THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

MAY 2022 DIET
PROFESSIONAL LEVEL EXAMINATIONS

Question Papers

Suggested Solutions

Marking Guides

and

Examiner's Reports

FOREWARD

This issue of the **PATHFINDER** is published principally, in response to a growing demand for an aid to:

(i) Candidates preparing to write future examinations of the Institute of Chartered Accountants of Nigeria (ICAN);

(ii) Unsuccessful candidates in the identification of those areas in which they lost marks and need to improve their knowledge and presentation;

(iii) Lecturers and students interested in acquisition of knowledge in the relevant subject contained herein; and

(iv) The professional; in improving pre-examinations and screening processes, and thus the professional performance of candidates.

The answers provided in this publication do not exhaust all possible alternative approaches to solving these questions. Efforts had been made to use the methods, which will save much of the scarce examination time. Also, in order to facilitate teaching, questions may be edited so that some principles or their application may be more clearly demonstrated.

It is hoped that the suggested answers will prove to be of tremendous assistance to students and those who assist them in their preparations for the Institute's Examinations.

<u>NOTES</u>

Although these suggested solutions have been published under the Institute's name, they do not represent the views of the Council of the Institute. The suggested solutions are entirely the responsibility of their authors and the Institute will not enter into any correspondence on them.

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2022

CORPORATE REPORTING

Time Allowed: $3^1/_4$ hours (including 15 minutes reading time)

INSTRUCTION: YOU ARE REQUIRED TO ATTEMPT FIVE OUT OF THE SEVEN QUESTIONS IN THIS PAPER

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

The draft financial statements of Gbola Limited group and its investee companies Tanko Limited and Eze Limited at December 31, 2018 are shown below:

Draft statements of profit or loss for the year ended December 31, 2018.

	Gbola Limited	Tanko Limited	Eze Limited
	₦' 000	₦'000	₦'000
Revenue	17,070	7,320	2,235
Cost of sales	(8,640)	(3,210)	(885)
Gross profit	8,430	4,110	1,350
Other operating expenses	(2,070)	(810)	(600)
Profit from operations	6,360	3,300	750
Interest expense	(570)	(660)	(210)
Profit before tax	5,790	2,640	540
Income tax expense	(810)	(360)	(90)
Profit for the year	4,980	2,280	450

Draft statements of financial position as at December 31, 2018

	Gbola Limited		Tanko Limited		Eze Limited	
	₦'000	**₦'000**	**₦'000**	**₦'000**	**₦'000**	**₦'000**
Non-current assets:						
Property, plant and equipment		10,350		12,180		10,680
Investments		29,250				
		39,600		12,180		10,680
Current assets:						
Inventories	10,500		8,910		840	
Receivables	15,000		4,200		1,950	
Cash and cash equivalents	5,625		1,875		225	
Total current assets		31,125		14,985		3,015
Total assets		70,725		27,165		13,695
Equity and liabilities:						

Equity:			
Share capital (ordinary shares of ₦1 each)	28,125	12,000	7,500
Reserves	16,875	10,350	2,400
Total equity	45,000	22,350	9,900
Non-current liabilities:			
7% Loan notes	4,500	3,000	750
Current liabilities:			
Trade payables	20,250	1,515	2,820
Current income tax	975	300	225
	21,225	1,815	3,045
Total equity and liabilities	**70,725**	**27,165**	**13,695**

Additional information

(i) On January 1, 2014, Gbola Limited acquired 9,000,000 ordinary shares in Tanko Limited for ₦23,250,000 when the reserves of Tanko Limited were ₦3,000,000.

(ii) A new asset with a fair value of ₦1,500,000 was acquired during the year under a lease agreement by Gbola Limited. A clause in the lease agreement stipulated that ₦300,000 payments must be paid on December 31, each year for six years, starting from December 31, 2018. The interest rate implicit in the lease is 5.47%. Gbola Limited treated this as an operating expense; because the only accounting entry that the company believes must be made in relation to this asset is the ₦300,000 payment it has made.

(iii) Gbola Limited had an intangible asset of ₦750,000 for software in its statement of financial position. The directors of Gbola Limited believed that the software will have no recoverable value at the date of acquisition and Tanko Limited wrote it off shortly after its acquisition.

(iv) At the date of acquisition of Tanko Limited, the carrying amount of its property, plant and equipment, considered to have a remaining life of 10 years was ₦5,625,000 lower than its fair value.

(v) On January 1, 2017, Gbola Limited acquired 2,250,000 ordinary shares in Eze Limited for ₦6,000,000 when the reserves of Eze Limited were ₦1,350,000. The carrying amount of assets of Eze Limited was the same as their fair values at that date. Depreciation should be treated as an operating expense.

(vi) A component used by both Tanko Limited and Eze Limited is produced by Gbola Limited and it sells this component at a margin of 25% and goods worth ₦780,000 were sold to Tanko Limited during the year. None of these goods had been sold by Tanko Limited at December 31, 2018. Gbola Limited also sold goods worth ₦1,200,000 to Eze Limited and Eze Limited sold all of these goods as at December 31, 2018.

(vii) ₦900,000 in respect of amounts owed by Tanko Limited and ₦525,000 in respect of amounts owed by Eze Limited were included in the receivables of Gbola Limited. The corresponding balances in Tanko Limited and Eze Limited payables were ₦600,000 and ₦525,000 respectively. On December 31, 2018. Tanko Limited sent a cheque of ₦300,000 to Gbola Limited.

(viii) There has been no impairment for Eze Limited. However, the impairment test conducted on Tanko Limited's goodwill showed that goodwill is being impaired by 10% per annum on a straight-line basis.

(ix) Gbola Nigeria Limited cash and cash equivalents included Director's loan of ₦1,500,000. The Directors are of the view that the inclusion does not contravene any International Financial Reporting Standard.

Required:

a. Prepare the necessary adjustments to account for the lease contract based on additional information provided in (ii) above in accordance with IFRS 16 (5 Marks)

b. Prepare the consolidated statement of profit or loss and other comprehensive income for the group for the year ended December 31, 2018. (8 Marks)

c. Prepare consolidated statement of financial position of Gbola Limited group at December 31, 2018. (12 Marks)

d. Discuss the ethical implication of the Director's action in note (ix) above. (5 Marks)

(Total 30 Marks)

SECTION B: OPEN-ENDED QUESTIONS (40 MARKS)

INSTRUCTION: YOU ARE REQUIRED TO ATTEMPT ANY TWO OUT OF THE THREE QUESTIONS IN THIS SECTION

QUESTION 2

Heritage Limited and Legacy Limited are two competitors in merchandising and retailing sector of the economy. At a time when the sector is faced with escalating fuel prices and economic recession, both companies have shown resilience and adaptability. The financial statements of the companies for the year ended December 31, 2020 are as follows:

Statements of profit or loss for the year ended December 31, 2020:

	Heritage Limited	**Legacy Limited**
	₦'000	₦'000
Revenue	150,000	700,000
Cost of sales	(60,000)	(210,000)
Gross profit	90,000	490,000
Interest	500	12,000
Distribution costs	13,000	72,000
Administrative expenses	15,000	35,000
Total expenses	28,500	119,000
Profit before tax	61,500	371,000
Income tax expense	(16,605)	(100,170)
Profit for the year	**44,895**	**270,830**

The statements of financial position as at December 31, 2020:

	Heritage Limited	**Legacy Limited**
	₦'000	**₦'000**
Assets:		
Non-current assets:		
Property	-	500,000
Plant and equipment	190,000	280,000
	190,000	780,000
Current assets:		
Inventories	12,000	26,250
Trade receivables	37,500	105,000
Bank	500	22,000
	50,000	153,250
Total assets:	**240,000**	**933,250**

Equity and liabilities:		
Equity:		
Share capital	156,000	174,750
Retained earnings	51,395	390,830
	207,395	565,580
Non-current liabilities:		
Long-term debt	10,000	250,000
Current liabilities:		
Trade payables	22,605	117,670
Total liabilities	32,605	367,670
Total equity and liabilities	**240,000**	**933,250**

The Board of Directors of Patrimony Investments PLC is considering a proposal to buy into one of the companies in order to enhance the reported profit and stability of the company after the investment.

Required:

a. Assess the relative performance of the two companies for the year ended December 31, 2020 with **three** suitable ratios each of:

   i. Profitability and efficiency;

   ii Liquidity and solvency. (8 Marks)

b. Draft a report on the computed ratios for the considerations of the Board of Directors of Partrimony Investments PLC to appropriately guide the Board in taking decision on the proposal to buy into any one of the companies.

(12 Marks)

(Total 20 Marks)

QUESTION 3

Exposure to variety of risks may affect ability to achieve corporate objectives; thereby making risk management a corporate governance issue. Risk reports enable stakeholders to evaluate the importance attached to risk management and the company's effectiveness in managing identified risks. Therefore, risk reports boost shareholders' confidence that the company has adopted a responsible attitude towards risk.

As part of regulatory framework to manage risk, the Security and Exchange Commission (SEC) provided a number of guidelines for rules and content of effective risk reports.

Required:

a. Discuss the regulatory risk management provisions by SEC in Nigeria.

(10 Marks)

b. Analyse the components of effective risk reports and state the benefits of its application to financial institutions in Nigeria. (10 Marks)

(Total 20 Marks)

QUESTION 4

Emili PLC and Wagbo PLC are both public limited companies wholly owned by Tanimo PLC, also a public limited company. Tanimo group PLC operates in the agro-allied industry; but the directors felt that the current structure does not serve their intended purpose and are therefore considering two different restructuring plans for the group.

The statements of financial position of Tanimo PLC and its subsidiaries Emili PLC and Wagbo PLC as at May 31, 2021 are as follows:

	Tanimo PLC ₦m	Emili PLC ₦m	Wagbo PLC ₦m
Property, plant and equipment	600	200	45
Cost of investment in Emili PLC	60	-	-
Cost of investment in Wagbo PLC	70	-	-
Net current assets	160	100	20
Total assets	890	300	65
Share capital-ordinary shares of ₦1 each	120	60	40
Retained earnings	770	240	25
Total equity and liabilities	890	300	65

Tanimo PLC acquired the investment in Wagbo PLC on June 1, 2015 when the company's retained earnings balance was ₦20 million. The fair value of the net assets of Wagbo PLC on June 1, 2015 was ₦60 million. Emili PLC was incorporated by Tanimo PLC on June 1, 2015 and has always been a wholly owned subsidiary. The fair value of the net assets of Emili PLC as at May 31, 2021 was ₦310 million and of Wagbo PLC was ₦80 million. The fair values of the net current assets of both Emili PLC and Wagbo PLC are approximately the same as their carrying amount.

The directors are not certain on what effects the following plans would have on the individual accounts of the companies and the group accounts.

Local companies legislation requires that the amount at which share capital is recorded is dictated by the nominal value of the shares issued and if the value of the consideration received exceeds that amount, the excess is recorded in the share premium account.

Shares cannot be issued at a discount. In the case of a share for share exchange, the value of the consideration can be deemed to be the carrying amount of the investment exchanged.

It is the group's policy to value non-controlling interests at its proportionate share of the fair value of the subsidiary's identifiable net assets.

The two different plans to restructure the group are as follows:

Plan 1
Emili PLC is to purchase the whole of Tanimo's PLC investment in Wagbo PLC. The directors are undecided as to whether the purchase consideration should be 50 million ₦1 ordinary shares of Emili PLC or a cash amount of ₦75 million.

Plan 2
The assets and trade of Wagbo PLC are to be transferred to Emili PLC at their carrying amount. Wagbo PLC would initially become a non trading company. The consideration for the transfer will be ₦60 million which will be left outstanding on the intercompany account between Emili PLC and Wagbo PLC.

Required:

Discuss the key considerations and the accounting implications of the above plans for the Tanimo PLC group. Your answer should show the potential impact on the individual accounts of Tanimo PLC, Emili PLC and Wagbo PLC and the group accounts after each plan has been implemented. **(Total 20 Marks)**

SECTION C: OPEN-ENDED QUESTIONS (30 MARKS)

INSTRUCTION: YOU ARE REQUIRED TO ATTEMPT ANY TWO OUT OF THE THREE QUESTIONS IN THIS SECTION

QUESTION 5

The debate over principle-based and rule-based accounting standards has increased as the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) seek to converge accounting standards for global uniformity. There have been divergent opinions as to whether rule-based standards are superior to principle-based standards and that principle-based standards pose greater ethical challenge to accountant than rule-based standards.

Required:

a. What are the major benefits and basic criticisms of principle-based accounting standards? (10 Marks)

b. What are the consequences of transiting from rule-based to principle-based accounting standards? (5 Marks)

(Total 15 Marks)

QUESTION 6

International Financial Reporting Standards - IFRS(s) are sets of accounting standards and it is unrealistic to assume that these standards could not replace those based around rules. However, where rule based system has been in operation, there is likely to be an expansion of ethical challenges for both accountants and auditors that are involved with the financial statements if principles based approach was adopted. Therefore, regulatory authorities need to ensure ethical practices in order to achieve high quality financial statements. This is drawing attention to the need for closer or greater monitoring. Apart from this fact, corporate financial reporting regulations have been in operation before the advent of IFRS(s).

Required:

a. Appraise the rationale behind different regulatory frameworks for corporate financial reporting (8 Marks)

b. Analyse in details, the various sources of regulations for corporate financial reporting in Nigeria (7 Marks)

(Total 15 Marks)

QUESTION 7

a. Femmy PLC operates in a city where a major insurance company has just announced a restructuring that will lay off 4,000 employees. For Femmy PLC, accounts receivable represents one of the major assets of the company. Although the company's annual uncollectible accounts are not out of line, they are material in size. The company is about to submit its application for a bank loan. Sales and net income have declined in the past year and some customers are falling behind in settling their accounts. A steady financial performance is necessary to be able to secure the anticipated bank loan. Therefore, management felt there is the need to underestimate the uncollectible accounts this year to show a small growth in earnings. They believe that future successful years will average out the losses. More so, since the company has a history of success, the adjustments are seen as mere accounting measures and estimates. The Chief Accountant viewed management's action as unethical.

Required:

i. Discuss the meaning of unethical act by organisations. (5 Marks)

ii. What should the Chief Accountant do under this circumstance? (5 Marks)

b. Securities and Exchange Commission, Nigeria (SEC) requires that the annual report of all quoted companies should include a corporate governance statement.

To this effect, general requirements for the content of the Governance Report are clearly spelt out.

Required:

Discuss the content of the Governance Report of corporate entities. (5 Marks)

(Total 15 Marks)

SOLUTION 1

(a) Gbola is the lessee in this scenario

IFRS 16 – Leases, requires lessees to recognise an asset and a liability for all leases, unless they are short-term or of a minimal value.

Therefore, this will be accounted for as a right-of-use assets in the books of the lessee.

Lessee accounting

At the commencement of the lease, IFRS 16 requires that the lessee recognises a lease liability and a right-of-use asset.

Initial recognition

DR	Right-of-use-asset	₦1,500,000
CR	Lease liability	₦1,500,000

Being initial recognition of right-of –use asset

Workings:

(i) The lease liability is initially measured at the present value of the lease payments payable during the lease term.

In this case, since there are fixed payments of ₦300,000 for 6 years annuity formular should be applied.

$$PV = P \times \frac{1-(1+r)^{-n}}{r}$$

PV	=	present value of an ordinary annuity		
P	=	value of each payment	=	₦300,000
r	=	interest rate per period	=	5.47%
n	=	number of periods	=	6 years

PV = P x $\frac{1-(1+r)^{-n}}{r}$

PV = ₦300,000 x $\frac{1-(1-0.0547)^{-6}}{0.0547}$

PV = ₦300,000 x 5

PV = ₦1,500,000

The present value of the minimum lease payments amounts to ₦1,500,000 which will be recognised at the inception and armotised over the period of the lease.

(ii) **Subsequent measurement**
For right-of-use-asset

Depreciation ₦1500,000/6 = ₦250,000

DR Profit or Loss ₦250,000

CR Right-of-use-asset ₦250,000

Being annual depreciation charged on right-of-use asset

Statement of financial position (extract) as at December 31, 2018

Non-current asset - Right-of-use asset (₦1,250,000)
(₦1500,000 - ₦250,000)
Non-current liability - (wk iii) ₦1,052,180 (balance owing in one year's time)
Current liability (wk iii)= ₦229,870) -(₦1,282,050 - ₦1,052,180)
Retained earnings will reduce by = ₦32,050 (profit reduction in the income statement).

(iii) **For lease liability**

Years	Opening		Instalment	Interest implicit 5.47%	Closing
	₦'000		₦'000	₦'000	₦'000
1	1500.00	-	300.00	82.05	1,282.05
2	1,282.05	-	300.00	70.13	1,052.18
3	1,052.18	-	300.00	57.55	809.73
4	809.73	-	300.00	44.29	554.02
5	554.02	-	300.00	30.31	284.33
6	284.33	-	300.00	15.67	Nil

(iv) **Adjustment to account for the lease**

		DR ₦'000	CR ₦'000
DR	Profit or loss (finance cost)	82.05	
CR	Lease obligation		82.05
Being recognition of Interest in 2018			

(v)

		DR ₦'000	CR ₦'000
DR	Lease obligation	300	
CR	Operating expenses (P or l)		300
Being reversal of initial amount wrongly charged to operating expenses			

(b)

Gbola Limited
Consolidated statement of profit or loss and other comprehensive income for the year ended December 31, 2018

	₦'000
Revenue ₦(17,070+7,320-780)	23,610
Cost of sales ₦(8,640+3,210-780+195)	(11,265)
Gross profit	12,345
Other operating expenses ₦(2,070+810-300+562.5+562.50 +250)	(3,955)
Profit from operation	8,390
Interest expense ₦(570+660+82)	(1,312)
Share of profit of associate (30% of ₦450)	135
Profit before tax	7,213
Tax expense ₦(810+360)	(1,170)
Profit for the year	**6,043**

(c)

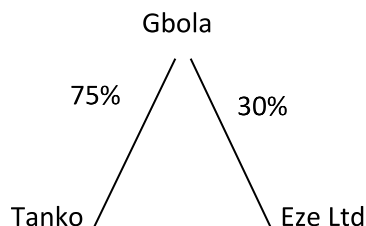
Gbola Limited
Consolidated Statement of financial position
As at Dec. 31, 2018

	₦'000
Non-current asset	
Goodwill (W2)	6,094
Property plant & equipment ₦(10,350+12,180+5,625 – 2,250+1,250)	27,155
Investment (W4)	6,315
Total non-current assets	39,564
Current assets:	
Inventories ₦(10,500+8,910-195)	19,215
Receivables ₦(15,000+4,200-900)	18,300
Cash & cash equivalents ₦(5,625+1,875+300)	7,800
Total current assets	45,315
Total asset	**84,879**
Equity & liabilities	
Equity:	
Ordinary share capital	28,125
Reserves (Wk 3)	20,563
Non-controlling interest (Wk 8)	4,969
Total equity	53,657
Non-current liabilities	
7% Loan note ₦(4,500+N3000)	7,500
Lease obligation	1,052
Total non- current liabilities	8,552
Current Liabilities	
Trade payables ₦(20,250+1,515-600)	21,165
Tax payables ₦(975+300)	1,275
Lease obligation	230
Total current liabilities	22,670
Total equity and liability	**84,879**

Working Notes

W1

Group structure



Gbola in Tanko = 9000/12000 x 100= 75% Parent

Non-controlling interests = 25% NCI

Gbola in Eze = 2250/7000 x 100 = 30% Associate

W2
Fair value of net assets acquired

Net assets of:		**Tanko Limited**	**Eze Limited**
At reporting date:		**₦'000**	**₦'000**
Share capital		12,000	7,500
Retained earnings		10,350	2,400
Fair value adjustment		5,625	-
Depreciation adjustment (5,625/10 x 4 years)		(2,250)	-
		25,725	9,900
At acquisition:			
Share capital		12,000	7,500
Retained earnings		3,000	1,350
Fair value adjustment		5,625	-
Software written off		(750)	
		19,875	8,850
Cost of Investment	23,250		
Fair value of NCI	4,969	(28,219)	
		8,344	
Impairment ₦5,625,000 x 10% x 4years		(2,250)	
Goodwill		6,094	

W3	**Consolidated retained earnings**	**₦'000**
	Gbola Limited	16,875
	Tanko Limited (25,725 – 19,875) W2	5,850
	Eze – 30% x (9,900 – 8,850) W2	315
	Unrealised profit adjustment Tanko Limited W5	(195)
	Reduction in profit (Part a)	(32)
	Impairment of goodwill of Tanko Limited (W2)	(2,250)
		20,563

W4	Investment in Associate Eze Limited	**₦'000**
	Cost	6,000
	Share of post-acquisition profit (W3)	315
		6,315

W5 Unrealised profit
Sales to Tanko Limited ₦780,000 x 25% = ₦195,000

Increase cost of sales and decrease inventory

Note:
Any impact on this year's profit will also change the retained earnings figure (W3)

No adjustment is required for Eze Limited as the inventory has been sold at year-end.

W6 Intra-group balances: Reduce receivables by ₦900,000 reduce payables by ₦600,000 and increase cash by ₦300,000.

Intra-group sales: Reduce revenue and cost of sales by ₦780,000. No adjustments are made for inter-company sales/balances for associates.

W7 Shares of associate profits is 30% x ₦450,000 = ₦135,000

W8 Non-controlling interest is 25% x ₦19,875 (W2) = ₦4,969

(d) Disclosing a loan as cash and cash equivalents is misleading and not in agreement with the Generally Accepted Accounting Principles (GAAP). According to the Framework for Financial Reporting, the characteristics of financial statements are stated as:

i. Relevance
ii. Faithful representation
iii. Comparability
iv. Verifiability, understandability; and timeliness

These characteristics would ordinarily preclude the disclosure of directors' loans in cash and cash equivalent.

- Financial information should be presented in a way that the reader would easily comprehend it. This presupposes that there would be no intendment at confusing readers with no advanced accounting knowledge.

- Similarly, information would need separate disclosure as it is relevant to users as its shows the nature of the practices carried out by the company.

- Reliability, on the other hand, requires information to be free from bias and to be a faithful representation of the transaction.

- Comparability would be difficult if transactions are not classified correctly and fairly.

Directors have responsibility for the fair presentation of the statutory financial statements. Where the directors believe that this is not being done, or when the financial statements are not in agreement with IFRS, they are required to take all steps to ensure that the error or irregularity is corrected. Directors are deemed to be individually and collectively aware of the contents of the financial statements.

In Nigeria, Section 296 of the CAMA generally prohibits companies from giving loans to its directors or directors of its holding company or giving guarantees or providing any security in connection with a loan made to such director.

Similarly, IAS 24 - Related Party Transactions, requires the financial statements to disclose the following on such director related transactions.

i. Relationship that exists;
ii. Nature of transaction (loan to director);
iii. Amount of transactions; and
iv. Commitment to pay outstanding amount.

The directors are under obligation to follow this guideline in the presentation of the report.

Directors have a responsibility to act honestly and ethically and not be motivated by personal interest and gain. If the ethical conduct of the directors is questionable, then other areas of the financial statements may need scrutiny. Conflicts of interest may arise as a result of this type of loan and could interfere in the directors' personal interest as director conflict with those of the company.

Conclusion

Loan to a director cannot be reported or disclosed as cash and cash equivalents, rather it should be recognised as either current liability or non-current liability depending on the tenor of maturity of the loan.

Examiner's report

Part (a) of the question tests candidates' knowledge of the necessary adjustment to account for the lease contract in accordance with IFRS 16. Part (b) of the question tests candidates' knowledge of the preparation of group consolidated statement of profit or loss and other comprehensive income. Part (c) of the question tests candidates' knowledge of the preparation of group consolidated statement of financial position, while part (d) tests ethical responsibility of directors when loan advanced to them are shown as cash and cash equivalents.

All the candidates attempted the question and their performance was below average.

The common pitfalls of the candidates were their inability to prepare the necessary adjustments in accounting for lease payments; lack of in-depth knowledge in the preparation of consolidated group financial statements and failure to identify and discuss ethical responsibility of directors.

Candidates are advised to do in-depth study to understand application of accounting standards and basic principles of consolidating group financial statements. They should also pay attention to ethical issues in financial reporting and practice more questions by making use of ICAN study texts for better performance in future examinations.

Marking guide

		Marks	Marks
1a.	Adjustments to account for lease contract		
	- Initial recognition	¾	
	- Subsequent measurement	3	
	- Adjustment in the account	1¼	5
b.	Consolidated statement of profit or loss:		
	- Revenue	1	
	- Cost of sales	1¼	
	- Profit from operation	2	
	- Profit before tax	1	
	- Profit after tax	1¾	
	- Other adjustments	1	8
c.	Consolidated statement of financial position:		
	Non-current assets	2	
	Current assets	2	
	Equity	1	
	Non-current liabilities	1	
	Current liabilities	2	
	Computation of goodwill	2	
	Computation of retained earnings	2	12
d.	Discussion on showing a loan to a director as cash and cash equivalents		
	Relevance to financial reporting framework	1½	
	Relevance to IAS 24	1	
	Relevance to CAMA	1	
	Conclusion	1½	5
	Total		**30**

SOLUTION 2

(a)

Heritage and Legacy Limited

Financial Statement Analysis for the year ended December 31, 2020

S/n	Ratios	Formulae	Heritage PLC	Legacy Limited
i.	ROCE (%)	PBIT/C.E X100 = C.E=TA-CL or E+D	(61,500+500)/(240,00-22,605) = 28.5%	(371,000+12,000)/(933,250-117,670) = 47.0%
ii.	Gross Profit (GP) margin (%)	GP/Revenue x 100	90,00/150,00 X 100 = 60.0%	490,000/700,000 x 100 = 70.0%
iii.	Operating Profit Margin (%)	PBIT/Revenue x 100	(61,500+500)/ 150,00 x 100 = 41.3%	(371,000+12,000)/ 700,000 x 100 = 54.7%
vi.	ROE (%)	(PAT-NCI-Pref dividend)/(equity-NCI) x 100	44,895/207,395 x 100 =21.6%	270,830/565,580 x 100 = 47.9
v.	ROA (%)	PBIT/Total Assets x 100	(61,500+500)/240,000 x 100 = 25.8%	(371,000+12,000)/933,250 x 100 = 41.0%
	Efficiency ratios:			
i.	Asset turnover (times)	Revenue/capital employed x 100	150,00 /(240,00-22,605) = 0.69 times	700,000/)/(933,250-117,670) = 0.86times
ii.	Inventory holding period(days)	av. Inventory/cost of sale x 365	12,000/60,000 x 365 = 73 days	26,250/210,000 x 365 = 46days
iii.	Trade receivable period (days)	Av receivable revenue x 365	37,500/150,000 x 365 = 91days	105,000/700,000 x 365 = 55days
vi.	Trade payable payment period (days)	Av. Payable/credit purchase or cost of sales	22,605/60,000 x 365 = 138 days	117,670/210,000x365 = 204 days
	Liquidity ratios			
i.	Current ratio	Current asset/Current liabilities	50,000/22,605 = 2.2:1	153,250/117,670 = 1.3:1
ii.	Quick ratio	(Current Asset--Inventory)/Current liabilities	50,000-12,000/22,605 = 1.7:1	153,250-26,250/117,670 = 1.1:1

iii.	Cash ratio	cash and cash equivalent/current liabilities	500/22,605 = 0.02:1	22,000/117,670 = 0.19:1
	Solvency ratios:			
i.	Debt to Equity			
	Capital gearing (%)	Debt/Equity x 100	10,000/207,395 x 100 = 4.8%	250,000/565,580x100 = 44%
		Debt/(debt +equity) x 100	10,000/(10,000+207,395) x 100 = 4.6%	250,000/(250,000+565,580) x 100 = 30.6%
ii.	Interest Cover (times)	PBIT/Interest Expense	(61,500+500)/500 = 124times	(371,000+12,000)/12,000 = 32 times

(b) The Board of Directors
Patrimony Investment PLC;
Ikeja, Lagos.

Dear Sir,

Report on analysis of investment proposals

Above subject refers, please.

Kindly find attached comments and suggestions on the ratios calculated in (a) as follows:

(i) **Profitability and efficiency:**
The ROCE achieved by Heritage Limited (28.5%) is substantially lower than that achieved by Legacy Ltd (47%). This variation in performance is also noticeable in gross profit percentage (60% compared to 70%) and net profit margin of 41.3% compared to 54.7%.

The variations in gross profit could be caused by differences in sales mix, inventory valuation methods or mark-up.

Since these entities operate in the same sector, it is unlikely that their selling prices differ significantly. However, Legacy, as a much larger entity, may be able to negotiate better prices from its suppliers.

Legacy Limited demonstrated greater efficiency in the use of its assets as it turns the assets over 0.86 times against Heritage Limited's 0.7 times. Similarly, Legacy Limited turns its inventory over within 46 days as against 73 days it takes Heritage Limited. Legacy Limited similarly demonstrated greater efficiency in collection of receivables which is done within 55 days as against 91 days it takes Heritage Limited. However, Legacy takes 204 days to settle its debt to suppliers which implies that the company gets more financing from the suppliers than Heritage which takes only 137 days to pay its suppliers.

(ii) **Liquidity and solvency:**
Legacy Limited is much more highly geared than Heritage Limited (44% compared to 4.8%). Legacy Limited has the ability to raise debt more easily because it is a more profitable business than Heritage Limited. Besides, Legacy Limited has property on which debt can be secured. Heritage Limited is not having such property.

The earnings of both companies can easily cover their interest payments, with Legacy doing so in 32 times and Heritage in 124 times.

(iii) Conclusion and advice to board:

Legacy Limited is more profitable and stronger in term of asset quality than Heritage Limited.

Yours faithfully,

Analyst

Examiner's report

Part (a) of the question tests candidates' knowledge of the assessment of the relative performance of two companies using profitability, efficiency, liquidity and solvency ratios. Part (b) of the question tests candidates' knowledge on report writing to guide the Board of Directors on taking decisions on investment proposal.

Majority of the candidates attempted the question and their performance was above average.

The common pitfalls of the candidates were their inability to write good business report and advise management on investment decision proposal.

Candidates are advised to ensure that they develop better business communication skills to convey their idea to management after computation of ratios.

Marking guide

		Marks	Marks
ai.	Computation of profitability and efficiency ratios	4	
ii.	Computation of liquidity and solvency ratios	4	8
b.	Presentation:		
	Opening	1	
	Rights on profitability and efficiency	6	
	Rights on solvency/liquidity	4	
	Conclusion	1	12
	Total		20

SOLUTION 3

(a) The provisions of SEC on risk management include:

i. Reporting entities should have risk management units within their organisations. This is needed to enable the applicable reporting entities

to easily identify risk, measure the identified risk and put relevant measures in place to mitigate or minimise the risks.

ii. Reporting entities must include risk management reports in their annual financial statements. This means that applicable reporting entities are expected to include reports on their risk management in their annual financial statements so as to assists users in their decision making.

iii. The board of every public company must establish a risk management committee to assist it in its oversight of risk.

iv. Every public company must include risk management as part of its accounting policies.

v. Public companies must disclose, by way of notes:
Any material effect of unmitigated risk on corporate profitability; and strategies for preventing risks the company is exposed to.

vi. The participants or reporting entities should have comprehensive risk management framework and investment policies for managing derivatives related risks. The framework should include but not limited to the following:
- The officer responsible for coordinating risk functions;
- The reporting lines;
- The risk appetite and risk tolerance for all classes of risks;
- The risk registers; and
- The roles and responsibilities of every staff including board members on risk management.

(b) (i) **Analysis of the components effective risk reports**

- Risk identification: This involves identifying the risks an entity faces and to achieve this, the entity must define its risk universe. The risk universe is simply a list of all possible risk such as operational risk, legal risk, political risk, credit risk, regulatory risk, etc. After identifying the risks, the entity will then select the risks to which it is exposed and categorise them into core and non-core risks.

- Risk measurement assessment: This involves providing information on the quantum of either a specific risk exposure or an aggregate risk exposure and the probability of a loss occurring due to those exposures.

- Risk mitigation: This involves decision by an entity on the risk to

minimise or eliminate and how much of its core risk can be retained. This can be achieved through diversification, hedging, buying insurance, etc.

- Risk reporting and monitoring: This involves regular reports based on specific and aggregate risks measures in order to ensure that the risk levels are maintained at an optimal level.
- Risk governance: This involves putting appropriate measures in place to ensure that the employees of an entity perform their duty in accordance with the risk management framework.
- Risk agenda and risk response.

(ii) Benefits of effective risk reports to financial institutions in Nigeria

- A financial institution risk reports contribute to sound risk management and decision-making by their relevant recipients, including the board, senior management, etc.
- It ensures that the information is meaningful and tailored to the
- needs of the recipients.
- It improves the decision-making process throughout the banking organisation.
- It reduces the probability and severity of losses resulting from risk management weaknesses.
- It improves the speed at which information is available and hence decisions can be made.
- It improves the organisation's quality of strategic planning and the ability to manage the risk of new products and services.

Examiner's report

Part (a) of the question tests candidates' knowledge of the regulatory risk management provisions by SEC in Nigeria, while part (b) tests analysis of the components of effective risk reports and the benefits of its application to financial Institutions in Nigeria.

Most candidates attempted the question and their performance was average.

The common pitfalls of the candidates were lack of understanding of SEC requirements on regulatory framework to manage risk and their inability to identify and list the contents of good risk report.

Candidates are advised to get familiar with knowledge of risk management provisions by relevant regulatory bodies in financial reporting, do in-depth study on

contemporary corporate reporting issues examinable at this level of the Institute examinations for better performance in future.

Marking guide

		Marks	Marks
a.	Regulatory risk management provisions by SEC in Nigeria		
	Five well discussed points at 2 marks each		10
b.	Analysis of the components of effective risk reports		
	Five points at 1 mark each	5	
	Benefits of effective risk reports to financial institutions in Nigeria (five points at 1 mark each)	5	10
	Total		**20**

SOLUTION 4

There are numbers of reasons why group restructuring or reorganisation may be undertaken. Instances of such include creation of group efficiency for tax purposes, transfer to another business, debt management, etc.

Plan 1

i. **Share for share exchange**

Where the purchase consideration was by share exchange, a share premium account should be maintained by Emili PLC as shares are either issued at par or premium and not at a discount.

The excess of the net book value over the nominal value (referred to as minimum premium) is calculated as viz ₦70m – ₦50m = ₦20m.

The effect on the group and each company is as shown below:

	Notes	Group PLC ₦'m	Tanimo PLC ₦'m	Emili PLC ₦'m	Wagbo PLC ₦'m
Property, plant & equipment		845	600	200	45
Intangible assets: goodwill	4	10			
Cost of investment					
Emili PLC	1		130		
Wagbo PLC	2			70	
Net current assets		280	160	100	20
		1,135	890	370	65
Share capital	3	120	120	110	40
Share premium				20	
Retained earnings	5	1,015	770	240	25
		1,135	890	370	65

NOTES

1. The list of investment in Emili PLC is increased by the amount of shares issued ₦50m + ₦20m = ₦70m

2. Cost of investment in Wagbo PLC i.e ₦70m + ₦60m = ₦130m is transferred to Emili PLC maintained its carrying amount.

3. Emili PLC's issued share capital of ₦50m increases the nominal value (₦60 + ₦50 = ₦110).

4. Goodwill on purchase of Wagbo PLC is ₦10m (₦70m – (₦40m + ₦20m).

5. The retained earnings

	Tanimo PLC	Emili PLC	Wagbo PLC
	₦'m	₦'m	₦'m
Retained earning per question	770	240	25
- At acquisition (2)	770		
Share of post-acquisition profits of - Emili PLC (100%)	240		
Share of post-acquisition profit of Wagbo PLC (100%) (₦25 – ₦20)	5		
	1,015		

ii. **Cash purchase**

The group as an entity is unaffected by the internal reorganisation. A gain or loss of sale of Wagbo PLC will be in Tanimo PLC's books.

The ₦80m Wagbo PLC's net asset is in excess of ₦75m cash price and its effects in the books are:

	Notes	Group	Tanimo PLC	Emili PLC	Wagbo PLC
		₦'m	₦'m	₦'m	₦'m
Property, plant & equipment		845	600	200	45
Goodwill		10			
Investment - Wagbo PLC	1			75	
- Emili PLC			60		
Net current assets	2	280	235	25	20
		1,135	895	300	65
Share capital		120	120	60	40
Retained earnings	3	1,015	775	240	25
		1,135	895	300	65

NOTES

1. Investment (cost) – Wagbo PLC cash purchase price is ₦75m
2. Net asset (current)
   Emili PLC's cash decreased by ₦75m and Tanimo PLC's cash increased by ₦75m
3. Retained earnings
   Profit on disposal of Wagbo PLC increased Tanimo's earnings by ₦5m and it is eliminated on consolidation.

Plan 2

One way to simplify a group structure is rationalisation restructuring.

Wagbo PLC was initially purchased at ₦70m and the net assets transferred to Emili PLC is ₦60m giving rise to goodwill of ₦10m. Note that investment in Wagbo PLC in Tanimo PLC book may be impaired.

The investment in Wagbo PLC in Tanimo PLC's books will be reduced to ₦60m and a corresponding change on the retained earnings below:

	Note	Group	Tanimo PLC	Emili PLC	Wagbo PLC
		₦'m	₦'m	₦'m	₦'m
Goodwill		10			
Property, plant & equipment		845	600	245	-
Investment (cost) - Emili PLC			60		
Wagbo PLC	1		60		
Net current assets	2	280	160	60	60
		1,135	880	305	60
Share capital		120	120	60	40
Revaluation surplus	3			5	
Retained earnings	4	1,015	760	240	20
		1,135	880	305	60

NOTES

1. Investment in Wagbo PLC

	₦'m
Per question	70
Net asset transfer	60
Impairment	10

2. Net current assets
   Emili PLC = ₦100m + ₦20m – ₦60m (intragroup payables) = ₦60m

3. Revaluation surplus ₦65m – ₦60m = ₦5m arose from the purchase of assets in Wagbo PLC.

Retained earnings	₦'m	₦'m
(Per question)	770	25
Less impairment	10	
Less loss on transfer of assets		5
	760	20

Calculation of group reatined earnings

	Group	Tanimo PLC	Emili PLC	Wagbo PLC
	₦'m	₦'m	₦'m	₦'m
Per question	770	770	240	25
At acquisition		-	-	(20)
		770	240	5

	₦'m
Share of post-acquisition	
Emili Ltd 10%	240
Wagbo Ltd 100%	5
	1,015

Examiner's report

The question tests candidates' knowledge of the key considerations and the accounting implications of using different plans to restructure a group business and the potential impact of the restructuring on separate financial statements of the entities.

Few of the candidates attempted the question and their performance was very poor.

The common pitfalls of some candidates were their inability to understand business restructuring, acquisition and combination options; others could not correctly interpret the requirements of the question.

Candidates are advised to do in-depth study to cover all areas of the syllabus, practice more questions and use ICAN study texts for better performance in future examinations.

Marking guide

	Marks	Marks
Plans to restructure the group		
Plan 1 - Share for share exchange and the accompanying notes	5	
Cash purchase and the accompanying notes	5	10
Plan 2 - Simplification of group		
- Structure as rationalisation restructuring	5	
- Accompanying notes	2	
- Calculation of group retained earnings	3	10
Total		20

SOLUTION 5

(a) **Advantages/benefits of principles-based accounting standards**

i. Principles-based accounting standards allow reporting practice to develop over time in response to the needs of users and changes in the business environment.

ii. It allows the use of judgement, so it is more flexible and able to deal with variety of situations and transactions.

iii. It is more difficult to use creative accounting when approach is based on fundamental principles.

iv. Principles-based accounting standards encourage accountants to follow the spirit of an accounting concept rather than to follow specific accounting rules.

v. It provides more consistent financial information

vi. It decreases investor uncertainty as the principle used in preparing the account are known to all.

vii. It allows reporting practice to develop overtime in response to the needs of users and changes in the business environment.

viii. Accounting principles require accountants to look deeper into the substance of the transaction.

Major criticisms/ Disadvantages of principles-based accounting **standards**

i. **Decreased Comparability**
If principles are used rather than rules, accounting information may start to become less consistent. It is possible for two accountants to look

at the same data and come to completely different conclusions about what the data mean. Two companies with the same assets, in this case, could present them differently on the statement of financial position.

ii. **Enforcement is more difficult**
Companies and accounting firms are constantly accused of misstating financial information, but asking judges and juries with no financial experience to interpret accounting principles during enforcement cases may be a bad idea.

iii. **Too much freedom**
Critics of principles-based accounting systems are of the opinion that they give companies too much freedom.

iv. **Lack of transparency**
They do not prescribe transparency.

v. **Lack of faithful representation**
They believe because companies do not have to follow specific rules that have been set out, their reporting may provide an inaccurate picture of its financial health.

vi. The existing framework is based on detailed rules, hence, users of the financial statements tends to view principles-based accounting as insufficiently rigorous.

vii. Correct approach may not always be obvious.

viii. The principle-based accounting is more expensive.

ix. The principle-based accounting is time-consuming, since it will require more disclosures than risk-based accounting.

(b) **Consequences of transiting from rule-based to principle based accounting standards**

Transiting from rule-based to principle-based accounting standards will have the following consequences on the company:

i. It will require educating and re-training of the staff about the principle based;

ii. It will have a cost implication on the company as the old system will be put aside while implementing the principle based;

iii. There will be a challenge of harmonisation of legislations in financial reporting with introduction of principled based;

iv. Transiting to principle-based will affect industry specific standards;

v. It will bring about the challenges of complexity and structure of principle- based accounting standard;

vi. There would not be a culture of secrecy any longer; and

vii. Transiting to principle-based will bring challenges for Small and Medium Enterprises (SME) and auditing and accounting firms.

Examiner's report

Part (a) of the question tests candidates' knowledge of the major benefits and basic criticisms of the principle-based accounting standards, while part (b) tests the consequences of transiting from rule-based to principle-based accounting standards.

Majority of the candidates attempted the question and their performance was above average.

The common pitfalls of the candidates was their inability to present their points in a logical sequence to convey the proper meaning of the terms. They also lack good understanding of transiting from rule-based to principle-based accounting standards.

Candidates are advised to familiarise themselves with all aspects of the syllabus for better performance in future examinations.

Marking guide

		Marks	**Marks**
a.	Advantages/benefits of principle-based accounting standards (5 correct points at 1 mark each)	5	
	Major criticisms/disadvantages of principle based accounting standards (5 correct points at 1 mark each)	5	10
b.	Consequences of transiting from rule-based to principle-based accounting standards (5 correct points at 1 mark each)		5
	Total		**15**

SOLUTION 6

a. Rationale behind regulatory frameworks for corporate financial reporting

There are several reasons why corporate financial reporting practice should be regulated.

i. The most obvious one is that without regulation, an entity would be free to adopt any accounting treatment that it chooses.

ii. Persons external to the business are normally dependent on the published financial statements for information about an entity's activities. Regulation ensures that external users of financial statements are provided with information that is relevant to their decisions and reliable.

iii. Accounting standards and other forms of regulation help to ensure that entities adopt similar accounting treatments for similar items and account for similar transactions in the same way over time. This makes it possible to compare the financial statements of different entities and to compare an entity's performance for the current year with its performance in previous years.

iv. Without regulation; management would adopt whichever accounting treatment presented its results and position in the best possible light.

v. Sometimes management might deliberately mislead users of the financial statements.

(b) **Sources of regulation**: The main sources of regulation in Nigeria are: Accounting standards, Company law; and Listing rules of the Stock Exchange.

i. **Accounting standards** are authoritative statements of how particular types of transactions and events are reflected in the financial statements.

Accounting standards may be rules-based or principles-based. IASs and IFRSs are mainly principles based, though some would argue that in practice they are a mixture of rules and principles. It is possible for rules and principles to complement each other. Many countries (including Nigeria, the UK, Canada and Australia) have a regulatory system in which company law deals only with some specific matters. Detailed financial reporting practice is developed by the accounting profession through accounting standards. In other countries, the content of financial statements and accounting practice may be prescribed in great detail by company law with little scope for individual judgement.

ii. Company law varies from country to country, but typically also it sets out rules for determining profits available for distribution, issuing and redeeming share capital, the reserves that a company must have and the uses to which they can be put. These matters are not covered in accounting standards. The main company law statute in Nigeria is the Companies and Allied Matters Act (CAMA) 2020 (as amended). CAMA is the primary source of company law in Nigeria. Amongst other things it establishes the accounting requirements for financial reporting by all companies in Nigeria. CAMA states requirement to keep accounting records and it also contains general requirements to prepare financial statements and also prescribes form and content of financial

statements.

iii. **Listing rules** set out the information which entities must supply when their shares are traded on the stock market. They must comply with these rules in order to maintain their listing. These rules include requirements relating to information, including financial reports that entities must prepare and provide to the stock market while they are listed. Further regulations are often issued by central banks and insurance regulators. These would apply to relevant entities in the financial services industry.

Examiner's report

Part (a) of the question tests candidates' knowledge of the rationale behind different regulatory frameworks for corporate financial reporting, while part (b) tests candidates' knowledge of the various sources of regulations for corporate and financial reporting in Nigeria.

Majority of the candidates attempted the question and their performance was below average.

The common pitfall of the candidates was their inability to understand various sources of regulatory frameworks for corporate and financial reporting and their requirements in Nigeria.

Candidates are advised to pay more attention to all aspects of the syllabus to understand various sources of regulations for financial reporting in Nigeria for better performance in the Institutes future examinations.

Marking guide

		Marks	Marks
a.	Rationale behind regulatory frameworks for corporate financial reporting (4 points discussed at 2 marks each)		8
b.	Sources of regulations for corporate financial reporting in Nigeria. Explanation of:		
	- Accounting standards as a source	2	
	- Company law as a source	3	
	- Listing rules as a source	2	7
	Total		**15**

SOLUTION 7

(ai) **Unethical behaviours of an organisation**

Unethical behaviour or Act is an action that falls outside of what is considered morally right or proper for a person, a profession or an industry. Individuals can behave unethically as well as businesses, professionals and politicians. Unethical means not conforming to a high moral standard: morally wrong: not ethical. An organisation acting ethically implies that the organisation have made decisions that will not lead to unethical behaviours or acts.

Corporate actions or decisions that are unethical

Management and employees of the company have made a conscious decision to act unethically when a company:

i. uses false advertising;
ii. cheats customers;
iii. pollutes the environment;
v. treats its employees poorly; or
vi. misleads investors by providing false information in annual reports;
vii. Dumping pollutants into the water supply rather than cleaning up the pollution properly;
viii. Releasing toxins into the air in levels above what is permitted by the Environmental Protection Agency;
ix. Coercing an injured worker not to report a work injury to workers' compensation by threatening him with the loss of a job or benefits;
x. Refusing to give an employee a final paycheck for hours worked after the employee leaves the company;
xi. Not paying an employee for all of the hours worked;
xii. Incorrectly classifying an employee as an independent contractor and not as an employee in order to reduce payroll taxes and avoid purchasing unemployment and workers' compensation insurance;
xiii. Engaging in price fixing to force smaller competitors out of business;
xiv. Using bait and switch or false advertising tactics to lure customers in or convince them to buy a product;
xv. Rolling back the odometer on a vehicle that is for sale; and
xvi. Refusing to honor a warranty claim on a defective product.

(aii)

- Accountants in business need to ensure that they do not prepare financial information in a way that is misleading or that does not show a true and fair view of the entity's operations or performance.
- Accountant must ensure that financial information is technically correct and is adequately disclosed.

- Accountants owe the public duty of care and the relevance given to professional accountants in the society must be respected by behaving ethically in all circumstances they find themselves.
- The Chief Accountant should formally write the management informing them that the act of underestimating uncollectible debt is unethical and that it is not acceptable.
- He should sensitise the management of the implication and consequences of such act of misleading the bank and public. He should let them understand that asset is overstated by this act of under estimating provision.
- If however the management insists on conducting such unethical act, then the Chief Accountant should consider tendering his resignation and possibly inform regulatory authority.

(b) The corporate governance report should convey clear information on the strength of the company's governance structures, policies and practices to stakeholders.

The report should include the following:

i. Details of the composition of board of directors stating the names of chairmen, CEO and non-executive directors;

ii. The roles and responsibilities of the board setting out matters which are reserved for the board and those delegated to management;

iii. Details of the process for making board appointments and the induction and training of board members;

iv. Details of the evaluation process for the board as a whole, its committees and each individual director with a summary of evaluation results;

v. Details of directors standing for re-election and their biographical details;

vi. The composition of board committees including names of chairmen and members of each committee;

vii. A description of the roles and responsibilities of the board committees and how the committees have discharged those responsibilities;

viii. The number of meetings of the board and the committees held during the year and details of attendance;

xi. Disclosure of the code of business conduct and ethics, if any, for directors and employees;

xi. Human resource policies, internal management structure, relations with employees, employee share ownership schemes and other work place development initiatives; and

xii. Companies' sustainability policies and programmes covering issues such as corruption, community service, environmental protection, HIV/AIDs, COVID 19 and general corporate social responsibility issues.

Examiner's report

Part (a) of the question tests candidates' understand of the meaning of unethical act by organisations and what the responsibilities of the professional accountants are in such circumstances, while part (b) of the question tests candidates' knowledge of the contents of the governance reports of corporate entities.

Majority of the candidates attempted the question and their performance was above average.

Common pitfalls of the few candidates that attempted the question were poor display of the expectations of professional accountants in ensuring adherence to standards and rules and what can be done when owners of corporate entities fail to comply. Most candidates' that attempted the question did not understand the contents of the governance reports of corporate entities.

Candidates are advised to understand the responsibilities of the professional accountants in relation to unethical acts in corporate reporting. They should also be familiar with ICAN study texts for better performance in the Institutes future examinations.

Marking guide

		Marks	Marks
ai.	Meaning of unethical behaviour by an organisation	2	
	Corporate actions or decisions that are unethical		
	(3 examples at 1 mark each)	3	5
ii.	Ethical responsibilities of an accountant		
	(5 correct points at 1 mark each)		5
b.	Contents of the governance report of corporate entities		
	(5 of the general requirements at 1 mark each)		5
	Total		**15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2022

ADVANCED TAXATION

Time Allowed: $3^1/_4$ hours (including 15 minutes reading time)

INSTRUCTION: YOU ARE REQUIRED TO ATTEMPT FIVE OUT OF THE SEVEN QUESTIONS IN THIS PAPER

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Dadinkowa Nigeria Limited has been in business since 2009 as a manufacturer of sugar cubes. The company sources its sugar cane from the Northern part of the country.

However, due to activities of some miscreants which prevented some of the local farmers to go about their farming activities, the company has been facing a lot of issues in getting the needed raw materials for its operations since 2016.

The company has issues with tax authorities on the treatment of some items (such as allowing/disallowing donation and dividend received at will) in the financial statements submitted and annual returns filed. The high overhead cost, particularly energy cost, make the operating environment not encouraging. In order to address this unpleasant business situation, the board of directors of the company, at its special meeting held recently, decided to "close business operations" temporarily or in the long-run, relocate to a neighbouring country, if the situation does not improve in the coming financial year.

As the company's tax consultant, you were informed of the decision of the Board by the General Manager when you visited the company to obtain documents that you intend to use to conduct tax audit and file statutory tax returns in respect of the just concluded year. He was of the opinion that your professional advice will be highly needed as he did not want the organisation to go on temporary closure next year or relocate to another country. In the course of your discussion, you suggested ways by which issues raised by the Board could be addressed. The General Manager was pleased with your informal submissions and decided to inform the Managing Director. A meeting has been scheduled between the Managing Director and your firm next week.
The profit or loss account in respect of the operations of the company for the year ended December 31, 2021 is as follows:

DADINKOWA NIGERIA LIMITED

Statement of profit or loss for the year ended December 31, 2021

	₦'000	₦'000
Turnover		382,500
Opening inventory	23,200	
Purchases	117,400	
Carriage inwards	5,900	
Closing inventory	(31,100)	
Less: Cost of goods sold		115,400
Gross profit		267,100
Miscellaneous income		11,060
		278,160
Deduct: Expenses		
Salaries and wages	89,500	
Rent and rates	12,300	
Electricity and lighting	26,650	
Transport and travelling	10,820	
Stamp duties for increase in share capital	1,500	
Auditor's remuneration	2,000	
Legal and professional fees	5,000	
Repairs and maintenance	2,100	
Allowance for doubtful debts	28,000	
Depreciation	35,600	
Interest on loan	6,000	
General and administrative expenses	48,470	
Donations and subscriptions	15,000	
Loss on disposal of foreign equity shares	1,750	284,690
Loss for the year		(6,530)

Extract from the company's statement of financial position as at December 31, 2021 revealed:

	₦'000
Non-current assets	600,400
Current assets	312,200
Total assets	912,600
Share capital	600,000
Reserves	87,600
Long-term borrowing	50,000
Liabilities due within 1 year	175,000
	912,600

The following additional information was made available:

(i) Miscellaneous income was made up of:

	₦'000
Excess on revaluation of investment	770
Dividend received (net)	3,460
Other income	6,830
	11,060

(ii) Legal and professional fees included:

	₦'000
Debt collection expenses	1,200
Tax consultant's professional fee	600
Renewal of short lease	1,900
Retainer fee	1,300
	5,000

(iii) Repairs and maintenance included:

	₦'000
Improvement to industrial building	700
Repairs of industrial plant	300
Renewals of tools and implements	200
Construction of company's building gate	900
	2,100

(iv) Allowance for doubtful debts consisted of:

	₦'000
General provision	17,400
Specific provision	12,900
Bad debt written off	10,200
Bad debt recovered	(12,500)
	28,000

(v) Interest on loan was paid on a facility obtained from a licensed Nigerian deposit money bank at commercial interest rate.

(vi) General and administrative expenses were made up of:

	₦'000
Vehicle running expenses	10,700
Insurance premium	12,200
Fine for driving offences	470
Other administrate expenses	25,100
	48,470

(vii) Donations and subscriptions
Included in donations was ₦12,000,000 paid to a fund created by the Federal Government for victims of communal crisis that took place where the company is situated.

(viii) The tax written down values of the qualifying capital expenditure (QCE) items as at December 31, 2020 were:

QCE	Year of Acquisition	Number of items	Amount ₦ '000
Industrial building	2016	1	84,000
Manufacturing industrial plants	2018	2	28,000
Motor vehicles	2019	2	14,000
Furniture and fittings	2019	10	2,700

(ix) Additions to QCEs during the year ended December 31, 2021 were:

QCE	Number of items	Amount ₦'000
Motor vehicles	1	4,500
Furniture and fittings	3	1,200

(x) Unrelieved capital allowances brought forward were ₦15,200,000.

(xi) Unabsorbed losses from previous years were:

Tax year	Amount ₦ '000
2017	8,290
2018	4,380
2019	9,800
2020	13,600

Required:

As the company's Tax Consultant, you are to draft a report to the Managing Director for the scheduled meeting expected to hold next week. This is expected to address the following:

a. Determination of the company's tax liabilities for the relevant tax year. **(20 Marks)**

b. Comment, in line with the provisions of Companies Income Tax Act Cap C21 LFN 2004 (as amended) on:
   i. The treatment of donations made by the company during the year under review (5 Marks)
   ii. Exemption of dividends from taxation (5 Marks)

(Total 30 Marks)

SECTION B: YOU ARE REQUIRED TO ATTEMPT ANY TWO OUT OF THE THREE QUESTIONS IN THIS SECTION (40 MARKS)

QUESTION 2

Professional accountants who are engaged in either tax practice or tax administration are confronted with many challenges due to changing operating environment, particularly disruptive technologies. While clients are demanding cutting edge services from professional accounting firms, it is worrisome to note that majority of tax administrators in Nigeria are still carrying out their work manually.

In a paper you recently delivered at a seminar organised by The Institute of Chartered Accountants of Nigeria (ICAN), you submitted that tax practitioners and administrators could make use of information technology to enhance their work and remain relevant in today's dynamic environment.

Among the participants at the seminar was a principal partner of an "old firm of chartered accountants", who confessed to you that his firm was finding it difficult to satisfy its clients efficiently and effectively due to a wide range of issues, new layers of complexity and regulatory pressure. He has therefore approached you to organise a two-day in-house training for his staff on "Technological tools, impact and challenges to tax practice and administration".

Required:

Having accepted the engagement, you are to prepare a paper to be presented at the training programme, which should focus on the following areas:

a. Identification and explanation of **FOUR** technology-driven tools that tax practitioners and administrators could use to enhance their work and reporting (8 Marks)

b. The impact of the identified technology-driven tools on tax practice and administration (8 Marks)

c. Challenges of technology-driven tools to tax practice and administration (4 Marks)

(Total 20 Marks)

QUESTION 3

Disposal of assets is an important concept in the determination of capital gains tax payable. Section 6 of Capital Gains Tax Act 2004 (as amended) specifically provides that a disposal of assets by a person occurs where any capital sum is derived from a sale, lease, transfer, an assignment, a compulsory acquisition or any other disposition of assets, notwithstanding that no asset is acquired by the person paying the capital sum. In the same vein, Section 2 (4) of Finance Act 2020 states the period for filing of self-assessment returns and when payment of the tax computed in respect of chargeable assets disposed is to be made.

Nice-One Nigeria Limited, a manufacturing concern, with head office in Calabar and branches in Ikeja, Kano and Abuja, has been in business for several years, reporting its accounts to December 31 of every year. The extracts from the books of accounts of the company during the year ended December 31, 2021, revealed the following transactions:

(i) **Disposal of an option**
On February 1, 2021, the company sold an option on a piece of land in Ikeja for the sum of ₦8,500,000 to Eco-Raheem Limited, which subsequently exercised the right by purchasing the land for ₦32,200,000.

(ii) **Acquisition of asset in exchange for debt**
On March 15, 2021, one of the company's debtors in Calabar, Mr. Baba Tee, reached an agreement with the company by exchanging his piece of land, which was valued at ₦15,000,000, for the debt of ₦13,500,000. The company, on May 7, 2021, disposed of the land for ₦18,000,000. Incidental expenses incurred towards the disposal of the land was ₦250,000.

(iii) **Disposal of a building**
The company has a staff estate, which comprises five buildings in its Abuja branch. In order to source for funds to construct a new staff estate in Kano, the company, on August 12, 2021, sold one of its buildings in the Abuja estate for ₦110,000,000. The cost of acquisition of the five buildings in the estate was ₦250,000,000. The cost of acquisition of the building sold was

₦75,000,000, while the remaining buildings unsold were professionally valued at ₦240,000,000. The company also incurred for the purpose of the disposal of the building, ₦400,000 on building repairs and professional valuers' fee of ₦1,100,000.

(iv) **Disposal of industrial plants**

One of the company's industrial plants in Kano branch, which cost ₦4,500,000, was disposed of on September 15, 2021, for ₦6,000,000. A new plant was bought for the purpose of the company's operations the following month for ₦8,000,000. During the installation of the new plant, it was found out that the plant could not efficiently satisfy the requirements of the company and it was subsequently sold on December 2, 2021 as "second-hand" for ₦7,300,000. The company incurred the sum of ₦25,000 as disposal expenses.

The Managing Director of the company is of the opinion that issues around the transactions undertaken by the company in the financial year are "technical", which only competent professional accountants, with experience in tax matters, can conveniently handle. Accordingly, your firm of accountants was contacted to help provide tax advice on each of the above transactions.

Required:

You have been directed by your firm's Head (Tax Matters) to take charge of the assignment and submit a report to him by the close of work in three days.

Your report should specifically cover:

a. The principles of disposal as provided for in Section 6 of Capital Gains Tax Act 2004 (as amended) (3 Marks)

b. Computation of capital gains tax payable and when the tax due is to be paid to the relevant tax authority for the following stated transactions:

   i. Disposal of an option in Ikeja branch (2 Marks)

   ii. Acquisition of asset in exchange for debt in Calabar head office (3 Marks)

   iii. Disposal of a building in Abuja branch (4 Marks)

   iv Disposal of industrial plants in Kano branch (8 Marks)

(Total 20 Marks)

QUESTION 4

As investors and policy makers adapt to the global energy transition in a bid to offer an effective hedge against swings in oil prices, the Federal Government has recognised that it is beneficial for the country to diversify its economy. The attention of the country is now towards the development of the solid minerals sector. The Nigeria Minerals and Mining Act 2007 (as amended) was enacted to regulate the industry. Incentives for operators in the sector are as provided for in section 5 of the Act.

One of the earliest investors in the mining sector, Dutse Mines (Nigeria) Limited, was granted a mining title by the Mining Cadastre Office (MCO) for exploitation of limestone in Nkalagu in the south-eastern zone of Nigeria in 2008. In spite of so many challenges the company is facing, it has managed to remain afloat in business.

The company has, of recent, been having tax disputes with the relevant tax authority, and your firm of chartered accountants has been engaged to help resolve them. In the 2022 tax returns filed by the company, the major area of dispute between the company and the tax authority was disparity in the treatment of certified exploration and processing expenditure of ₦60,000,000 incurred during the course of the year.

Your firm is provided with the following extracts (and supporting documents) from the books of the company for the year ended December 31, 2021:

	₦'000	**₦'000**
Turnover:		
- Export		1,125,000
- Local		705,000
Sundry income		28,500
		1,858,500
Expenses:		
Excavating expenses	260,000	
Salaries and wages	307,200	
Directors' remuneration	22,300	
Electricity and telephone	8,630	
Transport and traveling	13,300	
Allowance for doubtful debts	26,000	
Auditors and professional fees	10,000	
Donations	9,500	
Repairs and maintenance	24,900	
Depreciation	70,000	
General/miscellaneous expenses	15,200	
Legal expenses	12,000	
Bank charges	7,200	

Insurance premium	75,000	
Exploration and processing expenditure	60,000	
Income tax provision	180,000	
Education tax provision	5,000	1,106,230
Net profit		**752,270**

The following additional information was provided:

(i) The figure for sundry income included an amount of ₦8,500,000 realised as profit from disposal of the old excavating machine.

(ii) Allowance for doubtful debts were made up of:

	₦
Bad debts written off	2,500,000
General allowance for doubtful debts	10,500,000
Specific allowance for doubtful debts	8,000,000
Loan to customer written off	5,000,000

(iii) Included in donation was ₦5,000,000 given to victims of environmental degradation, as part of the company's social responsibility to the host community.

(iv) Legal fees included an amount of ₦750,000, which was paid as penalty for late filing of tax returns.

(v) The tax written down values of qualifying capital expenditure at the end of 2021 tax year revealed that:

	₦
Motor vehicles (2 years remaining)	25,000,000
Furniture and fittings (utilised for 2 years)	22,500,000
Mining expenditure (6 years remaining)	40,000,000

Required:

As the Manager (Tax Matters) assigned to handle this matter, you are to forward the report to your Senior Partner (Tax Matters) showing:

a. Computation of tax liabilities of the company for the relevant assessment year (14 Marks)

b. Comments on tax incentives available to a company in the mining of solid minerals in Nigeria (6 Marks)

(Total 20 Marks)

SECTION C: YOU ARE REQUIRED TO ATTEMPT ANY TWO OUT OF THE THREE QUESTIONS IN THIS SECTION (30 MARKS)

QUESTION 5

Mr. Barau Olubami completed his first degree in a reputable university in Nigeria seven years ago. After the compulsory youth service, he wrote and passed the professional examination and was subsequently admitted as an associate member of the Institute of Chartered Accountants of Nigeria. He had four-year training in a professional audit firm before he decided to establish his accounting firm. The firm consists of him as the principal partner, two accounting graduates (as Assistant Auditors/Consultants), a secretary and an office assistant.

Within six months of his professional practice, he was able to get three clients to which he provides services, that include preparation of tax records, computation of end of year tax liabilities, filing of tax returns, advisory to clients on tax matters, compliance with tax legislations and management of tax audit and investigation.

In one of social events he attended with his father, he was introduced to Mr. Chidi Odamo, his father's school mate in his polytechnic days. Mr. Odamo is the Chief Executive of Odamo Nigeria Limited, a company that manufactures paints. In a private chat they both had, Mr. Odamo complained bitterly that his current tax consultant has not been helping him to pay less amount of tax liability to the relevant tax authorities, unlike what his friends in the same industry are enjoying through the assistance of their tax consultants. Mr. Olubami informed Mr. Odamo that he knew his current tax consultant very well as he was his senior in the university. He also submitted that his (Olubami's) firm is the tax consultant to another company in the same industry with Odamo Nigeria Limited. He then promised Mr. Odamo that if he is given the tax consultancy/audit work, he knows how to resolve the issue with the tax officials and the company will be the better for it.

The engagement with the current tax consultant was terminated two weeks after Mr. Odamo and Mr. Olubami had "fruitful" discussion and the latter's firm was appointed as the company's new tax consultant after both parties agreed to a clause in the engagement contract that aside the professional fees, the firm is entitled to 20% of tax saved.

During the review of previous tax returns filed with and tax paid to the tax authority, he observed a significant material error of the sum of ₦3 million made by the tax authority in favour of his client (Odamo Nigeria Limited). Since, this could not be regarded as tax saved by his firm, he decided not to inform the company as this is considered as "by-gone".

During the course of the year's tax audit, documents and information received from the company's accountant were not independently validated. These documents were sent to the two Assistant Auditors to work with. Specifically, sales were grossly understated; the cost of new vehicle and furniture and fittings were understated while some expenses incurred were overstated.

At the completion of the work done by the two Assistant Auditors/Consultants, Mr. Olubami held a meeting with the company's Managing Director and presented a draft report, which showed that the company's total tax liability for the year was ₦12 million. He promised him that with the assistance of his "contact" at the Revenue Service, the tax liability would be reduced to ₦7 million. The company's Managing Director advised him to go ahead and file appropriate returns as the matter was fully settled. Self-assessment returns were filed and perhaps with the connivance of unscrupulous tax officials, the company paid ₦7 million tax liability. However, if a thorough job was done, the company's tax payable for the year would have been ₦18.25 million.

Required:

a. Examine **TEN** ethical issues that arose from the tax engagement.

(10 Marks)

b. What are the punitive measures put in place to ensure that accountants in practice adhere to legal and ethical issues when preparing tax returns?

(5 Marks)

(Total 15 Marks)

QUESTION 6

Maigona Agro Limited is a Nigerian company operating in the agricultural sector. It has a large expanse of land in the Northern part of the country, which is used strictly for the cultivation of cotton seeds. As a result of the collapse of the textile/garment industry, specifically due to unfavourable business climate in Nigeria, the company in 2015 established a branch, BAM Textile Mills, in the United Kingdom. Part of the cottons produced locally are sold to BAM Textile Mills at a competitive price, for the production of finished product (branded textile clothing).

A tax dispute recently arose between the Management of Maigona Agro Limited and officials of the Federal Inland Revenue Service (FIRS) on the correct assessment of profits made by BAM Textile Mills. The Managing Director is of the opinion that the tax paid by BAM Textile Mills in the United Kingdom should be the final tax since the company is only an overseas branch. He further averred that the provisions of the Companies and Allied Matters Act 2020 (as amended) are only applicable to companies incorporated in Nigeria. The Managing Director was furious when the

company received a reminder of notice of assessment from the FIRS and has therefore threatened to approach the Tax Appeal Tribunal for redress.

You have been engaged by the company as its Tax Consultant to provide professional advice on the tax implication of the profit made by BAM Textile Mills, UK and possibly representation at the Tax Appeal Tribunal sittings. The statement of profit or loss for the year ended October 31, 2021 (BAM Textile Mills result has been converted to Nigerian Naira at the prevailing exchange rate) and other relevant documents were handed over to you by the Managing Director.

The extracts from the statements of profit or loss of the two corporate entities revealed the following:

	MAIGONA Agro Ltd	BAM Textile Mills	Total
	₦'000	₦'000	₦'000
Gross turnover	975,100	1,820,500	2,795,600
Less:			
Cost of materials/inputs	350,200	672,000	1,022,200
Salaries and Wages	122,530	400,400	522,930
Administrative expenses	45,700	110,900	156,600
Depreciation	75,600	147,300	222,900
Donation	8,500	0	8,500
Share of head office expenses	33,300	50,000	83,300
Income tax paid in the UK	0	72,200	72,200
	635,830	1,452,800	2,088,630
Net profit	**339,270**	**367,700**	**706,970**

Additional information:

(i) The capital allowances of Maigona Agro Limited in respect of plant and equipment, farming tools and other qualifying capital expenditure as agreed with the tax authorities was ₦45,000,000. The amount of capital allowances of ₦57,000,000 claimable by BAM Textile Mills on qualifying assets was also certified by the tax authorities.

(ii) Included in donation was ₦5,000,000 given to victims of COVID-19 (Omicron variant) pandemic in Nigeria.

(iii) The UK tax rate is assumed to be 35%.

Required:

a. Advise the management of Maigona Agro Limited on the tax implications of the overseas branch. (4 Marks)

b. Compute the tax liabilities of the company in line with your submission in (a) above. (11 Marks)

(Total 15 Marks)

QUESTION 7

In the last three years, some major oil producing companies had decided to divest their investments from the Nigerian oil and gas sector. One of the reasons for this might be the new global energy order, which seems to favour the evolution of "green environment" as against the present use of hydrocarbons with its inherent environmental degradation and pollution.

Similarly, in response to the yearnings of various stakeholders in the oil and gas sector, the Federal Government had enacted the Petroleum Industry Act (PIA) 2021. Generally, the Act provides the legal, governance, regulatory and fiscal framework for the Nigerian petroleum industry, the development of host communities and for related matters.

Notable commentators and professionals in the sector did suggest that the divestment of major oil and gas operators in Nigeria could be beneficial to the local investors if funds are sourced and deployed to businesses in the sector. Mergers and Acquisition of indigenously-owned oil producing companies had been noted as one of valuable options in this regard.

Required:

a. In respect of Petroleum Industry Act 2021, **identify** the expenses allowable in the computation of adjusted profit of a company in upstream petroleum operations? (6 Marks)

b. Identify and explain **SIX** implications of mergers and acquisitions in respect of a situation where a new company takes over an existing company. (9 Marks)

(Total 15 Marks)

NIGERIAN TAX RATES

1. CAPITAL ALLOWANCES/

	Initial %	Annual %
Building Expenditure	15	10
Industrial Building Expenditure	15	10
Mining Expenditure	95	Nil
Plant Expenditure (excluding Furniture & Fittings)	50	25
Manufacturing Industrial Plant Expenditure	50	25
Construction Plant expenditure (excluding Furniture and Fittings)	50	Nil
Public Transportation Motor Vehicle	95	Nil
Ranching and Plantation Expenditure	30	50
Plantation Equipment Expenditure	95	Nil
Research and Development Expenditure	95	Nil
Housing Estate Expenditure	50	25
Motor Vehicle Expenditure	50	25
Agricultural Plant Expenditure	95	Nil
Furniture and Fittings Expenditure	25	20

2. INVESTMENT ALLOWANCE 10%

3. RATES OF PERSONAL INCOME TAX

Graduated tax rates and consolidated relief allowance of ₦200,000 or 1% of Gross Income, whichever is higher + 20% of Gross Income.

	Taxable Income (₦)	Rate of Tax (%)
First	300,000	7
Next	300,000	11
Next	500,000	15
Next	500,000	19
Next	1,600,000	21
Over	3,200,000	24

After the relief allowance and exemption had been granted, the balance of income shall be taxed as specified in the tax table above.

4. COMPANIES INCOME TAX RATE 30%; 20% and 0%

5. TERTIARY EDUCATION TAX 2½% of Assessable Profit (with effect from 2022 assessment year)

6. CAPITAL GAINS TAX 10%

7. VALUE ADDED TAX 7.5%

SOLUTION 1

OK & Co (Chartered Accountants)
Igbogbo Road, Lagos

Date: ......

The Managing Director
Dadinkowa Nigeria Limited
Lagos.

Dear Sir,

RE: COMPUTATION OF TAX LIABILITIES AND OTHER MATTERS THEREOF

I refer to our discussion of April 12, 2022 on your request for computation of the company's tax liabilities for 2022 assessment year and advice on treatment of donations made during the year and dividends exempted from tax. I hereby present a report for your review before same is processed for filing with the tax authorities.

(a) Determination of tax liabilities

Financial records of the company for the year ended December 31, 2021 revealed an operating loss of ₦6,530,000. For tax purposes and in line with the provisions of Companies Income Tax Act 2004 (as amended), the profit or loss made by a corporate entity has to be adjusted. When this was done, the company made an adjusted profit of ₦54,145,000.

The company was able to relieve all the unabsorbed losses for the 2017, 2018, 2019 and 2020 tax years, which amounted to ₦36,070,000. However, only ₦18,075,000 out of ₦71,568,980 capital allowances available for relief was utilised, while the unutilised portion of ₦53,493,980 is deferred to next year for possible utilisation from profit.

Following from above, the company has zero total profit for the period under review. Section 13 of Finance Act 2020 stipulates that any company that falls into this category (zero or insufficient profit) has to pay a minimum tax. Thus, the company is liable to pay a minimum tax of ₦1,946,650. There is also tertiary education tax that is compulsory for companies operating in Nigeria to pay. The new rate is 2.5% of adjusted profit, which is ₦1,489,000. The total tax liabilities for the 2022 tax year is ₦3,435,650.

We suggest that every effort be put in place for filing of annual tax returns with the Federal Inland Revenue Service within the statutory time limit provided under the Act.

(bi) The treatment of donations made by the company during the year under review

The CITA 2004 (as amended) recognises the importance of donations made by corporate entity. However, for such donations to be allowed as expenses in the determination of total profit and subsequently tax liabilities payable in any year of assessment, it has to fulfill some conditions. These conditions are:

- It must be made to any of the funds, bodies, institutions in Nigeria contained in the Fifth Schedule to CITA;
- It must be made out of profit;
- It must not be of capital nature, except donations to a university or other tertiary or research institutions;
- It must not exceed 10% of the company's total profits for an assessment year before any deduction for donation. In the case of donations to tertiary or research institution, up to 15% of total profit or 25% of tax payable in the year, whichever is higher;
- Donations made by companies in cash or kind to any fund set up by the Federal Government or to any similar fund or purpose in consultation with any Ministry, department or agency of the Federal Government, in respect of any pandemic, natural disaster or other exigency shall be allowed as deduction provided that requisite documentation documenting the donations and the cost thereof are provided to the relevant tax authority; and
- The amounts allowable for deduction in respect of the above, in any year of assessment shall be limited to 10% of assessable profits after deduction of allowable donations made by the company.

Based on the foregoing, it is evident that the ₦12 million donations made by the company to a fund established by the Federal Government for victims of crisis was to a recognised fund. However, the amount of the donation was in excess of 10% of the company's total profits for an assessment year before any deduction for donations. It is on the basis of the above that the tax authority will not regard the whole of ₦12 million donations made by the company as an allowable expense in the determination of tax liabilities for 2022 tax year.

The Revenue Service will only allow the amount of donations, which is restricted to 10% of assessable profits after such deduction. This is equal to ₦5,415,000.

(bii) Dividends exempted from taxation.

The CITA 2004 (as amended) clearly provides for treatment of dividend income. There is no inconsistency in its treatment. The following are dividends exempted from taxation:

- Dividends received by way of a bonus issue of shares;

- Dividends received from a pioneer company;
- Dividends received from a company subjected to tax under the PIA 2021;
- Dividends received from a foreign investment, provided such dividend is received through a domiciliary account;
- Dividends received net of withholding tax by a Nigerian company from another Nigerian company;
- Dividends received from small companies in the manufacturing sector in the first five years;
- Dividends received from investment in wholly export-oriented business;
- Dividends received from a unit trust scheme;
- Dividends received by a company from another one, provided that the equity participation on which the dividend is paid:

  - either wholly paid for in foreign currency or by assets brought to Nigeria; and
  - not less than 10% of the equity share capital of the company paying the dividend.

We hope that this report adequately represents the mandate assigned to us. Should you need further clarification on this, we will be glad to address it.

Kem Adek
Principal Consultant

Appendix 1: Computation of tax liabilities

	₦'000	**₦'000**
Loss as per accounts		(6,530)
Add back: Disallowable expenses		
Improvement to industrial building	700	
Construction of company's gate	900	
General allowance for doubtful debts	17,400	
Fine for driving offences	470	
Donations	12,000	
Stamp duties for increase in share capital	1,500	
Depreciation	35,600	
Loss on disposal of foreign equity shares	1,750	70,320
		63,790
Less: Tax exempt income		
Dividend received (net)	3,460	
Excess on revaluation of investment	770	4,230
		59,560
Less: Allowable donations (10/110 x ₦59,560)		5,415
Adjusted profit/assessable profit		54,145

Less: Unabsorbed loss b/f:		
2017	8,290	
2018	4,380	
2019	9,800	
2020	13,600	36,070
		18,075
Less: Capital allowances		
Unrelieved b/f	15,200	
For the year (appendix II)	56,368.98	
Total available for relief	71,568.98	
Relieved	(18,075)	(18,075)
Unrelieved c/f	53,493.98	
Total profit		Nil
Companies income tax (w. 6)		1,946.65
Tertiary education tax @ 2.5% of ₦59,560)		1,489
Total tax liabilities payable		**3,435.65**

Appendix II: Capital allowances computation

	Industrial building	Manufacturing industrial plant	Motor vehicles	Furniture & fittings	Non-industrial building	Capital allowances
	IA 15%	IA 50%	IA 50%	IA 25%	IA 15%	
	AA 10%	AA 25%	AA 25%	AA 20%	AA 10%	
	₦	₦	₦	₦		₦
2022 Tax Year						
TWDV	84,000,000	28,000,000	14,000,000	2,700,000		
Additions	700,000	-	4,500,000	1,200,000	900,000	
IA	(105,000)	-	(2,250,000)	(300,000)	(135,000)	2,790,000
AA	(16,860,000)	(27,999,980)	(7,562,500)	(1,080,000)	(76,500)	53,578,980
	W1	W2	W3	W4	W5	
						56,368,980
TWDV c/f	67,735,000	20	8,687,500	2,520,000	688,500	

Working notes

(1) AA for 2022 tax year- Industrial building

Old: ₦84,000,000 = ₦16,800,000
10 – 5 years

New: ₦700,000 – ₦105,000 = 60,000
10 years **16,860,000**

(2) AA for 2022 tax year- Manufacturing Industrial plant

= ₦28,000,000 = ₦28,000,000 less ₦10 x2
4 – 3 years
= **₦27,999,980**

(3) AA for 2022 tax year- Motor vehicle

Old: ₦14,000,000 = ₦7,000,000
4 – 2 years
New: ₦4,500,000 – ₦2,250,000 = 562,500
4 years **7,562,500**

(4) AA for 2022 tax year- Furniture & fittings

Old: ₦2,700,000 = ₦900,000
5 – 2 years

New: ₦1,200,000 – ₦300,000 = 180,000
5 years **1,080,000**

(5) AA for 2022 tax year- Non-industrial building

= ₦900,000 – ₦135,000 = **₦76,500**
10 years

(6) **Minimum tax computation**

Section 13 of Finance Act 2020 provides that minimum tax = 0.5% of gross turnover of the company less franked investment income. It also states that the applicable minimum tax is reduced to 0.25% for tax returns provided and filed for any year of assessment falling due on any date between 1 January 2020 and 31 December 2021.

0.5% of gross turnover of the company less franked investment income
Minimum tax = 0.5% of (₦382,500,000 + ₦6,830,000)
= = 0.5% of (₦389,330,000) = **₦1,946,650**

Examiner's Report

The question tests the candidates' understanding of the provisions of Companies Income Tax Act 2004 (as amended) regarding treatment of donations made, exemption of dividends from taxation and computations of companies income tax. Being a compulsory question, all the candidates attempted the question. Candidates demonstrated a fair understanding of the question and performance was average.

The commonest pitfall was the inability of some candidates to state correctly the provisions of Companies Income Tax Act 2004 (as amended) in respect of exemption of dividends from taxation.

Candidates are advised to familiarise themselves with issues concerning treatment of donations and exemption of dividends from taxation by reading extensively the Institute's Study Text, other relevant textbooks, and the Companies Income Tax Act 2004 (as amended).

Marking Guide

		Marks
(a)	**Determination of the company's tax liabilities**	
	Discussion (Memo)	½
	Appendix I:	
	Loss as per accounts	½
	Improvement to industrial building	½
	Construction of company's gate	½
	General allowance for doubtful debts	½
	Fine for driving offences	½
	Donations	½
	Stamp duties for increase in share capital	½
	Depreciation	½
	Loss on disposal of foreign equity shares	½
	Dividend received (net)	½
	Excess on revaluation of investment	½
	Donations	½
	Adjusted profit	½
	Unabsorbed loss b/f (₦36,070)	½
	Capital allowances: Unrelieved b/f	½
	For the year	½
	Relieved	½
	Unrelieved c/f	½
	Total profit	½
	Companies income tax	½

		Marks	
	Tertiary education tax	½	
	Total tax liabilities payable	½	
	Appendix II: Capital allowances computation (2022 tax year)		
	Additions (Industrial building)	½	
	Additions (Non-Industrial building)	½	
	IA (Industrial building)	½	
	IA (Non-Industrial building)	½	
	Additions (Motor vehicles)	½	
	Additions (Furniture and fittings)	½	
	IA (Motor vehicles)	½	
	IA (Furniture and fittings)	½	
	IA (Capital allowance)	½	
	AA (Industrial building)	½	
	AA (Manufacturing industrial plant)	½	
	AA (Motor vehicles)	½	
	AA (Furniture and fittings)	½	
	AA (Non-industrial building)	½	
	AA (Capital allowance)	½	
	Total (Capital allowance)	½	
	Minimum tax computation	½	**20**
(bi)	**Treatment of donations**		
	1 mark for each condition for donation to be allowed for tax purposes, subject to a maximum of 3 points	3	
	1 mark for each reason why the whole donation made by the Company was not allowed for tax purposes, subject to a maximum of 2 points	2	5
(bii)	**Exemption of dividends from donations**		
	1 mark for each exemption of dividends for tax purposes, subject to a maximum of 5 points		5
	Total		**30**

SOLUTION 2

"Technological tools, impact and challenges to tax practice and administration". Being a paper delivered at an in-house training for staff of ABC & Co (Chartered Accountants)

In the last few years, professional accounting firms and tax administrators have been facing more pressure than ever to deliver value to clients and taxpayers, respectively. Deployment of relevant technological tools has been seen to be a viable option in curtailing the challenges being faced by these tax practitioners and administrators. Some of the acclaimed technological tools that can assist both tax practitioners and administrators are discussed in turn:

(a) **Technology-driven tools**

(i) **Cloud computing technology:** There are cloud-based independent automated solutions for tax management. When a tax practice or administration subscribes to a cloud-based tax management solution, it is relieved of the need to invest in physical onsite servers with the attendant costs of maintenance and support. Cloud-based tax management solutions also enable tax practitioners and administrators to work remotely from practically any device with internet connection and serve their clients from any location at any time. This tool further helps tax practitioners to facilitate collaboration among themselves, clients and taxpayers.

(ii) **Artificial intelligence and robotics:** In the conventional tax practice, practitioners put a lot of efforts into collating and analysing financial data in order to serve their clients and taxpayers. Artificial intelligence and robotics make it easier for tax practitioners to simplify and accelerate various data- related tasks. Robotic Process Automation (RPA) software has been demonstrated to be effective in handling routine monotonous aspects of the tax man's job. Artificial intelligence and robotics help reduce costs and errors by streamlining operations.

(iii) **Blockchain technology:** This tool became popular globally through the advancements in digital currency transactions such as Bitcoin. Many businesses now leverage on the technology to record their financial and non-financial transactions in an open, secured and decentralised ledger. Where the tax consultants or the tax administrators are part of the transaction flow and given access to the data chain, it makes it possible for all parties to see each transaction and determine the tax implication. The tool can also be used to facilitate tax payments to the government at highly reduced processing cost.

(iv) **Data analytics technology:** This tool makes use of data and it allows real-time status monitoring of financial matters including their tax implications to be easily achieved. In the financial realm, data produces valuable insights, drives results and creates a better

experience for clients. The tool helps tax administrators to improve internal operations and build revenue for the government. Through data analytics software, tax practising firms could offer more valuable advisory services to their clients.

(v) **Social media technology:** The social media platforms: These platforms (such as Twitter, Facebook, Linkedin, Instagram) have become useful tools in the hands of tax practitioners and administrators. They are used primarily for dissemination of tax information due to their wide reach and makes collaboration among tax professionals, clients and administrators seamless.

(vi) **Mobile app technology:** Tax practitioners can make use of their mobile devices to access the financial data of their clients anytime and anywhere, especially where the client has adopted cloud accounting technology. Also, tax administrators and practitioners could develop and deploy mobile apps which taxpayers and clients could download and install for tax updates and news.

(b) **The identified technology-driven tools impact tax practice and administration in the following ways:**

(i) **Cloud computing technology**

- Tax management software hosted in the cloud;
- Storage and retrieval of tax transaction data in the cloud;
- Access and anayse tax data anytime, anywhere and on any device;
- Present results in robust databoards; and
- Collaboration and exchange of information between tax authorities and/or taxpayers.

(ii) **Artificial intelligence and robotics**

- Zero data entry;
- Responding to queries;
- The machine can be made to learn from tax auditor's conclusion and uses it on future scenarios; and
- Identify patterns in both structured and unstructured transactions data- which ones are "normal and abnormal".

(iii) **Blockchain technology**

- Decentralisation and distribution of shared database;
- All parties to a business transaction are involved in recording and validation from inception;
- No reconciliation needed; and
- No tax audit required.

(iv) **Data analytics technology**
- Analysis of volumes of data and helps in gaining better business insight;
- Identification and prediction of tax risk factors and anomalies; and
- Improved business and tax advisory services due to deeper insight.

(v) **Social media technology**
- Gain visibility and exposure;
- Be recognised as experts;
- Build their online networks; and
- Keep the clients informed and provide better and prompt customer service.

(vi) **Mobile app technology**
- Mobile accounting provides tax practitioners many benefits such as on-demand data and information, even if they are on the go; and
- Starting a laptop or computer every time one wants to work is a mere waste of time as against getting all the information with just a single tap with mobile app.

(c) **Challenges of technology-driven tools to tax practice and administration are:**

(i) Low computer literacy level;
(ii) Poor internet facility;
(iii) Possible cyber threat (attack);
(iv) High set up and implementation costs;
(v) Lack of technical know-how;
(vi) Challenge of data validation- garbage-in-garbage-out;
(vii) Resistance from the management and other users; and
(viii) Security risk.

Examiner's report

The question tests the candidates' knowledge of technological-driven tools being used by tax practitioners and administrators in Nigeria.

Over 60% of the candidates attempted the question and they exhibited a clear understanding of its requirements. The performance was above average.

The commonest pitfall was the inability of some candidates to identify correctly and explain the technological-driven tools.

Candidates are advised to pay attention to taxation of digital economy by reading the Institute's Study Text and other relevant textbooks.

Marking Guide

		Marks	Marks
(a)	**Identification and explanation of technological-driven tools**		
	1 mark for each technological tool identified, subject to a maximum of 4 tools	4	
	1 mark for each discussion of technological tools, subject to a maximum of 4 tools	4	8
(b)	**The impact of technological-driven tools on tax practice and administration**		
	2 marks for discussion of the impact of each of the identified technological-driven tools on tax practice and administration, subject to a maximum of 4 tools		8
(c)	**Challenges of technological-driven tools to tax practice and administration**		
	1 mark for each of the challenges of technology-driven tools to tax practice and administration, subject to a maximum of 4 points		4
	Total		**20**

SOLUTION 3

BB Philip & Co (Chartered Accountants)
Maiduguri Road, Calabar

INTERNAL MEMO

Date: ......

From: Assistant Tax Manager
To: Head (Tax Matters)

Subject: Re: Tax Issues on Disposal of Assets by Nice-One Nigeria Limited

I refer to our client's request on provision of Capital Gains Tax Act 2004 (as amended) on principles underlying disposal of chargeable assets and determination of capital gains tax payable on various disposals during the year ended December 31, 2021. I hereby present a report for your review before same is presented to the client.

(a) The principles of disposal as provided for in Section 6 of Capital Gains Tax Act 2004 (as amended) are:

i. Where any capital sum is derived by way of compensation for any loss of office or employment;
ii. Where any capital sum is received under a policy of insurance and the risk of any kind of damage or injury to, or the loss or depreciation of, assets;

iii. Where any capital sum is received in return for forfeiture or surrender of rights, or for the refraining from exercising rights; and
iv. Where any capital sum is received as consideration for use of exploitation of any asset.

(b) **Computation of capital gains tax payable and when the tax due is to be paid to the relevant tax authority for each of the following transactions:**

(i) **Disposal of an option**: The capital gain is the actual amount received from disposal of an option. This is ₦8,500,000 and capital gains tax payable is at the rate of 10%, which is ₦850,000 (see attached appendix I).

(ii) **Acquisition of asset in exchange for debt and subsequent disposal of the asset**: The amount of debt will be regarded as cost of acquisition. The capital gains derived is ₦4,250,000 and capital gains tax payable is ₦425,000 (see attached appendix II).

(iii) **Disposal of a building in an estate**: This is a case of full disposal as the cost of acquisition of the building is known. It is not a partial disposal. From appendix III, the capital gains is ₦33,500,000 and capital gains tax payable is ₦3,350,000 (see appendix III).

(iv) **Disposal of old industrial plant, re-investment in new one and subsequent disposal**: For re-investment in new plant within 12 months of disposal, the client is entitled to roll-over relief. Based on computation as shown in appendix IV, the company enjoyed full roll-over relief and no capital gains arose from the disposal of the old plant. Since the new plant purchased was resold, capital gains of ₦775,000 was realised and ₦77,500 is to be paid as capital gains tax.

Thank you

Julie Tosin

Appendix I

	₦
Sales proceeds	8,500,000
Capital gains	8,500,000
Capital gains tax @ 10%	**850,000**

Payment to be made by June 30, 2021 (see Section 2 of Finance Act 2020)

Appendix

	₦	₦
Sales proceeds	18,000,000	
Less: Value of debt (cost of acquisition)	13,500,000	
Incidental expenses	250,000	13,750,000
Capital gains	4,250,000	
Capital gains tax @ 10%		**425,000**

Payment to be made by June 30, 2021 (see Section 2 of Finance Act 2020)

Appendix III

	₦	₦
Sales proceeds		110,000,000
Less: Cost of acquisition	75,000,000	
Repairs	400,000	
Professional valuers fee	1,100,000	76,500,000
Capital gains		33,500,000
Capital gains tax @ 10%		**3,350,000**

Payment to be made by December 31, 2021 (see Section 2 of Finance Act 2020)

Appendix IV

(Old plant)

	₦
Sales proceeds	6,000,000
Less: Cost of acquisition	4,500,000
Capital gains	1,500,000

Determination of roll-over relief
Lower of:

Amount re-invested in new plant	8,000,000
Or	

Sales proceeds on disposal of old plant		6,000,000
Less: Cost of acquisition of old plant		4,500,000
Roll-over relief		1,500,000
Capital gains (as above)		1,500,000
Less: Roll-over relief		1,500,000
Net capital gains		Nil
Capital gains tax @ 10%		**Nil**

(Disposal of new plant)

	₦	₦
Sales proceeds		7,300,000
Less: Cost of acquisition	8,000,000	
Roll-over relief	1,500,000	
	6,500,000	
Incidental expenses	25,000	6,525,000
Capital gains		775,000
Capital gains tax @ 10%		**77,500**

Payment to be made by December 31, 2021 (see Section 2 of Finance Act 2020)

Examiner's report

The question tests candidates' understanding of the principles of asset disposal and capital gains tax computations.

About 80% of the candidates attempted the question and they showed a fair understanding of it, making the performance average.

The commonest pitfall was the candidates' inability to correctly compute capital gains tax liabilities arising from disposal of an option and acquisition of assets in exchange for debts.

Candidates are advised to prepare adequately for future examinations by reading the Institute's Study Text, other relevant textbooks and tax laws.

Marking guide

		Marks	Marks
(a)	**The principles of disposal as provided for in capital gains tax**		
	1 mark for each principle of disposal, subject to a maximum of 3 points		3

(bi) **Computation of capital gains tax payable in respect of disposal of an option in Ikeja branch**

	Marks	Marks
Heading	½	
Capital gains	½	
Capital gains tax	½	
Payment date	½	2

(bii) **Computation of capital gains tax payable in respect of acquisition of asset in exchange for debt in Calabar head office**

	Marks	**Marks**
Sales proceeds	½	
Value of the debt	½	
Incidental expenses	½	
Capital gains	½	
Capital gains tax	½	
Payment date	½	3

(biii) **Computation of capital gains tax payable in respect of disposal of a building in Abuja branch**

	Marks	Marks
A case of full disposal	½	
Sales proceeds	½	
Cost of acquisition	½	
Repairs	½	
Professional valuers fee	½	
Capital gains	½	
Capital gains tax	½	
Payment date	½	4

(biv) **Computation of capital gains tax payable in respect of disposal of industrial plants in Kano branch**

	Marks	Marks
(old plant)		
Sales proceeds	½	
Cost of acquisition	½	
Capital gains	½	
Amount re-invested in new plant	½	
Sales proceeds on disposal of old plant	½	
Cost of acquisition of old plant	½	
Roll-over relief	½	
Net capital gains	½	
Capital gains tax	½	
(New plant)		
Sales proceeds	½	
Cost of acquisition	½	

Roll-over relief	½	
Incidental expenses	½	
Capital gains	½	
Capital gains tax	½	
Payment date	½	8
Total		**20**

SOLUTION 4

Colamrud & Co (Chartered Accountants)
Lagos Road, Enugu

INTERNAL MEMO

Date: ......

From: Manager (Tax Matters)
To: Senior Partner (Tax Matters)

Subject: Dutse Mines (Nigeria) Limited

I refer to our client's request on determination of tax liability for 2022 assessment year and advice on tax incentives for companies operating in the mining sector in Nigeria. I hereby present a report for your review before same is presented to the client.

(a) **Determination of tax liabilities**

The Nigeria Minerals and Mining Act 2007 (as amended) treats exploration and processing expenditure costs as part of mining expenditure, which capital allowances have to be claimed. Hence, the treatment of the ₦60 million spent for exploration and processing as an item which was expensed during the accounting year is not in line with the provisions of the Act.

Based on the detailed result as presented in attached appendices I and II, the client made an adjusted profit of ₦1,075,020,000; entitled to claim capital allowances of ₦77,000,000 resulting in total profit of ₦998,020,000. Companies income tax payable is ₦299,406,000 and tertiary education tax of ₦26,875,500. This gives a total tax liability of ₦326,281,500.

(b) **Tax incentives available to a company in the mining of solid minerals sector in Nigeria are:**

(i) Tax holiday for an initial period of 3 years from commencement of operations and renewable for additional 2 years. Any dividends paid during the tax holiday period will not suffer withholding tax;

(ii) Exporters of mineral products may be permitted to retain part of their foreign exchange earning in a domiciliary account for the purpose of acquiring spare parts and other mining inputs;

(iii) Exemption from customs and import duties in respect of plant, machinery equipment and accessories imported exclusively for mining operations. However, the plant and equipment can only be disposed of locally upon payment of the applicable customs and import duties;

(iv) For transferability of foreign currency through the CBN for the payment for servicing of certified loan and remittance of foreign capital in the event of sale or liquidation of the business;

(v) Grant of personal remittance quota for expatriate personnel, free from any tax imposed by any enactment for the transfer of external currency out of Nigeria;

(vi) Accelerated capital allowance on mining expenditure (95% initial allowance and retention of 5% until asset is disposed of)

(vii) Grant of investment allowance of 10% on qualifying plant and machinery;

(viii) All infrastructure costs provided by the mining company and approved by the Mining Cadastre Office (MCO) to be capitalised and capital allowance claimed at 95% in the first year of operations;

(ix) An additional rural investment allowance on infrastructure cost, depending on the location of the company and the type of infrastructure provided;

(x) New entrants to the mining sector may apply to the Minister of Mines to enjoy annual indexation of unutilised capital allowance carried forward by 5%, which lapsed in 2012. Such application, however, will be treated on a case by case basis;

(xi) The Minister may grant a concession for the royalty payable on any mineral to be deferred by a number of years, subject to the approval of Federal Executive Council (FEC); and

(xii) Actual amount incurred out of reserves made for environmental protection, mine rehabilitation, reclamation and mine closure cost shall be tax deductible, subject to certification by an independent expert.

The CITA also provides that:

(xiii) The profits earned by a mining company after the initial tax holiday period may continue to be exempted from income tax under the following circumstances:

- If the minerals are exported from Nigeria and the proceedss from such exports are repatriated to Nigeria and used exclusively for the purchase of raw materials, plants, equipment and spares;
- If the minerals produced are exclusive inputs for the manufacture of products for exports, provided the exporter gives a certificate of purchase of input to the company; and
- Potential full or partial exemption of interest on foreign loan from income tax, subject to the conditions stipulated under CITA.

(xiv) With implementation of Finance Act 2019, where a mining company makes a turnover of less than ₦25 million, no tax will be paid. Where turnover is between ₦25 million and less than ₦100 million, tax will be paid at 20%;

(xv) Any interest, rent, royalty or dividend received by a Nigerian company from abroad and brought into the country through any of the approved Nigerian banks will be exempted from companies income tax;

(xvi) Interest and/or gains received from bonds issued by any government or corporate body in Nigeria as well as from short term securities issued by the Federal Government, are exempt from income tax. This exemption is only applicable until 2022 financial year (2023 tax year). However, bonds issued by the Federal Government of Nigeria shall continue to enjoy this exemption; and

(xvii) The company may be entitled to employment tax relief (lower of the gross emoluments paid to qualifying employees or 5% of the assessable profits for the year); work experience acquisition programme relief (exempt income tax of 5% of the assessable profits); and infrastructure tax relief (20% of the public infrastructure provided).

Thank you.

Tomisin Oyewole

Appendix I- Computation of tax liabilities

Dutse Mines (Nigeria) Limited
Computation of tax liabilities
for 2022 tax year

	₦'000	₦'000
Net profit as per accounts		752,270
Add back: Disallowable expenses:		
General allowance for doubtful debts	10,500	
Loan to customers written off	5,000	
Legal fees	750	
Depreciation	70,000	
Exploration and processing expenditure	60,000	
Income tax provision	180,000	
Education tax provision	5,000	331,250
		1,083,520
Less: Profit on disposal of machine		8,500
Adjusted profit		1,075,020
Less: Capital allowances (appendix II)		77,000
Total profit		998,020
Companies income tax @ 30%		299,406
Tertiary education tax @ 2½% of adjusted profit		26,875.5
Total tax liabilities		**326,281.5**

Appendix II- Capital allowances

	Motor Vehicle IA 50% AA 25%	Furniture & Fittings IA 25% AA 20%	Mining IA 95% AA Nil	Capital Allowances
	₦	₦	₦	₦
2022 tax year				
TWDV	25,000,000	22,500,000	40,000,000	
Additions	-	-	60,000,000	
IA	-	-	(57,000,000)	57,000,000
AA	(12,500,000)	(7,500,000)	-	20,000,000
				77,000,000

Workings:

(i) Annual allowance of motor vehicles

$$AA = \frac{₦25,000,000}{4 - 2 \text{ years}}$$

$$= \frac{₦25,000,000}{2} = ₦\mathbf{12,500,000}$$

(ii) Annual allowance of furniture & fittings

$$AA = \frac{₦22,500,000}{5 - 2 \text{ years}}$$

$$= \frac{₦25,000,000}{3} = ₦\mathbf{7,500,000}$$

(iii) Initial allowance of exploration and processing expenditure

= 95% of ₦60,000,000 = ₦**57,000,000**

Examiner's Report

The question tests candidates' understanding of tax incentives available to a company in the mining of solid minerals and companies income tax computations.

About 60% of the candidates attempted the question, but majority of them lacked a good understanding of its requirements, hence their performance was below average.

The major pitfall of the candidates was their inability to state correctly the tax incentives available to mining companies and poor treatment of certified exploration and processing expenditure in the computation of adjusted profit of the mining company.

Candidates are advised to study extensively the Institute's Study Text on mining taxation and other relevant tax laws.

Marking guide

		Marks	Marks
(a)	**Computation of the liabilities of the company for the relevant assessment year**		
	Heading	½	
	Treatment of exploration and processing expenditure (Memo)	1	
	Net profit as per accounts	½	
	General allowance for doubtful debts	½	
	Loan to customers written off	½	
	Legal fees	½	
	Depreciation	½	
	Exploration and processing expenditure	½	
	Income tax provision	½	

Education tax provision	½	
Profit on disposal of machine	½	
Adjusted profit	½	
Capital allowance	½	
Total profit	½	
Companies income tax	½	
Tertiary education tax	½	
Total tax liabilities	½	
Capital allowance computation:		
TWDV (Motor vehicle)	½	
TWDV (Furniture & fittings)	½	
TWDV (Mining)	½	
Additions (Mining)	½	
IA (Mining)	½	
Capital allowance (₦57 million)	½	
AA (Motor vehicle)	½	
AA (Furniture & fittings)	½	
Capital allowance (₦20 million)	½	
Capital allowance (₦77 million)	½	14

(b) **Comments on tax incentives available to a company in the mining of solid minerals in Nigeria**

1 mark for each tax incentive discussed, subject to a maximum of 6 points	6
Total	**20**

SOLUTION 5

(a) Ethical issues that arose from the tax engagement are:

(i) Conflicts of interest: Conflicts of interest that involve providing services to competing clients such that the interests of one client may be prejudiced;

(ii) Failure to liaise with the outgoing tax consultant to discuss whether or not to accept the engagement;

(iii) Poaching clients: Poaching or soliciting potential clients from other practitioners/ practices;

(iv) Fee setting: Basing the amount of the fee charged for tax services on the amount of tax saved/tax liability (that is, contingent fee setting);

(v) Prior years errors: Inaction by the tax practitioner in respect of a clear and significant error detected in a client's prior year returns;

(vi) Tax authority's error: Inaction by the tax practitioner in respect of a clear and significant mathematical or clerical mistake by the relevant tax authorities in favour of his client;

(vii) Reasonable enquiry: He failed to make reasonable enquiry where information or documents as furnished by the officers of his client (Odamo Nigeria Limited) appears to be inaccurate or incomplete;

(viii) Technical incompetence: The tax practitioner failed to maintain an appropriate level of professional competence, knowledge and skill in the execution of the assignment;

(ix) Continue to act: He continued to act for a client in circumstances where incorrect or misleading information is not corrected by the client;

(x) Professional judgment: Carrying out a client's instructions which are inconsistent with the professional judgment of the tax practitioner;

(xi) Personal gain: Conflicts between opportunities for personal financial gain (or other personal benefit) and proper performance of a tax practitioner's responsibilities;

(xii) Communication: Failure to communicate to client's unfavourable as well as favourable information and professional opinions;

(xiii) Breach of objectivity: Olubami connecting with the officials of the Revenue Service to pay a lesser tax of ₦7 million instead of ₦12 million is an indication of bias and lack of objectivity; and

(xiv) Confidentiality: Failure to ensure confidentiality with regard to privileged client information. This is evidenced from the disclosure he made to Mr. Odamo that he assisted the company, which operates in the same sector as his, in doing the nefarious activities.

(b) Punitive measures put in place to ensure that accountants in practice adhere to legal and ethical issues when preparing tax returns are:

(i) Imposition of fines by the Institute (professional body), which the tax practitioner is a member;
(ii) Suspension from membership of the Institute;
(iii) Expulsion from membership of the Institute;
(iv) Withdrawal of certificate and licence to practise;
(v) Reprimand; and
(vi) Payment of costs associated with the investigations and meetings.

Examiner's report

The question tests candidates' knowledge of ethics and professionalism in tax engagements.

About 70% of the candidates attempted the question. Candidates showed a good understanding of the requirements of the question and their performance was satisfactory.

The major pitfall was the inability of some candidates to identify correctly and explain ethical issues that arose from the tax engagement.

Candidates are advised to read the Institute's Study Text and other relevant textbooks, as this will go a long way in assisting them to pass future examinations.

Marking Guide

(a)	**Ethical issues that arose from the tax engagement**	
	1 mark for each discussion on possible legal and ethical issues, subject to a maximum of 10 points	10
(b)	**Punitive measures put in place to ensure that accountants in practice adhere to legal and ethical issues when preparing tax returns**	
	1 mark for each discussion on implications for not adhering to legal and ethical issues in preparation of returns and in reporting subject to a maximum of 5 points	5
	Total	**15**

SOLUTION 6

ECOBAF Consult Services
Plot 8, Ahmadu Road, Bauchi

April 13, 2022

The Managing Director
Maigona Agro Limited
99,Eyimba Road
Bauchi

Dear Sir

RE: ADVICE ON TAX IMPLICATIONS OF PROFIT MADE BY BAM TEXTILE MILLS, UK

We refer to our discussion of April 6, 2022 on the above subject-matter and our comments are as follows:

(a) Tax implications of the overseas branch- BAM Textile Mills, UK are:

i. The provisions of Nigerian tax laws as set out in the Companies Income Tax Act 2004 (as amended) on profit of an overseas branch of a Nigerian company is that such profit is deemed to be derived in Nigeria and is therefore liable to tax in Nigeria;

ii. Any foreign tax suffered is not allowable in determining the overseas profit;

iii. Assets in use in such a branch will be entitled to capital allowances claimed in Nigeria;

iv. Losses incurred from such a branch can be set off against profit in Nigeria provided the losses were incurred from the same source; and

v. Double taxation relief is available for any foreign tax suffered either based on bilateral agreement or based on tax relief available under the Commonwealth.

Since it is a fact that BAM Textile Mills, UK is a branch of a Nigerian company, the above provisions of the Act are applicable and profit made is fully liable to tax in Nigeria.

(b) Computation of tax liabilities of the corporation

i. Following the provisions of the Act in respect of the status of BAM Textile Mills, the adjusted profit of ₦587.2 million from its operations is liable to tax in Nigeria.

ii. However, due to existing Commonwealth taxation relief between Nigeria and the UK, the profit is available for double taxation relief of ₦88.080 million (but restricted to actual tax paid in the UK, ₦72.2 million).

iii. The relief helps in reducing the companies income tax liability from ₦270.021 million to ₦197.821 million. All these computations are shown in the attached Appendix 1.

Please do not hesitate to contact us if you need any further clarification on the above subject.

Yours faithfully,

Oluyemi Ukah
Principal Partner
for: ECOBAF Consult Services

Appendix 1: Computation of tax liabilities of the corporation

	Maigona Agro Limited ₦'000	**BAM Textile Mills ₦'000**	**Total ₦'000**
Net profit as per accounts	339,270	367,700	706,970
Add: Disallowable expenses			
Depreciation	75,600	147,300	222,900
Income tax paid in the UK	-	72,200	72,200
Adjusted profit	414,870	587,200	1,002,070
Less: Capital allowances	(45,000)	(57,000)	(102,000)
Total profit	369,870	530,200	900,070
Companies income tax @ 30% of ₦900,070			270,021
Less: Double taxation relief (W1)			(72,200)
Net Companies income tax payable			197,821
Tertiary education tax @ 2.5%			25,051.75
Total tax liabilities			222,872.75

Workings

(1) Computation of double taxation relief

Since BAM Textile Mills is a Nigerian company, the Commonwealth rate of tax is compared with ½ Nigerian rate of tax.
CR = 35%; NR = 30%; and ½NR = 15%
CR ≥ ½NR, therefore relief = ½NR
Thus, double taxation relief = 15% of ₦587,200,000 = ₦88,080,000
However, the calculated double taxation relief is greater than the actual tax paid in the UK. Therefore, the amount of double taxation relief claimable will be restricted to the actual tax paid (₦72,200,000).

Examiner's Report

The question tests candidates' understanding of tax treatment of an overseas branch and companies income tax computations.

About 70% of the candidates attempted the question and they showed a fair understanding of the question and performance was average.

The commonest pitfall was the inability of the candidates to compute correctly double taxation relief on the foreign tax paid by the overseas branch.
Candidates are advised to read the Institute's Study Text and other relevant laws on taxation of non-resident companies when preparing for future examinations.

Marking Guide

		Marks	Marks
(a)	**Advice on tax implications of the oversees branch**		
	Heading	1	
	Tax implications of the overseas branch		
	(Discussions on any 3 points at 1 mark each)	3	4
(b)	**Computation of tax liabilities**		
	Main body of the letter (Discussions on any 2 points at ½ mark each)	1	
	Appendix 1:		
	Computation of tax liabilities		
	Net profits as per accounts (Maigona)	½	
	Net profits as per accounts (BAM)	½	
	Net profits as per accounts (Total)	½	

	Marks	Marks
Depreciation (Maigona)	½	
Depreciation (BAM)	½	
Depreciation (Total)	½	
Income tax paid in UK (BAM)	½	
Income tax paid in UK (Total)	½	
Adjusted profit (Maigona)	½	
Adjusted profit (BAM)	½	
Adjusted profit (Total)	½	
Capital allowances (Maigona)	½	
Capital allowances (BAM)	½	
Capital allowances(Total)	½	
Global total profit (Total)	½	
Companies income tax	½	
Double taxation relief	½	
Net Companies income tax payable	½	
Tertiary education tax	½	
Workings on double taxation relief	½	11
Total		15

SOLUTION 7

(a) **Section 263(1) of Petroleum Industry Act 2021 provides that in computing the adjusted profit of a company in upstream petroleum operations related to crude oil for any accounting period, the following expenses are allowable:**

(i) Rents incurred by the company for the period pursuant to a petroleum mining lease or petroleum prospecting licence;

(ii) All royalties the liability for which was incurred and were paid by the company during the period in respect of crude oil and associated gas and where a petroleum mining lease includes payment to the Federation Account related to production sharing, profit sharing, risk service contracts or other contractual features under a model contract and the company has incurred liability for such payments in kind or in cash;

(iii) Expenses directly incurred for repair of plant, machinery or fixtures employed for the purpose of the business;

(iv) An expenditure tangible or intangible directly incurred in connection with the drilling of the first exploration well and the first two appraisal wells in the same field;

(v) Any amount contributed to a fund, scheme or arrangement approved by the Commission for the purpose of decommissioning and abandonment, provided that the surplus or residue of the fund shall

be subject to tax under this Act at the end of the life of the field, where such surplus is returned to the lessee;

(vi) All sums the liability of which was incurred by the company to the Federal Government or any State or Local Government Council by way of levies, stamp duties and fees;

(vii) Costs of gas re-injection wells, which are re-injecting natural gas that otherwise would be flared, subject to ratification by the Commission; and

(viii) Any amount contributed to any fund, scheme or arrangement approved by the Commission pursuant to the establishment of host communities development trusts, Environmental Remediation Fund, Niger Delta Development Commission and other similar contributions.

(b) **Implications of mergers and acquisitions in respect of a situation when a new company takes over an existing company are:**

(i) **Filing of annual returns**: The new company that emerges from a merger process is expected to file the audited accounts and returns with the FIRS within 18 months from the date of its incorporation or not later than 6 months after the end of its first accounting period, whichever is earlier;

(ii) **Basis of assessment**: The commencement rules will apply to the new company;

(iii) **Claim of capital allowances**: No initial or investment allowance will be claimed on the transferred assets. The annual allowance claimable will be based on the tax written down value of the transferred assets;

(iv) **Unabsorbed losses and capital allowance brought forward**: The unrelieved losses and unabsorbed capital allowances of the individual merging companies will not be allowed to be carried forward and set off against the assessable profits of the new company after the merger. However, the unutilised capital allowances may be added to the tax written down value of the assets taken over for annual allowance purposes in the enlarged entity;

(v) **Stamp duties**: Stamp duty payment will arise on the share capital of the new company. If a merger also results in increase in share capital, stamp duty will be paid on the increase in share capital.

(vi) **Merger cost**: The FIRS may seek to disallow expenses (legal and professional fees) incurred in the process of merger on the basis that they are capital in nature and as such not tax deductible;

(vii) **Value added tax and withholding tax**: The fees paid to the professionals for services rendered in connection with the merger will attract value added tax and withholding tax at the appropriate rates;

(viii) **Guarantee or security for payment of tax**: The FIRS may require the new company to guarantee or give security to the satisfaction of the FIRS for the payment in full of all tax due or to become due by any of the ceased companies; and

(ix) **End of service award**: When companies merge, the services of some employees may no longer be needed. The new company may have to pay benefits such as gratuity, compensation for loss of employment and other retirement benefits. These expenses will be treated as allowable for the new company (but subject to statutory limit, for instance, for compensation for loss of employment is ₦100 million- Finance Act 2020).

Examiner's Report

The question tests candidates' knowledge of expenses allowable in the computation of adjusted profit of a company in upstream petroleum operations and the implications of merger and acquisition of a new company with an existing company.

About 50% of the candidates attempted the question. Candidates displayed good understanding of the question, and performance was above average.

The major pitfall was the inability of some candidates to identify correctly some allowable expenses in line with the provisions of Petroleum Industry Act 2021.

Candidates are advised to read the Institute's Study Text, other relevant textbooks, and Petroleum Industry Act 2021, when preparing for future examinations.

Marking Guide

(a)	**Expenses allowable in the computation of adjusted profit of a company in upstream petroleum operation**	
	1 mark for each discussion on allowable expenses, subject to a maximum of 6 points	6
(b)	**Implications of mergers and acquisitions in respect of a situation where a new company takes over an existing company**	
	1½ marks for each discussion on tax implications of merger and Acquisition when a new company takes over an existing company, subject to a maximum of 6 points	<u>9</u>
	Total	**<u>15</u>**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2022

STRATEGIC FINANCIAL MANAGEMENT

Time Allowed: $3^1/_4$ hours (including 15 minutes reading time)

INSTRUCTION: YOU ARE REQUIRED TO ATTEMPT FIVE OUT OF THE SEVEN QUESTIONS IN THIS PAPER

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Vico Tony (VT) is a software design company established six years ago. The company is owned by five directors. Since establishment, the company has developed rapidly.

VT finds it difficult to obtain bank finance and relies on a long-term strategy of using internally generated funds to finance expansion. The directors are therefore giving consideration to the possibility of floating the company on the stock market. As a first step, you have been appointed by the directors to advise on the current value of the business under their ownership.

The company's most recent statement of profit or loss and the extracted balances from the latest statement of financial position are as follows:

Statement of Profit or loss

	₦'Million
Sales	10,000
Cost of sales	(6,000)
Gross profit	4,000
Other operating costs	(3,754)
Operating profits	246
Interest on loan	(148)
Profit before tax	98

Statement of Financial Position

	₦'Million
Opening non-current assets	2,400
Additions	132
Non-current assets (at cost)	2,532
Accumulated depreciation	(734)
Net book value	1,798
Current assets	
Cash and bank	100
Receivables	520
Inventory	280
	900
Total assets	2,698

Non-current liability: Loan	1,980
Current liabilities	
Payables	182
Tax payables	30
Interest payable	148
	360
Total liabilities	2,340
Shareholders Equity	358

During the current year:

(i) Depreciation is charged at 10% per annum on the year end non-current assets balance before accumulated depreciation, and is included in other operating costs in the statement of profit or loss.

(ii) The investment in net working capital is expected to increase in line with the growth in gross profit.

(iii) Other operating costs consisted of:

	₦'Million
• Variable component at 15% of sales	1,500
• Fixed costs	2,000
• Depreciation on non-current assets	254

(iv) Sales and variable costs are projected to grow at 9% per annum and fixed costs are projected to grow at 6% per annum.

(v) The company pays interest on its outstanding loan of 7.5% per annum and incurs tax on its profits at 30%, payable in the following year. The company does not currently pay dividends.

One of your first tasks is to prepare for the directors a forward cash flow projection for three years and to value the firm on the basis of its expected free cash flow to equity. In discussion with them, you note the following:

- The company will not dispose of any of its non-current assets but will increase its investment in new non-current assets by 20% per annum. The company's depreciation policy matches the currently available tax allowable depreciation.

  This straight-line write off policy is not likely to change;
- The directors will not take a dividend for the next three years but will then review the position taking into account the company's sustainable cash flow at that time;
- The level of loan will be maintained at ₦1.98 billion and interest rates are not expected to change;

- For estimating the appropriate required return on equity, it is decided to make use of the capital asset pricing model (CAPM). The challenge however, is that since the company is not quoted, an appropriate beta factor does not exist. You have found a listed company, Konputer Limited (KL) that is into software development. KL is also into computer hardware retailing. It has the following financial statistics:

Equity beta	1.40
Debt beta	0.20
Debt/Equity ratio	40%
Effective tax rate	25%

- About 60% of the market value of KL is attributed to software development division while 40% of the value is attributed to computer hardware retailing. The computer hardware retailing division has equity beta of 0.8;
- Risk-free rate is 4% and the market risk premium is 8%; and
- VT has maintained a long-term debt/ (debt+equity) ratio of 20%.

Required:

a. Provide an estimate of the appropriate rate of return to be used for the valuation of VT. Round your answer to the nearest whole number. (7 Marks)

b. Prepare a three-year cash flow forecast for the business on the basis described above highlighting the free cash flow to equity in each year. (14 Marks)

c. Estimate the value of the business based on the expected free cash flow to equity and a terminal value based on a sustainable growth rate of 4% per annum thereafter. (Note: Irrespective of your answer in (a), assume required return of 17%). (5 Marks)

d. Advise the directors on the assumptions and the uncertainties within your valuation. (4 Marks)

(Total 30 Marks)

SECTION B OPEN-ENDED QUESTIONS (40 MARKS)

INSTRUCTION: YOU ARE REQUIRED TO ATTEMPT ANY TWO OUT OF THE THREE QUESTIONS IN THIS SECTION

QUESTION 2

Effe is a Nigerian company specialising in the provision of information systems solutions to large corporate organisations. It is going through a period of rapid expansion and requires additional funds to finance the long-term working capital needs of the business.

Effe has issued one hundred million ₦1 ordinary shares, which are listed on the stock market at a current market price of ₦15 with typical increases of 10% per annum expected in the next five years. Dividend payout is kept constant at a level of 10% of post-tax profits. Effe also has ₦1,000 million of bank borrowings.

It is estimated that a further ₦300 million is required to satisfy the funding requirements of the business for the next five-years beginning July 1, 2021. Two major institutional shareholders have indicated that they are not prepared to invest further in Effe at the present time and so a rights issue is unlikely to succeed. The directors are therefore considering various forms of debt finance. Three alternative structures are under discussion as shown below:

- Five-year unsecured bank loan at a fixed interest rate of 7% per annum;
- Five-year unsecured bond with a coupon of 5% per annum, redeemable at par and issued at a 6% discount; and
- A convertible bond, issued at par, with an annual coupon rate of 4.5% and a conversion option in five years' time of five shares for each ₦100 nominal of debt.

There have been lengthy boardroom discussions on the relative merits of each instrument. Summarised below are the queries of three different directors concerning the instruments.

Director A: "The bank loan would seem to be more expensive than the unsecured bond. Is this actually the case?"

Director B: "Surely, the convertible bond would be the cheapest form of borrowing with such a low interest rate?"

Director C: "If we want to increase our equity base, why use a convertible bond, rather, than a straight equity issue?"

Required:

a. Write a response to the queries raised by the three directors and advise on the most appropriate financing instrument for Effe. In your answer, include calculations of appropriate yield for each instrument.

Ignore tax. (15 Marks)

b. Advise a prospective investor in the five-year unsecured bond issued by Effe on what information he should expect to be provided with and what further

analysis he should undertake in order to assess the credit worthiness of the proposed investment. (5 Marks)

(Total 20 Marks)

QUESTION 3

Opeyemi operates in an economy that has almost zero inflation. Management ignores inflation when evaluating investment projects because it is very low and considered insignificant. Opeyemi is evaluating a number of similar, alternative investments. The company uses an after tax cost of capital of 6% and has already completed the evaluation of two investments. The third investment is a new product that would be produced on a just-in-time basis and is expected to have a life of three years. This investment requires an immediate cash outflow of ₦200,000, which does not qualify for tax depreciation. The expected residual value at the end of the project's life is ₦50,000. A draft financial statement showing the values that are specific to this investment for the three years is as follows:

	Year 1	Year 2	Year 3
	₦	₦	₦
Sales	230,000	350,000	270,000
Production costs:			
Materials	54,000	102,000	66,000
Labour	60,000	80,000	70,000
Other*	80,000	90,000	80,000
Profit	36,000	78,000	54,000
Closing receivables	20,000	30,000	25,000
Closing payables	6,000	9,000	8,000

*Other production costs shown above include depreciation calculated using the straight line method.

The company is liable to pay corporate tax at a rate of 30% of its profits. One half of this is payable in the same year as the profit is earned, the remainder is payable in the following year.

Required:

a. Calculate the net present value of the above investment proposal. (14 Marks)

b. Explain how the above investment project would be appraised if there were to be a change in the rate of inflation, so that it became too significant to be ignored. (3 Marks)

c. The evaluation of the other two investments are shown below:

Investment	Initial investment	Net Present Value
	₦	₦
W	300,000	75,000
Y	100,000	27,000

The company only has ₦400,000 of funds available. All of the investment proposals are non-divisible. None of the investments may be repeated.

Required:

Recommend, with supporting calculations, which of the three investment proposals should be accepted. (3 Marks)

(Total 20 Marks)

QUESTION 4

The finance director of Keyman Plc. has recently reorganised the finance department following a number of years of growth within the business, which now includes a number of overseas operations. The company has created separate treasury and financial control departments.

Required:

a. Describe the main responsibilities of a treasury department, and comment on the advantages to Keyman Plc. of having separate treasury and financial control departments. (14 Marks)

b. Identify the advantages and disadvantages of operating the treasury department as a profit centre rather than a cost centre. (6 Marks)

(Total 20 Marks)

SECTION C: OPEN-ENDED QUESTIONS (30 MARKS)

INSTRUCTION: YOU ARE REQUIRED TO ATTEMPT ANY TWO OUT OF THE THREE QUESTIONS IN THIS SECTION

QUESTION 5

The directors of Jindadi Plc. (JP), an Abuja-based entertainment company, are currently considering the appropriate cost of capital to use in appraising capital investments. It is the policy of the company to assess the financial viability of all capital projects using net present value criterion.

You have been provided with some financial information of the company.

Most recent statement of financial position

	₦m	₦m
Equity finance		
Ordinary shares (₦1 nominal value)	200	
Reserves	120	320
Non-current liabilities		
7% Convertible bonds (₦ 100 nominal value)	160	
5% Preference shares (₦ 1 nominal value)	80	240
Current liabilities		
Trade payables	80	
Overdraft	120	200
Total liabilities		760

JP has an equity beta of 1.2 and the ex-dividend market value of the company's equity is ₦1 billion. The ex-interest market value of the convertible bonds is ₦168 million and the ex-dividend market value of the preference shares is ₦50 million.

The convertible bonds of JP have a conversion ratio of 19 ordinary shares per bond. The conversion date and redemption date are both on the same date in five years' time. The current ordinary share price of JP is expected to increase by 4% per year for the foreseeable future.

The equity risk premium is 5% per year and the risk-free rate of return is 4% per year. JP pays profit tax at an annual rate of 30% per year.

Required:

a. Calculate the market value after-tax weighted average cost of capital of JP, explaining clearly any assumptions you make. (10 Marks)

b. Discuss why market value weighted average cost of capital is preferred to book value weighted average cost of capital when making investment decisions. (5 Marks)

(Total 15 Marks)

QUESTION 6

a. You have worked with a major oil servicing company in Nigeria, with headquarters in the USA, for the past six years. Recently you completed your ICAN examinations and you have been asked to join the international treasury department in New York City for a two-year attachment.

The company is due to pay a UK supplier the sum of £5million in three months time. Your team is considering alternative methods of hedging the expected payment against adverse movements in exchange rate.

Exchange rate information

	US$ per £1
Spot rate	1.9410 – 1.9531
One – month forward rate	1.9339 – 1.9452
Three – month forward rate	1.9223 – 1.9339

Futures market (contract size of £62,500, Quotation: US$ per £)

2-month expiry	1.9305
5-month expiry	1.9170

Options market (£31,250 contracts size, premiums are quoted in cents per £1)

	Call option		Put option	
Exercise price	**2-month expiry**	**5-month expiry**	**2-month expiry**	**5-month expiry**
1.9000	2.88	3.55	0.15	0.28
1.9200	1.59	2.32	1.00	1.85
1.9400	0.96	1.15	2.05	2.95

You are required to advise the company which of the following hedging strategies should be adopted for the payment due to be made in three months. Show all workings.

i. Forward contract (2 Marks)
ii. Currency futures (5 Marks)
iii. Currency options (5 Marks)

b. In your personal investment portfolio, you have gone short (i.e. you have sold) 110,000 units of Big Bank plc. Call and put options exist on the bank's shares. You decide to hedge your position using put options on the bank's shares. For the relevant option you know that;

$$N(d_1) = 0.45$$

You are required to calculate how many put options you will need to buy or sell in order to delta-hedge. Be specific. (3 Marks)

(Total 15 Marks)

QUESTION 7

You are required to provide a briefing on the following dividend concepts:

a. Residual theory of dividends; (3 Marks)
b. Clientele effect; (3 Marks)
c. Asymmetric information; (2 Marks)
d. Signalling properties of dividends; (3 Marks)
e. The 'bird-in-the-hand' argument. (4 Marks)

(Total 15 Marks)

Formulae

Modigliani and Miller Proposition 2 (with tax)

$$K_{EG} = K_{EU} + (K_{EU} - K_D)\frac{V_D}{V_{EG}}(1-t)$$

Asset Beta

$$\beta_A = \left[\frac{V_E}{(V_E + V_D(1-T))}\beta_E\right] + \left[\frac{V_D(1-T)}{(V_E + V_D(1-T))}\beta_D\right]$$

Equity Beta

$$\beta_E = \beta_A + (\beta_A - \beta_D)\left(\frac{V_D}{V_E}\right)(1-t)$$

Growing Annuity

$$PV = \frac{A_1}{r-g}\left(1 - \left(\frac{1+g}{1+r}\right)^n\right)$$

Modified Internal Rate of Return

$$MIRR = \left[\frac{PV_R}{PV_I}\right]^{\frac{1}{n}}(1+r_e) - 1$$

The Black-Scholes Option Pricing Model

$$C_0 = S_0N(d_1) - Ee^{-rt}N(d_2)$$

$$d_1 = \frac{In\left(\frac{S_0}{E}\right) + (r + 0.5\sigma^2)T}{\sigma\sqrt{T}}$$

$$d_2 = d_1 - \sigma\sqrt{T}$$

The Put Call Parity

$$C + Ee^{-rt} = S + P$$

Binomial Option Pricing

$$u = e^{\sigma \times \sqrt{T/n}}$$

$$d = 1/u$$

$$a = e^{rT/n}$$

$$\pi = \frac{a-d}{u-d}$$

The discount factor per step is given by $= e^{-rT/n}$

Annuity Table

Present value of an annuity of 1 i.e. $\frac{1 - (1 + r)^{-n}}{r}$

Where r = discount rate

n = number of periods

Discount rate (r)

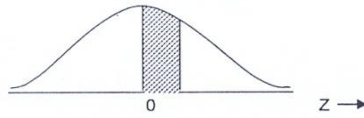
Periods

(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	
1	0·990	0·980	0·971	0·962	0·952	0·943	0·935	0·926	0·917	0·909	1
2	1·970	1·942	1·913	1·886	1·859	1·833	1·808	1·783	1·759	1·736	2
3	2·941	2·884	2·829	2·775	2·723	2·673	2·624	2·577	2·531	2.487	3
4	3·902	3·808	3.717	3·630	3.546	3.465	3·387	3·312	3·240	3·170	4
5	4·853	4·713	4·580	4·452	4·329	4·212	4·100	3·993	3.890	3·791	5
6	5·795	5·601	5·417	5·242	5·076	4·917	4·767	4·623	4.486	4·355	6
7	6·728	6.472	6·230	6·002	5·786	5·582	5·389	5·206	5·033	4·868	7
8	7·652	7·325	7·020	6·733	6·463	6·210	5·971	5·747	5·535	5·335	8
9	8·566	8·162	7·786	7.435	7·108	6·802	6·515	6·247	5·995	5·759	9
10	9·471	8·983	8·530	8·111	7·722	7·360	7·024	6·710	6.418	6·145	10
11	10·368	9·787	9·253	8·760	8·306	7·887	7.499	7·139	6·805	6.495	11
12	11·255	10·575	9·954	9·385	8·863	8·384	7·943	7·536	7'161	6·814	12
13	12·134	11·348	10·635	9·986	9·394	8·853	8·358	7·904	7·487	7·103	13
14	13·004	12·106	11·296	10·563	9·899	9·295	8·745	8·244	7·786	7·367	14
15	13·865	12·849	11·938	11·118	10·380	9·712	9·108	8·559	8·061	7·606	15

(n)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%	
1	0·901	0·893	0·885	0·877	0·870	0·862	0·855	0·847	0·840	0·833	1
2	1·713	1·690	1·668	1·647	1·626	1·605	1·585	1·566	1·547	1·528	2
3	2.444	2.402	2·361	2·322	2·283	2·246	2·210	2·174	2·140	2·106	3
4	3·102	3·037	2·974	2·914	2·855	2·798	2·743	2.690	2·639	2.589	4
5	3·696	3·605	3·517	3·433	3·352	3·274	3·199	3·127	3·058	2·991	5
6	4·231	4·111	3·998	3·889	3·784	3·685	3·589	3.498	3.410	3·326	6
7	4·712	4·564	4.423	4·288	4·160	4·039	3·922	3·812	3·706	3·605	7
8	5·146	4·968	4.799	4·639	4.487	4·344	4·207	4·078	3·954	3·837	8
9	5·537	5·328	5·132	4·946	4·772	4·607	4.451	4·303	4·163	4·031	9
10	5·889	5·650	5.426	5·216	5·019	4·833	4·659	4.494	4·339	4·192	10
11	6·207	5·938	5·687	5.453	5·234	5·029	4·836	4·656	4.486	4·327	11
12	6·492	6·194	5·918	5·660	5·421	5·197	4·988	4·793	4·611	4.439	12
13	6·750	6.424	6·122	5·842	5·583	5·342	5·118	4·910	4·715	4·533	13
14	6·982	6·628	6·302	6·002	5·724	5.468	5·229	5·008	4·802	4·611	14
15	7·191	6·811	6.462	6·142	5·847	5·575	5·324	5·092	4·876	4·675	15

NORMAL DISTRIBUTION

This table gives the area under the normal curve between the mean and a point Z standard deviations above the mean. The corresponding area for deviations below the mean can be found by symmetry.



$Z=\frac{(x-\mu)}{\sigma}$	0.00	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.08	0.09
0.0	.0000	.0040	.0080	.0120	.0159	.0199	.0239	.0279	.0319	.0359
0.1	.0398	.0438	.0478	.0517	.0557	.0596	.0636	.0675	.0714	.0753
0.2	.0793	.0832	.0871	.0910	.0948	.0987	.1026	.1064	.1103	.1141
0.3	.1179	.1217	.1255	.1293	.1331	.1368	.1406	.1443	.1408	.1517
0.4	.1554	.1591	.1628	.1664	.1700	.1736	.1772	.1808	.1844	.1879
0.5	.1915	.1950	.1985	.2019	.2054	.2088	.2123	.2157	.2190	.2224
0.6	.2257	.2291	.2324	.2357	.2389	.2422	.2454	.2486	.2518	.2549
0.7	.2580	.2611	.2642	.2673	.2704	.2734	.2764	.2794	.2823	.2852
0.8	.2881	.2910	.2939	.2967	.2995	.3023	.3051	.3078	.3106	.3133
0.9	.3159	.3186	.3212	.3238	.3264	.3289	.3315	.3340	.3365	.3389
1.0	.3413	.3438	.3461	.3485	.3508	.3531	.3554	.3577	.3599	.3621
1.1	.3643	.3665	.3686	.3708	.3729	.3749	.3770	.3790	.3810	.3830
1.2	.3849	.3869	.3888	.3907	.3925	.3944	.3962	.3980	.3997	.4015
1.3	.4032	.4049	.4066	.4082	4099	.4115	.4131	.4147	.4162	.4177
1.4	.4192	.4207	.4222	.4236	.4251	.4265	.4279	.4292	.4306	.4319
1.5	.4332	.4345	.4357	.4370	.4382	.4394	.4406	.4418	.4430	.4441
1.6	.4452	.4463	.4474	.4485	.4495	.4505	.4515	.4525	.4535	.4545
1.7	.4554	.4564	.4573	.4582	.4591	.4599	.4608	.4616	.4625	.4633
1.8	.4641	.4649	.4656	.4664	.4671	.4678	.4686	.4693	.4699	.4706
1.9	.4713	.4719	.4726	.4732	.4738	.4744	.4750	.4756	.4762	.4767
2.0	.4772	.4778	.4783	.4788	.4793	.4798	.4803	.4808	.4812	.4817
2.1	.4821	.4826	.4830	.4834	.4838	.4842	.4846	.4850	.4854	.4857
2.2	.4861	.4865	.4868	.4871	.4875	.4878	.4881	.4884	.4887	.4890
2.3	.4893	.4896	.4898	.4901	.4904	.4906	.4909	.4911	.4913	.4916
2.4	.4918	.4920	.4922	.4925	.4927	.4929	.4931	.4932	.4934	.4936
2.5	.4938	.4940	.4941	.4943	.4945	.4946	.4948	.4949	.4951	.4952
2.6	.4953	.4955	.4956	.4957	.4959	.4960	.4961	.4962	4963	.4964
2.7	.4965	.4966	.4967	.4968	.4969	.4970	.4971	.4972	.4973	.4974
2.8	.4974	.4975	.4976	.4977	.4977	.4978	.4979	.4980	.4980	.4981
2.9	.4981	.4982	.4983	.4983	.4984	.4984	.4985	.4985	.4986	.4986
3.0	**.49865**	.4987	.4987	.4988	.4988	.4989	.4989	.4989	.4990	.4990
3.1	**.49903**	.4991	.4991	.4991	.4992	.4992	.4992	.4992	.4993	.4993
3.2	**.49931**	.4993	.4994	.4994	.4994	.4994	.4994	.4995	.4995	.4995
3.3	**.49952**	.4995	.4995	.4996	.4996	.4996	.4996	.4996	.4996	.4997
3.4	**.49966**	.4997	.4997	.4997	.4997	.4997	.4997	.4997	.4997	.4998
3.5	**.49977**									

SOLUTION 1

a) **Computing the required return**

Step 1: Determine the equity beta of the software development division of KL. It is this division that has systematic risk similar to that of VT. Meanwhile, the given equity beta of KL (i.e. 1.40) is a weighted average of the software division (which is unknown) and that of the hardware retailing (0.8). If x is the unknown equity beta, then:

$0.6X + 0.4(0.8) = 1.40$

$X = 1.8$

This reflects the systematic business risk of the software industry and the financial risk of KL.

Step 2: Ungear the equity beta calculated above in order to remove the financial risk of KL. This means converting the equity beta to asset beta.

$$\beta_A = \left[\frac{V_E}{(V_E + V_D(1-T))}\beta_E\right] + \left[\frac{V_D(1-T)}{(V_E + V_D(1-T))}\beta_D\right]$$

β_E= equity beta of the software industry = 1.8

β_D= beta of debt of KL = 0.2

V_E = value of equity of KL = 100*

V_D = value of debt of KL = 40*

t = effective tax rate of KL = 0.25

(*Note: We actually do not need to know the absolute values V_E and V_D. We only need the relative values. With D/E of 40%, we simply maintain the ratio: D:E = 40:100 = 4:10 = 0.4:1, etc.)

$$\beta_A = \left[\frac{1.8 \times 100}{100 + 40(1-0.25)}\right] + \left[\frac{0.20 \times 40(1-0.25)}{100 + 40(1-0.25)}\right] = 1.43$$

Step 3: Regear the above asset beta to incorporate the financial risk of VT. This means converting the above asset beta to equity beta.

$$\beta_E = \beta_A + (\beta_A - \beta_D)\left(\frac{V_D}{V_E}\right)(1-t)$$

Where

β_A = asset beta of the industry (computed above) = 1.43

β_D = beta of debt of VT = 0. Not given and we assume the debt is risk-free.

t = effective tax rate of VT = 0.30

V_D = value of debt of VT = 20*

V_E = value of equity of VT = 80*

(*D/D+E of 20% means 20% of total asset is funded by debt and 80% by equity. Same as D/E of 20/80 = 0.25)

$$\beta_E = 1.43 + (1.43 - 0)\left(\frac{20}{80}\right)(1 - 0.3) = 1.68$$

Step 4: Compute the required rate of return, using CAPM.

$K_E = R_F + \beta_E (R_M - R_F)$

$= 4 + 1.68(8) = 17\%$ approx.

b) **Projected statement of profit or loss (₦million)**

	Year 1	Year 2	Year 3
Sales (9% growth)	10,900	11,881	12,950
Cost of sales (9% growth)	6,540	7,129	7,771
Gross profit	4,360	4,752	5,179
Operating cost (W1)	4,024	4,317	4,636
Operating profit (i.e. EBIT)	336	435	543

Projected cash flows (₦million)

	Year 1	Year 2	Year 3
EBIT	336	435	543
Add depreciation (W1)	269	288	311
Less incremental working capital (W3)	(40)	(43)	(47)
Less taxation (W4)	(30)	(56)	(86)
Less interest	(148)	(148)	(148)
Less investment in non-current assets (W2)	(158)	(190)	(228)
Free cash flow to equity (FCFE)	229	289	345

Working notes

1. **Operating Costs (₦million)**

	Year 1	Year 2	Year 3
Variable operating costs (9% growth)	1,635	1,782	1,943
Fixed costs (6% growth)	2,120	2,247	2,382
Depreciation (W2)	269	288	311
Total operating costs	4,024	4,317	4,636

2. **Non-current assets and depreciation (₦million)**

	Year 1	Year 2	Year 3
Opening non-current assets	2,532	2,690	2,880
Additions (20% growth)	158	190	228
Closing balance	2,690	2,880	3,108
Depreciation (10%)	269	288	311

3. **Working capital (₦million)**

- Current position

  Total current assets, excluding cash = 800

  Total current liabilities = 360   440

	Year 1	Year 2	Year 3
- Cumulative (9% growth)	480	523	570
- Incremental	40	43	47

4. **Taxation (₦million)**

Year 1 (given)	30
Year 2 30%×(336 - 148)	56
Year 3 30%×(435 - 148)	86

c) **Calculation of value of the company's equity (₦million)**

The value of the company's shares is the present value of the calculated FCFE.

Year 1	$229 \times (1.17)^{-1}$	= 196
Year 2	$289 \times (1.17)^{-2}$	= 211
Year 3	$345 \times (1.17)^{-3}$	= 215
		622

Add terminal value: $= \frac{FCFE_3(1.04)}{0.17-0.04} \times (1.17)^{-3}$

$$= \frac{345(1.04)}{0.17 - 0.04} \times (1.17)^{-3} = 1{,}723$$

Total value 2,345

On the basis of the above projection, the total value of the company shares is ₦2,345,000,000.

d) This valuation is based upon a number of assumptions which you should consider when reviewing this analysis:

- The required rate of return has been calculated using capital asset pricing model. A number of problems are associated with the model in this instance.
- It assumes the company is well diversified and therefore no unsystematic risk. There is no evidence in the scenario that the company is properly diversified.
- Since the company is not quoted, an appropriate beta factor does not exist. We have made use of the beta factor of a proxy company, with adjustments. These adjustments are not error-free. In fact, no two companies are completely identical.

- Finally we have assumed a terminal value based upon future cash flows from year three forward growing at a compound rate of 4% into the indefinite future. The resulting value will be particularly sensitive to this figure and it may be that you may wish to consider a different rate depending upon what you regard as sustainable in the long term for a business of this type.

Examiner's report

This is a standard question on valuation of business, using free cash flow to equity (FCFE) model.

Part (a) tests candidates' understanding of the calculation of specific cost of capital, using given information of proxy company.

Part (b) requires candidates to project a 3 – year FCFE, using the relevant information provided.

Part (c) requires candidates to provide a valuation of the company.

Finally, part (c) requires the candidates identify the relevant assumptions and uncertainties in their calculations.

Being a compulsory question almost all the candidates attempted it.

Generally the performance on the question was very poor.

In part (a), candidates lost marks due to the following errors:

- Failure to recognise that the relevant asset beta is that of the software division.
- The use of wrong leverage ratio.
- Making use of the tax rate of VT (30%) even when the tax rate of the proxy company was clearly given as 20%.

In part (b), marks were lost due to the following errors:

- Including cash in the calculation of FCFE
- Wrong calculations of purchase of Non – current assets
- Wrong calculation of depreciation
- Failure to adjust for tax

In part (c), the candidates could not calculate the terminal value of the company at the end of year 3.

It is recommended that students preparing for the institute's examination should cover the syllabus comprehensively.

Marking Guide

		Marks	Marks
a.	Determination of the equity beta of the software division	2	
	Ungearing of the equity beta of the software division to get asset beta	2	
	Regearing of the above asset beta	2	
	Computation of the required rate of return using CAPM	1	7
b.	Computation of sales for three years	1½	
	Computation of cost of sale for three years	1½	
	Computation of operating cost for three year	3	
	Computation of addition to non-current assets	2	
	Computation of depreciation for three years	1	
	Computation of changes in working capital for three years	2	
	Taxation for three years	1½	
	Computation of free cashflow to equity	1½	14
c.	Discounting of cashflows for the first three years	3	
	Computation of terminal value and total value	2	5
d.	Discussion of assumption and uncertainties	4	4
	Total		30

SOLUTION 2

a) **Response to Board members:**

Director A

- The redemption yield (YTM) allows the cost of the loan and bond to be compared on the same basis;
- The redemption yield is effectively the IRR of the cash flows under the debt instrument and so takes into account the time value of money;
- The bond is slightly cheaper than the loan, with a redemption yield of 6.45% instead of 7%;
- This result would be expected, since the bond is marketed to a wider investor base and so finer rates can be obtained; and
- Issue costs must also be taken into account; no information is provided in the question but costs can be expected to be significantly higher for the bond because of the publicity and underwriting required.

Director B

- Looking at coupon rate in isolation, the convertible bond appears to cost less than the bond: certainly the interest cost would be lower over the five-year period;
- However, if the share price rises by 10% a year as predicted, each convertible bond with face value of ₦100 will convert to 5 shares worth ₦120.80 after five years (W(iii)). The capital gain (₦20.80 = ₦120.80 - 100) is equivalent to a compound annual yield of 3.85% (= $(120.8/100)^{1/5}$ - 1)). This is in addition to the 4.5% coupon on the convertible.
  Alternatively, an overall yield can be determined. This is calculated as 8.04% (working (iii)) compared with the two other sources of borrowing, the convertible is the most expensive.
- In addition, from year 6 onwards, the entity will need to pay dividends on the shares created on conversion which is likely to increase the cost of capital, since the cost of equity is generally higher than the cost of debt.

Director C

- Investors may have concerns about the future growth of the entity and be reluctant to subscribe to shares at the present time, as indicated by the two major institutional shareholders.
- The convertible bond gives investors the opportunity to acquire new shares, but they have the assurance that they do not need to convert the bond into shares unless the entity performs well in the next five-year period.
- In the meantime, the entity benefits from lower financing costs for five years.

Recommendation

For a rapidly expanding entity such as Effe, the convertible bond may be the most appropriate. The convertible bond provides low cost finance for five years and may result in the desired equity base at the end of the five year period.

Working notes

Calculation of yield to maturity (YTM)

i) **Bank loan:** the YTM for the bank loan is equal to the annual coupon of 7%.

ii) **Bond:** Based on ₦100 nominal value for simplicity:
We try both 6% and 7%

Year	Cashflow	PV at 6%	PV at 7%
	₦	₦	₦
0	(94*)	(94)	(94)
1 – 5	5	21.062	20.501
5	100	74.726	71.299
NPV		1.788	(2.200)

$$\text{YTM} = \text{IRR} = 6 + \frac{1.788}{1.7888 + 2.2}(7 - 6) = 6.45\%$$

(* Recall that the bond is to be issued at a discount of 6%)

Alternative approach based on actual cashflows

Year	*Cashflow*	*PV at 6%*	*PV at 7%*
	₦m	*₦m*	*₦m*
0	*(300)*	*(300)*	*(300)*
1 – 5	*15.958*	*67.221*	*65.431*
5	*319.149**	*238.487*	*227.549*
NPV		*5.708*	*(7.020)*

$$YTM = 6 + \frac{5.708}{5.708 + 7.020}(7 - 6) = 6.45\%$$

(Note that cash of ₦300m is needed. With a discount of 6%, the face value of the bond must be: ₦300m × 100/94 = ₦319.149.* ***Interest is calculated on face value.*** *Thus, the annual total interest is 5% of ₦319.149)*

iii) **Convertible bond**

The "appropriate yield" that can be calculated here is 'the yield to conversion (YTC)' – on the assumption that the holders will indeed convert.

- Conversion value in year 5 = 15(1.10) × 5 shares = ₦120.788
- Annual interest years 1 – 5 = 4.5% × ₦100 = ₦4.5
- Issue price = ₦100

We need the IRR of these cashflows.
Trying 8% and 9%

Year	Cashflow	PV at 8%	PV at 9%
	₦	₦	₦
0	(100)	(100)	(100)
1 – 5	4.5	17.967	17.503
5	120.788	82.206	78.504
NPV		0.173	(3.993)

$$IRR = 8 + \frac{0.173}{0.173 + 3.993}(9 - 8) = 8.04\%$$

b) In assessing creditworthiness, a prospective investor should be provided with the following information:
- Financial statements for the last three years;
- Cash flow forecasts;
- Long- and short-term ratings from rating agencies of this and similar entities' bonds;
- Business prospects;
- Prospects for the market sector

  and undertake the following analyses:
- Calculate ratios (gearing, interest cover, dividend cover, working capital ratios);
- Analyse free cash flow; and
- Carry out a risk assessment of the business and the market sector.

Examiner's report

This question tests candidates' knowledge of the cost of various sources of debt financing.

Candidates were expected to calculate the relevant yield for each type of debt finance.

Only very few candidates attempted the question with very poor level of performance.

There was a very strong evidence that candidates could not carry out the required level of analysis. The relevant cash flows needed for the yield calculations could not be isolated.

Candidates are advised to practise standard examination questions when preparing for the examinations.

Marking guide

		Marks	Marks
a.	Identification of yield of bank loan	1	
	Computation of yield to maturity of the bond	3	
	More discussion about the queries of director A	2	
	Computation of conversion value	1½	
	Computation of yield of the convertible bond	2½	
	More discussion about the queries of director B	2	
	Discussion about the concerns of director C	2	
	Recommendation	1	15
b.	Discussion on assessing credit-worthiness and further analysis to be undertaken	5	5
	Total		20

SOLUTION 3

a) Depreciation has been included in "other costs" but since it is not a cash flow it must be removed. Annual depreciation using the straight line method is ₦50,000 (₦200,000 – ₦50,000) /3 years).

Revenues and costs need to be further adjusted using the values of receivables and payables to convert them into cash flows.

Calculations follow below:

Year	0	1	2	3	4
	₦	₦	₦	₦	₦
Investment	(200,000)			50,000	
Sales		230,000	350,000	270,000	
Less closing receivables		(20,000)	(30,000)	(25,000)	
Add opening receivables		0	20,000	30,000	25,000
		210,000	340,000	275,000	25,000
Product costs		(144,000)	(222,000)	(166,000)	
Less closing payables		6,000	9,000	8,000	
Add opening payables		0	(6,000)	(9,000)	(8,000)
		(138,000)	(219,000)	(167,000)	(8,000)
Pre-tax net cash flow	(200,000)	72,000	121,000	158,000	17,000
Taxation (see note)		25,800	38,400	31,200	
Less c/fwd		(12,900)	(19,200)	(15,600)	

Add b/fwd		0	12,900	19,200	15,600
Net tax due		(12,900)	(32,100)	(34,800)	(15,600)
Post-tax net cash flow	(200,000)	59,100	88,900	123,200	1,400
Discount Factor	1.000	0.943	0.890	0.840	0.792
PV	(200,000)	55,731	79,121	103,488	1,109
NPV = ₦39,449					

Note: Tax is calculated based on incremental cash profit as follows:

Year 1 (₦230,000 – 144,000) × 30% = ₦25,800

2 (₦350,000 – 222,000)× 30% = ₦38,400

3 (₦270,000 – 166,000)× 30% = ₦31,200

b) If inflation were to become relevant then each of the underlying elements of the project (that is sales and product costs) would need to be inflated by their own respective inflation rates. This may require product costs to be analysed in more detail if different rates of inflation apply.

These would then be converted into cash flows for each year, taking care to ensure that where receipts and payments relate to previous years sales and costs then these are at the money values of the year in which they arose.

The net cash flows of each year would then be discounted using the money cost of capital (that is a rate that includes an allowance for the effects of inflation). This can be calculated as follows:
(1 + real rate) × (1 + inflation rate) = (1 + money rate).

For example, if the real rate is 6% and if inflation is 4% then the money rate is approximately 10%.

c) As the projects are non-divisible, then in a capital rationing situation it is necessary to identify the combinations of projects/investments that are possible within the funding limitations and maximise the total NPV.

Possible project combinations are:

	Investment required	NPV
W & Y	₦400,000	₦102,000
Y & Product	₦300,000	₦66,449

Thus, it is recommended that investments W & Y are undertaken because they yield a higher total NPV.

Examiner's report

This question tests candidates' knowledge of standard investment appraisal.

Part (a) demands the calculation of NPV.
Part (b) asks candidates to explain the treatment of inflation in investment appraisal.
Part (c) deals with elementary single - period capital rationing.

Almost all the candidates attempted the question but surprisingly the level of performance was very poor.

Candidates lost marks due to the following factors:

- Failure to adjust the cash flows for receivables and payables.
- Failure to base tax calculations on incremental cash profits.
- Failure to comply with the timing of tax payment.

In part (b), most of the candidates who attempted the question could not explain the treatment of inflation in investment appraisal.

To hedge against failure in future examinations, candidates are advised to read widely and practise past examination questions.

Marking guide

		Marks	Marks
a.	Computation of depreciation	1	
	Computation of investment and scrap value	½	
	Computation of sales	½	
	Computation of closing receivables	1	
	Computation of opening receivables	1	
	Computation of product cost	1	
	Computation of closing payables & closing payables	2	
	Computation of pre-tax net cash flow	½	
	Computation of taxation	1½	
	Computation of net tax due	2	
	Computation of post-tax net cash flow	½	
	Computation of discount factor	1	
	Computation of PV	½	
	Computation of NPV	1	14

b.	Explanation of appraisal of investment project if inflation is significant	3	3
c.	Identification of possible combination of projects/investments	2	
	Recommendation	1	3
	Total		**20**

SOLUTION 4

a) The treasury function represents one of the two main aspects of financial management, the other being financial control.

Treasury is concerned with the relationship between the entity and its financial stakeholders, which include shareholders, funds lenders and taxation authorities, while financial control provides the relationship with other stakeholders such as customers, suppliers, and employees.

In larger entities, treasury will usually be centralised at head office, providing a service to the various units of the entity and thereby achieving economies of scale. Financial control will frequently be delegated to individual business units, where it can more closely impact on customers and suppliers and relate more specifically to the competition which those units have to face. As a result, treasury and financial control may often be separated by location as well as by responsibilities.

The key tasks of the treasury can be categorised according to the three levels of management as follows:

- Strategic – e.g. matters concerning the capital structure of the business and distribution/retention policies, raising capital, including share issues, assessment of the likely return from each source and the appropriate proportions of funds from each source, the decision as to the level of dividends, and consideration of alternative forms of finance;
- Tactical – e.g. the management of cash/investments and decisions as to the hedging of currency or interest rate risk;
- Operational – e.g. the transmission of cash, placing of surplus cash and other dealings with banks.

Treasurers require specialist skills to be able to handle effectively an ever-growing range of capital instruments. They also need a knowledge of taxation in all areas in which the group operates, and the ability to advise on policies that have taxation implications.

Both the treasurer and the financial controller will usually be responsible to the finance director. An example of how their roles may differ would be: the

treasurer is best able to assess cost of capital and quantify the entity's aversion to risk, while the financial controller relates these factors to group policy.

Advantages to the company of a separate treasury function

1. Control of cash will be recognised as a separate and significant activity, concentrating on the most efficient use of this vital resource.
2. Cash-reporting packages will be receivable in a suitable form and in good time to help management in making effective cash decisions.
3. The function will be geared to the short response times required for cash transactions.
4. As a specialist user, treasury can ensure that information technology software is made available to meet the specific needs of cash/ currency management.
5. Corporate planning staff will be aided by expert advice and quick feedback from specialists in such matters as interest rates and currency movements.
6. Marketing management will be given a competitive edge by specialist expertise and speed of response in making important cash-based decisions, especially with regard to overseas projects and transactions.
7. Treasury could provide a training ground in finance for future line management, as its staff will need to be capable of making quick-but-sound decisions.
8. Treasury could operate as a profit centre.

b) The main advantages of operating treasury as a profit centre rather than as a cost centre are:

- Individual business units of the entity can be charged a market rate for the services provided, thereby making their operating costs more realistic; and
- The treasurer is motivated to provide services as effectively and economically as possible to ensure that a profit is made at the market rate, e.g. in managing hedging activities for a subsidiary, thereby benefiting the group as a whole.

The main disadvantages are:

- The profit concept is a temptation to speculate, e.g. by swapping funds from currencies expected to depreciate into ones expected to appreciate;
- Management time is spent in arguments with business units over charges for services, even though market rates may have been impartially checked (say by the internal audit department); and
- Additional administrative costs may be excessive.

Examiner's report

This is a question of two parts, both dealing with treasury department. Part (a) tests candidates' knowledge of the functions of treasury department. In part (b) candidates were expected to discuss the advantages and disadvantages of operating the treasury department as a profit centre rather than cost centre.

Almost all the candidates attempted the question with average level of performance.

It is apparent that majority of the candidates were ill-equipped in this important area of finance. They therefore failed to pick up easy marks expected in this type of question.

To increase the chance of success in the examination, students need to practise standard examination questions.

Marking guide

		Marks	**Marks**
a.	Explanation of treasury function	3½	
	Describing the main responsibility of treasury department	3	
	Discussion the advantages of a separate treasury function	7½	14
b.	Discussion the advantages & disadvantages of operating the treasury department as a profit centre	6	6
	Total		**20**

SOLUTION 5

a)

- Cost of equity (K_E), using CAPM

  $K_E = 4 + (1.2 \times 5) = 10\%$

- Cost of convertible bonds

  Current market value of bonds =100 × 168/160 = ₦105 per bond

  Current share price = ₦1 billion/200m = ₦5 per share

  VPS in five years' time = ₦5 × 1.04^5 = ₦6.08

  Conversion value = 19 × ₦6.08 = ₦115.52

  Redemption value (assumed at par) = ₦100

  Since the conversion value is higher than the redemption value, it is assumed that the bondholders will likely convert.

  After-tax interest payment = 0.07 × 100 × (1- 0.3) =₦4.90 per bond

  Using linear interpolation:

Year	cash flow	₦	Discount at 7%	PV (₦)
0	Market price	(105.00)	1.000	(105.00)
1-5	Interest	4.90	4.100	20.09
5	Conversion value	115.52	0.713	82.37
				(2.54)

Year	cash flow	₦	Discount at 6%	PV (₦)
0	Market price	(105.00)	1.000	(105.00)
1-5	Interest	4.90	4.212	20.64
5	Conversion value	115.52	0.747	86.29
				1.93

After-tax $K_D = 6 + ((7-6) \times 1.93)/(1.93 + 2.54)) = 6 + 0.43 = 6.43\%$

- **Calculation of cost of preference shares**
  $K_P = 100 \times (0.05 \times 80m/50m) = 8\%$
  Alternatively, the preference dividend per share can be compared with the preference share price to find the cost of preference shares.

- **Calculation of weighted average after-tax cost of capital**
  Total value of company = 1000m+50m+168m=1,218 million
  After-tax WACC = ((10% ×1000) + (8% × 50m) + (6.43% ×168m))/1218m = 9.4%
  It is assumed that the overdraft can be ignored in calculating the WACC, even though it persists from year to year and is a significant source of finance for JP.

b) Market values of different sources of finance are preferred to their book values when calculating weighted average cost of capital (WACC) because market values reflect the current conditions in the capital market. The relative proportions of the different sources of finance in the capital structure reflect more appropriately their relative importance to a company if market values are used as weights. For example, the market value of equity is usually much greater than its book value, so using book values for weights would seriously underestimate the relative importance of the cost of equity in the weighted average cost of capital.

If book values are used as weights, the WACC will be lower than if market values were used, due to the understatement of the contribution of the cost of equity, which is higher than the cost of capital of other sources of finance. This can be seen in the case of JP, where the market value after-tax WACC was found to be 9.4% and the book value after-tax WACC is 8.7% (10% × 320 + 8% × 80 + 6.43% × 160/560).

If book value WACC were used as the discount rate in investment appraisal, investment projects would be accepted that would be rejected if market value WACC were used. Using book value WACC as the discount rate will therefore lead to sub-optimal investment decisions.

As far as the cost of debt is concerned, using book values rather than market values for weights may make little difference to the WACC, since bonds often trade on the capital market at or close to their nominal (par) value. In addition, the cost of debt is lower than the cost of equity and will therefore make a smaller contribution to the WACC. It is still possible, however, that using book values as weights may under – or over-estimate the contribution of the cost of debt to the WACC.

Examiner's report

The question tests candidates' knowledge of the calculations of WACC.
Candidates needed to first calculate cost of the individual capital components and then calculate the WACC.

Large number of the candidates attempted the question with below average level of performance.

Candidates once again lost valuable cheap marks due to the following avoidable mistakes:

- In using CAPM to calculate cost of equity, treating equity risk premium as market return.
- Using nominal values rather than market values
- Failure to identify the appropriate total market values.
- Treating the preference shares as redeemable even when a redemption date was not given.
- Failure to correctly calculate the conversion value of the convertible bonds.
- Failure to adjust for tax in interest.

Cost of capital is a central topic finance and candidates presenting themselves for this examination must be properly grounded in this area.

There is a very high probability of this topic coming out in every examination in one form or the other. Be prepared!

Marking Guide

a.	Computation of cost of equity using CAPM	1	
	Computation of after tax cost of convertible debt	6	
	Calculation of cost of preference shares	1	
	Determination of weights of capital components	1	
	Computation of weighted average cost of capital (WACC)	1	10
b.	Discussion on preference of market value weight to book value weight	5	5
	Total		**15**

SOLUTION 6

a)

i) **Forward Contract**

Since the payment is due in three months, the three-month forward contract should be used. The company is to buy pounds and the currency dealer is selling. We therefore make use of the selling rate of $1.9339.

The cost = £5 million × 1.9339 = $9,669,500

ii) **Currency Futures**

* Buy or sell futures?

You need to sell dollars in other to buy pounds, so we need to buy futures.

* Which expiry date?

The first futures to mature after the expected payment date (transaction date) are choosen. We therefore select the 5-month expiry date.

* How many contracts?

£5,000,000 ÷ £62,500 = 80 contracts

So we buy 80 contracts at $1.9170/£

* Predicted futures rate

Current basis = spot price – futures price = 1.9410 – 1.9170 = 0.0240

Unexpired basis on the transaction date $= \frac{2}{5} \times 0.0240$ = 0.0096

Lock-in exchange rate = opening futures price + unexpired basis

= 1.9170 + 0.0096 = 1.9266

Expected total cost = 5,000,000 × $1.9266 = $9,633,000

iii) **Currency options**

* Put or Call?

We are required to buy pounds so we must buy a call option on pounds.

* How many contracts?

£5,000,000 ÷ £31,250 = 160 contracts

* Which expiry date?

Same as under futures – we select the 5-month expiry date.

* Which exercise price?

We should choose the cheapest one that includes the exercise price and the premium. Since we are buying pounds we add the premium to the exercise price:

Exercise price	+	Premium	=	Net cost
1.9000	+	0.0355	=	1.9355
1.9200	+	0.0232	=	1.9432
1.9400	+	0.0115	=	1.9515

To minimise cost, an exercise price of 1.900 should be selected.

Summary of total cost			**$**
Payment through option	= 5,000,000 × 1.9000	=	9,500,000
Add option premium	= 160 × 31,250 × 0.0355	=	177,500
Net cost		=	9,677,500

Comment and recommendations

Based on cost, currency futures offer the best choice. However, these calculations ignore margin requirements on futures and problems of basis risk.

b) Put delta = 0.45 – 1 = –0.55

Let x = number of puts needed:

Delta of stock = – 110,000

Delta of put = – 0.55 x

Total delta of portfolio = – 110,000 – 0.55x

For delta hedging:

– 110,000 – 0.55x = 0

x = – 200,000 put options

Because this figure is negative, 200,000 put options should be sold.

Examiner's report

The question tests the candidates' knowledge of foreign exchange risk hedging techniques of forward contracts, currency futures contracts, and currency options.

Only about 5% of the candidates attempted the question. It is highly disappointing that despite the fact that the question was a verbatim reproduction of a very recent past question, candidates' performance was unacceptably low. This simply means that students are not making use of the institute's pathfinder.

It is recommended that students should make effective use of study materials provided by the institute.

Marking guide

		Marks	**Marks**
a.	Identification of the appropriate selling rate	1	
	Computing the cost of the forward contract	1	
	Decision to buy or sale futures	½	
	Selecting the 5 months expiry date	½	
	Computation of contract size	½	
	Computation of current basis	1	

	Computation of unexpired basis	1	
	Computation of lock-in exchange rate	½	
	Computation of expected total cost	½	
	Decision to buy or sale option	½	
	Computation of contract size	½	
	Computation of expiry date	½	
	Computation of exercise price	1½	
	Selection of the correct exercise price	½	
	Computation of payment through option	½	
	Adding option premium	½	
	Recommendation	1	
	Total		12
b.	Computation of put delta	½	
	Computation of delta of stock	¼	
	Computation of delta of put	¼	
	Computation of total delta of portfolio	½	
	Computation of delta hedging	½	
	Decision	1	3
	Total		15

SOLUTION 7

a) **Residual theory of dividends**. Dividends are only paid out if the capital needs of the enterprise (i.e. project with positive NPVs) are fully met and there are funds left over. Corporate profits are cyclical, but capital investment plans involve long-term commitments, then dividends take up the slack, as it were.

Financial managers cannot follow both a policy of stable dividends and a policy of long-term commitment to capital investment, unless they are willing to borrow in times of need to achieve both. With an objective of shareholder wealth maximisation, if the enterprise can invest in profitable projects (i.e. in excess of the cost of capital) and earn a higher return than the shareholders can in their alternative investment opportunities, then it should follow such a policy. Issues arise to strengthen and weaken the approach with market imperfections.

b) **Clientele effect**. This is an appealing and persuasive argument that enterprises attract particular types of shareholder by their nature and actions. In this case, the argument is on dividend clienteles, but the clientele argument could apply to leverage, growth enterprises.

The argument runs like this. Enterprises establish a track record for giving or not giving dividends. Shareholders recognise this and because of their preferences - receiving income now instead of the future because they need it for consumption,

or because of uncertainty ('bird in the hand'), or the tax argument - having attracted these clients, companies find it difficult to suddenly change their policy. The empirical evidence on dividend clienteles is generally not supportive.

c) **Asymmetric information**. In the context of dividends and dividend policy, this applies to the fact that shareholders and managers have incomplete and different information. Managers do not know how shareholders will react to a dividend change; likewise shareholders are not party to the information that is available to managers. The result of asymmetry in information is the information content of dividends, where dividends have signalling properties. This is taken up in (d) below.

d) **Signalling properties of dividends**. With asymmetry of information as in (c). above, dividends can be represented as signals from the managers of the enterprise to the shareholders and financial markets. For the successful transmission of the signal, it has to be encoded and decoded. Evidence (from a survey) points to the perception of investors, that dividends are a signalling device of future company prospects. With some exceptions, empirical studies indicate that dividend changes do convey some unanticipated information to the market. There is still some controversy because this would deny the EMH. Thus it might be that dividend announcements do not signal new information but only confirm already known or forecasted events.

e) **The 'bird-in-the-hand' argument**. This arises from the existence of uncertainty. If certainty exists and there are no transaction costs, dividends can be capitalised into the share price as the enterprise invests them internally at NPVs of 0 or greater. If shareholders need the cash now, they engage in a home-made dividend policy ofselling some shares to create the flow of income. With uncertainty, a series of other issues arise:

   i) The required rate of return, KE, rises as dividend pay-out is reduced. Risk-averse investors are not indifferent to the division of earnings into dividends and capital gains in the share price;

   ii) It follows that to offset a 1% reduction in dividends requires a more than 1% increase (in the Gordon model); and

   iii) With volatile stock markets, the maintenance of the increase in share price is not guaranteed. Shareholders may prefer to have the cash and invest it or spend it, particularly with the presence of agency costs.

Examiner's report

The question tests candidates' knowledge of basic dividend concepts.

They were expected to discuss:

- Residual theory of dividends
- Clientele effect
- Asymmetric information
- Signaling properties of dividends, etc.

About 10% of the candidates attempted the question but again the performance level was very low.

It appears that candidates do not understand these concepts despite the fact that they are in the syllabus.

Preparation for the institute's examinations demands a comprehensive coverage of the entire syllabus.

Marking guide

	Marks	Marks
Discussion on residual theory of dividend	3	
Discussion on clientele effect	3	
Discussion on asymmetric information	2	
Discussion on signally properties of dividends	3	
Discussion on the bird-in-the hand argument	4	
Total		**15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2022

ADVANCED AUDIT AND ASSURANCE

Time Allowed: $3^1/_4$ hours (including 15 minutes reading time)

INSTRUCTION: YOU ARE REQUIRED TO ATTEMPT FIVE OUT OF THE SEVEN QUESTIONS IN THIS PAPER

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

A firm of Chartered Accountants has 25 partners and 100 audit staff. The firm provides a range of audit, assurance, tax and advisory/consultancy services. The firm has offices around the country and clients ranging from sole traders to limited liability companies.

The quality control partner has recently resigned. He has not yet been replaced as the Board of Partners of the firm has not been able to find a suitable replacement. Before his departure, the quality control partner was in the process of implementing a system of ethical compliance for assurance staff. Based on the foregoing, staff would be required to confirm in writing their compliance with the Code of Ethics, hence, implementation of this system is incomplete.

Oshodi Plc is one of the firm's largest clients for which the firm provides audit, tax and other advisory services. A new engagement partner has been assigned to the audit, as the previous partner in charge was the one who resigned. The fee for the audit work and other services has been set at the same level as the previous year in spite of the fact that additional work will need to be performed because Oshodi Plc has introduced a new computerised system. The starting date of the audit has been delayed due to problems with the new system. The management of Oshodi Plc was very insistent that the fee should not be increased as a result of this.

Required:

Discuss the requirements of ISQC 1: *International Standard on quality control on overall audit firm level*, which address each of the following:

a. Leadership responsibilities for quality (3 Marks)
b. Ethical requirements (5 Marks)
c. Acceptance and continuance of engagements (5 Marks)
d. Human resources (5 Marks)
e. Engagement performance (5 Marks)
f. Monitoring (4 Marks)
g. Documentation (3 Marks)

(Total 30 Marks)

SECTION B: OPEN-ENDED QUESTIONS (40 MARKS)

INSTRUCTION: YOU ARE REQUIRED TO ATTEMPT ANY TWO OUT OF THE THREE QUESTIONS IN THIS SECTION

QUESTION 2

Pegrace Nigeria Limited (PNL), your audit client, is a national hotel group with substantial cash resources. Its accounting functions are well managed and the group's accounting policies are rigorously applied. The company's financial year end is December 31.

The company has been seeking to acquire a construction company for some time in order to bring in-house the building and refurbishment of hotels and related leisure facilities, like swimming pools, volley ball court and restaurants. The management has recently identified Robin Construction Company Limited (RCCL), as a potential target and has urgently requested that you undertake a limited due diligence review.

Further to the preliminary talks between the management of RCCL and PNL, you were provided with the following brief on Robin Construction Company Limited:

(i) The Chief Executive, Managing Director and Finance Director are all family members and major shareholders. The company has an established reputation for quality constructions;

(ii) Due to a recession in the building business, the company has been operating at its overdraft limit for the last 18 months and has been close to breaching debt obligation on several occasions;

(iii) Robin's accounting policies are generally less prudent than those of Pegrace (assets are depreciated over longer estimated useful lives);

(iv) Contract revenue is recognised on the percentage of completion method, measured by reference to costs incurred to date. Provisions are made for loss-making contracts;

(v) The company's management team includes a qualified and experienced quantity surveyor, whose main responsibilities are:
- Supervising quarterly physical counts at major construction sites;
- Comparing costs to date against quarterly rolling budgets; and
- Determining profits or losses, by contract, at each financial year end; and

(vi) Labour force is provided under subcontracts. During construction, the regulatory body visited the site and discovered non compliance with site health and safety regulations.

In February 2021, Robin received a claim that a site on which it built a housing development in Banana Estate was not properly drained and is now sinking. Residents are demanding rectification and asking for payment or damages. Robin has referred the matter to its legal counsel and denied all liability, as the site

preparation was subcontracted to Sahara Services Company Limited. No provisions have been made in respect of the claims, nor has any disclosures been made.

The auditor's report on Robin's financial statements for the year ended December 31, 2020 was signed, without modification, in March 2021.

Required
With reference to the above scenario:

a. Prepare a document to give the explanatory meaning of the term 'due diligence' and subsequently discuss items to investigate in a due diligence exercise. (12 Marks)

b. Advise on how to recognize, measure, present and disclose leases as required by IFRS 1 (8 Marks)

(Total 20 Marks)

QUESTION 3

Tijara Nigeria Limited has a credit facility of ₦6 million with Godiya Bank. The facility was due to expire on December 31, 2021. The overdraft in the recently audited statement of financial position as at September 30, 2021 is ₦5.5 million. The directors of Tijara have started negotiations with their bankers for a renewal of the facility and to increase the amount to ₦9 million. To support this request, the bank has asked Tijara to provide a business plan for the coming twelve months consisting of a cash flow forecast supported by a forecast income statement and statement of financial position.

The management of Tijara has produced a cash flow forecast for the period October 1, 2021 to September 30, 2022 and, at the request of the bank, has asked an auditor to examine and report on it.

The Audit Manager, who has recently completed Tijara audit, has been asked to make a preliminary examination of the cash flow forecast and supporting materials. The manager has made the following observations:

(i) The cash flows from sales are based on the assumption of an overall increase in sales of 24% compared to the previous financial year. Analysis shows that this is based on an increase in selling price of 5% and an increase in the volume of sales of 18%. Just over a quarter of all Tijara sales are made to foreign customers;

(ii) The cost of sales in the recently audited comprehensive income to September 30, 2021 was 80% of sales revenue, giving a gross profit of 20%. In the forecast income statement for the year to September 30, 2022 the cost of sales has fallen to 72%, giving a gross profit of 28%. Manufacturing costs are made up of equal proportion of materials, labour and production overheads;

(iii) The trade receivables collection period used in the cash flow forecast to September 30, 2022 is 61 days. In the year to September 30, 2021, this period averaged 93 days. Management has stated that it is its intention to inform all customers of a new standard 60-day credit period. In addition, an early settlement discount of 1% will apply to customers who settle their accounts within 30 days of the statement. Conversely, the credit period for trade payables has been extended from an average of 45 days in the current year to 90 days in the forecast; and

(iv) The cash flow forecast showed that the maximum credit required during the period would rise to nearly ₦9 million in August 2022.

Required:

a. Describe the general approach to the assurance work an auditor should consider before accepting the engagement of a reporting accountant on Prospective Financial Information (PFI) ISAE 3400: *The examination of prospective Financial Information.* (8 Marks)

b. Detail the procedures applicable to cash flow forecast of Tijara for the year to September 30, 2022. (7 Marks)

c. Prepare a summarised presentation of what the reporting accountant should consider in forming an opinion on pospective financial information (PFI). (5 Marks)

(Total 20 Marks)

QUESTION 4

The idea to incorporate Peters & Shamsudeen Haulages Limited was mooted in London and it was incorporated on the return of Alhaji Shamsudeen to Nigeria. He met Peters during his stay in the UK. They had good relationship which started in a coffee shop. As they met regularly in this shop, what to do on Alhaji Shamsudeen's return to Nigeria became the subject of discussion. Based on their experiences, the idea of Peters & Shamsudeen Haulages Limited was birthed. Alhaji Shamsudeen subsequently returned to Nigeria, incorporated the company, obtained the appropriate expatriate quota and Mr. Peters came in and started running the company. On commencement, Sejumade Uzoma & Co was appointed the company's external auditors. Whilst Mr. Peters was around, there was a good working relationship between the company and the audit firm.

After about nine years, Mr. Peters returned to UK leaving the company in the hands of Alhaji Shamsudeen. Subsequently, Sejumade Uzoma & Co started receiving complaints from Alhaji Shamsudeen and his key accounting staff. These complaints were rife even before the ninth month of the current year that Sejumade Uzoma & Co. decided not to continue with the engagement. The audit fee for the previous year had about thirty percent outstanding at this stage.

This was the position when Alhaji Shamsudeen approached your partner at Musa, Edewo & Co. (Chartered Accountants). Their discussion was fruitful for your firm, hence it was agreed by the partners that full professional procedures would be applied as normal. Part of the information available on interaction is that the year is almost ending and there was uncertainty about the firm that will do the audit before the engagement of your firm. You have the responsibility of assisting your partner in ensuring that proper documentations would be done without any compromise.

Required:

a. According to professional requirements, discuss the issues your firm is expected to address in her correspondence with Sejumade Uzoma & Co. (10 Marks)

b. Evaluate the various circumstances that would lead to change in professional appointment. (5 Marks)

c. In consideration of the client, analyse the procedures necessary for proper client identification in accordance with anti-money laundering requirements. (5 Marks)

(Total 20 Marks)

SECTION C: OPEN-ENDED QUESTIONS (30 MARKS)

INSTRUCTION: YOU ARE REQUIRED TO ATTEMPT ANY TWO OUT OF THE THREE QUESTIONS IN THIS SECTION

QUESTION 5

The Companies and Allied Matters Act, 2020 has classifications and responsibilities for various types of companies incorporated under it. A particular class that has received more attention in recent times and in the Act is small companies.

Your audit team has been approached by a few of these small companies for guidance on the issue and your team has been assigned this responsibility. Part of the concerns of your firm is whether or not those small companies merit the concerns of regulatory authorities and the accounting firms that have to be responsible for their audit.

Your team has a number of young assistants who are yet to understand the differences and therefore need enlightment on this as part of the training programmes.

Required:

a. Discuss the arguments for and against the exemption of small companies from audit. (10 Marks)

b. On the basis that an audit may be conducted for a small entity, evaluate the points the auditors would consider. (5 Marks)

(Total 15 Marks)

QUESTION 6

The accountancy profession earns confidence and public respect partly as a result of its self regulatory mechanism, application of legal principles and professional standards.

This issue became a subject of discussion when a group of business owners who just incorporated their companies were deliberating on who should carry out an audit and what are the guiding principles for determining the performance of such responsibility.

Required:

a. Prepare a manual to enable the discussants understand this professional members eligibility to act as an external auditor. (9 Marks

b. Discuss the objectives of an auditor in accordance with ISA 200: *Overall objectives of the independent auditor and the conduct of an auditor in accordance with International Standards on Auditing.* (6 Marks)

(Total 15 Marks)

QUESTION 7

BARCHI International Limited is a company with corporate registrations in both United Kingdom (U.K.) and Nigeria. The Chairman of the company is based in Nigeria and from time to time, travels to the U. K. to oversee the office there and order for the purchase of some of the articles for sale. To ensure steady supply of the products, some of the products are also ordered from China. The purchases from U.K. are charged to the Nigerian entity in pound sterling, while the purchases from China are charged to the Nigerian company in American dollars.

In September, 2020 the Chairman embarked on a trip to Dubai for two weeks where he spent part of his annual holiday. During this period, he hosted a couple of friends with the costs that were paid for by the company as the costs were above his approved annual holiday expenses. He subsequently traveled to UK and was quarantined for two weeks due to COVID-19 before moving to the usual business lodge that he uses. Despite using that period to oversee the UK company, all the costs incurred were borne by the Nigerian company.

The products bought in UK and sent to Nigeria were charged at cost plus 25%, while the Nigerian company was responsible for insurance and freight. The goods purchased from China were forwarded to Nigeria at cost of landing in Nigeria plus 30%. The China-made products are less expensive and therefore give better profits despite the cost of the long distance freight.

Money was transferred to the Chairman's account for the company's purchases in UK, the purchases made in China and the chairman's personal expenses. An agent in China bought the goods which were paid for by the Chairman.

The UK company staff handled the documentation of all the transactions of the Chairman while there and transferred them to Nigeria subject to the approval of the Chairman.

Separate records were not maintained for the Chairman's expenses in the UK. However, his comparison of the results of the two units showed that for the immediate past financial year, the Nigerian company had performed sub-optimally and way below the targeted profit in relation to the UK company. The Chairman is very unhappy about this as he expects that his personal visit to UK would reduce the purchasing and associated costs. It is usual for the Chairman to account for the cost of purchases based on his personal expenses attributable to each purchase together with the actual cost of purchases. The UK component is elated about this costing method which favours it and would wish that this arrangement continues. The two units prepare separate financial statements which are audited by separate accounting firms before the two financial statements are consolidated in Nigeria for the Chairman's evaluation.

Required:

Evaluate, with appropriate justifications, from the scenario above, the areas of risk which the auditor needs to consider. **(15 Marks)**

SECTION A

SOLUTION 1

The quality control procedures that are applied within audit firms will reflect the nature and size of the audit practice. However, personnel within the firm who are responsible for establishing and maintaining quality control procedures must have an understanding of the entire text of ISCQ 1. As the firm must meet the requirements of ISQC 1, it should have a system in place which addresses each of the following elements:

- Leadership responsibilities for quality;
- Ethical requirements;
- Acceptance and continuance of engagements;
- Human resources;
- Engagement performance;
- Monitoring; and
- Documentation.

The requirements of ISQC 1 in each of these areas are considered below:

(a) **Leadership responsibilities for quality**

i. ISQC 1 requires a firm to establish policies and procedures designed to promote an internal culture recognizing that quality is essential;

ii. Ultimate responsibility for quality control policies and procedures should rest with the firm's CEO (or equivalent) or Board of Partners (or equivalent); and

iii. Any person who has operational responsibility for quality control Should have appropriate experience, ability and the necessary authority.

(b) **Ethical requirements**

i. ISQC 1 requires a firm to establish policies and procedures to comply with relevant ethical requirements thus:
   - Communicate its independence requirements to staff, and
   - Identify and evaluate circumstances and relationships that create threats to independence, assessing the impact of such threats and applying safeguards or withdrawing from the engagement if appropriate.

ii. ISQC 1 requires a firm to maintain independence where required to do so by the following requirements:
   - Staff to notify the firm of circumstances and relationships that might create a threat to independence;
   - Staff to notify the firm of any breaches of independence of which they have become aware;

- The firm to communicate such breaches to the engagement partner and other relevant staff; and
- The engagement partner to advise the firm of action to be taken.

(c) Acceptance and continuance of engagements

ISQC 1 requires the firm to establish policies and procedures to provide it with reasonable assurance that the firm will only take on or continue work where the firm:

i. Is competent to perform the engagement;
ii. Has the capabilities (including the necessary resources) to do so;
iii. Can comply with the relevant ethical requirements; and
iv. Has considered the integrity of the client and does not have information which would lead it to conclude that the client lacks integrity.

The policies and procedures should require the firm to:

i. Obtain sufficient information to make such decisions (for new or existing engagements);
ii. Consider potential conflicts of interest and therefore, decide whether or not it should accept the engagement; and
iii. Document all identified issues and how they were resolved.

Before the start of the audit each year, the engagement partner for the audit should:

i. Ensure that all members of the audit team are independent of the client and there are no conflicts of interest; and
ii. Be satisfied with the ethical integrity of the client entity and its management.

(d) Human resources

ISQC 1 requires the firm to ensure that:

i. It has sufficient personnel with the competence, capabilities and commitment to ethical principles to meet its overall quality control objectives;
ii. For each engagement an appropriate engagement partner and team are assigned;
iii. Policies should therefore exist for the recruitment, training and development of staff. The firm should ensure compliance with ISAs and audit staff should have a good knowledge of accounting standards and local/national statutory accounting regulations;
iv. The firm's technical auditing procedures should be set out in a manual and reinforced by training. Newsletters and/or meetings could be used as a means of ensuring that professional staff are kept up-to-date on current developments;

v. Work should be assigned to staff that are competent to perform that work; and
vi. There should be procedures for ensuring that an audit team collectively has the appropriate level of technical knowledge for the audit engagement and includes individuals with experience of audits of a similar complexity, and an ability to apply professional judgment.

(e) Engagement performance

Policies and procedures are required to include:

i. Those to promote consistent quality engagement performance;
ii. Supervisory responsibilities;
iii. Review responsibilities (on the basis that more experienced team members review the work of less experienced team members);
iv. Guidance on consultation to ensure that:
    - Appropriate consultation takes place on difficult or contentious matters;
    - Sufficient resources are available for such consultation;
    - The nature, scope and conclusions of the consultation are documented (by both parties); and
    - Conclusions arising from the consultation are implemented.
v. Guidance on engagement quality control reviews to ensure that:
    - An engagement quality control review is required for audits of all listed entity clients;
    - Criteria are established to determine which other engagements should be subject to an engagement quality control review;
    - The review covers certain procedures (the same as set out in ISA 220);
    - Engagement quality control reviewers are eligible to carry out such reviews via technical qualifications, experience, authority and objectivity from the engagement; and
    - Engagement quality control reviews are properly documented.
vi. Procedures for dealing with any differences of opinion between the engagement team and those consulted or between the engagement partner and the engagement quality control reviewer; and
vii. Procedures in respect of completion of the final audit files on a timely basis and the confidentiality and safe custody of such documentation for an appropriate period.

(f) Monitoring of quality control

This procedure should ensure that:

i. The firm is required to establish a monitoring process designed to provide it with reasonable assurance that its quality control system is relevant, adequate and operating effectively. This process should

include inspecting, on a cyclical basis, at least one completed engagement for each engagement partner;

ii. Responsibility for the monitoring process should be given to a partner or other appropriate person with sufficient experience and authority. When monitoring reviews (also referred to as 'cold reviews') are carried out they should not be performed by those involved with the engagement or the engagement quality control review;

iii. The firm should evaluate the effect of any deficiencies found to determine if they do indicate a failing in the firm's quality control system;

iv. The firm should communicate such deficiencies to relevant personnel, together with appropriate remedial action such as:
   - Action in relation to individual engagements or employees;
   - Communication of findings to those responsible for training and professional development;
   - Changes to the firm's quality control system; and
   - Disciplinary action, especially against repeat offenders.

v. If the results of monitoring procedures indicate that an inappropriate report may have been issued, or procedures were omitted during the engagement, the firm should determine what further action is needed. This might include obtaining legal advice;

vi. The firm should produce an annual report for partners setting out:
   - The monitoring procedures performed;
   - The conclusions drawn; and
   - Any systematic deficiencies found and remedial action taken.

vii. The monitoring system should include procedures for dealing with complaints and allegations against the firm. These should include establishing channels through which employees can come forward without fear of reprisals.

(g) Documentation of quality control procedures

The following matters are required to be documented:

i. Evidence of the operation of each element of the system of quality control;

ii. Complaints and allegations made against the firm and how these were resolved; and

iii. Documentation must be retained for a sufficient period of time, as a minimum to comply with relevant laws and regulations.

Examiner's report

The question tests candidates' knowledge on ISQC 1: *Quality control for firms that perform audits and reviews of financial statements and other assurance and related service engagements.*

This being a compulsory question, about 95% of the candidates attempted it but the performance was below average despite the fact that some components of the same ISQC 1 was tested about two diets ago.

The commonest pitfalls of the candidates were their lack of essential knowledge of the components of quality control and their application in relation to the audit of financial statements.

Candidates are advised to familiarize themselves with the relevant aspects of the ingredients required in the review of financial statements as contained in appropriate standards. They should also study the Institute's Study Text and Pathfinders.

Marking guide

		Marks	**Marks**
a.	**Leadership responsibility for quality**		
	(i) Requirement for policies and procedures	1	
	(ii) Requirement for quality control	1	
	(iii) Operational responsibility	1	3
b.	**Ethical requirements:**		
	- Requirements to establish policies and procedures (1 mark each subject to a maximum of 2 points)	2	
	- Requirement to maintain independence (1 mark each subject to a maximum of 3 points)	3	5
c.	**Acceptance and continuance of engagement**		
	- Policies and procedures to provide reasonable assurance. (2 points out of 4 @ 1mark each)	2	
	- Policy requirements of the firm (2 points out of 3 @ 1 mark each)	2	
	- Responsibility of Exchange Partner (1 mark each for any 1 point)	1	**5**
d.	**Human resources**		
	(1 mark each subject to a maximum of 5 points)		5
e.	**Engagement performance**		
	Discussion of these policies and procedures:		
	First three policies (1 mark for each point)	3	
	Other policies (1 mark each for any 2 points)	2	5

f. **Monitoring of quality control procedures**
Discussion on these procedures
(1 mark each subject to a maximum of 4 points) 4

g. **Documentation of quality control procedures**
Discussion on the procedure
(1 mark each subject to a maximum of 3 points) 3

Total **30**

SOLUTION 2

(a) Due diligence:

(i) Refers to any engagement where the practitioner is engaged to make inquiries into the accounts, organization or activities of an entity;

(ii) Involves obtaining information about the target company, prior to the takeover (or merger). The objective should be to find out everything that may be relevant about the target company's operations, financial performance, financial position and future prospects. In addition, information should also be gathered about the business environment in which the target company operates;

(iii) Implies that the practitioner will also interview the senior management of the target company, other key employees and possibly external third parties. Due diligence work does not involve tests of controls (unless the client specifically asks for this), nor does it involve substantive testing. Due diligence work is not a form of audit work;

(iv) Main objective is often to provide information that will allow the client to decide whether a takeover or merger is actually desirable, and if so, whether the proposed cost of the acquisition is reasonable; and

(v) On presentation of an adverse or critical report may, therefore, result in:

(i) Abandoning a proposed takeover or merger, or
(ii) Reducing the offer price for the acquisition.

Items to investigate in a due diligence exercise include:

(i) **Financial performance and financial position.**
The practitioner will look at the available historical financial information about the target company, such as its financial statements for the past few years. Ratio analysis will often be used to make an assessment. The practitioner will also look at the target company's management accounts, budgets and profit/cash flow forecasts, and any current business plan.

(ii) **Operational issues**

The practitioner should also look for any operational issues in the target company that may raise questions about its value. For example, the target company might have important contracts with major customers, and the practitioner should try to find out when these contracts reach their termination dates and the probability that the contracts will be renewed. Other operational problems may be discovered, such as a high rate of labor turnover, or high costs incurred in meeting warranties or guarantees to customers.

(iii) **Management representations**

Management of the takeover target may have provided representations to the potential buyer. For example, they might have given a written assurance that the target company is not subject to any tax investigation or potential litigation. Due diligence work should seek to establish that these representations appear to be correct.

(iv) **Identification of assets.**

A takeover usually results in purchased goodwill in the consolidated accounts. However, the takeover target may have several intangible assets that do not appear in its statement of financial position (because they were internally-generated assets) but which should be recognized for the purpose of consolidation. Examples are internally-generated patent rights, customer lists and databases and brand names.

These should be identified and valued, for inclusion in the consolidated statement of financial position after the acquisition. It is also useful for the management of the potential buyer to be aware of the nature and estimated value of the intangible assets that they would be acquiring.

(v) **Benefits and costs of a takeover**

Due diligence may also include an attempt to estimate the future benefits of the takeover, such as cost savings from synergies and economies of scale. Any 'one off' expenses, such as redundancy costs and reorganization costs will have to be estimated by the potential buyer if not by the due diligence process.

Advice on how to recognize, measure, present and disclose leases as required by IFRS 16:

i. **Recognition of lease**

IFRS 16 "leases", requires that a lessee (a customer) should recognise a right-of-use asset and lease liability in every lease contract. However, IFRS 16 permits the lessee to expense short term lease and low value lease in the statement of profit or loss.

ii. **Measurement**

- IFRS 16 requires that the right-of use asset should be initially measured at cost. The cost of the right-of use asset is the present value of the lease payments plus directly attributable costs incurred by the lessee. After the initial recognition, IFRS 16 requires that the right-of use asset should be measured, using the cost model of IAS 16 "Property, Plant and Equipment" at cost less accumulated depreciation and accumulated impairments.

- The lease liability should be initially measured at the present value of lease payment and subsequently measured using the amortized cost method of IFRS 9 "Financial Instruments".
- The entity must demonstrate that the application of the Standard to a portfolio is done on the basis of a reasonable expectation that the effects of so doing would not differ materially from the application of the rules to individual leases. This will require the entity to construct representative samples and evaluation for them to support their assertion. Has the auditor examined these, perhaps forming their own samples, in order to conclude whether the materiality of any difference is acceptable?
- Are those previous determinations of "arrangements" (contracts) that whilst not legally a lease, are nevertheless in substance, a lease, still applicable under IFRS 16?
- There is a preference for discounting, using the interest rate implicit in the lease, but as an alternative, if the interest rate implicit is not determinable, then the lessee's incremental borrowing rate is used. Has any such rate taken into account not just an observable current interest rate, but also adjusted for factors unique to the lease (e.g. the lessee's credit standing, the amount being borrowed, the term of the borrowing, the quality of any collateral etc.)? and
- Are the portfolio groupings of leases that share similar characteristic appropriate?

iii Presentation and disclosure requirements include:

- The description of the lease arrangement;
- The amount of depreciation charge on the right-of use asset;
- The amount of interest expense on the lease liability;
- The amount expense relating to short term lease and low; value lease during the year; and
- The additions of right-of use asset during the year.

Examiner's report

The question tests the candidates' knowledge of the meaning of due diligence, and the items to investigate in a due diligence exercise. Candidates are also required to recognise, measure, present and disclose leases as required by IFRS 16.

About 70% of the candidates attempted the question and the performance was average.

The commonest pitfall of the candidates was their lack of adequate knowledge of standards and the specific ingredients required of leases.

Candidates are advised to review relevant standards that are essential for professional practice and appraise themselves with the Institute's provided study materials.

Marking guide

		Marks	Marks
a.	**Explanatory meaning of due diligence**		
	(1 mark each subject to a maximum of 4 points)	4	
	Items to investigate in a due diligence exercise		
	(Identification of any 4 points @ 1 mark each)	4	
	Discussion of each of the 4 points identified		
	(1 mark each for any point)	4	12
b.	**Recognition, measurement, presentation disclosure of leases by IFRS 16**		
	i. Recognition of lease	2	
	ii. Measurement		
	(2 marks each subject to a maximum of 2 points)	4	
	iii. Presentation and disclosure requirements		
	(1 mark each subject to a maximum of 2 points)	2	8
	Total		**20**

SOLUTION 3

(a) The general approach to the assurance work should be similar to the approach for audit work or other assurance work, but with some modifications to allow for the specific nature of the work.

Procedures will include the following:

i. Where the audit firm has no previous knowledge of the entity, it should obtain sufficient knowledge of the entity and its environment;

ii. If best estimate assumptions have been used in preparing the prospective financial information (PFI) (a forecast), the auditor should seek evidence to support these estimates;
iii. If hypothetical assumptions have been used to prepare a projection, the auditor should assess whether they are realistic and sensible, and whether the full implications of the hypothetical assumptions have been properly reflected in the PFI;
iv. The auditor should assess whether the PFI contains all the relevant material items and that nothing of significance has been omitted;
v. If part of the 'future period' in the forecast or projection has already passed, the auditor should review the actual results for that part of the period, and compare actual results with the forecast or projection. The differences will help the auditor to assess the reliability of the forecast or accuracy of the projection;
vi. The auditor should also check the arithmetical accuracy and consistency of the projected financial information that has been prepared;
vii. The auditor should obtain representations from management on:
    - Management's acceptance of responsibility for the information
    - The intended use of the information
    - The completeness of the assumptions that we were made to prepare the PFI;
viii. Many of the points relevant to deciding whether to accept any audit or assurance engagement will apply to accepting a PFI assurance engagement;
ix. Issues to consider will include, for example:
    - The availability of resources and staff with the necessary expertise;
    - The time scale for the completion of the engagement; and
    - Agreeing a fee for the work with the client;
x. The accountant should also establish with the client the form that the assurance report should take. It is particularly important that the client should understand that in a review of forward-looking information, only negative assurance can be provided;
xi. The client should also be informed that the audit firm will comply with the requirements of ISAE 3400 when reviewing the prospective financial information; and
xii. An engagement letter should be agreed and signed by both parties before the work is actually started.

(b) Procedures in a PFI engagement of Tijara

There are several specific points that might apply to PFI engagements:

i. Understanding the nature of the information to be examined;
ii. Establishing the intended use of the information (and the intended recipients of the final report);

iii. Establishing whether the information will be for general distribution or limited distribution to a small number of users;
iv. Evaluating the nature of the assumptions that have been made by management (whether they are best estimate assumptions for a forecast, or hypothetical assumptions for the purpose of making a projection);
v. Determining the time period covered by this information. When deciding the nature, timing and extent of the procedures required to complete a PFI assurance engagement, the auditor should consider the following issues;
vi. Ascertaining the likelihood of material misstatement in the forecast or projection;
vii. Applying the knowledge that the auditor has obtained during any previous similar engagements;
viii. Evaluating the competence of the client's management with regard to the preparation of PFI;
ix. Determining the extent to which the PFI is affected by management's judgment (in other words, to what extent does the PFI depend on judgment about best estimates or hypotheses); and
x. Assessing the adequacy and reliability of the underlying data and assumptions that have been used as the basis for preparing the prospective financial information.

(c) The summarized presentation of what the reporting accountant should consider in forming an opinion on PFI are:
i. A reference to the ISAE;
ii. A statement that management is responsible for the PFI, including the assumptions on which it is based;
iii. A reference to the purpose of the PFI and/or the restricted; distribution of the report (and the PFI) to a limited number of users;
iv. A statement of negative assurance as to whether the assumptions that management have made provide a reasonable basis for the PFI; and
v. An opinion as to whether the PFI is properly prepared on the basis of these assumptions, and whether the PFI is presented in accordance with the relevant financial reporting framework.

Examiner's report

The question tests candidates' knowledge on the approach the auditor should take in accepting engagements of a reporting accountant on prospective financial information (PFI), procedures applicable in cash flow forecast and what to consider in the presentation of an opinion on PFI.

About 50% of the candidates attempted the question and the performance was average.

The commonest pitfall of the candidates was their lack of understanding of relevant standards, guidelines on acceptance and performance of assurance engagements and the reporting procedure of such engagements.

Candidates are advised to endeavour to read widely, study the relevant standards and guidelines for practice. They should study the Institute's study text and Pathfinders.

Marking guide

		Marks
a.	**Procedures to the PFI**	
	Description of the general approaches to assurance work	
	(1 mark each subject to a maximum of 8 procedures)	8
b.	**Procedures in a PFI assurance engagement**	
	(1 mark each subject to a maximum of 7 points)	7
c.	**Summarised presentation on forming opinion**	
	(1 mark each subject to a maximum of 5 points)	5
	Total	**20**

SOLUTION 4

(a) Musa, Edewo & Co (the prospective firm) should communicate with the current auditors (Sejumade Uzoma & Co) to establish if there are matters that they should be aware of when deciding whether or not to accept the appointment.

This is in line with the professional requirements. The issues that will be addressed in the correspondence will include the following:

i. Professional clearance from the current auditors before accepting the audit engagement;
ii. Any known problem or anticipated problem areas concerning the audit from the current auditor;
iii. Any disputed issue concerning outstanding audit fee;
iv. Request for previous audit working papers of the past audit exercise concerning the client; and
v. Request for cooperation from the current auditor regarding access to necessary information and explanation on the past audited financial statements.

(b) Practicing professional accountant member may be asked to accept a new audit appointment in a situation where the previous auditor (old auditor) will not be reappointed. This may be for any of the following reasons:

i. The current firm is too small to cope with the demands of an expanding client (who now operates from multiple locations, in different towns or countries);
ii. There may be change in the composition of the company's board of directors, and the new directors wish to appoint an auditor of their own choice;
iii. There may be a perceived lack of independence, possibly one that has just arisen;
iv. There may have been a disagreement between the directors and the 'old' audit firm (for example, over the accounting treatment of an item in the financial statements);
v. Where there is a regulatory restriction on the current auditor not to continue in office;
vi. There may have been a loss of confidence in the 'old' audit firm;

(b) In order to comply with anti-money laundering regulations, the audit firm should carry out client identification procedures. The purpose of these procedures is to confirm that the client 'is who he says he is', and that there are no grounds for suspicion in the case of a company.

The procedures include:

i. If the client is a company or other business entity, documentary evidence of the identity of the entity should be obtained – for example, a certificate of incorporation in the case of a company;
ii. Evidence should be obtained to confirm the address of the entity, such as letterhead;
iii. In the case of officials of the client, evidence of identity can be obtained from a passport or driving license, and evidence of address (possibly) from a recent utility bill;
iv. The audit firm should consider whether the business of the potential new client 'makes commercial sense'. It would not make sense for a very large company to be engaged in operating a number of dry cleaning shops, because the size of the company would most probably be too large for the nature of its business operation. When this happens, the client's declared business may simply be a front or cover for hidden illegal activities; and
v. In most cases, the client identification procedure should be a formality, but the client may be surprised that they are necessary. The audit firm should explain the regulatory purpose of client identification, to remove any doubts or concerns that the new may have.

Examiner's report

The part (a) of the question tests candidates' knowledge of the issues to discuss in correspondence with previous auditors; while (b) tests issues that would lead to changes in professional appointment. The part (c) requires the candidates to explain test procedures for proper client identification in accordance with anti-money laundering requirements.

Almost 85% of the candidates attempted the question and the performance was good.

The commonest pitfall of the candidates was the lack of detailed knowledge of new client engagement procedures and the anti-money laundering regulations.

Candidates are advised to devote time to their studies and to go through ICAN Study Texts and Pathfinders.

Marking guide

		Marks	Marks
a.	**Communication with previous auditor**		
	Explanation of points to establish	2	
	The requirements to be addressed in the correspondence (2 marks each subject to a maximum of 4 requirements)	8	10
b.	**Basis for change of appointment**		
	(1mark each for any point)		5
c.	**Client identification in accordance with anti-money laundering requirements**		
	(1mark each subject to a maximum of 5 points)		5
	Total		**20**

SOLUTION 5

(a) Arguments for audit exemption for small entities

There are various arguments in favour of the view that small companies should be exempted from statutory external audits. These include:

i. Audit costs are high: the resources could be spent by smaller entities to obtain more useful financial services;

ii. Providers of loan finance (for example, banks) will normally attach their own specific conditions to borrowings. These conditions are often independent of the content of the borrower's financial statements; and

iii. Many countries allow smaller companies to publish 'abbreviated' financial statements. Consequently, only a limited amount of audited information is available to users of the statements.

Arguments against audit exemption for small entities

There are also various arguments against the view that small companies should have an exemption from statutory external audits. Some of these arguments emphasize the potential benefits of annual audits. The argument are:

i. An audit provides some assurance that this provide a true financial statements and fair view and do not contain material misstatements;
ii. The audit is valuable, especially to user groups other than the shareholders (such as trade suppliers, tax authorities), by giving them some reassurance about the financial statements of small entities;
iii. Shareholders, especially minority shareholders, should be entitled to receive financial statements from the entity that have been independently audited;
iv. The external audit imposes a level of discipline on companies, in matters relating to accounting and internal control. The auditors can advise management on ways of improving internal control;
v. The audit may identify areas, where efficiency and cost savings can be made by the entity. These savings would have the effect of reducing the overall cost of the audit;
vi. If a small company expects to approach its bank to ask for loan finance, the bank may demand to see audited financial statements (for the purpose of assessing the loan application);
vii. The tax authorities accept audited financial statements as a valid basis for computing the company's tax liability. However, in Nigeria, none of submission of financial statements would lead to the use of 'Best of judgement' assessment to determine the tax liability of a taxpayer; and
viii. If the small company expects to grow, it will become large enough at some time in the future to require a statutory annual audit. If there are material errors in its financial statements, the cost of its first statutory audit could be high.

(b) Evaluation of points the auditor would consider

Standard audit practice requires the auditor to gain an understanding of the business and its environment in developing an audit strategy. Applying this principle to the audit of smaller entities will allow the auditor to focus attention on the main features of the client, which will affect the audit approach.

The points the auditors will consider include:

i. Segregation of duties which is likely to be weak, due to the restricted numbers of staff employed by smaller entities;
ii. Proprietors or senior management are likely to dominate all major aspects of the business activities. This is useful as a form of supervisory

control, but the internal controls over management themselves are likely to be very weak and ineffective;

iii. In an expanding business, senior management may be closely involved in developing the business, leaving them with little time for supervisory controls or for implementing and monitoring other controls; and

iv. Record keeping and documentation of system and controls may be informal and inadequate. This further weakness the internal control system.

Examiner's report

The question test candidates' knowledge of the requirements of CAMA 2020 concerning the audit of small entities.

More than 80% of the candidates attempted the question but the performance was just below average.

The commonest pitfall of the candidates was their inability to identify the points an auditor will consider to gain an understanding of the business and its environment in developing an audit strategy.

Candidates are advised to carry out a thorough preparation and acquaint themselves with new laws and regulations, paying attention to the study materials provided by the Institute.

Marking guide

		Marks	Marks
a.	**Arguments for and against audit exemption for small activities**		
	Argument for		
	(1 mark each for any point)	3	
	Arguments against		
	(1 mark each subject to a maximum of 7 points)	7	10
b.	**Evaluation of the points the auditor would consider for the conduct of an audit**		
	Introductory statement	2	
	Other points		
	(1 mark each subject to a maximum of 3 marks)	3	5
	Total		**15**

SOLUTION 6

(a) Eligibility to act as an external auditor is considered from different regulations.

(i) Self-regulation by the audit profession

Eligibility to act as an external auditor is usually determined by membership of an appropriate 'regulatory body', such as ICAN.

The role of such regulatory bodies normally includes the following:

- Offering professional qualifications for auditors, to provide evidence that auditors possess a minimum level of technical competence; and
- Establishing procedures to ensure that the professional competence of auditors is maintained. This includes matters, such as:
  - Ensuring that audits are performed only by 'fit and proper' persons, who act with professional integrity;
  - Requiring that the members carry out their audit work in accordance with appropriate technical standards (for example, in accordance with International Standards on Auditing, known as ISAs);
  - Ensuring that auditors remain technically competent and up to date with modern auditing practice (for example, by following a programme of continuing professional development);
  - Providing procedures for monitoring and enforcing compliance by its members with the rules of the regulatory body. This includes rules and procedures for the investigation of complaints against members and the implementation of disciplinary procedures where appropriate; and
  - Maintaining a list of 'registered auditors', which is made available to the public. Such a system is referred to as a system of self-regulation. In such a system, the regulation of auditors is carried out by their own professional bodies.

ii) Regulation by government

The government may appoint a public body with similar responsibilities to a self-regulating professional body, such as the Financial Reporting Council of Nigeria (FRCN). The public body may, therefore, establish rules and procedures:

- For approving/authorising individuals to perform audit work;
- For ensuring that authorized auditors have the necessary

minimum skills and knowledge to carry out their audit work to a proper standard; and

- For handling complaints and taking disciplinary measures against auditors, where appropriate. In addition, it is usual for statute law to establish that certain individuals are ineligible to act as an external auditor in the context of a given company, even if they are a member of an appropriate regulatory body. These exclusions are designed to help to establish the independence of the auditor.

Based on section 403 of CAMA 2020, the following individuals are prohibited by Nigerian law from acting as an auditor of a company:

- An officer or servant of the company;
- A person who is a partner of or in the employment of an officer or servant of the company; or
- A body corporate;
- A person does not qualify for appointment as an auditor of a company if he is:
  - A debtor to the company or its subsidiaries in an amount exceeding ₦500,000;
  - A shareholder and his spouses;
  - A person who has an interest in the keeping of the register of holders of debentures of the company; and
  - An employee of or consultant to the company who has been engaged for more than one year in the maintenance or preparation of any of its financial statements/records.

(b) ISA 200: Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing

The objectives of the auditor, per ISA 200 are:

i. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. This allows the auditor to give an opinion on whether or not the financial statements have been prepared in accordance with the applicable financial reporting framework; and

ii. To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.
Where the auditor is unable to obtain reasonable assurance and a qualified opinion is insufficient, the auditor must disclaim an opinion or resign.

ISA 200 requires the auditor to:

(i) Comply with all **ISAs** relevant to the audit;

(ii) Comply with relevant **ethical requirements;**
(iii) Plan and perform an audit with **professional skepticism;**
(iv) Exercise **professional judgement** in planning and performing an audit; and
(v) Obtain **sufficient and appropriate** audit evidence to allow him to obtain reasonable assurance.

Examiner's report

The question (a) tests candidates' knowledge on the eligibility to practice as an external auditor based on legal and ethical requirements while (b) tests the overall objectives of an independent auditor in accordance with ISA 200.

About 60% of the candidates attempted the question and the performance was average.

The commonest pitfall of the candidates was their inability to evaluate the eligibility to practice from both the professional and governmental regulations, and the requirements of the relevant standards.

Candidates are advised to go through ICAN Study Text and other relevant reading materials when preparing for future examinations.

Marking guide

		Marks	Marks
a.	**Eligibility to act as external auditor**		
	Self regulation by the audit profession		
	- Membership of appropriate regulatory body	1	
	- The role of regulatory bodies (1mark each subject to a maximum of 4 points)	4	
	Regulation by government:		
	- Regulatory body such as FRCN	1	
	- Different points from the procedure, section 403 of CAMA 2020 (1mark each for any 3 points)	3	9
b.	**Overall objectives of the independent auditor by ISA 200**		
	Objectives		
	- Reasonable assurance	1	
	- Report on financial statements	1	
	- Opinion on inability to obtain reasonable assurance	2	
	- Activities on the requirements of ISA 200		
	- (1mark for any point)	1	6
	Total		**15**

SOLUTION 7

Areas of risk to consider by an auditor in the given scenario include:

a. **Foreign exchange risk**
The purchases from UK are charged to the Nigerian entity in pound sterling while the purchases from China are charged to the Nigerian company in American dollars. There seems to be no measures in place to manage the risk of foreign exchange conversion. The treatment of forex gains or losses in the financial statements may result in material misstatements depending on the volume of transactions;

b. **Internal control risk**
Lack of segregation of functions. Activities are over-concentrated on the Chairman. All activities are either undertaken by the chairman personally or solely approved by him;

c. **Financial statement risk (over/under statements)**
Balances such as bank and accounts payable are likely to be misstated as substantial parts of the company's banking transactions and trade payables were routed through the Chairman's personal bank account rather than the company's records. Proper bank reconciliation exercise cannot be conducted under the circumstance;

d. **Risk of overstatement of Nigeria operating expenses**
The costs during the period the chairman spent to oversee the UK company are all borne by the Nigerian company. UK procurement expenses being channeled to the Nigerian company will result in the overstatement of the Nigerian company expenses;

e. **Risk of understatement of UK expenses**
There is the risk of understatement of UK expenses especially as it relates to bank charges on foreign procurements as those charges will mostly reflect in the Chairman's personal account. The UK expenses charged to the Nigerian company will understate UK expenses;

f. **Risk of understatement of Nigeria expenses**
Expenses especially as it relates to bank charges on foreign procurements as those charges will mostly reflect in the Chairman's personal account rather than the company's records;

g. **Lack of adherence to entity concepts**
The entity concept is not adhered to. The company is not being treated as an entity that is separate from its owner. Money being transferred to the Chairman's account for the UK company's purchases, the Chinese purchases and the chairman's personal expenses could lead to overstatements of expenses.

Separate records were not maintained for the chairman's expense while he traveled abroad;

h. **Possible money laundering activities by the Chairman**
Money is transferred to the Chairman's account for the UK company's purchases, the Chinese purchases and the chairman's personal expenses. These could lead to possible money laundering activities;

i. **Corporate governance risk**
There is a risk that good corporate governance practices are not followed which may lead to the failure of the organization. There is absolute power and authority vested in the Chairman. There is no mention of the existence of Internal Audit function to vet or review the transactions undertaken by the chairman;

j. **Risk of understatement of UK company's activities**
Incomplete records of the UK company's transactions will result in the understatement of the UK company's liabilities and purchases as procurements and accounts payable transactions are charged to the Nigerian company;

k. **Risk of misallocation of costs**
There is wrong costing method resulting from the allocation of costs. This method favors the UK company to the detriment of its Nigerian counterpart;

l. **Exchange translation risk**
Sub optimal results due to the arbitrary determination of costing method and estimates such as the charging of the UK procurements to the Nigerian company at cost plus 25% while the purchases from China are transferred to the Nigerian company at expected cost of landing in Nigeria plus 30%;

m. **Incomplete recording**
Audit risk arising from Incomplete and inaccurate recording of transactions and poor audit trail. Sufficient appropriate audit evidence is lacking in this environment, which increases audit risk as the auditors are likely to express inappropriate opinion due to the fact that the financial statements may be materially misstated in either or both companies;

n. **Risk of increased cost from COVID-19**
The effect of COVID-19 creates additional costs and risks which impact on measurement of operational activities. Costs are incurred and benefits were not derived. Choosing to travel at that times when there were travel challenges creates a business risk;

o. **Different reporting requirements**
Because the two companies are operated under different reporting requirements, the combination for proper comparison would present a financial statement risk.

The Nigerian audit firm that is putting together the financial statements would be relying on the objectivity of the UK audit firm; and

p. **Risk of different basis of measurement**
Proper business valuation for the purpose of ascertaining net worth could be impaired due to the different measurement scenarios in the conduct of business and measurement of the different units. This portends a financial statement risk.

Examiner's report

The question tests the candidates' ability to evaluate business risks from a scenario.

About 60% of the candidates attempted the question and the performance was above average.

The commonest pitfall was the candidates' inability to identify issues that portend risk to a business.

Candidates are advised to go through ICAN Study Text and other relevant reading materials to enhance their performance in future.

Marking guide

	Marks
Identification of areas of risk in the business scenario:	
Identification of 10 risks	
(½ mark each subject to a maximum of 10 points)	5
Discussion of each of the 10 points identified	
(1 mark each subject to a maximum of 10 points)	10
Total	**15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2022

CASE STUDY

Time Allowed: 4 hours (including reading time)

INSTRUCTION: YOU ARE TO USE CASE STUDY ANSWER BOOKLET FOR THIS PAPER

Pre-seen

This material is issued prior to the examination date to enable candidates familiarise themselves with the case scenario so as to undertake any research and analysis they think fit. This pre-seen part of the Case Study examination is also published on the Institute's website: www.ican.org/students.

You **MUST NOT** bring this material with you to the Examination Hall. On receipt of the material, you are to spend the few days to the examination date to familiarise yourself with the information provided, carry out additional research and analysis about the industry and analyse the financials provided in preparation for the examination. Candidates should note that the use of pre-seen part of the Case Study will not significantly help them in their preparation for this examination. It is essential that they carry out sufficient analytical work on their own in order to have a good understanding of the pre-seen part of the case scenario.

At the start of the examination, candidates will receive the complete case scenario which will include both the pre-seen and the unseen which includes the requirements. You must use the answer paper provided by ICAN in the Examination Hall. Any solution presented with other papers **WILL NOT** be assessed.

Assessment of the Case Study

The marks in the Case Study examination are awarded for professional skills and are approximately allocated as follows:

Assimilating and using information	20%
Structuring problems and solutions	20%
Applying judgement	20%
Drawing conclusions and making recommendations	20%
Demonstrating integrative and multidisciplinary skills	10%
Presenting appropriate appendices	10%

Ethical issues do not form a specific requirement, as this is deemed to have been tested in other subjects of the ICAN professional examination, but will be tested within a requirement which may include the following areas:

- Lack of professional independence or objectivity;
- Conflicts of interest among stakeholders;
- Doubtful accounting and/or creative accounting practice;
- Unethical business/commercial practice; and
- Inappropriate pressure to achieve a reported result.

Candidates should note that marks are not awarded for just simply restating facts from the case scenario but are awarded for demonstrating professional skills and technical depth. Therefore, to succeed, candidates are required to:

- Show sufficient evidence of knowledge of the case scenario;
- Carry out analyses of the issues involved and suggest feasible solutions to the problems identified;
- Demonstrate ability to make informed judgement on the basis of analyses carried out; and
- Generate conclusions upon which relevant recommendations are made.

Omission of any of these instructions will adversely affect the candidate's performance in the examinations.

May 2022 Case Study: Best Price Fashions Limited (BP Fashions)

List of exhibits

1 About you (Tunde Taiwo) and your employer, Okelola, Idemudia, Seidu & Co, (Chartered Accountants)

2 Nigerian fashion industry

3 Best Price Fashions Limited (BP Fashions)

4 BP Fashion's management accounts – 2018 to 2020

Exhibit 1

About you (Tunde Taiwo) and your employer (Okelola, Idemudia, Seidu & Co)

You are Tunde Taiwo, writing the Professional level of ICAN examination. You are working in the Lagos office of Okelola, Idemudia, Seidu & Co (Chartered Accountants) which has its offices in all the state capitals of Nigeria. You are reporting to Dasuki Seidu, the partner in charge of the business advisory unit of the firm. Your responsibilities include:

- Preparing detailed financial analyses and reports on the performance of your business advisory clients;
- Analysing your clients' financial statements to identify areas of weakness and proffering likely solutions to correct the anomalies;
- Assessing operational and strategic business proposals submitted by clients to see how each aligns with the client's objectives and its impact on its business and financial risks;
- Assessing clients' financial and business forecast together with the assumptions upon which they are based to form judgements and recommendations to your partner; and
- Drafting reports to be submitted to clients on the result of clients' financial, operational and strategic business analyses you have carried out.

Your responsibilities demand that you keep yourself abreast with your clients' industries and external (national and global) operating environments, so as to be able to carry out the above tasks effectively.

Exhibit 2

Nigerian fashion industry

The fashion industry in Nigeria plays an important cultural role and contributes significantly to the country's economy. Casual attire is commonly worn, but formal and traditional styles are also worn, depending on the occasion. Clothing incorporates a variety of colours, fabrics, and embellishments (often beads). Many of the component cultures of Nigeria wear styles that are unique to their tribal societies and customs. Nigeria is known not only for its fashionable textiles and garments, but also for its fashion designers who have increasingly gained international recognition.

The worldwide fashion industry has been estimated to be worth over $3.5 trillion, with Africa's share estimated at less than 1% of the total. Euromonitor suggests that the fashion market in Africa is worth $31 billion, with Nigeria accounting for 15% of the $31 billion, that is $4.7billon.

Growth in the industry

Nigerian fashion industry has grown rapidly within a decade. Since 2010, statistics from the Nigerian Bureau of Statistics (NBS) indicated that the textile, apparel and footwear sector of the economy has an average growth rate of 17% per annum. This rise has not only been as a result of an increase in demand, but also partly by unprecedented initiatives that continue to push Nigeria into global fashion consciousness. This is being championed by events, such as "Lagos Fashion Week" through its annual run-way shows and incubator style techniques being used to grow brands.

With increasing population which is primarily a young population, Nigeria is home to Africa's fastest-growing fashion industry. The Nigerian fashion business is booming and it does not appear to be slowing down anytime soon. Rising internet broadband access, the ease with which young people can buy their favourite fashion styles online, etc., have been recognised as contributing to and will continue to contribute to the industry's growth.

Challenges of the fashion industry

Despite perceived growth in the industry, there have been many challenges which, if tackled properly, would result in much more contribution of the industry to the nation's gross domestic product (GDP). Each component of the value chain of the industry currently has significant deficiencies. Cotton farming in Nigeria, for example, is at an all-time low, and despite rhetorics to the contrary, textile production in the country is still small.

Another challenge is that we are unable to create the basic fabrics and must therefore import them. In general, the raw materials required to manufacture textiles are imported into the country. Although the Nigerian cotton textile market was booming in the 1960s and 1970s, unfortunately, we were unable to match the demand for textile materials as our population continues to rise. Also, lack of infrastructure to support manufacturing industry, (such as power and good roads, increase in exchange rate, lack of investment in manufacturing and lack of government backing for the textile industry's growth) has led to the collapse of the industry. This has led to the need to import textiles and fabrics to feed the fashion industry.

Although, President Muhammadu Buhari signed Executive Order 003 of 2017, which made it mandatory for government ministries, departments and agencies (MDAs) to stop importing their uniforms from overseas, this has remained active only on paper. As at today, most MDAs of government still import their uniforms from abroad despite local capacity for such apparels.

In the same way, the procurement of school uniforms from abroad by many private schools and rising dependency on used clothing and apparels by many Nigerians continue to undermine the growth of the textile sector. For African prints like "*Ankara*", operators noted that distributors have broken the value chain and now import directly from China with made-in-Nigeria labels.

Data from the National Bureau of Statistics showed that Nigeria's importation of textile materials had been on the rise, with the country importing ₦200.6 billion worth of goods as at Q3 of 2020, whereas, the country only exported a paltry value of ₦5.05 billion worth of goods during the same period.

Despite the government ban on importation of finished textiles to protect local manufacturers and designers, smuggled goods continue to make inroads into the country through Benin Republic, Chad and Niger borders, costing the economy at least $4 billion yearly. **(Adapted from "why textile sector is on brink despite interventions", by Femi Adekoya and Saxone Akhaine, retrieved online on September 5, 2021).**

Exhibit 3

Best Price Fashions Limited (BP Fashions)

HISTORY

Best Price Fashions (BPF) Limited was established in 2005 by four friends, who also constitute the board of directors of the company. The first store was opened in Lagos in January, 2005, while another one was opened in Abuja in March 2005. BP Fashions specialises in men and women casual and corporate wears. In January 2010, a specialist men accessories store was opened by BP Fashions, catering for both cultural and corporate men's accessories in Lagos and Abuja. Later in the year, BP Fashions opened "Women Collections" in both Lagos and Abuja as well.

BP Fashions currently has 14 stores spread all over Nigeria. Only Lagos and Abuja have separate stores for men accessories and women collections. In the other cities, men accessories and women collections are operated as departments in BP Fashions stores.

Directors

The directors of BP Fashions and their shareholdings are as follows:

Name	Designation	Shareholding
Marian Dagogo	Managing Director	25%
Mary Adesola	Concept/Design Director	25%
Helen Thomas	Finance Director	25%
Sola Martins	Inventory/Procurement Director	25%

Business model

- **People:** People are our greatest assets. We are transparent, authentic, open to new ideas and take responsibility. Therefore, our people are simply innovative.
- **Customers:** Customers are the life blood of our business. They deserve the best service and should enjoy the experience of being in our stores. So, we serve our customers as kings and queens.
- **Merchandise:** Product range should be fashionable, excellent in quality, aspirational, value for money and simply authentic.
- **Retail footprint:** We seek prestigious locations in the commercial hub of each city. Our reach extends beyond bricks and mortar, as we engage our customers through social media. Our virtual showroom is second to none in the industry

Stores

BP Fashions operates three types of store as follows:

- Men and women clothing;
- Men accessories; and
- Women collections.

BP Fashions currently operates from 14 stores across the country. There are three stores each in Lagos and Abuja, as BP Fashions operates from different building for each type of store in Lagos and Abuja. While the stores located in other cities have separate departments for men and women clothing, men accessories and women collections.

Strategy

- Customer experience: Our customers window shop with our competitors and make their purchases from our stores.
- Of course, we do not provide credit facility to customers because we are not in banking business, but simply a retailer.
- We carry out intense analysis of our customers' buying patterns and product sales data to identify "winners" and "losers" early and react early enough.
- Listening to customers and employees is our hobby as they provide the best feedback.
- We keep up our social media platforms and spurn traditional advertising.
- Our practice is to visit our competitors' stores at least, once a month.

Key risks

- Increasing competition from global fashion brands that have entered the country's market directly.
- Customer spending is linked to underlying economic conditions – economy in recession for some time now.
- Fashion industry is notoriously fickle, making forecasting trends and anticipating demand difficult, and any misjudgment could lead to short-term losses/declining profit.
- Increasing overhead costs due to high inflation, volatile fuel prices, rising electricity costs, may impact operating margins, as all cost increases may not result in price increase.

Exhibit 4

Best Price Fashions Limited

Summarised financial information
Income statement

	2018 Audited ₦m	2019 Audited ₦m	2020 Management ₦m
Revenue	2,952	3,510	4,139
Cost of sales	(1,402)	(1,671)	(1,987)
Gross profit	1,550	1,839	2,152
Other income	15	21	25
Operating costs:			
Employee costs	(390)	(460)	(538)
Occupancy costs	(262)	(312)	(373)
Other operating costs	(278)	(326)	(389)
EBITDA	635	762	877

Summarised financial information
Statement of financial position

	2018 Audited ₦m	2019 Audited ₦m	2020 Management ₦m
Property, plant and equipment	375	470	470
Deferred tax	30	35	40
Non-current assets	405	505	510
Inventories	425	525	655
Trade and other receivables	125	150	175
Cash and equivalents	425	545	780
Current assets	975	1,220	1,610
Total assets	**1,380**	**1,725**	**2,120**
Share capital and reserves	885	1,135	1,430
Long term loans	125	125	125
Employees' benefits	20	35	50
Deferred tax	55	65	70
Non-current liabilities	200	225	245
Trade and other payables	270	335	410
Tax payable	25	30	35
Current liabilities	295	365	445
Total equity and liabilities	**1,380**	**1,725**	**2,120**

Note: Interest on the term loan is 21% per annum and companies income tax rate is 32%. You can assume that the tax written down value of the company's assets is equal to the carrying amount.

UNSEEN

May 2022 Case Study: Best Price Fashions Limited (BP Fashions)

List of exhibits

The following exhibits are newly provided and did not form part of the material provided as Pre-seen:

5 Email from Dasuki Seidu to Tunde Taiwo

6 Email from Helen Thomas to Dasuki Seidu

7 Best Price Fashions – key financial indicators

8 Proposed diversification into garment industry

9 Financial information of the proposed "Project Fit"

10 Special order from the Federal Ministry of Education

11 Treatment of certain items under IAS 2

12 Inventory obsolescence allowance

Best Price Fashions Limited (BP Fashions): Case Study requirement

You are Tunde Taiwo, a final level trainee ICAN Chartered Accountant working in the Lagos office of Okelola, Idemudia, Seidu & Co (chartered accountants). One of your clients is Best Price Fashions Limited, a company which runs retail fashions stores across Nigeria. You report to Dasuki Seidu, partner in charge of the business advisory unit of the firm.

Requirement

You are required to prepare a draft report for the BP Fashions' board, as set out in the email dated October 6, 2021 from Dasuki Seidu to you (**Exhibit 5**). Your report should comprise the following:

- An executive summary
- Responses to the two detailed requirements set out in Exhibit 5, including appropriate appendices.

State clearly any assumptions you have made. All workings should be attached to your answer.

The following time allocation is suggested:

Reading and planning	1 hour
Performing calculations and financial analysis	1 hour
Drafting report	2 hours

Marks allocation

All marks in the Case Study are awarded for the demonstration of professional skills, allocated broadly as follows:

a.	Applied to the four elements of your report (as described above)	
	Assimilating and using information	20%
	Structuring problems and solutions	20%
	Applying judgement	20%
	Drawing conclusions and making recommendations	20%
		80%
b.	Applied to your report as a whole	
	Demonstrating integrative and multidisciplinary skills	10%
	Presenting appropriate appendices	10%
		100%

Ensure that you address the two requirements in your report, failure to address any requirement or not submitting an executive summary will adversely affect your chances of success. In addition, as indicated above, all four skills areas will be assessed under each of the four elements of your reports. Accordingly, not demonstrating your judgement or omitting to include appropriate conclusions and/or recommendations in each of your reports will adversely affect your chances of success.

Exhibit 5

Email from Dasuki Seidu to Tunde Taiwo

From: Dasuki Seidu
To: Tunde Taiwo

Sent: October 6, 2021

Subject: Best Price Fashions Limited

I have just received an email from Helen Thomas, BP Fashions' finance director, asking us to evaluate the company's financial performance, from 2018 to 2020 and benchmark them with equivalent reports of three of their major competitors, based on selected key financial indicators, attached **(Exhibit 7)**. The company will also want us to evaluate two business proposals **(Exhibits 8 -10)** and report on our findings. Also, Helen would want us to comment on their application of IAS 2 to certain items in the management accounts **(Exhibit 11)**, as well as assisting the company in evaluating the adequacy or otherwise of the company's inventory obsolescence allowance for 2020 **(Exhibit 12)**. She is willing to provide more details from the company's inventory management system to assist us in this regard.

I am attaching to this email, **Exhibits 6 to 12** in respect of the above.

Please draft for my review, a report addressed to the board of Best Price Fashions. The report should comprise:

1. Evaluation of the company's performance in the previous three years (2018 – 2020), using the key financial indicators provided and benchmark same with equivalent figures from three of the company's major competitors. Also, let me have your comments on the treatment, in the management accounts, as mentioned by Helen, the three items covered by IAS 2. Furthermore, let me know other reports we may need to ask for, from BP Fashions' Information Systems Manager, to enable us properly evaluate the inventory obsolescence allowance in the 2020 financial statements, as requested by Helen.
2. Evaluate the two business proposals, in financial terms and make appropriate recommendations to the board of BP Fashions. Also, review the key risks that may be associated with these two proposals and advise the board on how to manage the identified risks.

I will expect your report in the next two weeks to enable me carry out a review and submit to Helen, for BP Fashions' board in the next three weeks. In case you need any clarifications, feel free to see me.

I look forward to receiving your draft report.

Seidu

Exhibit 6

Email from Helen Thomas to Dasuki Seidu

From: Helen Thomas – Finance director – Best Price Fashions Limited.

To: Dasuki Seidu – Partner – Okelola, Idemudia, Seidu & Co.

Subject: Business Advisory

Date: October 4, 2021

Seidu,

Our board will be meeting in a month's time to consider our performance in the preceding years and to take decisions on two major business opportunities. Therefore, as usual, the board would like you to review our performance in the last three years, based on some key financial indicators, attached as exhibit 7 and to benchmark them with those of our three major competitors, attached as part of exhibit 7.

The board would also like you to carry out evaluation of two business proposals BP Fashions intends to explore in the coming year. First, is the decision of the board to go into garment production, using technology as the spring board, details of which are in exhibits 9 and 10. The second proposal relates to an order we received from the Federal Ministry of Education for the supply of school uniforms and house wears to unity schools. This is one of the advance orders we have received in connection with our proposed garment industry. Details of this order is in exhibit 11.

Furthermore, issues regarding treatment of some items, as mandated by IAS 2, have been generating debate at the board meetings, therefore, I would like you to give your opinion on these issues, as listed in exhibit 12. In the same vein, our auditors have expressed some reservations on the figure for inventory obsolescence we provided in the 2020 financial statements, I therefore include details about how I arrived at the figure, as additional notes for your evaluation and suggestions. Our Information Systems Manager, Tade Sobayo, will be ready to provide you with any other report you may need from our inventory management system, to assist you in this regard.

I will be looking forward to the receipt of your report on the above issues. I need to receive your report on time before our next board meeting, which comes up in four weeks' time.

Thanks for always being there for us.

Helen

Exhibit 7

Best Price Fashions

Key financial indicators

	2018	2019	2020
Revenue growth			
Gross profit margin			
EBITDA growth			
EBITDA/Revenue			
Numbers of stores at year end	14	14	14
Average store size	400m^2	400m^2	400m^2
Trading density (revenue/m^2)			
Inventory turnover			
Trade receivable days			
Trade and other payable days			
Return on equity			

Competitors' key indicators

	Penny 2019	Stores 2020	Value 2019	Plus 2020	Fashion 2019	Extra 2020
Number of stores	12	14	7	10	27	31
Cash sales ratio (%)	82%	75%	30%	35%	76%	81%
Average revenue per store (₦m)	16	16.5	17	17.2	21	23
Average store size (m^2)	450	446	475	485	376	382
Gross profit margin	41.1%	41.6%	52.5%	51.8%	43.6%	45.8%
EBITDA	18.5%	18.9%	21.2%	20.8%	11.5%	12.8%

Exhibit 8

Proposed diversification into garment industry

Best Price Fashions Nigeria Limited has just taken a decision to diversify into the garment production industry. This is because the company has discovered a good opportunity in the industry as a result of recent global demand and discussions on African inspired clothing, which has led to tremendous boost in sales for brands and products of some African designers, whose works have caught the eyes of international celebrities, such as Beyonce, Michelle Obama, Rihanna and Thandie Newton.

The new project will be the production hub for BP Fashions, which will market the garments. The project will be driven by what we have termed "Project Fit". The idea is to use big data to analyse our customer measurement data and using that data to manufacture better fitting garments and also offer a more personalised service to our customer. This project will also enable the company to go into the production of uniforms which are currently being imported into the country. The uniforms being used by most international private schools, government colleges and uniformed men in Nigeria are being imported into the country. Therefore, this project, when fully implemented will be able to save the country's foreign exchange earnings.

Our overall strategy is to combine technology, modern design and African craftmanship to produce beautifully made, ready to wear fashion and accessories. Therefore, we are going to leverage on modern technologies, such as the internet, big data, data analytics, e-commerce, etc.

Business model

Our design ethos will all be about rich textures, fabulous fabrics, and modern femininity and the total man. Each production will be inspired by the everyday woman with global outlook, she is the working mum, the boss chick, the graduate in her first job, the high-powered executive, while our man is the total man, the upcoming corporate executive, the man with a social outlook and the board room icon. Our key strategy is to focus on the customer, our passion is to make sure that we provide and cater for our customer's fashion needs.

Customer focus

Although our primary focus will be on the Nigerian markets and secondarily African, but we want to position the company as a global business. We hope to grow our international business by revenues, site visitor number and social media followership. We will introduce fabrics that are truly African but with international appeal.

Production and marketing process

We are revolutionising the design, production and marketing of garments. Most fashion designer brands take between 12 – 18 months before they are released into the market, but we are going to reduce this to approximately two weeks. The design process will start with the design team thinking about what we really want to wear or whose style we are passionate about. Our idea is on designing and making what you want to wear right now.

The collection is then broken down into technical packs and sent to the factory for a sample to be made. Once the sample is ready, we will fit our moulds on different bodies. This is part of our approach, ensuring that sizes reflect the customers' body shapes.

Once the fit test is done, the sample is sent to the studio to be photographed for our website. This is then produced, after we have carried out quality check and checked again for fit. We shall operate a fast fashion model, so each piece is made in small runs with new styles hitting the website on a weekly basis.

Success factor

We have a very clear vision on how to disrupt one of the largest and most profitable markets in Africa, indeed in the world, fast fashion by the use of data and vertical integration. Our fashion products, which will be designed in-house will be adapted to better serve local market needs and we shall use data in transformative ways, from gathering data on real men and women's measurements to develop better fitting clothes for all body shapes, and using data to understand consumer demands and making clothes suited to local trends. These will allow us to be able to deliver a much more personalised shopping experience than customers currently get offline.

We are repositioning our website and virtual showrooms to enable us achieve our goal. Our website will become more robust and user friendly, with a great front desk appeal. Our vision is to use our virtual showroom to understand our customers through their visits, build our customer base and win the customers' love.

We believe that the major driver of growth is going to be online, and more specifically, mobile.

(Adapted from "Meet the Woman Disrupting the African Fashion Industry with Technology" by Mfonebong Nsehe. Retrieved online from https://www.forbes.com › mfonobongnsehe)

Exhibit 9

Financial information of the proposed project "Fit"

1. **Project costs**
   a. **Capital costs:** The capital costs are as follows:

      Building - ₦40m;

      Equipment – industrial sewing machines and other auxiliary equipment - ₦50m;

      Design equipment - ₦10m;

      Studio equipment - ₦20m;

      Showroom equipment - ₦10m;

      Website development and virtual showroom - ₦10m; and

      IT equipment (hardware and software) - ₦10m.

   b. **Working capital:** The initial working capital is estimated to be ₦25m.

2. **Operational costs:** The following operational costs are projected:
   a. Materials – 30% of selling price;
   b. Labour – from design to production – 20% of selling price;
   c. Marketing cost (variable) – 5% of selling price;
   d. Overheads (75% fixed and 25% variable) – 20% of selling price.

3. **Revenue structure**

a.	Men's casual	₦5,000 per piece
b.	Men's corporate	₦25,000 per suit
c.	Men's shirt	₦5,000 per piece
d.	Men's traditional wear	₦25,000 and above
e.	Women casual	₦6,000 per piece
f.	Women's corporate	₦20,000 per suit
g.	Women's blouse/shirt	₦4,000 per piece
h.	Women's traditional wear	₦20,000 and above
i.	School uniform	₦5,000 per pair
j.	School's house wear	₦3,000 per piece.

4. **Sources of fund:** The company will finance the project from retained earnings and term loan from the bank. However, the directors have decided to use 21% weighted average cost of capital to evaluate the project.

5. **Sales forecast:**

The following sales forecast have been made, based on three demand levels, as follows:

Demand level	**Sales value**	**Probability**
	₦m	**%**
High	250	25
Moderate	150	50
Low	100	25

Market research has indicated that the above sales forecast will grow by 10% per annum from year 2 and will continue to year 5.

6. **Payback period**

The company intends to use five years payback period to evaluate this project.

Exhibit 10

Special order for school uniforms from the Federal Ministry of Education

Based on the website set up for the garment outfit by Best Price Fashions, the Federal Ministry of Education has contracted the company for production of uniforms for its unity schools – Federal Government Colleges – across the 36 states of the country.

Details of the order are as follows:

Quantity:	School uniform – 120,000 pairs (for both male and female students); and House wear – 120,000 pieces (for both male and female students).
Price:	School uniform at the company price per pair less 25% discount; and House wear at the company's price per piece less 30% discount.
Colour:	The shirts and blouses will be white, while trousers and pinafores will be sky blue.
Contract period:	This order will be for a period of ten years, but supply will be made every two years. However, contract for each supply will be executed separately.
Textile:	Shirts and blouses will be made of cotton materials, while the trousers, knickers and pinafores will be made of woolen synthetic material.
Payment terms:	50% order value will be paid on signing the contract while the balance 50% will be paid after delivery to the ministry's store is confirmed.
Performance bond:	Best Price will be expected to submit to the ministry a performance bond from any reputable bank, covering the 50% deposit.
Contract period:	Supply is expected to be completed between June and September in each year of supply within the ten-year contract period.
Quality:	The ministry expects Best Price to produce to the standard of the quality of textile and sewing submitted as samples to the company by the ministry.

Bank charges: The bank will charge 1% fee of the value of each bond executed.

Exhibit 11

Treatment of certain items under IAS 2

I need your opinion on three specific areas in IAS 2. These are:

(a) **Storage costs** – IAS 2 states that storage costs should be excluded from the cost of inventories. To me, that makes no sense when it comes to management decision making and control. For example, at BP Fashions, our business is seasonal and we need to order and store large quantities of products for a number of months. Therefore, the cost of storage is inextricably linked to the cost of merchandise – to include these costs in other operating costs would not be reflecting the true cost of our merchandise;

(b) **Inventory write-offs** – IAS 2 maintains that obsolescence allowance, inventory write-offs and shrinkage in the cost of inventories be expensed. However, I think inventory write-offs are the result of poor planning by the buyers. So, there is no reason punishing sales department for higher inventory costs when the Buyers made the mistake. I therefore think reporting inventory write-offs as a separate line item in other operating costs in our monthly management accounts provides a better information. Also, you will agree with me, inventory write-offs are so easy to manipulate from year to year, by varying our procedures for identifying slow moving inventory so as to achieve a desired level of gross profit percentage; and

(c) **Royalties**: BP Fashions has numerous licencing agreements with foreign brands and we pay royalties on the brands. IAS 2 states that royalties paid to our foreign suppliers be included in the cost of inventories. However, royalties are paid when we sell merchandise and not when we order and store merchandise. If we do not sell the merchandise, we do not pay royalties. Therefore, I think we should report royalties paid as a selling expense in our management accounts.

Obviously, I know we will need to comply with IFRS for our financial reporting purposes, but we can differ from IFRS in our management accounts as I believe, we do not have to manage our business using illogical principles.

You may also give your opinion on my interpretation of IAS 2 on the above items.

Exhibit 12

Inventory obsolescence allowance

Our external auditors, Oluleke, Chukwuma & Co, are currently concluding the audit of 2020 financial statements. The auditors are however, concerned with possible misstatement of the inventory obsolescence allowance and have asked me to have a look at the figures again and confirm that there is no misstatement.

The following is our computation of obsolescence allowance for the financial year:

Stores	**Total inventory balance (per inventory age analysis**	**Obsolescence allowance**	**Allowance as % of total inventory**
	₦	**₦**	**%**
Men and women clothing	53,633,560	2,681,678	5
Men's accessories	8,520,120	170,402	2
Women's collection	7,421,942	148,439	2
Total	69,575,622	3,000,519	4.3

I would appreciate your assistance with the review of the reasonableness of the obsolescence allowance. Additional information on inventory, to assist you in this regard, is attached to this email.

Email attachment

Inventory obsolescence allowance – additional notes

I think the following additional notes will be of assistance to you on the review of our inventory obsolescence allowance:

1. I arrived at the figure of ₦3,000,519 as follows:

    a. For men and women clothing stores: The allowance was determined as 30% of the cost of all inventory held for longer than six months. This was based on the inventory balance in the '180 days or more' column in the inventory age analysis at December 31, 2020;

    b. For Men Accessories and Women Collection Stores: A list of inventories sold below cost in January 2021 was generated from the inventory management system. The difference between the total of the selling prices and cost prices revealed by the report, ₦318,841, was used as the inventory obsolescence allowance.

You can rely on the accuracy of these calculations.

2. Our inventory management system in BP Fashions is very robust and it is capable of generating any inventory-related report.

3. In case you need further report from the inventory management system, to assist you in consideration of the sufficiency of the obsolescence allowance, Tade Sobayo, our Information System Manager, will be ready to assist you. Just send to him the list of such reports.

4. The following reports have already been extracted:

    a. Details of inventory balances at December 31, 2020 and at December 31, 2019; and

    b. The inventory age analysis at December 31, 2020 and at December 31, 2019 for each store.

5. Other relevant operations-related information:

    a. Different sizes of a particular clothing item do not sell equally well, i.e., though a particular clothing item may sell very well, a particular store can be left with large quantity of very large or very small sizes of the item;

    b. For each size of a particular item of clothing, a unique stock identification code (SIC) is maintained on the inventory management system. For each SIC, full particulars of the inventory, including its unit cost, the quantities on hand at each store, and the season for which it has been purchased (e.g., summer 2021 or season neutral) are recorded; and

    c. BP Fashions is well known for its ‘end of season’ sales, where all stocks for the past season are marked down by amounts ranging from 20% to 80%.

ICAN CASE STUDY MAY 2022

Marking

DATE			CANDIDATE NO.	

TIME			MARKER NUMBER	

	Exc. Summary	Req 1	Req 2	Overall	TOTAL
SA					
CA					
BC					
NC					
V					
Total	5	8	8	4	25

1 General

* States the purpose of the report
* States the summary of the two requirements
* States the assumptions
* States reservations, e. g. scepticism

V	NC	BC	CA	SA

2 Requirement 1: Conclusions

* Cost of sales ratio is gradually increasing thus reducing gross margin marginally
* BP Fashions needs to provide more information for a proper evaluation of inventory obsolescence allowance.
* Operating expenses is increasing, thus reducing EBITDA ratio.
* Management may not follow IAS 2 requirements in management accounts.

V	NC	BC	CA	SA

4 Requirement 2: Conclusions

* Project Fit is viable.
* Project Fit has a positive NPV.
* Order from Federal Ministry of Education will result in additional contribution.
* Robust cyber security is needed.

V	NC	BC	CA	SA

5 Requirement 2: Recommendations

* BP Fashions should go ahead with Project Fit.
* BP Fashions should manage the identified risks associated with Project Fit.
* BP Fashions should accept the order from the Federal Ministry of Education.
* BP Fashions to invest in robust cyber security architecture.
* BP Fashions to introduce good welfare package for its specialist employee.

V	NC	BC	CA	SA

3 **Requirement 1: Recommendations**

* Cost control to reduce cost of sales through optmal purchasing.
* Cost control to reduce operating cost.
* Management accounts could be presented to suit the company's requirement for effective management decision making.
* Management to provide report on all items sold below cost price in 2020

V	NC	BC	CA	SA

V	NC	BC	CA	SA

REQUIREMENT 1 - BP Fashions Limited's financial statement analysis.

1 USES DATA AND INFORMATION APPROPRIATELY

* Uses information on exhibit 4 to calculate key financial ratios
* Uses information on exhibit 7 to benchmark BP Fashions' key financial ratios with those of the competitors.
* Uses information on exhibit 11 to discuss issues raised on IAS 2.
* Uses information on exhibit 12 to evaluate and discuss BP Fashions' inventory obsolescence allowance for 2020.

V	NC	BC	CA	SA

2 USES PROFESSIONAL TOOLS AND KNOWLEDGE

* Shows revenue growth
* Shows growth in EBITDA
* Calculates revenue growth.
* Calculates EBITDA/revenue ratio
* Calculates trading density
* Calculates inventory turnover
* Calculates trade receivable days
* Calculates trade and other payable days
* Calculates returns on equity
* Calculates profit after tax

V	NC	BC	CA	SA

3 **USES ANALYTICAL SKILLS (material points)**

written report

* Determines trend in BP Fashions' revenue.
* Determines trend in BP Fashions' gross margin
* Determines trend in BP Fashions' trade receivable days.
* Determines trend in BP Fashions' EBITDA.
* Determines trend in BP Fashions' trade and other payables days.
* Determines trend in BP Fashions' trend of EBITDA to revenue ratio.

  Determines trend in BP Fashions' trading density.
* Determines trend in BP Fashions' return on equity.
* Determines trend in BP Fashions' inventory turnover.

V		NC	BC	CA	SA

4 **IDENTIFIES ISSUES AND OPTIONS**

* Identifies that growth in revenue in 2020 dropped by 1% from that of 2019.
* Identifies that gross profit margin is gradually decreasing.
* Identifies that growth in EBITDA to revenue is reducing.

  Identifies that trade and other payables days is increasing gradually.
* Identifies that growth in EBITDA is reducing..
* Identifies that trade receivable days is stable.
* Identifies that trading density is increasing from year to year.
* Identifies that inventory turnover is stable.
* Identifies that returns on equity is reducing.

V		NC	BC	CA	SA

5 **APPLIES PROFESSIONAL SCEPTICISM AND ETHICS**

* Recognises that BP Fashion is keeping large idle cash that could have been invested on short term basis.

* Recognises that BP Fashions may be using inventory obsolescence allowance to manage earnings.

* Recognises that although BP Fashions says it sells on cash basis but trade receivables is gradually increasing.

* Recognises that BP Fashions needs to manage its relationship with suppliers as trade and other payables days is increasing.

V	NC	BC	CA	SA

6 **EVALUATIVE SKILLS AND JUDGEMENT**

* Recognises that the company's EBITDA growth has reduced from 20% in 2019 to 15% in 2020.

* Recognises that return on equity has dropped from 46.77% in 2018 to 40.46% in 2020.

* Recognises that the gross margin is almost the same but gradually reducing.

* Recognises that the efficiency ratios are stable.

V	NC	BC	CA	SA

7 **CONCLUSIONS**
(Draws distinct conclusions under a heading)

* Concludes that BP Fashions needs to watch its cost of sales as gross margin is gradually reducing.

* Concludes that although BP Fashions's EBITDA is increasing in value but the rate of increase is dropping which means that operating costs is going up.

* Concludes that BP Fashions' operating cost is increasing from year to year.

* Concludes on the treatment of the three IAS 2 issues, identified by BP Fashions' finance director, on their management accounts.

* Concludes on further inventory reports to be demanded from BP Fashions' Information Systems Manager to evaluate the inventory obsolescence allowance for 2020.

* Concludes on the adequacy of the inventory obsolescence allowance for 2020.

V

NC	BC	CA	SA

8 **RECOMMENDATIONS (commercial / relevant)**

* Recommends that BP Fashions needs to control its cost of sales to stem the downward tide of the gross profit margin.

* Recommends that BP Fashions needs to control the continuous growth in its operating expenses as this is eroding its EBITDA.

* Recommends that BP Fashions need not comply with the provision of IAS 2 in its management accounts as it is not meant for outsiders but for management decision making.

* Recommends that the company should explore possibility of reducing its inventory holdings.

* Recommends that the inventory obsolescence allowance is adequate with justification.

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NC	BC	CA	SA

REQUIREMENT 2 - Appraisal of Project Fit and order from Federal Ministry of Education

1 **USES DATA AND INFORMATION APPROPRIATELY**

- Uses information in exhibit 8 for details on Project Fit.
- Uses financial information in exhibit 9 on Project Fit.
- Uses information in exhibit 10 on Federal Ministry of Education order.
- Uses information in exhibit 2 for discussion on Project Fit
- Uses information in exhibit 3 for discussion on possible risks in Project Fit.

V	NC	BC	CA	SA

2 **USES PROFESSIONAL TOOLS AND KNOWLEDGE** (written into report)

- Calculates total capital costs
- Calculates operating variable cost percentage.
- Calculates fixed cost percentage.
- Calculates expected revenue for the 5 years.
- Calculates the NPVof the proposed Project Fit.
- Calculates the additional contribution from the Project Fit.
- Calculates the value of each order from the Federal Ministry of Education
- Calciulates the net contribution from the Federal Ministry of Education

V	NC	BC	CA	SA

3 **USES ANALYTICAL SKILLS (material points)**

- Determines the total variable costs in percentage.
- Determines the fixed costs in percentage.
- Determines total value for each Federal Ministry of Education's order.
- Determines the net value of each order of the Federal Ministry of Education.
- Determines the net contribution from each Federal Ministry of Education's order.
- Determines the yearly contribution from Project Fit.
- Determines the net present value of Project Fit.

V	NC	BC	CA	SA

4 **IDENTIFIES ISSUES AND OPTIONS**

- Identifies that the final viability of Project Fit will depend on the accuracy of the forecast costs.
- Identifies that the viability of Project Fit depends on the accuracy of the sales projections from year 1 to year 5.
- Identifies the risks of inability of BP Fashions not able to produce the quality of uniform and house wear provided by the Federal Ministry of Education.
- Identifies the problem of being able to keep specialist employees, such as Designers by BP Fashions, when the new factory is in full swing.

5 **APPLYING PROFESSIONAL SCEPTICISM AND ETHICS**

- Discusses the risks associated with Project Fit.
- Discusses the risk of fluctuations in cost of borrowing from bank.
- Discusses the risk of not being able to produce the quality required by the Federal Ministry of Education.
- Discusses the problem of inflation which has not been considered.

V

6 **EVALUATIVE SKILLS AND JUDGEMENT**
(uses analytical headings)

- Evaluates the expected yearly contribution from Project Fit.
- Evaluates the net present value of Project Fit.
- Evaluates the the contribution from each order from the Federal Ministry of Education.
- Evaluates the net contribution from each order of the Federal Ministry of Education.

V

7 **CONCLUSIONS**

(Draws distinct conclusions under a heading)

- Concludes on the viability of Project Fit.
- Concludes that the NPV of Project Fit is positive.
- Concludes that the order from the Federal Ministry of Education will generate additional contribution, despite the discount.
- Concludes that BP Fashions will need a robust cyber security to secure its website from hackers and other criminals.
- Concludes that BP Fashions must introduce good staff welfare schemes to enable the company keep its specialist employees.

V	NC	BC	CA	SA

8 **RECOMMENDATIONS (commercial / relevant)**

- Recommends that the NPV of Project Fit is positive,
- Recommends that BP Fashions should accept the Federal Ministry of Education's order.
- Recommends that BP Fashions should invest in a robust cyber security architecture to protect it website.
- Recommends that BP Fashions should introduce measures to manage the various risks associated with Project Fit.
- Recommends that BP Fashions should introduce good welfare package for its specialist employees.

V	NC	BC	CA	SA

Appendices		Main Report
1 **R1: Appendices**		**Report: Structure**
◆ Shows revenue growth ◆ Shows growth in EBITDA		◆ Sufficient appropriate headings
◆ Shows gross profit margin ◆ Shows EBITDA/revenue ratio ◆ Shows trading density		◆ Appropriate use of paragraphs / sentences
◆ Shows inventory turnover ◆ Shows trade receivable days ◆ Shows trade and other payable days		◆ Legible/clear hand writing
◆ Shows returns on equity ◆ Shows calculation of profit after tax		◆ Correctly numbered pages
V NC BC CA SA		**V** NC BC CA SA
2 **R2: Appendices**		**Report: Style and language**
◆ Shows calculation of total capital costs ◆ Shows caculation of operating variable cost percentage.		◆ Relevant disclaimer (external report)
◆ Shows the calculation of fixed cost percentage. ◆ Shows the calculations of expected revenue for the 5 years. ◆ Shows the NPV of the proposed Project Fit		◆ Suitable language for the board

- Shows the additional contribution from the Project Fit.
- Shows the caculation of the value of each other from the Federal Ministry of Education.
- Shows the calculation of net contribution from the Federal Ministry of Education.

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- Tactful / ethical comments
- Acceptable spelling and punctuation

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CC	
SC	
IC	
ID	
NA	
Total	

Appendix 1
BP Fashions Limited
Key financial ratios

		2018	**2019**			**2020**		
1	Revenue growth	**Value (₦m)**	**Value (₦m)**	**Growth (₦m)**	**%**	**Value (₦m)**	**Growth (₦m)**	**%**
		2,952.0	3,510.0	558.0	18.9	4,139.0	629.0	17.9
2	Gross profit margin	1,550/2,952*100		1,839/3,510*100			2,152/4,139*100	
		52.50%		52.40%			52.00%	
3	EBITDA growth	**2018**	**2019**			**2020**		
		Value	**Value**	**Growth**	**%**	**Value**	**Growth**	**%**
		635	762	127.0	20.0%	877	115.0	15.1%
4	EBITDA/Revenue	635/2,952*100			762/3,510*100			877/4,139*100
		21.5%			21.7%			21.2%
5	Trading density (revenue/m²)	2,952/400			3,510/400			4,139/400
		₦7.4m			₦8.8m			₦10.3m
6	Inventory turnover							
	Cost of sales/average stock	1,402/425*			1,671/575			1,987/590
		3.3 times			3.5 times			3.4 times
7	Trade receivables days							
	Trade receivables/Revenue*365	125/2952*365			150/3,510*365			175/4,139*365
		15 days			15.6 = 16 days			15.4 = 15 days
8	Trade and other payables days (trade payables/cost of sales*365)	270/1,402*365			335/1,671*365			410/1,987*365
		70.3 = 70 days			73.2 = 73 days			75.3 = 75 days

* Closing inventory for 2018 used for lack of 2017 closing inventory.

9	Return on equity	413.95/885*100	500.31/1,135*100	578.51/1,430*100
		46.77%	44.08%	40.46%

10 Calculation of profit after tax

	2018	2019	2020
	₦m	₦m	₦m
EBITDA	635	762	877
Less Interest on loan	26.25	26.25	26.25
Profit before tax	608.75	735.75	850.75
Tax expense	194.8	235.44	272.24
Profit after tax	413.95	500.31	578.51
Equity	885.00	1,135.00	1,430.00

Appendix 2

BP Fashions

Project Fit appraisal

Capital cost:

	₦m
Building	40
Equipment	50
Design equipment	10
Studio equipment	20
showroom equipment	10
Website development	10
IT equipment	10
	150
Working capital	25

Operating costs

Variable:		
Materials		30% of sales value
Labour		20% of sales value
Marketing cost		5% of sales value
Overheads	(25%of 20%)	5% of sales value
		60% of sales value
Fixed	(75% 0f 20%)	15% 0f sales value

Expected revenue

	Demand	Sales value	Probability	Expected sales value (Yr1)	Expected sales value (Yr2)	Expected sales value (Yr3)	Expected sales value (Yr4)	Expected sales value (Yr5)
		₦m		₦m	₦m	₦m	₦m	₦m
	High	250	0.25	62.5				
	Moderate	150	0.5	75				
	Low	100	0.25	25				
	Total			162.5	178.75	196.625	216.287 5	237.9163

Contribution

	Year 1	Year 2	Year 3	Year 4	Year 5
	₦'000	₦'000	₦'000	₦'000	₦'000
Sales value	162,500.00	178,750.00	196,625.00	216,287.50	237,916.2 5
Variable cost of sales(60%)	97,500.00	107,250.00	117,975.00	129,772.50	142,749.7 5
Contribution	65,000.00	71,500.00	78,650.00	86,515.00	95,166.50

Net present value (NPV)

Year		Cash flow	Discount factor	Present value
		₦'000		₦'000
0	Capital cost	- 150,000.00	1.0000	- 150,000.0 0
0	Working capital	- 25,000.00	1.0000	- 25,000.00

1	Contribution	65,000.00	0.8264	53,716.00
2	Contribution	71,500.00	0.6830	48,834.50
3	Contribution	78,650.00	0.5645	44,397.93
4	Contribution	86,515.00	0.4665	40,359.25
5	Contribution	95,166.50	0.3855	36,686.69
5	Working capital	25,000.00	0.3855	9,637.50
	NPV			58,631.86

Appendix 3
BP Fashions
Evaluation of the Federal Ministry of Education order

Calculation of oder value

	Quantity	Unit price	Value	Discount	Net value
			₦'000		**₦'000**
School uniform	120,000	5,000.00	600,000.00	25%	450,000.00
House wear	120,000	3,000.00	360,000.00	30%	252,000.00
					702,000.00

Calculation of net contribution

₦'000

Sales value	702,000
Variable costs (960,000 X [60%-5%])	528,000
Contribution	174,000
Bank charges 1% of 960,000	9,600
Net contribution	**164,400**

Note: Marketing cost of 5% of sales value will not be incurred on this order.

CASE STUDY

MAY 2022 EXAMINATION DIET

Examiner's report

The Case Study is about a company operating in the fashion industry. The company has 14 stores across the country, with Lagos and Abuja having separate stores for men accessories and women collections. While in other cities, men accessories and women collections operate as departments in the fashion stores.

The company has two projects under consideration, these are:

- A diversification into garment making industry, by building a factory for that purpose, called "Project Fit"; and
- Special order for school uniforms from the Federal Ministry of Education.

As usual, the case has two requirements, these are:

- Evaluation of the company's performance in the previous three years, 2018 – 2020, using the key financial indicators provided as Appendix 7 to the case and benchmarking same with those of three of the company's competitors. Comments are also required on the treatment of some items under IAS 2 and information to be requested from the Information Systems Manager to properly evaluate inventory obsolescence allowance in 2020 financial statements; and
- Evaluation of the two business proposals – Project Fit and the special order from the Federal Ministry of Education. A review of the key risks associated with the two projects is also required.

To perform well in the Case Study, candidates are expected to:

- Calculate the key financial indicators, following the template provided in the case scenario;
- Prepare an appraisal of Project Fit by determining the total capital cost, working capital required, expected revenue, contribution and net present value of the project; and
- Evaluate whether to accept the special order or not, by calculating the value of the order and net contribution from the order.

Candidates' performance was poor as only few candidates scored 50% or above.

The common pitfalls of the candidates are their inability to:

- Write a good report with appropriate sections, headings and appendices;
- Carry out evaluation of "Project Fit" from the array of data provided;
- Determine the net contribution from the Federal Ministry of Education's special order; and

- Identify risks that may be associated with "Project Fit" and the special order from the Ministry of Education.

To perform well in future Case Study examinations, candidates are advised to:

- Learn the skills of report writing, covering executive summary, report structure and uses of appendices;
- Have hand-on experience by practising on previous Case Study papers;
- Make use of the Institute's Pathfinder for guidance, when preparing for their examination; and
- Ensure they use the Institute's Case Study Text as it contains all materials needed for successful attempt on Case Study papers.