K Mining Company Ltd for the year ended 31st December, 2018:

REQUIRED:

(i) Evaluate the environmental issues that may lead to the risk of material misstatement in the financial statements. **(3 marks)**

(ii) Recommend the action and audit procedures that VIVA & Associate should undertake when they realize that P & K Mining company has environmental issues that may affect the financial statements. **(7 marks)**

(Total: 20 marks)

QUESTION 4

(a) Explain three (3) reasons that may make a firm of auditors decide to reject re-election as auditors of an entity. **(3 marks)**

(b) Papua Ltd is a wholesaler of electronic equipment. Papua Ltd buys the equipment from six major manufactures and sells them to over 600 different customers ranging from large retail chain stores to small owner – controlled business. The receivables balance therefore includes customers owing up to TZS.125 million to small customers owning TZS.5 million, all with different due dates of payment and credit limits. Although all information is stored in Papua Ltd computer systems, the previous audits works tended to adopt an "audit around computer" approach.

You are the audit senior in charge of the audit of receivables balance for Papua Ltd. You have decided to use audit software to assist with the audit of receivables balance the act which will be done for the first time at the client. Computer staff at Papua Ltd are willing to help the auditors, although they cannot confirm completeness of systems documentation, and warn that the system is running in a computer with a very old operating systems, which limit files compatibility with more modern programs. The change in audit approach has been taken mainly to fully understand Papua Ltd's computer systems prior to new internet module being added next years. To limit the possibility of damage to Company's computer files, copy of files will be provided by Papua computer staff for auditors to use with their own audit software.

REQUIRED:

(i) Explain four (4) audit procedures that should be carried out using audit software on the receivables balance at Papua Ltd. For each procedure, explain the reason for the procedure. **(4 marks)**

(ii) Explain three (3) potential problems of using audit software at Papua Ltd., and for each problem, explain how it can be resolved. **(3 marks)**

(c) (i) Explain the importance of the bank letter and describe the procedures used to obtain confirmation from the bank. **(6 marks)**

(ii) Describe how you would test a client's bank reconciliation. **(4 marks)**

(Total: 20 marks)

QUESTION 5

(a) Chanika Tyres Ltd which is engaged in the business of manufacturing tyres has been experiencing a reduction in its profitability. The company has therefore planned to collaborate with a Germany company which will enable it to increase its product quality through the use of a technology that will ensure increased tyre resistance to puncture. If this is successful, the company is optimistic that it will certainly increase its market share by about 20% and therefore results in an increase in profit.

Mr. Bingwa, the Finance Manager, has prepared some prospective financial information in the form of profit forecasts for the next five years for circulation to shareholders and prospective investors to support the proposal. Chanika's management appoints Malezi Accountants, Certified Public Accountants, to examine and report on the profit forecasts. Malezi Accountants has not performed such an assignment before.

REQUIRED:

(i) Explain the term "Prospective Financial Information (PFI)". **(4 marks)**

(ii) Discuss the matters that Malezi Accountant should consider before accepting the assignment to examine and report on the profit forecasts. **(4 marks)**

(iii) Describe the procedures which Malezi Accountants must follow while examining the profit forecasts. **(6 marks)**

(b) State any four (4) advantages and any two (2) disadvantages of using flow charts to record accounting control system. **(6 marks)**

(Total: 20 marks)

QUESTION 6

(a) You are employed by Kibangu Associates as an Audit Manager and your firm has been appointed as auditors of Kifaru Ltd. You have visited the company premises in Bagamoyo. Kifaru Ltd deals with Internet Service Provision (ISP) and also offers various computer consultancy service and training.

The main services offered by Kibangu Limited include:

1. Provision of cost effective e-learning through its highly connected modernized technology.
2. Connecting users to the International network and allowing clients to have e-mail addresses on the ISP's machine.

3. Allowing access to CPA candidates who download various NBAA publications and electronic payments to NBAA through NBAA website.
4. Development of client's websites and web-hosting.

The internal auditor of Kifaru Ltd play an important role in monitoring the effectiveness of the systems and controls related to the services offered.

It is now time for the audit team briefing meeting to be involved in the interim audit of Kifaru Ltd and your audit plan contains the following:

1. Flowcharts documenting the accounting and control systems of Kifaru Ltd.
2. The consideration of the possible use of Internal audit work in the performance of the audit.
3. Sample of accounts receivables meant for circularization.

Your risk assessment indicates that there is a high risk of material misstatements in the receivables of the company.

REQUIRED:

(i) Explain the criteria Kibangu Associates will consider before determining whether the work of the internal audit function can be used. **(6 marks)**

(ii) Discuss whether Kibangu Associates should use negative confirmation as the sole substantive procedures when auditing the accounts receivables in Kifaru Ltd. **(4 marks)**

(iii) Explain four (4) audit procedures to be performed for any exceptions and non-responses to the receivables confirmation at Kifaru Ltd. **(4 marks)**

(b) *ISA 530: Audit Sampling* states that the objective of the auditor, when using audit sampling, is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

REQUIRED:

Explain the difference between *statistical sampling* and *non-statistical sampling* and describe four methods of sampling selection. **(6 marks)**

(Total: 20 marks)

EXAMINATION	**:**	**FINAL LEVEL**
SUBJECT	**:**	**BUSINESS AND CORPORATE FINANCE**
CODE	**:**	**C3**
EXAMINATION DATE	**:**	**THURSDAY, 31ST OCTOBER, 2019**
TIME ALLOWED	**:**	**THREE HOURS (9:00 A.M. – 12:00 NOON)**

GENERAL INSTRUCTIONS

1. There are **TWO** Sections in this paper. Sections **A** and **B** which comprise a total of **SIX** questions.
2. Answer question **ONE** in Section **A**.
3. Answer **ANY THREE** questions in Section **B.**
4. In total answer **FOUR** questions.
5. Marks are shown at the end of each question.
6. Show clearly all your workings in the respective answers where applicable.
7. This question paper comprises **9** printed pages.

SECTION A
Compulsory Question

QUESTION 1

(a) KIPARA Co. is company based in the USA, supplying medical equipment to the USA and Europe. It is 30th November 2019 KIPARA Co's Treasury Department is currently dealing with a sale to a Swiss customer of CHF12.3 million which has just been agreed, where the customer will pay for the equipment on 31st May 2020. The Treasury Department intends to hedge the foreign exchange risk on this transaction using traded futures or options as far as possible. Any amount not hedged by a futures or option contract will be hedged on the forward market.

Exchange rates (quoted as US$/CHF 1)

Spot	1.0292-1.0309
Three months forward	1.0327-1.0347
Six months forward	1.0358-1.0380

Current futures (contract size CHF 125,000, futures price quoted as US$ per CHF1)

Futures price:

December	1.0318
March	1.0345
June	1.0369

Currency options

- Contract size CHF 125,000
- Exercise price quotation US$ per CHF1
- Premium: US cents per CHF1

	Calls			Puts		
Exercise Price	**December**	**March**	**June**	**December**	**March**	**June**
0.0375	0.47	0.50	0.53	0.74	0.79	0.86

Futures and options contracts mature at the month end.

Non-Executive Director's comments

A new Non-Executive Director has recently been briefed about the work of the Treasury Department and has a number of questions about hedging activities. He wants to understand the significance of basis risk in relation to futures. He also wants to know the significant features of over-the-counter forward contracts and options, and why KIPARA Co. prefers to use exchange-traded derivatives for hedging.

The Non-Executive Director has also heard about the mark-to-market process and wants to understand the terminology involved, and how the process works, using the transaction with the Swiss customer as an example. The Treasury Department has supplied relevant information to answer his query. The contract specification for the CHF futures contract states that an initial margin of US$1,450 per contract will be required and a maintenance margin of US$1,360 per contract will also be required. The tick size on the contract is US$0.0001 and the tick value is US$12.50. You can assume that on the first day when KIPARA Co. holds the future contracts, the loss per contract is US$0.0011.

REQUIRED:

(i) Evaluate which of the exchange-traded derivatives would give KIPARA Co. the higher receipt, considering scenarios when the options are and are not exercised. **(10 marks)**

(ii) Discuss the benefits and drawbacks for KIPARA Co. in using forward contracts compared with using over-the-counter currency options, and explain why KIPARA Co may prefer to use exchange-traded derivatives rather than over-the-counter derivatives to hedge foreign currency risk. **(5 marks)**

(iii) Explain to the Non-Executive Director how the mark-to-market process would work for the CHF futures, including the significance of the data supplied by the Treasury Department. Illustrate your explanation with calculations showing what would happen on the first day, using the data supplied by the Treasury Department. **(5 marks)**

(b) Mwanakwetu plc is an exploration company based in Mtwara region. Currently, the company incurs heavy spending in exploring oil and gas reserve in the region. The company has normalized earnings of TZS.700 million. Mwanakwetu plc's monetary assets value has been established as TZS.50 million while the firm's tangible assets amounts to TZS.1,850 million. The company's cost of capital and growth rate is currently standing at 12% and 10% respectively. The growth rate is expected to fall to 5% from year six onwards. The current risk-free rate is 4% and the industry's average returns for the firms trading on the basis of their intangible assets are currently at 7%.

REQUIRED:

Calculate the value of Mwanakwetu plc's intangible assets using Lev's knowledge earning method. **(10 marks)**

(c) In certain situations, a corporate may want to refund or redeem the bond prior to the maturity date. This would be undertaken with the idea of replacing the same with a debt carrying lower interest rate.

The Finance Manager is of the view that bond refund and debt replacement are not simple. Numerous factors need to be considered before performing the same.

REQUIRED:

Develop a plan detailing the important parameters which influence the bond refund analysis. **(5 marks)**

(d) A bond has the following characteristics: Nominal value TZS.10,000 yield to maturity of 9% (with annual compounding frequency), 11% coupon rate and annual coupon frequency. Bond period is 5 years.

REQUIRED:

Calculate the price of the 5-year bond. **(5 marks)**

(Total: 40 marks)

SECTION B

There are **FIVE** questions. Answer **ANY THREE** questions.

QUESTION 2

(a) Your bank's Dar es Salaam Office has surplus funds to the extent of TZS.500 million for a period of 3 months. The cost of the funds to the bank is 7 per cent per annum. It proposes to invest these funds in Dar es Salaam, Nairobi or Durban and obtain the best yield, without any exchange risk. The following rates of interest are available at the three centres of investment of domestic funds for a period of 3 months.

Dar es Salaam	8%
Nairobi	10%
Durban	6%

The market rates in Dar es Salaam for Kenyan shilling and South African Rands are as follows;

Dar es Salaam on Nairobi (quoted as KES/TZS)

Spot	2.4950/2.4965
1 month	0.30/0.40c discount
2 months	0.80/0.90c discount
3 months	1.50/1.60c discount

Dar es Salaam on Durban (quoted as ZAR/TZS)

Spot	6.2360/5.3290
1 month	1.80/1.70 pf premium
2 months	2.90/2.80 pf premium
3 months	4.00/3.90 pf premium

REQUIRED:

Determine the centre at which the investment will be made and the net gain (to the nearest TZS.) to the bank on the funds. Ignore brokerage and cable expenses. **(10 marks)**

(b) KINGEGE is a Tanzanian based company and you happen to be its Corporate Treasurer. In October 2019 you have realized that in mid-November the company will need to borrow $1 million for 3 months. You are concerned that interest rates might rise in the intervening period. The following data is made available to you in October:

October spot $ interest rate 10%
November 3 months Eurodollar futures 11%
The contract size for Eurodollar futures is $1m
November spot rates are as follows:

9%
11%
13%

REQUIRED:

Show how you might hedge his position using a futures market operation. Assume the funding requirement is on the last day of November futures trading. Illustrate your answer with reference to the November spot rates. **(10 marks)**
(Total: 20 marks)

QUESTION 3

(a) A service company with 100 percent owned subsidiaries in four countries experiences major cash flows between these subsidiaries. The subsidiaries are in Alphaland, Betaland, Gammaland and Deltaland. The respective countries currencies are the ax, the bon, the cop and the drac. The monthly cash flows are as follows:

Alphaland pays	bon 500,000 to Betaland
	drac 40,000,000 to Deltaland
Betaland pays	ax 250,000 to Alphaland
	drac 60,000,000 to Deltaland
	cop 400,000 to Gammaland

Gammaland pays	bon 600,0000 to Betaland drac 50,000,000 to Deltaland
Deltaland pays	ax 200,000 to Alphaland bon 400,000 to Betaland cop 500,000 to Gammaland

where ax 1 = cop 4 = bon 4 = drac 200.

REQUIRED:

Analyse how might this system be improved, and what would be the benefits? **(10 marks)**

(b) NICE Shoes Limited is evaluating the possibility of acquiring BEST Shoes Limited. The following are data for the two companies:

	NICE	BEST
Profit after-tax (TZS.)	547,500	99,000
Earnings per share (TZS.)	73	22
Dividend per share (TZS.)	42	12
Number of shares	7,500	4,500
Total market capitalization (TZS.)	10,000,000	1,350,000

BEST's earnings and dividends are expected to grow at 7.5 percent without merger and at 10 percent with merger.

REQUIRED:

(i) Calculate the price-earnings ratio of both the companies before merger. **(2 marks)**

(ii) Determine the gain from the merger and the cost of merger if BEST is paid cash of TZS.400 per share. **(2 marks)**

(iii) Determine the cost of merger if the share exchange ratio is 0.25. **(3 marks)**

(c) Progress in technology of connected computers and cryptography, has given rise to blockchain phenomenon which is re-defining the whole record keeping mechanism for the better. Blockchain is changing the way transactions ownership and value are recorded and shared by a community.

REQUIRED:

Differentiate the following:

(i) Blockchain, Bitcoin and Cryptocurrency **(1 mark)**

(ii) Fiat currency and Cryptocurrency **(2 marks)**

(Total: 20 marks)

QUESTION 4

(a) Write short notes on the following:

(i) Features of interest rates futures **(4 marks)**

(ii) Floating to fixed interest rate swaps **(3 marks)**

(b) Hilton, a U.S. based multinational company will receive 2,000,000 Euros in one year time from items it exported. It did not hedge this transaction. Hilton believes that the future value of the Euro will be determined by Purchasing Power Parity (PPP). It expects that inflation in countries using the Euro will be 12% next year, while inflation in the U.S. will be 7% next year. The spot rate of the Euro is $1.46 and the one-year forward rate is $1.50.

REQUIRED:

(i) Estimate the amount of U.S. dollars that Hilton will receive in the one year when converting its Euro receivables into U.S dollars. **(3 marks)**

(ii) The spot rate of the Australian dollar is pegged at $0.13. Hilton believes that the Australian dollar will remain pegged to the US dollar for the next year. If Hilton decides to convert its 2 million Euros into Australian dollars instead of U.S. dollars at the end of one year, estimate the amount of Australian dollars that Hilton will receive in one year when converting its Euro receivables into Australian dollars. **(3 marks)**

(c) A Tanzanian investor enters into an agreement to purchase a property in Kenya for a sum of KES.50,000,000. The full amount has to be paid in three months. He has adequate funds in his bank account in Dar es Salaam, which fetches him 0.50% interest per month, compounded monthly, to pay for the property. At present, the spot exchange rate is TZS.21.46/KES and the three-month forward exchange rate is TZS.21.80/KES. In Nairobi, the money market interest rate is 1.8% for a three month investment. His investment adviser informs him he can decide on two alternative ways of paying for the property.

1. Continue to maintain the funds in his Dar es Salaam bank account and buy KES.50 million forward.
2. Purchase KES at spot today and invest the amount in a Nairobi bank for three months so that at the end of three months the maturity value equals to KES.50 million.

REQUIRED:

Evaluate both payment methods and explain which method you would recommend. **(7 marks)**

(Total: 20 marks)

QUESTION 5

(a) Spartan, Inc. is considering the development of a subsidiary in Singapore that would manufacture and sell tennins rackets locally. Spartan's management has asked various departments to supply relevant information for a capital budgeting analysis. In addition, some Spartan executives have met with government officials in Singapore to discuss the proposed subsidiary. The project would end in 4 years. All relevant information are as follows.

An estimated 20 million Singapore dollars (S$), which includes funds to support working capital, would be needed for the project. Given the existing spot rate of $.50 per Singapore dollar, the US dollar amount of the parent's initial investment is $10 million.

The estimated price and demand schedules during each of the next 4 years are shown here:

Year	**1**	**2**	**3**	**4**
Price per racket (S$)	350	350	360	380
Demand in Singapore (Units)	60,000	60,000	100,000	100,000

The variable costs (for materials, labour, etc.) per unit have been estimated and consolidated as shown here:

Year	**1**	**2**	**3**	**4**
Variable costs per racket (S$)	200	200	250	600

The expense of leasing extra office space is S$1 million per year. Other annual overhead expenses are expected to be S$1 million per year.

The Singapore government will allow Spartan's subsidiary to depreciate the cost of the plant and equipment at a maximum rate of S$2 million per year, which is the rate the subsidiary will use.

The Singapore government will impose a 20 percent tax rate on income. In addition, it will impose a 10 percent withholding tax on any funds remitted by the subsidiary to the parent. The U.S. government will allow a tax credit on taxes paid in Singapore; therefore, earnings remitted to the U.S parent will not be taxed by the U.S. government.

The Spartan subsidiary plans to send all net cash flows received back to the parent firm at the end of each year. The Singapore government promises no restrictions on the cash flows to be sent back to the parent firm but does impose a 10 percent withholding tax on any funds sent to the parent, as mentioned earlier.

The Singapore government will pay the parent $0.12 million to assume ownership of the subsidiary at the end of 4 years. Assume that there is no capital gains tax on the sale of the subsidiary.

The spot exchange rate of the Singapore dollar is $0.50. Spartan uses the spot rate as its best forecast of the exchange rate that will exist in future periods.

Thus, the forecasted exchange rate for all future periods is \$50. Spartan, Inc. requires a 15 percent return on this project.

REQUIRED:

Conduct capital budgeting analysis from the parent's perspective, based on the assumption that the subsidiary is intended to generate cash flows that will ultimately be passed on to the parent and advise on the viability of the proposed subsidiary. **(7 marks)**

(b) KOBE Inc. is a Tanzanian based company which intends to expand its operations through international diversifications in order to reduce both systematic and unsystematic risks.

REQUIRED:

Discuss the validity to investors of Kobe Inc's objective for risk reduction through international diversification. **(3 marks)**

(c) Kibaha Pharmaceuticals Ltd is a pharmaceutical company engaged in the manufacture of antibiotics. The company is considering a 10-year patent to manufacture a drug which would be used for cardiac treatment. The product is technically viable but highly expensive to manufacture, and its immediate potential market will be relatively small.

A cash flow analysis of the project suggested that the present value of the cash inflows from the project, if adopted now, would be TZS.300 billion, while the cost of the project would be TZS.400 billion. The technology is evolving rapidly, and a simulation of alternative scenarios yields a wide range of present values, with an annualised standard deviation of 0.4. The 10-year yield on government securities is 8%.

REQUIRED:

(i) Estimate the value of the option to invest in the project. **(7 marks)**

(ii) Discuss the factor that influences the price or value of option contracts. **(3 marks)**

(Total: 20 marks)

QUESTION 6

(a) A shareholder of Kimondobay Co. is concerned about the recent performance of the company and has collected the following information:

Year to 31st December	**2018**	**2017**	**2016**
Turnover (TZS.) million	680	680	660
Earnings per share (TZS.)	58.9	64.2	61.7
Dividend per share (TZS.)	40.0	38.5	37.0
Closing ex dividend share price (TZS.)	648	835	740
Return on equity predicted by CAPM	8%	12%	

One of the items discussed at a recent board meeting of Kimondobay Co was the dividend payment for 2019. The Finance Director proposed that, in order to conserve cash within the company, no dividend would be paid in 2019, 2020 and 2021. It was expected that improved economic conditions at the end of this three-year period would make it possible to pay a dividend of TZS.70 per share in 2022. The Finance Director expects that an annual dividend increase of 3% per year in subsequent years could be maintained. The current cost of equity of Kimondobay Co. is 10% per year. Assume that dividends are paid at the end of each year.

REQUIRED:

(i) Calculate the dividend yield, capital gain and total shareholder return for 2017 and 2018, and briefly discuss your findings with respect to the returns predicted by the Capital Asset Pricing Model (CAPM) and the other financial information provided. **(10 marks)**

(ii) Calculate and comment on the share price of Kimondobay Co using the dividend growth model in the following circumstances; based on the historical information provided and based on if the proposed change in dividend policy is implemented. **(5 marks)**

(b) Discuss the relationship between investment decisions, dividend decisions and financing decisions in the context of financial management, illustrating your discussion with examples where appropriate. **(5 marks)**

(Total: 20 marks)

EXAMINATION	**:**	**FINAL LEVEL**
SUBJECT	**:**	**ADVANCED TAXATION**
CODE	**:**	**C4**
EXAMINATION DATE	**:**	**FRIDAY, 1ST NOVEMBER, 2019**
TIME ALLOWED	**:**	**THREE HOURS (2:00 P.M. – 5:00 P.M.)**

GENERAL INSTRUCTIONS

1. There are **TWO** Sections in this paper. Sections **A** and **B** which comprise a total of **SIX** questions.
2. Answer question **ONE** in Section **A**
3. Answer **ANY THREE** questions in Section **B**.
4. In total answer **FOUR** questions.
5. Marks are shown at the end of each question.
6. Show clearly all your workings in the respective answers where applicable.
7. Calculate your answers to the nearest one decimal point where necessary.
8. Applicable tax rates are provided in Appendices on page **10** of **10**.
9. This question paper comprises **10** printed pages.

SECTION A
Compulsory Question

QUESTION 1

(a) Describe main categories of incomes excluded in calculating investment income according to section 9(3) of the Income Tax Act, Cap 332. **(4 marks)**

(b) The Tax Administration Act, Cap 438, provides that, a person who is aggrieved by a tax decision made by the Commissioner General, may object the decision by filling an objection to the Commissioner General.

REQUIRED:

Explain conditions of a valid notice of objection in Tanzania. **(5 marks)**

(c) In calculating a person's income from separate petroleum rights for a year of income, some of the expenses are not allowable expenses.

REQUIRED:

Highlight the non-allowable expenses. **(5 marks)**

(d) Briefly explain the following terms that are used in taxation of income from retirement fund operations:

(i) Retirement fund
(ii) Retirement payment
(iii) Defined contribution plan
(iv) Pensionable service **(8 marks)**

(e) Elegance Insurance is a resident corporation dealing with general and life insurance business. It is an insured corporation at the same time an insurer in some cases depending on the insurance services cycle within its operations. On 31st December 2017, Elegance Insurance reported the following information:

PAYMENT	TZS.	INCOME	TZS.
Costs to improve assets	100,000,000	Life insurance premium	300,000,000
Administrative expenses	20,000,000	Other underwriting income	24,000,000
Life insurance claims	30,000,000	Accounted premiums	300,000,000
Expenses for insurance claims	40,000,000	Investment income	80,000,000
Re-insurers share (claims)	10,000,000	Coded re-insurance premium	100,000,000

The following information relates to Elegance Insurance during the tax year ended 31st December 2017:

- TZS.60,000,000 premium was received by Elegance in the form of proceeds.
- Life insurance claims was for only two risks which are old age scheme TZS10,000,000 and education scheme TZS.20,000,000
- Life Insurance premium was received for these risks: education scheme, death and personal injury at work scheme and old age scheme amounting to TZS50,000,000, TZS.20,000,000,000 and TZS.30,000,000 respectively.
- Elegance holds assets in Norway that have to be insured, hence it paid premium to the Hilton Insurance, a Norwegian based corporation, an amount equivalent to TZS.2,000,000.
- Elegance paid for its re-insurance to XYZ Company Limited, another insurance company residing in Malawi where the corporation own several assets with a value of TZS.1,200,000,000.
- One-half of the total insurance claims above have not been reported in the accounts due to the accounting errors of omission.
- Elegance holds 75% shares of the assets in the Hilton Insurance Co., while during the previous three years it had owned only 50% shareholding. It hence, realized a total of TZS.70,000,000 from that change.

REQUIRED:

(i) Briefly differentiate between "general insurance" and "life insurance". **(4 marks)**

(ii) Calculate the net taxable income of the Elegance Insurance Corporation as per the Income Tax Act, Cap 332. **(14 marks)**

(Total: 40 marks)

SECTION B

There are **FIVE** questions. Answer **ANY THREE** questions

QUESTION 2

(a) A charitable organization is one form of non-profit organizations which is based on humanity goals and other activities servicing the public interest or common good. Upon fulfilment of certain conditions they may be given the tax relief by the Commissioner.

REQUIRED:

Discuss the conditions to be satisfied for the entity to be classified as a charitable organization. **(6 marks)**

(b) Taxpayers may be financed by the use of equity or debt or both of them. The returns of equity capital and debt capital are treated differently for tax purposes. Interest payments incurred on loans used in production of income are generally tax deductible items, sometimes are subject to certain conditions and restrictions. Distribution of profits whether in the form of dividends or returns on capital are not tax deductible items.

The way in which a business is financed has an impact on the calculation of the taxable income. This raises tax concerns regarding the balance between the amount of equity capital and debt capital especially for the thinly capitalized businesses.

REQUIRED:

(i) Briefly discuss the concept of thin capitalization. **(4 marks)**

(ii) Discuss reasons for the companies opt to choose thin capitalization from the tax perspective **(4 marks)**

(iii) Discuss how the countries can curb tax evasion through thin capitalization.

(2 marks)

(c) Young Associate was a resident company during the year 2017. It sold its building, which was not used, for as store for TZS.40,000,000. The building was acquired for TZS.15,000,000 four years back on which the amount of TZS.3,000,000 was spent on improvement and TZS.1,500,000 in connection with the sale of the house. Young Associates also had business income of TZS.16,000,000 during the said year of income.

REQUIRED:

Determine capital gain tax liability and its payment procedures. **(4 marks)**

(Total: 20 marks)

QUESTION 3

(a) The tax systems are relying more heavily on voluntary self-reporting and self-assessment. The need to understand the processes underlying tax compliance is increasingly important and urgent in the current regime of administration than in any other time. This was revealed recently by the traders as well as small miners in their different meetings with the President of the United Republic of Tanzania.

REQUIRED:

(i) Explain the meaning of voluntary tax compliance. **(2 marks)**

(ii) Discuss the factors affecting the voluntary tax compliance in Tanzania. **(6 marks)**

(b) ABC Corp (ABC) is a company resident in Country A, and will shortly commence business operations in Country B through the establishment of a branch. ABC manufactures cigar products in Country A, and will sell these products through its Country B branch to independent customers based in Country B.

A Double Taxation Agreement (DTA) exists between Country A and Country B, based on the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention. Both countries also have transfer pricing legislation based on the OECD Transfer Pricing Guidelines.

Two options for the implementation of the proposed arrangement are currently under consideration by ABC.

Option 1:

Profits derived from the sale of products through the branch in Country B will be treated as profits belonging to ABC. An income tax return will not be lodged in Country B.

Option 2:

The branch will be treated as a separate legal entity in Country B and ABC will set the transfer price of the cigars charged to the branch as the cost of manufacture to ABC plus an uplift of 7.5%. This will result in a guaranteed profit to the Country B branch in relation to the sale of cigars.

REQUIRED:

(i) Explain the concept of a 'branch' or 'permanent establishment', including how the transfer pricing provisions will apply. **(4 marks)**

(ii) Which of the above options would you recommend to ABC's management board? In your response, you should refer to any relevant provisions of any DTA that might apply, with explanation of how the provisions relate to each option, and explain how any transfer pricing rules will apply to the options proposed. **(8 marks)**

(Total: 20 marks)

QUESTION 4

(a) **Tupo Pamoja** shopping centre Ltd is Value Added Tax (VAT) registered trader and carries on the business of shop on cash basis. The company's statement of financial performance for the month of March 2019:

Cash Sales:	**TZS.**	**TZS.**
General taxable goods		168,000,000
General exempt supplies		30,000,000
		198,000,000
Opening stock	300,000,000	
Purchase for cash and credit:		
General goods	120,000,000	
Periodicals	20,000,000	
	440,000,000	
Closing stock	280,000,000	160,000,000
Gross profit		38,000,000
Expenditure:		
Advertising	2,000,000	
Rent of premises	5,000,000	
General exempt supplies	18,000,000	
Other expenses (subject to VAT)	6,000,000	31,000,000
Profit for the month		7,000,000

REQUIRED:

Compute output tax, input tax and VAT payable for the month of March 2019 for Tupo Pamoja shopping. **(12 marks)**

(b) Despite being provided for under Tax Administration (Transfer Pricing) Regulations, 2018, Advance Price Agreement (APA) is being perceived as practically impossible.

REQUIRED:

Briefly explain at least six challenges likely to face the application of APA rule in Tanzania. **(4 marks)**

(c) Before gaining popularity to tax administrators, transfer price was just an accounting concept practised by associated companies.

REQUIRED:

Discuss at least four reasons for charging transfer price. **(4 marks)**

(Total: 20 marks)

QUESTION 5

(a) A VAT refund is an amount of VAT that is payable by Tanzania Revenue Authority (TRA) to a taxable person where the total amount of input tax exceeds the total amount of output tax in a particular tax period, or a taxable person has paid an amount of VAT, in excess of the amount that should have been paid.

REQUIRED:

Explain the requirements for effecting VAT refunds. **(6 marks)**

(b) Simama Company Ltd (Simama) furnished to the Tanzania Revenue Authority (TRA) its statement of estimated tax payable for the year of income 2017 on the 15^{th} December 2016. The statement declared a total estimated taxable income of TZS.320,000,000 and Simama paid the first instalment on the same date it furnished the statement. Simama's year of income normally runs from 1^{st} August of each year.

On 1^{st} March 2017, Simama paid the second instalment before revising its estimates to a taxable income of TZS.380,000,000 from 1^{st} April, 2017. The rest of the instalments were paid on their due dates but Simama failed to file the return of income for the year of income 2017 as required. On 21^{st} May 2018, the TRA officers made an assessment of a total taxable income of TZS.560,000,000. Simama paid the tax on assessment within the date specified.

REQUIRED:

(i) Calculate the amount of tax payable on the second and third instalments. **(6 marks)**

(ii) Determine the tax payable on assessment as at 21^{st} May 2018, taking in account all taxes payable as a result of any Simama's non-compliance. (Assume the statutory rate is 12%) **(8 marks)**

(Total: 20 marks)

QUESTION 6

(a) Tax Revenue Appeals Tribunal (TRAT) was established along with the coming into force of the Tanzania Revenue Authority (TRA) Act of 2000; which empowers the Commissioner General of (TRA) to deal and oversee all undersigned revenue laws. In order to implement the policy of TRAT, the Parliament enacted the Tax Revenue Appeals Act, Cap 408 which establishes Tax Revenue Appeals Board and Tax Revenue Appeals Tribunal.

REQUIRED:

Elucidate the full procedures provided for by the Tax Revenue Appeals Act, Cap 408 for handling disputes relating to assessments. **(6 marks)**

(b) Nyodu, Masahani and Matsova are partners in one enterprise dealing in transport business. Their business income statement for the year 2018, has the following results:

	TZS.
Revenue	208,000,000.00
Other income	400,000.00
Total income	208,400,000.00
Less: Operating Expenses	
Depreciation allowance	10,800,000.00
Fuel and oils	90,000,000.00
Spares, repairs and maintenance	14,000,000.00
Licenses	300,000.00
Interest	5,600,000.00
Salaries and wages	26,000,000.00
Stationery	800,000.00
Tyres and tubes	55,500,000.00
Miscellaneous expenses	8,000,000.00
	211,000,000.00
Net loss for the year	2,600,000.00

Additional information is given as follows:

1. The partners equally spent 10% of fuel and oils used for office vehicles for private purposes.

2. Analysis of salaries and wages:

	TZS.
• Drivers	7,000,000
• Office attendant	3,000,000
• Nyodu	8,000,000
• Masahani	4,000,000
• Matsova	4,000,000

3. Analysis of miscellaneous expenses:

	TZS.
• Office cleaning	350,000
• Weigh bridge fines	3,500,000
• Total tax paid partners	3,300,000
• Office electricity	250,000
• Tip to police to allow speeding the car	600,000

4. The partners share profits/losses equally.

5. Other income: This represents interest on drawings paid by Matsova.

6. Interest analysis:

	TZS.
Interest on bank overdraft	5,000,000
Interest on loan paid to Nyodu	600,000

7. Masahani's personal account showed TZS.2,000,000, 3,000,000 and 5,000,000 as income received from royalty, dividend and realization respectively. A non-resident corporation paid dividend, realization is part payment of sale of a building for TZS.20,000,000. The building that cost TZS.4,000,000 in year 2000 and used for residence was sold to Mr. Jojejo in 2018.

8. Asset acquisition during the year were:

	TZS.
Land rover	10,000,000
Tractor	40,000,000
Pick up	7,500,000
Land cruiser	35,000,000

All these were used in the partnership business. The depreciation basis as at 31st December, 2017 after pooling assets base on the Income Tax Act, Cap 332 showed the following:

Class	**I**	**II**
Value (TZS.)	50,000,000	123,000,000

REQUIRED:

(i) Determine the partnership profit/losses **(6 marks)**

(ii) Determine the partners' taxable income **(8 marks)**

(Total: 20 marks)

Appendices

(1) Applicable resident individual income tax rates:

Monthly income	Tax rate
Where total income does not exceed TZS.170,000/=	NIL
Where total income exceeds TZS.170,000/= but does not exceed TZS.360,000/=	9% of the amount in excess of TZS.170,000/
Where total income exceeds TZS.360,000/= but does not exceed TZS.540,000/=	TZS.17,100/= plus 20% of the amount in excess of TZS.360,000/=
Where total income exceeds TZS.540,000/= but does not exceed TZS.720,000/=	TZS.53,100/= plus 25% of the amount in excess of TZS.540,000/=
Where total income exceeds TZS.720,000/=	TZS.98,100/= plus 30% of the amount in excess of TZS.720,000/=

(2) Applicable presumptive income tax rates:

Annual turnover	Tax payable when section 80 is not complied with	Tax payable when section 80 is complied with
Where turnovers does not exceed TZS.4,000,000	NIL	NIL
Where turnover exceeds TZS.4,000,000 but does not exceed TZS.7,000,000	TZS.100,000	3% of the turnover in excess of TZS.4,000,000
Where turnover exceeds TZS.7,000,000 but does not exceeds TZS.11,000,000	TZS.250,000	TZS.90,000 + 3% of the turnover in excess of TZS.7,000,000
Where turnovers exceeds TZS.11,000,000 but does not exceed TZS.14,000,000	TZS.450,000	TZS.230,000 + 3% of the turnover in excess of TZS.11,000,000
Where turnover exceeds TZS.14,000,000 but does not exceed TZS.100,000,000	Not applicable	TZS.450,000 + 3.5% of the turnover in excess of TZS.14,000,000

(3) Car benefit quantification table as per the 5th Schedule

ENGINE SIZE OF VEHICLE	QUANTITY OF PAYMENT PER YEAR	
	Vehicle up to 5 years old	**Vehicle more than 5 years old**
Not exceeding 1000cc	TZS.250,000	TZS.125,000
Above 1000cc but not exceeding 2000cc	TZS.500,000	TZS.250,000
Above 2000cc but not exceeding 3000cc	TZS.1,000,000	TZS.500,000
Above 3000cc	TZS.1,500,000	TZS.750,000

(4) Statutory rate to be used is 9%

(5) 1 currency point = TZS.15,000

(6) Standard rate of VAT = 18%

(7) Capital gain rates for resident is 10% and for non-resident is 20%.

SUGGESTED SOLUTIONS
C 1 – CORPORATE REPORTING
NOVEMBER 2019

ANSWER 1

(a) **MANGI GROUP'S CONSOLIDATED STATEMENT OF FINANCIAL POSITON AS AT 30TH NOVEMBER 2018**

	TZS. Million
ASSETS	
Non-current assets	
Property, plant and equipment (W9)	1,606.00
Goodwill (W2)	190.00
In Tangible assets (W8)	227.00
Investment in Putting (W3)	50.50
	2,073.50
Current assets (W10)	1,607.00
Disposal group	33.00
Total assets	**3,713.50**
EQUITY AND LIABILITIES	
Equity attributable to owners of parent	
Share capital	920.00
Retained earnings (W5)	936.08
Other components of equity (W5)	77.80
	1,933.88
Non-controlling interest	394.62
	2,328.50
Total non-current liabilities (W10)	711.00
Disposal group (W11)	3.00
Current liabilities (W6)	671.00
Total liabilities and equity	**3,713.50**

Working 1
Boza

	TZS. Million	**TZS. Million**
Purchase consideration		730
Fair value of non-controlling interest		295
Fair value of identifiable net assets acquired:		
Share capital	400	
Retained earnings	319	
OCE	27	
FV adjustment – land	89	
		(835)
Goodwill		190

Working 2
Hai

	TZS. Million	TZS. Million
Purchase consideration		320
Less: consideration belonging to NCI – (30% of TZS.320)		(96)
NCI fair value of 44% holding		161
Fair value of identifiable net assets:		
Share capital	200	
Retained earnings	106	
OCE	20	
FV adjustment – land	36	
		(362)
Goodwill		23

Impairment test of Boza and Hai

	Boza TZS. Million	Hai TZS. Million
Goodwill	190	23
Assets	1,130	595
Fair value adjustment	89	36
Total asset value	1,409	654
Recoverable amount	(1,425)	(604)
Impairment	n/a	50

There is no impairment in the case of Boza but Hai's assets are impaired. Goodwill of TZS.23 million plus TZS.27 million of the in Tangible assets will be written off. The reason for the latter write down is because the directors feel that the reason for the reduction in the recoverable amount is due to the in Tangible assets' poor performance.

Group reserves will be debited with TZS.28 million and NCI with TZS.22 million, being the loss in value of the assets split according to the profit sharing ratio.

Total goodwill is therefore (TZS.190m + TZS.23m – TZS.23m impairment), i.e. TZS.190 million

Working 3
Puttin
The gain of TZS.3 million (TZS.21m – TZS.18m) recorded within OCE up to 1stJune 2018 would not be transferred to profit or loss for the year but can be transferred within equity and hence to retained earnings under IFRS 9 Financial Instruments.

The amount included in the consolidated statement of financial position would be:

	TZS. million
Cost (TZS.21 million + TZS.27 million)	48
Share of post-acquisition profits (TZS.30 million x 0.5 x 30%)	4.5
Less: dividend received	(2.0)
	50.5

The dividend should have been credited to Mangi's profit or loss and not OCI. Dividend income as an investment and as an associate is treated in the same way as a credit to profit or loss. There is no impairment as the carrying amount of the investment in the separate financial statements does not exceed impairment as the carrying amount of the investment in the separate financial statements does not exceed the carrying amount in the consolidated financial statements nor does the dividend exceed the total comprehensive income of the associate in the period in which the dividend is declared.

Working 4
In Tangible assets

Mangi should recognize the TZS.10 million as an in Tangible asset plus the cost of the prototype of TZS.4 million and the TZS.3 million to get it into condition for sale. The remainder of the costs should be expensed including the marketing costs. This totals TZS.9 million, which should be taken out of in Tangibles and expensed.

Dr Retained earnings	TZS.9 million
Cr in Tangible assets	TZS.9 million

Working 5
Retained earnings

	TZS. million
Balance at 30th November 2018: Mangi	895.00
Post-acquisition reserves: Boza (70% of (442 – 319))	86.10
Hai (56% of (139 – 106))	18.48
Putting: fair value of investment at acquisition from OCE	3.00
Putting: share of post-acquisition retained profits (W3) (4.5 – 2)	2.50
Dividend income from OCE	2.00
In Tangible asset	(9.00)
Impairment loss on goodwill of Hai (W2)	(28.00)
Impairment loss on disposal group (W11)	(34.00)
Total	**936.08**

Other components of equity

	TZS. million
Balance at 30th November 2018: Mangi	73
Post-acquisition reserves: Boza (70% of (37 – 27))	7
Hai (56% of (25 – 20))	2.8
Dividend income to retained earnings	(2)
Transfer to retained earning	(3)
	77.8

Working 6

Current liabilities	**TZS. million**
Balance at 30th November 2018 Mangi	408
Boza	128
Hai	138
	674
Disposal group	(3)
	671

Working 7

Non-controlling interest	**TZS. million**
Boza (W1)	295
Hai (W2) – purchase consideration	(96)
Fair value	161
Post-acquisition reserve - Boza	
Retained earnings (30% of (442 – 319))	36.9
OCE (44% if (37 – 27))	3
Hai	
Retained earnings (44% of (139 – 106))	14.52
OCE (44% if (25 – 20))	2.2
Impairment loss (W2)	(22)
	394.62

Working 8

In Tangibles	**TZS. million**
Mangi	198
Boza	30
Hai	35
In Tangible expenses	(9)
Impairment of in Tangible	(27)
	227

Working 9

Property, plant and equipment	TZS. million	TZS. million
Mangi	920	
Boza	300	
Hai	310	
		1,530
Increase in value of land – Boza (W1)		89
Increase in value of land – Hai (W2)		36
		1,655
Disposal group		(49)
		1,606

Working 10

Non-current liabilities	TZS. million
Mangi	495
Boza	123
Hai	93
	711

Current assets	TZS. million
Mangi	895
Boza	480
Hai	250
	1,625
Disposal group	(18)
	1,607

Working 11

Disposal group	TZS. million
PPE	49
Inventory	18
Current liabilities	(3)
Proceeds	(30)
Impairment loss	34

The asset and liabilities will be shown as single line items in the statement of financial position. Assets at (TZS.67 – TZS.34m), i.e. TZS.33 million and liabilities at TZS.3 million. A plan to dispose of net assets is an impairment indicator.

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30TH NOVEMBER 2018

ASSETS
Non-current assets
Property, plant and equipment (W9)
Goodwill (W2)
Intangible assets (W8)
Investment in Puttin (W3)
Current asset (W10)
Disposal group
EQUITY AND LIABILITIES
Equity attributable to owners of parent
Share capital
Retained earnings (W5)
Other components of equity (W5)
Non-controlling interest
Total non-current liabilities (W10)
Disposal group (W11)
Current liabilities (W6)

Workings

Working 1: Goodwill – Boza
Working 2: Goodwill – Hai
Working 5: Group retained earnings
Working 7: Non-controlling interest
Working 9: Property, plant and equipment
Working 11: Disposal group

(b) (i) A joint arrangement is an arrangement in which two or more parties have joint control over another entity. Joint Control is the contractually agreed sharing of control. This exists only when decisions are made with the unanimous consent of the parties sharing control. There are two types of joint arrangement:

- Joint operation; and
- Joint venture

- **Joint operation**
  This is an arrangement through which the parties to the arrangement have rights to certain asset and obligations for certain liabilities of the arrangement. Joint operations may or may not separate legal entities. Each venture will record its share of the operation's assets, liabilities, expenses and gains as determined by the substance of the contract setting up the joint operation. There are no adjustments needed on consolidation.

- **Joint venture**
  This is an arrangement through which the parties have joint control over the NET ASSETS of the venture (as distinct from the individual assets and liabilities). It will be a separate legal entity. in this situation, the investment is accounted for either at cost, or in accordance with IFRS 9 in the individual financial statements of each venturer. On consolidation, equity accounting is used exactly as for associates.

(ii) **Joint Venture: (Accounting for joint venture (IAS28)**

- An entity with joint control of, or significant influence over, an investee shall account for its investment in an associate or joint venture using EQUITY METHOD except that investment qualifies for exception in accordance to IAS 28.

- Under the equity method, on initial recognition the investment is recognized at cost and the carrying amount is increased or decreased to recognized the investor's share of the profit or loss of the investee after the date of acquisition.

- The investor's share of the investee's profit or loss is recognized in the investor's profit or loss.

- Distributions received from an investee reduce the carrying amount of investment.

- Adjustments the carrying Amount may also be necessary for changes in the investors proportionate interest in the investees arising from changes in the investees other comprehensive income. Such changes includes those arising from the Revaluation of PPE and from Foreign exchange translation difference. The investor's share of those changes is recognized in investor's OCI.

(iii) 1. This transaction involves the agreement between Songolo Marine and a partner to develop single project. No new entity is formed. Both parties would seem to be responsible for their own costs, and revenue division in pre-agreed. Therefore, there is no provision for an ongoing relationship between the parties. This is clearly a joint operation. Each party is responsible for their own assets, liabilities, expenses and gains, and will account for these.

Songolo Marine will recognize TZS.80 million in revenue once the ship is complete and control is handed over to the customer. Songolo Marine will also recognize TZS.62 million in cost of sales. It will not recognize the costs or revenue attributable to the engine manufacturer.

Journal	TZS. million	TZS. million
Dr Cash	80	
Cr Revenue		80
(recognition of revenue and cash received)		
Dr Cost of sales	62	
Cr Cash/payables		62
(Recognition of costs incurred, possibly paid)		

2. This transaction appears to be an agreement between two parties to construct a new asset and manage it jointly. A new entity is formed, and each party contributed 50% of the capital invested, it appears that the entity is under joint control, with neither party having full control over any individual assets or liabilities of the new entity. hence the arrangement is a joint venture.

   Under IFRS 11, joint venture are accounted for using equity accounting, similarly to associate companies. Hence the new entity will initially be varied in the books of Songolo Marine at TZS.130 million (cost of investment). The carrying value will be adjusted by Songolo Marine's share of any profits or losses recognized by the joint venture. In the current year, this will amount to TZS.2 million (50% of TZS.4 million).

Journal	TZS. million	TZS. million
Dr investment in joint venture	130	
Cr Cash		130
(recognition of investment made in joint venture)		
Dr Investment in joint venture	2	
Cr Profit or loss		2
(Recognition of share of profit earned by the venture in the year)		

3. Under IFRS 10, control is the ability to direct the operations of another
   entity and benefits from it. Marine Service Company Ltd would appear to be under the control of Songolo Marine. Despite having a 50% interest, less than that which would automatically indicate control, the fact that Songolo Marine makes all operational decisions and has a majority of the Board would suggest that control exists. Hence, Marine Service Company should be consolidated with Songolo Marine and a 50% Non-controlling interest recognized.

Journal	TZS. million	TZS. million
Dr Assets	50	
Cr Liabilities		48
Cr Non-controlling interest		1
Cr Group reserves		1
(recognition of net assets of Marine Service Company at 1st August 2017 in group accounts of Songolo Marine)		
Dr Group reserve/profit or loss	2.4	
Dr Non-controlling interest	2.4	
Cr Net assets		4.8
(Recognition of loss for year ended 31st July 2018 in the group accounts of Songolo Marine)		

(c) (i) **Investment entity**

Is an entity that:

- Obtains funds from one or more investors for the purpose of providing these investors with investment management services;
- Commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and
- Measures and evaluates the performance of substantially all of its investments on a fair value basis.

(ii) **Accounting requirement for an investment entity with subsidiaries**

- An Investment entity shall not consolidate its subsidiary when it obtains control, instead it shall measure an investment in a subsidiary at fair value through profit or loss in accordance with IFRS 9.

- In case the investment entity has a subsidiary that is not itself an investment entity, and whose main purpose and activities are providing services that relate to the investment entity's, investment activities, it shall consolidate the subsidiary.

ANSWER 2

(a) (i) **Sale of goods to QQ Bank**

In accordance with IFRS 15 – *Revenue from contracts with customers*: this agreement is worded as a sale, but Shamu has the option to repurchase the goods.

- Where an option to repurchase exists the terms of the agreement should be analyzed to see whether, in substance, the risks and rewards of ownership have been transferred.

- Under the term of the agreement with QQ Bank PLC, Shamu has not transferred these risks and rewards.

- If the market value of the goods rises sufficiently, Shamu will exercise the option, repurchase the goods and sell them on for a profit.

- If the market value of the goods falls, QQ Bank will exercised its option and Shamu will be required to repurchase the goods, even though they will be sold at a loss.

  This should be treated as a financing arrangement, since the repurchase price (TZS. 387.2m) is greater than the original selling price (TZS. 320m)

- Generally, this is a secured loan, Shamu should continue to recognize the stock in the SOFP and should treat the receipt from QQ Bank as a loan, and not revenue.

- Finance cost of TZS. 16,000,000 (i.e TZS. 320m x 10% x $^{6}/_{12}$) should be changed to the SOPL.

(ii) **Machine Tools**

As per IFRS 15 *Revenue from contracts with customers:* Shamu should recognize 81m (i.e. TZS. 810m x 10%) as performance obligations has not been fulfilled (i.e. the performance obligation has been partly fulfilled at 10%).

The other balance should be recognized as differed income.

(iii) **Subscription**

- In accordance with IFRS 15, *Revenue from contracts with customers:* Shamu should recognize TZS.30m as the performance obligation has been partly fulfilled.

- The other TZS. 210m should be recognized as deferred income, in the SOFP.
- Therefore, revenue of TZS. 30m i.e. (240m x $^{3}/_{24}$) should be recognized in the SOPL.

(b) (i) **Sell of Printing Machine**

The contract contains a significant financing component because of the length of time between when the customer paus for the asset and when Tango transfers the asset to the customer, as well as the prevailing interest rate in the market. A contract with a customer which has a significant financing component should be separated into a revenue component (for the notional cash sales price) and a loan component. Consequently, the accounting for a sale arising from a contract which has a significant financing component should be comparable to the accounting for a loan with the same features. An entity should use the discount rate which would be reflected in a separate financing transaction between the entity and its customer at contract inception. The interest rate simplicity in the transaction may be different from the rate to be used to discount the cash flows, which should be the entity's incremental borrowing rate. IFRS 15 would therefore dictate that the rate which should be used in adjusting the promised consideration is 5%, which is the entity's incremental borrowing rate, and not 11.8%.

Tango would account for the significant financing component as follows:
Recognize a contract liability for the TZS.240,000 payment received on 1st December 2017 at the contract inception:

Dr Cash TZS.240,000
CR Contract liability TZS.240,000

During the two years from contract inception (1st December 2014) until the transfer of the printing machine, Tango adjusts the amount of consideration and accretes the contract liability by recognizing interest on TZS.240,000 at 5% for two years.

Year to 30th November 2018
Dr Interest expenses TZS.12,000
Cr Contract liability TZS.12,000
Contract liability would stand at TZS.252,000 at 30th November 2015.

Year to 30th November 2019
Dr Interest expense TZS.12,600
Ccr Contract liability TZS.12,600

Recognition of contract revenue on transfer of printing machine at 30th November 2016 of TZS.264,600 by debiting contract liability and crediting revenue with this amount.

(ii) **Construction of Printing Machine**

Tango accounts for the promised bundle of goods and services as a single performance obligation satisfied over time in accordance with IFRS 15. At the inception of the contract, Tango expects the following:

Transaction price TZS.1,500,000

Expected costs TZS.800,000
Expected profit (46.7%) TZS.700,000

At contract inception, Tango excludes the TZS.100,000 bonus from the transaction price because it cannot conclude that it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur. Completion of the printing machine is highly susceptible to factors outside the entity's influence. By the end of the first year, the entity has satisfied 65% of its performance obligation on the basis of costs incurred to date. Cost incurred to date are therefore TZS.520,000 and Tango reassesses the variable consideration and concludes that the amount is still constrained. Therefore, at 30th November 2015, the following would be recognized:

Revenue TZS.975,000
Costs TZS.520,000
Gross profit TZS.455,000

However, on 4th December 2018, the contract is modified. As a result, the fixed consideration and expected costs increase by TZS.110,000 and TZS.60,000, respectively. The total potential consideration after the modification is TZS.1,710,000 which is TZS.1,610,000 fixed consideration + TZS.100,000 completion bonus. In addition, the allowable time for achieving the bonus is extended by six months with the result that Tango concludes that it is highly probable that including the bonus in the transaction price will not result in a significant reversal in the amount of cumulative revenue recognized in accordance with IFRS 15. Therefore the bonus of TZS.100,000 can be included in the transaction price. Tango also concludes that the contract remains a single performance obligation. Thus, Tango accounts for the contract modification as if it were part of the original contract. Therefore, Tango updates its estimates of costs and revenue as follows:

Tango has satisfied 60.5% of its performance obligation (TZS.520,000 actual costs incurred compared to TZS.860,000 total expected costs). The entity recognizes additional revenue of TZS.59,550 [(60.5% of TZS.1,710,000) – TZS.975,000 revenue recognized to date] at the date of the modification as a cumulative catch-up adjustment. As the contract amendment took place after the year end, the additional revenue would not be treated as an adjustment event.

ANSWER 3

(a)

(i) The answer should be focused on using the current and quick ratios. While the current ratio has steadily increased, it is to be noted that the liquidity has not resulted from the most liquid assets as the CEO proposes. Instead, from the quick ratio one could note that the increase in liquidity is caused by an increase in inventories. For a fresh food firm one could argue that inventories are relatively liquid when compared to other industries. Also, given the information, the industry-benchmark can be used to derive that the firm's quick ratio is very similar to the industry level and that the current ratio is indeed slightly higher again, this seems to come from inventories.

(ii) Inventories turnover, days sales in receivables, and the total asset turnover ratio are to be mentioned here. Inventory turnover has increased over time and is now above the industry average. This is good – especially given the fresh food nature of the firm's industry. In 2018 it means for example that every 365/62.65 = 5.9 days the firm is able to sell its inventories as opposed to the industry average of 6.9 days. Days' sales in receivables has gone down over time, but is still better than the industry average. So, while they are able to turn inventories around quickly, they seem to have more trouble collecting on these sales, although they are doing, better than the industry. Finally, total asset turnover is going down over time, but it is still higher than the industry average. It does tell us something about a potential problem in the firm's long term investments, but again, they are still doing better than the industry.

(iii) Solvency and leverage is captured by an analysis of the capital structure of the firm and the firm's ability to pay interest. Capital structure: Both the equity multiplier and the debt-to-equity ratio tell us that the firm has become less levered. To get a better idea about the proportion of debt in the firm, we can turn the D/E ratio into the D/V ratio: 2018: 43%, 2017: 46%, 2016: 47%, and the industry-average is 47%. So based on this, we would like to know why this is happening and whether this is good or bad. From the numbers it is hard to give a qualitative judgement beyond observing the drop in leverage. In terms of the firm's ability to pay interest, 2018 looks pretty bad. However, remember that times interest earned uses EBIT as a proxy for the ability to pay for interest, while we know that we should probably consider cash flow instead of earnings. Based on a relatively large amount of depreciation in 2018 (see info), it seems that the firm is doing just fine.

(b) **Comments**

(i) **Liquidity and Solvency Position**

Current Ratio is 2.9. it means current assets of TZS.2.90 are available against each TZS. of current liability. The position is satisfactory on the basis of current ratio. However, the Liquidity Ratio is 0.65:1. It means greater part of current assets constitute stock; the stock is slow-moving. Therefore, the liquidity position is not satisfactory.

(ii) **Credit Terms**
The collection system is faulty because debtors enjoy a credit facility for 96 days, which is beyond normal period. The performance of Debt Collection Department is poor.

(iii) **Profitability**
Gross Profit Ratio is 20% which is a healthy sign. But the Net Profit Ratio is only 5%. It means operating expenses are higher.

(iv) Debit-Equity Ratio is 0.34: 1. It means the firm is not dependent on outside liabilities. The position is satisfactory. Capital Gearing Ratio is also satisfactory. However, the fixed assets to position is satisfactory. Capital Gearing Ratio is also satisfactory. However, the fixed assets to proprietorship ratio reveals that the entire fixed assets were not purchased by the proprietors' equity. It means the firm depends on outside liabilities. It is not desired.

(c) **The importance of CSR in Financial Reporting Standard are follows:**

1. CSR plays an essential role in audit committees because the audit committees are constantly dealing with regulatory governance and compliance.
2. Primary financial statements, such as the income statement, balances sheet, and statement of cash flow, are the main sources of relevant information to users. The decision-makers of cash flow, are the main sources of relevant information to users. The decision-makers are investors, lenders and other creditors in the financial sector. the financial statements are constructed for the public interest. Also, it has been argued that non-financial information is important. Evidently, information reported in the financial statements helps decision-makers to execute better financial strategies. As a result, CSR and sustainability play vital roles when the numbers are reported in financial statements. For instance, financial reports and sustainability have been analyzed from a GRI perspective.
3. Companies that have adopted CSR into their financial reporting experience a high auditor quality standard as compared to companies that have not adopted CSR.
4. Companies in the international market want to understand the existing relationship between stakeholder theory and the TBL theory. CSR appears to be a promising concept in academia and the business world. Companies that have adopted CSR have been forced to disclose more information in their financial statements related to the environmental and social activities.
5. Research studies have shown that it is imperative to seek uniformity in a CSR international financial reporting system. For example, 40% companies worldwide follow and comply with GRI standard (Bonson & Bednarova 2015).
6. Typically, the CSR report covers important areas such as the company's goals and objectives, environmental performance and the human impact. Statistical research showed that about 57% of the U.S. Fortune 500 companies reported CSR on their websites. In the global market, about 95% of the 250 largest companies issue CSR reports and follow CSR compliance guidelines.

7. Scholars and practitioners acknowledge that there is an existing relationship between corporate governance and CSR. This existing relationship promotes corporate strategy, accountability, stakeholder engagement and the company's social responsibility.

ANSWER 4

(a) **New machinery**

The grant has been received and as the company is depreciating the asset over 8 years useful life this indicates an intention to keep the asset for that period and therefore the condition attaching to the grant should be met.

The grant should be taken to deferred income and TZS.7, 500,000 (60,000,000/8) released to P & L account each year or credited to fixed assets and TZS.240, 000,000 (300,000,000 – 60,000,000grants) depreciated over 8 years.

	TZS	TZS
Dr Bank	60,000000	
Cr Deferred income		60,000,000
Being receipt of grant		
Dr Deferred income	7,500,000	
Cr Grant income		7,500,000
Being recognition of grant income		

Training costs

The grant has been received, TZS.15, 000,000 has been spent on training and the company budgets to exceed the TZS 40,000,000 spend over two years to 31 may 2019. It is reasonable to assume that the company will meet the TZS 40,000,000 target and grant should be recognized as differed income.

TZS.3, 750,000 (to match against 25% of the training costs incurred to date) should be transferred from deferred income to the P & L Accounts.

	TZS	TZS
Dr Bank	15,000,000	
Cr Deferred income		15,000,000
Being receipt of grant		
Dr Deferred income	3,750,000	
Cr P/L grant income		3,750,000
Being recognition of grant income		

Startup cost

As this grant relates to costs incurred in the past it should be taken directly to the 2018 to P/L accounts

Dr Bank	5000,000	
Cr P/L grant		5000,000

Being recognition of grant income

Change of boilers
The company has not incurred and is not obliged to incur the cost of changing the boilers. Therefore, there is not reasonable assurance that the grant will be received. The grant should not be recognized. No entry is required.

(b) **The Chairman of the Audit Committee, MPANGA KIPENGELE PLC**

FROM: Accountant

DATE: 31st October 2019

A REPORT ON THE ACCOUNTING TREATMENT OF VARIOUS ACCOUNTING ISSUES FOR THE YEAR ENDED 30TH DECEMBER 2018

Dear Chairman,

Please have the stated accounted treatment of various accounting issues as follows:

The accounting treatments of each of the above transaction as per the requirements of IAS 16 Property, Plant and Equipment's for the year ended 30th December 2018

(i) **Installation of electricity**
This should be capitalized and recognized as part of the property, plant and equipment and reported in the statement of financial position as non-current asset.

(ii) **Improving access roads in its game reserves**
This should be capitalized in the financial statements at TZS.84, 000,000. this is because the construction improves the assets.

(iii) **Installed water supply system.**
This is also capital expenditure. It should be recognized as non-current asset and reported in the statement of financial position as at TZS.16, 000,000.

(iv) **Staff houses in Kalulu and Mulele**
These should be capitalized at TZS.158, 000,000 all related expenditures in this case are capital expenditure. They should form part of the building, hence recognized as non-current asset in the financial statement.

(v) **Procured motor vehicles, computers, equipment's and other related facilities for TZS.33,431,600,000**
These should be treated as 30th December 2018. This is due to the fact that, they were paid on 12th December 2018 and received on 12th January 2019

(vi) **Tender evaluation of various bid documents for TZS.6, 880,000.**
All these should be expensed in the statement of profit or loss for the year ended 30th December 2018 as they are revenue expenditure.

(vii) **Staff training cost**
This must be expensed in the statement of profit or loss for the year ended 30th December 2018 as they are revenue expenditure.

(viii) **Funding proposal**

This must be expensed in the statement of profit or loss at TZS.11, 520,000. for the year ended 30th December 2018 as they are revenue expenditure.

(ix) **Construction of 60 Signposts**

This should be reported in the as Work in Progress at TZS.141, 000,000.in the statement of financial position as at 30th December 2018. A disclosure note should be included in the notes to the financial statements for the year ended 30th December 2018, explaining the construction process and expected cost and date of completion.

(x) **Acquisition of Smart TV Sets and Office Furniture and Fittings**

- The office furniture and fittings should be recognized as **non-current assets** and reported in the statement of financial position as at 30th December 2018 at TZS.23, 000,000. this is capital expenditure and at the reporting date they have been delivered to the company.
- The **Smart TV Sets** should be treated as **Prepayments** under current assets in the statement of financial position as at 30th December 2018 at TZS.15, 345,900. This is due to the fact that, they were paid on 11th November 2018 and received on 11th February 2019. Therefore, at the reporting date, they were not delivered.

ANSWER 5

(a) (i) The present value of the restoration cost should be capitalized as part of the cost of acquiring the asset if the obligating event causing the liability has occurred. Here, the obligating event causing the obligation to dismantle the plant has occurred, as the plant is built. How over, the obligating event for the 25% relating to the removal of waste fuel has not, as no waste fuel yet exists.

Hence a provision should be recognized for TZS.3, 000, 000,000 (TZS.4, 000 000,000 * 75%) at 1st August 2018. This will be added to the purchase cost of the plant, capitalizing a total of TZS.23, 000, 000,000.

At 31st July 2019, this amount will be depreciated over 20 years, being the useful economic life of the plant.

Accordingly, (TZS23,000,000,000/20years) =TZS.115, 000,000, will be charged to profit or loss in respect of depreciation

Finally, the provision will be remeasured due to the unwinding of the discount as time passes. An amount of TZS.180, 000,000 million (TZS.3,000, 000,000 * 6%) will be charged to finance costs and credited to the provision.

(ii) IAS 37 requires the recognition of a restructuring provision only when:

- A detailed formal plan has been prepared and it is unlikely that it will be withdrawn and
- This plan has been communicated to those affected. Both these condition appear to be met in this case.
  Provision should be made on 31st July 2019 for the redundancy costs of TZS.750, 000,000 and the loss on disposal of the plant TZS.1,200,000,000. The retraining costs should not be provided for as these are not direct costs of the closure.

  No obligating event has yet occurred to justify a provision for these costs.

(b) (i) Stock of DVD players

This is an adjusting event as it provides additional evidence to the implication of declining stock.

A further write down of the stock is required by TZs.127.5m i.e. 210m – 82.5m.

The entry will be:

Dr Loss on write down of stock	127.5m	
Cr Stock		127.5m

(ii) This is a non-adjusting event.

The information on dividends should be disclosed in accordance with IAS I.

(iii) This is a non-adjusting event as the stock theft wasn't foreseen during the year.

The entity will only disclose it in the notes to financial statements in case the amount is material. In case such theft results into a loss that threatens the company's going concern, the necessary adjustments relating to going concern will have to be done.

(iv) This is an adjusting event, providing more evidence to the estimated loss from the receivable.

Total Doubtful debt = (TZS80m-(TZS80m*15%) =TZS68m)

The allowance for doubtful debts should be increased by TZS.43m i.e. TZS.68m – 25m.

The entry will be:

Dr Doubtful debts expenses	43m	
Cr allowance for doubtful debts		43m

ANSWER 6

(a) (i) **Main circumstances that give rise to related parties**

A party is related to an entity (it is a related party) in any of the following circumstances.

- The party controls the entity, or is controlled by it.
- It has significant influence over the entity.
- It has joint control over the entity.
- The parties are under common control.
- The party is an associate.
- The party is a joint venture in which the entity is a venturer.
- The party is a member of the key management personnel of the entity or its parent.
- The party is a close family member of any of the above.

(ii) **Reasons for the disclosure of related party relationships and transactions:**

- For transparency and accountability purposes and
- To facilitate a better understanding of the financial position and performance of the reporting entity.

(iii) **The financial effect that Hombolo's instruction may have on the financial statements of the companies within the group and the implications this may have for other interested parties.**

- This could affect profit for the year for the group and the individual company. If it could have been sold outside the group, higher profit could have been earned.
- This will mislead users of financial statements who normally expect the financial statements to reflect transactions that have taken place on normal commercial terms ('at arm's length'). The user of the financial statements would want to be informed if: transactions have taken place that were not at 'arm's length', or there are parties that could enforce transactions on the entity that are not on an 'arm's length's basis.

(b) Given the market value of the property and the terms of the sale to the bank (price and re-purchase option), the substance of the transaction is a loan (TZS.300, 000,000) secured using the property, rather than sale of property (as the legal form of the transaction suggests). The framework requires that transaction are reported based on their economic substance when it differs from their legal form.

This means that:

- Kambililtd should continue reporting the property in its statement of financial position at its carrying account. At 31st December 2017 this will be TZS.196, 000,000 (i.e. 200,000,000 – 4,000,000 depreciation). Where was obtained by taking TZS 4,000,000=TZS120,0000,000/30years

- Additionally, a disclosure that this property has been pledged as security should be made.
- A loan (and its one year interest) should be shown in the statement of financial position at a value of TZS.300, 000,000. This will be coopted with a disclosure of the terms of the loan in the notes.
- Interest expense should be recognized to profit/loss for 2017. The amount will be determined as the difference between the exercise price of the repurchase option and the price at which the property was "sold", for the year 2018 this is TZS.30,000,000. Of course depreciation expense (TZS.4, 000,000) will also be charged to P/L.

SUGGESTED SOLUTIONS
C2 – AUDITING AND ASSURANCE SERVICES
NOVEMBER 2019

ANSWER 1

(a) (i) **Business risk**

(1) ***Leasing of equipment and specialist staff.*** As Air Citizen leases its equipment and the most specialized of its staff from another Airline, there is a risk that its equipment and/or pilots could be withdrawn leaving it unable to operate.

(2) ***Condition of exclusive right.*** The TCCA requires Air Citizen Aircraft engines be overhauled biannually. There is a risk that Air Citizen will be unable to meet this condition, if the lessor company does not agree to regular overhaul of that it will be too expensive for Air Citizen to meet this requirement and it could lose the right to operate, or its exclusivity, opening it up to competition. There may be other conditions which Air Citizen has to meet, such as the two weekly flights being a minimum.

(3) ***Necessary Service suspension.*** As Air Citizen is required to overhaul its engines every two years, there will be significant period every two years where Air Citizen will either have to incur the cost of leasing other planes (assuming this is possible) or will have to suspend services. The cost of leasing other planes might be prohibitively expensive or the disruption to service might mean that conditions relating to the right to operate might not be met. As Air Citizen a only has one plane, service would also be interrupted if there was an emergency relating to the plane, such as fire or a crash.

(4) ***Age of Aircraft. The Aircraft being leased is old.*** This raises operational risks (it may not always be able to fly due to necessary maintenance), finance risks (it may require regular repair) ad compliance risks (it may not meet environmental or safety standards, now or in the future).

(5) ***High proportion of expensive seats.*** The plane leased by Air Citizen has high proportion of unrequired expensive seats and therefore insufficient (overbooked) cheaper seats. Although Air Citizen an appease customers by upgrading them, this means the Airline is operating well below capacity.

(6) ***Cargo.*** The flight route results in the Airline carrying a large amount of horticultural produce. This raises various risks – that Air Citizen might be liable for any breaches of law by its passengers (for example, if prohibited items are transferred into or form each country. Many countries prohibit the importation of animals or meat products or plants).

(7) ***On- board services.*** Air Citizen should consider entering into a contract with a they must not breach any existing contract with the Kampala Company and so in the meantime should review the type of food provided. For example, it might be safer to only offer cold food, for example sandwiches and cake is set up, it might still be best to offer cold food as there is less chance of health problems arising as a result serving cold food rather than hot food.

(8) ***Pricing*** – As discussed above, Air Citizen should review the pricing policy. They should also establish limits on how many of certain types of tickets (non – refundable/ single etc) can be issued for one flight and they should institute a centralized system to ensure that each agent is aware when limits have been reached. As the agents must be linked to a similar system already (to be aware of whether tickets are available for sale) this should not be too difficult to achieve.

(9) ***Safety.*** The company should appoint a member of staff to be specifically responsible for safety operations (such as training, updating for legal requirements, educating passengers) and should ensure that staff are regularly appraised about safety issues.

(10) ***Exchange rate risk.***Air citizen operates in two countries where the receivables and payables are subjected to the risk of exchange rate.

(ii) **Managing Risks**

(1) ***Lease.*** Air Citizen must ensure that the terms of the contract with the international Airline ensure that Aircraft and staff cannot be withdrawn without reasonable notice, and that in the event of withdraw, substitutes will be given

(2) ***Conditions.*** Air Citizen must ensure that all staff are aware of any conditions and the importance of meeting them. However, this risk must simply be accepted as there is little Air Citizen can do about conditions imposed on them by the governing body of their industry.

(3) ***Service Suspension.*** Air Citizens must have contingency plans for services suspension, such as ensuring their contract with the International Airlines ensure alternative Aircraft will be made available to them in the event of maintenance or damage to the Aircraft or by making arrangements to lease from a different Airline in the event of emergency. As a minimum, Air Citizen must ensure that the Airline they lease from would give them financial compensation in the event of Aircraft or staff not being available so that Air Citizen's customers could be compensated.

(4) ***Age of Aircraft.*** Air Citizen should have plans in place to be able to lease/afford newer planes if required to by law. Again this could be written into their contract with the Airline. Air Citizen should manage cash flow and borrowing facilities so as to be able to afford ongoing maintenance when required.

(5) ***High promotion of expensive seats.*** Air Citizen should negotiate a reconfiguration of the plane with the lessor so that business and first class seating could be reduced and more economy seats made available. If this is not possible with the current lessor, Air Citizen should investigate leasing differently configured planes from another company. If it is not feasible to adjust the plane seating, Air Citizen should consider its pricing and on-board facilities policies to make business and first class seats more attractive to customers. As the seats are not being sold anyway, it is probable that a reduction in prices would increase overall revenue, although this might reduce potential profit.

(6) ***Cargo***. Air Citizen should publish a cargo policy to ensure that customers are aware of their legal obligations. They should ensure that staff are sufficiently trained to discuss the contents of baggage with customers and are aware what items Air Citizens should not carry. They should insure against lost damaged cargo.

(7) On-board services. Air Citizens should consider entering into a contract with a company in Dodoma to provide food for the Dodoma to Kampala journey. Obviously they must not breach any existing contract with the Kampala Company and so in the meantime should review the type of food provided. For example, it might be suffer to only offer could food, for example sandwiches and cake until to Dodoma contract can be set up. Even if a new contract is set up, it might still be bet to offer cold food as there is less chance of health problems arising as a result of serving cold fold rather that hot food.

(8) ***Pricing.*** As discussed above, Air Citizen should review the pricing policy. They should also establish limits on how many of certain types of tickets (non-refundable/single etc) can be issued for one flight and they should institute a centralized system to ensure that each agent is aware when limits have been reached. As the agents must be linked to a similar system already (to be aware of whether tickets are available for sale) this should not be too difficult to achieve.

(9) ***Safety.*** The company should appoint a member of staff to be specifically responsible for safety operations (such as training, updating for legal requirements, educating passengers) and should ensure that staff are regularly appraised about safety issues.

(10) ***Exchange rate:*** The Air Citizen could take out hedging contracts against the payables and receivables. For example, cost of fuel, salaries, commissions etc.

(b) **ISA 320 Audit Materiality** is one of the international standards on Auditing. It serves to expect the auditor to establish an acceptable materiality level in designing the audit plan. Materiality is the amount by which the financial statement must change in order to change the decisions made by users of the financial statement.

Materiality in the financial statements can be assessed through qualitative and quantitative factors;

1. Qualitative factors

The list of factors that determine materiality is not exhaustive. Some of the factors that need to be considered when making a judgement on materiality are:

a) **Relative significance**
This is to determine the materiality of the item by viewing its significance in relation to the class to which it belongs.

b) **Comparison with the corresponding previous year's figures: patterns of income and expenses**
Comparison with previous year's figures under similar headings is yet another criterion for determining materiality.

c) **Transactions of abnormal and non-recurring nature**
If a transaction is of an abnormal or of non-recurring nature, it is considered to be material, even if the amount involved may not be large e.g. related party transactions, acquisition of new business, research and development expenses etc.

d) **Statutory requirement**
Omission of any amount that has to be disclosed because of statutory requirements is material in nature. Hence, qualitative materiality refers to a transaction which is not material because of its size, but because of the nature of the item e.g. statutory requirement.

e) **Regular checks**
Few items should be regularly checked for misstatements even though their monetary value might be insignificant. This is because these items are material to the users. Certain errors such as critical point errors need to be examined as they have the capability to change a loss into a profit.

f) **Recurring errors**
Certain errors are recurring errors and occur frequently. While determining materiality levels, it is important toinclude these items even though they are of small amounts as they signify a weakness in the accountingsystem. For example, if the internal audit report of the previous year indicates that there were errors in thecalculation of wages during the earlier year because it was handled by a trainee, then the auditor, during thecurrent year, will have to check the calculation of wages for amounts which exceed the set materiality level.

2. Quantitative factors

Calculated materiality amounts derived using quantitative approaches may be increased or decreased based onthe auditors' professional judgement about the possible effect of qualitative factors.

(c) **The benefits to DARUBINI CO for forming an audit committee**

Providing the directors with financial expertise.
DARUBINI Co currently has no financial director leading to potential errors in financial reporting. The other directors do not have financial knowledge and will have to spend a lot a time ensuring reporting requirements are met. As at least one member of the audit committee will have recent, relevant financial experience they can provide expertise to the board temporarily allowing the directors to focus on operational issues.

Improvement to internal controls
We are told that the board of DARUBINI Co. does not understand the reports of internal audit. This means that attention to control system many be inadequate with the board not expressing the need for internal controls throughout the organization. By having an audit committee the control environment will be improved with the committee able to ensure that the board and management understand the need for strong internal controls.

Less reliance on external auditors
The lack of understanding on the board of internal audit reports due to lack of financial knowledge means that too much reliance may be placed on the work of external audit. An audit committee will provide an independent reporting mechanism for external audit and will have the financial expertise to recommend to the board how to implement the recommendations of external audit.

External auditor appointment.
In order to ensure independences the external auditor should appointed by an audit committee. This reduces the risk that the external auditors become too familiar with the board and is appointed for reasons other than ability. DARUBINI Co currently appoint the external auditor through the board, so by establishing an audit committee the external auditor can be appointed independently using the expertise of the committee.

Compliance with combined code.
The combined code recommends that an audit committee be set up. DARUBINI Co is not listed and is not required to follow the requirements, but following them may provide benefits such as improved transparency. Having an audit committee will show DARUBIN Co's stakeholders that they are committed to strong internal controls and financial reporting. This may make it easier for DARUBINI Co raise finance.

Improved independence
DARUBINI Co does have any no – executive directors which mean that the decisions made by the executive directors are not challenged by independent directors. As an audit committee is made up of no – executive directors and one of these could be appointed to the board. This provides the board with some independent advice**.**

(d) **The procedure that could be used to review the interim financial information include:-**

(i) Reading last year's audit and previous reviews files.
(ii) Considering any significant risks that were identified in the prior year audit.
(iii) Reading the most recent and comparable interim financial information.
(iv) Considering materiality.
(v) Considering the nature of any corrected or uncorrected misstatement in last year's financial statements
(vi) Considering significant financial accounting and reporting matters of ongoing importance.
(vii) Considering the results of any interim audit work for this year's audit.
(viii) Inquire from management whether what their assessment is of the risk that the interim financial statements might be affected by fraud.
(ix) Inquiring management on any significant changes in business activity and affect they had
(x) Inquiring management about any significant changes in internal controls and the potential effect on preparing the interim financial information.
(xi) Asking how the interim financial information has been prepared and the reliability of the underlying accounting records.

(e) (i) **Advantage of independent audit**

a) Independent audits are important for inspiring and maintaining users trust because they demonstrate that the organisation is committed to financial transparency and accountability.
b) It helps the management in detection errors and frauds
c) It helps the management in obtaining loans from banks and other financial institutions as the audited statements are relied upon.
d) It builds up the reputations of the business.
e) Auditors can give concrete suggestion regarding improvement of business on the basis of their findings in record.
f) Audited financial statements help the board of director have more confidence in the organization's financial statements because they based on an analysis by an objective third – party.

(ii) *The phase **"the auditor must be seen to be independent both in fact and appearance"***

Independent in fact – This is the state of mind that permits the provision of an opinion without being affected influence that compromise professional judgment, allowing individual to act with integrity and exercise objective and professional skepticism.

Independence in appearance - This is the avoidance of facts and circumstances that are so significant that a reasonable and informed third party having knowledge of all relevant information, including safeguard applied, would reasonably conclude a firms or members of the assurance team's integrity, objectivity or professional skepticism had been compromised. This refers to how independent observers perceive the auditors behaviors in relation to performance of his professional duty.

(iii) **The inherent limitations of auditing are:-**

- **Minimization and not elimination of errors** – Due to time and cost constants, the auditors uses selective testing to examine the transactions. Consequently, there may be material misstatements resulting in errors and fraud that remain undetected. It is also not possible for the auditors to uncover a carefully laid scheme of fraud. Thus auditing only reduces and does not eliminate the possibility of existence of errors and fraud in books of account and financial statements.
- **Inconclusiveness of evidence –** the evidence obtained by an auditor is persuasive rather than conclusive. Therefore, an auditor can only draw reasonable conclusions from such evidence.
- **Exercise of judgment –** The nature, timing and extent of audit procedure to be performed is matter of professional judgment of the auditor. In addition, the auditor exercise judgment to ascertain the reasonableness of various estimates made by the management and not reached through the scientific process.
- Inherent limitations of internal control system- These also contribute to the inherent limitations of audit. This arises due to:
  - ✓ Potential human error
  - ✓ Possibility of collusion
  - ✓ Possibility that a person responsible for exercising controls could abuse the authority
  - ✓ Possibility that procedure may become inadequate due to changes in entity's business and economic environment.

ANSWER 2

(a) (i)

Ethical threat	Managing Risks
Staff membership rates at SNNCHE – self-interest threat. Such a benefit could cause a self – interest threat to the audit, because the recipients may not want to lose their benefit, and therefore be biased in their audit work or not seek adjustments where there are materials issues in the financial statements.	Auditors are not allowed to accept such benefits unless their value is trivial and inconsequently. In this case, the value of a reduced membership of a spa is unlikely to be trivial and inconsequently to audit staff members and therefore count and should reject this offer.
Partner invited to sit on the board familiarity / management If a partner was to sit on the board of directors, there is risk that the partner could lose their audit objectivity as they may start to be too closely with the company and its other directors. There is also a risk that audit partner may start making management decisions at SUNCHE Co.	Auditors are prohibited by the code of Ethics from sitting on the boards of their clients. Saida Lamb should explain this to Machoge Wambecha and politely decline the invitations.

Finance controller married to audit manager – familiarity threat. The finance controller at SUNCHE married to an audit manager at count and Co. There is no indications that Anthony Chogo has any connection to the audit of Co. Cleary, the personal relationship between Pamela and Anthony Chogo means that Anthony could not carry out this audit objectivity	Therefore, he must not be involved in the audit of SUNCHE Co whilst Pamela is finance controller. However, it is acceptable for the firm to carry out the audit under these conditions.
Assurance re insurance claim advocacy threat Auditing firms must always ensure that accepting other services does not impact on audit objectivity, whether due to the amount of fees relating to the services or as a result of the nature of the services itself.	The partners should discover more about the size and nature of this engagement to determine whether it will affect independence. In particular they should determine whether such an engagement would put the form in the position of advocating SUNCHE positions to the insurance firm, as this cause an insurmountable barrier to independence. They should also monitor the level of fee income this would earn count and Co from all work performed for SUNCHE Co does not provide a fee threshold percentage. However the code does state that once fees from all services from a public interest entity amount 15% or more of the forms gross income that safeguards should be put in place to mitigate threats to independences. This is a good percentage to use as guide.
Conflicts of interest **Count** and Co has been invited to tender for an audit which will involve SUNCHE major competitor, Revitalize. It is appropriate for audit forms to audit competitors, but the clients involved might feel that there is a threat to client confidentiality and may prefer to seek other auditors in such situation	Count and Co should therefore disclose to that they are in the process of tendering for the audit of a competitor. If either SUNCHE Co or Revitalize is unhappy with this situation then count and co will need to decide which audit they want to secure. If count and co performs both audits, they must ensure that they use separate audit partners and team and set up "Chinese walls" to maintain confidentiality.

(ii) **Procedures that auditor carry out to obtain an understanding SUNCHE Co in order to conduct first year audit:**

i. Talk to Machoge Wambecha and Pamela Chogo about SUNCHE to obtain knowledge about how the business operate so that they know what its main risks and issues are and what has happened to and in the company during the year under review.

ii. Visit the spa and observe the types of asset it possesses and the system in place which allow it to function. This will enable them to build up an understanding of the types of issue and balances the auditors would expect to see in the financial statements and the quality of the control systems.

iii. Obtain any available accounts, for example, draft financial statements and management accounts. Although the company has not been audited before, the company is likely to have prepared accounts for taxation purpose and therefore analytical review on current and past accounts should d be compared to identify risk areas. This means they can focus audit work on the more risks areas.

iv. Obtain budgets for the year under review and compare them to draft financial statements to identify any risk areas, perhaps where there have been major variances between intentions and actual results and discus the results with Wambecha and Eva.

v. Review the system manual of the system put in operation by Pamela and assesses whether they are capable of preventing or detecting and correcting errors. If so, carry out tests of controls to determine whether they have operates as intended during the year.

vi. Review the insurance claim in respect of the incident during the year to determine the extent of the damage and impact on the financial statements.

(b) **Conditions that can lead to qualification of audit report.**

(i) Where proper accounting records have not been kept

(ii) Where books of account if kept, do not agree with the audit financial statements prepared by the management

(iii) Where proper returns adequate for the purpose of the audit have not been received from branches not visited by the auditors.

(iv) Where the information given in the directors reports is not consistent with information in the accounts.

(v) Where auditors are unable to obtain all the information and explanation required for the purpose of their audit.

(vi) Where the management of the enterprise did not comply with relevant statutory and professional regulations in preparing the financial statements.

(vii) Where there are significant departures form accounting standards.

(viii) Where internal control system are not effective within the enterprises

(ix) Where there is a doubt as to the going concern concept status of the company.

ANSWER 3

(a) (i) **The following audit opinions are recommended.**

1. Since the inconsistency is traced to the financial statements, it may be considered that the financial statements are materiality misstated. The perverseness of the effect of the matter will be considered and if it is only material, a **qualified opinion** except for be issued. On the other hand, if the effect is considered as being both material and pervasive, and adverse opinion will be appropriate.
2. TZS 2 million reductions in the value of stocks amount to 10% of the total assets of the company. This is material misstatement of the financial statement and non – compliance with applicable financial reporting frame wok. The recommended audit opinion will be a **qualified opinion.**
3. Since the auditors consider the effect of the matter to be both material and pervasive, it means that there was a significant inability to obtain sufficient appropriate audit evidence to determine misstatement in the financial statements. The auditors will be unable to express an opinion therefore a **disclaimer of opinion** will be appropriate
4. Since management refused to make a provision for the write – off of the debtor, the requirement of IAS 37 have not been complied and thus will be materiality misstated. **A qualified opinion is recommended.**

(ii) The auditors may consider the reason behind the director's refusal effect the changes and determine whether it borders on the directors wanting to commit fraudulent financial reporting which will reflect on their integrity. It could also mean the directors are difficult and just do not want to cooperate with the auditors. Whether the case, the auditors may want to bring this to the attention of the shareholders in the annual general meeting.

(b) **(**i) **The environmental issues that may lead to the risk of material misstatements in financial statements:**

- Provisions such a site restoration costs
- Contingent liabilities which arising from pending action
- Asset values, such as inventory or non – current asset which may subject to environment concern
- Accounting for capital or revenue expenditure on cleaning up the production process or to meet legal or other standards.
- Product redesign costs
- Product viability /going concern considerations.

(ii) **Actions and Audit procedures that should be undertaken by VIVA and Associates**

- Obtain an appropriate understanding of the company, its operation and in particular, its environmental issues.
- Evaluate whether there is any possible risk of misstatement in the financial statements as a result of environmental issues.
- Enquire of management as to any system of control which are in place to identify risk, evaluate control and account for environmental matters.
- Obtain an understanding of the control environmental within the client.

- Obtain written representations from management on any environmental matters.
- Obtain evidence from environmental experts where this is necessary.
- Seek corroborative evidence of any statements by management.
- Use professional judgment to consider whether the evidence in relation to environment matters is sufficiently persuasive.
- Consider minutes of directors, board committee or environmental officers.
- Review documentation
- Review all assets for impairment
- Review liabilities and provision to ensure all have been included.
- Review contingency and ensure adequate disclosure
- Include environmental issues in the review of the appropriate of going concern.

ANSWER 4

(a) **Reasons that a firm auditor's decide to reject re – election as auditors of entity are follows:**

Disagreement with the client
The audit firm may have disagreed with the client for a number of reasons, for example, over accounting treatment used in the financial statements. A disagreement over a significant matter is likely to cause a breakdown in the professional relationship between auditor and client, meaning that the audit firm could lose faith in the competence of management. The auditor would be reluctant to seek re- election if the disagreement were not resolved.

Lack of integrity of client
The audit firm may feel that management is not acting with integrity, for example the financial statements may be subjected to creative accounting or dubious business ethics decision could be made by management such as the exploitation of child labour. The auditor would be likely not to seek re- election (or to resign) in this case to avoid being associated with the clients poor decision.

The audit firm could be unable to demand a high enough audit fee from the client to cover the costs of the audit. In the situation the audit firm may choose not to offer itself for re-election, to avoid continuing with a loss making engagement, and consequently to use resources in more come commercially advantageous way.

Fee payments.
The audit firms have outstanding fees which may not be fully recovered due to client's poor cash flow position. Or, the client could be slow paying, causing the audit firm to chase for payment and possibly affecting the relationship between the two businesses. In such cases the audit firm may make the commercial decision not to act for the client any longer.

Resources
The audit firm may find that it lacks the resources to continue to provide the audit service to a client. This could happen if the client company grows rapidly,

financial or operationally, meaning that a larger audit team necessary. The audit firm may simply lack the necessary skilled staff expand the audit team.

Competence
The audit firm could feel that it is no longer competent to perform an audit service. This could happen for example if a client company diversified into a new and specialized business operation of which the audit firm had little or no experience. The audit firm would not be able to provide a high quality audit without building up or buying in the necessary knowledge and skills, and so may decide not to be considered for re-election.

Overseas expansion.
A client acquires one or several material overseas subsidiaries. If the audit firm does not have an associate office in the overseas location, the firm may feel that the risk and resources involved in relying the work of the auditors is too great, and so decide not to act for the client any longer.

Independence
There are many ethical in relations t independence which must be adhered to by auditors, and in the event of a potential breach of the guidelines, the audit firm may decide not to seek re-election. For example, an audit firm may need to increase the audit size. This could have the effect of increasing the fee receiving form the client above the allowed thresholds. As there would no ethical safeguard strong enough to preserve the perception of independence, in this case the audit firm would not be able to continue to provide the audit the audit service.
Tutorial note: other examples may be used to explain why the issues of independence could cause an audit firm not to seek re-election, e.g audit firm takes on a financial interest in the client, close personal relationships develop between the firm and the client.
Conflicts of interest.
Audit firm may become involved in a situation where a conflict of interest arises between an existing audit client and other client of the firm. For example, an audit firm could take on a new audit client which is a competitor of an existing audit client. Although with the use of appropriate safeguards this situation could be successfully managed, the audit firm may decide that stepping down as auditor of the existing firm is the best course of action.

(b) (i) **Audit procedures using software on receivables balance at Papua LTD**
The following are Procedures and reasons

- Cast the receivable ledger to ensure it agrees with the total on the receivables control account in order to ensure the completeness and accuracy f recording of items in the receivables ledger and control account.
- Compare the balance on each receivable account with its credit limit to ensure this has not been exceeded so as to check for violation of system rules.
- Review the balance in the receivables ledger to ensure no balance exceeds total sales, to check for unreasonable items in the ledger,

- Calculate receivables days for each month end to monitor control of receivables over the year so as to obtaining new/relevant statistical information.
- Stratify receivables balance to show all materials items and select appropriate sample for testing in order to select items for audit testing.
- Produce and aged receivable analysis to assist with the identification of irrecoverable receivable in order to assist with receivable valuation testing.

(ii) **Problems of using audit software**

Cost

The may be substantial setup costs to use the software, especially where the computer systems of the client have not been fully documented, as the situation in Papua Ltd. A cost benefit analysis form the audit point-of view should be carried out to deciding audit software.

Lack of software documentation

The computer audit department at Papua Ltd cannot confirm that all system documentation is available, especially for the order 'legacy' systems currently in use. This again confirms the view that use of audit software should be deferred until next year to avoid extensive setup cost which cannot recouped due to system changes.

Change to clients system

Changes to client's computer systems can result in costly amendments to the software. Given that PapuaLtd.'s systems will change next year, this almost certain to result in amendments to the software. Starting to use audit software this year is therefore not advisable.

Output obtained.

The audit manager needs to be clear exactly audit assertions are to be tested with the audit software and what outputs are expected, starting testing just obtain in knowledge of the system is inappropriate as testing may be too detailed and output produced that is not required, increasing the cost for the client.

Use of copy files

The use of files means that the auditor will not be certain that these are the actual files being used within Papua Ltd computer systems, especially as the provenance of those files will not be checked. To ensure that the files are genuine either the auditor should supervise the copying of the' live' files on Papua Ltd.'s computer systems should be use.

(c) (i) The bank letter is important because it is independent confirmation of a numbers of significant matters in the client's financial statements. It confirms cash and bank balances which may well be a significant asset. It also provides confirmation of customers' assets held as security, customers' other assets held (as custodian) and contingent liabilities.

Auditors also the bank to give details of other banks ad braches that the respondents bank is aware have a relationship with the client and branches that the respondents bank is ware have a relationship with the client.

The following are the procedures used to obtain confirmation from the banks

i. Obtain written authority from the client to the bank to disclose the necessary Information.
ii. Send a bank letter in standard form to the bank in sufficient time for it to arrive at least a month before the year-end. The letter should state both the year-end date and the previous year-end date, and should refer to the client's granting of Authority.
iii. If additional information over and above what is in the standard letter is requested, send a separated letter requesting that information.
iv. When confirmation is received from the bank, check that the bank has answered all questions in the letter.
v. Follow up all disclosed in the bank letter.

(ii) **The following test should be carried out on the bank reconciliation**

- Obtain standard bank confirmation from each bank with which the client conducted business during the period.
- Test arithmetic of bank reconciliation by recasting.
- Trace cheques shown as outstanding from the bank reconciliation to the cash book
  prior to the year-end and to the after-date bank statements and obtain explanations
- For any larger or unusual items not cleared at the time of the audit.
- Verify by checking paying-in slips that uncleared banking are paid in prior to the year-end and review whether uncleared banking are cleared quickly after the year-end.
- Verify balances per cash book according to the reconciliation with cash book and general ledger.
- Verify the bank balances with reply to standard bank letter and with the bank statements.
- Scrutinize the cash book and bank statements before and after the period-end for exceptional entries or transfers which have a materials effect on the balance shown to be in hand audit.
- Verify by checking paying in slips that uncleared banking are paid in prior to the year-end and review whether uncleared banking are cleared quickly after the year-send.
- Verify balances per cash book according to the reconciliation with cash book and general ledger.
- Verify the bank balances with reply to standard bank letter and with the bank statements.

- Identify whether any accounts are secured on the assets of the company.
- Consider whether there is a legal right of set-off of overdrafts against positive bank balances.
- Determine whether the bank accounts are subject to any restrictions.

ANSWER 5

(a) (i) Prospective financial information (FPI)

ISAE 3400 defines PFI as financial information based on:
-Assumptions about events that may occur in the future; and
-Possible actions by an entity.

Prospective financial information can be in the form of a forecast, a projection or a combination of both.
A forecast is defined by ISAE 3400 as PFI prepared on the basis of assumptions about future events that management expects to take place and the actions management expects to take the time the information is prepared (best-estimated assumptions).

Projection
A projection is defined by ISAE 3400 as PFI prepared on the basis of:
Hypothetical assumptions about future events and management actions which are not necessarily expected to take place (e.g. when entities are starting up or restructuring); or mixture of best-estimate and hypothetical assumptions.

(ii) **Accountants should consider the following matters before accepting the assessment to examine and report on the profit forecasts:**
Purpose of PFI i.e. profit forecast and risk involved
Malezi Accountants must understand why the forecast are prepared and how they are going to affect the user's decisions. This will also help with understanding the risk factor involved in the assignment. As Chanika's profit forecasts are intended for the existing shareholders and other prospective investors, there seem to be a larger number of users. Therefore, the risk is high.

Although other factors might play their role in affecting the shareholders' decisions (such as the price offered by the bidding company), these forecasts would certainly affect user's decision (to some extent) of whether to let the company be taken over by another company or whether to remain invested in the original company.

Therefore, there seems to be a higher risk of materials misstatement in Malezi's assurance on the profit forecasts.
Malezi must consider all these points before accepting the appointment

Type of assumption made
In assessing the risk, Malezi must verify the type of assumptions made in calculating the financial figures of various items of expenditure or income. This is because an assumption based on a hypothetical situation will be more risky than a best estimate assumption. In the given scenario, Chanika expects an increase in profits upon implementation of the new technology. This is a hypothetical assumption because it does not know whether the new technology will result in better quality tyres. Additionally, Chanika competitors might already be in the process of implementing such a technology so that by the time Chanika actually adopts the new technology, the competitor might have captured an additional market share, leaving very little left over for Chanika. Malezi must discuss the viability of the company's plan to develop new technology and accordingly assess the risk involved.

Time period covered
This will enable Malezi to assess the basis of assumption that might have been used by the management. For example, the rate of inflation over five years or likely fluctuations in the foreign exchange rate might be expected during the five years.

Competency of the client's firm
Before accepting the engagement, the auditor must verify whether the firm is **competent enough to achieve** the claims made by the PFI or not. If the financial position of the company is not reliable, or if the auditor feels that the company will not be able to achieve the target presented in the PFI i.e. the auditor is doubtful of the company's capacity, then he should not accept the engagement.

Nature of the information provided
The auditor must take into consideration the extent and relevance of the information provided. It will become difficult for an auditor to deal with data that he has **very little information** on. For example, if a detailed calculation of provision for a contingent liability is not given, the auditor may not be able to verify that item. Similarly, the auditor should be able to understand the information provided. If the information is **highly complex and technically difficult to understand**, it can be a barrier for an auditor to accept the engagement.

Technical competence of the reparer of PFI
Malezi must check whether Mr. Bingwa, who has prepared the profit forecast, has the technical expertise and professional experience and judgment to do this work. This will enhance the reliability of the forecasts. However, Malezi should not solely depend on this fact while examining the forecast.

(iii) **The following are Procedures which Malezi must follow while examiningthe profit forecasts:**

Examination of the results of the past projections if any
If possible, Malezi should verify the result of past projections, if any were made by the management, and compare the results of such projections with the actual figures in order to assess the accuracy of the management's judgment. The auditor must ensure that too much time is not spent on this exercise as it will divert him, form the main assignment and will also eat into the time allotted for the main assignment i.e examining the profit forecasts. The sole purpose of examining any past result must be to judge the expertise of the management in preparing such projections and to determine the nature, timing and extent of the examination.

Verification of the basis of assumption
In examining any type of projections or forecast, the auditor must verify the basis of various assumptions that have been made to assess the reliability of such projections. Malezi has been appointed to examine profit forecast. it must therefore verify the basis of the assumptions made for various and expense figures in order to estimate yearly profits.

For example, if Chanika has agreed to pay consulting fees to the technicians of the Germen Company the estimated consulting fees can be verified on the basis of a management contract entered with the German company.

While verifying the basis of the assumption, Malezi must focus on its appropriateness ad whether it is capable of giving reliable results. For example, Malezi must check whether the management's negotiations with the German Company, with respect to the final agreement, are complete or still in progress. This is so because, if the agreement is not yet finalized, then reliability of all the assumptions made on the basis of the agreement happening is questionable.

Analysis of past trend
Analysis of the past trend of movements in various prices can be used to verify the calculations of various incomes and expenses affecting the profit figures. Malezi could check the following:

- Change in sales prices
- Change in sales volume
- Change in purchase
- Average growth in the number of employees
- Average increase in the salary of employees
- Level of alary of directors and senior managers
- Intervals at which maintenance charges are incurred on machinery.

Ratio analysis is an important and useful tool that Malezi could use to analyze the past trends for various figures, for example, calculating the gross profit ratios for each year and comparing the average ratios with that of the projected gross profit ratio.

A study of the market trend of various elements that affects the financial decisions of the management is essential. Malezi can check the following market parameters to assess whether Mr. Bingwa has taken them into consideration:

- Prevailing and forecasted rate of inflation
- Likely fluctuations in exchange rates
- Potential changes in customer preferences and demand
- Position of Chanika's competitors

Opening balances

Malezi must ensure that Mr. Bingwa has reflected the correct opening position of the company while preparing the forecasts. In the case of profit forecasts, these include the opening inventory figures, which must coincide with those of the previous year's closing figures.

A part form the above, Malezi must conduct regular audit procedures (such as checking mathematical accuracy) before arriving at an opinion on the reliability of such forecast and issuing a report.

(b) **Advantages of flowcharts to record accounting control system**

(i) After a little experience they can be prepared quickly.

(ii) As the information is presented in a standard form, they are fairly easy to follow and to review

(iii) They generally ensure that the system is recorded in its entirety, as all document flows have to be traced form beginning to end. Any 'loose ends' will be apparent form cursory examination.

(iv) They eliminated the need for extensive narrative and can be of considerable help in highlighting the salient points of control and any deficiencies in the system.

(v) Makes easy to understand the system

Disadvantage of flowcharts to record accounting control system

(i) They are most suitable for describing standard systems. Procedures for dealing with unusual transactions will normally have to be corrected using narrative notes.

(ii) Major amendment is difficult without redrawing.

(iii) Time can sometimes be wasted by charting areas that are of no significances.

ANSWER 6

(a) (i) **The following are the Criteria which Kibangu Associates will consider before determining whether the works of the Internal Audit Function can be used -**

- **The extent to which its objectivity is supported by its organizational status, relevant policies and procedures** – Kibangu Associates should consider the status of the internal audit functions, to whom it reports, any conflicting responsibilities, any constraints or restrictions, whether those charged with governance oversees employee decisions regarding internal auditors, Additionally should consider whether management acts on recommendation made, whether internal auditors are members of professional bodies and obligated to comply their requirements for objectivity**.**

- **The level of competence of the function** – Kibangu Associates should consider whether the internal audit function is adequately resources, whether internal auditors are members of relevance professional bodies, have adequate technical training and proficiency, whether there are established policies for hiring and training, whether internal auditors possess the required knowledge of financial reporting/ the applicable financial reporting framework.

- **Consider whether the internal audit function applies a systematic and disciplined approach (including quality control)** – Kibangu Associates consider whether internal audit activities include a systematic and disciplined approach to planning, supervising reviewing and documenting assignments, whether the functions has appropriate quality control procedures, the existence of audit manuals, work programs and internal audit documentation

- **The professional qualifications of the internal auditor both on competency and ethical grounds**
  Kibangu Associate should consider the professional qualification of staff of internal department of Kifaru ltd to see if they have required professional qualification as internal audit professional requirements**.**
- **The adequacy of planning, control and documentation in the internal audit department**
  Kibangu need also to understating the planning and documentation procedures of Kifaru internal audit department to see whether are properly or not before decide to use the work of Kifaru internal audit department**.**
- **The responsibility of the internal audit department**
  Kibangu Associate need to know the responsibility of internal audit departmentwhether it report to board of director generally or an audit committee or to the Head of Accounts or Finance
- **The efficiency of operations of the Internal Audit Department**
  Kibamgu Associate should consider the efficiency of internal audit to carry out its functions
- **The scope of the internal audit department's work.**

Kibangu need to know the scope of work of Kifaru internal audit to see if the internal audit departments cover common ground with the external auditor, this would be more useful than a department with a very restricted role**.**

(ii) **Use of negative confirmation in Kifaru Ltd:**

A negative confirmation request is one in which the confirming party responds directly to the audit only if they disagree with the information in the request.

The negative method provides less persuasive audit evidence and shall not be used as the sole substantive procedure to audit of receivables unless all of the following conditions are present:

i. The risk of material misstatement has been assessed as low.
ii. The auditor has obtained sufficient appropriate audit evidence on the operating effectiveness of relevant controls.
iii. The population consists of a large number of small, homogenous account balances.
iv. The auditor is not aware of circumstance or conditions that would cause customers to disregard the requests.

The risk of materials misstatement in Kifaru Ltd has been assessed as high. Therefore, negative confirmation cannot be used as the sole substantive procedure to audit receivables in Kifaru Ltd. A positive confirmation should be used. A positive confirmation request is one which the confirming party responds directly to the auditor indicating whether they agree or disagree with the information in the request or provides the requested information **(**

(iii) **Audit procedures regain any exceptions and non-response to receivable confirmation in Kifaru Ltd:**

i. Review after-date cash receipts by inspecting bank statements and cash receipts documentation.
ii. Examine the customer's account and customer correspondence to assess whether the balance outstanding represents specific invoices and confirm their validity.
iii. Examine the underlying documentation (purchase order, dispatch documentation, duplicate sales invoice etc.
iv. Inquiries from management explanations for invoices remaining unpaid after subsequent ones have been paid.
v. Check whether the balance on the account is growing and if so, find out why by discussing with management.

(b) **Statistical sampling is** any approach to sampling that involves random selection of a sample, and the use of probability theory to evaluate sample results, including measurements of sampling risk.

Non-statistical sampling is where the auditor does not use statistical methods and draws a judgment opinion about the population.

Sample selection methods include the following:

(i) **Random selection** ensures that all items in the population have an equal chance number tables or random number generators.

(ii) **Systematic selection** involves selecting items using a constant interval between sections, the first interval having a random start.

(iii) **Haphazard selection** may be an alternative to random selection provided auditors are satisfied that the sample is representative of the entire population. It is a selection of a sample without following any particular structured technique and requires care to guard against making a selection which is based.

(iv) **Block selection** may be used to check whether certain items have particular characteristics.

For example, an auditor may use a sample of 50 consecutive cheques to test whether cheques are signed by authorized signatories rather than picking 50 single cheques throughout the year.

SUGGESTED SOLUTIONS
C3 – BUSINESS AND CORPORATE FINANCE
NOVEMBER 2019

ANSWER 1

(a) (i) KIPARA Co will have a Swiss Franc receipt in six months' time and needs to hedge against the dollar strengthening.

Futures
Sell Swiss futures and use June futures contracts.
No. of contracts = CHF 12,300,000/125,000 = 98.4, say 98

Reminder to be hedged on the forward market is CHF 12,300,000 – CHF 12,250,000 = CHF 50,000

Receipt = CHF 50,000 x 1.0358 = $51,790

Calculation of futures price
Assume that basis reduces to zero at contract maturity in a linear fashion. Estimate from March and June future contract rates.
Predicted futures rate at the end of May
= 1.0345 + ([1.0369 – 1.0345] x 2/3)
= 1.0361

Expected receipt = CHF 12,250,000 x 1.0361 = $12,692,225

Outcome	**$**
Futures	12,692,225
Reminder on forward market	51,790
	12,744,015

Alternative
Calculation of futures price
Alternatively, use spot rate = 1.0292
Predicted futures rate at the end of May = 1.0292 + (6/7 x (1.0369 – 1.0292)) = 1.0358 (when the June futures contract is closed out in May).
Expected receipt = CHF 12,250,000 x 1.0358 = $12,688,550

Outcome	**$**
Futures	12,688,550
Reminder on forward market	51,790
	12,740,340

Options contract
KIPARA Cowould purchase CHF June put options.
Number of contracts 98 as before
Amount not hedged, hedged by forward contract CHF translated as $51,790 as before.

Assuming the options are exercised:	**$**
Receipt (CHF 125,000 x 98 x 1.0375)	12,709,375
Premium (1.0375 options = 98 x 125,000 x 0.0086)	(105,350)
Forward contract	51,790
	12,655,815

The options would give the higher receipt if they were not exercised and the spot rate moved sufficiently in KIPARA Co's favour. If KIPARA Co allowed the option to lapse, it would obtain the same receipt as under the futures if the US$/CHF spot rate was x. such that:

12,692,225 = 12,250,000x - 105,350
12,250,000x = 12,692,225 + 105,350
So that x is US$1.0447 = CHF1.

Or

12,688,550 = 12,250,000x – 105,350
12,250,000x = 12,688,550 + 105,350
So that x is US$1.0444 = CHF1.

Comments

If the options are exercised, the futures would give the higher receipt. The options give a lower receipt because of the premium which KIPARA Co has to pay. The futures will be subject to the risk that basis (the difference between the futures price and the spot price) may not decrease linearly as the futures approach maturity as assumed in the above calculations. This will mean that the hedge of the CHF 12,250,000 is imperfect, and the receipt may be unpredictable despite a futures hedge being taken out.

The options can also be allowed to lapse if for some reason the contract is not completed. If this happens, KIPARA Co will only have to settle the forward contract.

(ii) **Benefits of a forward contract**

- A forward contract would not involve payment of a large premium upfront to the counterparty.
- A forward contract is simple arrangement to understand, whereas the basis of calculation of premium for an over-the-counter (OTC) option may be unclear.
- A forward contract gives a certain receipt for the purposes of budgeting.

Drawbacks of a forward contract

- Forward contract has to be fulfilled, even if the transaction which led to the forward contract being purchased is cancelled.
- Exchange rate movements may mean that the contract has to be fulfilled at an unfavourable rate. An OTC option can be allowed to lapse if it is not needed.
- A forward contract does not allow the holder to take advantage of favourable exchange rate movements. An OTC option need not be exercised if the exchange rate moves in the holder's favour.
- A forward contract may only be available for a short time period, depending on what currencies are involved. An OTC option may be purchased for a longer time period, over a year.
- The rate offered on a forward contract will be determined by a prediction based on expected interest rates. The rate offered on an OTC option may be more flexible. This may suit a holder who is prepared to tolerate the risk of some loss in order to have the opportunity to take advantage of favourable exchange rate movements, but who wishes to use the option to set a limit to possible losses.

Reasons why exchange-traded derivatives are used

- One of the main reasons why the treasury function uses exchange-traded derivatives is that the contracts can be bought and sold as required.
- Also, because the markets are regulated by an exchange, counterparty risk (the risk of the other party to the transaction defaulting) should be minimised.

(iii) The mark-to-market process begins with KIPARA Co having to deposit an amount (the initial margin) in a margin account with the futures exchange when it takes out the futures. The margin account will remain open as long as the futures are open. The profit or loss on the futures is calculated daily and the margin account is adjusted for the profit or loss.

The maintenance margin is the minimum balance which has to be maintained on the margin account.

If the losses on the futures are so large that the balance on the margin account is less than the maintenance margin, then the futures exchange will make a demand (a margin call) for an extra payment (the variation margin) to increase the balance on the account back to the maintenance margin.

The initial margin = \$1,450 x 98 = \$142,100
Maintenance margin = \$1,360 x 98 = \$133,280
Loss in ticks = 0.0011/0.0001 = 11
Total loss = 11 ticks x \$12.50 x 98 = \$13,475
Balance on margin account = \$142.100 - \$13,475 = \$128,625

This is less than the maintenance margin, so KIPARA Co would have to deposit an extra ($133,280 - $128.625) = $4,655
(the variation margin) to bring the balance on the margin account up to the maintenance margin.

(b) **Calculate the value of Mwanakwetu Plc's intangible assets**

Step 1:
Computation of normalised earnings
It is given in the question as TZS.700 million

Step 2:
Separate earnings driven by other assets so as to remain with earnings driven by the intangibles.

	TZS. Mil
Normalised earnings	700
Less: Return on financial/monetary assets (50 x 4%)	(2)
Returns on tangible assets (1,850m x 7%)	(129.5)
Earnings driven by intangible assets	**568.5**

Capitalizing the value of intangible earnings
In order to capitalize the earnings o TZS.568.5, the growth for each year need to be established.

Growth for (year 1 to 5) = 10%
Growth for (year 6 to infinity) = 5%

Year	**CF: g = 10% for Year 1 to 5 and 5% Year 6 onwards**	**Discount factor at 12%**	**PV**
Now	568.5	1	
1	625.35	0.8929	558.38
2	687.89	0.7972	548.39
3	756.68	0.7118	538.60
4	832.35	0.6355	528.96
5	915.59	0.5674	519.51
6 onwards	961.34		
6-oo PV = CF/r	8,011.17	0.5066	4058.46
Capitalised value of intangible earnings			**6,752.30**

(c) **Bond valuation**

(i) **Bases of the developing a plan**

- The interest rate scenario – whether rates are expected to fall further or even out. Further decisions on switching from fixed rate loans to floating rate loans or vice versa is also critical.
- The estimated savings in interest outflow from replacement of debt (post tax)
- Flotation costs that would be incurred on new issue
- Tax saving impacts on interest outflow, floatation costs etc.
- Period between incurring new debt and replacement of old debt.

(ii) **Calculating the price of 5-year bond**

The coupon for TZS.10,000 = TZS.1,000 x 11% = TZS.1,100

$$\text{The Price of the Bond} = \frac{1,100}{0.09} \times \frac{1}{1-(1.09)^5} + \frac{10,000}{(1.09)^5}$$

$= 1,100 \times 3.8896 + 0.64993$

$=$ TZS.4,278.62 + TZS.6,499.30

$=$ TZS.10,777.92

ANSWER 2

(a) The investment centre will be decided upon the interest differential at the three centres. The interest differential will be determined by the interest earnings on the Kenyan shilling and the South African Rand equivalent of TZS.500 mil vis a vis the interest earning on TZS.500 mil in Dar es Salaam.

(i) Kshs equivalent of TZS.500 mil at the spot selling rate Ksh.2.4950 would be Kshs.1,247,500.00

Add: Interest on this sum at 10% p.a. for 3 months $\frac{1,247,500 * 10 * 3}{100 * 12}$

= 1,247,shs. x 0.1 x 3/12

	31,187.00
	1,278,687.00
This sum converted into TZS. At the end of 3 months at the 3 months forward rate, vz. Kshs.2,5125 (Spot buying rate – Kshs.2.4965 plus 3 months discount – 0.160) will come to	TZS.508.93035 mil
Thus, interest earning in Nairobi would be (TZS.508.93035 – TZS.500 mil	TZS. 8.93035 mil
(ii) Rand equivalent of TZS.500 mil at the spot selling rate of 6.2360 would be	Rs. 3,118,000,000
Add: interest on this sum @ 6% for 3 months	Rs. 46,770,000
	Rs. 3,164,770,000
This sum converted into TZS at the end of 3 months at the forward rate viz, Rands 6,1970 spot buying rate – Rands 6.2360 less premium 0.0390 would yield	TZS. 510,693,884
Thus, interest earning in Durban would be (TZS.510,693,884 – TZS.500,000,000)	TZS. 10,693,884
Interest earning in Dar es Salaam on TZS.500,000,000 at 8% p.a. for 3 months would be	TZS. 10,000,000
Hence, an investment of TZS.500,000,000 for 3 months at Durban would yield the Highest income for the bank	TZS. 10,693,884
Less: cost of funds 7% p.a. for 3 months	8,750,000
Net gain	**TZS. 1,943,884**

(b) Interest rates rise the prospective borrower will suffer. To hedge this position the treasurer must sell Euro dollar futures. This commits him/her to borrowing dollar at 11% and he/she will profit if spot rates rise above this level. Also the contract size is $1m this will involve the sale of 1 future.

The net position will be as follows:

November spot interest rates	Cost of borrowing $1m for 3 months in cash market $m	Profit/(loss) On future $m	Net cost $m
9%	22,500	(9% -11%) * $1m * 3/12 = (5,000)	27,500
11%	27,500	0	27,500
13%	32,500	(13% - 11%) * $1m 3/12 = 5,000	27,500

The net cost is secured at $27,500, i.e. $27,500/$1,000,000 * 12/3 = **11% per annum**

ANSWER 3

(a) **A multinational Netting Matrix (Figures in ax 000):**

	Receiving subsidiary				**Total**	**Total**	
	Alphaland	**Betaland**	**Gammaland**	**Deltaland**	**Payments**	**Net**	**Eliminated**
Alphaland	-	125		200	325	-	325
Betaland	250	-	100	300	650	275	375
Gammaland	-	150	-	250	400	175	225
Deltaland	200	100	125	-	425	-	425
Total Receipts	450	375	225	750			
Net	125	-	-	325			
Eliminated	325	375	225	425			

The net result is that the Betaland and the Gammaland subsidiaries pay the equivalent of Ax 275,000 and ax 175,000 respectively and this is received by the Alphaland and Deltaland subsidiaries as to the equivalent of ax 125,000 and ax 325,000.

Transaction costs are saved on the eliminated transfers totalling the equivalent of ax 1.35 mil.

(b) **Nice Shoes Limited and Best Shoes**

(i) Calculate the price-earnings ratio of both the companies before merger.

	NICE	**BEST**
PAT (TZS)	547,500	99,000
EPS (TZS)	73	22
DPS (TZS)	42	12
Number of shares	7,500	4,500
Total market capitalisation (TZS)	10,000,000	1,350,000
Market price per share	1,333.3	300
P/E ratio	**18.26**	**13.64**

(ii) **After merge**

BEST's growth without merger = 7.5%

Cost of equity (without merger):

(12/300) + 0.075 = 11.5%

BEST's growth with merger = 10%

BEST's share price after merger = [1/20/(0.115 – 0.10)] = 800

BEST's total value if merged = 800 x 4,500 = 3,600,000

Gain from acquisition

= (10,000,000 + 3,600,000) – (10,000,000 + 1,350,000)

= 13,600,000 – 11,350,000

= 2,250,000

Cash paid: [400 x 4,500] = 1,800,000

Cost if cash is paid 1,800,000 – 1,350,000 = 450,000

(iii) Number of shares issued to BEST:

Exchange ratio 0.25: 4,500 x 0.25 = 1,125

Total shares after merger 7,500 + 1,125 = 8,625

Value given to BEST's shareholders: (1,125/8,625) x 13,600,000 = 1,773,913

Cost under share exchange = 1,773,913 – 1,350,000 = 423,913

(c) (i) **Difference between Blockchain, Bitcoin and Cryptocurrency**

Blockchain is the technology on which Bitcoin is built on. Bitcoin or cryptocurrency is just one application of Blockchain Technology.

(ii) **Differences between Fiat currency and Cryptocurrency**

Legally

Governments issue fiat currencies, which are in return regulated by the central bank. Fiat money is deemed legal tender in that it is often the official means of finalizing transactions. Governments control fiat money supply and issue policies from time to time that affect their value. Cryptocurrencies, on the other hand, are merely digital assets that act as a medium of exchange that governments have no control over. The decentralization aspect means no central body can control or influence their value.

Tangibility
It is not possible to have a physical feel of cryptocurrencies as they operate online as virtual coins. Fiat currencies, on the other hand, have a physical aspect as they can exist as coins and notes thus possible to have a physical feel.

Supply
A major difference between fiat money and cryptocurrency has to do with supply. Fiat money has an unlimited supply which means central authorities have no cap to the extent in which they can produce money. Most cryptocurrencies have a cap when it comes to supply, which means there is a set amount of coins that will ever be in supply. For example, the total number of Bitcoin coins that will ever be in supply is capped at 21 million.

Storage
Cryptocurrencies virtual aspect means they can only exist online thereby stored in digital wallets commonly referred to as cryptocurrency wallets. The versatility of fiat money, on the other hand, means it can be stored in various forms. For instance, there are payment providers such as PayPal that allow people to store fiat money in digital form. Banks also do act as custodian of hand currencies.

ANSWER 4

(a) **Short notes**

(i) **Features of interest rate future**

An interest rate futures contract is a future contract with an interest-bearing instrument as its underlying asset. He underling asset could be Treasury bills and notes, certificates of deposit (CD), commercial paper (CP), etc.

Features include:

- IRF are exchanged traded derivatives i.e. they can be traded only on organised exchanges.
- They are standardized contracts standard contract size, margin and delivery dates.
- Tick values: to capture even the smallest movement in future prices, tick value is expressed in terms of basis points – one basis point being 0.01% of the amount of the underlying asset.
- Transparency: since trades happen through the exchange, all the parties are provided with complete information.

(ii) **Floating to fixed interest rate swaps**

Floating to fixed interest rate swap – are used by companies to fix the interest obligation on their floating rate borrowings. Under these swaps, companies make fixed rate payments and receive floating rate payments that can be used to offset the floating interest obligations on a corresponding principal amount of these borrowings.

Advantages include:

Flexible risk management: companies can enter into swap at any time, for any term and on any portion of their variable rate debt.

Independent hedge: borrowers can allocate the benefits of an of their swaps to any of their borrowings since swaps and loans are distinct facilities.

(b) **Hilton**

(i) Amount to be received

Expected depreciation of euro $= \frac{1 + 0.07}{1 + 0.12} - 1 = -0.04464$

Expected spot rate of euro in one year = 1.46 x (1 – 0.04464) = $1.3948

Expected dollars received from receivables = 2,000,000 units x $1.3948
= $2,789,600

(ii) Expected spot rate of Australian dollar in one year = $0.13 since it will remain pegged.

Expected cross rate in one year = $1.3948/$0.13 = AUD10.7296 per euro.

So 2 million euros will convert to 2,000,000 x 10.7296 = AUD21,458,462.

(c) **Investor**

- To settle the forward contract amounting to Kshs.50 million in 3 months' time, the amount of TZS. required

= Kshs.50 million x TZS.21.80 = TZS.1,090,000,000

As the funds re required 3 months hence, and his investment in the bank earns 0.5% compounded monthly, the present value of the investment in TZS.

$$= \text{TZS.}\frac{1.090 \text{ million}}{1.005^3} = \text{TZS.}1,073,812,148$$

Thus, the present value of the property is TZS.1,073,812,148

- Purchase Kshs. at spot today and invest in a Nairobi bank.

We first determine the amount in Kshs. needed today that will equal to Kshs.50 million in three months' time.

As the interest rate in Nairobi is 1.8% for 3 months.

$$\text{The present value of Kshs.50 million} = \text{Kshs } \frac{50 \text{ mill}}{1,08} = \text{Kshs.}49,115,914$$

The investor has to buy Kshs.49,115,914 today at today's spot of TZS.21.46/Kshs.

= TZS.49,115,914 x 21.46 = TZS.1,054,027,514

Under this alternative, the cost of the property is TZS.1,054,027,514.

On a comparison of the two alternatives, it is clear that buying Kshs. 3 months forward is expensive than investing in the money market in Nairobi. By doing this the investor pays TZS.19,784,634 more for the property.

ANSWER 5

(a) **Capital Budgeting Analysis Figures in '000'**

Year	0	1	2	3	4
Initial investment by parent $S	(10,000)				
Total revenue S$		21,000	21,000	36,000	38,000
Total variable cost S$		(12,000)	(12,000)	(25,000)	(26,000)
Contribution S$		9,000	9,000	11,000	12,000
Annual lease expenses S$		(1,000)	(1,000)	(1,000)	(1,000)
Other fixed annual expenses		(1,000)	(1,000)	(1,000)	(1,000)
Noncash expense depreciation		(2,000)	(2,000)	(2,000)	(2,000)
Earnings before tax S$		5,000	5,000	7,000	8,000
Host government tax (20%)		(1,000)	(1,000)	(1,400)	(1,600)
After-tax earnings S$		4,000	4,000	5,600	6,400
Add back depreciation		2,000	2,000	2,000	2,000
Net Cash Flow S$		6,000	6,000	7,600	8,400
Withholding tax (10%)		(600)	(600)	(760)	(840)
Remitted after withholding taxes		5,400	5,400	6,840	7,560
Salvage value S$					12,000
		5,400	5,400	6,840	19,560
Exchange rate of S$/$		0.5	0.5	0.5	0.5
Cash flows to parent $	(10,000)	2,700	2,700	3,420	9,780
Discount (15%)	1	0.8696	0.7561	0.6575	0.5718
PV of CFs $	(10,000)	2,347.92	2,041.47	2,248.65	5,592.20

Then:

NPV = Sum of PV – Initial Investment
= (2,247,920 + 2,041,470 + 2,248,650 + 5,592,200) – 10,000,000
= 12,130,240 – 10,000,000
= **$2,130,240**

Because the proposed subsidiary has a positive Net Present Value of $ **130,240),** it is viable and it should be established.

(b) **The validity to investors of Kobe Inc's objective for risk reduction through international diversification**

In theory a well-diversified investor will not place any extra value on companies that diversify. This is because an investor can diversify himself, by investing in shares and in securities of different companies operating across countries. If the diversification is international, the benefits will depend on whether the countries where the investments take place are part of any integrated market or are largely segmented by government restrictions taxes and exchange controls. If markets are segmented, international diversification may offer the opportunity to reduce both systematic and unsystematic risk. An integrated market would only offer the opportunity to reduce unsystematic risk. However, most markets are neither fully integrated nor segmented, meaning that international diversification will lead to some reduction in systematic risk, which would be valued by investors. It is to be hoped that risk reduction is not the only objective of Shalom Inc. Limited – returns and shareholder utility are important.

(c) **Estimation of the value of the option to invest in the project**

(i) Pa = PV of cash inflow on project = TZS.300 billion
Pe= Cost of investing in the project = TZS.400 billion
t = 10 years
r = 8%
s = 0.4

The Black-Scholes option pricing model

$$c = PaN\ (d1) - PeN\ (d_2)e^{-rt}$$

Where

$$d_1 = \frac{In\left(P_a / Pe\right) + \left(r + 0.5s^2\right)t}{s\sqrt{t}}$$

$$d_2 = d_1 - s\sqrt{t}$$

$$d_1 = \frac{In\left(300 / 400\right) + \left(0.08 + 0.5\ x\ 0.4^2\right)10}{0.4\sqrt{10}}$$

$$d_1 = \frac{In\,(0.75) + 1.6}{1.2649}$$

$$d_1 = 1.0375$$

$$d_2 = d_1 - s\sqrt{t}$$

$$d_2 = 1.0375 - 1.2649$$

$$d_2 = (0.2274)$$

$$c = PaN\ (d_1) - PeN\ (d_2)e^{-rt}$$

$$N(d_1) = 0.3508 + 0.5 = 0.8508$$

$$N(d_2) = 0.5 - 0.0871 = 0.4129$$

$$c = 300 \times 0.8508 + 400\ (0.4129)2.7183^{-0.08\ x\ 10}$$

$$c = 255.25 + 74.21$$

$$c = 329.45$$

Value of call (Product patent) = TZS.329.45 billion

(ii) **Factor that influences the price or value of option contracts**

- **Value of the underling**
  The value of a call option increases with an increase in the actual price of the underlying assets. This is because the option buyer can purchase the underlying assets from the option seller at the strike price and sell them immediately at a higher price. With a put option, the case is exactly the opposite, as the value of a put option increases with a reduction in the actual price of the underlying assets since the put option buyer can sell the underlying assets to the put option seller at the strike price and buy the underlying assets at the actual price.
- **Strike price**
  The value of a call option decreases as the strike price increases since as the strike price increase, the probability of a call option being exercised decreases. The value of a put option increases as the strike price increases as the probability of the put option being excised increases.
- **Time to expiration**
  The chances of a fluctuation in the price of the underlying, is greater when there is a longer time to expiry. This may give rise to an advantage to one of the parties to the contract. The longer the time to expiry, the higher the possibility of the option being in-the-money. This is because the option has more time to move to an "in-the-money" position.
- **Volatility**
  Volatility is the tendency of the underlying security's market price to fluctuate either upwards or downwards. It reflects the magnitude of the change of price. It does not imply a bias toward price movement in one direction or the other. The higher possibility that the option will move to an "in-the-money" position. Generally, as the volatility of an underlying asset increase, the premiums of both call and put options on that asset increase, and vice versa.
- **Risk-free rate**
  An increase in the risk free rate will increase the value of a call option because the money saved by purchasing the call option rather than the underlying security is increased. The opposite is true for the value of a put option (i.e. an increase in the risk free rate will decrease the value of a put option).
- **Dividend expectations**
  The prices of options are impacted if there are dividend declared on the underlying stock or if there are dividend expectations. This is because the underlying price would change after payment of dividend. However the call option is not eligible for dividend and this would be reflected in the price of the call option.

ANSWER 6

(a) (i) Dividend yield is calculated as the dividend divided by the share price at the start of the year:

2017: dividend yield = 100 x 38.5/740 = 5.2%

2018: dividend yield = 100 x 40.0/835 = 4.8%

The capital gain is the difference between the opening and closing share prices, and may be expressed as a monetary amount or as a percentage of the opening share price.

2017: capital gain = 835 – 740 = 95 or 12.8% (100 x 95/740)

2018: capital gain = 648 – 835 = (187) or (22.4%) (100 x – 187/835)

The total shareholder return is the sum of the percentage capital gain and the dividend yield, or the sum of the dividend paid and the monetary capital gain, expressed as a percentage of the opening share price.

2017: total shareholder return = 100 x (95 + 38.5)/740 = 18.0% (5.2% + 12.8%)

2018: total shareholder return = 100 x (-187 +40)/835 = -17.6%(4.8% – 22.4%)

- **The return on equity predicted by the CAPM**

  The actual return for a shareholder of KIMONDOBAY Co, calculated as total shareholder return, is very different from the return on equity predicted by the CAMP. In 2017 the company provided a better return than predicted and in 2018 the company gave a negative return while the CAMP predicted a positive return.

Year	2018	2017
Total shareholder return	(17.6%)	18.0%
Return on equity predicted by CAPM	8%	12%

  Because the risk-free rate of return is positive and the equity risk premium is zero or positive, and because negative equity betas are very rare, the return on equity predicted by the CAPM is invariably positive. This reflects the reality that shareholders will always want a return to compensate for taking on risk. In practice companies sometimes give negative returns, as is the case here. The return in 2017 was greater than the cost of equity, but the figure of 10% quoted here is the current cost of equity; the cost of equity may have been different in 2017.

- **Other comments**

  Kimondobay Co had turnover growth of 3% in 2017, but did not generate any growth in turnover in 2018. Earnings per share grew by 4.1% in 2017, but fell by 8.3% in 2018. Dividends per share also grew by 4.1% in 2017, but unlike earnings per share, dividend per share growth was maintained in 2018. It is common for dividends to be maintained when a company suffers a setback, often in an attempt to give reassurance to shareholders.

There are other negative signs apart from stagnant turnover and falling earnings per share. The shareholder will be concerned about experiencing a capital loss in 2018. He will also be concerned that the decline in the price/earnings ratio 2018 might be a sign that the market is losing confidence in the future of Kimondobay Co. if the shareholder was aware of the proposal by the finance director to suspend dividends, he would be even more concerned. It might be argued that, in a semi-strong form-efficient market, the information would remain private. If Kimondobay Co desires to conserve cash because the company is experiencing liquidity problems, however, these problems are likely to become public knowledge fairly quickly, for example through the investigations of capital market analysts.

Workings:

Year	2018	2017	2016
Closing share price	648	835	
Earnings per share	58.9	64.2	61.7
PER	11 times	13 times	
Year	**2018**	**2017**	**2016**
Earnings per share	58.9	64.2	61.7
Dividend per share	40.0	38.5	37.0
Divider cover	1.5 times	1.7 times	1.7 times
Earnings per share growth	(8.3%)	4.1%	
Dividends per share growth	3.9%	4.1%	
Turnover growth	Nil	3%	

(ii) Historical dividend growth rate = $(40/37)^{0.5} - 1 = 0.04$ or 4% per year
Share price using dividend growth model = (40 x 1.04)/(0.1 – 0.04) = TZS.693.

In three years' time, the present value of the dividends received from the fourth year onwards can be calculated by treating the fourth-year dividend as D_1 in the dividend growth model and assuming that the cost of equity remains unchanged at 10% per year. Applying the dividend growth model in this way gives the share price in three years' time: Share Price = 70/(0.1 – 0.03) = TZS.1,000.

For comparison purposes this share price must be discounted back for three years:
Share price = 0.751 x 1,000 = TZS.751

The current share price of TZS.648 is less than the share price of TZS.693 calculated by the dividend growth model, indicating perhaps that the capital market believes that future dividend growth will be less than historical dividend growth. The share price resulting from the proposed three-year suspension of dividends is higher than the current share price and the share price predicted by the dividend growth model. However, this share price is based on information that is not public and it also relies on future dividends and dividend growth being as predicted. It is very unlikely that a prediction as tentative as this will prove to be accurate.

(b) Investment decisions, dividend decisions and financing decisions have often been called the decision triangle of financial management. The study of financial management is often divided up in accordance with these three decision areas. However, they are not independent decisions, but closely connected.

For example, a decision to increase dividends might lead to a reduction in retained earnings and hence a greater need for external finance in order to meet the requirements of proposed capital investment projects. Similarly, a decision to increase capital investment spending will increase the need for financing, which could be met in part by reducing dividends. The question of the relationship between the three decision areas was investigated by Miller and Modigliani. They showed that, if a perfect capital market was assumed, the market value of a company and its weighted average cost of capital (WACC) are constant irrespective of dividend and/or financing decision.

SUGGESTED SOLUTIONS
C4 – ADVANCED TAXATION
NOVEMBER 2019

ANSWER 1

(a) Section 9(3) provides that the following amounts are to be excluded in calculation gains or profits from conducting an investment:

(i) Exemption amounts.
(ii) Final withholding payments.
(iii) Amounts that are in calculating the person's income from any employment or business.

(b) **Handling of Tax objections in Tanzania**

Section 51(1) of the Tax Administration Act, provides that, a person who is aggrieved by a tax decision made by the Commissioner General, may object the decision by filling an objection to the Commissioner General, within 30 days from the date of service of the tax decision.

A valid notice of objection must fulfill the following conditions:

(i) It must be in writing to the commissioner (not verbal communication) (section 51(4)
(ii) The objection must be filed and received by the commissioner within 30 days from the date of service of the tax decision (section 51(4)).
(iii) It must state the grounds in which objection is made. (section 514))
(iv) The person objecting must pay the amount of tax which is not in dispute or one third of the tax assessed whichever is greater, within a period of thirty days from the date of service of tax decision, pending final determination of the objection. (sect.51(5)).

(c) (i) Under sections.

- 15 – Agriculture improvement, research development and environmental expenditure.
- 16 – Gifts to public, charitable and religious institutions
- 17 – Depreciation allowances for depreciable assets or
- 26 – loss carry back

(ii) For an unrelieved loss under section 19, except as permitted by section 65(q) (income from the separate petroleum right for any year of income may be reduced by reason of the use of unrelieved losses from that operation, subject to other limitations imposed by section 19 but not below 30 per centum of that income before any reduction for losses.

(iii) Any bonus payment

(iv) Expenses incurred by the person in implementing the decommissioning plan for the operation in excess of deposits in the decommissioning fund.

(d) (i) Retirement fund
Means any entity established and maintained solely for the purpose of accepting and investing retirement contributions in order to provide retirement payments to individuals who are beneficiaries of the entity.

(ii) Retirement payment
Means payment, by a way of lump sum, pension or commuted pension, made by a person to an individual in the evet of the individual's retirement or a relative of an individual in the event of the individual death.

(iii) Defined contribution plan
A defined contribution plan is a type of retirement plan where employers, employees, or both make regular contributions, and future employee benefits are based on the dollar amount of contributions made and their eventual value based on investment growth. They differ from defined benefit plans in that they do not guarantee a specific benefit to be paid in the future.

(iv) Pensionable service
A pensionable service is the amount of time a worker enrolled in a pension plan accrues toward that plan during their employment. Typically reported on statements as a yearly figure, pensionable service is one of the primary factors in determining a worker's pension benefits, along with highest average salary.

(e) (i) **Life insurance:**
Life insurance can be understood as the insurance contract, in which the lifetime risk of an individual is covered. It is a form of investment. Life insurance is a protection against financial loss that could result from the premature death of an insured individual. In case of death of the insured, the nominee receives the proceeds and is thereby safeguarded from the financial impact of the death of the insured. In case the life insured survives, her or she gets the survival benefit as per the policy term. It includes event of death, individual to be incapacitated , series of payments payable to sustain injuries and reinsurances of the above situations

General insurance
Refers to the insurance, which is not covered under life insurance and includes various types of insurance, i.e. fire, marine, motor, etc. it is a contract of indemnity.

(ii) **Computation of Net Taxable Income of Elegance Insurance Corporation**

Income	**TZS.**
Proceed received	60,000,000
Death and personal injuries	NIL
Education scheme	NIL
Old age scheme	NIL
Gain on realization of shares	70,000,000
Accounted premium	300,000,000
Code premium	100,000,000
Investment income	80,000,000
Other underwriting income	24,000,000
	634,000,000
Payments	
Premium to Hilton insurance	2,000,000
Insurance claim 1/2 *(50,000,000)	25,000,000
Payment to XYZ insurance	NIL
Education scheme	NIL
Old age scheme	NIL
Insurance claim	40,000,000
Re-insurance claim	10,000,000
Administrative expenses	20,000,000
	97,000,000
Net taxable income	**537,000,000**

ANSWER 2

(a) Conditions to be satisfied to be charitable organization

(i) The entity was established and functions solely as an organization for:

- The relief of poverty or distress of the public
- The advancement of education or
- The provision of general public health, education, water or road construction or maintenance.

(ii) The entity has been issued with a ruling by the Commissioner in Tax administration Act currently in force stating that it a charitable organization for religious organization and its tax liability computations will be done under section 64 of ITA.

(iii) Has a public character. This means its benefits are directed to the community or a section of the community which is ascertainable and not to the private individuals.

(b) (i) Thin Capitalization refers to the situation in which a company is financed through a high level debt compared to equity. Thinly capitalized companies are sometimes known as highly leveraged or highly geared companies. In other words a company is considered thinly capitalized when its capital is made up of a much greater proportion of debt than equity.

The motive may be among others, to benefit from its tax advantage. The 1987 OECD Report describe the term thin capitalization as the "hidden equity capitalization through excessive loans".

(ii) Reasons for thin capitalization

The main reason is to minimize the tax liabilities. This is because loan interests are tax deductible items while income distributed to the shareholders in the form of dividends is subject to two levels of taxes which are corporate taxes and withholding taxes when making distribution.

For the multinational companies, they can choose their capital structure according to differences in international taxation, in order to minimize the tax burden of the whole group of companies. For example, a company located in a low tax country could lend to an affiliate in a high tax country. This would allow the company located in the high tax country to deduct interest payments from its profits resulting in reduction of the overall tax payment which would not be the case if the company is equity financed.

(iii) How to curb tax evasion through thin capitalization

- Thin capitalization rule – some countries apply specific laws to specify a maximum debt equity ratio to restrict the loans provided by controlling non-resident shareholders.
  Specific rules include ITA section 12 where interest is limited of 3 to 7 debt equity ratio by non resident person, Advanced transfer pricing etc

- General anti avoidance rule – some countries such as Brazil, Colombia, India, Singapore and Sweden do not have specific rules to curb thin capitalization. They apply general anti avoidance rule and common law provisions to curb the practices in their respective countries.

(c) Determination of Capital Gain Tax liability and payment procedures

	TZS.
Selling price of the buildings	40,000,000
Less: Costs	
Acquisition Price	15,000,000
Improvement thereon	3,000,000
Selling costs	1,500,000
Capital gain	20,500,000

As the company is resident it will be taxed initially at 10% which will be TZS.2,050,000/=

However, at the end of the financial year Young Associate will make a tax return and include its capital gain in its total income which will be taxed at corporate rate of 30%.

Young will be given the tax credit of TZS.2, 050,000/= which was already paid.

ANSWER 3

(a) Voluntary tax compliance and the factors affecting voluntary tax compliance in Tanzania.

(i) **Voluntary Tax Compliance**

Voluntary tax compliance is the willingness of individuals and other entities to act within the spirit as well as letter of tax law and administration without application of enforcement activities.

The taxpayers make their tax returns, declare correct income and make payments of taxes in time.

(ii) **Factors affecting voluntary tax compliance in Tanzania**

- Unclear language of tax legislation - the language is not very clear and difficult to be complied with some taxpayers.
- Failure to understand tax legislation – this is caused by the complexity of tax legislations which needs the advice of tax consultants and lawyers to live with the tax obligations.
- Perception of unfairness in tax burden distribution – it is attributed by several factors such as exemptions of certain class over others, different tax rates and tax incentives to others. For example, employees are taxed heavily compared with group such as political leaders and small traders.
- Ignorance of tax laws – it is rare to have a well thought out strategy for disseminating enacted laws to the public. Only the television and radio programmes are used to air the tax matters. Newspapers and other means of communication are rarely used.
- Difficult of being detected by tax authorities – some taxpayers avoid taxes on the basis of TRA's failure to detect their actions. The strength of tax authorities to detected non-compliance has deterrent effect on voluntary compliance.
- Secrecy in formulating the tax laws – the passing of the tax law is bureaucratic and secretive. It is triggered by the need of the Ministry of Finance to collect more revenue rather than other tax policy issues.
- Use of the public money – the programmes financed by the government of the day may encourage or discourage the taxpayers from voluntary compliance. Any negative public perceptions on use of public money may impair the voluntary compliance. On the other hand, financing the projects directly benefiting the majority may encourage the voluntary tax compliance.

(b) (i) **The concept of permanent establishment and branch exists**

Article 5 of the OECD Model Tax Convention should be considered to determine if a permanent establishment or branch exists.

The concept of a permanent establishment or branch determines the right of a tax administration to tax the profits of an enterprise of another jurisdiction. Under Article 7 (Business profits), this cannot happen unless it carries out its business through a permanent establishment. According to Article 5, for a permanent establishment to exist there must be:

- Place of management
- A branch
- An office
- A factory
- A workshop
- A mine, oil or gas well, quarry or other place of extraction of natural resources
- A building site or construction or installation project if more than 12 months

A permanent establishment will not exist in these instances:

- Maintenance of facilities for storage, display or delivery of goods/merchandise

- Maintenance of goods/merchandise for:
  - Storage, display or delivery
  - Processing by another entity
  - Purchasing goods or collecting information

Transfer pricing rules apply irrespective if a transaction involves a company and its branch in another country/jurisdiction. Therefore, a permanent establishment or branch should be treated as if it were an independent enterprise and ensure that it receives an arm's length return.

(ii) **Option 1**

Is not acceptable to Country B as this would result in no income being returned despite economic activity.

Option 2

Is an example of the cost plus transfer pricing method demonstrating the best method and that a 7.5% mark-up was adequate by reference to comparable transaction between unrelated parties (subject to documentation and comparability studies confirming).

Overlapping mechanisms can apply – the DTA and the domestic Transfer Pricing rules in Country B can both apply.

Explanation as to how the domestic rules might apply – the independent entity approach and using Comparable Uncontrolled Pricing or one of the other methods.The DTA "Associated Enterprises" (Article 9) provision is unlikely to apply in this case as it specifically requires two separate enterprises (companies) and arguably has no relevance to a company/branch situation.

The "Business Profits" (Article 7) is likely to apply as it deals specifically with a Company/PE situation. This results in a right fencing of the PE and treatment as an independent entity. The issue is different as the question is what "business profit might the PE be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE".

ANSWER 4

(a)

(i) **Output Tax**

Details	Value	VAT (output tax)
General taxable goods	168,000,000	30,240,000
General exemptions	30,000,000	-
TOTAL	**198,000,000**	**30,240,000**

(ii) **Input tax**

Details	**Value**	**Input tax (VAT)**	**Explanations/Assumptions**
General goods	120,000,000	21,600,000	The goods were purchased from a VAT registered person
Periodicals	20,000,000	-	-
Advertisement	2,000,000	360,00	The payment was made to a VAT registered person
Rent	5,000,000	900,000	Landlord is a VAT registered person and the premise is used for residential purposes
General exempt supplies	18,000,000	-	
Other expenses	6,000,000	1,080,000	-
TOTAL		**23,940,000**	

NOTE: The question requires to calculate input tax (not input tax credit)

(iii) **VAT payable**

Details	**Amount**
Total output tax (refer part (i) above)	30,240,000
Less: Total input tax credit (w1)	23,585,455
Add/Less Increasing/(Decreasing) adjustment	-
NET VAT PAYABLE	**6,655,545**

WORKINGS

Working 1 (w1): Total input tax credit

Details	Input tax attributable to taxable supplies A	Input tax attributable to exempt supplies B	Partial input tax C	Explanations/Assumptions
General goods	21,600,000	-	-	-
Periodicals	-	-	-	Exempt
Advertising	-	-	360,000	Both taxable and exempt goods were advertised
Rent			900,000	
General exempt supplies	-	-	-	Exempted, therefore no input tax was paid
Other expenses	-	-	1,080,000	It is assumed that, the figure for direct expenses was incurred for the purpose of making both taxable and exempt supplies (for instance electricity and telephone bills)
TOTAL	**21,600,000**	**-**	**2,340,000**	

According to S. 68(1) of Value Added Tax Act, 2014, Tupo Pamoja shoping centre Ltd is entitled to claim the whole 21,600,000 of input as it was tax incurred for the purpose of making taxable supplies.

In addition to that, the company may claim all, none or part of partial input tax.To know how much of the partial input tax is deductible, there is a need to perform 'T/A' test as stipulated under S. 70 of Value Added Tax Act, 2014.

T/A= 168M/198M * 100 = 84.9%

Since T/A*100 is above 10% but does not exceed 90%, the company is entitled to claim

just part of the partial input tax as calculated below

84.9%*2,340,000= 1,985,455

Therefore, total claimable input tax

= 21,600,000 + 1,985,455

=23,585,455

(b) Despite being provided for under Tax Administration (Transfer Pricing) Regulations, 2018, Advanced Price Agreement (APA) is being perceived as practically impossible. Briefly explain the challenges likely to face the application of APA rule in Tanzania

Challenges of Advance Price Agreement (APA)

- Lack of data
- Inappropriate record keeping
- Comparability analysis is not easy as taxpayers and competitions are looking on the same data
- Lack of competence. People are unaware on how APA is to be prepared and submitted
- It defeat the purpose. Majority of taxpayer are unwilling to prepare the ALP. So using APA is a seek shelter using provisions of the law/APA
- Transparency; taxpayers are not ready to give out all the data for proper determination of APA by the commissioner. Before gaining popularity to tax administrators, transfer price was just an accounting concept practiced by associated companies. Discuss the reasons for charging transfer price.

Reasons:

- Seeking to share revenue from final sales to other constituents of the group. (i.e. to intentionally move profits between divisions or locations).
- As a way to fund/finance the units/companies involved with research and development.
- To provide information that motivates divisional managers to make good economic decisions.
- To minimize overall income and other government taxes transfer prices may diverge from market prices for reasons of marketing or financial policy, or to minimize tax.
- Manager risks – exchange rate; exchange controls; political;
- Comply with antitrust and other regulations.
- Provide information that is useful for evaluating the managerial and economic performance of the divisions.
- To ensure that divisional autonomy is not undermined.

ANSWER 5

(a) A VAT refund, cannot be affected unless the applicant has submitted among others the following documents and or attachments:

(i) Certificate of genuiness issued by an auditor who has been registered by NBAA and who is registered as a tax consultant with TRA.

(ii) Brief working from the auditor as to how the claimed amount has been arrived at including the summary of purchases and sales.

(iii) A checklist of details of issues regarding the refund application must be properly filled and completed by the applicant.

(iv) For a case of Regularly Repayment traders the following documents are vital to be submitted;

- Single Bill of Entry, Bill of Lading, Airway bill, Road consignment note, Landing certificate, EFDs receipts/invoices

(b) Estimated tax payable before revision: 320,000,000 x 30% = TZS.96,000,000
Estimated tax payable after revision: 380,000,000 x 30% = TZS.114,000,000

Installment	[A – C]/B	TZS.
15th December 2016: 1st	[96,000,000 – 0]/4	24,000,000
1st March 2017: 2nd	[96,000,000 – 24,000,000]/3	**24,000,000**
30th April 2017: 3rd	[114,000,000 – 48,000,000/2	**33,000,000**
31st July 2017: 4th	[114,000,000 – 81,000,000]/1	33,000,000
Total tax paid up to 1st May 2018		114,000,000

A] **INTEREST:**

(i) **Interest for underestimating estimates tax payable by installment**
Test for underestimation:
Correct amount: Use assessment made by tax officers TZS.560,000,000 x 30%
= TZS.168,000

80% of correct amount is TZS.134,000,000; this shall be compared with the estimated revised tax paid, and the revised tax paid is TZS.114,000,000

The revised tax payable is less than 80% of correct amount, therefore there is underestimation, hence interest is payable.

$$\mathbf{I = Y[1 + R)^N - 1]}$$

Monthly statutory = 1%
Y = TZS.168,000,000 – TZS.114,000,000 = TZS.54,000,000
N = 15 since the tax return were made after the last day of 6th months after the year.
I = TZS.54,000,000[(1 + 1%)^{15} – 1)]
I = TZS.8,692,323.58

(ii) **Interest for failure to pay tax on or before due date**

- Failure to pay quarterly tax installments:
  I = Z[(1 + R)^{N} – 1]
  - Failure to pay 1st installment on due date
    Tax outstanding: TZS.24,000,000; period: 2 months
    I = TZS.24,000,000[(1 + 1%)^{2} – 1]
    I = TZS.482,400
  - Failure to pay 2nd installment on due date
    Tax outstanding: TZS.24,000,000; Period: 1 month
    I = TZS.24,000,000 [(1 + 1%)^{1} – 1]
    I = TZS.240,000
  - There was no failure to pay 3rd and 4th installment

Therefore, Total interest payable for failure to timely pay installments is **TZS.722,400**

- Failure to pay tax payable on assessment
  $I = Z[(1 + R)^N – 1]$
  Z = TZS.168,000,000 – TZS.114,000,000 = TZS.54,000,000
  N = 4 months
  I = TZS.54,000,000$[(1 + 1\%)^4 – 1]$
  I = TZS.2,192,616.54

B] **PENALTY**

(i) Penalty for failure to file statement of estimate and tax returns on due dates

- Failure to file statement of estimated on due date
  Period: 2 months
  Tax payable: TZS.96,000,000 (TZS.320,000,000 x 30%)
  Tax paid up to December 2016: NIL

  Penalty for each and part of a month of failure is the higher of:
  - 2.5% (of estimated annual tax payable less tax paid up to the start of December 2016)
    = 2.5% x (TZS.96,000,000 less 0) = TZS.2,400,000

  - 15 currency points = TZS.15,000 x 15 = TZS.225,000

    Taking the higher TZS.2,400,000, hence the penalty is TZS.2,400,000 x 2 months = **TZS.4,800,000**.

- Failure to file tax returns on due dates
  Period: 4 months
  Tax payable: TZS.168,000,000)TZS.560,000,000 x 30%)
  Tax paid up to start of May 2018: TZS.114,000,000

  Penalty for each and part of a month of failure is the higher of:
  - 2.5% (of estimated annual tax payable less tax paid up to the start of December 2016)
    = 2.5% x (TZS.168,000,000 less TZS.114,000,000) = TZS.1,350,000
  - 15 currency points = TZS.15,000 x 15 = TZS.225,000

    Taking the higher TZS.1,350,000, hence the penalty is TZS.1,350,000 x 4 months = **TZS.5,400,000**.

SUMMARY OF TAX PAYABLE ON ASSESSMENT

S/N	Type of tax	Amount of tax (TZS.
	Interest for understating estimated tax payable by installment	8,692,323.59
	Interest for failure to pay tax on or before the due date	
	• Failure to pay quarterly tax installment:	
	- 1st installment TZS.240,000	
	- 2nd installment TZS.482,400	722,400
	• Failure to pay tax payable on assessment	2,192,616.54
	Penalty for failure to file statement of estimates	4,800,000
	Penalty for failure to file return of income	5,400,000
	Total tax taxes for non-compliance	21,807,340.13
	Total annual tax payable on tax officer assessment	168,000,000
	Total annual tax payable for the year of income 2016	**189,807,340.13**
	Total tax paid by installment	114,000,000
	Total tax payable on assessment	75,807,340.13

ANSWER 6

(a) (i) Object in writing to the Commissioner within 30 days from the date of service of assessment.
The objection cannot be entertained unless the tax net in dispute or deemed as being not in dispute is paid to the commissioner. Tax deemed not be in dispute arises where a person disputes more than 50% of assessed. In such circumstances tax deemed not in dispute is one third of the tax assessed procedure.

(ii) If the taxpayer is not satisfied with the decision or the commissioner on objection, he may appeal to the Tax Revenue Appeals Board.

Such an appeal must be lodged within 45 days of the date of service of the commissioner's decision on the objection and the taxpayer must serve a notice of intention to appeal to the commissioner within 30 days of the date of service of the decision of the commissioner.

(iii) If a taxpayer is not satisfied with the decision of the Tax Revenue Appeals Board, he may appeal against such a decision to the Tax Revenue Appeal Tribunal.

Such appeal lodged with the tribunal within 30 days of the decision of the board and the person intending to appeal must serve the other party to the appeal with a notice of intention to appeal within 15 days of lodging the appeal.

(iv) A person not satisfied with the decision of the tax revenue appeals tribunal may appeal against such a decision to the Tanzania Court of Appeal.

Should the appeal be lodged with the court of appeal then the Appeal's Court Rules will apply.

(b) (i) **Determination of partnership profit/losss**

	TZS.	**TZS.**
Loss as per return		(2,600,000)
Add back:		
10% fuel and oils	9,000,000	
Partner salaries	16,000,000	
Interest on loan	600,000	
Weight bridge fines	3,500,000	
Total tax paid	3,300,000	
Depreciation		
	10,800,000	
Tip to police	600,000	43,800,000
Sub totals		**41,200,000**
Deduct:		
Interest on drawings (note v)		-
Depreciation (W1)		77,312,500
Adjustable distributable loss		**(36,112,500)**

(ii) **Partner's taxable incomes -** Determination of partner's taxable incomes

Distributable partnership income to partners

Adjustable distributable loss	(36,112,000)
Less: Appropriated partnership income(W1)	25,600,000
Distributable partners loss	**(61,712,000)**

	Nyodu	**Masahani**	**Matsova**
Salaries	8,000,000*	4,000,000*	4,000,000*
Fuel and oils	3,000,000*	3,000,000*	3,000,000*
Interest on loan	600,000		
Total figure	**11,600,000**	**7,000,000**	**7,000,000**
Distributable loss	**20,570,833.33**	**20,570,833.33**	**20,570,833.33**
Add. Investment Income			
Royalty		2,000,000	
Dividend		FWP Sec. 86	
Realization		5,000,000	
Sec. 21 (2) on cash basis, the total taxable income	**8,970,833.33**	**6,570,833.33**	**13,570,833.33**

*** Instead of total figure ticked, even the stated figures were considered**

W1=Appropriation of partnership income

	Nyodu	**Masahani**	**Matsova**	**Total**
Salaries	8,000,000	4,000,000	4,000,000	16,000,000
Fuel and oils	3,000,000	3,000,000	3,000,000	9,000,000
Interest to Nyodu	600,000			
Total app. Income	**11,600,000**	**7,000,000**	**7,000,000**	**25,600,000**

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