THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

NOVEMBER 2021 DIET

PROFESSIONAL LEVEL EXAMINATIONS

Question Papers

Suggested Solutions

Marking Guides

and

Examiners' 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.

NOTES

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.

TABLE OF CONTENTS

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2021

CORPORATE REPORTING

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Makoko Intercontinental Holdings Limited is a global merchant of cash crops. A policy of strategic acquisitions over the years has placed the company in a postion to source for export products competitively. The lockdown arising from the recent pandemic posed a significant challenge for the export of their products throughout the year 2020. At a board meeting to review the performance of the company for that year and discuss the impact of the pandemic, the Managing Director noted the significant drop in the general performance indices. In order to get a greater market presence and higher demand locally, the board decided to acquire the following investments on January 1, 2021:

- 60% of the equity share of Ojodu Limited;
- 50% of 10% loan notes of Ojodu Ltd at par;
- 40% stake in the ordinary shares of Egbeda Confectioneries Limited.

In the opinion of the board, both Ojodu Limited and Egbeda Confectioneries Limited are the biggest local customers of Makoko Intercontinental Holdings Limited and a control through shareholding would give the investing company greater stake in the operational decisions of the investee companies. Importantly, it would also boost revenue by allowing unrestricted access to local markets. It is believed that this will forestall any adverse impact of further lockdowns that may hinder export sales in the future.

The draft financial statements of the companies for the year are as follows:

Statements of financial position as at December 31, 2021

	Makoko Limited ₦'000	Ojodu Limited ₦'000	Egbeda Limited ₦'000
Assets:			
Non-current assets:			
Freehold property	85,250	62,000	75,500
Plant and equipment	46,705	42,405	21,820
Investments in subsidiaries	136,000	-	-
	267,955	**104,405**	**97,320**
Current assets:			
Inventories	42,100	38,150	49,240
Trade and other receivables	12,850	11,200	4,500
Cash and cash equivalents	32,720	14,100	5,600
	87,670	63,450	59,340
Total assets	**355,625**	**167,855**	**156,660**
Equity and Liability:			
Equity:			
Ordinary shares of ₦1.00 each	180,000	100,000	85,000
Retained earnings	45,455	22,225	17,000
Total equity	**225,455**	**122,225**	**102,000**
Non-current liabilities:			
8% Loan notes	28,000	-	-
10% Loan notes	-	10,000	12,500
Deferred taxation	60,308	8,440	16,000
Total non-current liabilities	**88,308**	**18,440**	**28,500**
Current liabilities:			
Trade payables	25,222	15,185	14,346
Accruals	7,820	5,525	6,589
Provisions	8,820	6,480	5,225
Total current liabilities	41,862	27,190	26,160
Total liabilities and equity	**355,625**	**167,855**	**156,660**

Additional information:

i. Makoko Limited paid ₦90 million for the acquisition of Ojodu Limited when the retained earnings of Ojodu Limited were ₦13 million.

ii. The fair value of Ojodu's freehold property was ₦6.5 million higher than the carrying amount as at the date of acquisition. This valuation has not been reflected in the books of Ojodu Limited.

iii. Makoko Limited paid ₦41million for the shareholding in Egbeda Limited when the retained earnings of Egbeda Limited were ₦12 million.

iv. An impairment test as at December 31, 2021 showed that goodwill was impaired by ₦3.5 million and the investment in Egbeda Limited was impaired by ₦0.8 million.

v. During the year, Makoko Limited sold products to Egbeda Limited at a price of ₦8 million. These goods had cost Makoko Limited ₦5 million. Half of the goods were still in the inventory of Egbeda Limited as at December 31, 2021.

vi. The companies issued share capital has not changed since the date of acquisition.

vii. No dividends were paid during the year.

viii. Non-controlling interests in subsidiaries are to be measured at the appropriate proportion of the subsidiary's identifiable net assets.

Required:

a. Prepare the consolidated statement of financial position for the Makoko Group for the year ended December 31, 2021. (20 Marks)

b. The Directors of Makoko Intercontinental Holdings Limited are concerned about getting significant influence, if not absolute control, of all entities they intend to buy into. The five-year strategic plan of the company (2020 – 2024) focuses on having control of the cash crops segment of the agribusiness sector of the economy. This is in order to make them ready to roll out the next developmental phase of the business, which is to migrate from exporting raw products to finished products for industrial and household use.

Towards this goal, the board requires the Group Accountant to make a presentation on the accounting implications of gaining significant influence in another entity.

Required:

Discuss the issues involved in the requirements of the Board as specified above. (5 Marks)

c. A friend to the Chief Accountant of Makoko Intercontinental Holdings Limited, who is a consultant to Ojodu Limited and Egbeda Confectionaries Limited is requesting for information on the new acquisitions from his friend, the Chief Accountant.

Required:

Identify the ethical issues involved in the above scenarios and their implications. (5 Marks)

(Total 30 Marks)

SECTION B: OPEN-ENDED QUESTIONS (40 MARKS)

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

QUESTION 2

a. Past surveys revealed that one of the most important financial indicators in evaluating ordinary shares is the expected changes in earnings per share (EPS). Corporate earnings is a key component of this financial indicators and, as far as investors are concerned, the quality of earnings is important in measuring a company's prospects. Quality of earnings can be affected by a number of factors which are at the discretion of management. A simple or complex capital structure also play vital role in the assessment of earnings quality and EPS.

Required:

i. What does "quality of earnings" connote and how can it be assessed? (5 Marks)

ii. What are the factors that can affect quality of earnings of an organisation? (3 Marks)

b. The following financial information relates to Nsukka group for the year ended June 30, 2021.

Nsukka Group
Consolidated statement of financial position as at June 30, 2021

Assets:	**₦'000**
Property, plant and equipment	41,655
Goodwill	1,654
Investment in subsidiary	4,226
	47,535
Current assets	
Inventories	4,577
Trade receivables	10,692
Prepayments	10
Cash	3,886
	19,165
Total assets	66,700
Equity and liabilities	
Equity:	
Issued share capital (₦1 ordinary shares)	8,400
Share premium	1,900

Retained earnings	35,314
3% cumulative irredeemable preference shares	2,000
Foreign currency translation reserve	(1,967)
Revaluation surplus	8,560
Total equity	**54,207**
Non-current liabilities:	
Finance lease	1,937
Provision	174
Other non-current liabilities	2,026
Total non-current liabilities:	**4,137**
Current liabilities:	
Finance lease	1,000
Provision	358
Other current liabilities	6,998
Total current liabilities:	**8,356**
	12,493
Total equity and liabilities	**66,700**

Additional Information:

The following additional information about earnings and movements in share capital of the company have been incorporated into the statement of financial position above.

(i) Nsukka PLC reports a profit after tax, after adjusting for all current year accounting issues, of ₦1,850,000 and effective tax rate of 20%.

(ii) For the first time, Nsukka PLC issued 1,000,000 ordinary shares and granted options for 400,000 shares on July 1, 2020. The exercise price was the market price of ₦1.50 per share at the grant date. Options vest on July 1, 2020 and expire on June 30, 2022. The average market price of shares in Nsukka Plc during year ended June 30,2022 was ₦1.834.

(iii) Rights issue of 1 for every 20 shares was made on May 31, 2021 at a price of ₦1.30 per share. The market price at this date was ₦1.60 and the average price for the year to June 30, 2021 was ₦1.65.

(iv) Nsukka PLC has ₦1,000,000 of 6% convertible loans included in other non-current liabilities. These were in issue throughout the year and may be converted into 100,000 ordinary shares. No loans were converted during the year. There are no dividends in arrears on the 3% preference shares.

Required:

Evaluate basic and diluted earnings per share from the consolidated statement of financial position as at June 30, 2021 for Nsukka Plc.

(12 Marks)

(Total 20 Marks)

QUESTION 3

Maazi Limited had been in operation for a long time. The management of Maazi Limited would like to make the company's financial statement good such that the financial report to be presented to the shareholders at its Annual General Meeting (AGM) will look attractive. Unfortunately, this had been an illusion rather than real.

Maazi Limited in a move to reinvigorate the company, sacked the management and appointed a new Board chaired by Mr. Gogobiri.
One cardinal point that the new management wishes to pursue is how to make the company responsive to its environment, enhance corporate culture through good corporate governance and ensure sustainable development.

Required:

As the Chief Finance Officer (CFO) of Maazi Limited, the Chairman of the Board, has asked you to critically examine the following:

a. The deficiency in financial reporting of the previous management of the company. (10 Marks)
b. The concept of sustainability reporting pursued by the present management as comparable with integrated reporting; (2 Marks)
c. The drawbacks and the benefits of integrated reporting? (8 Marks)

(Total 20 Marks)

QUESTION 4

You are the Financial Controller of Fidipote PLC, a bottling company with diverse products. The accountant responsible for preparing the 2020 annual financial statements is considering the accounting treatment of the following and has approached you for guidance:

a. On December 31, 2020, Fidipote PLC has a litigation proceeding involving a customer claiming damages in the sum of ₦50 million because she had allegedly been injured when drinking one of the company's products. She had claimed that the company bottled a sharp object inside the content of the product which she swallowed and had to be operated upon in order to remove the object. Fidipote Plc is disputing the claim, maintaining that any injury was due solely to negligence on the part of the customer. As at December 31, 2020, the case was yet to be decided. (8 Marks)

b. Fidipote PLC signed a ten-year lease agreement on a property requiring annual payment of ₦5million in advance on January 1, 2016. The property was used over the years as Cinema Hall. As a result of Covid-19 pandemic and the lockdown during 2020, the consequent long closure of the hall made patronage of cinema shows to be financially unsustainable. Fidipote PLC discovered that it has no further use of the building. It is not possible to sub-lease the building to another tenant and re-modelling cannot be done due to certain provisions of the lease agreement. As at December 31, 2020, the present value cost of outstanding lease installments amounted to ₦22.5million. (6 Marks)

c. The Managing Director made a proposal that, the Fidipote brand name is unique and of significant market persuasion and should, therefore, be included as an asset in the financial statements. Due diligence, including market research by a certified consultant, has been done on this proposal. A valuation of ₦250 million was determined to be included in the financial statements as at December 31, 2020. (6 Marks)

Required:
Explain how the above information 'a' to 'c' should be presented in the financial statements of Fidipote PLC for the year ended December 31, 2020.

(Total 20 Marks)

SECTION B: OPEN-ENDED QUESTIONS (30 MARKS)

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

QUESTION 5

Accountants in business who are responsible for the preparation of financial information must ensure that the information they prepare is technically correct, completely disclosed without any omission and also report the substance of the transaction. However, accountants are usually faced with the danger of influence from senior managers to present figures that inflate profit or assets or understate liabilities. This always put accountants in a difficult position. This is the situation that the Chief Accountant of Fola PLC found himself.

Fola PLC has December 31 as its year end and the managing director (MD) feared that the forecast of 2020 profitability goals would not be reached. Therefore, when Fola PLC received a large order on December 30, the MD immediately directed that the Chief Accountant should record it as revenue for the period. This order represents about 13% of Fola PLC revenue. However, the inventory control department did not separate the goods for shipment until January 1, 2021. Separated goods are usually not included in the inventory because they have been sold. Physical inventory taking under the periodic inventory system was conducted on December 31, as it is customary for the company's external auditors to be in attendance. The Chief Accountant was confused and not willing to be involved in any unethical act.

Required:

a. Appraise the effects and implications of treating the order as revenue on 2020 and 2021 profitability. (5 Marks)

b. In such circumstance, what should be the responsibilities of the Chief Accountant? (5 Marks)

c. Analyse the dangers of inappropriate disclosure of information in the financial statements. (5 Marks)

(Total 15 Marks)

QUESTION 6

Directors of companies are expected to issue financial statements that present fairly the financial position, financial performance and cashflows of their entities. Hence, financial statements are supposed to be a faithful representation of the effects of transactions and other events in accordance with the definition and recognition criteria for assets, liabilities, income and expenses set out in IFRS. However, a fair presentation can encompass a range of different figures because alternative accounting policies can produce different results. Also, the application of accounting policies in accordance with IAS 8 is often based on estimates and judgements. As a matter of fact, valuations and estimations are key factors in drafting financial information. Regulatory frameworks, both local and global asserted conscious efforts to address some of these problems. However, the strength of a regulatory framework may be undermined by commercial pressures on those responsible for preparing financial statements.

Required:

a. Evaluate the ways in which IFRS has tried to alleviate the problems illustrated above. (5 Marks)

b. Discuss **FIVE** likely commercial pressures on preparers of financial statements. (5 Marks)

c. Examine **TWO** techniques employed by accountants to produce desired accounting results when faced with such pressures. (5 Marks)

(Total 15 Marks)

QUESTION 7

The Conceptual Framework 2010 was criticised for its lack of clarity, the exclusion of certain important concepts and for being outdated in terms of the IASB's current thinking. The revised Conceptual Framework 2018 includes some new concepts such as prudence, provides updated definitions and recognition criteria for assets and liabilities and clarifies some important concepts in a well arranged eight chapters.

Chapter four of the revised conceptual framework 2018 on elements of financial statements redefined some basic elements and concepts.

Required:

a. Evaluate the arguments for and against re-introduction of prudence into the Conceptual Framework. (7 Marks)

b. Identify **TWO** of the concepts; (Asset and liability) which definitions were revised and justify the reasons for revised definitions. (8 Marks)

(Total 15 Marks)

SOLUTION 1

Makoko Intercontinental Holdings Limited
Consolidated statement of financial position as at December 31, 2021

	₦'000
Assets	
Non-current assets:	
Freehold property (85,250 + 62,000+ 6,500	153,750
Plant and equipment (46,705 + 42,405)	89,110
Goodwill (WN1)	14,800
Investment in associate (41,000 + 1,200 – 600)	41,600
	299,260
Current assets:	
Inventories (42,100 + 38,150)	80,250
Trade and other receivables (12,850+11,200)	24,050
Cash and cash equivalents (32,720 +14,100)	46,820
	151,120
Total assets	**450,380**
Equity and Liabilities:	
Ordinary shares of ₦1.00 each	180,000
Retained earnings (WN 2)	48,090
Total equity	**228,090**
Non-controlling interests (WN3)	51,490
	279,580
Non-current liabilities:	
8% Loan notes	28,000
10% Loan notes (10,000 – 5,000)	5,000
Deferred taxation (60,308 + 8,440)	68,748
	101,748
Trade payables (25,222 + 15,185)	40,407
Accruals (7,820 + 5,525)	13,345
Provisions (8,820 + 6,480)	15,300
	69,052
Total equity and liabilities	**450,380**

Group Structure

Makoko

60%   40%

NCI 40%   Egbeda 40%

Ojodu

i. Goodwill on acquisition of Ojodu:

	Marks ₦'000	Marks ₦'000
Price paid for Ojodu		90,000
Ojodu's share capital (1/1/2021)	100,000	
Ojodu's retained earnings (1/1/2021)	13,000	
Fair value adjustment for property	6,500	
	119,500	
60% x ₦119,500		(71,700)
Goodwill on acquisition		18,300
Less: Impairment of goodwill		(3,500)
		14,800
Purchase of Egbeda:		
Price paid for Egbeda		41,000
Egbeda's share capital (1/1/2021)	85,000	
Egbeda's retained earnings (1/1/2021)	12,000	
	97,000	
40% x ₦97,000		(38,800)
Goodwill on purchase of Egbeda		2,200*

Since the goodwill on purchase of Egbeda is positive, then it is not recognised separately but as part of the carrying value of the investment.

ii. Group retained earnings

Makoko's retained earnings 31/12/2021)		45,455
Ojodu's retained earnings (31/12/2021)	22,225	
Ojodu's retained earnings (1/1/2021)	13,000	
	9,225	
60% x 9,225		5,535
Less: Goodwill impairment		(3,500)
		47,490
Associate's retained earnings:		
= 40% (17,000 – 12,000)	2,000	
Less: Impairment	(800)	1,200
Unrealised profit in inventory of associate:		
= 40% [½ (8,000-5,000)]		(600)
		48,090

iii. **Non-controlling interests:**

	₦'000
Subsidiary's share capital (31/12/2021)	100,000
Subsidiary's retained earnings (31/12/2021)	22,225
Fair value adjustment	6,500
	128,725
Non-controlling interests (40% x 128,725)	51,490

b. IAS 28 deals with the subject of Investments in Associates and Joint Ventures.

- An associate is defined by IAS 28 as "an entity over which the investor has significant influence"
- Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

The issue involved in the matter above is the specification of the evidence of significant control and how such influence could be achieved.

- When an investor company holds at least 20% of the voting power of an investee company, significant influence is presumed to exist unless it can be otherwise demonstrated.
- Holding at least 20% of a company's voting power means possessing at least 20% of that company's ordinary shares.

The existence of significant influence is usually evidenced in any of the following ways:

i. Representation on the board of directors which governs the investee company;

ii. Participation in policy-making processes of the investee, including; participation in decisions about dividends or other distributions;
iii. Material transactions between the investor and the investee;
iv. Interchange of managerial personnel; and
v. Provision of essential technical information.

An investor company loses significant influence over an investee company when it loses the power to participate in the investee's financial and operating policies.
This occurs when the investor no longer holds at least 20% of the investee's voting power.

c. An accountant needs to be upright and uphold ICAN Ethical Code of Conduct as follows:
- Professional competency;
- Due care and diligence;
- Integrity;
- Objectivity;
- Professional behaviour; and
- Confidentiality.

In relation to the Chief Accountant of Makoko, he owes his employers, Makoko Limited, the duty of trust and confidentiality of information at his disposal arising from his employment. Therefore, all information gained during the course of his service to Makoko cannot be traded at the altar of friendship, pecuniary or any other interest at the disadvantage of Makoko.

As a responsible member of a profession therefore, the Chief Accountant must exercise extreme caution and refrain from a wilful, deliberate and casual disclosure of pertinent information that border on corporate strategy or secret. This could be done by:

- Dealing with familiarity threat seemingly at work between the two friends. Official request for information would be required as information can only be formally shared between investor and investee companies;
- All trade secret and strategy should be kept confidential; and
- Any disclosure of information by the Chief Accountant on the basis of friendship may be a violation of professional ethical code of ICAN. Such actions have consequences that may be grave.

Examiner's report

Part (a) of the question tests candidates' knowledge of the principles of preparing group consolidated statement of financial position involving parent, a subsidiary and an associate. The (b) part of the question tests candidates' knowledge of the accounting implications of an entity gaining significant control over the other, while part (c) tests ethical issues involving wilful and inappropriate disclosure of corporate information.

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

The common pitfalls of the candidates were their inability to explain evidences of significant influence in another entity and failure to identify and discuss ethical issues in concealment of information.

Candidates are advised to do in-depth study of basic principles of consolidating complex group structure, accounting implications of an entity gaining significant control and ethical issues in corporate reporting. They are also advised to practice more questions and use ICAN Study Texts for better performance in future examinations.

Marking guide

		Marks	Marks
a.	Statement of financial position	5	
	Working Notes	6	
	Computation of goodwill	4	
	Computation group of retained earnings	4	
	Determination of non-controlling interests	1	20
b.	Discussing the accounting implication of significant control		5
c.	Discussing the ethical issues on the new acquisition		5
	Total		30

SOLUTION 2

a.

i. Quality of earnings

The quality of earnings refers to the substance of earnings and their sustainability into future accounting periods. Quality of earnings connotes the degree to which earnings reflect underlying economic effects, they are better estimates of cash flows, conservative, and are predictable.

Assessment of earnings quality

An assessment of earnings quality would be based on the following factors:

- Correlation between reported earnings and underlying economic activity;
- Permanence and sustainability of reported earnings;
- Relationship between reported earnings and market valuation;
- Extent and impact of discretionary accruals;
- Transparency and completeness of disclosures;
- Impact of low reported earnings on corporate image;
- Ability of the company to handle bad news;
- Degree to which earnings are good estimates of cash flows; and
- Adoption of conservative accounting policies by the Company.

ii. Factors that can affect quality of earnings

- The accounting methods and estimates, accounting policies or financing strategies.
- The nature of non-operating items included on the income statement. A complex capital structure will dilute the earnings.
- Using operating leases or finance leases.
- Choosing to re-value non-current assets or choosing the historical cost model.
- Timing the acquisition of non-current assets or the timing of new financing.
- Inflation and changes in credit terms: the inflation effect is to be reduced from the sales or net income and if there are changes in credit terms due to which sales are increased, the effect of the same is also to be reduced.
- Non-cash expenses: non-cash expenses like depreciation on tangible assets, amortisation of intangible assets and impairment losses are to be added back to calculate the effective quality of income.

b. Calculation of Basic and Diluted EPS

NSUKKA financial year is from July 1, 2020 to June 30, 2021

The basic earnings per share is calculated below:

	₦'000
Calculation of opening ordinary share capital	
Ordinary shares at June 30, 2021	8,400
Less rights issue (8,400/21) x 20	(400)
Less ordinary shares issued	(1.000)
Ordinary shares at July 1, 2020	7,000

Basic earnings per share: Basic EPS = $\frac{\text{Equity earnings}}{\text{Weighted average number of shares}}$ x 100

Calculation of Weighted average number of share	**₦ '000**			**₦ '000**
Opening share in issue	7,000			
Add bonus element (400 – (400 x 1.50 /1.834))	73			
Deemed shares before rights issue	7,073	x	$\left(\frac{8}{12}\right)$	4,715
Add issue of shares at full market price	1,000			
	8,073	x	$\left(\frac{3}{12}\right)$	2,018
Add bonus issue less bonus element (400 -73)	327			
	8,400	x	$\left(\frac{1}{12}\right)$	700
Weighted average number of shares				7,433
Calculation of basic earnings per share	**₦'000**			
Profit after tax	1,850			
Less preference dividend (2,000,000 x 0.03)	(60)			
Basic earnings	1,790			
Weighted average number of shares	7,433			(8,400)
EPS (1,790/7,433)	₦ 0.24			
Previous year (1,790/8,400)				₦ 0.21
Calculation of diluted Earnings per Share				
Diluted earnings:				**₦'000**
Basic earnings				1,790
Add interest saved (₦1,000,000 x 6%)				60
Less tax on interest saved				(12)
Diluted earnings				(1,838)
Diluted shares:				
Basic shares	7,433			
Add convertibles	100			
Add share options	400			
Diluted Shares	7,933			
Diluted EPS				**₦ '000**
Diluted earnings				1,838
Diluted shares				7,933
Diluted EPS				₦0.23

Examiner's report

Part (a) of the question tests candidates' knowledge of the meaning of quality of earnings, how it can be assessed and the factors that can affect quality of earnings of an organisation. Part (b) of the question tests the evaluation of basic and diluted earnings per share (EPS).

Majority of the candidates attempted the question but performance was poor.

The common pitfalls of the candidates were their inability to clearly explain the term "quality of earnings" and inability to correctly compute basic and diluted earnings per share.

Candidates are advised to ensure that they cover all sections of the syllabus and pay special attention to relevant statement of accounting standards when preparing for future examinations.

Marking guide

			Marks	Marks
a	i.	Connect definition of quality of earnings		2
		Assessing earnings quality(6 points @ ½ mark)		3
	ii.	6 factors affecting quality of earnings @ ½ mark		3
b.		Calculation of opening ordinary shares	2	
		Formula for basic earnings	1	
		Calculation of basic earnings per share	2	
		Formula for diluted earnings	1	
		Calculation of diluted earnings	2	
		Calculation of diluted shares	1	
		Diluted EPS	2	
		Interpretation	1	12
		Total		**20**

SOLUTION 3

a. **Deficiencies in financial reporting**

- For numerous reasons, corporate financial statements depend on estimates and judgment that can be off the mark, even when made in good faith.

- Standard financial metrics intended to enable comparisons between companies may not be the most accurate way to judge the value of any particular company giving rise to unofficial measures that come with their own problems.

- Managers and executives routinely encounter strong incentives to deliberately inject error into financial statements.

The following are the deficiencies in financial reporting which could have been used by the previous management of the company:

- **Fair value accounting Vs. Historical cost**
  Corporate financial statements relied on historical cost, being easily verifiable. However, companies now use fair value in their financial statements in that it will yield a truer picture of current economic reality. But since not everyone agrees on what "fair value" means, the measure has injected enormous subjectivity into the financial reporting process, creating new challenges for both preparers and users of financial statements;

Cooking the decisions, not the books

- Managers may deliberately overstate expenses or losses, such as bad debts or restructuring costs to create a hidden reserve that can be released in future periods to artificially inflate profits. A company might deliberately make under-provision; delaying the recognition of an expense or a loss in the current year. Estimating costs requires managers to exercise judgment, to deliberately estimates in such a way that profit is borrowed from future periods to boost present profit thus resulting in corporate decision making that serves the interest of short-term reporting but undermines long-term performance;

Managers distort the numbers by manipulating operations, not reports

- Where a company has substantial excess capacity, the managers can choose to ramp up output, allowing fixed manufacturing costs to be spread over more units of output resulting in a reduction in unit cost and, therefore, lower costs of sales and increased profits;

  This practice leads to high finished-goods inventories, imposing a heavy burden on a company in return for that short-term improvement in margins.

  Above are not the disturbing factors but that such actions are not violations of GAAP or IFRS. Corporate executives can do as they please in the comforting knowledge that auditors cannot challenge them;

Unofficial earning measurements

- Companies have been employing non-GAAP and non-IFRS measures of earnings for a long time, most popular is EBITDA (or earnings before interest, taxes, depreciation, and amortisation), because it's thought to provide a quick proxy for the amount of cash flow available to service debt to convince analysts and investors that their businesses had value despite the absence of profits (and sometimes even of revenue);

Revenue recognition

- Under GAAP rules, if there is no objective way to measure such costs beforehand, a business is not allowed to record any revenue from that sale until all upgrade requirements have been delivered and their costs are known. This regulation has prompted companies to write contracts that carve out and separately price hard-to-value services. In doing so, the companies solve an accounting problem—but compromise their ability to adopt a conceivably more attractive bundling strategy. The result is a perverse system in which accounting rules influence the way business is done, rather than report on companies' performance.

  The shortcomings of revenue-recognition practices have also caused companies to increasingly use unofficial measures to report financial performance, especially for businesses operating in the virtual space;

Universal standards

- In revolutionising accounting, a single set of international accounting standards (convergence) has stalled, and further substantive changes seem unlikely in the near future. Understanding the true value of a firm and comparing company accounts across countries continue to be major challenges;

- The way that IFRS regulations are applied varies widely from one country to another. Each has its own system of regulation and compliance, and in many countries compliance and enforcement are weak. The quality and independence of the accounting profession are also often patchy. Results under GAAP versus IFRS can be different enough to change an acquisition decision; and

- Many countries have created their own versions of the IFRS system by imposing "carve outs" (removal of offending passages) and "carve ins" (additions) to the official standard promulgated by the International Accounting Standards Board (IASB). It's always worth checking to see if a company of interest has adopted a truncated or bastardised version.

b. **Comparing concept of integrated reporting with sustainability reporting**

An integrated report is a narrative document that explains how a company's current operations may affect its long-term profits. The focus is on explaining the connections between the company's various activities and how the different parts contribute value.
An integrated report should provide an outline of the future by linking financial and non-financial data to estimate how current operations might create (or destroy) profits in the future.

In contrast to numerical financial statements, the integrated report's conciseness (ideally), and its focus on the long term, make the fundamental differences between it and an annual financial statement.

What makes it different from a sustainability report is that an integrated report asks whether the impacts that have been identified in a sustainability analysis will have a positive or negative effect on the company's value. That's a different matter from itemising the effects of water use, for example, on the environment.

Another difference between an integrated report and a sustainability report is that an integrated report needs board sign-off. That encourages companies to ensure the finance team is involved in the making of an integrated report.

Finally, integrated reporting is guided by a principles-based framework. There are no hard rules about how information is presented. The upside is that without strict rules governing integrated reporting, corporations are more likely to embrace it. The very big downside is that at present there is no clear standard for assessing integrated reports.

c. (i) **Integrated reporting drawbacks**

- Integrated reporting is not able to cover the needs of all stakeholders. The interests of some categories of stakeholders are important only insofar as they impact the prosperity of the organisation. Integrated reporting is therefore seen as a conversion from a more social-friendly perspective to a perspective more focused on business reporting that has relegated the needs of some stakeholders to a secondary role.

- The deficiencies in integrated reporting also relate to the composition of the governing council of International Integrated Reporting Council (IIRC) that is composed of mostly accounting and multinational professionals but less of environmental and social accounting such as Global Reporting Initiative supporters representatives.

- Integrated reporting is a meeting of different values and opinions, potentially in conflict, that need to be reconciled through continuous compromise effort to make it legitimate. It is complex to make legitimate compromise and unless the compromise that leads to ambiguity in reporting is avoided, the integrated report will not serve the purpose intended.

(ii). **Benefits of integrated reporting**

- Annual financial statements have for a long time been an important part of the public information provided by organisations. Their purpose is to keep current and potential shareholders informed about organisations and their activities.

- Communication has become more crucial that organisations are beginning to understand how the reporting process can drive positive behaviour change. Integrated reporting can be used as a tool to reshape the public image of corporate behaviour by providing limited forward-looking and quantitative information regarding their sustainability actions.

- Better integrated report drives integrated thinking. Organisations are more accountable now to their stakeholders, and corporate reputation is one of the business's greatest assets.

- Stakeholders are looking for more inclusive, less risky and more long-term sustainable organisations. Organisations must, in turn, find ways to meet these demands and understand her own inputs, the world around them and their effect on society and their environment.

- Integrated reporting helps to drive important behaviour change by breaking down silos and challenging management to think holistically about how the organisation creates value for its stakeholders while demonstrating the connectivity of the business model, strategy, performance and risks.

- Integrated reporting is also a communication tool with external benefits. It provides clear and concise communication of an organisation's most important and relevant issues to their investors and other stakeholders.

- A well-crafted Integrated report enables stakeholders identify how the organisation creates wider value beyond the purely financial and gives them a greater understanding of how the entity operates.

- Integrated report can be used to demonstrate to stakeholders whether they are investors, customers, communities or employees that an organisation has a clear purpose in society. In short, integrated reporting is better reporting which in turn leads to better decision-making.

Examiner's report

Part (a) of the question tests candidates' knowledge of the deficiencies in financial reporting. Part (b) tests the concept of integrated and sustainability reporting, while part (c) tests the drawbacks and the benefits of integrated reporting.

Most candidates attempted the question but performance was poor.

The common pitfall of the candidates were their inability to understand the expectations of the question in terms of defining and explaining relevant terms such as integrated and sustainability reporting.

Candidates are advised to make sure they have a good understanding of contemporary corporate reporting issues examinable at this level of the Institute examinations.

Marking guide

		Marks
a.	Deficiencies in financial reporting	
	Dependency of financial statements on estimates and judgments	2
	Standard metrics for comparison of companies may not be most accurate	2
	Stating and explaining six (6) deficiencies of financial reporting	6
b.	Discussing 4 concept of integrated reporting and sustainability reporting @ ½ mark each	2
	Discussing three (3) drawbacks of integrated reporting @ 1mack each	3
	Discussing five (5) benefits of integrated reporting @ 1 mark each	5
	Total	**20**

SOLUTION 4

ai. The relevant standard is IAS 37-Provisions, Contingent Liabilities and Contingent Assets.

ii. Contingent liabilities are possible contractual or legal obligations due to an organisation but the outcome can only be determined by the occurrence of uncertain future events that are not wholly within the control of the entity.

iii. IAS 37 states that provisions should be made if the contingent liability is certain or probable and must be disclosed in the note to the account if it is probable it will occur and its impact is material.

Relating the above to Fidipote pending litigation,

- The litigation proceeding is a relevant information in the preparation of the financial statements of Fidipote PLC for the year ended December 31, 2020,
- The maximum amount of probable claim in damages is known but the actual amount is unknown;
- This is a contingent liability which is dependent on whether an uncertain future event occurs;
- Similarly, the eventual probable payment cannot be measured reliably.

Therefore, this amount should not be recognised but it should only be disclosed in Fidipote PLC's financial statements for the year ended December 31, 2020.

This implies that no provision is required at this stage but the event must be disclosed in the notes to the account as at December 31, 2020.

b. The lease agreement is an onerous contract. An onerous contract is one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received from it. The present obligation under an onerous contract should be recognised and measured as a provision.

Therefore, the discounted amount of the outstanding lease payments should be fully provided for as at December 31, 2020 as follows:

	Dr.	Cr.
	₦'000	₦'000
Provision for Lease – SOCI	22,500	
Provision for Lease – SOFP		22,500
Being provision for lease costs		

c. The brand name must be evaluated under the recognition criteria of the IASB framework and IAS 38 on Intangible Assets.

- It is probable that any future economic benefits associated with the brand will accrue to Fidipote;
- However, the brand name is an internally generated intangible asset of the Company
- In accordance with IAS 38, internally generated brands and similar intangibles cannot be recognised because it cannot be measured reliably, in spite of the certification of the consultant.
- Reliability of measurement would be determined by an eventual willing buyer who successfully acquired the brand by making full payment as valued. However, the value can be disclosed by way of a note to the financial statement.

Examiner's report

Part (a) of the question tests candidates' knowledge of the application of IAS 37-Provisions, Contingent Liabilities and Contingent Assets. Part (b) of the question tests the consequences of an onerous contract/agreement, while part (c) examined the application of IAS 38-Intangible Assets.

Majority of the candidates attempted the question but performance was below average.

The common pitfalls of the candidates were: their inability to correctly interpret and properly apply knowledge of accounting standards; and inability to identify onerous contract and recognition criteria for local branded internally generated brand names.

Candidates are advised that they should ensure they cover all aspects of the syllabus when preparing for future examinations.

Marking guide

		Marks
a.	Discussion and explanation of provisions under IAS 37	8
b.	Discussion and application of the Provision on onerous contract	6
c.	Recognition of criteria of the IASB and IAS 38 on internally generated intangible asset	6
	Total	**20**

SOLUTION 5

a. The effects and implications of treating the order as revenue in 2020

Treating the order as revenue in 2020 will lead to the following revenue effects:

i. Violation of matching concept as expenses relating to the order will take place in 2021 and recorded in 2021 while revenue would have been recognised in 2020;
ii. Overstatement of profit in 2020 while 2021 profit will be understated;
iii. Overstatement of closing inventory in 2020 and decrease in cost of goods sold as the goods is still part of the inventory;
iv. Higher revenue and distribution expenses in 2021 as expenses relating to the sales will take place in 2021 and recorded in 2021;
v. Increase in sale by the order in year 2020;
vi. Understatement of revenue in 2021 and decrease in cost of goods sold in the year 2020;
vii. There will be increase in year 2020 profit as a result of increase in revenue;
viii. There will be decreased in the profit of the company in the year 2021; and
ix. There is an element of window dressing in the situation.

b. An accountant has the responsibility while preparing financial statements to ensure the following:

i. Should ensure and uphold the relevant standards of recognising the revenue;
ii. Should ensure that any of the unethical issues has not been committed.
iii. Must ensure that the invoice of the order is accurately issued and rightly approved;
iv. Must ensure the full disclosure of the transaction in the notes to the account.
v. Must ensure the goods are classified and label as goods sold in the warehouse to mitigate against the risk of double counting by the external auditors;
vi. Should advise and educate the management on the issues like this for future occurrence;
vii. Information must be prepared and presented fairly, honestly and in accordance with relevant professional standards. In particular financial statements must be prepared and presented in accordance with the applicable financial reporting standards;
viii. Information for which he is responsible describes clearly the true nature of business transactions, assets or liabilities;

ix. Financial statement classify and record information in a timely and proper manner; and represents the facts accurately and completely in all material respects.
x. Evaluates the effects of significance threats to ethical principles, safeguards should be considered and applied as necessary to eliminate the threats or reduce them to an acceptable level;
xi. When necessary, consultation with superiors within the employing organisation, for example, the audit committee or other body responsible for governance, or with a relevant professional body;
xii. Where it is not possible to reduce the threat to an acceptable level, a chartered accountant should refuse to remain associated with information they consider is or may be misleading;
xiii. If the chartered accountant is aware that the issuance of misleading information is either significant or persistent, he should consider informing appropriate authorities in line with the guidance in the code of ethics for professional accountants; and
xiv. The chartered accountant in business may also wish to seek legal advice or resign.

c. **Danger of omission and inappropriate disclosure of information in financial reports**

The full disclosure principle ensures that the readers and users of a business's financial information are not misled by any lack of information. The reason for not disclosing information could be to manipulate the financial statements to make them look stronger than the business actually is. Therefore, an inappropriate disclosure of financial information will lead to the following:

i. It will make the financial statements to be misleading;
ii. Relevant, reliable and accurate financial information will be missing;
iii. It may lead potential investors and others making uninformed decisions;
iv. The business could be seen as undervalued.
v. If reported profit is too high –it can lead to a higher tax liability.
vi. If the reported profit is too low, the stock price may drop
vii. The company reputation takes a hit and it may become tougher to obtain capital;
viii. There's the risk that the errors in reporting are material enough to violate GAAP;
ix. Discovering material omissions in the financial statements of a publicly traded company after the CEO have signed off on the accuracy of such financial statements attracts penalty;
x. Inaccurate information in internal reports makes it harder to make good decisions.

Examiner's report

The question tests candidates' knowledge of the ethical responsibilities of accountants while preparing financial statements and the implications of falsification of figures to inflate profits or assets and understate liabilities. It also tests dangers of inappropriate disclosure of information in the financial statements.

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

The commonest pitfall of the candidates was their inability to marshal points on the dangers of inappropriate disclosure of information in the financial statements.

Candidates are advised to familiarise themselves with the ethical responsibilities of accountants and apply basic ethical principles in real life situation for better performance in future examinations.

Marking guide

		Marks
a.	Discussing five effects and implications of treating the order as revenue in 2020 at 1mark each	5
b	Discussing ethical responsibility of an accountants at 1 mark each	5
c.	Discussing five dangers of inappropriate disclosure of information	5
	Total	**15**

SOLUTION 6

a. **International Financial Reporting Standards has tried to alleviate the problems illustrated in the question in a number of ways including:**
   i. Removing choice of accounting policies – there are fewer areas of choices now than before the adoption of IFRS;
   ii. Providing rules on the selection of accounting policies (IAS 8);
   iii. Requiring disclosure of judgements, estimates and key sources of measurement uncertainty (IAS 1);
   iv. Including better guidance on fair values (IFRS 13);
   v. Ensuring that the financial statements are fairly presented by requiring disclosure of significant accounting policies (IAS 1);
   vi. IAS 1 requires financial statements to give a fair presentation of the financial position, financial performance and cash flows of an enterprise. In virtually all circumstances, a fair presentation is achieved by compliance with applicable IFRS's;
   vii. A fair presentation also requires an entity:
      - To select and apply accounting policies in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. IAS 8 sets out a hierarchy of authoritative guidance that management considers in the absence of a standard or an interpretation that specifically applies to an item;
      - To present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information; and
      - To provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

b. **Commercial pressures on preparers of financial statements**
   i. Adverse market reactions to the share price of a listed entity when results fail to meet the market's expectations (which directors and management may have encouraged), whether or not the expectations were reasonable;
   ii. Directors and management's incomes being highly geared to results and/or heavily supplemented by stock options;
   iii. The importance of meeting targets to ensure protection of the jobs of directors, management and other employees;
   iv. The desire to understate profits to reduce taxation liabilities;
   v. Legal and regulatory requirements to meet specific financial thresholds or ratios;
   vi. The need to ensure compliance with loan covenants or to pacify bankers;
   vii. Pressure by employers to manipulate tax returns;
   viii. Need to produce figures to mislead shareholders;
   ix. Recognise sales order as revenue before the goods are delivered
   x. Concealment of information.

xi. Manipulate overhead absorption rates to extort more income from customers;
xii. Produce misleading projected figures to obtain additional finance;
xiii. Conceal improper expense claims put in by senior managers;
xiv. Over- or undervalue assets;
xv. Misreport figures in respect of government grants;
xvi. Information which could lead to charges of 'insider dealing; and
xvii. Redefine bad debts as 'good' or vice versa.

c. **The accounting techniques used to create desired results include the following:**

i. **Window dressing**:
An entity enters into a transaction just before the year end and reverses the transaction just after the year end. For example, goods are sold on the understanding that they will be returned immediately after the year end; this appears to improve profits and liquidity. The only reason for the transaction is to artificially improve the view given by the financial statements.

ii. **'Off balance sheet' finance to conceal gearing:**
Transactions are deliberately arranged so as to enable an entity to keep significant assets and particularly liabilities out of the statement of financial position ('off balance sheet'). This improves gearing and return on capital employed. omission of a firm's debt from the financial statement. Examples include sale and repurchase agreements and some forms of leasing.

iii. **Changes to accounting policies or accounting estimates**:
An entity can revalue assets (change from the cost model to the revaluation model) to improve gearing or change the way in which it depreciates assets to improve profits.

iv. **Capitalising expenses**:
Recognising 'assets' which do not meet the definition in the IASB Conceptual Framework or the recognition criteria. Examples include: human resources, advertising expenditure and internally generated brand names.

v. **Profit smoothing:**
Manipulating reported profits by recognizing (usually) artificial assets or liabilities and releasing them to profit or loss as required.

vi. **Aggressive earnings management**:
Artificially improving earnings and profits by recognizing sales revenue before it has been earned

vii. **Income smoothing:**
This can be achieved by manipulating the period in which the expenses are recognised (for instance, the useful life of the asset can be adjusted thereby affecting the amount of depreciation charged as expense) or by the use of discretionary accruals (for instance, management can determine the amount to be provided as a provision for bad and doubtful debts or the amount of provision in respect of a warranty on a company's product).

viii. Recognition of revenue before it is earned.

Examiner's report

The question tests candidates' knowledge of the application of accounting standards on estimates and judgements, valuations and estimations when drafting financial information and also the challenges of IFRS in ensuring faithful representation of financial statements.

Majority of the candidates attempted the question but performance was below average.

The commonest pitfall of the candidates was their inability to apply the provisions of IFRS to solve the problem presented in the question.

Candidates are advised to pay more attention to the provisions of the various accounting standards for better performance in the Institute's future examinations.

Marking guide

		Marks
a.	Evaluating five ways in which IFRS alleviate the problems at 1mark each	5
b.	Discussing Commercial Pressures on prepares of Financial Statement at 1 mark each	5
c.	Explaining any two accounting techniques for creative accounting @21/2 mark each	5
	Total	**15**

SOLUTION 7

a. The arguments for and against re-introduction of prudence into the Conceptual Framework

(i) **Argument against the inclusion of prudence**

The inclusion of prudence is not necessary as it contradicts other accounting assumptions. Prudence conflicts with neutrality. A 'prudent accountant would make provisions in the accounts for the potential bad debts and then notify superiors' therefore adjusting books in bias and recovering the monies, whereas a 'neutral accountant would wait until

the matter unfolds before taking any action'. Thus, keeping both prudence and neutrality in the framework will only lead to confusion and misrepresentation of the truth in the financial statement.

- Furthermore, other areas of the framework such as faithful representation also clash with the concept of prudence, as the information decisions which are made under the prudence concept do not always represent transactions faithfully, leading to information not being fully reliable. Therefore, as long as financial statements are as accurate as possible and represent the reality of the accounts as much as possible following the other frameworks, prudence is not needed.
- Showing contrast, many may argue that in circumstances where assets and profits have been overstated, accounts, accountants and accounting standards are most criticised due to the result their actions and decisions have had on financial reports. There is an obvious risk in prudence that it can cause bias in financial reporting as it introduces a degree of conservatism that diverts the reports from unbiased and/or neutral. Thus, many accountants saw the disappearance of the prudence concept as a positive outcome, as it discouraged the 'cookie jar' accounting that concealed volatility.
- When challenged over the desirability of restraint in profit recognition it is often pointed out that while prudence may hold back profits in one year, such restraint may simply lead to their release in a subsequent period which as a result will show exaggerated results (cookie jar accounting).

(ii) **Argument for the inclusion of prudence**

- Accounts are a parallel representation of a company's results. This view is agreed upon by professionals along with the public. As a company's financial conditions are major concerns to both investors and creditors, it is important for there to be true image of a company's finance. Underestimating a company's profits may put off investors, conversely, overestimating a company's expenses may worry creditors.

- Prudence is an important factor in recording financial statements as it is where both asset and profits have been overstated to an extent where accountants felt it was necessary, and where liabilities and expenses are understated to provide a sense of stability to a firm's accounts. If accountants are to overestimate losses on business, the company's income will look much worse than it actually is. Underestimation has the reverse effect, where income looks much better than its reality.
- There is an ideology that audited numbers are 'hard', this being exercised during estimates upon looking at previous frameworks. Estimates, by their nature, tend to overstate and understate a company's performance. Thus, best way to avoid misstatement is to follow the standard accounting principle of prudence and be cautious when making judgments under conditions of uncertainty.

- The reintroduction of prudence will only support other accounting frameworks, working side by side to create a real image of accounts which can be used in order to make the best decisions by users.

- Prudence requires an open mindedness that is a necessary trait for accountants. It is required by accountants regardless of whether it is included in the framework or not. Inherited from the early years, it is recognisable by everyone that the prudence concept is a key principle in financial accounting by being a characteristic of past standards, existing and future standards.

Conclusion

It not necessary to be recognized by the conceptual framework as it further enhances precaution in financial accounts. The application of precaution helps the financial misstatements and can give a false optimism to the information's users, especially investors who make decisions based on the information provided. Companies use the precautionary principle of prudence to retain revenues or create hidden reserves in financial reporting, which distorts true, realistic figures which can affect the decisions made by information users.

b. i. **Asset:**

Previous definition

A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity

New definition

A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic
benefits.

Justification

The new definition clarifies that an asset is an economic resource, and that the potential economic benefits no longer need to be 'expected' to flow to the entity – they do not need to be certain or even likely (but if this is the case, the recognition and measurement of the asset may be affected).

ii. **Liability**

Previous definition

A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits

New definition

A present obligation of the entity to transfer an economic resource as a result of past events. An obligation is a duty of responsibility that the entity has no practical ability to avoid.

Justification

The main difference is that the new definition clarifies that a liability is the obligation to transfer an economic resource, and not the ultimate outflow of economic benefits. The outflow also no longer needs to be 'expected', similar to the change in the definition of an asset, above. The Board also introduced the concept of 'no practical ability to avoid' to the definition of an obligation, and factors used to assess this will depend on the nature of an entity's duty or responsibility, which requires the use of judgement. Chapter 4 includes discussions of how to apply the concept in different circumstances.

Examiner's Comment

The question tests candidates' knowledge of comparing the conceptual framework of 2010 with the revised conceptual framework of 2018 with a view to bring out argument for and against reintroduction of prudence concept into the conceptual framework. The question also tests knowledge of old and new definition of assets and liabilities with justification.

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

The commonest pitfalls of the candidates were poor display of the awareness of the revised conceptual framework and their inability to differentiate between new and old definitions of assets and liabilities.

Candidates are advised to familiarise themselves with current developments in financial reporting. They should also be familiar with ICAN study texts for better performance in the Institute's future examinations.

Marking guide

		Marks	Marks
a.	Argument for re-introduction of prudence into conceptual framework	3	
	Argument against re-introduction of prudence into conceptual framework	3	
	Conclusion	1	7
b.	Old definition	2	
	New definitions of assets and liabilities	2	
	Justification for the revised definition	4	8
	Total		**15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2021

ADVANCED TAXATION

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Carrol Nigeria Limited, a medium- sized company, commenced business in 2011. The company has three subsidiaries, which are into manufacturing of household utensils and baby products. The fortunes of the company have been dwindling in the last three years due to high cost of imported raw materials, overheads, low patronage from customers and ever-increasing demands from the host communities on provision of social amenities.

As a result of this unfavourable business climate, the board in one of its meetings in 2016 decided to reduce the workforce and permanently close down one of its subsidiaries. Two of the staff in the Finance Department who are chartered accountants were affected. A young promising first degree holder, with limited knowledge in taxation and fiscal policy, was subsequently appointed as the Group Accountant.

In the last three years, the company has been facing challenges with the tax authorities on issues that bother on tax compliance. The Group Managing Director was embarrassed last month when the tax officer informed him that proper books or records of accounts necessary for the correct determination of tax liabilities were not kept by the company. In addition, gaps were noticed in the information provided in the company's annual returns filed and the Revenue Service is in the process of conducting back duty audit.

You have been approached by the Group Managing Director to help in finding solution to these challenges, which the company is presently facing. The Group Managing Director also provided you with some documents, which you may need in recomputing the company's income tax liabilities for the year ended December 31, 2020.

The statement of profit or loss for the year ended December 31, 2020, is as follows:

	₦'000	₦'000
Gross turnover		88,200
Less:		
Opening inventory	2,300	
Purchases	24,650	
Carriage inwards	1,050	
Closing inventory	(3,410)	
Factory salaries and wages	4,040	
Depreciation of factory plants	1,890	
Other factory overhead expenses	4,480	35,000
Gross profit		53,200
Other income		2,500
		55,700
Less:		
Administrative salaries	6,600	
Administrative expenses	7,750	
Pension fund contribution	1,120	
Motor running expenses	1,250	
Staff medical expenses	800	
Audit and professional fees	2,000	
Donation	750	
Transport and traveling	900	
Rent and rates	1,200	
Telephone	300	
Printing and stationery	950	
Repairs and maintenance	480	
Allowance for doubtful debts	1,000	
Depreciation of office equipment	2,640	
Miscellaneous expenses	1,550	29,290
Net profit		26,410

Additional information

(i) Other income included ₦320,000 realised from the disposal of the company's old plant.

(ii) Administrative expenses included ₦250,000 paid to a legal practitioner for the defense and release of the company's driver who was caught by traffic officers for driving against traffic.

(iii) 30% of motor running expenses was expended on the personal expenses of the Managing Director.

(iv) 20% of the donation was paid to a fund created by the State Government for assisting victim of insurgents.

(v) Repairs and maintenance included ₦215,000 being the cost of erecting the company's gate that was destroyed during a protest by the youths in the area of company's operations.

(vi) Allowance for doubtful debts comprised of general provision, ₦600,000 and specific provision, ₦400,000.

(vii) Miscellaneous expenses included ₦450,000 incurred on the purchase of hamper gifts to the company's customers during Sallah and Christmas seasons.

(viii) A check made on the documents given to the tax consultant revealed that the gross turnover was understated by ₦750,000.

(ix) Below is the schedule of qualifying capital expenditure on property, plant and equipment.

Nature	**Date of acquisition**	**Amount ₦'000**
Factory building	September 8, 2016	3,800
Furniture and fittings	October 12, 2016	1,600
Motor van	June 19, 2018	4,200
Factory building	March 8, 2020	6,500
Furniture and fittings	April 15, 2020	2,000
Industrial plant	July 1, 2020	5,700
Motor van	December 20, 2020	4,240

(x) Unutilised capital allowances brought forward was ₦1,500,000 and balancing charge of ₦155,000 realised on disposal of the old industrial plant.

Required:

As the company's tax consultant, you are to send a report to the Group Managing Director addressing the following areas:

a. Provisions of the Companies Income Tax Act CAP C21 LFN 2004 (as amended) and Finance Act 2020 regarding maintenance of books or records of accounts (4 Marks)

b. Back duty audit and its implications (4 Marks)

c. Computation of the company's tax liabilities (with supporting schedules) for the relevant tax year (22 Marks)

(Total 30 Marks)

SECTION B: OPEN-ENDED QUESTIONS (40 MARKS)

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

QUESTION 2

Debby Oil Limited is an oil prospecting company that has been operating in the deep ocean of Niger Delta since 1990. The company makes up its accounts to December 31 every year.

The company is in discussion with a consortium of five deposit money banks in Nigeria for the purposes of taking a medium term (5years) loan facility of US $5 million to finance further expansion of its facilities and acquisition of a marginal field. As part of the documents required by the banks for processing the loan facility, are the audited financial statements and tax computations for the last five financial years. The company is yet to submit the documents for the year ended December 31, 2020 to the consortium.

The extract from its activities for the year ended December 31, 2020 is as presented below:

	₦'000
Oil inventory- January 1, 2020	1,220,000
Oil inventory- December 31, 2020	1,380,000
Sales: Export	9,524,000
Local	2,900,500
Other income	1,235,300
Production cost	3,440,000
Operating expenses	1,789,600
Intangible drilling cost	1,425,200
Tangible drilling cost	532,000
Travelling expenses	54,000
Salaries and wages	1,860,000
Pension fund contribution	175,000
Loan interest	150,000
General expenses	800,500
Depreciation	170,000
Royalties and production rentals	810,000
Donation	20,000
Bank charges	25,300
Habour dues	15,000
Non-productive rent	350,000
Audit and accountancy fees	28,000
Customs duty on essentials	7,300
Income tax provision	865,860
Transfer to general reserves	900,000

Additional information

(i) Posted prices of crude oil exported is US$35 per barrel at the standard API gravity of 32^0.

(ii) Actual realised price is arrived at after adjusting for the deviation from the standard API. A decrease from the standard API gravity attracts a decrease of US $0.20 and vice versa for an increase in the API gravity.

(iii) Crude oil exported during the year was 650,000 barrels at API gravity of 34^0. Other income for the year amounting to ₦735 million was made from the company's ocean tanker going business. The associated expenses incurred, ₦580.5, million, was included in general expenses.

(v) Included in operating expenses was the sum of ₦9 million spent on renewal of short lease.

(vi) Pension fund contribution was approved by the State Internal Revenue Service.

(vii) Loan interest included ₦78 million paid to a subsidiary company. The terms of the loan agreement was approved by the board of directors.

(viii) The company acquired a new pipeline and storage tank for the sum of ₦150 million and is used in off-shore operation in territorial waters and continental shelf area of 180 metres water depth.

(ix) The board at one of its sittings approved the amount transferred to general reserves.

(x) Capital allowances agreed with the tax authorities for the year were annual allowance ₦120 million and balancing charge ₦8 million.

(xi) Assume ₦420 is equivalent to US $1.

Required:

As the company's Assistant Tax Manager, you are to draft a report to the Tax Manager showing the tax liability of the company for the relevant assessment year in line with the provisions of Petroleum Profits Tax Act Cap P.13 Laws of the Federation of Nigeria 2004 (as amended). **(Total 20 Marks)**

QUESTION 3

The board of directors of Dragbat Limited, Lagos, a medium-sized company, at its last meeting, deliberated on the company's tax related issues vis-à-vis one of its major competitors in the same line of business. The Managing Director presented the audited accounts of the two companies for the previous three years. He affirmed that their company has been paying more corporate and tertiary education taxes than their competitors, while returning lower profit before tax in each of the years under review. The board has since directed the Managing Director to do a thorough investigation on how competitors, according to the Chairman of the board, are having it easy with the tax authorities.

With the assistance of a former course-mate in the university, who works in the Finance unit of a competitor's organisation, the Managing Director was informed that the competitor was involved in tax planning and tax avoidance activities and these have helped in reducing the company's tax liabilities over the years.

Being an engineer with sparse knowledge of accounting and taxation, the Managing Director has contacted you as the company's tax consultant to help explain some fundamental issues in tax planning and tax avoidance. To help you in carrying out this assignment, the Managing Director of Dragbat Limited provided you with the audited financial statements of the two competing companies for the last three years. He also informed you that the major difference between the two companies is simply that their organisation is servicing a loan facility of ₦120 million obtained five years ago and the company is not finding it comfortable in implementing the terms of the loan, despite its increased profitability over the last three years.

As the board will be meeting in a fortnight to consider the report on the preliminary investigation carried out, the Managing Director expects you to submit your report to him next week.

Required:

As the company's tax consultant, you are expected to address and advise on the following issues in your report:

a. The concepts of tax planning, tax avoidance and thin capitalisation (9 Marks)

b. Tax planning activities and strategies (6 Marks)

c. Tax implications on companies that practice tax planning, tax avoidance and thin capitalisation (5 Marks)

(Total 20 Marks)

QUESTION 4

Colends Nigeria Limited, Abeokuta, is a manufacturer of plastic materials. The company is well known for prompt payment of taxes as at when due. The cordial relationship between the company and the Federal tax authorities is about to be breached as a result of disagreement in the classification of some transactions made by the company. The tax authorities considered those transactions to be artificial or fictitious, while the Managing Director, who is not an accountant, felt otherwise.

The company is in the process of re-organising its operations so as to compete favourable with its contemporaries, particularly with the implementation of Africa Continental Free Trade Area Agreement (ACFTA) by some African countries.

The following transactions were concluded by the company during the financial year ended December 31, 2020:

(i) Land and building acquired for ₦70 million on March 6, 2015 were sold for ₦125 million. Advertisement cost was ₦500,000, while the estate agent received as commission 5% of the sale proceeds;
(ii) Plant and machinery, which originally cost ₦28 million were sold for ₦32 million to one of its subsidiaries, Colmas Limited. The market value of the assets sold was ₦40 million;
(iii) A saloon motor vehicle acquired for ₦5 million in 2017 was sold to the General Manager of the company for ₦3.5 million. The market value of the car was put at ₦5.5 million; and
(iv) A giant generator that was acquired in 2018 for ₦12 million was disposed of for ₦15 million. The cost of disposal amounted to ₦200,000.

At a recent meeting of the board, the following transactions were approved and management completed implementation of the decision in December 2020:

- Acquisition of a vast acreage of land and a building in the outskirt of the city-centre for the purpose of the business for ₦100 million;
- Purchase of a modern plant and machinery for the sum of ₦50 million;
- A saloon motor vehicle was purchased for ₦10 million; and
- A brand new generator that cost ₦20 million was acquired.

Colends Nigeria Limited has just appointed you as its tax consultant.

Required:

Draft a report to the Managing Director of the company explaining:

a. Connected persons and artificial transactions (4 Marks)

b. The tax implications, if any, on transactions executed by the company in accordance with the provisions of Capital Gains Tax Act Cap C1 LFN 2004 (as amended) (16 Marks)

(Total 20 Marks)

SECTION C: OPEN-ENDED QUESTIONS (30 MARKS)

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

QUESTION 5

The rapid growth in information and communication technology in Nigeria has brought with it boundless opportunities and changes in the way business activities are done. A significant number of transactions in Nigeria, in recent times, are consummated using mobile devices and online payments. In the same vein, the online platforms (mostly operated by international private entities), are perceived by various governments in developing countries (Nigeria inclusive) as means of undermining the economic interest of their host countries through non-payment of taxes in spite of their significant economic presence.

In the light of the above, the Finance Act 2019 provides for the treatment of digital and other services' providers in relation to significant economic presence of a foreign entity. This was also followed up with the issuance of Companies Income Tax (Significant Economic Presence) Order 2020 by the Federal Government of Nigeria.

You have been contacted by a foreign online outfit with interest in mobile networking and consultancy, TWITTY Incorporation, California, USA, through its official partner in Nigeria MAAbioro Partners, to explain issues on significant economic presence of a foreign entity, deemed to be operating in Nigeria.

Required:

As a tax consultant to TWITTY Incorporation, you are to draft a report explaining the under listed areas:

a. The objectives of the relevant provisions of Finance Act 2019 and Companies Income Tax (Significant Economic Presence) Order 2020 in respect to significant economic presence of a foreign entity (3 Marks)

b. Conditions for the determination of significant economic presence for digital activities 5 Marks)

c. Determination of significant economic presence for technical and consultancy services (2 Marks)

d. Activities exempted from significant economic presence in Nigeria (3 Marks)

e. The tax implications of the Order 2020 on activities of TWITTY Incorporation. (2 Marks)

(Total 15 Marks)

QUESTION 6

At a workshop on "Base Erosion and Profit Shifting (BEPS)" organised by the Federal Ministry of Industries, one of the resource persons submitted that BEPS is a corporate tax planning strategy used by multinational corporations to "shift" profits from higher-tax jurisdictions to lower-tax jurisdictions, thereby eroding the tax base of the higher-tax jurisdictions.

One of the participants, an engineer and the General Manager of a leading manufacturing outfit based in Jos, with head office in one of the European countries, was unable to understand the issues being discussed. He sought explanation from two other participants, yet he was not convinced.

On getting to the office after the workshop, he decided to approach you as the company's Tax Manager for explanation on the concept of BEPS and whether it will be worthwhile for the company (in collaboration with the head office) to engage in such activities.

Required:

As the company's Tax Manager, you are to draft a paper addressing the concern of the General Manager, particularly in the following areas:

a. Distinction between base erosion and profit shifting (3 Marks)

b. Techniques of base erosion and profit shifting (4 Marks)

c. The **SIX** action initiatives of the Organisation for Economic Cooperation and Development against base erosion and profit shfting (6 Marks)

d. The implications of engaging in base erosion and profit shifting (2 Marks)

(Total 15 Marks)

QUESTION 7

The inability of the Federal government revenue generating agencies meeting up with set revenue targets was the subject of discourse between the Minister of Finance and Chief executives of these agencies in October 2021.

The Minister stressed that the Federal government has given more than necessary incentives and support to these agencies, yet abysmal performance was the end result. The Federal government has therefore decided to wield the "big stick" on any chief executive that fails to meet up with revenue targets for the financial year ending December 31, 2021.

The decision of the Federal government was seen as a challenge by its state counterpart. As a result, the chairman of "MATS" State Board of Internal Revenue, in a bid to increase the revenue drive from the self – employed category, announced various incentives to staff who are able to meet the revenue targets set.

You have been engaged as the tax consultant to the chairman of "MATS" State Board of Internal Revenue.

Required:

Advise the chairman of "MATS" State Board of Internal Revenue in:

a. Identifying constraints facing the tax authorities in the assessment and collection of taxes from self-employed taxpayers (8 Marks)

b. Evolving strategies for expanding the Nigerian tax net to improve tax collection from the self- employed category of taxpayers (7 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 with 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%
5. TERTIARY EDUCATION TAX (2% of Assessable Profit)
6. CAPITAL GAINS TAX 10%
7. VALUE ADDED TAX 7.5%

SOLUTION 1

Shinny Tax Consultants
Plot 3, Junaid Avenue, Ilorin

March 19, 2021
The Group Managing Director
Carrol Nigeria Limited
Kaduna

RE: MAINTENANCE OF BOOKS OR RECORDS OF ACCOUNTS, BACK AUDIT AND COMPUTED TAX LIABILITIES

We refer to our discussion and subsequent appointment as the company's tax consultant for the purpose of providing professional services on issues of concern to the company. Our comments are as follows:

a. Provisions of Companies Income Tax Act (CITA) CAP C21 LFN 2004 (as amended) and Finance Act 2020 on maintenance of books or records of accounts

Maintenance of books or records of accounts is essential for correct assessment of a taxpayer (individual or corporate entity) to be made by the relevant tax authority. In order to give clarity and importance to this aspect, section 63, CITA 2004 (as amended) was expunged and substituted with a new one, Section 17, Finance Act 2020.

The new provisions in Finance Act 2020 include the following:

i. Every company, including a company granted exemption from incorporation, shall, whether or not the company is liable to pay tax, maintain books or records of accounts, containing sufficient information or data of all transactions;
ii. The books and records required to be maintained shall be in English language and shall, for the purposes of tax accounts, be consistent with the format that may be prescribed by the Revenue Service;
iii. Where a record of a company is maintained in a language other than the English language, the company shall, on demand by the Revenue Service, produce, at its own expense, a translation in English language, which shall be certified by a sworn translator;
iv. Any company that on request by the Revenue Service, fails to provide any record or book prescribed by this Act shall be liable to pay as penalty:
   - ₦100,000 in the first month in which the failure occurs; and
   - ₦50,000 for each subsequent month in which the failure continues.
v. Where, in the opinion of the Revenue Service, a company fails or refuses to maintain books or records of accounts or adequate for the

purposes of tax, the Revenue Service may, by notice in writing, require it to maintain such records, books and accounts as the Service considers adequate, in such form and language as may be specified in the notice;

vi. Any direction of the Service made shall be subject to objection and appeal in like manner as an assessment; and

vii. Any book or record required to be kept shall be kept for a period of at least six years after the year of assessment in which the income relates.

b. **Back duty audit and its implication**

Back duty: The tax laws, CITA 2004 (as amended) (for companies) and PITA 2004 (as amended) (for individuals and unincorporated entities) provide that relevant tax authority may from time to time and as long as it wishes, carry out a back duty audit on a taxpayer. Back duty has the following features:

i. During the course of the audit, the records of the taxpayer are checked to examine the truth in the information that was earlier provided in the annual returns or tax computations;

ii. The objective of the back duty audit is to confirm that income has not been materially understated and that expenses have not been overstated;

iii. It also seeks to determine whether all the expenses included in the tax computations are allowable for tax purposes; and

iv. The audit will also verify the values of the qualifying capital expenditure so as to confirm that the basis of capital allowance computation is reliable.

Implications of back duty audit are:

i. At the end of the audit, the findings of the tax computations are reviewed and compared with the tax computations earlier submitted and on which remittances were previously based. The shortfall on a yearly basis is determined and this forms the basis of an additional assessment.

ii. An additional assessment arising from such an exercise is subject to the objection and appeal procedures.

iii. The Service during the back duty audit may open the records of the company to the preceding years up to 6years or beyond.

c. **Computation of the company's tax liability**

The attached Appendices 1, 2 and 3 show the results of the adjusted profit, tax liability and capital allowance. The results indicate that the adjusted profit of the company for the year ended December 31, 2020 was ₦32,810,000.

The company was able to relieved its capital allowance, which amounted to ₦11,697,990, thereby having a total profit of ₦21,267,010.

In line with the provision of Finance Act 2019, the company being a medium-sized company was liable to pay companies income tax at the rate of 20%. This gives tax liability of ₦4,253,402.

Following the provision of Tertiary Education Trust Fund (Establishment, etc) Act 2011 (as amended), the company is liable to pay 2% of its assessable profit as tertiary education tax. This amounted to ₦659,300.

In order not to be sanctioned by the Revenue Service, you are advised to file your annual returns, which must include the audited financial statements and schedule of tax computations with the Revenue Service and payment made within the statutory period allowed.

Please do not hesitate to contact the undersigned, should you require further clarifications.

Yours faithfully,

Raheem Ojo
Principal Partner
For: Shinny Tax Consultants

Appendix 1: Computation of adjusted profit for the year ended December 31, 2020

	₦	₦
Net profit as per accounts		26,410,000
Add back: Disallowable items:		
Depreciation of factory plant	1,890,000	
Depreciation of office equipment	2,640,000	
Administrative expenses	250,000	
Motor running expenses (30% of ₦1,250,000)	375,000	
Repairs and maintenance	215,000	
General provision for doubtful debts	600,000	
Understatement of turnover	750,000	6,720,000
		33,130,000
Less: Disposal of old plant		320,000
Adjusted profit		**32,810,000**

Appendix 2: Tax liability for 2021 Tax Year	**₦**	**₦**
Adjusted profit		32,810,000
Add: Balancing charge		155,000
Assessable profit		32,965,000
Less: Capital allowances		
Unutilised b/f	1,500,000	
For the year	10,197,990	
Available for relief	11,697,990	
Relieved	(11,697,990)	(11,697,990)
Unutilised c/f	NIL	
Total profit		**21,267,010**
Companies income tax @ 20% of ₦21,267,010		4,253,402
Tertiary education tax @ 2% of ₦32,965,000		659,300

Appendix 3: Capital allowance computation

	Factory building IA 15% AA 10%	Furniture & Fittings IA 25% AA 20%	Motor van IA 50% AA 25%	Industrial plant IA 50% AA 25%	Capital allowance
2017 Y/A	₦	₦	₦	₦	₦
Cost	3,800,000	1,600,000			
IA	(570,000)	(400,000)			970,000
AA	(323,000)	(240,000)			563,000
					1,533,000
2018 Y/A					
TWDV	2,907,000	960,000			
AA	(323,000)	(240,000)			**563,000**
2019 Y/A	2,584,000	720,000			
Cost			4,200,000		
IA			(2,100,000)		2,100,000
AA	(323,000)	(240,000)	(525,000)		1.088,000
					3,188,000
2020 Y/A					
TWDV	2,261,000	480,000	1,575,000		
AA	(323,000)	(240,000)	(525,000)		**1,088,000**
2021 Y/A					
TWDV	1,938,000	240,000	1,050,000		
Cost	6,500,000	2,000,000	4,240,000	5,700,000	
IA	(975,000)	(500,000)	(2,120,000)	(2,850,000)	6,445,000
AA	W3(875,500)	(539,990)	(1,055,000)	(712,500)	3,182,990
		W1	W2		
Invest allow				(570,000)	570,000
					10,197,990

Workings

1.	Annual allowance for furniture and fittings in 2021 Y/A	₦239,990
	AA for the old asset = ₦240,000 – ₦10 =	
	AA for the new acquisition = $\frac{₦2,000,000 - ₦500,000}{5}$	300,000
		539,990
2.	Annual allowance for motor van in 2021 Y/A	
	AA for the old asset =	₦525,000
	AA for the new acquisition = $\frac{₦4,240,000 - ₦2,120,000}{4}$	530,000
		1,055,000
3.	Annual allowance for factory building in 2021 Y/A	
	Old factory building AA =	₦323,000
	New factory building AA = $\frac{₦6,500,000 - ₦975,000}{10}$	552,500
		875,500

Examiner's report

The question tests the candidates' understanding of the provisions of Companies Income Tax Act 2004 (as amended) and Finance Act 2019 regarding maintenance of books or records of accounts, back duty audit 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 above average.

The commonest pitfall was the inability of some candidates to state correctly the provisions of Finance Act 2019 in respect to maintenance of books or records of accounts.

Candidates are advised to familiarise themselves with issues concerning maintenance of books or records of accounts by reading extensively the Institute's Study Text, other relevant textbooks and the Finance Act 2019.

	Marking guide	Marks	Marks
(a)	Heading	1	
	Provision of CITA and Finance Act (Discussions on any 3 points @ 1 mark each)	3	4
(b)	Back duty audit (Any 2 points @ 1 mark each)	2	
	Implication (Any 2 points @ 1 mark each)	2	4
(c)	Computation of tax liability:		
	Main body of the letter (Any 2 points @ ½ mark each)	1	
	Appendix 1- Adjusted profit:		
	Net profit as per accounts	½	
	Depreciation of factory plant	½	
	Depreciation of office equipment	½	
	Administrative expenses	½	
	Motor running expenses	½	
	Repairs and maintenance	½	
	General provision for doubtful debts	½	
	Understatement of turnover	½	
	Disposal of old plant	½	
	Adjusted profit	½	
	Appendix 2- Tax liability for 2021 tax year:		
	Balancing charge	½	
	Assessable profit	½	
	Capital allowances:		
	Unutilised	½	
	For the year	½	
	Total profit	½	
	Companies income tax	½	
	Tertiary education tax	½	
	Appendix 3- Capital allowance computation:		
	2017 Y/A (9 ticks @ ¼ mark each)	2¼	
	2018 Y/A (5 ticks @ ¼ mark each)	1¼	
	2019 Y/A (10 ticks @ ¼ mark each)	2½	
	2020 Y/A (7 ticks @ ¼ mark each)	1¾	
	2021 Y/A (19 ticks @ ¼ mark each)	4¾	
			22
	Total		**30**

SOLUTION 2

Debby Oil Limited
Plot 45, Aboki Road, PortHarcourt

INTERNAL MEMO

April 1, 2021

From: Assistant Tax Manager
To: Tax Manager

Subject: COMPUTATION OF TAX LIABILITY FOR 2020 YEAR OF ASSESSMENT

Your memo on the above subject matter dated March 28, 2021, refers.

I have completed the assignment and the result shows that our company will pay a total tax liability of ₦2,132,004,000, which comprises chargeable tax of ₦2,080,208,000 and ₦51,796,000 tertiary education tax.

Attached herewith for your perusal and further necessary action, is the schedule, which shows how the result was arrived at.

Best regards,

Segge Oshah
Assistant Tax Manager

SCHEDULE OF COMPUTATION OF TAX LIABILITY

Debby Oil Limited
Computation of Tax Liability
For 2020 Year of Assessment

	₦'000	₦'000	₦'000
Crude oil exported (W1)			9,664,200
Crude oil sold locally			2,900,500
Difference in inventory (₦1,220,000 – ₦1,380,000)			(160,000)
Other income (₦1,235,300 – ₦735,000)			500,300
Balancing charge			8,000
			12,913,000
Less: Allowable expenses			
Production cost		3,440,000	
Operating expenses		1,789,600	
Intangible drilling cost		1,425,200	
Traveling expenses		54,000	
Salaries and wages		1,860,000	
Pension fund contribution		175,000	
Loan interest (₦150,000 – ₦78,000)		72,000	
General expenses (₦800,500 – ₦580,500)		220,000	
Royalties and production rentals		810,000	
Bank charges		25,300	
Harbour dues		15,000	
Non-productive rent		350,000	
Audit and accountancy fees		28,000	
Customs duty on essentials		7,300	
Tertiary education tax (2/102 x ₦2,641,600)		51,796	10,323,196
Adjusted profit/Assessable profit			2,589,804
Less: Capital allowances:			
Lower of actual annual allowance	120,000		
Petroleum investment allowance (W2)	22,500		
	142,500		
Or			
85% of assessable profit of ₦2,589,804	2,201,333		
Less 170%of PIA (1.7 x ₦22,500)	38,250		
	2,163,083		
			142,500
Chargeable profit			2,447,304
Assessable tax @ 85% of ₦2,447,304			2,080,208
Chargeable tax			2,080,208
Tertiary education tax			51,796
Total tax liability			2,132,004

Workings

(1) **Crude oil exported**

	API	$
Standard	32^0	35.00
Actual	34^0	
Difference	2^0 x $0.2	0.40
Posted price		35.40

Since US $1 is equivalent to N420, the posted price in Naira = 35.4 x ₦420 = ₦14,868 per barrel

Crude oil exported = ₦14,868 x 650,000 barrels = ₦9,664,200,000. This is greater than the actual receipt of ₦9,524,000,000 as reported in the financial statements. The practice of the Revenue is to pick the higher of the two figures.

(2) **Petroleum investment allowance (PIA)**
Cost of a new pipeline and storage tank = ₦150 million
Location of the asset is 180 metres water depth. Rate = 15%
Therefore, PIA = 15% of N150 million = ₦22.5 million.

Examiner's report

The question tests the candidates' knowledge of assessment of an oil prospecting company to petroleum profits tax.

Over 70% of the candidates attempted the question and they exhibited a clear understanding of the requirements of the question. Performance was good.

The commonest pitfall was the inability of some candidates to correctly identify allowable expenses needed for the determination of assessable profit.

Candidates are advised to pay attention to assessment of oil prospecting companies to petroleum profits tax by reading the Institute's Study Text, other relevant textbooks and tax laws.

Marking guide

	Marks
Heading of the memo	1
Discussion on the result of the tax computation	
(Body of the memo)	1
Schedule of computation of tax liability:	
Heading	1
Crude oil exported	½
Crude oil sold locally	½
Difference in inventory	½
Other income	½
Balancing charge	½
Production cost	½
Operating expenses	½
Intangible drilling cost	½
Travelling expenses	½
Salaries and wages	½
Pension fund contribution	½
Loan interest	½
General expenses	½
Royalties and production rentals	½
Bank charges	½
Harbour dues	½
Non-productive rent	½
Audit and accountancy fees	½
Customs duty on essentials	½
Tertiary education tax	½
Adjusted profit/assessable profit	½
Actual annual allowance	½
Petroleum investment allowance (PIA)	½
85% of assessable profit	½
170% of PIA	½
Capital allowance figure (₦142,500)	½
Chargeable profit	½
Assessable tax	½
Chargeable tax	½
Tertiary education tax	½
Total tax liability	½
Workings:	
Posted price figure ($35.40)	½
Value of crude oil exported (₦9,664,200,000)	½
PIA value (₦22.5 million)	½
Total	**20**

SOLUTION 3

Sunny & Co. (Tax Consultants)
Success Avenue
Lagos

October 4, 2021

The Managing Director
Dragbat Limited
Independence Road
Lagos.

Dear Sir,

RE: ADVICE ON TAX PLANNING, TAX AVOIDANCE AND THIN CAPITALISATION

I refer you to our discussion in your office requesting us to address and provide advice on the above subject. We have since concluded the assignment and our comments are as follows:

a. Concepts of tax planning, tax avoidance and thin capitalisation

i. **Tax planning**

- This is the analysis and arrangement of a taxpayer's financial situation in order to maximise allowances and tax reliefs and minimise tax liabilities in a legal and efficient manner.
- It involves anticipating a set of circumstances and the identification of opportunities to minimise or defer tax liabilities within the law.
- Tax rules can be complicated, but taking some time to know and use them for one's benefit can change how much one ends up paying as tax.

ii. **Tax avoidance**

- This arises in a situation where the taxpayer arranges his financial affairs in a form that would make him pay the least possible amount of tax.
- For example, avoidance of value added tax can be achieved by anyone or organisation that does not buy the goods and /or services on which VAT is levied.
- Apart from boycotting the goods or services, tax avoidance schemes are carried out after a critical review of the tax laws. The taxpayer would then implement devices to exploit loopholes in the tax laws that would enable him avoid or minimise tax.
- To a very large extent, tax avoidance is legal once it is done within the limits permissible by the tax laws.

iii. **Thin capitalisation**

- A company is said to be thinly capitalised when its capital is made up of a much greater proportion of debt than equity. It shows that the company's gearing or leverage is too high.
- A thinly capitalised company is perceived to create problems for two classes of people. These are:
  - **Creditors:** They bear the solvency risk of the company, which has to repay the bulk of its capital with interest; and
  - **Tax authorities:** They are concerned about abuse by excessive interest deduction, which at the end of the day, will lead to loss of tax income to the tax authorities/government.
- Following from the review carried out by us on your financial statements, your company is headed towards thin capitalisation. We advise that the terms of the loan should be restructured in such a way that annual interest payment will be less and the principal sum spread over long period. In such a way, more money hitherto spent in paying the loan will be freed and used for other ventures that will have positive effect on the company's profitability.

b. **Tax planning activities and strategies**

The following are known tax planning activities and strategies:

i. There are always tax planning opportunities for companies regardless of their sizes or the jurisdictions they work in;

ii. At the local level, corporate tax planning is carried out through a review of the company's income generation activities, expenses, benefits and other deductions, profit distribution, tax rates and any other variable that may affect the final result, against the applicable law to find optimisation opportunities;

iii. In addition to local planning strategies, multinational enterprises can make use of international tax planning to take advantage of the differences in the rates from one jurisdiction to another, and the different tax benefits that may be offered between jurisdictions;

iv. With a sound corporate tax planning process, companies can reflect their requirements to comply with local legislation in countries they operate;

v. Tax planning is a right that taxpayers, including your company, must exercise to reduce tax liability and improve profitability while fully complying with the extant legislation to avoid penalties and further risks; and

vi. As a matter of urgency, your company should engage an experienced and trusted tax planning strategist/ consultant to receive sound advice and guidance so as to make informed decisions on how to protect the company. Perhaps, this may be the cutting hedge your competitor is using over the years to pay lesser tax liabilities.

c. Tax implications on companies that practise tax planning, tax avoidance and thin capitalisation are:

i. There is no offence in practising tax planning so far it is not done to the limit. If properly implemented, planning could result in significant financial advantage to a business concern as lower tax liability will be paid;
ii. However, if it is practiced to the limit, the tax authorities can disregard such transactions and appropriate tax liability paid by the taxpayer;
iii. On tax avoidance, this is also supported by tax laws and is legal as the taxpayer only exploited loopholes in the tax legislation to pay reduced/lower tax liability;
iv. When tax avoidance schemes are stretched to the limit, transactions would be seen only in mere form and lacking in substance. When this signal is present, the Revenue Service would want to step in to disallow such transactions;
v. The possible reaction of the Revenue Service to where loopholes in the tax legislation have been exploited is to take steps to block the loopholes. Thus, specific legislation would be passed to block particular loophole(s);
vi. For companies having thin capitalisation issues, the profit as well as tax liabilities will be significantly affected negatively; and
vii. The Revenue Service will pay more attention to the interest payment. When it is above a particular threshold in a year (such as 30% of earnings before interest, taxes, depreciation and amortisation, on loans by a foreign connected person, Finance Act 2019), such is considered as excess interest and recognised as a disallowable deduction in that year.

If you require further clarifications on issues raised above, please do not hesitate to contact us.

Your faithfully,

Sunny Kaj
Principal Partner
For: Sunny & Co. (Tax Consultants)

Examiner's report

The question tests candidates' understanding of the concepts of tax planning, tax avoidance and thin capitalisation.

About 50% of the candidates attempted the question, but majority of them lacked a good understanding of the requirements of the question, hence performance was below average.

The major pitfall of the candidates was their inability to state clearly tax implications on companies that practice tax planning, tax avoidance and thin capitalisation.

Candidates are advised to read extensively the Institute's Study Text on tax planning, tax avoidance and thin capitalisation and other relevant tax laws.

Marking guide

		Marks	Marks
(a)	Heading	1	
	Tax planning (Discussions on any 2 points @ 1 mark each)	2	
	Tax avoidance (Discussions on any 3 points @ 1 mark each)	3	
	Thin capitalisation (Any 3 points @ 1 mark each)	3	9
(b)	Tax planning activities and strategies		
	(Discussions on any 6 points @ 1 mark each)		6
(c)	Tax implications on companies that practice tax planning, tax avoidance and thin capitalisation		
	(Discussions on any 5 points @ 1 mark each)		5
	Total		**20**

SOLUTION 4

ToksBlaqy & Co (Tax Consultants)
20, Camp Road, Abeokuta

January 22, 2021

The Managing Director
COLENDS Nigeria Limited
Abeokuta

Dear sir,

RE: CONNECTED PERSONS, ARTIFICIAL TRANSACTIONS AND TAX COMPUTATION

We refer to your memo dated January 10, 2021 and our meeting with the company's management on January 12, 2021, seeking our services as tax consultants to help address the above subject matter. We have completed our assignment and our comments are as follows:

a. Connected persons and artificial transactions

These are explained as follows:

i. In tax practice, certain persons are treated as being so closely involved with each other that they have to be viewed as the same person or that transactions between them need to be treated differently from those "at arm's length". These persons are referred to as "connected persons";

ii. Transactions between such persons may be regarded as artificial or fictitious for the purpose of determining the tax liability arising there from;

iii. The Revenue Service can make whatever adjustments as it considers necessary to counteract the reduction of liability to tax that could otherwise result from such transactions;

iv. Section 23 of Capital Gains Tax 2004 (as amended) provides that where a person acquires an asset and the person making the disposal is connected with him, the person acquiring the asset and the person making the disposal shall be treated as parties to a transaction made otherwise than by way of a bargain at arm's length;

v. The consideration (amount paid) shall be disregarded if less than the market value and the effective consideration shall be deemed to be the market value; and

vi. By applying the provisions of the law to the transactions made by the company, the disposal of the company's plant and machinery to one of its subsidiaries and salon motor vehicle to the General Manager are clearly artificial transactions as the company's subsidiary and the General Managers are connected to the company. This is the main reason why the Revenue Service rejected the proceeds received by the company (from plant and machinery, ₦32million and saloon motor vehicle, ₦3.5 million) and chose instead, the market values of ₦40million and ₦5.5 million for the two assets, respectively.

b. **Tax implications on transactions executed are:**

i. Section 32 of Capital Gains Tax Act 2004 (as amended) makes provision for specific classes of asset that qualify for roll-over relief. The relief is granted to a taxpayer that applied consideration received from disposal of old asset used only for the purposes of trade in acquiring a new asset similar to the one disposed;

ii. The amount of the roll-over relief is deducted from capital gains before the determination capital gains tax payable;

iii. All the assets disposed, except motor vehicle, are part of the classes of asset that qualified for roll-over relief; and

iv. Schedule 1 provides the details of the tax implications on transactions executed.

The company is liable to pay:

- ₦1,825,000 as capital gains tax on land and building;
- ₦Nil on plant and machinery;
- ₦50,000 on saloon motor vehicle; and
- ₦Nil on generator.

This gives total tax payable of ₦1,875,000.

Kindly get in touch with us if you need further clarifications.

Yours faithfully

Abiodun Bambam
Senior Tax Consultant
For: ToksBlaqy & Co (Tax Consultants)

SCHEDULE 1

(i) Computation of capital gains tax liability

	Land and building	
	₦'000	₦'000
Consideration		125,000
Less:		
Cost of acquisition	70,000	
Advertisement	500	
Estate agent's commission	6,250	76,750
Capital gains record		48,250
Less: Roll-over relief (W1)		30,000
Capital gains		18,250
Capital gains tax @ 10% of capital gains		1,825

Plant and machinery

	₦'000
Consideration (market value)	40,000
Less:	
Cost of acquisition	28,000
Capital gains record	12,000
Less: Roll-over relief (W1)	12,000
Capital gains	NIL
Capital gains tax @ 10% of capital gains	NIL

Saloon motor vehicle

	₦'000
Consideration (market value)	5,500
Less:	
Cost of acquisition	5,000
Capital gains	500
Capital gains tax @ 10%	50

Generator

	₦'000	₦'000
Consideration		15,000
Less:		
Cost of acquisition	12,000	
Disposal expenses	200	12,200
Capital gains record		2,800
Less: Roll-over relief (W1)		3,000
Capital gains		NIL
Capital gains tax @ 10% of capital gains		NIL

(ii) Computation of roll-over relief

	Land and building	Plant and machinery	Generator
	₦'000	₦'000	₦'000
Lower of:			
Sale proceeds (old asset)	125,000	40,000	15,000
Re-investment (new asset)	100,000	50,000	20,000
Less: Cost of acquisition (old asset)	70,000	28,000	12,000
Roll-over relief	30,000	12,000	3,000

Examiner's report

The question tests candidates' understanding of the concepts of connected persons and artificial transactions, and capital gains tax computations.

About 70% of the candidates attempted the question and they showed good understanding of the question and performance was good.

The commonest pitfall was the candidates' inability to correctly identify the assets that qualify for roll-over relief, necessary for correct computation of capital gains tax liabilities.

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

Marking guide

		Marks	**Marks**
(a)	Heading	1	
	Main body of the letter (discussions on any 3 points @ 1 mark each)	3	4
(b)	Tax implications on transactions executed		
	Main body of the letter (discussions on any 2 points @ 1 mark each)	2	
	Schedule 1:		
	Computation of capital gains tax liability- land and building:		
	Consideration	½	
	Cost of acquisition	½	
	Advertisement	½	
	Estate agent's commission	½	
	Roll-over relief	½	
	Capital gains	½	
	Capital gains tax	½	
	Computation of capital gains tax liability- plant and machinery:		
	Consideration	½	
	Cost of acquisition	½	
	Roll-over relief	½	
	Capital gains	½	
	Capital gains tax	½	
	Computation of capital gains tax liability- saloon motor vehicle:		

Consideration	½	
Cost of acquisition	½	
Capital gains	½	
Capital gains tax	½	
Computation of capital gains tax liability- generator		
Consideration	½	
Cost of acquisition	½	
Disposal expenses	½	
Roll-over relief	½	
Capital gains	½	
Capital gains tax	½	
Computation of roll-over relief		
Sale proceeds- old asset (3 entries x ¼ mark each)	¾	
Re-investment- new assets (3 entries x ¼ mark each)	¾	
Cost of acquisition- old asset (3 entries x ¼ mark each)	¾	
Roll-over relief (3 entries x ¼ mark each)	¾	16
Total	**20**	

SOLUTION 5

Zigzag Tax Consultants
Aseye Road, Benin City

August 29, 2021

TWITTY Incorporation
California
USA.

Attention: The Principal Partner,

MAAbioro Partners
Sabon-Yewa Avenue
Kano

Dear Sir,

RE: SIGNIFICANT ECONOMIC PRESENCE OF A FOREGN ENTITY

We refer to our discussion on August 22, 2021, in respect of the above subject matter and our subsequent engagement as a tax consultant to TWITTY Incorporation, USA. Having concluded the assignment, we are pleased to present our report for further necessary action by the management of TWITTY Incorporation.

a. The objectives of the provisions of Finance Act 2019 and Companies Income Tax (Significant Economic Presence) Order 2020

These are:

i. The Finance Act 2019 introduced the concept of significant economic presence to expand the scope of Nigerian tax on foreign companies deriving income from their activities in Nigeria which were hitherto not captured in the tax net;

ii. Consequently, the Companies Income Tax (Significant Economic Presence) Order 2020 was issued by the Federal Government of Nigeria; and

iii. The Order provides clarification on what constitutes a significant economic presence for foreign companies doing business, or providing services to customers in Nigeria, in line with section 13(2)(c) and (e) of Companies Income Tax Act 2004 (as amended).

b. **Conditions for determination of significant economic presence for digital activities**

The Order provides that a foreign company shall have a significant economic presence in Nigeria in any accounting year, where it:

Derives ₦25million annual gross turnover or its equivalent in other currencies from any or combination of the following digital activities:

i. Streaming or downloading services of digital contents, including but not limited to movies, videos, music, applications, games and e-books to any person in Nigeria; or
ii. Transmission of data collected about Nigerian users which has been generated from such users' activities on a digital interface including website or mobile applications; or
iii. Provision of goods or services other than those under sub-paragraph 5 of the Order, directly or indirectly through a digital platform to Nigeria; or
iv. Provision of intermediation services through a digital platform, website or other online applications that link suppliers and customers in Nigeria; or
v. Uses a Nigerian domain name (i.e. .ng) or registers a website address in Nigeria; or
vi. Has a purposeful and sustained interaction with persons in Nigeria by customising its digital page or platform to target persons in Nigeria, including reflecting the prices of its products or services in Nigerian currency or providing options for billing or payment in Nigerian currency.

c. **Determination of significant economic presence for technical and consultancy services**

The Order provides that a foreign company providing technical, professional, management or consultancy services shall have a significant economic presence in Nigeria in any accounting year where:

i. It earns any income; or
ii. Receives any payment from a person resident in Nigeria; or

iii. It has a fixed base or agent of a foreign company in Nigeria.

d. **Activities exempted from significant economic presence in Nigeria**

The Order exempts the activities of the following foreign companies from constituting a significant economic presence in Nigeria:

i. Any foreign company under a multilateral agreement and consensus arrangement to address tax challenges arising from the digitalisation of the economy who will be treated under such agreement or arrangement; or

ii. Any foreign company making any payment, where the payment, is made:
  - To an employee under a contract of employment; or
  - For teaching in an educational institution or for teaching by an educational institution; or
  - By a foreign fixed base of a Nigerian company.

e. **The tax implications of the Order 2020 on the activities of TWITTY Incorporation are:**

i. The current status of TWITTY Incorporation is within the ambit of the Order 2020. The implication is that profit derived by the company from Nigerian operation will be assessable to tax in Nigeria;

ii. Maintenance of proper books of accounts that will be relevant for assessment of the company to Nigerian taxes;

iii. For the company to enjoy from numerous tax incentives available to companies incorporated in Nigeria, the company should have a fixed base or better still be fully incorporated as a Nigerian company; and

iv. Failure by the company to comply with the Order 2020 may result to severe sanctions from the Nigerian government. This can cause disruption in operations of the company within the Nigerian space.

Should you need further clarifications, please do not hesitate to contact us.
Yours faithfully,

Otigba Suru
Senior Partner
For: Zigzag Tax Consultants

Examiner's report

The question tests candidates' knowledge of the provisions of Finance Act 2019 and Companies Income Tax (Significant Economic Presence) Order 2020 on the treatment of digital and other service providers of a foreign entity having significant economic presence in Nigeria.

About 50% of the candidates attempted the question. Candidates showed poor understanding of the question, therefore, performance was below average.

The major pitfall was the inability of some candidates to explain correctly the objectives of the relevant provisions of Finance Act 2019 and Companies Income Tax (Significant Economic Presence) Order 2020.

Candidates are advised to read the Institute's Study Text, other relevant textbooks, Finance Act 2019 and Companies Income Tax (Significant Economic Presence) Order 2020 as this will go a long way in assisting them to pass future examinations.

Marking guide

		Marks	Marks
(a)	Heading	1	
	The objectives of the provisions of Finance Act and Order 2020 tend to achieve (Any 2 points @ 1 mark each)	2	3
(b)	Conditions for determination of significant economic presence (discussions on any 5 points @ 1 mark each)		5
(c)	Determination of significant economic presence for technical and consultancy services (Any 2 points @ 1 mark each)		2
(d)	Activities exempted from significant economic presence in Nigeria (Any 3 points @ 1 mark each)		3
(e)	Tax implications of the Order 2020 on activities of TWITTY (Any 2 points @ 1 mark each)		2
	Total		**15**

SOLUTION 6

Welldone Manufacturing Company
New Area Avenue, Jos
INTERNAL MEMORANDUM

From: Tax Manager
To: General Manager
Date: October 5, 2021

Subject: BASE EROSION AND PROFIT SHIFTING (BEPS)

In line with our discussion of October 3, 2021 on your request to be informed on the above subject matter, my comments are as follows:

a. Distinction between base erosion and profit shifting

Base erosion has the following attributes:

i. It is the use of financial measures and tax planning to reduce the size of the company's taxable profits in a country;
ii. It is often achieved by structuring income to have more favourable tax

treatment or by finding ways to write off certain expenditure against taxable income; and

iii. It has the effect of reducing a company's tax payment below it would otherwise have been.

Profit shifting:

Profit shifting has the following attributes:

i. This involves making payment to other group companies in order to move profit from high-tax jurisdictions to lower-tax regimes;

ii. This serves to increase the overall profits available to the group shareholders;

iii. Often, these inter-group payments take the form of royalties and interest payments, as these expenses can be deducted from pre-tax profits; and

iv. Another issue with these types of payment is that some jurisdictions Have lower tax rates on them when received as income by other persons.

b. **Techniques of base erosion and profit shifting**

Base erosion and profit shifting could be achieved using any of the following techniques:

i. Trademark and technology licensing/transfer pricing: Managing the group's trademark, design and patent through an entity that applies a lower tax rate to intellectual property, and then charging group companies royalties on the use of the brand;

ii. Thin capitalisation: By setting up subsidiaries with minimal share capital, group can use a financing arm to fund the new company's operation with debt. This large debt attracts interest, which has different treatment in some jurisdiction and can therefore reduce the group tax payment if structured correctly;

iii. Hybrid mismatch arrangements: Different tax rules between countries can sometimes give rise to unintended effects like "double non-taxation", which can be exploited by businesses to reduce their tax burden. This primarily applies to national treatment of certain instruments in such a way that they are treated in the paying country as tax deductible debt, but seen in the receiving country as tax exempt income;

iv. Putting assets into entity without substance: Some countries introduce preferential tax regimes as a way to compete for business. However, this is only useful if the business with substance begin to locate them in the country. Otherwise, this form of tax competition simply erodes the tax base of the country where the activity takes place; and

v. Tax havens: A multi-national enterprise may locate its head office in a jurisdiction with tax preference on tax haven and its operations with its subsidiaries and permanent establishments located in another jurisdiction may be such that is eroding the tax base of the countries where the subsidiaries are located.

c. **The Organisation for Economic Cooperation and Development (OECD)'s SIX action initiatives against base erosion and profit shifting. These include the following:**

i. Address the tax challenges of the digital economy;
ii. Neutralise the effects of hybrid mismatch arrangements;
iii. Strengthen controlled foreign company rules;
iv. Limit base erosion via interest deductions and other financial payments;
v. Counter harmful tax practices more effectively, taking into account transparency and substance;
vi. Prevent treaty abuse;
vii. Prevent the artificial avoidance of permanent establishment status;
viii. Assure that transfer pricing outcomes are in line with value-creation-intangibles;
ix. Assure that transfer pricing outcomes are in line with value-creation-risk and capital;
x. Assure that transfer pricing outcomes are in line with value-creation-other high risk transactions;
xi. Establish methodologies to collect and analyse data on BEPS and the action to address it;
xii. Require taxpayers to disclose their aggressive tax planning arrangement;
xiii. Re-examine transfer pricing documentation and country-by-country reporting;
xiv. Make dispute resolution mechanisms more effective; and
xv. Develop a multilateral instrument to modify bilateral tax treaties.

d. **The implications on the company if it engages in base erosion and profit shifting are:**

i. Base erosion and profit shifting are basically tax avoidance strategies used to exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations;
ii. It reduce the total profit upon which tax is payable;
iii. It reduce the tax revenue in the country where it is being practiced;
iv. This act is totally condemned by more than 100 countries in the world as being unfair practice; and

v. The initiatives put in place by OECD in combating this activity are legendary. It is therefore advisable for the company (in collaboration with its parent company) not to involve in this act.

Examiner's report

The question tests candidates' understanding of the concept and techniques of base erosion and profit shifting.

About 50% of the candidates attempted the question and they showed fair understanding of the question, therefore, performance was average.

The commonest pitfall was the inability of the candidates to correctly explain the techniques of base erosion and profit shifting. Many candidates mistook it for examples of base erosion and profit shifting.

Candidates are advised to read the Institute's Study Text and other relevant laws on base erosion and profit shifting, when preparing for future examinations.

Marking guide

		Marks	Marks
a.	Heading	1	
	Discussion on base erosion (Any 2 points @ ½ mark each)	1	
	Discussion on profit shifting (Any 2 points @ ½ mark each)	1	3
b.	Discussion on techniques of base erosion and profit shifting (Any 4 points @ 1 mark each)		4
c.	OECD initiatives against base erosion and profit shifting (Any 6 points @ 1 mark each)		6
d.	Implication on the company if it engages in base erosion and profit shifting (Any 2 points @ 1 mark each)		2
			15

SOLUTION 7

Jaiye & Co. (Chartered Accountants)
11 Edith Muhammad Street
Ojodu, Lagos

13 October 2021

The Chairman
MATS State Board of Internal Revenue
Odo-Eran
Nigeria

Dear Sir,

Re: Assessment and Collection of Taxes from Self-Employed Taxpayers

We refer to our appointment as Consultant to MATS State Internal Revenue Service for the purpose of providing advisory services on the above subject.

Self-employed taxpayers are unincorporated individuals or body of individuals engaged in their own businesses either as sole traders or in partnerships. Such persons include individual contractors, traders, professionals, consultants, market men and women, artisans and all other entities that are not liable to tax under the Companies Income Tax Act, but under the Personal Income Tax Act CAP P8 LFN 2004 (as amended). This means such persons are taxable on income accruing to them personally.

All self-employed taxpayers are required to file self-assessment tax returns with the relevant state tax authorities every year. Such tax return is expected to disclose transactions relating to the individual's income for the year.

(a) **Constraints being faced by tax authorities in assessing and collecting taxes from self-employed taxpayers include:**

   (i) **Lack of taxpayers' data /information**
   There is no detailed information on or database for the self-employed in Nigeria, thus bringing them into the tax net is difficult;

(ii) **Inefficient utilisation of tax revenue**
There is a general apathy to voluntary compliance with the provisions of the tax laws because of the level of decay in basic infrastructure which has always called to question the need for continued payment of tax in Nigeria;

(iii) **Tax evasion and avoidance**
It is easier for self-employed persons to evade tax than employees whose incomes are taxed at source. Also self- employed persons have evolved several tax avoidance strategies which require anti-avoidance provisions;

(iv) **Lack of experience and suitable qualified personnel**
There is the dearth of experienced tax personnel, hence the difficulty in ascertaining the correct assessments for self-employed taxpayers;

(v) **Inadequate penalties / absence of enforcement**
In Nigeria, the penalties for non-compliance with relevant tax provisions are too lenient to compel the self-employed to pay tax. There is also a general lack of enforcement of existing penalties;

(vi) **Inadequate records**
Most self-employed persons do not maintain records of their income and expenditure. Some also mix their business activities with their private affairs, thus making it difficult to determine the income taxable;

(vii) **Lack of public enlightenment**
Most taxpayers do not know what tax to pay, when to pay, who to pay to, where to pay and what reliefs and allowances they are entitled to. A good tax system should be certain and easy to administer. The public should be educated on their responsibility with respect to tax at all times;

(viii) **Level of corruption**
Some tax officials collude with would-be taxpayers to defraud the government of taxes;

(ix) **Level of poverty**
Several self-employed persons are struggling to survive due to the unconducive operating environment. The society has been impoverished such that paying tax may further impoverish the low-income earners; and

(x) The over-dependence on oil revenue for a very long time has led to the neglect of all other non-oil revenue sources.

(b) **Strategies for expanding the Nigerian tax net to improve tax collection drive covering the self-employed are:**

(i) **Public enlightenment and education**
The revenue should embark on aggressive publicity and education of taxpayers on the various taxes payable by all self-employed individuals;

(ii) **Enforcement of withholding tax provision**
By further encouraging companies to implement the withholding tax provision, more self-employed persons who render various services to companies can be brought into the 'tax net';

(iii) **Requirement for presentation of tax clearance certificate (TCC)**
By providing and insisting that TCC be produced for any form of transaction with government, more self-employed persons will be compelled to pay their taxes;

(iv) **Stiffer penalties for non-compliance**
If the consequences of failure to comply with the provisions of the tax laws are made stiffer, more taxpayers will willingly comply with the tax laws;

(v) **Encouragement of cooperative unions**
By encouraging artisans in particular, to form associations through which government can reach the members, improvement in tax revenue generation from that category of self-employed persons will be achieved;

(vi) **Effective utilisation of tax revenue**
Improvement in the level of basic infrastructural facilities will encourage voluntary compliance with provisions of the tax laws as they will show that the tax revenue is being utilised effectively;

(vii) **Promulgation of anti-avoidance provision**
Making provisions to block the several loop holes in the tax laws will enhance further compliance with the tax laws and increase tax revenue;

(viii) **Use of information technology**
The use of appropriate information technology that will make it difficult to evade tax will enhance tax revenue from self-employed taxpayers;

(ix) **Investigation and intelligence unit**
The investigation and intelligence units of the Revenue should be vibrant and effective. It is the responsibility of these units to trace self-employed persons in the society, who have not been paying their taxes. This can be done by going through the Land Registry and Vehicle Licencing Offices. Information can also be obtained from banks by insisting that they should file returns of all their new customers with the Revenue;

(x) **Engagement of experienced and qualified personnel**
Employing qualified personnel and paying competitive remuneration will further enhance dedication to duty and ultimately increase tax revenue; and

(xi) **Regular amendment to the tax laws**
The tax laws should be regularly updated and the provisions should be such that are reasonable and easy to comply with. Most of the provisions of the Nigerian tax laws are outdated and which makes it difficult to comply with. Some of those provisions encourage tax evasion.

Please do not hesitate to contact the undersigned, should you require further clarifications.

Yours faithfully,

Bunmmy AY
For: Jaiye & Co (Chartered Accountants)

Examiner's report

The question tests candidates' knowledge of constraints facing the tax authorities in the assessment and collection of taxes from self-employed taxpayers and the strategies for improving tax collection.

About 80% of the candidates attempted the question. Candidates displayed good understanding of the question and performance was good.

The major pitfall was the inability of some candidates to proffer correctly the strategies for improving tax collection from self-employed category of taxpayers.

Candidates are advised to ensure that they read the Institute's Study Text and other relevant textbooks on assessment and collection of taxes when preparing for future examinations.

Marking guide

		Marks	Marks
(a)	Heading of the letter	1	
	Constraints in assessing and collecting tax (7 correct points @ 1 mark each)	7	8
(b)	Strategies for expanding the Nigeria tax net to improve collection (7 correct points @ 1 mark each)		7
	Total		**15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2021

STRATEGIC FINANCIAL MANAGEMENT

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Femi Appliances Limited (FAL) is a Nigerian – based manufacturer of household appliances with many distribution centres across various locations in Nigeria and along the ECOWAS sub-region. FAL is now considering the development of a new motor vehicle vacuum cleaner – VC4.

The product can be introduced quickly, and has an expected life of four years change with a more efficient model. Costs associated with the product are estimated to be:

Direct costs (per unit)
Labour:
3.5 skilled labour hours at ₦500 per hour.
4 unskilled labour hours at ₦300 per hour.

Materials:
6 kilos of material Z at ₦146 per kilo
Three units of component P at ₦480 per unit
One unit of component Q at ₦640
Other variable costs: ₦210 per unit.

Indirect costs
Apportionment of management salaries: ₦10,500,000 per year
Tax allowable depreciation of machinery: ₦21,000,000 per year
Selling expenses (not including any salaries): ₦16,600,000 per year
Apportionment of head office costs: ₦5,000,000 per year
Rental of buildings: ₦10,000,000 per year
Annual interest charges: ₦10,400,000
Other annual overheads: ₦7,000,000 (including apportionment of building rates ₦2,000,000. N.B. rates are a local tax on property).

If the new product is introduced it will be manufactured in an existing factory, and will have no effect on rates payable. The factory could be rented for ₦12,000,000 per year (not including rates), to another company if the product is not introduced.

New machinery costing ₦86,000,000 will be required. The machinery is to be depreciated on a straight-line basis over four years, and has an expected salvage value of ₦2,000,000 after four years. The machinery will be financed by a four year fixed rate bank loan, at an interest rate of 12% per year. Additional working capital requirement may be ignored.

The new product will require two additional managers to be recruited at an annual gross cost of ₦2,500,000 each, and one manager currently costing ₦2,000,000 will be moved from another factory where he will be replaced by a deputy manager at a cost of ₦1,700,000 per year. 70,000 kilos of material Z are already in inventory and are not required for other production. The realisable value of the material is ₦9,900,000.

FAL will use the existing advertising campaigns for its distribution centres to also advertise the new product. This will save approximately ₦5,000,000 per year in advertising expenses.

The price per unit of the product in the first year will be ₦11,000, and demand is projected at 12,000, 17,500, 18,000 and 18,500 units in years 1 to 4 respectively.

The inflation rate is expected to be 5% per year, and prices will be increased in line with inflation. Wage and salary costs are expected to increase by 7% per year, and all other costs (including rent) by 5% per year. No price or cost increases are expected in the first year of production.

Income tax is at the rate of 35% payable in the year the profit occurs. Assume that all sales and cost are on cash basis and occur at the end of the year, except for the initial purchase of machinery which would take place immediately. No inventory will be held at the end of any year.

Required:

a. Calculate the expected internal rate of return (IRR) associated with the manufacture of VC4. Show all workings to the nearest ₦million. (19 Marks)

b. i. What is meant by an asset beta and how it is different from an equity beta? (2 Marks)

   ii. If you are told the company's equity beta is 1.2, the market return is 15% and the risk free rate is 8%, discuss whether you would recommend introducing the product. (4 Marks)

c. The company is worried that the government might increase corporate tax rates.

Advise the directors by how much that the tax rate would have to change before the project is not financially viable. A discount rate of 17% per year may be assumed for part (c). (5 Marks)

(Total 30 Marks)

SECTION B: OPEN-ENDED QUESTIONS (40 MARKS)

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

QUESTION 2

You run a financial consultancy firm and you have been approached by a new client for advice on a potential acquisition. Kola Plc (KP) is a large engineering company that was listed on the stock market ten years ago with the founders retaining a 20% stake in the business. Whilst KP had previously experienced rapid growth in earnings before tax, problems arose soon after the listing as competition intensified. Although the company remains profitable, annual growth has declined significantly and is currently 4%. The board is concerned by the lack of future growth opportunities. The current share price reflects these concerns, trading well below the offer price of ten years ago. In response, the directors have decided to invest in a market development strategy for future growth, utilising significant cash reserves to acquire companies in other areas of the country where competition is less intense. The board has identified a potential target, Temidayo Engineering (TE).

Temidayo Engineering (TE)

TE is a private engineering company, established eight years ago. Accumulated unrelieved losses were incurred in the early years of development, although the company is now profitable and achieving growth in earnings before tax of 8% per annum. However, cash reserves are low. Access to capital has been a serious constraint to TE's investment potential throughout this period. The founders and their families own 70% of the shares with the balance held by a venture capitalist who acquired its equity stake around five years ago.

Acquisition information

KP's board is keen to ensure that TE's founders remain as directors after the acquisition and the company has sufficient cash reserves to purchase TE outrightly. It is believed that a cash offer of ₦13.10 per share is likely to encourage TE's shareholders to approve the acquisition. As an alternative, the board is considering a share-for-share exchange to fund the acquisition in order to preserve cash for future acquisitions and dividend payments. Recent mergers have attracted an acquisition premium of around 25% - 30% and TE's directors indicated that their shareholders would be expecting a premium towards the higher end of this scale for a share-for-share offer. KP has therefore asked you to design a share-for-share offer scheme which will allow for a 30% acquisition premium. You have been provided with extracts from the latest financial statements of both companies.

Extracts from the most recent financial statements

	KP	**TE**
	₦m	**₦m**
Operating profit	8,972	4,036
Earnings before tax	7,638	2,326

Additional financial information:
KP has ₦0.50 ordinary shares of ₦7,500 million with each share currently trading at ₦5.28. It is believed that the company's price earnings (P/E) ratio will increase by 10% if the acquisition proceeds.

TE upgraded its main manufacturing facility during the previous year and expects to make annual pre-tax cost savings of ₦50 million from the start of the current financial year. The company has ₦0.25 ordinary shares of ₦700 million. Based on an analysis of companies of comparable size and cost structure, it is estimated that TE's P/E ratio is 20% higher than KP's current P/E ratio.

KP's chief executive officer estimates annual pre-tax revenue and cost synergies of ₦304 million to arise as a result of the acquisition. Furthermore, the finance director anticipates annual pre-tax financial synergies of ₦106 million although she insists this is a cautious estimate after reading an article on recent merger and acquisition activity where post-acquisition synergies have either been overestimated or failed to materialise. Assume tax rate of 20%.

Required:

a. Discuss possible sources of financial synergy arising from KP's acquisition of TE. (6 Marks)
b. Advise the directors on a suitable share-for-share exchange offer which meets the criteria specified by TE's shareholders and calculate the effect of the cash and share-for-share offers on the post-acquisition wealth of both KP's and TE's shareholders (14 Marks)

(Total 20 Marks)

QUESTION 3

ZY Plc is an all-equity financed and a listed company which operates in the food processing industry. The ZY family owns 40% of the ordinary shares; the remainder are held by large financial institutions. There are 10 million, ₦1 ordinary shares currently in issue.

The company has just finalised a long-term contract to supply a large chain of restaurants with a variety of food products. The contract requires investment in a new machinery costing ₦24 million. This machinery would become operational on

1 January 2022, and payment would be made on the same date. Sales would commence immediately thereafter.

The company policy is to pay out all profits as dividends and, if ZY Plc continues to be all- equity financed, there will be an annual dividend of ₦9 million in perpetuity commencing 31 December 2022.

There are two alternatives being considered to finance the required investment of ₦24 million:

1. A 2-for-5 rights issue, in which case the annual dividend would be ₦9 million. The cum rights price per share would be ₦6.60; and

2. Issuing 7.5% irredeemable bonds at par with interest payable annually in a arrears. For this alternative, interest would be paid out of the ₦9 million otherwise available to pay dividends.

For either alternative, the directors expect the cost of equity to remain at its present annual level of 10%.

Required:

a. Calculate the issue and ex-rights share prices of ZY Plc., assuming a 2-for-5 rights issue is used to finance the new project at 1 January 2022. Ignore taxation. (4 Marks)

b. Calculate the value per ordinary share in ZY Plc at 1 January 2022 if 7.5% irredeemable bonds are issued to finance the new project. Assume that the cost of equity remains at 10% each year. Ignore taxation. (4 Marks)

c. Write a report to the directors of ZY Plc which
   i. Compare and contrast the rights issue and the bond issue methods of raising finance – you may refer to the calculations in your answer to requirements (a) and (b) and to any assumptions made. (6 Marks)
   ii. Discuss the appropriateness of the following alternative methods of issuing equity finance in the specific circumstances of ZY Plc:
      - a placing
      - an offer for sale
      - a public offer for subscription. (6 Marks)

(Total 20 Marks)

QUESTION 4

Leye Limited (LL) is a privately-owned toy manufacturer in Nigeria. It trades internationally both as a supplier and a customer. Although LL is privately owned, it has revenue and assets equivalent in amount to some public listed companies. It has a large number of shareholders, but has no intention of seeking a listing at the present time. In fact, the major shareholders have often expressed a wish to buy out some of the smaller investors.

The entity has a long history of sound and spectacular profitability. The directors and shareholders are reasonably happy with this situation and are averse to adopting strategies that they think involve a substantial increase in risk, for example, acquisition or setting up manufacturing capability overseas. As a consequence, LL accepts its growth rate will be relatively low, compared with some of its competitors.

The entity is financed 70% equity and 30% debt (based on book values). The debt is a mixture of secured and unsecured bonds carrying interest rates of between 7% and 8.5% and repayable in 5 to 10 years' time. Assume for this purpose that inflation is near zero and interest rates are low and possibly falling. The Company Treasurer is investigating the opportunities for, and consequences of refinancing.

LL's main financial objective is simply to increase dividends each year. It has one non-financial objective, which is to treat all stakeholders in the organisation with "fairness and equality". The Board has decided to review these objectives. The new Finance Director believes maximisation of shareholder wealth should be the sole objective, but the other directors do not agree and think a range of objectives should be considered, for example profits after tax and return on investment and performance improvement across a number of operational areas.

Required:

a. Evaluate the appropriateness of LL's current objectives and the Finance Director's suggestion, and discuss the issues that the LL Board should consider when determining the new corporate objectives. Conclude with a recommendation. (10 Marks)

b. Discuss the factors that the treasury department should consider when determining financing, or re-financing strategies in the context of the economic environment described in the scenario and explain how these might impact on the determination of corporate objectives. (10 Marks)

(Total 20 Marks)

SECTION C: OPEN-ENDED QUESTIONS (30 MARKS)

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

QUESTION 5

a. Ibile is a local government entity. It is financed almost equally by a combination of central government funding and local taxation. The funding from central government is determined largely on a per capita (per head of population) basis, adjusted to reflect the scale of deprivation (or special needs) deemed to exist in Ibile's region. A small percentage of its finance comes from the private sector, for example from renting out City Hall for private functions.

   Ibile's main objectives are:
   - To make the region economically prosperous and an attractive place to live and work; and
   - To provide service excellence in health and education for the local community.

b. Layo is a large, listed entity with widespread commercial and geographical interests. For historic reasons, its headquarters are in Ibile's region. This is an anomaly as most entities of Layo's size would have their HQ in a capital city, or at least a city much larger than Ibile.

   Layo has one financial objective: To increase shareholders' wealth by an average of 10% per annum. It also has a series of non-financial objectives that deal with how the entity treats other stakeholders, including the local communities where it operates.

   Layo has total net assets of ₦1.5 billion and a gearing ratio of 45% (debt to debt plus equity), which is typical for its industry. It is currently considering raising a substantial amount of capital to finance an acquisition.

Required:

Discuss the criteria that the two entities described above have to consider when setting objectives, recognising the needs of each of their main stakeholder groups.

Make some reference in your answer to the consequences of each of them failing to meet its declared objectives. **(Total 15 Marks)**

QUESTION 6

Bettaluck plc has been enjoying a substantial net cash inflow. The funds have been invested in a small portfolio of short-term equity investments until they are needed to meet tax, dividend payments and to finance further capital expenditure in several months' time.

Details of the portfolio, which consists of shares in four Nigerian listed companies are as follows:

Company	**Holding**	**Market price**
Dashing plc	60,000 shares of ₦1 each par value	₦4.29
Elegant plc	80,000 shares of 50k each per value	₦2.92
Fantastic plc	100,000 shares of 25k each per value	₦2.17
Gaudy plc	125,000 shares of ₦1 each per value.	₦3.14

Company	Equity beta Co-efficient	Dividend yield p.a.(%)	Capital gains yield p,a, (%)
Dashing plc	1.16	6.10	13.4
Elegant plc	1.28	3.40	20.6
Fantastic plc	0.90	5.70	11.8
Gaudy plc	1.50	3.30	19.7

The yield on Treasury Bills is 11% a year and the market return is 19% a year.

Required:

a. On the basis of the data given, calculate the risk (i.e. Beta) of Bettaluck's short-term investment portfolio relative to the market. (4 Marks)

b. Recommend, giving your reasons, whether the composition of the company's short-term investment portfolio should be changed. (Relevant calculations must be shown). (6 Marks)

c. Discuss the factors that a financial manager should take into account when investing in marketable securities. (5 Marks)

(Total 15 Marks)

QUESTION 7

James Obasi plc is a medium-sized manufacturing firm making drones. It is considering a 1 for 5 rights issue at a 15% discount to the current market price of ₦4.00 per share. Issue costs are expected to be ₦2m and these costs will be paid out of the funds raised. It is proposed that the rights issue funds raised will be used to redeem some of the existing bonds at par. Financial information relating to James Obasi plc is as follows:

Statement of financial position

	₦'000	₦'000	₦'000
Fixed Assets			8,000
Current Assets			
Inventory		3,000	
Receivables		2,500	
Cash		500	
		6,000	
Current liabilities			
Trade payables	2,100		
Overdraft	2,250	4,350	
Net current assets			1,650
Total assets less liabilities			9,650
12% bonds			4,500
			5,150
Ordinary shares (par value 50k)			4,000
Reserves			1,150
			5,150
Other information:			
Price/earnings ratio of James Obasi plc			15.24
Overdraft interest rate			6%
Corporate tax rate			30%
Sector averages: debt/equity (book value)			100%
Interest cover			6 times

Required:

a. Ignoring issue costs and any use that may be made of the funds raised by the rights issue, calculate:

   i. the theoretical ex rights price per share;
   ii. the value of rights per existing share. (4 Marks)

b. What alternative actions are open to the owner of 1,500 shares in James Obasi plc as regards the rights issue? Determine the effect of each of these actions on the wealth of the investor. (6 Marks)

c. Calculate the current earnings per share and the revised earnings per share if the rights issue funds are used to redeem some of the existing bonds.

(5 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. $\dfrac{1 - (1 + r)^{-n}}{r}$

Where r = discount rate

n = number of periods

Discount rate (r)

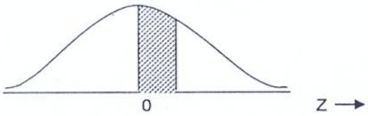
Periods

(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. **Project's Cash Flows (₦ million)**

Year	**0**	**1**	**2**	**3**	**4**
Costs:					
Direct labour (W2)		35	55	61	67
Material Z (W3)		10	16	17	19
Component P (W3)		17	26	29	31
Component Q (W3)		8	12	13	14
Other variable costs (W4)		3	4	4	5
Management salaries (W5)		7	7	8	8
Rental (W6)		12	13	13	14
Other fixed overheads (W7)		5	5	6	6
Selling expenses (W8)		17	17	18	19
Total operating costs		117	155	169	183
Sales (W1)		132	202	218	236
Cash profit		18	47	49	53
Tax (W12)		1	(9)	(10)	(11)
Machinery	(86)				2
NCF	(86)	19	38	39	44

Calculation of IRR

Year	**CF**	**PV at 18%**	**PV at 20%**
	₦m	**₦m**	**₦m**
0	(86)	(86)	(86)
1	17	14.407	14.167
2	38	27.291	26.389
3	39	23.737	22.569
4	44	22.695	21.219
NPV =		3.825	0.01

At 20%, the NPV is zero and therefore the IRR is approximately 20%.

Working notes

1. Sales

Year	1	2	3	4
Qty sold (q)	12,000	17,500	18,000	18,500
Selling price (₦)	11,000	11,550	12,128	12,734
Sales (₦m)	132	202	218	236

2. Direct labour

		1	2	3	4
Cost per unit (₦) = (L)	=	2,950	3,157	3,377	3,614
Total cost (₦m) = ($q \times L$)	=	35	55	61	67

3. Materials

- Material Ƶ

		₦m	
Year 1:			
Total needed= $6 \times 12,000$	=	72,000	
Available in inventory	=	70,000	
To be bought		2,000	
Opportunity cost of kilos in		₦m	
Inventory		9.90	
New purchase =2,000 × ₦146		0.292	
Total, rounded		10.192	=10
Year 2 $17,500 \times 6$ kilos $\times 146\ (1.05)$			=16
Year 3 $18,000 \times 6$ kilos $\times 146\ (1.05)^2$			=17
Year 4 $18,500 \times 6$ kilos $\times 146\ (1.05)^3$			=19

- Component P

Year	1	2	3	4
Cost per unit of VC4 (k)	₦1,440	₦1,512	₦1588	₦1667
Total cost (₦m) = ($q \times k$)	17	26	29	31

- Component Q

Year	1	2	3	4
Cost per unit of VC4 (T)	₦640	₦672	706	741
Total cost (₦m) = ($q \times T$)	8	12	13	14

4. Other Variable costs

Year	1	2	3	4
Cost per unit of VC4 (k)	₦210	22.1	232	24.3
Total cost (₦m) = ($q \times k$)	3	4	4	5

5. **Management salaries**
Only incremental management salaries are relevant, the two new managers plus the replacement deputy manager, costing total ₦6,700,000 (₦5,000,000 + ₦1,700,000) in year 1, increasing by 7% per year subsequently.

6. **Rental**
The opportunity rental of ₦12 million is the relevant cost in year 1, increasing by 5% per year subsequently.

7. **Other fixed overhead**
The only relevant cost is the amount given (₦7millon) less the apportioned building rates of ₦2m (i.e. ₦5 million in year 1).This will rise by 5% per year subsequently.

8. **Selling expenses**
These will be ₦16.60 million (rounded to ₦17 million in year 1 and then rising by 5% per year subsequently.

9. **Interest cost**
This is ignored as the cost of finance is encompassed within the discount rate.

10. Apportioned head office costs do not involve cash flow and therefore irrelevant.

11. **Advertisement cost**
No incremental cash flow is involved and therefore irrelevant.

12. **Tax**

Year	1	2	3	4
Cash profit	18	47	49	53
Tax allowable depreciation	21	21	21	21
Taxable	(6)	26	28	32
Tax at 35%	(2)	9	10	11

bi. An asset beta reflects a company's systematic business risk and is the weighted average of the beta of equity and the beta of debt (including any relevant tax effects). On the other hand, equity beta reflects both systematic business risk and financial risk. Only systematic risk, the risk that cannot be diversified away, is considered in an asset beta and equity beta.

Using CAPM, the required return (R_i) is:

$$R_i = R_F \times \beta_i (R_m - R_i)$$
$$= 8 \times 1.2 (15 - 8) = 16.4\%$$

If 16.4% is the appropriate cost of capital it would appear that the project is acceptable because the IRR of 19% is higher than the required rate of return of 16.4%. However, there are several other reasons to consider in arriving at the appropriate decision.

- **Cost of equity vs WACC**
  The required return calculated above is cost of equity. It will only be the appropriate required return if the company is pure equity financed. Information in the question indicates that the project is to be financed by a bank loan. That introduces financial leverage and financial risk. In such circumstances the appropriate required return is the weighted average cost of capital (WACC) and not cost of equity.

- **Beta of project vs beta of company**
  The beta of 1.2 is the beta of the company and not beta of the new project. If the project belongs to a different risk class (both business and financial), the calculated required return will be inappropriate.

- **Level of diversification**
  If the company is not well diversified, management may not consider systematic risk to be an appropriate measure as some unsystematic risk is present.

- **Problems with CAPM**
  The capital asset pricing model is subject to criticism, both theoretical, and with respect to practical problems of data collection. The model might, therefore, be mis-specifying the appropriate rate of return.

- **Non-financial factors**
  Non-financial factors might have an important influence on this investment decision.

c) **Step 1**: Compute the NPV of the project, using discount rate of 17%.

Year	**0**	**1**	**2**	**3**	**4**
NCF	(86)	19	38	39	44
PVF at 17%	1	0.855	0.731	0.624	0.534
PV	(86)	16.25	28	24	23

NPV = ₦5.25 million

Step 2: Calculate, at 17%, the present value of tax liability.

Year	**1**	**2**	**3**	**4**
Tax cash flows	(1)	9	10	11
PVF at 17%	0.855	0.731	0.624	0.534
PV	(0.86)	6.6	6.2	5.9
Total = ₦17.84million				

Step 3: Compute the sensitivity margin (SM)

$$SM = \frac{NPV}{PV\ of\ tax liability} \times 100 = \left(\frac{5.25}{17.84}\right) = 19.4\%$$

This means that the project can absorb increase in tax rate of 23.53%. Thus, the maximum tax rate allowed for the project to breakeven is 35 × (1.2353) = 43.24%.

Examiner's report

This is a standard investment appraisal question and it is in three parts. Part (a) tests the candidates' understanding of:

- Relevant costs:
- Investment appraisal and inflation and taxation; and
- Calculation of IRR

Part (b) requires the candidates to distinguish between asset beta and equity beta. It also tests a number of practical issues concerning the appropriate cost of capital required for the appraisal of a project.

Part (c) of the question deals with sensitivity of the tax rate.
Being a compulsory question, almost all the candidates attempted it.

Generally, the performance on this question was disappointing. This is difficult to understand because the scenario is straight forward and well defined in the question.

Most scripts were characterised by errors in the following areas:

- A failure to omit irrelevant costs like interest, advertising, apportioned costs, etc;
- Accurate handling of taxation and inflation; and
- Confusion regarding arrangement of cash flows.

In part (b), most of the candidates could not explain clearly the difference between asset beta and equity beta.

In part (c), majority of the candidates did not even make any attempt at all.
It is recommended that students preparing for the institute's examination should cover the syllabus comprehensively.

Marking guide

		Marks	Marks
1a.	Computation of direct labour	1	
	Computation of cost of material Z	2	
	Computation of cost of component P	1	
	Computation of cost of component Q	1	
	Computation of other variable cost	1	
	Computation of management salaries	2	
	Computation of rental cost	1	
	Computation of other fixed overhead	1	
	Computation of selling expenses	1	
	Computation of sales	1	
	Tax computation	2	
	Cost of machinery and salvage value	½	
	Determination of net cash flow (NCF)	1	
	Determination of IRR	2	
	Ignoring interest cost	½	
	Ignoring apportioned head office cost	½	
	Ignoring savings from advert	½	19
bi.	Explanation of asset beta & equity beta	2	
bii.	Computation of cost of equity using CAPM	½	
	Recommendation	½	
	Discussion of the appropriateness of the computed cost of equity	3	6
c.	Computation of project NPV	2	
	Computation of PV of tax liability	2	
	Determination of sensitivity margin	1	5
	Total		**30**

SOLUTION 2

a) ***Tutorial notes***

*It is very important to note that the question asks for **FINANCIAL SYNERGY**. Any discussions of revenue synergy or cost synergy will not be rewarded. Furthermore, the discussion must be within the context of the given scenario rather than being generic.*

Financial synergies

Many acquisitions are justified on the basis that the combined organisation will be more profitable or grow at a faster rate than the companies operating independently. The expectation is that the acquisition will generate higher expected cash flows or a lower cost of capital, creating value for shareholders. The additional value created is known as synergy, the sources of which can be categorised into three types: revenue, cost and financial synergies.

Based on the scenario, there are a number of possible sources of financial synergy. As a private company, TE is experiencing a funding constraint whereas KP has significant cash reserves but limited growth opportunities. The combination of the two can create additional value, since TE may be able to utilise KP's cash resources to fund its expansion in a way which would not have been possible otherwise, leading to an increase in the expected cash flows.

Assuming both companies' cash flows are less than perfectly correlated, those of the combined company will be less volatile than the individual companies operating independently. This reduction in volatility will enable the combined company to borrow more and possibly cheaper financing than would otherwise have been possible. This increase in debt capacity, and therefore, the present value of the tax shield, increases the value of the combined company in the form of a lower cost of capital.

Further benefits may arise if KP is able to utilise TE's unrelieved tax losses. Whilst TE is no longer loss making and could offset these tax losses independently, the combined company may be able to obtain tax relief earlier since the acquisition increases the availability of profits against which carried forward tax losses can be offset. The present value of the tax saved will therefore be greater in the combined company.

If both companies were publicly traded, there would be no benefit from diversification since investors are capable of diversifying at a lower cost and with greater ease than the company, However, TE is privately owned and the shareholders are therefore exposed to diversifiable unsystematic risk. Therefore, the acquisition may lead to potential diversification and risk reduction benefits. The reduction in the cost of the capital increases the value of the combined company.

b) Pre-acquisition valuations

Number of shares in KP = 7,500m/0.5 = 15,000m
KP's total value = 15,000m × ₦5.28 = ₦79,200m
Future maintainable earnings (FME) = ₦7,638m × (1 – 0.20) = ₦6,110.40m
Current P/E ratio = ₦79,200m/₦6,110.40m = 12.96
TE FME = (₦2,326m + ₦50m) (1.02) = ₦1,900.80m
TE P/E ratio = 12.96 × 1.20 = 15.55
TE current value = 15.55 × ₦1,900.80m = ₦29,557.44m
Total pre-acquisition value = ₦79,200m + ₦29,557.44m = ₦108,757.44m

Post-acquisition Valuation

	₦m	₦m
Current FME - KP	6,110.40	
- TE	1,900.80	8,011.20
Synergies - revenue and cost	304.00	
- financial	106.00	
	410.00	
Less tax at 20%	(82.00)	328
Post-acquisition total FME		8,339.20
Combined P/E ratio = 12.96 × 1.1 =		14.26
Combined post-merger value=14.26 × ₦8,339.20m		₦118,917m
Combined pre-merger value =		108.757m
Value created based on synergies =		10,160m

Share-for-share offer

	KP ₦m	TE ₦m
Pre-acquisition value	79,200	29,557.44
Add 30% premium	-	8,867,24
Balance of excess value due to KP (₦10,162.77 – 8,856)	1,293	
Post-acquisition value	80,493	38,424.68
Relative value	2.1	1

Shares to be issued to TE's current shareholders = 15,000m × $^{1}/_{2.1}$ = 7,142.86m or (say) 7,143m.
Existing shares in TE = ₦700m/₦0.25 = 2,800m
Share exchange ratio = 7,143/2,800m = 2.55

This means that every current share in TE will receive approximately 2.55 shares in KP. The shareholding structure in KP will be as follows:

Current shareholders in:	Post-acquisition shares in KP	% Holding in KP
KP	15,000m	67.74
TE	7,143m	32.26
Total	22,143	100

Impact on shareholder wealth

	KP	TE
	₦m	₦m
Pre-acquisition value	79,200	29,557.44
Cash offer		
Cash paid to TE = 2,800m × ₦13.10		36,680
KP post-acquisition value		
= ₦118,882.77m – 36,680m =	82,237	
% increase in wealth	3.83%	24.01%
Share-for-share offer		
Post-acquisition value:		
₦118,882.77 × 67.74%	80,554.38	
₦118,882.77 × 32.26%		38,362.62
% increase in wealth	1.71%	29.79%

Thus, the terms of the share-for-share offer meet the criteria specified by the directors of TE.

Examiner's report

This is a question on business valuation and merger. In part (a), candidates are expected to identify, from the given scenario, possible financial synergy. In part (b), candidates were expected to value a company for takeover, using P/E ratio and to design a share-for-share payment scheme.

Only very few candidates attempted the question and the performance was poor.
In part (a), common errors include:

- Discussion of revenue and cost synergies rather than financial synergy; and
- Failure to relate discussion to the given scenario. Generic discussion earned very little or no credit.

In part (b), it is apparent that majority of the candidates were ill-equipped in business valuation. They could not sort out the appropriate earnings to use with the given P/E ratio – thereby losing significant marks.

Candidates are advised to practise standard examination questions when preparing for this examination in the future.

Marking guide

		Marks	Marks
2a.	Explanation of Synergy	1	
	Discussion of possible sources of financial Synergy in line with the question	5	6
2b.	Computation of number of shares of Kola Plc.	¼	
	Computation of capitalisation value of Kola Plc.	¼	
	Computation of future maintainable earnings of Kola Plc	½	
	Determination of current P/E ratio of Kola Plc.	½	
	Computation of future maintainable earnings (FME) of TE	½	
	Determination of current P/E ratio of TE	¼	
	Computation of current capitalisation of TE	¼	
	Total pre-acquisition value	½	
	Computation of Post-acquisition FME	1½	
	Computation of combined P/E ratio	½	
	Computation of value of synergies	1	
	Determination of share exchange ratio	4	
	Analysis of the impact on shareholders wealth	4	14
	Total		**20**

SOLUTION 3

a) **Rights issue**

$$\text{Offer price} = \frac{\text{Finance needed}}{\text{Number of shares issued}} = \frac{₦24\text{m}}{4\text{m}} = ₦6 \text{ per share}$$

$$\text{Ex} - \text{rights price} = \frac{[(5 \times ₦6.60) + (2 \times ₦6)]}{7} = ₦6.43$$

b) **Irredeemable bonds**

Dividends per annum = ₦9m – (7.5% × ₦24m) = ₦7.2m

Dividend per share = ₦0.72 pa

$$\text{Share price} = \text{PV of dividends} = \frac{0.72}{0.1} = ₦7.20$$

c) **REPORT**

To: Directors of ZY Plc

From: Accountant

Date: xx of 20xx

Raising new finance

The project represents a sizeable increase in the company's operations and the financing of it will have a material impact on the capital structure and the shareholders' wealth.

i) **Bond issue or rights issue**

The bonds would introduce significant gearing, and may include restrictive covenants which dictate the repayment timings. In addition, there may be restrictions on the operations of the business in order to maintain certain gearing ratios or interest cover. They will probably require security over assets, or compensate for the additional risk of less than full security by applying a higher interest charge.

However, the issue costs associated with the bonds are likely to be lower than those incurred on a rights issue. In addition, the fixed income and asset security will lead to a cheaper cost than the equity which is enhanced by the tax relief available on debt interest.

The calculations in (b) have assumed the cost of equity (and hence the total market value) would stay the same under a bond issue. However, the risk to the shareholders would increase (as the financial risk of the interest being paid out of profits increases the fluctuation in returns) and so the return required would increase. It therefore may not be as beneficial to shareholders as it appears, as the share value may drop from the price calculated.

Finally, it is possible that not all shareholders will want to take up their rights, which will involve the company selling the rights to other shareholders or the general public if possible. The family would see its shareholding reduced if it could not finance its share of the rights issue.

ii) **Alternative methods of issuing equity**

A wider issue of equity than a rights issue would have more chance of success but would reduce the holding of current shareholders such as the family, and is likely to have higher issue costs.

A placing is where an issuing house places shares with clients, and is likely to have relatively low costs as it avoids underwriting and much of the advertising. It is likely, however, to concentrate shareholdings which will threaten the family's control.

An offer for sale is when an issuing house buys the shares and then offers them to the public, at a fixed price or via a tender, by circulating a prospectus. The costs are likely to be higher as the fees effectively incorporate underwriting of the issue.

A public offer for subscription means that Y Plc itself would issue the prospectus and invite subscription from the public at a fixed price. Costs are likely to be high, as they will have to cover underwriting, publicity and specialist advice.

Examiner's report

This is a question on sources of long-term finance. Part (a) deals with the calculation of issue price and ex-right price. Part (b) requires candidates to compute value of equity after the issue of an irredeemable bonds. Part (c)(i) asks the candidates to compare right issues and bond issues. In part (c)(ii), candidates are expected to discuss the appropriateness of three methods of raising equity finance: placing, offer for sale and public offer.

Almost all the candidates attempted the question and performance was fair.
Some of the candidates were able to make the required calculations in parts (a) and (b).

Part (c) of the question proved to be a major discriminator between stronger and weaker candidates, with some picking up fairly good marks, while many others showed complete lack of understanding. Between these two extremes, the most common error was failure to relate their answers to the circumstances of the company.

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

Marking guide

		Marks	Marks
3a.	Computation of offer price	2	
	Computation of ex-right price	2	4
b.	Computation of total dividend	1½	
	Determination of dividend per share	½	
	Determining share price	2	4
ci.	Memo format	1	
	Explanation of bond issue and right issue	5	6
cii.	Explanation of placing, offer for sale and offer for subscription	6	6
	Total		**20**

SOLUTION 4

a) **Evaluation**

- Theory supports the Finance Director, suggesting that maximisation of shareholder wealth is the only true objective of the entity – now considered an extreme view – and one which may have contributed to some of the corporate scandals in recent years that have occasioned the increase in corporate governance requirements.
- Many entities now establish objectives that aim to maximise shareholders' wealth while recognising constraints, legally enforceable or voluntary, imposed by society.
- A major problem with this objective in the circumstances of LL is that this is a private entity that does not have a quoted share price. Shareholders' wealth, as traditionally valued, is difficult to determine.
- Looking only at dividends as an objective has its limitations, for example dividends could increase while earnings fall. The dividend ratio therefore needs to be considered alongside dividend payout. Alternatives such as those being considered by other directors, are therefore worth further consideration.
- For example: profitability as measured by returns after tax and return on investment. The main advantages are:
- Well understood measures and recognised guidelines are available in the form of International Accounting Standards.
- Shareholders expect profitability – and indeed the current objective is to increase earnings.

Disadvantages are:

- Accounting ratios are historic and backward-looking;
- They are subject to manipulation;
- A variety of accounting policies are available – even within Accounting Standards; and
- Tax can be affected by factors outside the control of managers.

Recommendation

Maximisation of shareholder wealth, using the theoretical definition, is difficult to apply in the circumstances of LL. As a minimum it would be worth introducing an objective that incorporates earnings growth as well as dividend growth.

A range of objectives could be considered, such as risk-related returns to investors, but again this is more difficult with a private entity than one with a share listing.

The entity needs to consult its shareholders and possibly, consider using a balanced scorecard approach to determine a range of objectives appropriate for an entity such as LL.

b) The scenario in this question concerns a large privately owned entity based in Nigeria. It trades internationally, both as a supplier and customer. Inflation is zero and interest rates are low and, possibly falling. The treasury department needs to decide how to deal with the challenges and opportunities the specific set of circumstances provide and evaluate the impact on the entity's capital structure.

(i) Finance theory suggests that entities should use a judicious amount of debt in their capital structure to lower cost of capital. Debt is cheaper than equity because interest payments attract tax relief and are (generally) cheaper than equity. This is because interest is (usually) secured and providers of debt do not participate in profits. Here we have a mixture of secured and unsecured debt, but the entity appears sound and of high credit worthiness so should be able to borrow at comparatively favourable rates.

(ii) This might even be an argument in favour of increasing gearing which will provide the ability to pay a special dividend or undertaken a share buyback, as seems to be the desire of the major shareholders.

(iii) The opposite argument is that in a period of low and falling interest rates, fixed rate debt becomes a burden. Some of the reasons are as follows:

- The real value of debt is not being eroded when there is low or no inflation, so one of the benefits of debt disappears;
- The return on assets funded by debt will fall and lower taxable profits, meaning the tax benefit of debt is reduced;
- If the growth is low, debt interest may have to be paid out of static (or even falling) profits, lowering return to shareholders;
- Although interest rates may fall, they never become negative, so the real cost of borrowing increases;
- The equity risk premium will tend to be less in inflationary times, so equity is relatively less expensive; and
- Raising equity is safer if profits really dive; dividends do not have to be paid and the shareholders do not get their money back in a liquidation. However, raising new equity in a private entity is more difficult than in a public entity, where shares are listed so there is a ready benchmark for the price of new shares.

(iv) Floating rate debt overcomes some of these concerns, but if markets are efficient then the interest rate obtainable should reflect expectations.

(v) In theory (according to MM), the mix of debt and equity does not affect the value of profits to three groups of stakeholders: lenders, government (taxers) and owners (shareholders).

(vi) The main question is therefore what combination of dividend policy and capital structure is likely to maximise the present value of cash flows to shareholders. This is where the financing strategies adopted contribute to the achievement of the objectives of the entity.

The treasury department needs to specifically look at:

- Terms of existing borrowing to see if refinancing at lower rates is feasible, recognising any possible penalties for early retirement of loans; and
- Discuss with the directors and major shareholders the possibility (or even probability) that returns are likely to be lower. The lower the rate of interest, the lower the cost of capital and therefore, the return that can be expected – not least because the rate sought by competitors will be lower.

Examiner's report

This is a question of two parts. Part (a) deals with appropriate corporate objective for a large private company and part (b) deals with the factors treasury department should consider in financing strategies. Almost all the candidates attempted the question.

Part (a) was reasonably well answered. However it was disappointing to note that most candidates did not relate their answers to the circumstances of the company. For example, the fact that the company is not quoted means that an 'appropriate' value does not exist.

In part (b), either through a lack of attention to the precise question being asked or, more probably, an inability to answer that precise question, a good number of the candidates simply reproduced all that they know about sources of finance.

At this level of the Institute's examinations, students are advised to pay critical attention to questions' requirements and avoid generic answers.

Marking guide

		Marks	Marks
4a.	Evaluation of the current objectives and finance directors suggestion	5	
	Disadvantages/issues to be considered	2	
	Recommendation	3	10
4b.	Detailed discussion of the factors to be considered in financing strategies and re-financing strategies	10	10
	Total		**20**

SOLUTION 5

The main issues to consider when determining objectives are:

Who are the main stakeholders?

In the case of Ibile, it is the local population who are the main stakeholders, irrespective of whether or not they are taxpayers. The concept of "universal service" means a local government body must allow all inhabitants equal access to services. The government is also a major stakeholder as it provides much of the finance.

In the case of Layo, the main stakeholders are the shareholders who provide the risk capital of the business. The entity needs to recognise the needs of this group, in respect of the risk/return relationship and the attitude to dividends versus capital growth.

Both entities have other groups of stakeholders, such as employees and suppliers, but nowadays there is likely to be little difference in how the two entities recognise these groups when setting objectives. An interesting fact about Layo is that it chooses to maintain its HQ in a relatively small town. This suggests the company takes seriously its responsibilities to "minor" stakeholders, such as employees and the local community and makes it even more comparable with Ibile than many large listed companies. There could also be implications of this decision for shareholders, although whether it is favourable (lower costs of an HQ) or otherwise (distance from City and major shareholders perhaps) is hard to say.

Where is the financing coming from, and in what proportions?

Ibile is financed almost equally by central government and the local population. As central government's funding comes from taxpayers, then many of Ibile's stakeholders and financiers will fall into both categories. Layo is financed mainly by its shareholders, who are therefore its main stakeholders, as noted.

Are there other, higher level, objectives that will supersede those set by the public sector entity, for example political aims/goals set by the government?
In the case of Ibile, the government's objectives cannot be ignored, although the political persuasion of the elected council might influence the extent to which the central and local objectives complement each other.

Does the objective need to be measurable?
The objectives of both entities are difficult to measure, but it is easier to interpret whether Layo has achieved its objective than Ibile. Setting a financial objective has the main advantage of being measurable. If Ibile were to have a financial objective it could be benchmarked against the performance of similar entities. Both public sector and private sector entities should have measurable objectives to aid comparison with other similar entities.

Will information on the two entities' performance be subject to public scrutiny?
In both cases, the entities' performance will be public information. Ibile has to provide annual reports, as well as a substantial amount of other information for its population. Layo has to provide annual reports and accounts, but it is not legally obliged to provide information beyond what is required by Company Law and International Financial Reporting Standards. The difference might be that those who scrutinise Layo's accounts and publicly announced information are better able to absorb and analyse it than those who receive Ibile's information.

Examiner's report

This question which is closely related to the preceding question, tests candidates' understanding of corporate objective setting in the public sector - a local government. A large number of the candidates attempted the question but performance was very disappointing.

Candidates made it clear that most of them are lacking in the elementary knowledge of business and finance by writing 'maximisation of shareholders wealth', 'maximisation of profit, etc., in a local government! Those candidates therefore lost easy marks.

Once again, it is very important that students prepare adequately for this examination, making use of all the study supports made available by the Institute.

Marking guide

		Marks
5.	Detailing the criteria of ibile	5
	Detailing the criteria of Layo	5
	Explanation of the consequences	5
	Total	**15**

SOLUTION 6

a) The beta of the portfolio is the weighted average of the beta of each of the companies. The weighting is by the market value of shares.

Company	Total Market Value	Beta	Hash Total
Dashing (D)	257,400	1.16	298,540
Elegant (E)	233,600	1.28	299,008
Fantastic (F)	217,000	0.90	195,300
Gaudy (G)	392,500	1.50	588,750
	1,100,500		1,381,598

Portfolio Beta = 1,381,598/1,100,500 = 1.26
Since the beta is more than 1, the short-term investment portfolio is more risky than the market (which has a beta of 1).

b) The composition of the short term investment portfolio may be considered from two viewpoints:

i. Is the expected performance of the individual investments within the portfolio satisfactory?

ii. Does the portfolio provide the most suitable form of short-term investments for the company?

The individual shares may be examined to establish if they are expected to provide a satisfactory return for the systematic risk they involve.

Using CAPM, the required return is:

$R_i = R_f + \beta (R_m - R_f)$

$= 11 + \beta_i (19 - 11)$

$= 11 + 8\beta_i$

D 11 + 8(1.16) = 20.28%

E 11 + 8(1.28) = 21.24%

F 11 + 8(0.9) = 18.20%

G 11 + 8(1.50) = 23.00%

For each stock, the expected return (= the total return) is the dividend yield plus the capital gains yield.

Company	Expected return (%) (K)	Required return (%) (T)	Abnormal return (%) (K - T)	Recommendation
D	19.50	20.28	-0.78	Sell shares
E	24.00	21.24	2.76	Buy more shares
F	17.50	18.20	-0.70	Sell shares
G	23.00	23.00	0	Hold

If the above data are accurate, the shares in companies D and F are not expected to give a satisfactory return relative to their systematic risk and should be sold. Further shares in company E should be bought because they offer a return higher than what is required by the level of systematic risk. Shares in company G should be held because alpha value is zero.

This analysis considers only systematic risk. If Bettaluck does not have other investments and is not well diversified, systematic risk is likely to under estimate the risk to Bettaluck of these investments.

ii) The portfolio is unusual for a short-term investment portfolio. Short-term investments are usually made for a specific purpose, for example to ensure cash is available for purchase of assets, payment of dividends, taxes or payables where a known amount of funds is required. Most companies are not willing to tolerate much risk of price movement in their short-term investments. This portfolio of investments in ordinary shares is exposed to substantial price movements as share prices change and the possibility that one or more of the companies could fail. Although the expected returns are relatively high, the risk of this portfolio is very high relative to most portfolios of marketable securities. Unless Bettaluck is happy to take such risks it is recommended that short-term investments should concentrate upon fixed interest marketable securities such as Treasury Bills, certificate of deposit and bills of exchange. Such investments involve much less risk of price movement and default, and, if held short-term, possible inflation is not a concern.

c) The factors that a financial manager should take into account when investing in marketable securities include:

i. Default risk: The risk that interest and/or principal will not be paid on schedule on fixed interest investments. Most short-term investment in marketable securities is confined to investments with negligible risk of default;

ii. Price risk: The risk of the value of the investment changing for example when interest rates change. Financial managers normally wish to avoid substantial price risk;

iii. Marketability. Securities should normally be marketable at short notice at close to the quoted market price;
iv. Taxation: Are there any special tax effects of the selected marketable securities?
v. Yield: Managers will usually try to achieve the maximum yield possible consistent with a satisfactory level of risk and marketability;
vi. Foreign exchange risk: If marketable securities are not denominated in the domestic currency of the investor, foreign exchange risk must be taken into account;
vii. The amount of funds to be invested. Some types of investment require a minimum size of investment; and
viii. The period for which the investment is to be made. The type of investment should be matched with the timing requirements of the future need for funds.

Examiner's report

This is a three – part question. Part (a) deals with calculation of portfolio beta. In part (b), candidates are expected to calculate, using CAPM, securities' required returns and the relevant alpha values. Part (c) requires candidates to identify factors to consider when investing in marketable securities.

Almost all the candidates attempted the question. Part (a) was reasonably well answered by a number of the candidates. Major errors include:

- Calculation of market values of the given companies using par values of shares rather than market values; and
- Calculation of portfolio beta using quantity of shares rather than total market values.

Part (b) was poorly answered virtually by all the candidates because they could not figure out the appropriate expected return. They failed to realise that return to shareholders is a combination of dividend yield and capital gain.

Some good answers were given to part (c) and a number of candidates cleared all the allocated 5 marks.

To increase the chance of success in future examinations, candidates need to practise standard examination questions.

Marking guide

		Marks	Marks
6a.	Determination of total market value	2	
	Determination of weight of coys	1	
	Computation of portfolio beta	1	4
6b.	Computation of expected return	1	
	Computation of required return	2	
	Recommendation	1	
	Reasons for the recommendation	2	6
6c.	Explanation of factors to be considered	5	5
	Total		**15**

SOLUTION 7

a) Right issue price = ₦4 × 0.85 = ₦3.40

		₦
i)	5 existing shares @ ₦4 =	20.00
	1 new share @ ₦3.40 =	3.40
	6	23.40

Theoretical ex-right price (TERP)= ₦23.40/6 = ₦3.90

ii) Value of right per existing share = (₦3.90 – ₦3.40)/5 = ₦0.10

b) A number of options are available to the owner of the 1,500 shares:

i) **Do–nothing**

	₦
Pre - right value = 1,500 × ₦4 =	6,000
Post- right value = 1,500 × ₦3.90 =	5,850
Loss in value (1,500 × ₦0.10) =	150

If the investor does nothing, he will suffer a loss of ₦150

ii) **Take up the rights**

Ex- right holding = 1,500 × 6/5= 1,800 shares

Ex – right value =1,800 × ₦3.90 =	₦7,020
Cash paid for additional shares = 300 × ₦3.40 =	(1,020)
Net ex-right wealth	6,000

The rights issue has a neutral effect if the additional shares are taken up.

iii) **Sell the rights**

Ex – right holding 1,500 shares

Ex – right value of holding = 1,500 × ₦3.90	= ₦5,850
Value of rights sold = 1,500 × ₦0.10	= 150
Net ex – right wealth	₦6,000

The rights issue also has a neutral effect on the investor's wealth.

iv) **Sell some rights and take up the balance**

If an investor does not want to gain or lose cash in a right issue, he can sell some of the rights and then buy the balance of his rights. The number of rights which should be sold is given by:

Total number of rights × (issue price/ TERP)

= (1,500/5)× (₦3.40/₦3.90) = 262*

(* rounded up because fraction of shares cannot be traded)

Number of rights bought = 300 – 262 = 38

	₦
Proceeds from right sold = 262 × ₦0.50	131
Cost of additional shares bought = 38 × ₦3.40	129.20*

(* Difference due to the rounding up of number of rights sold).

c) **Calculation of EPS**

i) Existing EPS

EPS = VPS/PER = ₦4/15.24 = 26.25K

ii) **Post – rights EPS**

$$= \frac{4m}{0.50} \times \frac{6}{5} \qquad = 9.6m\ shares$$

Gross funds raised = 1.6m × ₦3.40	= ₦5.44m
Less issue costs	₦2.00m
Net proceeds	= ₦3.44m
Current profit after tax = 26.25k × 8m shares	= ₦2.10m
Add bond interest saved, net of tax = 12% × ₦3.44m × (1 – 0.30)	= 0.289m
Revised profit after tax	= 2.389m

Revised EPS = ₦2.389m/9.6m shares = 24.88k.

Examiner's report

The question tests some basic calculations on rights issues of shares.
Almost all the candidates attempted the question with average level of performance.

Parts (a) and (b) were reasonably well answered but candidates struggled with part(c). Avoidable errors were found in candidates solutions. For example, candidates ignored interest saved on bond repaid when calculating revised profit.

Furthermore, the additional shares arising from the rights issue were ignored when computing the revised EPS.

Candidates are advised to prepare adequately for future examinations.

Marking guide

7		**Marks**	**Marks**
a.	Computation of right issue price	1	
	Computation of ex-right price	2	
	Computation of value of right	1	4
b.	Determination of effect on the investor's wealth for three alternatives	6	6
c.	Computation of existing EPS	1	
	Computation of gross fund raised	½	
	Consideration of issue cost to get net proceeds	½	
	Computation of current profit after tax	1	
	Computation of interest saved from retired bond	1	
	Computation of revised EPS	1	5
	Total		**15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2021

ADVANCED AUDIT AND ASSURANCE

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Eat Well Bakeries is a private limited liability company. It bakes bread and other confectioneries which produces from the main bakery and another small bakery, in another part of the town. The bakeries' products are sold from the two bakeries and five other outlets in the same town. Those who sell the products to other neighbouring towns are distributors who buy the products outright and bear the risk of sale or lose subsequently.

The main administrative functions and the management of the bakeries are undertaken from the main bakery. The small bakery and the sales outlets keep some basic records on activities. These records are transmitted to the main office every morning by the support staff in each location. Detailed accounting records and putting everything together to ascertain performance is done in the main and administrative office.

Though Eat Well Bakeries is a private business, the chairman has insisted on transparently ensuring that proper standards are maintained as he believes and shares the view that the bakery is to be competitive and is able to excel among competitors and remain relevant.

The partner you work under and the chairman of the bakeries met in a social gathering and after interactions between the two, the chairman decided to transfer the company's audit to your firm. Professional clearance was sought and obtained from the predecessor auditor but not much other documentation were found to have been available. The partner knew the company to be a small one but did not bother to do detailed documentation when the audit was started.

You have come to continue from where the associates assigned to the task have reached and to ensure that the expectations and confidence of the chairman is met.

Required:

a. Evaluate the Auditor's objective in respect of ISA 250 that would be discussed with the chairman. (5 Marks)

b. Prepare in an outline format the matters that are to be communicated. (5 Marks)

c. Your review of the system of operations shows some challenges with the internal control processes of the company. Based on this, prepare a brief on:

   i. The meaning of deficiency which may need to be focused on as identified by ISA 265; (3 Marks)

   ii. The things required to be included in the communication to the chairman on deficiencies (5 Marks)

d. Evaluate the audit strategies available from which an appropriate model would be selected for application to Eat Well Bakeries (12 Marks)

(Total 30 Marks)

SECTION B: OPEN-ENDED QUESTIONS (40 MARKS)

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

QUESTION 2

The auditors of Sunsit Manufacturers Limited had disagreements with the company on various issues. This came to a climax with the withholding of a part of the payment of the last audit fees. The auditors had also been disenchanted with the undue pressures of management, and have decided that as a result of this and the withheld fees would disengage from the client.

The company's chairman, in consideration of the issues in the past has considered the size of the audit firm as being partly responsible for its inability to manage adequately the pressures from the company accounting and management team. He has subsequently approached your firm for a change and the partners have accepted the engagement despite the predecessor auditor's declaration of the forfeiture of the firm's outstanding fees and none further involvement with the client and issues relating to the company.

Required:

a. Following the background to the client and the engagement, evaluate the internal and external business risks that need to be considered with respect to the client. (10 Marks)

b. Discuss the pre-engagement activities to be carried on the client. (10 Marks)

(Total 20 Marks)

QUESTION 3

a. The availability of Computer Assisted Audit Techniques (CAATs) should be considered by the Auditor when planning the nature, extent and timing of tests in an audit. Hence the auditor must determine his testing strategies which will depend on his decision of either using a Manual Testing method or CAATs method, to avoid loss of audit trail.

Required:

i. Discuss **FIVE** solutions to loss of audit trail. (5 Marks)

ii. Evaluate the merits and demerits of the application of CAATs. (7 Marks)

b. You have been appointed as the auditor of a company that processes its accounting functions using a computer system. You have decided to use computer assisted audit techniques (CAATs) to generate necessary audit evidence for this engagement.

Required:

i. Discuss the activities members of the audit team could perform with their computers in the client's office. (4 Marks)

ii. Analyse **TWO** types of audit software in use in computer based information systems. (4 Marks)

(Total 20 Marks)

QUESTION 4

Your firm is the auditor of Sharp Electronics Co. Plc a listed company, which assembles electronic home appliances for sale on retail and wholesale bases. The electronic appliances parts are purchased from within and outside the country. The extract from the statement of financial position of the company is as follows:

Sharp Electronics Co. Plc
Statement Of Financial Position

	2019 ₦'000	2018 ₦'000
Non-current assets		
Development cost	59,810	101,400
Tangible assets	99,400	73,000
Investments	85,100	-
	244,310	174,400
Current assets:		
Inventory	58,190	63,010
Receivables	184,630	156,720
Cash at bank and in hand	9,970	62,620
	479,100	**456,750**
Current liabilities:		
Payables: amounts falling due within one year	231,510	170,900
Payables: amount falling due after one year	101,180	93,840
Equity:		
Share capital	89,700	89,700
Share premium account	11,300	11,300
Revaluation reserve	19,750	9,750
Retained earnings	43,660	81,260
	497,100	**456,750**

You have been asked by the partner in charge of the audit to consider your firm's audit responsibilities with respect to subsequent events, and the associated audit on such matters.

Required:

a. Discuss the responsibilities of the auditors for detecting misstatements in the financial statements during the following periods.

i. From the end of the reporting period and up to the date of the audit report. (8 Marks)

ii. After the date of the audit report and before financial statements are issued. (6 Marks)

iii. After the financial statements have been issued. (3 Marks)

b. State the details of the work you will carry out in period (a)(ii) above to confirm that no adjustments are required on the financial statements. (3 Marks)

(Total 20 Marks)

SECTION C: OPEN-ENDED QUESTIONS (30 MARKS)

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

QUESTION 5

Yeye Oge Limited has decided to change its auditors after the current year's audit. The present auditor has served for a number of years and there is a mutual agreement on the change. The relationship between the company's key officials and the partner of the present audit firm had become so cordial that both parties are now getting concerned about the likely deviation from professional relationship, hence, the mutual agreement for the change of auditors.

You work for the present audit firm and your partner who is involved in this case has been asked to participate in the selection of a new audit firm for this client. Both the Chief Executive of the company and your partner have agreed also to follow due processes in selecting the new auditor. For proper understanding of what is required, it is necessary that certain background processes required for professional selection are made available to the chief executive of the company.

Required:

a. Evaluate the requirements of the Institute on advertising and publicity that need to be focused on while considering the competing firms. (5 marks)

b. Discuss the approved tendering process and evaluation of tender as a guide, giving proper meaning to the term "Low balling". (10 marks)

(Total 15 Marks)

QUESTION 6

The firm you work for has considered the growing development in some sectors of the economy and the opportunities this development portends.
Your firm is a sole practitioner and though the partner has the skills and professional competences necessary to undertake big jobs, applications for big jobs have always been turned down.

In order to get involved and secure some of these big jobs, your partner has dialogued with some other sole practitioners who share the same view with him. They have agreed and decided to operate a merged firm from the year 2022. The appropriate registration of the new practice name with Corporate Affairs Commission and application for licence in the new name from the Institute are also being processed.

To get ready to secure and execute some of these big jobs, preparations are to commence immediately the registrations are approved. Some of the target jobs are computerised entities, hence your partner has assigned you some tasks to prepare, as he is the lead partner.

Required:

a. Prepare a document showing the application controls that will be focused on in the computerised systems of the entities. (7 Marks)

b. Develop an appropriate audit strategy in accordance with ISA 300, *"Planning an audit of financial statements".* (8 Marks)

(Total 15 Marks)

QUESTION 7

Egunje Distributors Limited is a private company in which Chief Idowu is the major shareholder. Chief Idowu set up the business to help provide resources for his philanthropic gestures. He has been involved in the major control activities and the business was achieving its purpose and things were working well.

After a number of years, Chief Idowu stepped aside from the business and handed over the effective management to one of his subordinates who he equally elevated to the rank of General Manager (GM). The GM followed the control processes of Chief Idowu for only one year and began to introduce new ideas and processes which has led to undue amounts going into his private accounts rather than the accounts of the business. This has affected the results of the company.

While Chief Idowu has not decided to take any hasty action, he has decided to bring in your firm, because of your firm's size so that through your work, he may understand the reasons for the dwindling performance. It has also been discussed and agreed that your report on the audit will give insight into the reasons for the observed decline in performance.

Required:

a. Discuss the control environment focusing on the requirements of ISA 315 – *Identifying and assessing the risk of material misstatement through understanding the entity and its environment,* that will be relevant to this situation. (9 Marks)

b. Evaluate the control activities that will require your attention. (6 Marks)

(Total 15 Marks)

SOLUTION 1

a. The objectives of the auditor in respect of ISA 250 that would be discussed with the chairman are:
   - **obtain a general understanding** of the applicable legal and regulatory framework and how the entity is complying with that framework. This is part of obtaining an understanding of the entity and its environment
   - **obtain sufficient appropriate audit evidence** in respect of compliance with those laws and regulations which might be expected to have a direct effect on material amounts and disclosures in the financial statements
   - **perform the following audit procedures** to help identify such instances of non-compliance:
     - Make enquiries of management as to whether or not the entity is complying with the relevant laws and regulations
     - Inspect any correspondence with the relevant authorities
   - during the audit, remain alert to the possibility that other audit procedures might bring instances of non-compliances to the auditor's attention
   - obtain **written representations from management** that all known instances of non-compliance have been disclosed to the auditor
   - document all identified or suspected instances of non-compliance and the results of discussions with management and other parties.

b. The matters to be communicated include the following:
   - the auditor's responsibilities in relation to the audit, including notification that
     - he is responsible for forming and giving an opinion on the financial statements prepared by management, and
     - the audit does not relieve management or those charged with governance of their responsibilities, with respect to the financial statements.
   - an overview of the planned scope and timing of the audit.
   - any significant findings from the audit.

   These are often called the management letter points and are usually communicated along with, any deficiencies in internal control as required by ISA 265. They also include:
   - the auditor's views on the entity's accounting policies, estimates and financial statement disclosures
   - any significant difficulties encountered during the audit
   - any significant matters arising from the audit already brought to the attention of management and written representations requested
   - any other matters arising from the audit that are significant to the oversight of the financial reporting process.

c.

(i) a deficiency is defined by ISA 265 as where:

- A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct misstatements in the financial statements on a timely basis, or
- A control necessary to prevent, or detect and correct misstatements in the financial statements on a timely basis is missing.
- A significant deficiency is one which merits the attention of those charged with governance.

(ii) The communication to the chairman of significant deficiencies must be in **writing** and is **required** to cover:

- A description of the deficiencies and explanation of their potential effects.
- Sufficient information to allow those charged with governance and management to understand the context of the communication, including an explanation that:
- The purpose of the audit was to express an opinion on the financial statements
- The audit did include consideration of internal controls in order to design appropriate audit procedures. This was not done for the purpose of expressing an opinion on the effectiveness of internal control, and
- The matters being reported are limited to those deficiencies identified during the audit and considered of sufficient importance to be reported.

d. The main audit strategies are summarised in the table below:

Strategy/approach	**Outline of approach**
Statement of financial position approach	(i) This approach concentrates on the statement of financial position figures using substantive testing, on the argument that if the opening and closing statements of financial position are accurate, then the profit or loss for the year must also be stated accurately.
Substantive testing approach	(ii) This approach focuses on applying substantive test to a large number of transactions and account balances recorded in the accounting system of the client. (iii) This focus on recorded transactions and balances means that under-statements may not be detected. (The auditor may ignore transactions that have not been recorded.) (iv) This approach is time consuming and costly

	for the audit of large companies. (v) This approach is appropriate where systems and controls are weak or not operating. Substantive tests on transactions and balances are therefore necessary to reach an opinion about the financial statements. (vi) It is widely used for the audit of smaller entities where controls are likely to be weak and also some specialized audit. (vii) There is a danger of spending too much time auditing transactions or balances that are not material. (viii) There is a risk that misstatements in the financial transactions will not be detected unless all transactions are tested, not just a sample.
Systems-based approach	• The audit focus is on the application of tests of control to the systems that produce the figures in the financial statements, rather than on the figures themselves. • A systems-based approach is supported by some degree of substantive testing, because of the unavoidable transactions or weaknesses in the internal control systems. (The amount of substantive testing required will depend on the auditor's judgement about the effectiveness of the internal controls.) • It is also supported by the use of analytical procedures. • It is more cost-effective than a full substantive testing approach, but there is still a danger of doing too much unnecessary auditing of areas where controls are operating well.
Risk-based approach and business risk approach	(i) An assessment is made of the likelihood of material misstatement existing in each area of the audit. (ii) Areas that are assessed as high risk are audited extensively (using substantive test, a systems-based approach and analytical procedures.) (iii) Areas assessed as low-risk are given a low level of attention in the audit. (iv) Auditing methods (applied mainly by large audit practices) focus on 'business risk' rather than 'overall audit risk'.

Examiner's report

The question tests candidates' knowledge of the requirements of ISA 250: *Consideration of Laws and Regulations in an Audit of Financial Statements*, matters for communication, internal control processes and deficiencies in accordance with ISA 265; and audit strategy.

This is a compulsory question and all candidates attempted it. Candidates' performance was poor.

The common pitfalls of the candidates were the presumption that the requirement of part (a) of the question tested the requirements of ISA 260: *Communication with those Charged with Governance* and lack of knowledge of the required standards.

Candidates are advised to farmiliarise themselves with the Institute's Study Texts and Pathfinders which are freely available on the Institute's website.

Marking guide

			Marks	Marks
1	a)	1 mark each for any 5 points		5
	b)	1 mark each for any 5 points		5
	ci)	1½ marks each for any 2 points		3
	cii)	1 mark each for any 5 points		3
	d)	1 mark each for identification of each strategy/approach	4	
		1 mark each for any 8 points subject to at least one point from each strategy	8	12
		Total		**30**

SOLUTION 2

a. The internal business risks for consideration include the following:

- Risks arising from ineffective employees or weak management;
- The risks from a lack of customer care and attention to customer needs: poor customer awareness will eventually have an effect on sales demand.
- Poor financial management such as excessive levels of gearing, poor cash management and poor working capital control.
- Lack of finance for capital expenditure on equipment replacement or modernization.
- Risks due to systems weaknesses or system failures: internal control weaknesses.
- Risk from over-reliance on one or two key individuals.
- Risk of fraud or misappropriation of assets.

The external business risks for considerations include the following:

- The possible loss of a major contract as a result of a dispute with a customer.
- Long-term decline in demand for the company's products, and failure to invest in research and development of new products.
- The impact of new competitor moving into the market.
- The impact of proposed changes in laws and regulations, for example where a company needs a licence to operate (as in financial services) there may be a risk that the licence will be withdrawn or will not be renewed.
- The effect of new technology.
- The effect of changes in the macro-economy, such as changes in interest rates or exchange rates or a downturn in the economy (lower economic growth or possibly an economic recession).
- The impact of natural hazards (such as storms and flooding that may affect the company's ability to maintain operational capacity).
- Threats from competitors to a company's patents or copyrights.
- Uncomfortable business environment.

b. The pre-engagement activities necessary for the situation include:

- Agreeing the terms of engagement in accordance with ISA 210 – *Agreeing Terms of Audit Engagement,* and this is done by –

  (i) Establishing whether the preconditions for an audit are present; and
  (ii) Confirming that there is a common understanding between the auditor and the management.

To establish if the preconditions for an audit are present, ISA 210 requires the auditor to:

- To establish if the financial reporting framework to be used in the preparation of the financial statements is acceptable.
- Obtain the agreement of the management that it acknowledges and understands its responsibility:
  - for the preparation of the financial statements;
  - for internal controls to ensure that the financial statements are not materially misstated;
  - to provide the auditor with all relevant and requested information and unrestricted access to all personnel.

- ISA510: *Initial audit engagements,* provide guidance on the auditor's responsibility in relation to balances where:
  - The financial statement for the prior period were not audited; or

- The financial statements for the prior period were audited by another auditor (referred to as predecessor auditor)

The objective of the auditor when considering such an initial audit engagement is to obtain sufficient appropriate audit evidence about whether:

- The opening balances contain misstatements that materially affect the current period's financial statements, and
- Appropriate accounting policies reflected in the opening balances have been properly accounted (or change of accounting policy has been accounted for and disclosed).

The following audit procedures are required:

(i) Read the most recent financial statements and audit report, if any, for information relevant to opening balances.

(ii) Check that the prior period's closing balances have been correctly brought forward.

(iii) Check that opening balances reflect appropriate accounting policies.

(iv) One or more of the following procedures:

- Where the prior period financial statements were audited, review the predecessor auditor's working papers to obtain evidence in relation to opening balances.
- Consider whether audit procedures carried out in the current period provide evidence on some of the opening balances. For example if cash received from customers in the current period gives evidence of the existence of a receivable at the opening date.
- Carry out audit procedures to obtain evidence in relation to opening balances and a review of the audit report on the financial statements for the previous period.

- if evidence is found that opening balances could contain material misstatements affecting the current period's financial statements, perform appropriate additional procedures to assess the effect,
- if such misstatements do exist, communicate to those charged with governance in accordance with ISA 450.
- check that the accounting policies reflected in the opening balances have been consistently applied in the current period (or a change of accounting policy has been properly accounted for and disclosed).

Examiner's report

The question tests candidates' knowledge of the business risks associated with a clients' operations and pre-engagement activities.

The question was attempted by about 90% of the candidates. The performance of the candidates in part (a) of the question was good, but they displayed poor understanding of part (b). The overall performance was below average.

The commonest pitfall of the candidates was their inability to evaluate the risks associated with an audit.

Candidates are advised to familiarise themselves with practical aspects of audit engagement and also to study properly the Institute's Study Texts and Pathfinders.

Marking guide

			Marks	Marks
2	a)	1 mark each for any 5 internal points	5	
		1 mark each for any 5 external points	5	10
	b)	1 mark each for 2 points on the terms with ISA 210	2	
		1 mark each for the precondition on ISA 210	2	
		1 mark each for any 2 points on ISA 510	2	
		1 mark each for any 4 points on the audit procedures	4	10
		Total		20

SOLUTION 3

a (i) Solutions to loss of audit trail include:

- External back up of the data to ensure there is another copy;
- Restriction of unauthorised personnel into the data processing environment;
- Transmission of the control of specified and responsible personnel;
- Production of a hard copy of the evidence generated through the audit process;
- The application of a computer assisted audit technique e.g test data and computer audit program to provide the necessary audit trail;
- 'Getting into the computer system' to check the completeness of the data;

- Ensuring that the computer system is maintained in a dust or hazardous free environment;
- The auditor may perform alternative audit procedure such as third party confirmation and physical verification as a basis for corroborating computer generated balance.

(ii) **Merits of CAATs:**

- They give the auditor an ability to test the completeness and accuracy of the electronic processing itself (the computer software), rather than relying only on testing the accuracy and completeness of inputs and outputs.
- They give the auditor an ability to test a large number of transactions in a relatively short amount of time: testing large amounts of data reduces overall audit risk.
- They allow the auditor to test the effectiveness of the controls that are programmed into the computer.

Demerits of CAATs

CAATs give the auditor the ability to audit the processing transactions in a computer-based information system. However, the value of using CAATs should be assessed on the cost-benefit basis. CAATs should only be used if the benefits from their use exceed the costs.

The costs related to the use of CAATs may include:

- Purchasing or developing the programs;
- Keeping the programs up-to-date, for changes in hardware and software;
- Training audit staff in their use. CAATs are of no value unless auditors are properly trained in how to use them;
- Obtaining time on the client's computer systems to run the CAATs.

b. (i) It is usual for members of an audit team to take laptop computers with them to the client's premises, for use with the administration, documentation and performance of the audit assignment. Laptop computers may be used for tasks such as:

- Audit administration and control (for example, preparing time sheets and audit work programs);
- Audit planning work (for example, for risk and materiality assessments);
- Preparing audit working papers;
- Analytical procedures (including holding on file a record of statistics and financial ratios for the client for previous years);
- Sampling software, if appropriate.

(ii) Audit software is computer programs used by the auditor to extract information from a clients computer-based information system, for use in the audit.

The main types of audit software include:

- Interrogation programs, to access the client's files and records and extract data for auditing;
- Interactive software, for use in interrogation of on-line computer systems;
- 'Resident code' or 'embedded software', to monitor and review transactions as they are being processed by the client's programs. This type of software is called embedded audit facilities.

Examiner's report

The question tests the concept of loss of audit trail, CAATs, use of computer systems in audit and audit software.

The question was attempted by about 70% of the candidates, but the performance was poor.

Majority of the candidates failed to exhibit good knowledge of the use of computers in performing audit functions in a client's environment and were unable to discuss the two types of audit software in use in computer audit systems.

Candidates are advised to pay close attention to the technicalities associated with computerised audit environments and to read the Institute's Study Texts and Pathfinders.

Marking guide

		Marks
3 a) (i)	1 mark each for any 5 points	5
(ii)	1 mark for each point on merits	3
	1 mark for each point in demerits	4
b) (i)	1 mark each for any 4 points	4
(ii)	2 marks for any 2 points	4
	Total	**20**

SOLUTION 4

a(i) **Events occurring after the reporting period and up to the date of the audit report.**

Between the end of the reporting period and the date of the audit report, the auditor is required to obtain sufficient appropriate evidence that all events that require adjustment of or disclosure in the financial statements:

- have been identified, and
- are suitably reported in the financial statements.

Normal audit verification work

The auditor may find sufficient evidence of subsequent events in the course of normal audit verification work. Where this is the case he is not required to perform additional audit procedures. Such normal audit verification work will include looking at sales, invoices and cash transactions after the year-end in order to verify items in the statement of financial position at the year end. For example:

- The audit of receivables will consider whether receivables at the end of the reporting period are collectable. Cash receipts after the year-end may indicate a significant non-payment, suggesting the need to write off a debt as 'bad'.
- The audit of inventory procedures includes a review of the net realizable value of inventory. Sales of inventory after the year-end may indicate that some inventory in the statement of financial position is over-valued (because subsequent events have shown that its NRV was less than cost).
- A search for unrecorded liabilities may discover the existence of some unrecorded liabilities, from invoices received after the reporting period but relating to the period covered by the financial statements.
- A review of the entity's cash position at the end of the reporting period may find that a cheque from a customer, recorded as part of the bank balances, was dishonoured after the reporting period.

Procedures aimed specifically at identifying subsequent events

The auditor should also actively look for 'subsequent events', up to the time that he prepares the audit report. Taking into account his risk assessment of this area, he should:

- obtain an understanding of management's procedures for identifying subsequent events;
- inquire of management as to whether any subsequent events have occurred which might affect the financial statements;
- read the entity's latest subsequent financial statements;
- read minutes of shareholders' meetings, meetings of the board of directors and senior management meetings held after the date of the financial statements and inquire about matters discussed at any such meetings where minutes are not available;
- obtain written representations in respect of subsequent events.

(ii) **Facts discovered after the date of the audit report and before the financial statements are issued**

Even after the date on which the audit report is signed, the auditor retains some degree of responsibility for **events of which he becomes aware**, up to the time that the financial statements are issued. He is not required, during this period, to actively look for subsequent events. His level of responsibility is therefore much reduced compared with the period before the signing of the audit report.

If the auditor becomes aware of a fact that, had it been known to him at the date of the report, may have caused him to amend his report then he must:
- discuss the matter with management;
- determine whether the financial statements need amending; and
- inquire how management intend to address the matter in the financial statements.

If the financial statements are amended, the auditor is required to:
- carry out the necessary audit procedures on the amendment(s), and
- extend his review of subsequent events up to the date of the new audit report.

If management do not amend the financial statements for the subsequent event, but the auditor feels that an amendment should be made, the auditor should take the following action.

- If the audit report has not yet been provided to the entity, modify his opinion as appropriate.

If the audit report has been provided to the entity:
- instruct management not to issue the financial statements before the necessary amendments have been made
- if they do so, take appropriate action to prevent reliance on the audit report, after taking legal advice.

(iii) **Facts discovered after the financial statements have been issued**

The auditor has no obligation to perform audit procedures or make inquiries regarding the financial statements after they have been issued.

However, if he becomes aware of a fact that, **had it been known to him at the date of his audit report, may have caused him to amend his report** then he should:

- discuss the matter with management
- determine how the financial statements need amending, and
- inquire how management intend to address the matter in the financial statements.

If the financial statements are amended, the auditor is required to:

- carry out the necessary audit procedures on the amendment
- extend his review of subsequent events up to the date of the new audit report (as above)
- review the steps taken by management to inform anyone who received the original financial statements and audit report of the situation
- issue a new audit report, containing an **emphasis of matter paragraph** or **other matter paragraph.** This should refer to a note in the revised financial statements that explains in more detail the reason for the re-issue of the financial statements.

b Disclosures for non-adjusting events after the reporting period

Non-adjusting events after the reporting period are treated differently. A non-adjusting event relates to conditions that did not exist at the end of the reporting period, therefore the financial statements must not be updated to include the effects of the event. IAS 10 states quite firmly: 'An entity shall not adjust the amounts recognized in its financial statements to reflect non-adjusting events after the reporting period.

However, IAS 10 goes on to say that if a non-adjusting event is material, a failure by the entity to provide a disclosure about it could influence the economic decisions taken by users of the financial statements. For **material non-adjusting events** IAS 10 therefore requires disclosure of:

i. the nature of the event; and
ii. an estimate of its financial effect, or a statement that such an estimate cannot be made.

This information should be disclosed in a note to the financial statements.
IAS 10 gives the following examples of **non-adjusting events:**

i. A fall in value of an asset after the reporting period, such as a large fall in the market value of some investments owned by the entity between the end of the reporting period and the date the financial statements are authorized for issue.
ii. The acquisition or disposal of a major subsidiary.
iii. The formal announcement of a plan to discontinue a major operation.
iv. Announcing or commencing the implementation of a major restructuring.
v. The destruction of a major plant by a fire after the reporting period.

Examiner's report

This question tests knowledge of the auditor's responsibility for detecting misstatements in financial statements at various stages of the audit and reporting processes.

Only about 45% of the candidates attempted this question and this performance was poor.

The commonest pitfall was the candidates' lack of understanding of the auditors' responsibilities with respect to misstatements in financial statements.

Candidates are advised to pay close attention to the requirements of each question, and ensure that they read the Institute's Study Texts and Pathfinders when preparing for future examinations.

Marking guide

			Marks
4 a)	(i)	1 mark each for any 8 points	8
	(ii)	1 mark each for any 6 points	6
	(iii)	1 mark each for any 3 points	3
b)		1 mark each for any 3 points	3
		Total	**20**

SOLUTION 5

a. Advertising and publicity

When a professional accountant in public practice solicits new work through advertising or other forms of marketing, there may be a threat to compliance with the fundamental ethical principles. For example, a self-interest threat to compliance with the principle of professional behaviour is created if services, achievements, or products are marketed in a way that is inconsistent with that principle.

Advertising and publicity activities by accountancy firms are therefore regulated by IFAC and ICAN through their codes of ethics and conduct respectively. Note that ICAN has adopted all of IFAC's guidance in this matter.

The main requirements for marketing professional services are that the advertising and publicity material used by any firm:

i. must not bring into disrepute the professional body, the firm or the profession as a whole;
ii. should not make exaggerated claims for services offered, qualifications possessed or experience gained – it should be honest and truthful and not mislead;
iii. must not discredit the services provided by other firms or make disparaging references or unsubstantiated comparisons to the work of another Chartered Accountant
iv. must not break any locally-recognised codes of advertising practice.

In addition, it is recommended that advertising and publicity material should avoid any reference to fees. If fees are mentioned, there should be a statement of the basis on which the fees are to be charged. Comments about fees:

(i) must not be misleading;
(ii) must not offer discounts, and
(iii) must not make comparison with the fees of other service providers.

ICAN's Professional Code of Conduct and Guide for Members states that if a Chartered Accountant in public practice is in doubt whether a proposed form of advertising or marketing is appropriate, they should consult through the Registrar/Chief Executive of ICAN.

b. **Tendering**

Tendering is a commercial process widely-used by companies (especially larger companies) when they wish to change auditors. Tendering involves two or more audit firms being invited by an entity/prospective client to submit a proposal for its audit work.

The invitation may or may not include the existing auditor.

This section describes the commercial tender process used by prospective clients to select new auditors. There are the specific legal and ethical mechanism associated with actually changing the auditor in Nigeria.

The tendering process should be broken down into the following stages (assuming that a firm is submitting a tender for the audit of a new client):

(i) Collect background information about the possible new client. (This is necessary when evaluating any new client, whether the fee is to be set by tender or by any other method.)
(ii) Establish the precise scope of the work to be performed and the specific requirements of the prospective client.

(iii) Carry out a preliminary audit risk assessment and prepare a preliminary plan for the audit. The plan must cover the staffing requirements and the time requirements for the work.
(iv) Estimate a fee.
(v) Prepare a **submission document** for the potential client. The contents of this document will typically include:
   - an outline of the key characteristics of the firm;
   - clarification of the nature of the audit work or other non-audit work to be performed;
   - a statement of the requirements of the client and how the firm will comply with them;
   - an outline of how the work will be performed;
   - the proposed fee and the basis of its calculation;
   - the range of other services which the firm could offer to the client.
   - If required, prepare and give a presentation to the potential client.

Evaluating the tender

In evaluating the tender, the client (company) is likely to consider the following issues:

- Fees
- The services that the firm is able to provide
- Geographical locations and coverage of the firm's offices
- Expertise of the firm and its staff
- Reputation of the firm
- Whether the senior management of the prospective client think that they will be able to work well (on a personal level) with the potential engagement partner and key audit staff
- The formal presentation itself by the audit firm
- The extent to which the company wants to change its audit firm, and its dissatisfaction with the current audit firm.

Low balling

Low balling is the practice of tendering for the audit work at a very low fee, with the objective of winning the audit. If it is successful in obtaining the audit, the firm will hope that:

- it will be able to raise the audit fee in future years, or
- it will be able to recover losses on the audit fee by providing other, more lucrative non-audit services.

Although there is no evidence that low balling leads to a poor-quality audit, the fact that it exists does nothing to improve the reputation of the auditing profession. The existence of low fees may suggest to the business community and to the general public that audit work is of a low quality. All fees should be sufficiently adequate to compensate a firm for the work that it carries out.

Examiner's report

The question tests candidates' knowledge of the requirements of the Institute's Code of Conduct on advertising and publicity, and the tendering process.

Over 90% of the candidates attempted the question and the performance was above average.

The common pitfall was the candidates' poor understanding of the contents of the Code of Conduct for members.

Candidates are advised to read thoroughly the Institute's Study Texts and Pathfinders.

Marking guide

			Marks
5	a)	1 mark for any 5 points	5
	b)	1 mark each for any 4 points on Tendering	4
		1 mark each for any 4 points on Evaluating the Tender	4
		1 mark each for the 2 points on Low bailing	2
		Total	**15**

SOLUTION 6

a. **Application controls**

It is also necessary for the auditor to identify and assess the application controls in each specific computer-based application such as the inventory, receivables and payroll system. The auditor must be satisfied that the application controls for a particular system are affective.

Application controls are specific controls over each specific computerised accounting application or system. The purpose of application controls is to provide assurance that:

(i) processed transactions have been properly authorised, and
(ii) the processing of data is complete, accurate and timely.

In a manual processing system, internal controls vary according to the application. For example, internal controls over inventory are different from the controls over payroll processing. Similarly, application controls in a computer-based information system will vary depending on the nature of the application.

However, application controls for different computer applications share a number of common features, regardless of the particular application involved.

In particular, the auditor will place a high degree of emphasis on controls over **input**. For application controls to be effective, it is essential that input must be complete and accurate. If the input is not correct, the output from the application cannot be expected to be correct.

Application controls that will be focused on in computerized system entities are:

Control area	Controls
Input	**Authorisation** • Data for input should be authorised before input • Data is input only by authorised personnel **Completeness** There should be checks to ensure that all data has been processed. Checks might consist of: (i) Document counts (for example, counting the number of invoices) (ii) Control totals (iii) Checking output to input (iv) Review of output against expected values (for example, is the total payroll cost broadly in line with expectations) **Accuracy** There should be some checks within the computer software in the validity of input data items (data validation checks). These may include: • Checks digits for key code items, such as supplier codes, customers codes and employee identification numbers • Range checks(= a check on whether a particular value or figure is feasible and within a realistic range of values) • Existence checks (= a check on whether a particular code exists) • Revenue and reconciliation of output • Use of control totals

Processing	There should be checks that all inputs have been processed and that processing is complete. Checks might include: • Control totals • Batch totals (where the computer counts the number of transactions in a processed batch and this is checked against a manual record of the number of items in the batch) • Manual review • On-screen warning that processing is not complete
Master files and standing data	• Management review of master files and standing data • Regular updates of master files • Record counts

The auditor should review the application controls for each application, to establish whether they are effective 'on paper'. He should then carry out tests of controls to establish whether the application controls are operating effectively in practice.

b. Audit strategy in accordance with ISA 300, *Planning an audit of financial statements*

The auditor's work on planning is regulated primarily by ISA 300 *Planning an audit of financial statements*, which requires the auditor to plan the audit so that the audit work will be performed in an effective manner. An overall audit plan should be developed, detailing the expected scope of the audit and how the audit should be conducted.

ISA 300 states that:

i. an audit should be planned so that it is performed effectively
ii. the auditor should establish an overall audit strategy, and
iii. the audit plan should include measures for the direction, supervision and review of audit work.

Audit strategy memorandum

Most auditors prepare an **audit strategy memorandum**. This is a document setting out the main points involved in the planning process and the key planning decisions that have been taken.

The memorandum will cover the following areas:

- The assignment objectives and reports to be issued.
- The audit timetable, to meet the required reporting deadlines for the auditor's report.

- Changes in the client's organisation or business, or external ('environmental') changes affecting the client's business, since the previous audit.
- A summary of key financial ratios and other ratios from previous years.
- Planning decisions for the audit.
- The use that will be made of the client's staff in the audit (for example, internal auditors) and the use that will be made of external experts.
- Possible problem areas in the audit and the approach to be adopted to deal with them.
- Staffing requirements for the audit, the planned allocation of the work between members of the audit team, time budgets and records from previous audits.
- Attendance locations (if the client has more than one location).
- Proposed methods of communication with the client (for example, meeting/reports).

The memorandum should be reviewed and approved by the engagement partner.

Examiner's report

The question tests candidates' knowledge of the controls in computerised systems and audit strategy in accordance with ISA 300: *Planning the Audit of Financial Statements.*

About 60% of the candidates attempted the question and they showed good understanding of the second part of which appeared to be the attraction.

The commonest pitfall was the shallow understanding of the computerised environment and the components of ISA 300.

Candidates are advised to read the Institute's Study Texts and Pathfinders.

Marking guide

		Marks	Marks
6 a)	1 mark each for 7 points subject to:		
	4 points from Input	4	
	2 points from Processing	2	
	1 point from Master files and Standing data	1	7
b)	1 mark each for any 8 points		8
	Total		**15**

SOLUTION 7

a. ISA 315 identifies five components which together make up an internal control system. These are:
   i. the control environment
   ii. the entity's risk assessment process
   iii. the information system
   iv. Control activities (internal control)
   v. The review and monitoring of controls

   The control environment has been defined by the Institute of Internal Auditors as follows: "the attitude and actions of the board [of directors] and management regarding the significance of control within the organisation. The control environment provides the discipline and structure for the achievement of the primary objectives of the system of internal control. The control environment includes the following elements:

- Integrity and ethical values
- Management's philosophy and operating style
- Organisational structure
- Assignment of authority and responsibility
- Human resource policies and practice and
- Competence of personnel.

A strong control environment is typically one where management shows a high level of commitment to establishing and operating sound controls.

The existence of a strong control environment cannot guarantee that controls are operating effectively, but it is seen as positive factor in the auditor's risk assessment process. Without a strong control environment, the control system as a whole is likely to be weak.

b. Control activities are the practices and procedures, other than the control environment, used to ensure that the entity's objectives are achieved. They are the application of internal controls.

   Control activities are the specific procedures designed.
   i. to prevent errors that may arise in processing information, or
   ii. to detect and correct errors that may arise in processing information

The control activities that will require attention are evaluated below:

- **Authorisation controls**: These require that all significant transactions must be authorised by a manager at an appropriate level in the organisation.
- **Physical controls over assets:** These are controls for safeguarding assets from unauthorised use, or from theft or damage. An example is limiting access to inventory areas to a restricted number of authorised personnel.
- **Arithmetic controls:** These are checks on the arithmetical accuracy of processing. An example is checking invoices from suppliers, to make sure that the amount payable has been calculated correctly.
- **Accounting controls:** These are controls that are provided within accounting procedures to ensure the accuracy or completeness of records.
- **Management controls**. These are controls applied by management. They include supervision by management of the work of subordinates, management review of performance and control reporting (including management accounting techniques such as standards setting, variance analysis, budgeting and budgetary control).
- **Segregation of duties**
  Segregation of duties means dividing the work to be done between two or more individuals, so that the work done by one individual acts as a check on the work of the others. This reduces the risk of error or fraud.
  - If several individuals are involved in the completion of an overall task, this increases the likelihood that errors will be detected when they are made. Individuals can often spot mistakes of other people more easily than they can identify their own mistakes.
  - It is more difficult for a person to commit fraud, because a colleague may identify suspicious transactions by a colleague who is trying to commit a fraud.

Examiner's report

This question tests the candidates' knowledge of the control environment in accordance with the requirements of ISA 315 and the control activities that require auditor's attention.

About 60% percent of the candidates attempted the question but the performance was below average.

The commonest pitfall was the candidates' inability to discuss the control environment focusing on the requirements of ISA 315.

Candidates are advised to familiarise themselves with ISAs, the Institute's Study Texts and Pathfinders to improve their performance in future.

Marking guide

			Marks
7	a)	1 mark each for any 9 points	9
	b)	1 mark each for any 6 points	6
		Total	**15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2021

CASE STUDY

Time Allowed: 4 hours (including reading time)

INSTRUCTION: YOU ARE TO USE THE 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.icanig.org/student**

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 analysis 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 marked/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%

Of the total marks available, 20% are awarded for the executive summary and approximately 10% for the relevant discussion of ethical issues within your answer to the requirements. Although ethical issues do not form a specific requirement, as this has been 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 marks 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;
- Be able to carry out appropriate analysis of the issues involved and suggest feasible solutions to the problems identified;
- Demonstrate ability to make informed judgement on the basis of analysis carried out; and
- Generate reasoned conclusions upon which relevant recommendations are made.

Candidate that omits any one of these will have a slim chance of success in the examination.

November 2021 Case Study: Zed - Air Nigeria Limited

List of exhibits

1 About you (Joel Garba) and your employer, Babatunde, Farouk, Ibazebo & Co. (Chartered Accountants and Tax Practitioners)
2 Zed–Air Nigeria Limited: History, operations, competitors, board and management
3 4- year summarised financial statements: 2015 – 2018
4 Board paper No. 257

Exhibit 1

About you (Joel Garba) and your employer, Babatunde, Farouk, Ibazebo & Co. (Chartered Accountants and Tax Practitioners)

You are Joel Garba, writing the Professional level of ICAN examination. You are employed as a Trainee at Babatunde, Farouk, Ibazebo & Co. (Chartered Accountants and Tax Practitioners). You are reporting to David Ibazebo, the partner in charge of business advisory services of the firm. Your responsibilities include:

- Preparing detailed financial analyses and reports as may be required by your firm's clients;
- Analysing your clients' financial statements to identify areas of weakness and proffering likely solutions to correct any anomalies;
- Assessing operational and strategic business proposals to see how each aligns with the client's objectives and its impact on its business and financial risks;
- Assessing your firm's clients' financial and business forecasts together with the assumptions upon which they are based to form judgements and recommendations to their respective board; and
- Drafting reports for your partner's perusal and approval before sending it to your clients.

Your responsibilities demand that you keep yourself abreast of the business and economic environments, both nationally and internationally, so as to be able to carry out the above tasks effectively.

Exhibit 2

Zed – Air Nigeria Limited
History, operations, competitors, board and management

Zed – Air Nigeria Limited was established in 1995, when four friends who worked in different industries, but are all graduates of chemical engineering came together to explore business opportunities in air – gases. One of them, Dotun Gbadebo, has worked as a production manager with one of the leading companies in the industry, Air Liquide Nigeria Plc., for several years. The others have the following work experience:

- Dr Theophilus Adie lectures at the department of chemical science in one of the Federal Government Universities for several years. He is currently a professor of chemical engineering;
- Alhaji Yahaya Galadima worked for several years in one of the oil exploration companies in Nigeria where he recently retired as a director; and
- Dan Chukwuma worked in one of the leading manufacturing companies in Nigeria as General manager - Factory operations.

The company's factory is located in Iganmu Industrial Estate in Apapa. The company's factory was commissioned by the Lagos State Commissioner for Trade, Commerce and Industries in February 1996.

The company has since been one of the leading companies producing medical gases and has also ventured into the provision of gases for the food and pharmaceutical industries.

Business Focus

The company has segmented its business into three different business categories as follows:

Zed – Air healthcare products: Zed – Air's purpose is to provide effective support for hospital care throughout the country. The company's products offered to hospitals are:

- Liquid nitrogen for conservation and dermatology;
- Mixture protoxide of nitrogen (N_2O) and oxygen (O_2) for pain relief and sedative conscious;
- Protoxide of nitrogen (N_2O) for anesthesia;
- Nitrogen monoxide (NO) for acute respiratory distress and pulmonary hypertension
- Oxygen (O_2), mixture of oxygen and helium (O_2/He) for hypoxia (lack of oxygen in the blood) asthma and carbon monoxide poisoning;
- Surgical argon for functionality of surgical equipment; and
- Carbon dioxide (CO_2) for expansion of abdominal walls.

Food and Beverage: Zed – Air offers the following products:

- Cryogenic fluids for transportation, for the maintenance of the cold chain from the manufacturer to consumer;
- Carbon dioxide for the manufacturing of carbonated drinks;
- Inerting/Deoxygenation for protecting food products, whether solid or liquid, so that they can retain all their properties;
- Multiple injection of protective gases to shelf life span of dairy, ultra – fresh and ice cream products;
- Carbon dioxide (CO_2) and liquid nitrogen (N_2) for cryogenic freezing of meat, sausages and sea foods for freezing and rapid cooling; and
- Oxygen for oxygenation of fish ponds and streams for quality breeding.

Pharmaceutical Industry: Zed-Air supplies gases to the pharmaceutical industry for inerting at various steps in the production and packaging processes and also quality analytical gases that include pure gases and mixtures for quality assurance.

Operations

The operations of the company involve the following activities:

- Air is collected directly from the atmosphere;
- The collected air is compressed using a compressor;
- Water is separated from the air collected and compressed;
- The resulting air is passed through evaporation, cooling and chilling processes;
- Water is separated from the air again;
- Carbon is filtered from the air;
- The air is now made to pass through the process of drying, using air driers;
- Dust is then separated from the air;
- Air is separated to give liquid oxygen and argon gas; and
- The liquid oxygen is then pumped into oxygen cylinders.

Competitors

The following are the major competitors in the industry:

- Air Liquide Nigeria Plc.;
- Air Separation Nigeria Limited;
- BOC Gases Plc.;
- Apex African Gas Nigeria Limited;
- Sona Industrial Gas Limited; and
- Sabbyn Industrial Gas Limited

Air Liquide Nigeria Plc. is the market leader followed by BOC Gases Plc. Others are operating at the same level with Zed – Air Nigeria Limited and each is struggling to move up as the third leading supplier of the various gases. However, each of these companies has its various areas of strength. Some concentrate on industrial gases, while Zed – Air concentrates on healthcare, food and pharmaceutical industries.

Board and management

Board

The company is being run by a board of six members. The chairman of the board is Professor (Dr) Tunde Ejilola, a retired medical director of Lagos Teaching Hospital and a professor of surgery. He has several years of distinguished service in many teaching hospitals in Nigeria and has once served as a Federal Minister of Health.

He was invited to the company by the four promoters so as to take advantage of his wealth of experience. He holds 10% shares in the company. Other directors are:

- Dotun Gbadebo
- Dr Theophilus Adie
- Alhaji Yahaya Galadima
- Dan Chukwuma; and
- Dr. Julius Nduaka - Managing director/chief executive officer

Shareholding structure in the company is as follows:

- Prof. (Dr.) Tunde Ejilola - 10%
- Dotun Gbadebo - 20%
- Dr Theophilus Adie - 20%
- Alhaji Yahaya Galadima - 20%
- Dan Chukwuma - 20%
- Maria Idera - 10%

The authorised share capital of the company is 200,000,000 of 50 kobo each, out of which 180,000,000 have been issued.

Management

The management of the company comprises the following:

- Dr. Julius Nduaka - Managing director/chief executive officer
- Debo Afolabi - Chief finance officer
- Emannuel Irabor - Production controller
- Hajia Khadjat Sambo - Marketing controller
- Johnson Kosofe - Human resources controller

Exhibit 3

Zed – Air Nigeria Limited Financial summary
Statement of profit or loss and other comprehensive income

	2018 ₦million	2017 ₦million	2016 ₦million	2015 ₦million
Revenue	860	876	941	776
Cost of sales	(684)	(624)	(590)	(493)
Gross profit	176	252	351	283
Other income	85	-	23	91
Operating expenses	(112)	(62)	(103)	(103)
Administrative expenses	(362)	(415)	(289)	(181)
Operating profit/(loss)	(213)	(225)	(18)	90
Finance costs	(35)	(30)	(37)	(39)
Net finance costs	(35)	(30)	(37)	(39)
Profit/(Loss) before taxation	(248)	(255)	(55)	51
Income tax (expense)/credits	(6)	2	2	-
Profit/(Loss) for the year	**(254)**	**(253)**	**(53)**	**51**
Other comprehensive income				
Remeasurement loss on defined benefit plan	-	(37)	(3)	(5)
Income tax effect		11	1	1
Other comprehensive loss for the period	-	(26)	(2)	(4)
Total comprehensive loss for the period	**(254)**	**(279)**	**(55)**	**47**

Statement of financial position

	2018 ₦million	2017 ₦million	2016 ₦million	2015 ₦million
Assets				
Non – current assets				
Property, plant and equipment	392	365	392	432
Intangible assets	-	1	1	3
Other assets	235	205	-	-
Total non – current assets	**627**	**571**	**393**	**435**
Current assets				
Inventories	237	296	212	248
Trade and other receivables	252	325	253	136
Other financial assets		-	52	11
Prepayment and other current assets	39	44	237	329
Cash and bank balances	29	71	124	84
Total current assets	557	736	878	808
Total assets	**1,184**	**1,307**	**1,271**	**1,243**
Equity and liabilities				
Equity:				
Issued share capital	90	90	90	90
Share premium	2	2	2	2
Retained earnings	(459)	(172)	107	207
Total equity	(367)	(80)	199	299
Non – current liabilities				
Interest bearing loans and borrowings	-	-	43	80
Employees benefits	-	102	69	60
Deferred tax liabilities	-	-	13	30
Total non – current liabilities	-	102	125	170
Current liabilities				
Trade and other payables	1,253	1,095	834	601
Interest bearing loans and borrowings	184	186	109	149
Income tax payable	10	4	4	11
Other current liabilities	104	-	-	13
Total current liabilities	**1,551**	**1,285**	**947**	**774**
Total liabilities	**1,551**	**1,387**	**1,072**	**944**
Total equity and liabilities	**1,184**	**1,307**	**1,271**	**1,243**

Exhibit 4

Zed – Air Nigeria Limited
Board paper No. 257
Purchase of plant and machinery

Part of the strategies approved in the last board meeting to revamp the company, is the importation of a modern plant and machinery which will enable the company to compete effectively with new entrants into the market.

However, as a result of the company's current financial problem, the possibility of financing the importation through its funds or bank loan is not feasible. Therefore, the management is seeking the board's approval for the company to finance the purchase through a finance lease.

From our findings, the period of the lease will be five years, with annual repayment of five equal installments. The first instalment will become payable after the first year of drawdown.

Julius Nduaka
Managing director

UNSEEN

November 2021 Case Study: Zed – Air Nigeria Limited

List of exhibits
The following exhibits are newly provided and did not form part of the material provided as Pre-seen:

5 Email from David Ibazebo to Joel Garba
6 Email from Debo Afolabi to David Ibazebo
7 Letter from Alcat Leasing Company Nigeria Limited
8 Letter from the Ministry of Health
9 Installation of air plants: Financial projections
10 2019 summarised management accounts

Zed – Air Nigeria Limited: Case Study requirement

You are Joel Garba, a final-year trainee ICAN Chartered Accountant working as a Trainee at Babatunde, Farouk, Ibazebo & Co. (Chartered Accountants and Tax Practitioners). You report to David Ibazebo, the business advisory partner.

Requirements

You are required to prepare a draft report, as set out in the email dated 2 July 2020 from David Ibazebo 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 of report	2 hours

Marks allocation

All of the marks in the Case Study are awarded for the demonstration of professional skills, allocated broadly as follows:

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%

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 as failure to address any requirement including 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 report. Accordingly, not demonstrating your judgement or failing to include appropriate conclusions and/or recommendations in your report will affect your chances of success.

Exhibit 5

Email from David Ibazebo to Joel Garba

From: David Ibazebo

Sent: 2 July 2020

To: Joel Garba

Subject: Zed – Air Nigeria Limited

I have just received a mail from the chief finance officer (CFO) of Zed – Air, asking us to advise the company on a way out of their current financial situation. The company will also want us to advise on the effect of a proposed plant leasing on their financial statements and key financial indicators. In addition, the CFO wants us to carry out an appraisal of a new business proposal, the installation of turnkey air plants in four of the teaching hospitals in the country.

I am attaching to this email, exhibits 6 to 10 in respect of the above.

Please draft for my review a report addressed to the board of Zed-Air. The report should comprise:

1. A review of Zed – Air's financials from 2015 to 2019, using their financial statements for 2015 to 2018 in our files and the company's summarised management accounts attached to this mail. Your analyses should focus on the company's profitability, liquidity and financial strengths' trend for the period. You are to provide a brief commentary on the result of your review and proffer advice to the company on the financial strategies the company should pursue to help it out of its financial troubled waters.
2. An appraisal of the installation of air plants project in four teaching hospitals across the country and an advice to the company whether or not to go ahead with the project. You are also required to prepare an extract of the effects of the lease on the company's financial statements and demonstrate with appropriate calculations its effects on the company's financial indicators.

I look forward to receiving your draft report.

Exhibit 6

Email from Debo Afolabi to David Ibazebo

From: Debo Afolabi – Zed – Air Nigeria Limited
To: David Ibazebo – Babatunde, Farouk, Ibazebo & Co.
Subject: Financial Advisory
Date: 30 June 2020

David,
No doubt, you are aware of the current problem our company is going through, in terms of financial constraints occasioned by turbulent operating environment that has turned the company into loss making. We have accumulated losses which have eroded our shareholders' equity.

The board of our company is desperately looking for ways out of the wood and to bring the company back on its feet. Therefore, our board has approved that you carry out a review of our financials for the past four years, together with the management accounts for 2019, so as to advise the board on the financial strategies, in your opinion, based on your analysis, that the company should pursue to address the situation. You should have our financial statements for 2015 to 2018 in your file, therefore, I am attaching to this mail our 2019 summarised management accounts for your analysis.

Also, we have just received an approval from the Ministry of Health, giving us permission to install a turnkey air plant in four of the teaching hospitals in the country. Details of the terms of the approval and our projections on the project are attached as appendices to this mail. As usual, you are to carry out an appraisal of this project and give us your view on it.

In the last meeting, our board approved that we import a new plant that will enable the company compete effectively with the new entrants into the industry. However, due to our financial situation, we could not raise the fund to purchase the plant. We have contacted Alcat Leasing Company Nigeria Limited and the company has agreed to offer us a finance lease for the purchase of the plant. I am aware that the board will want to know the implications of this on our financial statements and financial indicators, when they are considering the proposal from the leasing company. I will therefore, want you to carry out an analysis of this, as part of your report, showing clearly the effect of the transaction on our financial statements and financial indicators. I also attach the terms of the finance lease approval in principle from the leasing company to aid your analysis.

I am looking forward to the receipt of your report on the above issues. I hope that, you still remember that the next board meeting will be coming up in the next two weeks. Thanks for your continued assistance.

Debo

Exhibit 7

Letter from Alcat Leasing Company Nigeria Limited

Alcat Leasing company Nigeria Limited
10, Commercial Road
Victoria Island
Lagos

10 July 2020

The Managing director
Zed – Air Nigeria Limited
5 Abebe Village Road
Iganmu Industrial Estate
Apapa
Lagos

Attention: Debo Afolabi

Dear Sir

RE: FINANCE LEASE OF ₦250m

Your application to our company and our recent discussions on the above refers. This is to convey our board's approval of your application to you, based on the following terms:

- Our company will provide the fund to import the plant and machinery you intend to purchase and pay all incidental costs up to the installation of the plant in your premises, however, the total commitment of our company will not exceed ₦250m;
- The interest rate applicable shall be 15% per annum;
- Your company will also be required to pay the following: commitment fee 0.5%; and management fee 1% at the commencement of the lease period;
- The period of ordering to installation, as stated by your company, will not exceed three months, interest on our company's exposure during the period will be 15% of any amount provided, before the commencement of the lease period. The interest will be added to the accumulated cost of the project;
- The lease period will be five years and repayment will be in five equal annual instalments, with the first instalment becoming payable twelve months after the commencement of the lease period;
- The lease period will start from the day the plant is commissioned;
- Your company will be responsible for maintenance, insurance and other incidental costs of running the plant;
- At the end of the lease period, your company will be given the option of purchasing the plant for a sum of ₦10m.

You are to sign and affix your company's seal on the enclosed duplicate copy of this letter, if you agree with the terms and conditions as stated above.
Your company will be required to sign a formal lease agreement at the commencement of the lease period.

Thanks for giving us the opportunity to support you.

Yours faithfully
For: **Alcat Leasing Company Nigeria Limited**

Lekan Salami
Managing Director

Exhibit 8

Letter from the Ministry of Health

The Federal Ministry of Health
Plot 1165, Constitution Road
Garki
Abuja

5 July 2020

The Managing Director
Zed – Air Nigeria Limited
5 Abebe Village Road
Iganmu Industrial Estate
Apapa
Lagos

Attention: Julius Nduaka

Dear sir

INSTALLATION OF TURNKEY MEDICAL AIR PLANT IN FEDERAL TEACHING HOSPITALS

Your proposal on the above refers.

I am pleased to convey to you the honourable Minister of Health's approval of your proposal.
The terms of the approval are as follows:

1. Construction of turnkey medical air plant in Lagos, Enugu, Ilorin and Kaduna teaching hospitals;
2. Project period, covering installation and commissioning, will be six months;
3. The cost of each plant will not be more that ₦50m, giving a total of ₦200m;
4. The project is on the basis of build and run;
5. The Federal Government will not commit any fund to the project, other than the provision of land for installation of the plant in each of the hospitals;
6. The Federal Government is prepared to issue a ₦180m guarantee to the Bank of Industry, to provide loan to your company for importation of relevant plant and machinery;
7. Regular maintenance and operations of the plant will completely be your company's responsibility;
8. Land rent of ₦120,000 per annum is payable on yearly basis to each of the hospitals by your company;
9. Utility charges of ₦60,000 per annum is payable to each of the hospitals by your company to cover cost of electricity, water and other utilities;
10. Your company will bill each hospital for its medical air consumptions on a monthly basis; and

11. It is estimated that your company will run the plant for ten years, during which your company must have recouped its investment in the plant, and transfer the plant to each of the hospitals at a cost of ₦5m.

Your company is required to sign a formal agreement with each of the hospitals' management board, to be supervised by the Ministry, within the next 21 days, if the terms and conditions are acceptable to your company.
Accept my best wishes.

Musa Garuba
Permanent Secretary
Federal Ministry of Health

Exhibit 9

Installation of air plants: Financial projections

1. Based on past experience in medical gas requirements for these hospitals, the management came up with the following projections:

   Revenue: The following probable monthly billings to each of the hospitals for medical gas are:

Situation	₦'000	Probability
High	1,000	0.25
Medium	800	0.50
Low	600	0.25

2. **Costs:** Apart from utiltity cost and land rental charges, it is projected that the company will incur the following additional cost:

   Labour cost: It is estimated that labour to run each plant will be ₦60,000 per month; and

   Plant maintenance: appropriately ₦5,000 per plant per month.

3. **Bank of Industry's loan terms:** Letter of offer from the Bank of Industry include the following terms:

   Loan facility: ₦180m term loan;
   Repayment: Ten equal annual instalments of ₦31,857,150, starting after 12 months after draw down;
   Applicable interest rate: 12% per annum; and
   Management fees: 0.5% upon draw down.

4. The company's objective is to achieve 15% per annum returns on its investments.

Exhibit 10

Zed – Air Nigeria Limited: 2019 summarised management accounts
Statement of profit or loss and other comprehensive income

	2019
	₦million
Revenue	905
Cost of sales	(578)
Gross profit	327
Other income	18
Operating expenses	(47)
Administrative expenses	(188)
Operating profit	**110**
Finance costs	(40)
Net finance costs	(40)
Profit before taxation	**70**
Income tax (expense)/credit	(9)
Profit for the year	**61**
Other comprehensive income	
Remeasurement loss on defined benefit plan	-
Income tax effect	-
Other comprehensive loss for the period	-
Total comprehensive profit/loss for the period	**61**

Statement of financial position	**2019**
	₦million
Assets	
Non – current assets:	
Property, plant and equipment	387
Intangible assets	-
Other assets	318
Total non – current assets	**705**
Current assets	
Inventories	233
Trade and other receivables	273
Other financial assets	
Prepayment and other current assets	72
Cash and bank balances	43
Total current assets	621
Total assets	**1,326**
Equity and liabilities	
Equity:	
Issued share capital	90
Share premium	2
Retained earnings	(398)
Total equity	**(306)**
Non – current liabilities	
Interest bearing loans and borrowings	-
Employees benefits	74
Deferred tax liabilities	10
Total non – current liabilities	**84**
Current liabilities	
Trade and other payables	1,284
Interest bearing loans and borrowings	119
Income tax payable	3
Other current liabilities	142
Total current liabilities	**1,548**
Total liabilities	**1,632**
Total equity and liabilities	**1,326**

Executive Summary: Zed Air Nigeria Limited

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

- The company's financial structure needs to be re-jigged.
- There is need to introduce additional permanent working capital.
- Fear that suppliers may stop suppling materials to the company on credit, if the outstanding is not settled.
- Needs to maintain current improvement.
- Shareholders urgently need to bring additional fund.

4. Requirement 2: Conclusions

- Proposed four air plants are financially viable.
- The proposed four air plants will improve cash flow.
- The lease facility will impact on the company's financial indicators.
- Would the company be able to meet with the lease obligations?

5. Requirement 2: Recommendations

- The four air plants are good projects to improve cash flow.
- Needs to sensitise the market if it will be able to absorb production from the proposed leased machine
- The company should hire experienced staff to run the proposed four Air plants
- The company should go ahead with the lease agreement.

3. Requirement 1: Recommendations

- Open discussions with suppliers to agree on payment plan.
- Look for ways of reducing cost of sales to improve gross margin.
- Go for a rights issue or if not possible, for a new issue of ordinary share capital.
- Improve on assets utilisation efficiency.

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REQUIREMENT 1 - Zed - Air Nigeria Limited's financial statement analysis

1 USES DATA AND INFORMATION APPROPRIATELY

- Uses information on exhibit 3 and 10 - income statement to show trend of Zed - Air's profitability trend.
- Uses information on exhibit 3 and 10- statement of financial position to calculate relevant ratios.
- Uses information on exhibit 3 and 10 - to show trend in Zed - Air's financial strength.
- Uses information on exhibit 3 and 10 to show trend in Zed - Air's trend in liquidity

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2 USES PROFESSIONAL TOOLS AND KNOWLEDGE

- Calculates gross margin ratios.
- Calculates liquidity ratios.
- Calculates leverage ratios.
- Calculates return on capital employed ratio.

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4 IDENTIFIES ISSUES AND OPTIONS

- Identifies that the company has been accumulating losses since 2016, with a little profit in 2019.
- Identifies that the suppliers may not continue to support the. company, unless the company settles the outstanding trade payable.
- Identifies that the company has a negative equity as a result of accumulated losses.
- Identifies that the company has liquidity problem.

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5 APPLIES PROFESSIONAL SCEPTICISM AND ETHICS

- Recognises that unless Zed - Air's management does something the company may not continue in business for a long time.
- Recognises that the company is relying on suppliers' credit to trade.
- Recognises that the management accounts for 2019 may not be relied upon because it has not been audited.
- Recogises that the company needs injection of long term capital in form of equity.

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3 USES ANALYTICAL SKILLS (material points) written report

- Determines trend in profitability ratios.
- Determines trend in Zed - Air's cost of sales.
- Determines trend in Zed - Air's liquidity.
- Determines trend in financial strength.

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6 EVALUATIVE SKILLS AND JUDGEMENT

- Recognises that the company's financial indicators have been on the downward trend from 2015 to 2018, although there was some recovery in 2019.
- Recognises that the company is running on negative equity as its equity capital has been eroded by accumulated losses.
- Recognises that the company is in a serious liquidity crisis.
- Recognises that the company has been using suppliers' fund to trade and this may not be able to continue indefinitely.
- Recognises that the company needs to ask the shareholders to bring in capital in form of rights issue.

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7 **CONCLUSIONS**

(Draws distinct conclusions under a heading)

- Concludes that the company needs urgent financial re-engineering
- Concludes that the liquidity position of the company is a threat to its future prospect.
- Concludes that the suppliers may stop supplying materials to Zed - Air on credit.
- Concludes that the company should endeavour to continue on its recovery path, as seen in 2019.
- Concludes that the company needs injection of equity capital.

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8 **RECOMMENDATIONS (commercial/relevant)**

- Recommends that Zed - Air should enter into discussion with its suppliers so as to reach agreement on how to settle the outstandings, with a view of securing their continued support
- Recommends that the company should try and improve on its gross margin.
- Recommends that the company should call the shareholders to inject more capital in form of rights issue.
- Recommends that the company should improve on efficient utilisation of its assets as returns on asset are very low.

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REQUIREMENT 2 - Appraisal of Plant leasing and turnkey air plants

1 USES DATA AND INFORMATION APPROPRIATELY

- Uses information in exhibit 7 - letter from Alcat Leasing.
- Uses additional information on exhibit 8 - Letter from the Ministry of Health.
- Uses information in exhibit 9 - Financial projections on the turnkey air plants.
- Uses information in exhibit 4 - Board paper seeking board's approval for the lease.
- Uses information in exhibit 5 on the evaluation required.

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2 USES PROFESSIONAL TOOLS AND KNOWLEDGE

(written into report)

- Determines the lease liability.
- Determines the total cost of right of use asset.
- Determines the entries necessary in the books to give .

  effect to the lease.
- Determines the effect on the company's financial indicators.
- Determines the expected yearly revenue from the air plants.
- Determines the yearly net cash inflow from the air plants.
- Determines the net present value of the air plants.

  factory.

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4 IDENTIFIES ISSUES AND OPTIONS

- Identifies that there has been a change in recording lease transactions as a result of IFRS 16 that has removed the dycotomy between finance and operating lease.
- Identifies that the lease will result in a right of use asset.
- Identifies that the lease will affect the company's financial indicators, such as leverage, profitability and liquidity.
- Identifies that the air plant has a positive net present values.
- Identifies that the air plant will result in net cash inflow to the company.

V

5 APPLYING PROFESSIONAL SCEPTICISM AND ETHICS

- Discusses the possibility of Zed - Air being able to meet up with the lease obligations
- Discusses the veracity of the financial projections used for evaluation of the air plants
- Discusses the possibility of Zed - Air being able to operate the air plants

  successefuly within the premises of government hospitals.
- Discusses the possibility of the government officials asking for kickbacks and how Zed - Air will handle such demand.

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3	**USES ANALYTICAL SKILLS (material points)**		6	**EVALUATIVE SKILLS AND JUDGEMENT**
				(uses analytical headings)
◆	Calculates the lease liability.		◆	Evaluates the expected revenue from the air plants.
◆	Calculates the total value of right of use asset.		◆	Evaluates the net present value of the proposed air plants.
◆	Shows the entries necessary to record the lease transaction.		◆	Evaluates the possibility of Zed - Air being able to meet up with the lease obligations lease obligations.
◆	Calculates the yearly expected revenue from the air plants.		◆	Evaluates the ability of Zed - Air to run the new leased plant profitably
◆	Calculated the net present value of the air plants.		◆	Evaluates the effect of the lease transactions on the company's financial indicators
V	NC BC CA SA		**V**	NC BC CA SA

7 CONCLUSIONS

(Draws distinct conclusions under a heading)

- Concludes that the air plants project has a positive net present value.
- Concludes that the proposed air plants project will result in net cash inflow.
- Concludes that the proposed lease facility will affect the company's financial indicators.
- Concludes on the need for Zed - Air to evaluate the possibility of meeting with the lease obligations considering the company's present financial situation.

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8 RECOMMENDATIONS (commercial / relevant)

- Recommends that Zed - Air should go on with the turnkey air plants,
- Recommends that the company should carry out market survey to ensure that it will be able to run the proposed plant profitably before entering into leasing agreement.
- Recommends that Zed - Air needs a competent staff to man each of the air plants.
- Recommends that Zed - Air should enter into the lease agreement as that is the only immediate way forward.

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Appendices

1. Appendices R1: Content and style

Shows trend of Zed - Air's operating performance.

- Shows appropriate profitability ratios.
- Shows appropriate ratios on the company's liquidity.
- Shows appropriate ratios to evaluate the company's financial strength.

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2. Appendices R2: Content and style

- Shows expected revenue from the air plants.
- Shows the net present value (NPV) of the air plants.
- Shows the calculation of the yearly operating costs of the air plants.

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Main Report

3. Report: Structure

- Sufficient appropriate headings
- Appropriate use of paragraphs / sentences
- Legible/clear hand writing
- Correctly numbered pages

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4. Report: Style and language

- Relevant disclaimer (external report)
- Suitable language for the board
- Tactful / ethical comments
- Tactful / ethical comments
- Acceptable spelling and punctuation

V NC BC CA SA

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IC	
ID	
NA	
Total	

Appendice 1

Financial statement analysis

Zed - Air Nigeria Limited

Ratios analysis	**2015**	**2016**	**2017**	**2018**	**2019**
Profitability:					
Gross margin	283/776 X%	351/941 X %	252/876 X %	176/860 X %	327/905 X %
	36.47%	37.30%	28.77%	20.47%	36.13%
Operating margin	90/776 X %	(18)/941 X%	(225)/876 X%	(213)/860 X%	110/905 X%
	11.60%	-1.91%	-25.68%	-24.77%	12.15%
Return on assets	90/1243 X%	(18)/ 1271 X%	(225)/1,307 X%	(213)/1,184 X%	110/1,326 X%
	7.24%	-1.42%	-17.21%	-17.99%	8.30%
Return on capital employed (ROCE)	90/469 X%	(18)/324 X%	(225)/22 X%	(213)/(367) X%	110/(222) X%
	19.19%	-5.56%	1,022.73)%	?	?
Return on equity	51/299 X%	(53)/199 X%	(253)/(80) X%	(254)/(367) X%	61/(306) X%
	17.06%	-26.63%	?	?	?
Liquidity	-	-	-	-	-
Current ratio	808 ÷ 774	878 ÷ 947	736 ÷ 1,285	557 ÷ 1,551	621 ÷ 1,548
	1.04:1.00	0.93:1.00	0.57: 1.00	0.36: 1.00	0.40:1.00
Acid test ratio	560 ÷ 774	666 ÷ 947	440 ÷ 1,285	320 ÷ 1,551	388 ÷ 1,548
	0.72: 1.00	0.70: 1.00	0.34: 1.00	0.21: 1.00	0.25: 1.00
Financial strength					
Debts to total assets	944/1243 X%	1,072/1,271 X%	1,387/1,307 X%	1,551/1,184 X%	1,632/1,326 X%
	75.95%	84.34%	106.12%	131.00%	123.08%
Debt/Equity ratio	170/299 X%	125/199 X%	102/(80) X%	00.00/(367) X%	84/(306) X%
	56.86%	62.81%	?	?	?
Non- current liability/Equity + Non current liability	170/469 X%	125/324 X%	102/22 X%	00.00/(367) X%	84/(222) X%
	38.25%	38.58%	?	?	?
Interest cover	90/39	(18)/37	(225)/30	(213)/35	110/ 40
	2.3times	?	?	?	2.75 times

Appendice 2
Zed - Air Nigeria Limited
Evaluation of Installation of air plants
Calculation of yearly cash flow

	₦'000
Revenue	38,400.00
Operating cost	35,697.15
Net cash flow per annum	2,702.85

Net present value

Year	Amount (₦'000)	Discount factor	Present value
0 - Management fees	900.00	1.0000	-900
1-10 - Net cash flow	2,702.85	5.019	13,566
10 - Disposal value (5,000,000 X 4)	20,000.00	0.247	4,940
Net present value			**17,606**

Calculation of expected yearly revenue	**Amount (₦'000)**	**Probability**	**Expected value ₦'000**
High	1,000	0.25	250
Medium	800	0.5	400
Low	600	0.3	150
			800
No of plants			4

Total revenue per month	-	-	3,200
Total revenue per annum (3,200 X 12)			38,400
	₦'000		
Calculation of yearly operating cost			
Land rent (12,000 X 4)	480.00	-	-
Utility (60,000 X 4)	240.00		
Labour (60,000 X 4 X 12)	2,880.00	-	-
Plant maintenance (5,000 X 4 X 12)	240.00		
Loan repayment	31,857.15		
	35,697.15		

Zed - Air Nigeria Limited
Proposed Finance lease

Initial fees

	₦'000
Commitment fees	1,250
Management fees	2,500
	3750.00

Calculation of lease liability

Determination of yearly payment 250,000,000/3.3521551

74,578,888

Year	Opening liability	Interest (15%)	Lease Repyt.	Closing liab.
1	250,000,000	37,500,000	-74,578,888	212,921,112
2	212,921,112	31,938,167	-74,578,888	170,280,391
3	170,280,391	25,542,059	-74,578,888	121,243,561
4	121,243,561	18,186,534	-74,578,888	64,851,208
5	64,851,208	9,727,681	-74,578,888	1
			-372,894,440	

Lease Liability

Lease repayments	372,894,440
Purchase option	10,000,000
	382,894,440

Total cost of right of use asset

Lease liability	382,894,440
Initial fees	3,750,000
	386,644,440

Entries necessary in the books:

	Dr.	**Cr.**
Right of use asset	386,644,440	
Alcat Leasing - Lease liability		382,894,440
Bank		3,750,000
	386,644,440	**386,644,440**

Depreciation on the right of use asset would be provided for yearly, based on the lease period and the company's depreciation policy.

Effect on financial indicators

1. Because of the lease liability, it will increase the debt/equity ratio.
2. Because of the increase in the non-current assets figure, it will reduce the return on capital employed ratio.
3. Because of the current portion of the lease liability, it will reduce the working capital ratio.

Note:

Under IFRS 16, finance leases do not exist from the perspective of lessees. All leases (with limited exception, i.e., lease of small value and short term lease) are recorded on statement of financial position, similar to finance lease treatment under IAS 17.

Lessees are required to initially recognise as a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term. The lease liability is measured at the present value of the lease payments to be made over the lease term.

Lease liability

Lease liability is determined as follows:

Fixed payments for lease elements, less any lease incentives receivable over the lease term;

Plus: Certain variable payments linked to an index/rate based on level of index/rate at commencement under residual value guarantees;

Plus: Residual value guarantee: amounts expected to be payable;

Plus: Purchase options / Termination costs: exercise price of a purchase option if the lessee is reasonably certain to exercise that option or reflects exercise of a termination; and

Less: Payments made previously, as lease payments made to lessor at or before commencement date.

Right of use asset

Right of use asset is determined as follows:

Lease liability - the initial amount;

Plus: Initial direct costs;

Plus: Costs of removal / Costs to restore, as the estimated cost of removing and/or restoring leased asset;

Plus: Payments made previously; and

Less: Lease incentives received.

NOVEMBER 2021 EXAMINATION DIET

CASE STUDY

Examiner's report

The Case Study is about a company operating in the air gases industry, with head/operating office in Lagos. As usual, there are two requirements that students are to address. These are:

- A review of Med – Air's financials from 2015 to 2019, using their financial statements for 2015 to 2018 in our files and the company's summarised management accounts attached to this mail. Your analyses should focus on the company's profitability, liquidity and financial strengths' trends for the period. You are to provide a brief commentary on the result of your review and proffer advice to the company on the financial strategies the company should pursue to help the company out of its financial troubled waters.

- An appraisal of the installation of air plants project in four teaching hospitals across the country and an advice to the company whether or not to go ahead with the project. You are also required to prepare an extract of the effects of the lease on the company's financial statements and demonstrate with appropriate calculations its effects on the company's financial indicators.

To perform very well in the Case Study, candidates must prepare the following appendices:

- Calculations of appropriate ratios on profitability, liquidity and financial strength;
- NPV of the proposed air plants;
- Computation of lease liability;
- Computation of the value of right of use asset;
- Entries to record the lease transaction in the company's books, showing their effects on the financial statements and financial indicators.

Candidates' performance was very poor as only very few candidates scored up to 50%.

The commonest pitfalls of the candidates were:

- Most candidates did not address requirement 2 of the Case Study, thereby losing substantial marks;
- Some candidates did not calculate the appropriate ratios, while some were showing trend analysis which was not required by the Case Study requirements;

- Lack of understanding of how to write a formal report with appropriate headings and subheadings to address issues required; and
- Inability to write a good executive summary.

Candidates are advised to practise and perfect the art of report writing, learn to address the specific requirements of each Case Study and ensure they bring to bear the knowledge they had gained in other subjects when preparing for future examination.