THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

NOVEMBER 2022 DIET
PROFESSIONAL LEVEL EXAMINATIONS

Question Papers

Suggested Solutions

Examiner's Reports

and

Marking Guides

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.

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2022

CORPORATE REPORTING

EXAMINATION INSTRUCTIONS

PLEASE READ THESE INSTRUCTIONS BEFORE THE COMMENCEMENT OF THE PAPER

1. Check your pockets, purse, mathematical set, etc. to ensure that you do not have prohibited items such as telephone handset, electronic storage device, programmable devices, wristwatches or any form of written material on you in the examination hall. You will be stopped from continuing with the examination and liable to further disciplinary actions including cancellation of examination result if caught.
2. Write your **EXAMINATION NUMBER** in the space provided above.
3. Do **NOT** write anything on your question paper **EXCEPT** your examination number.
4. Do **NOT** write anything on your docket.
5. Read all instructions in each section of the question paper carefully before answering the questions.
6. Do **NOT** answer more than the number of questions required in each section, otherwise, you will be penalised.
7. All solutions should be written in **BLUE** or **BLACK INK**. Any solution written in **PENCIL** or **RED INK** will not be marked.

TUESDAY, NOVEMBER 15, 2022

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2022

CORPORATE REPORTING

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

The following draft statements of financial position of RAM, DAM and TAM all of which are public limited companies as at April 30, 2021 are:

Statements of financial position as at April 30, 2021

	RAM Plc	DAM Plc	TAM Plc
	₦'m	₦'m	₦'m
Non-current assets:			
Property, plant and equipment	2,030	705	356
Investment in DAM	690	-	-
Investment in TAM	180	110	-
Total non-current assets	2,900	815	356
Current assets:			
Inventories	450	185	75
Trade receivables	270	115	60
Cash and cash equivalents	105	65	85
Total current assets	825	365	220
Total assets	3,725	1,180	576
Equity and liabilities			
Equity:			
Ordinary share capital	2,400	620	220
Share premium	300	105	56
Revaluation reserves			60
Retained earnings	685	280	76
	3,385	1,005	412
Non-current liabilities	200	65	64
Current liabilities	140	110	100
Total equity and liabilities	3,725	1,180	576

Additional information:

(i) Three years ago, May 1, 2018 RAM Plc had acquired 80% of the ordinary share capital of DAM Plc when the retained earnings of DAM Plc were ₦110m. Since the group structure was created, there were no new issue of shares. The fair value of the non-controlling interests was ₦160m as at the date of acquisition; while the fair value of the net assets of DAM Plc was ₦850m. Any fair value adjustments related to inventory had been realised by the current year end.

(ii) Two years ago, to veil the identity of the true owner of TAM Plc, RAM Plc acquired 40% while DAM Plc acquired 25% of their interest in TAM's Plc ordinary share capital on the same date when the retained earnings of TAM Plc were ₦65m and those of DAM Plc were ₦160m. The fair value of the non-controlling interest in TAM Plc was ₦155m as at the acquisition. There was no revaluation reserve in the books of TAM as at the date of acquisition. The fair values of the net assets of TAM Plc as at the date of acquisition were not materially different from their carrying amount.

(iii) The group operates in the oil industry and incurs expenditure on research and development of products. These costs were formerly written off to the statement of profit or loss and other comprehensive income as incurred but then reinstated when the related products were brought into commercial use. The reinstated costs are shown as 'Development Inventory'. The costs do not meet the development criteria in IAS 38-Intangible Assets for classification as intangibles and it is unlikely that the net cash inflows from these products will be in excess of the development costs. In the current year, DAM Plc has included ₦22m of these costs in inventory.

(iv) DAM Plc had purchased a significant amount of new production equipment early in the year. The cost before trade discount of this equipment was ₦60m. The trade discount of ₦12m was taken to the income statement. Depreciation is charged on the straight-line basis over a six-year period.

(v) The policy of the group is now to state tangible non-current assets at depreciated historical cost. The group changed from the revaluation model to the cost model under IAS 16-Property, Plant and Equipment at the beginning of the current year and restated all of its tangible non-current assets to historical cost in that year except for the tangible non-current assets of TAM Plc. These had been revalued by the directors of TAM Plc on the first day of the current year. The values were incorporated in the financial records creating a revaluation reserve of ₦80m.The tangible non-current assets of TAM Plc were originally purchased on May 1, two years before the current year end, at a cost of ₦320m. The assets are depreciated over six years on the straight-line basis. The group does not make an annual transfer from revaluation reserves to the retained earnings in respect of the excess depreciation charged on revalued tangible non-current assets. There were no additions or disposals of the tangible non-current assets of TAM Plc for the two years to the current year end.

vi) The goodwill arising from the DAM Plc acquisition was impairment tested at the first and second year-end after acquisition and again at the current year-end. The first and second impairment review revealed no impairment. However, the current review identified a recoverable value of ₦900m for DAM Plc. There has been no impairment in TAM's Plc goodwill since acquisition.

vii) It is the group policy to value the non-controlling interests at fair value.

Required:
Prepare a consolidated statement of financial position of the RAM Group as at April 30, 2021. **(Total 30 Marks)**

SECTION B: OPEN-ENDED QUESTIONS (40 MARKS)

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

QUESTION 2

A-Z is considering raising external finance through offering of its shares for sale or obtaining term loan from the bank. To this effect, the last financial statements of the company for the year ended November 30, 2021 presented below have been subjected to financial analysis.

Statement of comprehensive income for year ended November 30:

	2021	2020
	₦'000	₦'000
Profit before interest and tax	6,600	4,710
Interest expense	(510)	(450)
Profit before tax	6,090	4,260
Income tax expense	(2,190)	(1,560)
Profit after tax	3,900	2,700
Dividends paid	(750)	(750)
Retained profit	3,150	1,950

Statement of financial position as at November 30.

	2021	2020
	₦'000	₦'000
Non-current assets	19,050	16,800
Current assets:		
Trade receivables	6,300	6,210
Inventories	5,130	4,620
Total current assets	11,430	10,830
Total assets	**30,480**	**27, 630**
Equity and liabilities		
Equity:		
Share capital (ordinary shares of ₦1 fully paid up)	9,000	9,000
Retained earnings	11,100	7,950
	20,100	16,950
Non-current liabilities:		
10% Loan notes 2022/ 2023	4,500	4,500
Current liabilities:		
Trade payables	3,120	3,390
Taxation	1,650	1,350
Bank overdraft	1,110	1,440
Total equity and liabilities	**30,480**	**27, 630**

Required:

a. Compute the following ratios for the years 2020 and 2021:

i. Return on equity;
ii. Dividend cover;
iii. Dividend pay-out ratio;
iv. Interest cover (8 Marks)

b. Based on the ratios computed above, prepare a report on the performance and state of the company assuming potential shareholders and lenders are the recipients of your report. (12 Marks)

(Total 20 Marks)

QUESTION 3

Evo Plc acquired a cash-generating unit (CGU) several years ago. The directors of Evo Plc were concerned that the value of the CGU had declined because of a reduction in sales due to new competitors entering the market. At February 28, 2021, the carrying amounts of the assets in the CGU before any impairment testing were:

	(₦ m)
Goodwill	3
Property, plant and equipment	10
Other assets	19
Total	32

The fair values of the property, plant and equipment and the other assets at February 28, 2021 were ₦10 million and ₦17 million respectively and their costs to sell were ₦100,000 and ₦300,000 respectively. The CGU's cash flow forecasts for the next five years are as follows:

Date (Year ended)	Pre-tax cash flow	Post tax cash flow
	₦' m	**₦' m**
28 February 2022	8	5
28 February 2023	7	5
28 February 2024	5	3
28 February 2025	3	1·5
28 February 2026	13	10

The pre-tax discount rate for the CGU is 8% and the post-tax discount rate is 6%. Evo Plc has no plan to expand the capacity of the CGU and believes that a reorganisation would bring cost savings, but as yet, no plan has been approved.

The directors of Evo Plc need advice as to whether the CGU's value is impaired.

The following extract from a table of present value factors has been provided:

Year	Discount rate 6%	Discount rate 8%
1	0·9434	0·9259
2	0·8900	0·8573
3	0·8396	0·7938
4	0·7921	0·7350
5	0·7473	0·6806

Required:

a. How is impairment loss determined and accounted for by a business entity. (6 Marks)

b. Advise the directors of Evo plc on:

   i. Whether the CGU's value is impaired. (7 Marks)

   ii. How the transactions above should be treated in its financial statements in accordance with the provisions of IAS 36 – Impairment of Assets. (7 Marks)

(Total 20 Marks)

QUESTION 4

a. DOVE-TAIL (Nigeria) Limited is into production of Cashew Nuts for global consumption. The entity has 3,000 employees on the payroll who are qualified for approved defined contribution plan being operated. The company makes annual pension contribution of ₦28,000 per employee. In 2016, the company paid total contribution amounting to ₦150 million, as well as ₦119 million and ₦54 million in 2017 and 2018 respectively.

Required:

In accordance with IAS 19, how should the pension contribution be treated and accounted for in the financial statements of the company?. (10 Marks)

b. There are no international standards on Corporate Social Responsibility (CSR) reporting. However, there is a strong trend towards the provision of more information on a statutory or a voluntary basis, and this trend in corporate reporting is likely to continue in the future. Therefore, companies are encouraged to provide disclosures and report on environmental, social and corporate governance issues. To this effect, voluntary guidelines for the content of and principles to be applied for social and environmental reports are given.

Required:

   i. Explain the principles of corporate social responsibility, (5 Marks)

   ii. Discuss the suggested contents of social and environmental reports. (5 Marks)

(Total 20 Marks)

SECTION C: OPEN-ENDED QUESTIONS (30 MARKS)

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

QUESTION 5

One of the major limitations of traditional financial statements is that they reflect only the effects of transactions that could be reliably measured in monetary terms. Many corporate organisations now include management discussion analysis in their published financial statements. At present, entities reporting under IFRS do not have to publish non-financial information. However, many useful non-financial information had been identified and disclosed by some organisations voluntarily.

Required:

a. Appraise the problems associated with the disclosure of only financial information in an annual report. (5 Marks)

b. Analyse major non-financial information that are considered useful for voluntary disclosure. (5 Marks)

c. Discuss the benefits associated with the disclosure of non-financial information in corporate annual reports. (5 Marks)

(Total 15 Marks)

QUESTION 6

Compliance with the fundamental ethical principles may potentially be threatened by a broad range of circumstances. It is expected for professional members to evaluate identified threats and put up enough safeguards as appropriate responses to such threats. Unless any threat is clearly insignificant, members must implement safeguards to eliminate the threats or reduce them to an acceptable level so that compliance with the fundamental principles is not compromised. Many threats fall into the following categories:

i. Self-interest;
ii. Self-review;
iii. Advocacy;
iv. Familiarity; and
v. Intimidation.

Required:

a. Evaluate two circumstances which may give rise to each of the categories of threats enumerated above. (10 Marks)

b. Recommend two safeguards to eliminate or reduce the threats to an acceptable level. (5 Marks)

(Total 15 Marks)

QUESTION 7

Kukundawa Plc acquired a property for ₦8 million on which annual depreciation is charged on a straight line basis at the rate of 7.5%. An impairment loss of ₦700,000 was recognised at the end of May 31, 2018 financial year when accumulated depreciation was ₦2million. Consequently, the property was valued at its estimated value in use. The company planned to move to new premises, before the property was re-classified as held for sale on October 1, 2018. By this time, the fair value less costs to sell was ₦4.8million. Kukundawa Plc published interim financial statements on December 1, 2018, by which time the property market value had improved and the fair value less costs to sell was reassessed at ₦5.04million. At the year end, on May 31, 2019 it had improved further, so that the fair value less costs to sell was ₦5.9 million. The property was disposed off eventually on June 5, 2019 for ₦6 million.

Required:

a. Assess the above transactions based on the requirements of IFRS 5-Non-Current Assets Held for Sale and Discontinued Operations. (5 Marks)

b. Evaluate the impact of the events occurring on the property over time and on the reported gain in accordance with relevant accounting standard. (10 Marks)

(Total 15 Marks)

SECTION A

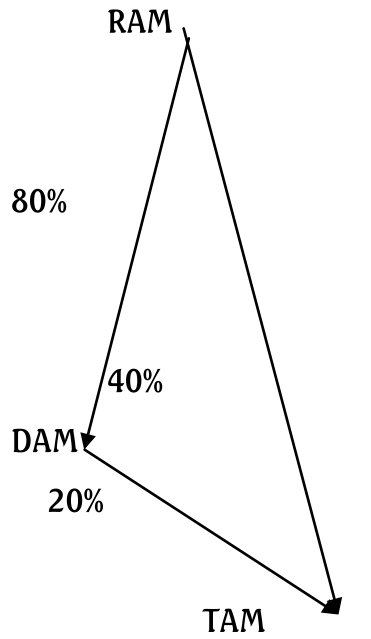
SOLUTION 1

Ram Group
Consolidated statement of financial position
as at April 30, 2021

Non - current assets	**₦'m**
Goodwill (WK 3)	9
Property, plants and equipments (2,030 + 705 + 356 – 64-10)	3,017
Total non- current assets	**3,026**
Current assets:	
Inventory (450 + 185 + 75 – 22)	688
Trade receivables (270 + 115 + 60)	445
Cash and cash equivalents(105 + 65 +10 + 85)	265
Total current assets	**1,398**
Total assets	**4,424**
Equity and liabilities	
Equity:	
Ordinary share capital	2,400
Share premium	300
Retained earnings (**wk 5**)	731
Non- controlling interest (**wk 4**)	314
Total equity	**3,745**
Non - current liability	
Non - current liabilities (200 + 65 + 64)	329
Current liability:	
Current liability(140 + 110 + 100)	350
Total equity and liabilities	**4,424**

Working notes

1. **Group structure**



	%	
Direct	40	
Indirect	20	60
NCI	<u>40</u>	

2. **Fair Value of subsidiary net assets**

	DAM		TAM	
	Acquisition 01/05/2018 ₦'m	Reporting 30/04/2021 ₦'m	Acquisition 01/05/2019 ₦'m	Reporting 30/04/2021 ₦'m
Ordinary share capital	620.000	620.000	220.00	220.00
Share premium	105.00	105.00	56.00	56.00
Retained earnings	110.00	280.00	65.00	76.00
Discount on PPE		(10.00)		
Reduction in carrying amount of inventory		(22.00)	-	-
Fair value adjustment:				
Fair value of net assets 850				
Carrying amount of assets <u>(835)</u>	<u>15.00</u>			
Revaluation reserve transfer				16
	<u>850.00</u>	**973.00**	**<u>341.00</u>**	**<u>368.00</u>**
Post-acquisition profit				
₦(₦973-850)	**123**			
₦(368 -341)			**<u>27</u>**	

3. **Goodwill**

DAM		TAM	
	₦'m		₦'m
Purchase consideration	690.00	Purchase consideration RAM	180.00
Fair value of NCI	160.00	Purchase consideration DAM	110.00
Total purchase consideration	**850.00**	Indirect holding (110 × 20%)	(22.00)
Fair value of net assets	(850.00)	Fair value of NCI	155.00
Goodwill at acquisition	NIL	Fair Value of net assets	341.00
Carrying amount of assets at year end	**973.00**	Total Purchase consideration	423.00
Recoverable amount	**900.00**	Goodwill at acquisition	82.00
Impairment (Balance)	**73.00**	Impairment	NIL
		Goodwill at reporting date	82.00

Goodwill = ₦(82-73) = ₦9m

4. **Non-controlling Interest**

DAM	₦'m	TAM	₦'m
Fair value of NCI	160.00	Fair value of NCI	155.00
Indirect holding (₦110 x 20%)	(22.00)	Share of post acquisition profit 40% x ₦(368 – 341)	10.80
Share of post acquisition profit (₦123 x 20%)	24.60		165.80
	162.60		
NCI share of impairment (20% x 73)	(14.60)		
	148.00		
Total NCI=(₦148.00 + 165.80)			=₦313.8

5. **Group retained earnings**

	₦'m
Parent retained earnings	685,00
Share of post acquisition profit DAM ₦(973 – 850) =(₦123 x 80%)	98.40
TAM (368 – 341) = (27 x 60%)	16.2
Less revaluation reserve transferred (60% x ₦16)	(9.60)
Transfer of impairment (80% x ₦73)	(58.40)
	731.60

6. **Error in Inventory**

Re-instatement costs written off is not permissible. The development inventory must be written off.

The correct entry is:

Dr. Retained earnings ₦22m

Cr. Inventory ₦22m

Being reinstated development cost written off

7. **Error in discount**

Discount recognised in income statement has caused corresponding overstatement of non-current assets of ₦12m at the beginning of the year.
Depreciation element of₦2m reduces the figure of net assets in the statement of financial position by ₦10m at the end of the year. The over depreciation amount of ₦2m is credited to income statement.
The correct entry is:
Dr. Income Statement ₦12m (to remove discount error)
Cr. Property, plant and equipment₦10m (to get the NCA back to place)
Cr. Income statement (Dep.) ₦2m (to remove over-depreciation charged)
Being discount received on acquisition of new equipment now reversed.

8. **Revaluation reserve transferred**

Dr. Revaluation reserve ₦80m (to remove wrong reserve)
Cr. Retained earnings ₦16m (to transfer 1/5 of the reserve)
Cr. Property, plant and equipment ₦64m (to remove the remainder of the reserve)
Being entry to reverse wrong revaluation transfer reserve

Examiner's report

The question tests candidates' knowledge of the preparation of consolidated statement of financial position and the adjustment arising thereon.

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

The common pitfalls of the candidates were their inability to prepare the necessary adjustments relating to re-instatement costs written off and discount recognised in statement of profit or loss. Majority of the candidates did not attempt this aspect of the question due to lack of in-depth knowledge in the preparation of consolidated financial statements.

Candidates are advised to pay more attention to application of accounting standards and basic principles of various adjustments to the preparation of consolidated statement of financial position. They are to practice more questions and use ICAN Study Texts for better performance in future examinations.

Marking guide

	Marks	Marks
Consolidated statement of financial position:		
Non-current assets	1	
Correct assets	2	
Equity	2	
Non-current liabilities	½	
Current liabilities	½	6
Workings relating to statement of financial position	6	
Group structure	1	
Determining fair value of subsidiary net assets	5	
Computing goodwill of DAM and TAM	3¼	
Determination of non-controlling interest of DAM and TAM	3¼	
Computing group retained earnings	2¾	
Entries to correct error in inventory	¾	
Entries to correct discount errors	1	
Entries to correct revaluation reserve transferred	1	24
Total		**30**

SOLUTION 2

a) **A - Z**

Computation of financial ratios for the years 2020 and 2021

Nos	Ratios	Formula	Workings	2021	Workings	2020
i	Return on equity (ROE) (%)	$= \frac{\text{PAT} - \text{NCI} - \text{PREF. DIV}}{\text{EQUITY}} \text{X } 100$	$\frac{3{,}900}{20{,}100} \text{X } 100$	19.4%	$\frac{2{,}700}{16{,}950} \text{X } 100$	15.9%
ii	Dividend cover (times)	$\frac{\text{EPS}}{\text{DPS}}$	$\frac{43\text{K}}{8\text{K}}$	5.3 times	$\frac{30\text{K}}{8\text{K}}$	3.8 times
	Earnings per share (EPS)	**EPS** $= \frac{\text{PAT} - \text{NCI} - \text{PREF}}{\text{No. of shares}} \text{X } 10($	$\frac{3.900}{9{,}000} \text{X } 100$ **43K**		$\frac{2{,}700}{9{,}000} X\ 100$ **30K**	
	Dividend per share (DPS)	$\textbf{DPS} = \frac{\text{Dividend paid}}{\text{No. of shares}} \text{X } 100$	$\frac{750}{9{,}000} X\ 100$ = 8K		$\frac{750}{9{,}000} X\ 100$ = 8K	

iii	Dividend payout (%)	$\frac{DPS}{EPS} X\ 100$	$\frac{8K}{43K}$	**18.6%**	$\frac{8K}{30K}$	**26.7%**
iv	Interest cover (times)	$\frac{PBIT}{Interest}$	$\frac{6,600}{510}$	**12.9 times**	$\frac{4,710}{450}$	**10.5 times**

PBIT = Profit before interest and tax

PAT = Profit after tax
EPS = Earnings per share
DPS = Dividend per share
NCI = Non- controlling interest
PREF. DIV = preference dividend
CE = Capital employed

b) The Shareholders/Lenders December 3, 2022
A-Z Company Ltd

Report on the performance and state of the company
This report is based on the financial state of A -Z that is considering raising external finance through offering of its shares for sale or obtaining term loan from the bank.

Profitability ratios
These ratios measure how well the entity is performing in the area of returns. The higher the ratios the better.

i. Return on equity (**ROE)** is a measure of how effectively a business uses equity or the money contributed by its stockholders and cumulative retained earnings to produce income. In other words, ROE indicates a company's ability to turn equity capital into net profit.
ii. A-Z ROE has increased from 15.9% in 2020 to 19.4% in 2021, which indicates an increase of 3.5% year-on-year. This is a good indication for the company because it shows that the company's management team is more efficient when it comes to utilising investment financing to grow their business. This is more likely to provide better returns to investors.

Shareholders/ Potential investors ratios

iii. **Dividend cover ratio** is a financial metric that measures the number of times that a company can pay dividends to its shareholders. From the ratio computed, the number of times increased from 3.8 times in 2020 to 5.3 times in 2021. This shows a good improvement on the part of the entity.

iv. **Dividend payout ratio** gives us a clearer picture about how much the company gives back its shareholders as part of the total profit earned in the form of dividends and to what extent it is ploughing back the profit for future investments, repay its debt or add to its cash reserves in this case there is a reduction from 26.7% to 18.6%, which implies that more funds is ploughed back into the basis.

v. **Interest cover ratio** is a measure of the number of times a company could make its interest payments with its earnings. The result above shows the profit before tax can cover more times of the interest as it increased from 10.5 times to 12.9 times.

Conclusion:
It can be concluded that the business state of affairs currently is stable and acceptable. The business has improved on her performance between 2020 and 2021. A-Z investors and lenders ratios are favorable due to increase in profitability as evidenced in the ratios calculated for the period. The management was able to return ₦19.4 for every₦1invested by the shareholders and covers interest on loan comfortably due to improve profitability for years2020 and 2021. Management should maintain and surpass this performance for the future.

Thank you,
Yours Faithfully,
Mr ZXY

Examiner's report

Part (a) of the question tests candidates' knowledge of the computation of return on equity; dividend cover; dividend pay-out and interest cover ratios. Part (b) of the question tests candidates' knowledge on report writing on performance and state of the company to guide potential shareholders and lenders in taking investment decisions.

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

The common pitfalls of the candidates were their inability to derive the figures to be used for the computation of the ratios and poor interpretation of the results. They are unable to write good report and advise management on investment decision.

Candidates are advised to ensure that they practice more past questions on ratio analysis, as this is, a recurring question at this level of examination. They should also develop better report writing skills to convey their opinion to guide management, potential shareholders and lenders after computation of ratios.

Marking guide

		Marks	Marks
a.	Computation of return on equity ratios	2	
	Computation of dividend cover ratios	2	
	Computation of dividend pay-out ratios	2	
	Computation of interest cover ratios	2	8
b.	Format of the report	1½	
	Report on profitability ratios	3	
	Report on shareholders /potential investors ratios	6	
	Conclusion of the report	1½	12
	Total		**20**

SOLUTION 3

a. The determination and treatment of impairment loss

Impairment loss is the amount by which the carrying amount of an asset (or a cash-generating unit) exceeds its recoverable amount.

The stages involves in accounting for an impairment loss are as follows:

Stage 1 – Establish whether there is indication of impairment (Identification of impairment or possible impairment);

Stage 2 – If so, assess the recoverable amount; and

Stage 3 – Write down the affected assets to their recoverable amount, by the amount of the impairment loss.

Stage 1: Identification of impairment or possible impairment

At the end of each financial year, an entity must carry out an impairment review when there is evidence or an indication that impairment may occur. Possible indicators of impairment are classified by IAS 36 as external and internal indicators.

External indicators may be indicators outside the entity itself, such as market factors and changes in the market situation, an unexpected decline in asset's market value, increase in interest rate affecting value in use of the asset, significant changes in technology, economic factors or law and regulations that have adverse effect on the company. External indicators may also include a company's net asset having higher carrying amount than its recoverable amount. The recoverable amount of an asset is the higher of its fair value less costs to sell or its value in use. Value-in-use is calculated as the present value (PV) of the future net cash flows the asset will generate including the residual value discounted at the cost of capital.

Internal indicators may relate to the following:

- The actual condition of the asset;
- The condition of the entity's business operations;
- Evidence that the asset is damaged;
- Evidence that the asset is no longer of use to the entity;
- Plans to discontinue or restructure the operation for which the asset is currently used;
- Reduction in the asset's expected remaining useful life; and
- Evidence that the entity's actual performance is worse than expected.

IAS 36 also stipulates some assets that must be reviewed for impairment, at least annually, even when there is no evidence of impairment. These include:

- An intangible asset with an indefinite useful life; and
- Goodwill acquired in a business combination.

Stage 2: Assessing the recoverable amount

If there is an indication that an asset (or cash-generating unit) is impaired, then it is tested for impairment. This involves the calculation of recoverable amount of the item in question and comparing this to its carrying amount.

Stage 3: Write down the affected assets to the recoverable amount

The impairment loss should be recognised immediately the income statement by debiting the statement of profit or loss and crediting the property, plant and equipment with the impairment amount thus reducing the profit in the income statement and reducing total assets on the statement of financial position.

b i. **Determination of recoverable amount** is higher of fair value less cost to sell and present value of future cash flows, that is value, in use.

	Fair value	Cost to sell	Fair value less cost to sell
	₦' m	₦' m	₦' m
Goodwill	-	-	-
PPE	10	0.1	9.9
Other assets	17	0.3	16.7
Total			**26.6**

Calculation of value in use

Year	Cash flow	Discount factor	Present value
	₦'m	@ 6%	₦'m
1	5	0.9434	4,717
2	5	0.8900	4.450
3	3	0.8396	2.518
4	1.5	0.7921	1.188
5	10	0.7473	7.473
			20.346

The recoverable amount is ₦26.6m.
The asset (CGU) should be valued at the lower of carrying amount and recoverable amount.

Therefore, value of CGU is ₦26.6m.
Impairment = ₦32m-₦26.6m = ₦5.4m must be recognised.

b. ii. The impairment loss of ₦5.4m should be recognised immediately in the statement of profit or loss.

This is accounted for as follows:

	Debit	Credit
Statement of profit or loss	₦5.4m	
Property, plant and equipment		₦5.4m

Being impairment loss suffered on the cash generating unit.

Examiner's report

Part (a) of the question tests candidates' knowledge of how to determine and account for impairment loss by a business entity, while part (b) tests computation and the treatment of impairment in financial statements, in accordance with provisions of IAS 36- Impairment of Assets.

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

The common pitfalls of the candidates were lack of understanding of the requirement of the question relating to IAS 36 and their inability to compute, determine and understand the treatment of impairment in financial statements.

Candidates are advised to get familiar with knowledge of how to compute impairment loss and treat them in the financial statements. They should also do in-depth study on accounting standards examinable at this level of the Institute examinations for better performance in future.

Marking guide

		Marks	Marks
a.	Identification of the three stages involved in accounting for impairment loss:		
	- Determination of indicators of impairment loss	3	
	- Assessing the recoverable amount	1	
	- Writing down the affected assets	2	6
b. i	Advice to the directors on whether the CGU's value is impaired:		
	Determination of recoverable amount	3	
	Calculation of value-in -use	3	
	Determination of impairment loss	1	7
ii	Recognition of impairment on the asset	2	
	Accounting treatment of the impairment loss	5	7
	Total		**20**

SOLUTION 4

(a) In accordance with the provision of IAS 19:

i. Unpaid (unremitted) pension contribution should be recognised as accrued expense under current liability

ii. Proportion paid during the reporting period should be treated as expense under profit or loss account.

Consequently, the effect of the above transaction will appear as shown below:

Dove-Tail (Nig.) LTD
Statement of financial position as at December 31

	2016	2017	2018
	₦'000	₦'000	₦'000
Current asset:			
Prepaid pension contribution	66,000	101,000	71,000

Dove-Tail (Nig.) Ltd
Statement of profit or loss for the year ended December 31

	2016	2017	2018
	₦'000	₦'000	₦'000
Employee benefits:			
Pension contribution	84,000	84,000	84,000

Pension contribution:

Year Workings	Amount due P / L ₦	Cash paid ₦	Difference ₦ SoFP.	Bal. b/f
2016 (3,000 x ₦28,000)	84,000,000	150,000,000	(66,000,000)	(66,000,000)
2017(3,000 x ₦28,000)	84,000,000	119,000,000	(35,000,000)	(101,000,000)
2018 (3,000 x ₦28,000)	84,000,000	54,000,000	30,000,000	(71,000,000)

NOTE: SOFP means Statement of Financial Position

b. i. **Principles of corporate social responsibility**

The principles of corporate social responsibility are as follows:

- Support and respect the protection of international proclaimed human rights within their sphere of influence;
- Make sure that they are not complaints in human rights abuses;
- Uphold the freedom of association and the effective recognition to the right of collective bargaining;
- Uphold the elimination of all forms of forced and compulsory labour;
- Uphold the effective abolition of child labour;
- Eliminate discrimination in respect of employment and occupation;

- Support a precautionary approach to environmental challenges;
- Undertake initiatives to promote greater environmental responsibilities;
- Encourage the development and diffusion of environmentally-friendly technologies; and
- Work against all forms of corruption, including extortion and bribery.

ii. **Contents of environmental report**

Typically, an environmental report will include an outline of the following:

- The entity's policies towards environmental issues;
- Any improvements since previous years;
- An assessment of the key risks faced and how the company intends to respond;
- Government legislation on environmental matters and how the entity ensures compliance with the legislation;
- Significant initiatives taken by the company to improve environmental issues;
- Key environmental performance indicators: that is targets of the industry and the relative performance of the entity; and
- Financial information relating to environmental costs, including the entity's accounting policy.

Contents of a social report

A social report which may be combined with the environmental report may include the following:

- Employee numbers and employee involvement;
- Employee sick leave, health and safety issues, accidents at work,
- Recruitment of ethnic minorities and the disabled;
- Involvement with local charities and local communities; and
- Working groups to communicate with stakeholders.

Examiner's report

Part (a) of the question tests candidates' knowledge of the treatment of pension contribution in accordance with IAS 19 and how it will affect the financial statements of the entities, while part (b) of the question tests candidates' knowledge of the principles behind corporate social responsibility and the contents of social and environmental reports.

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

The major pitfall of the candidates was their inability to understand and correctly interpret the requirements of the question.

Candidates are advised to carry out in-depth study to cover all areas of the syllabus, practise more questions and pay attention to contemporary issues in corporate reporting. They should make use of ICAN Study Texts for better performance in future examinations.

Marking guide

		Marks	Marks
a.	Treatment of paid and unpaid pension contributions	2	
	Effects on the statement of financial position	1½	
	Effects on the statement of profit or loss	1½	
	Computation of prepaid pension contribution	5	10
b. i	Principles of corporate social responsibility	5	
ii	Contents of social and environmental reports	5	10
	Total		**20**

SOLUTION 5

a. **Problems associated with disclosure of only financial information in annual reports**

It is important to consider both financial and non-financial information when evaluating business performance. This is because of the following problems and limitations of focusing only on financial parameters:

i. It could have negative impacts on performance;
ii. It gives limited insight into the performance of the business;
iii. It weakens business relationships with stakeholders;
iv. It creates negative publicity and media exposure;
v. Many relevant information cannot be expressed easily in monetary terms or in numbers as businesses and their transactions are becoming increasingly complex; and
vi. Businesses increasingly accept that they are not only accountable to investors and lenders, but to a much wider group of people, or 'stakeholders who are often more interested in the non-financial effects of an entity's activities, for example, its effect on the natural environment than in its financial performance.

b. **Major non-financial information useful for voluntary disclosures**

Environmental, Social, and Corporate Governance (ESG) information are usually the major non-financial information in the annual reports used in measuring the sustainability and societal impact of a company. ESG Reporting Non-financial information is often defined as Environmental, Social, and Corporate Governance (ESG) information.

i. **Environmental component:**
This explains how a company is exposed to and manages risks and opportunities related to climate, natural resource scarcity, pollution, waste, and other environmental factors and the impact that a company has on the environment and climate.

ii. **Social component**:
This relates to information about the company's values and business relationships. For example, social topics include labour and supply-chain standards, employee health and safety, product quality and safety, privacy and data security, and diversity and inclusion policies and efforts.

iii. **Governance component**:
The information about a company's corporate governance. This could include:
- Information on the structure and diversity of the board of directors;
- Executive compensation;
- Critical event responsiveness;
- Corporate resiliency; and
- Policies on lobbying, political contributions, and bribery and corruption.

c. **Benefits of disclosure of non-financial information in annual reports**

i. Encourages businesses to think beyond profits.
ii. Provides a broader insight into business performance.
iii. Strengthens customer retention and relationships with customers.
iv. Increases transparency and strengthen trust relationship with stakeholders.
v. Enhances better stakeholder's confidence.
vi. Attracts, retains and maintains satisfied workforce, improve efficiency and process management.
vii. Improves business reputation.
viii. Differentiate the company from competitors.
ix. Generates positive publicity and exposure in media.
x. Improves management decisions.
xi. Increases credibility within the community.
xii. Lowers risk of problems.
xiii. Improves operations.
xiv. Allows greater access to capital.

Examiner's report

Part (a) of the question tests candidates' knowledge of the appraisal of the problems associated with the disclosure of only financial information in annual reports. Part (b) of the question tests candidates' knowledge of major non-financial information that are considered useful for voluntary disclosure, while part (c) tests the benefits associated with the disclosure of non-financial information in corporate annual reports.

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

The common pitfalls of the candidates were their inability to present their points in a logical sequence to convey the proper meaning of the terms. They also lack good understanding of financial and non financial information.

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

Marking guide

		Marks	Marks
a.	Problems with disclosure of only financial information	5	
b.	The usefulness of voluntary disclosures of non-financial information	5	
c.	Benefits of non-financial information disclosure	5	15
	Total		**15**

SOLUTION 6

a) **Circumstances leading to different threats to ethical principles**

Self- interest threats

Self-interest threats may occur as a result of the financial or other interests of members or their immediate or close family members. Such financial interests might cause members to be reluctant to take actions that would be against their own interests. Examples of circumstances that may create self-interest threats include, but are not limited to the following:

i. Financial interests, loans or guarantees;
ii. Incentive compensation arrangements;
iii. Inappropriate personal use of corporate assets;
iv. Concern over employment security;
v. Commercial pressure from outside the employing organisation;
vi. Undue dependence on total fees from a client;
vii. Having a close business relationship with a client;
viii. Concern about the possibility of losing a client;
ix. Potential employment with a client;
x. Contingent fees relating to an assurance engagement;
xi. A loan to or from an assurance client or any of its directors or officers; and
xii. Close personal or business relationships.

Self-review threats

Self-review threats occur when a previous judgment needs to be re-evaluated by members responsible for that judgment.

Circumstances that may create self-review threats include, but are not limited to the following:

i. Business decisions or data being subject to review and justification by the same chartered accountant in business responsible for making those decisions or preparing that data;
ii. The discovery of a significant error during a re-evaluation of the work of the chartered accountant in practice;
iii. Reporting on the operation or the financial systems after being involved in their design or implementation;
iv. Preparation of the original data used to generate records that are the subject matter of the engagement; and
v. When a reporting officer has recently been a director or officer of that client;

Advocacy threats

A chartered accountant in business may often need to promote the organisation's position by providing financial information. As long as information provided is neither false nor misleading, such actions would not create an advocacy threat.

Advocacy threat may occur when a chartered accountant promotes a position or opinion to the point that subsequent objectivity may be compromised.

Circumstances which may give rise to advocacy threats for members include the following:

i. Commenting publicly on future events;
ii. Situations where information is incomplete or where the argument being supported is against the law;
iii. Promoting shares in a listed company which is also an audit client; and
iv. Acting as an advocate for an assurance client in litigation or dispute with third parties.

Familiarity threats

Familiarity threats occur when a close relations, or members become too sympathetic to the interests of others.

Examples of circumstances that may create familiarity threats include the following:

i. A chartered accountant in business in a position to influence financial or non-financial reporting or business decisions having an immediate or close family member who is in a position to benefit from that influence;

ii. Long association with business contacts influencing business decisions;

iii. Acceptance of a gift or preferential treatment, unless the value is clearly insignificant;

iv. A former partner of the firm being a director or officer of the client or an employee in a position to exert direct and significant influence over the subject matter; and

v. Long association of senior personnel with the assurance client.

Intimidation threats

Intimidation threats occur when a member's conduct is influenced by fear or threats, actual or perceived. For example, when the individual encounters an aggressive and dominating client or an employer.

Examples of circumstances that may create intimidation threats include the following:

i. Threat of dismissal or replacement over a disagreement about the application of an accounting principle or the way in which financial information is to be reported;

ii. A dominant personality attempting to influence decisions of the chartered accountant;

iii. Threats of litigation; and

iv. Being pressured to reduce inappropriately the extent of work performed in order to reduce fees.

b. **Safeguards to the threats**

Safeguards to self- interest threats

The threat created can be reduced to an acceptable level by the application of the following safeguards:

i. Ask the individual involved to notify the firm when entering serious employment negotiations with the assurance client;

ii. Removal of the affected individual from the assurance engagement; and

iii. Perform an independent review of any significant judgments made by such individual while on engagement.

Safeguards to self-review threats

The related safeguards may include the following:

i. Involving an additional chartered accountant to carryout a peer review of the work done by Mr. A or otherwise advise as necessary;

ii. Adopting independent internal quality reviews; and
iii. If the threats are significant, the affected individual should not be part of the assurance engagement team.

Safeguards to advocacy threats

The safeguards might include the following:

i. Consider the appropriateness or necessity of modifying the assurance plan for the assurance engagement;
ii. Assigning an assurance team that is of sufficient experience in relation to the individual who has joined the assurance client;
iii. Involve an additional chartered accountant who was not a member of the assurance team to review the work or advise as necessary;
iv. Quality control review of the assurance engagement;
v. Ensuring that the individual concerned is not entitled to any benefits or payments from the firm unless these are made in accordance with fixed predetermined arrangements. In addition, any amount due to the individual should not be of such significance to threaten the firm's independence; and
vi. Ensuring that the individual does not continue to participate or appear to participate in the firm's business or professional activities.

Safeguards to familiarity threats

The safeguards might include the following:

i. Consider the appropriateness or necessity of modifying the assurance plan for the assurance engagement;
ii. Assigning an assurance team that is of sufficient experience in relation to the individual who has joined the assurance client;
iii. Involve an additional chartered accountant who was not a member of the assurance team to review the work or advise as necessary;
iv. Quality control review of the assurance engagement;
v. Ensuring that the individual concerned is not entitled to any benefits or payments from the firm unless these are made in accordance with fixed pre-determined arrangements. In addition, any amount due to the individual should not be of such significance to threaten the firm's independence; and
vi. Ensuring that the individual does not continue to participate or appear to participate in the firm's business or professional activities.

Safeguards to intimidation threats

The safeguards might include the following:

i. Ensuring that the individual concerned is not entitled to any benefits or payments, from the firm unless these are made in accordance with fixed predetermined arrangements;
ii. In addition, any amount due to the individual should not be of such significance to threaten the firm's independence;

iii. Ensuring that the individual does not continue to participate or appear to participate in the firm's business or professional activities;
iv. Consider the appropriateness or necessity of modifying the assurance plan for the assurance engagement;
v. Assigning an assurance team that is of sufficient experience in relation to the individual who has joined the assurance client;
vi. Involve an additional chartered accountant who was not a member of the assurance team to review the work or advise as necessary; and
vii. Quality control review of the assurance engagement.

Examiner's report

Part (a) of the question tests candidates' knowledge of the evaluation of the circumstances which may give rise to self- interest; self-review; advocacy; familiarity and intimidation threats, while part (b) tests candidate's knowledge of the various safeguards to eliminate or reduce the threats to an acceptable level.

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

The major pitfall of the candidates was their inability to understand various safeguards regarding threats to ethical principles.

Candidates are advised to pay more attention to all aspects of the syllabus. They are to understand all contemporary issues and areas of threats which its non-compliance will threaten fundamental principles of corporate financial reporting for better performance in Institutes future examinations.

Marking guide

		Marks	Marks
a.	Two circumstances leading to different threats:		
	- Self- interest	2	
	- Self-review	2	
	- Advocacy	2	
	- Familiarity	2	
	- Intimidation	2	10
b.	Two safeguards to the threats:		
	- Self- interest	1	
	- Self-review	1	
	- Advocacy	1	
	- Familiarity	1	
	- Intimidation	1	5
	Total		**15**

SOLUTION 7

a. In accordance with the requirements of IFRS 5- Non-Current Assets Held For Sale and Discontinued Operations, Kukundawa PLC transactions would be treated as follows:

i. The property would be removed from non-current assets and presented separately under current assets in the statement of financial position;

ii. The property will no longer be depreciated from the date of classification (i.e. fromOct 1, 2018) as held for sale, hence, it will only be depreciated for the first four months before classification as held for sale (i.e. from 1/6/2018 – 1/10/2018);

iii. The property would be measured at the lower of carrying amount and fair value less costs to sell; and

iv. Impairment must be considered both at the time of classification as held for sale and subsequently as follows:
   - Any impairment loss is recognised on profit or loss, unless the assets had been revalued before in which case the impairment is treated as a revaluation decrease; and
   - A gain from any subsequent increase in fair value less costs to sell of an asset is recognised in the profit or loss to the extent that it is not in excess of the cumulative impairment loss already recognised in line with IFRS 5.

b. i The property was classified as held for sale on October 1, 2018. The carrying amount of the asset should be compared with the fair value less cost to sell of the asset. The carrying amount would be determined as the cost of the asset ₦8 million less accumulated depreciation as at May 2018 of ₦2 million and impairment loss of ₦0.7 million. Additional depreciation for 4 months till October 1, 2018 should be charged of ₦0.177 million. The carrying amount would be ₦5.123 million while the fair value less cost to sell is ₦4.8 million, an impairment loss of ₦0.323 million would be recognised to bring the asset to the lower of carrying amount and fair value less cost to sell.

ii. On December 1, 2018, in the interim financial statements, the property market has improved and fair value less costs to sell is reassessed at ₦5.04 million. The gain of ₦240,000 (₦5·04 million – ₦4·8 million) is less than the cumulative impairment losses recognised to date (₦700,000 + ₦323,333, i.e.₦1,023,333). Therefore, it is credited to profit or loss and the property is carried at ₦5·04 million.

iii. On May 31,2019, the property market has continued to improve, and fair value less costs to sell is now assessed at ₦5.9 million. The further gain of ₦860,000 is, however, in excess of the cumulative impairment losses recognised to date (₦700,000 plus ₦323,333 – 240,000=₦760,000).

Accordingly, a restricted gain of ₦783, 333 is credited to profit or loss and the property is carried at ₦5,823,333.

iv. Subsequently, the property was sold for ₦6million at which point a gain of ₦200,000 is recognised. This sale would be a non-adjusting event under IAS 10-Events after the Reporting Period, if deemed to be material.

Workings:

Carrying amount as at 1/10/2018

	₦
Cost	8,000,000.00
Accumulated depreciation	(2,000,000.00)
Accumulated impairment loss	(700,000.00)
	5,3000,000.00
Depreciation from May to September	(176,666.67)
	5,123,333.33
Useful life (1.0/0.75)	13.33 years
Time already spent	(3.33 years)
Remaining useful life	10 years

Test for impairment

Determination of impairment as at May 31, 2018	5,123,333.33
NRV	(4,800,000.00)
Impairment	323,333.33
Dr: Profit or Loss	323,333.33
Cr: Motor Vehicle	323,333.33
Cumulative impairment on asset	₦700,000 + 323,333
	₦1,023,333.00

As at December 1, 2018

	₦
Carrying amount	4,800,000.00
NRV	5,040,000.00
Increase in value of asset	240,000.00

The increase in value is less than the cumulative impairment and can be reversed

	₦
DR: Motor vehicle	240,000.00
Cr: Profit or loss	240,000.00

As at May 31, 2018

	₦
Carrying amount	5,040,000.00
NRV	5,900,000.00
	860,000.00

The maximum impairment to be reversed is ₦760,000
(₦ 1,023,333 - ₦240,000 - ₦23,333)

Dr: Motor vehicle	760,000.00
Cr: Profit or loss	760,000.00

June 5, 2019

	₦
Disposal of asset	
Sales proceeds	6,000,000.00
Carrying amount (504000+760,000)	5,800,000.00
	200,000.00

The gain on disposal should be disclosed in note form in the financial statement if considered.

Examiner's report

Part (a) of the question tests candidates' practical understanding of the transactions based on the requirements of IFRS 5- Non-Current Assets Held for Sale and Discontinued Operations, while part (b) of the question tests candidates' knowledge of the events occurring on the assets over time in accordance with relevant accounting standard.

Few candidates attempted the question and their performance was below average. Common pitfalls of the candidates were poor display of the expectations of professional accountants in ensuring adherence to IFRS 5. Most candidates' that attempted the question did not understand the safeguards to eliminate or reduce the threats to an acceptable level.

Candidates are advised to understand the requirements of IFRS 5 and also the responsibilities of the professional accountants in unethical acts in corporate financial reporting. They should also be familiar with ICAN Study Texts for better the performance in the Institutes future examinations.

Marking guide

		Marks	Marks
a.	Assessment of transactions in accordance with IFRS 5		5
b.	Evaluation of the impact of events occurring on the property :		
	- Determination of impairment loss	2½	
	- Treatment of the impairment loss in P or L statement	2½	
	- Treatment of the restricted gain in statement of P or L	2½	
	- Treatment of property sold in accordance with IAS 10	2½	10
	Total		**15**

ICAN/222/V/C4 Examination No..........................

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2022

ADVANCED TAXATION

EXAMINATION INSTRUCTIONS

PLEASE READ THESE INSTRUCTIONS BEFORE THE COMMENCEMENT OF THE PAPER

1. Check your pockets, purse, mathematical set, etc. to ensure that you do not have prohibited items such as telephone handset, electronic storage device, programmable devices, wristwatches or any form of written material on you in the examination hall. You will be stopped from continuing with the examination and liable to further disciplinary actions including cancellation of examination result if caught.

2. Write your **EXAMINATION NUMBER** in the space provided above.

3. Do **NOT** write anything on your question paper **EXCEPT** your examination number.

4. Do **NOT** write anything on your docket.

5. Read all instructions in each section of the question paper carefully before answering the questions.

6. Do **NOT** answer more than the number of questions required in each section, otherwise, you will be penalised.

7. All solutions should be written in **BLUE** or **BLACK INK**. Any solution written in **PENCIL** or **RED INK** will not be marked.

8. Tax and Capital Allowances rates are provided with this examination paper.

TUESDAY, NOVEMBER 15, 2022

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2022

ADVANCED TAXATION

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

As a result of the developing nature of Nigeria's economy, there are some industries and products that are not well developed on a scale that can adequately cater for the needs of the populace. One of the investment incentives available to industries and products in this category, is contained in the Industrial Development (Income Tax Relief) Act 1971. Application has to be made to the Federal Government in order to enjoy any of these numerous investment incentives.

Owoeye Machine Tools Nigeria Limited was incorporated on January 20, 2016, and was initially granted a pioneer certificate on April 1, 2016. At the end of the pioneer period, the company, as a result of negligence, failed to follow due process in applying for extension of the pioneer certificate. The company, however, retained March 31 as its financial year end.

The following records and information were obtained from the company:

(i) Qualifying capital expenditure on property, plant and equipment (certified by the Federal Inland Revenue Service) incurred during the pioneer period:

	₦'000
Industrial building	23,800
Building (non-industrial)	11,600
Motor vehicles	6,200
Plant	10,400
Furniture and fittings	5,800

(ii) Statement of adjusted profits/(losses) during the pioneer period:

Period under review	**Total profits/(losses)**
	₦'000
Year ended March 31, 2017	(44,450)
Year ended March 31, 2018	(23,140)
Year ended March 31, 2019	8,700

(iii) Both the qualifying capital expenditure on property, plant and equipment and adjusted profits/(losses) were certified by the Federal Inland Revenue Service.

(iv) The company made a gross turnover of ₦312,450,000 and adjusted profit of ₦52,250,000 during the year ended March 31, 2020.

(v) Extract from the statement of profit or loss for the year ended March 31, 2021, revealed the following:

	₦'000	**₦'000**
Gross turnover		320,220
Less: Cost of sales		(176,550)
Gross profit		143,670
Less: Expenses:		
Salaries and wages	48,430	
Transport and traveling	2,360	
Motor running expenses	1,580	
Postage and telephone	1,150	
Bank charges	870	
Repairs and maintenance	3,660	
Auditors' remuneration	1,500	
Legal and professional fees (see note i)	2,000	
Depreciation	15,770	
Donations	1,600	
Allowance for doubtful debts (see note ii)	7,000	
Administrative expenses (note iii)	10,070	95,990
Net profit		**47,680**

Notes:

- Legal and professional fees included ₦1,400,000 paid to the company's lawyer in respect of acquisition of land for the purposes of the business.

- Allowance for doubtful debts comprised:
  ₦1,350,000 for specific provision;
  ₦4,150,000 for general provision; and
  ₦1,500,000 for bad debts written off.

- Administrative expenses included ₦850,000 paid to a financial consultant who helped in preparing feasibility study on viability of a proposed product line.

- The schedule of qualifying capital expenditure on property, plant and equipment purchased during the year ended March 31, 2021, is as follows:

Type	**Date of acquisition**	**Amount ₦'000**
Motor vehicles (2)	April 15, 2020	3,200
Plant (1)	July 1, 2020	5,000
Furniture and fittings (4)	February 13, 2021	1,200

Required:

As the company's Tax Manager, you are to prepare a report for the attention of the Managing Director showing the company's:

a. Adjusted profit for the year ended March 31, 2021 (6 Marks)

b. Tax liabilities for 2021 and 2022 assessment years (24 Marks)

(Total 30 Marks)

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

QUESTION 2

Colamrud Petroleum (Nigeria) Limited is a subsidiary company of a foreign oil and gas company. The company has been involved in petroleum prospecting and exploration (upstream) for both local and foreign sales for over ten years.

As a corporate board policy, the management meets and considers the report in respect of its operations on quarterly basis. The results for the first quarter (January – March) 2022 of the company, as prepared by the Finance Controller, revealed the following:

	₦'000	**₦'000**
Income:		
Value of oil sold (export)		900,380
Value of oil sold (local)		223,300
Value of gas sold		430,100
Other income		7,200
Gross revenue		1,560,980

Expenses:

Production cost	210,730	
Tangible drilling cost for the first appraisal well	18,800	
Intangible drilling cost for the first appraisal well	17,600	
Cost of gas reinjection wells	4,000	
Cost of drilling 3 appraisal wells	24,000	
Rent	13,000	
Royalties on export sales	69,300	
Royalties on local sales	9,800	
Salaries and wages	170,500	
Head office shared costs	62,000	
Repairs and maintenance	8,930	
Customs duty on essentials	2,900	
Depreciation	66,000	
Interest on loans	4,400	
Allowance for doubtful debts	34,000	
Administrative expenses	79,200	
Stamp duties on increase in share capital	1,000	
Bank charges	900	
Miscellaneous expenses	22,500	
Income tax provision	90,000	
Tertiary education tax provision	6,000	915,560
Net profit		**645,420**

The following additional information was provided:

(i) The monthly fiscal oil and gas prices at each measurement point have been approved on an export parity basis by the Nigerian Upstream Petroleum Regulatory Commission.

(ii) Head office shared costs included:

	₦'000
Research and development costs	12,000
Indirect production costs	50,000
	62,000

(iii) Repairs and maintenance expenses were made up of:

	₦'000
Repairs of oil pipelines and storage tanks	6,000
Repairs of plant	1,500
Improvement to the company's building	1,430
	8,930

(iv) Allowance for doubtful debts included:

	₦'000
Specific provision	10,000
General provision	20,000
Bad debt written off	4,000
	34,000

(v) Administrative expenses consisted of:

	₦'000
Natural gas flare fees	10,000
Transport cost	13,200
Cost of obtaining information on existence of oil	7,300
Expenditure for acquisition of geological information	14,900
Other allowable expenses	33,800
	79,200

(vi) Miscellaneous expenses included:

	₦'000
Tenement levy paid to the local government	2,000
Contribution to Niger Delta Development fund	5,500
Contribution to Host Community Development fund	12,000
Donation made to widows and orphans association	3,000
	22,500

(vii) Unabsorbed losses brought forward from previous years were ₦35,000.

Required:

As the company's Assistant Tax Manager, you have been asked by the Tax Manager to submit a report to him for review in the next three days as the Management Committee meeting is slated for next week. The report should specify:

a. The adjusted profit and assessable profit of the company for the first quarter of 2022 in line with the provisions of Petroleum Industry Act 2021. (18 Marks)

b. Comments on the cost-price ratio of the company in view of the provisions of the Sixth Schedule to Petroleum Industry Act 2021. (2 Marks)

(Total 20 Marks)

QUESTION 3

Microfin Garment Nigeria Plc has been in business for many years as manufacturers of textiles. At the recently held annual general meeting, some of the shareholders observed the downward trend in the profitability, market share price, dividends declared and paid to owners of the business. It was also noted that a particular product line of the company, perhaps due to stiff competition from local and foreign competitors, was not doing well in the market. A complete reorganisation of the company was the resolution proposed and accepted by majority of members of the company who attended the annual general meeting. The exercise was to be completed within quarter 3 of the new financial year.

The Board of Directors, in complying with the resolution reached at the annual general meeting, met last month and took the following decisions:

(i) The General Manager (Mr. Chukwu Bala) and Operations Manager (Mr. Ojo Ekaite) of the "problematic" segment that was not contributing to the overall profitability of the company were to be relieved of their jobs;

(ii) The relieved staff were to be paid compensation for loss of office. Mr. Bala and Mr. Ekaite would receive ₦12 million and ₦7.5 million, respectively;

(iii) All the relevant production and administrative staff are to be redeployed to other branches of the company; and

(iv) Details of qualifying property, plant and equipment disposed are as follows:

	Industrial building	**Plant and machinery**	**Factory equipment**
	₦'000	₦'000	₦'000
Cost	85,000	128,500	150,600
Tax written down value	36,125	16,062.5	37,650
Sales proceeds	123,900	80,000	160,000
(see note bullet 2)		60,000	

Notes:

- Industrial building was acquired in 2014. Towards the disposal of the asset in February 2021, the company spent ₦288,000 for renovation; and incidental cost of ₦150,000. The sum of ₦100,200,000 out of ₦123,900,000 realised from the disposal of the industrial building was used in July 2021 to acquire another building at the head office.

- Plant and machinery was acquired in 2017. Part of it was sold in April 2021 for ₦80,000,000. The market value of the part undisposed was professionally valued at ₦65,300,000. The remaining part was disposed of in August 2021 for ₦60,000,000 and ₦30,000 was incurred as expenses incidental to the sale.

- The factory equipment was acquired in 2018. The company had difficulty in disposing of the asset, until a friend to one of the directors bought it in September 2021. The market value of the asset was

₦162,500,000 at the date of disposal. The company incurred ₦250,000 to refurbish the equipment before disposal.

Required:

As the company's Tax Consultant, you are to submit a report to the Managing Director showing:

a. The capital gains (if any) and the capital gains tax payable on:

   i. Disposal and subsequent acquisition of industrial building (7 Marks)
   ii. Disposal of plant and machinery (6 Marks)
   iii. Disposal of factory equipment (3 Marks)

b. State the due dates for filing of self-assessment return and payment of the tax computed on each of the assets disposed of. (2 Marks)

c. Comment on the provisions of the Finance Act 2020 in respect of compensation for loss of office to be paid to the two staff disengaged by the company. (2 Marks)

(Total 20 Marks)

QUESTION 4

Transfer pricing has become a topical issue in the world of taxation in recent years. This is partly to prevent fiscal evasion and avoid economic double taxation. In light of this, various governments, both in developed and emerging countries, have continued to issue regulations to guide the operations of transfer pricing system within their jurisdictions.

The first step towards the provision of legal framework for regulation of transfer pricing system in Nigeria took place in August 2012, with the enactment of Income Tax (Transfer Pricing) Regulations Number 1, 2012. Due to some shortcomings noticed in the implementation of this Regulation, it was revoked and another, Income Tax (Transfer Pricing) Regulations 2018, was subsequently enacted.

One important principle (as enshrined in various transfer pricing regulations), which every taxpayer is expected to comply with in dealing with transactions between related entities is arm's length principle. The principle has attracted a lot of attention among academics, regulatory Institutions and professionals, yet debate on it is yet to abate.

Required:

a. Explain the significance of transfer pricing to both the taxpayers and tax authorities. (2 Marks)

b. In complying with arm's length principle, discuss **TWO** guiding actions which enterprises and multinationals must follow in dealings between them. (3 Marks)

c. Identify and explain **FOUR** ways, which multinational companies adopt in financial dealings with their associated or subsidiary entities that are not consistent with the arm's length principle. (6 Marks)

d. In the administration of Transfer Pricing Regulations 2018, highlight and discuss **THREE** fundamental areas to be noted and complied with by taxpayers and tax practitioners. (6 Marks)

e. Explain how disputes that arise between a taxpayer and tax authorities are resolved under the Transfer Pricing Regulations 2018. (3 Marks)

(Total 20 Marks)

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

QUESTION 5

In its bid to increase market power, growth and enhanced operating economies, the Board of Directors of a medium-sized beverage outfit, Yemmysea Beverages Limited, Abeokuta, considered the proposals on merger or acquisition with a business entity in the same line of business. The Chairman of the Board found all the proposals attractive.

The Financial Accountant, however, submitted that the Board needs to take into consideration tax implications on each of the merger or acquisition arrangements tabled before it. A reputable tax consulting outfit, with vast tax experience in merger, acquisition and re-organisation was recommended for this assignment.

Your firm has just been approached to offer professional advice on tax implications on each of the following merger or acquisition arrangements:
Proposal 1: When an existing company absorbs another existing company;
Proposal 2: When merger results in the cessation of business; and
Proposal 3: When a business is sold or transferred.

Required:

As the company's Tax Consultant, you are to submit a report to the Managing Director explaining:

a. The tax implications when an existing company absorbs another existing company (5 Marks)

b. The tax implications when merger results in the cessation of business (3 Marks)

c. The tax implications when a business is sold or transferred (3 Marks)

d. The powers of the Federal Inland Revenue Service on issues that concern mergers and acquisition of companies (4 Marks)

(Total 15 Marks)

QUESTION 6

Singapura PTC Limited, a company registered in Singapore, derived a range of income from Nigeria in year 2021 and the tax office in Nigeria had raised an assessment on the company, based on the provisions of Companies Income Tax Act. The company wanted you to object to the assessment, claiming that being a resident of Singapore, it is not liable to tax in Nigeria, as a benefit of the double taxation agreement between Nigeria and Singapore.

Required:

a. Do you agree with the company, that its residence in Singapore qualifies it for tax exemption in Nigeria? (5 Marks)

b. What are the benefits that may be available to a resident of Singapore under the double taxation agreement between Nigeria and Singapore? (5 Marks)

c. State **FIVE** circumstances under which a company registered in Singapore will be liable to tax in Nigeria. (5 Marks)

(Total 15 Marks)

QUESTION 7

The issue of correct computation and presentation of deferred taxes in financial statements has been a source of worry to the Managing Director of ICTREC Mining Company Limited. Last year, the Federal Inland Revenue Service raised a query on the financial statements of the company and the annual tax returns filed for purposes of tax assessment.

In order to avoid any tax query on the financial statements, your firm of chartered accountants has been approached by the Managing Director of the company to assist in the preparation of financial statements suitable for presentation at the annual general meeting of the company and to the tax authorities for purposes of determination of tax liabilities payable.

All the relevant books of accounts have been made available to you in respect of the company's financial transactions. The extract from the accounts of the company for the year ended December 31, 2021 revealed the following:

	₦'000	₦'000
Turnover		125,400
Rent and rates	12,200	
Direct mining transportation cost	1,190	
Direct mining cost	47,400	60,790
Gross profit		64,610
Dividends income (net)		3,900
Interest on foreign deposit		2,750
		71,260
Salaries and wages	25,340	
Depreciation of mining plant	2,500	
Depreciation (other non-current assets)	7,840	
Other administrative and general expenses	4,210	
Loan interest	850	
Loss on sale of old mining plant	200	40,940
Net profit		**30,320**

The following additional information was provided:

(i) The interest on foreign deposit was repatriated to the country through the company's domiciliary account in a Nigerian deposit money bank.

(ii) The company has unrelieved losses of ₦2,800,000.

(iii) Capital allowance as agreed with the relevant tax authorities for the year was ₦7,250,000.

(iv) The tax written down value of qualifying capital expenditure as at December 31, 2021, after the above capital allowances have been taken into account was ₦35,110,000, while the net book value on the same date was ₦23,700,000.

(v) The opening tax written down values and net book values were ₦42,620,000 and ₦33,900,000, respectively.

(vi) Unpaid tax at the beginning of the year was ₦15,620,000, while payment in the year was ₦18,860,000.

(vii) Assume a depreciation rate of 10% per annum on its mining plant.

(viii) The company revalued its mining plant during the year ended December 31, 2017. The revaluation surplus there from which amounted to ₦5 million was reflected in the company's financial statements for that year.

Required:

You have been directed by your Principal Partner to work on this assignment and present a draft of the report to him for review before sending it to the Managing Director of ICTREC Mining Company Limited. The report should show explicitly the computation of the company's:

a. Tax liabilities for the relevant year of assessment (7 Marks)

b. Deferred tax provisions for 2021 and 2022 (8 Marks)

(Total 15 Marks)

NIGERIAN TAX RATES

1. CAPITAL ALLOWANCES

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

2. INVESTMENT ALLOWANCE 10%

3. RATES OF PERSONAL INCOME TAX

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

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

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

4.	**COMPANIES INCOME TAX RATE**	30%; 20% or 0%
5.	**TERTIARY EDUCATION TAX**	2.5% of Assessable Profit
6.	**CAPITAL GAINS TAX**	10%
7.	**VALUE ADDED TAX**	7.5%
8.	**HYDROCARBON TAX**	15% (Petroleum prospecting License and Marginal Fields Companies) 30% (Petroleum Mining Lease Companies)

SOLUTION 1

(a)

Owoeye Machine Tools Nigeria Limited

Address ....

INTERNAL MEMO

Date: ....

From: Tax Manager

To: Managing Director

RE: ADJUSTED PROFIT AND TAX LIABILITIES PAYABLE

I refer to your request on computations of adjusted profit for the year ended March 31, 2021 and tax liabilities for 2021 and 2022 assessment years. I hereby present the report for your perusal.

(a) **Determination of adjusted profit for the year ended March 31, 2021**

The adjusted profit of the company for the year ended March 31, 2021 (the first year after the pioneer period), as shown in appendix 1 was ₦69,850,000. As a result of aggregate losses of ₦58,890,000 made during the pioneer period, which the adjusted profit of 2021 was used to relieve, the total profit produced a nil figure. No companies income tax is payable. Since 2021 assessment year is the first year of its new business and in line with the provisions of CITA 2004 (as amended), the company is exempted from paying minimum tax. Tertiary education tax of ₦1,045,000 only will be paid by the company.

As for the 2022 assessment year, the company generated total profit of ₦29,097,000 (after utilisation of capital allowances). The company, therefore would pay companies income tax of ₦8,729,100 and tertiary education tax of ₦1,746,250. This gives total tax liabilities of ₦10,475,350.

Attached herewith are appendices 1, 2, 3, 4 and 5, which contained all the computations in respect of adjusted profit and tax liabilities for the period under review.

Thank you.

Segge Danny

Appendix 1: Computation of adjusted profit
For the year ended March 31, 2021

	₦'000	₦'000
Net profit as per accounts		47,680
Add back: Disallowable expenses:		
Legal and professional fees	1,400	
Depreciation	15,770	
Allowance for doubtful debts	4,150	
Administrative expenses	850	22,170
Adjusted profit		**69,850**

(b) **Appendix 2: Computation of tax liabilities**
For 2021 and 2022 assessment years

	₦'000	₦'000
2021 assessment year		
Basis period: 1/4/19 – 31/3/20		
Adjusted profit (given)		52,250
Less: Loss b/f from pioneer period	58,890	
Relieved	(52,250)	(52,250)
Unrelieved loss c/f	6,640	
Capital allowance for the year	22,054	
Utilised	Nil	
Unutilised capital allowance c/f	22,054	
Total profit		NIL
Companies income tax (minimum tax (appendix 5) (Exempted)		NIL
Tertiary education tax @ 2% of ₦52,250		1,045
Total tax liability payable		1,045
2022 assessment year		
Basis period: 1/4/20 – 31/3/21		
Adjusted profit (appendix 1)		69,850
Less: Unrelieved loss b/f	6,640	
Relieved	(6,640)	(6,640)
Unrelieved loss c/f	NIL	
		63,210
Unutilised capital allowance b/f	22,054	
Capital allowance for the year	12,059	
Capital allowance available for utilisation	34,113	
Utilised	(34,113)	(34,113)
Unutilised capital allowance c/f	NIL	
Total profit		29,097

Companies income tax @ 30% of ₦29,097	8,729.1
Tertiary education tax @ 2½% of ₦69,850	1,746.25
Total tax liability payable	10,475.35

Appendix 3: Capital allowances

	Industrial Building	**Non-industrial building**	**Motor vehicle**	**Plant**	**Furniture and fittings**	**Capital allowance**
Initial allowance	15%	15%	50%	50%	25%	
Annual allowance	10%	10%	25%	25%	20%	
	₦'000	**₦'000**	**₦'000**	**₦'000**	**₦'000**	**₦'000**
2021 A/Y						
Cost	23,800	11,600	6,200	10,400	5,800	
IA	(3,570)	(1,740)	(3,100)	(5,200)	(1,450)	15,060
AA	(2,023) w1	(986) w2	(775) w3	(1,300) w4	(870) w5	5,954
Inv. allow	-	-	-	(1,040)	-	1,040
						22,054
2022 A/Y						
TWDV b/f	18,207	8,874	2,325	3,900	3,480	
Additions	-	-	3,200	5,000	1,200	
IA	-	-	(1,600)	(2,500)	(300)	4,400
AA	(2,023)	(986)	(1,175) w6	(1,925) w7	(1,050) w8	7,159
Inv. allow	-		-	(500)	-	500
						12,059
TWDV c/f	16,184	7,888	2,750	4,475	3,330	

Workings

(1) Industrial building 2021 annual allowance

$$= \frac{₦23,800,000 - ₦3,570,000}{10} = ₦2,023,000$$

(2) Non-industrial building 2021 annual allowance

$$= \frac{₦11,600,000 - ₦1,740,000}{10} = ₦986,000$$

(3) Motor vehicle 2021 annual allowance

$$= \frac{₦6,200,000 - ₦3,100,000}{4} = ₦775,000$$

(4) Plant 2021 annual allowance

$$= \frac{₦10,400,000 - ₦5,200,000}{4} = ₦1,300,000$$

(5) Furniture and fittings 2021 annual allowance

$= \frac{₦5,800,000 - ₦1,450,000}{5}$	=	₦870,000

(6) Motor vehicle 2022 annual allowance

Old: $\frac{₦2,325,000}{4-1}$	=	₦775,000
New: $\frac{₦3,200,000 - ₦1,600,000}{4 - 1}$	=	400,000
		1,175,000

(7) Plant 2022 annual allowance

Old: $\frac{₦3900,000}{4-1}$	=	₦1,300,000
New: $\frac{₦5,000,000 - ₦2,500,000}{4-1}$	=	625,000
		1,925,000

(8) Furniture and fittings

Old: $\frac{₦3,480,000}{5-1}$	=	₦870,000
New: $\frac{₦1,200,000 - ₦300,000}{5}$	=	180,000
		1,050,000

Appendix 4: Statement of total profit or loss from pioneer business (Section 14 deductions)

Accounting year	**Total profit/ (loss) ₦'000**
1/4/16 – 31/3/17	(44,450)
1/4/17 – 31/3/18	(23,140)
1/4/18 – 31/3/19	8,700
Total	**(58,890)**

Appendix 5: Minimum tax computation for 2021 assessment year

	₦'000
Gross turnover	312,450
Less: Franked investment income	Nil
	312,450
Minimum tax @ 0.25%	**781.125**

However, the company (having just commenced business operations) is exempted from paying minimum tax for the first 48 calendar months (2021, 2022, 2023 and 2024).

Examiner's report

The question tests the candidates' understanding of the provisions of Companies Income Tax Act 2004 (as amended) regarding pioneer companies, computations of adjusted profit, and companies income tax.

Being a compulsory question, all the candidates attempted the question. Candidates demonstrated a good understanding of the question and performance was above average.

The commonest pitfall was the inability of some candidates to identify correctly the allowable and disallowable expenses in line with the provisions of Companies Income Tax Act 2004 (as amended).

Candidates are advised to familiarise themselves with issues concerning pioneer legislation and computations of companies income tax by reading extensively the Institute's Study Text, other relevant textbooks, and the Companies Income Tax Act 2004 (as amended).

Marking guide

		Marks	Marks
(a)	**Computation of adjusted profit**		
	Heading/address	1	
	Discussion (memo)	2	
	Appendix 1- adjusted profit:		
	Net profit as per accounts	½	
	Legal and professional fees	½	
	Depreciation	½	
	Allowance for doubtful debts	½	
	Administrative expenses	½	
	Adjusted profit	½	6
(b)	**Tax liabilities for 2021 and 2022 assessment years**		
	Appendix 2- Tax liabilities:		
	2021 assessment year		
	Basis period	½	
	Adjusted profit	½	
	Less: Loss b/f from pioneer period	½	
	Relieved	½	
	Unrelieved loss c/f	½	
	Capital allowance for the year	½	
	Utilised	½	
	Unutilised capital allowance c/f	½	
	Total profit	½	
	Companies income tax	½	
	Tertiary education tax	½	

2022 assessment year	
Basis period	½
Adjusted profit	½
Less: Unrelieved Loss b/f	½
Relieved	½
Unrelieved loss c/f	½
Unutilised capital allowance b/f	½
Capital allowance for the year	½
Utilised capital allowance	½
Total profit	½
Companies income tax	½
Tertiary education tax	½
Appendix 3- Capital allowances:	
2021 assessment year	
Cost (Industrial building)	¼
Cost (Non-industrial building)	¼
Cost (Motor vehicle)	¼
Cost (Plant)	¼
Cost (Furniture and fittings)	¼
IA (Industrial building)	¼
IA (Non-industrial building)	¼
IA (Motor vehicle)	¼
IA (Plant)	¼
IA (Furniture and fittings)	¼
Capital allowance (IA column)	¼
AA (Industrial building)	¼
AA (Non-industrial building)	¼
AA (Motor vehicle)	¼
AA (Plant)	¼
AA (Furniture and fittings)	¼
Capital allowance (AA column)	¼
Investment allowance (Plant)	¼
Capital allowance (Inv. allow column)	¼
Total capital allowances	¼
TWDV (Industrial building)	¼
TWDV (Non-industrial building)	¼
TWDV (Motor vehicle)	¼
TWDV (Plant)	¼
TWDV (Furniture and fittings)	¼
Additions (Motor vehicle)	¼
Additions (Plant)	¼
Additions (Furniture and fittings)	¼
IA (Motor vehicle)	¼
IA (Plant)	¼
IA (Furniture and fittings)	¼

Capital allowances (IA column	¼	
AA (Industrial building)	¼	
AA (Non-industrial building)	¼	
AA (Motor vehicle)	¼	
AA (Plant)	¼	
AA (Furniture and fittings)	¼	
Capital allowance (AA column)	¼	
Investment allowance (Plant)	¼	
Capital allowance (Inv. allow column)	¼	
Total capital allowances	¼	
Opening balance:		
TWDV (Industrial building)	¼	
TWDV (non-industrial building)	¼	
TWDV (Motor vehicle)	¼	
TWDV (Plant)	¼	
TWDV (Furniture and fittings)	¼	
Appendix 4 (Total losses from pioneer period)	½	
Appendix 5 (Minimum tax computation)	1	24
		30

SOLUTION 2

Colamrud Petroleum (Nigeria) Limited

Internal Memo

Date:

From: Assistant Tax Manager

To: Tax Manager

RE: REPORT ON THE COMPANY's ADJUSTED PROFIT AND ASSESSABLE PROFIT FOR THE FIRST QUARTER OF 2022 AND COMMENTS ON COST-PRICE RATIO

I refer to your request on computations of adjusted profit and assessable profit for the first quarter of 2022 and comments on the company's cost-price ratio for the period under review. I hereby present a report for your perusal before same is presented at the next management committee meeting.

(a) Computation of adjusted profit and assessable profit

The provisions of Section 262 (ascertainment of crude oil revenue, adjusted profit, assessable profit and chargeable profits), 263 (allowable deductions) and 264 (disallowable deductions) were complied with in the computations of adjusted profit and assessable profit of the company. Using two formats (as shown in appendices 1 and 2), the company's adjusted profit revealed ₦941,350,000. When the unabsorbed loss of ₦35,000 was relieved, the assessable profit for the first quarter was ₦941,315,000.

(b) Comments on cost - price ratio

The Petroleum Industry Act 2021 provides that all costs presented under Section 263 and under the Sixth Schedule to the Act in an accounting period, the sum of which is eligible for deduction under the hydrocarbon tax shall be subject to a cost-price ratio limit of 65% of gross revenue determined at the measurement points.

However, certain costs such as rent, royalty and contributions to the environmental remediation fund, host community fund, Niger Delta Development Commission fund and other similar contributions are excluded from this provision.

Any such cost not deductible shall be carried forward to subsequent years for deduction provided the amount to be deducted shall not exceed the total cost incurred.

Thank you.

Dipe Olu

Appendix 1: Computation of adjusted profit and assessable profit for the first quarter 2022 (Format 1)

	₦'000	**₦'000**
Net profit as per accounts		645,420
Add back: Disallowable deductions (Section 264)		
Cost of drilling appraisal wells (1/3 of ₦24,000)	8,000	
Head office shared costs	62,000	
Repairs and maintenance (building improvement)	1,430	
Customs duty on essentials	2,900	
Depreciation	66,000	
Interest on loans	4,400	
Allowance for bad debts	34,000	
Administrative expenses:		
Natural gas flare fees	10,000	
Cost of obtaining information on oil	7,300	
Bank charges	900	
Miscellaneous expenses:		
Donation to widows and orphans	3,000	
Income tax provision	90,000	
Tertiary tax provision	6,000	295,930
Adjusted profit		941,350
Less: Unabsorbed losses b/f		35
Assessable profit		**941,315**

Appendix 2: Computation of adjusted profit and assessable profit for the first quarter 2022 (Format 2)

	₦'000	₦'000
Gross income		1,560,980
Less: Allowable expenses (Section 263 deductions)		
Production cost	210,730	
Tangible drilling cost	18,800	
Intangible drilling cost	17,600	
Cost of gas reinjection wells	4,000	
Cost of drilling appraisal wells (2/3 of ₦24,000)	16,000	
Rent	13,000	
Royalties:		
Export sales	69,300	
Local sales	9,800	
Salaries and wages	170,500	
Repairs and maintenance (₦8,930 – ₦1,430)	7,500	
Administrative expenses (₦13200 + ₦14,900 +₦33,800)	61,900	
Stamp duties on increase in share capital	1,000	
Miscellaneous expenses (₦22,500 – ₦3,000)	19,500	619,630
Adjusted profit		941,350
Less: Unabsorbed losses b/f		35
Assessable profit		**941,315**

Examiner's report

The question tests candidates' knowledge of computations of adjusted profit, assessable profit, and cost-price ratio of a company in upstream petroleum operations, consistent with the provisions of Petroleum Industry Act 2021.

About 70% of the candidates attempted the question, but majority of them lacked a good understanding of its requirements, hence their performance was below average.

The major pitfall of the candidates was their inability to identify correctly the allowable and disallowable expenses relevant in the computations of cost-price ratio.

Candidates are advised to study extensively the template provided by the Federal Inland Revenue Service on computations of hydrocarbon tax, Companies Income Tax, and relevant sections of the Petroleum Industry Act 2021.

Marking guide

Format 1

		Marks	Marks
(a)	**Determination of adjusted profit and assessable profit for the first quarter of 2022**		
	Heading/title	½	
	Discussion (memo)	½	
	Net profit as per accounts	1	
	Cost of drilling appraisal wells	1	
	Head office shared costs	1	
	Repairs and maintenance (building improvement)	1	
	Customs duty on essentials	1	
	Depreciation	1	
	Interest on loans	1	
	Allowance for bad debts	1	
	Natural gas flare fees	1	
	Cost of obtaining information on oil	1	
	Bank charges	1	
	Donation to widows and orphans	1	
	Income tax provision	1	
	Tertiary tax provision	1	
	Adjusted profit	1	
	Unrelieved loss b/f	1	
	Assessable profit	1	18
(b)	**Comments on cost-price ratio**		
	(1 mark for each discussion of cost-price ratio, subject to a maximum of 2 points)		2
	Total		**20**

Format 2

		Marks	Marks
(a)	**Determination of adjusted profit and assessable profit for The first quarter of 2022**		
	Heading/title	½	
	Discussion (memo)	½	
	Gross income	1	
	Production cost	1	
	Tangible drilling cost	1	
	Intangible drilling cost	1	
	Cost of gas reinjection wells	1	
	Cost of drilling appraisal wells	1	
	Rent	1	
	Royalties: export sales	1	

Royalties: local sales	1	
Salaries and wages	1	
Repairs and maintenance	1	
Administrative expenses	1	
Stamp duties	1	
Miscellaneous expenses	1	
Adjusted profit	1	
Unrelieved loss b/f	1	
Assessable profit	1	18

(b) **Comments on cost-price ratio**
(1 mark for each discussion of cost-price ratio, subject to a maximum of 2 points) 2
Total **20**

SOLUTION 3

Sunny & Co (Tax Consultants)

Jaye Road, Mowe

Date ……

The Managing Director
Yemmysea Beverages Limited
Abeokuta

Dear Sir

RE: COMPUTATION OF CAPITAL GAINS TAX PAYABLE ON DISPOSAL OF ASSETS

I refer to your request relating to advice on tax payable on disposal of assets made by the company; due date for filing of returns and tax implication of compensation for loss of office to staff who are to be relieved of their jobs. My comments are as follows:

a. (i) **Disposal and subsequent acquisition of industrial building**
The capital gains made on disposal of asset on February 2021 was ₦38,462,000. But as a result of subsequent re-investment in new building for purposes of the business made in July 2021, the company was entitled to roll-over relief. The net capital gains, therefore, was ₦23,262,000 and capital gains tax payable was ₦2,326,200 (see appendix 1).

(ii) **Disposal of plant and machinery**

There was a part disposal made in April 2021 and this generated capital gains of ₦9,249,828 and capital gains tax payable of ₦924,982.80. The second disposal made in August 2021 resulted in capital gains of ₦2,220,172 and capital gains tax payable of ₦222,017.20 (see attached appendix 2).

(iii) **Disposal of factory equipment**

Factory equipment was disposed of in September 2021 to a friend to one of the directors for ₦160 million when the market value of the asset was ₦162.5 million. The tax authority, in line with the provisions of the Capital Gains Tax 2004 (as amended), would treat the disposal as made to a connected person. Hence, the market value of the asset would be used as the sales proceeds. This transaction generated a capital gains of ₦11,650,000 and capital gains tax of ₦1,165,000 (see attached appendix 3).

(b) **Due dates for filing of self-assessment return and payment of the tax computed on each of the assets disposed of**

Section 2 of the Finance Act 2020 specifies that every person having disposed a chargeable asset shall, not later than June 30 and December 31 of that year, compute the capital gains tax, file self-assessment return, and pay the tax computed in respect of the chargeable assets disposed in the periods.

In line with this provision of the Act, the disposals made by the company would be due for filing of self-assessment return and payment of capital gains tax as stated in appendix 4.

(c) **Compensation for loss of office**

Section 4(a) of Finance Act 2020 states that sums obtained by way of compensation for loss of office, up to a maximum of ₦10 million shall not be chargeable gains and subject to tax; provided that any sum in excess of ₦10 million shall not be so exempt but the excess amount shall be chargeable gains and subject to tax accordingly.

Section 4(b) further provides that any person who pays compensation for loss of office to an individual is required at the point of payment of such compensation to deduct and remit the tax due to the relevant tax authority. The tax so deducted shall be remitted within the time specified under the PAYE regulations.

Following the provisions of the Act, compensation for loss of office to be paid to Mr. Bala would attract capital gains tax of N200,000 (10% of the excess of

₦12 million over threshold of ₦10 million), which is to be paid to the tax authority by the recipient. Mr. Ekaite's compensation for loss of office of ₦7.5 million (which is below the threshold of ₦10 million) will not attract any capital gains tax.

Also, in remitting tax due on pay-as-you-earn to the State Internal Revenue Service, the amount of tax due on compensation for loss of office of both Mr. Bala and Mr. Ekaite should be computed and remitted to the tax office.

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

Rosco Atanda
Principal Consultant

Appendix 1: Disposal and subsequent acquisition of industrial building

	₦	₦
Sales proceeds		123,900,000
Less:		
Cost of acquisition	85,000,000	
Renovation expenses	288,000	
Incidental cost	150,000	85,438,000
Capital gains		38,462,000

Roll-over relief computation

Lower of:	
Sales proceeds	123,900,000
And	
Amount re-invested	100,200,000
Less: Cost of acquisition of old asset	85,000,000
Roll-over relief	15,200,000

Computation of capital gains tax

	₦
Capital gains	38,462,000
Less: Roll-over relief	15,200,000
Net capital gains	23,262,000
Capital gains tax (@ 10% of net capital gains)	**2,326,200**

Appendix 2: Disposal of plant and machinery

Disposal in April 2021

$$\text{Cost of part disposed} = \frac{A}{A + B} \times C$$

Where,

A = sales proceeds = ₦80,000,000
B = market value of asset undisposed = ₦65,300,000
C = overall cost of asset = ₦128,500,000

$$\text{Therefore, cost of part disposed} = \frac{₦80{,}000{,}000}{₦80{,}000{,}000+₦65{,}300{,}000} \times ₦128{,}500{,}000$$

$$= ₦\underline{70{,}750{,}172}$$

Computation of capital gains tax

	₦
Sales proceeds	80,000,000
Less: Cost of acquisition	70,750,172
Capital gains	9,249,828
Capital gains tax (@ 10% of capital gains)	**924,982.80**

Disposal in July 2021

Cost of remaining assets = overall cost – cost of part disposed
= ₦128,500,000 – ₦70,750,172
= ₦57,749,828

Computation of capital gains tax

	₦	₦
Sales proceeds		60,000,000
Less:		
Cost of acquisition	57,749,828	
Incidental cost	30,000	57,779,828
Capital gains		2,220,172
Capital gains tax (@ 10% of capital gains)		**222,017.20**

Appendix 3: Disposal of factory equipment

Computation of capital gains tax

	₦	₦
Sales proceeds		162,500,000
Less:		
Cost of acquisition	150,600,000	
Refurbishment cost	250,000	150,850,000
Capital gains		11,650,000
Capital gains tax (@ 10% of capital gains)		**1,165,000**

Appendix 4: Due date for filing of returns and payment of capital gains tax

Asset disposed	**Disposal date**	**Due date for filing of returns and payment of capital gains tax**
Industrial building	February 2021 but funds realised was re-invested in July 2021	June 30, 2021
Plant and machinery	1st disposal in April 2021 2nd disposal in August 2021	June 30, 2021 December 31, 2021
Factory equipment	September 2021	December 31, 2021

Examiner's report

The question tests candidates' understanding of capital gains tax computations and treatment of compensation for loss of office paid to disengaged staff.
About 80% of the candidates attempted the question. Candidates showed a good understanding of the requirements of the question, and their performance was satisfactory.

The major pitfall was the inability of some candidates to identify correctly and explain the provisions of the Finance Act 2020 in respect of compensation for loss of office paid to staff disengaged by the company.

Candidates are advised to read the Institute's Study Text, other relevant textbooks and the Capital Gains Tax Act 2004 (as amended), as this will go a long way in assisting them to pass future examinations.

Marking guide

		Marks	Marks
a(i)	**The capital gains tax (if any) and the capital gains tax payable on disposal and subsequent acquisition of industrial building**		
	Heading/title	½	
	Discussion (memo)	½	
	Sales proceeds	½	
	Cost of acquisition	½	
	Renovation expenses	½	
	Incidental cost	½	
	Roll-over: Sales proceeds	½	
	Amount re-invested	½	
	Cost of acquisition	½	
	Roll-over relief	½	
	Capital gains (computation of CGT)	½	
	Roll-over relief	½	
	Net capital gains	½	
	Capital gains tax	½	**7**
(ii)	**The capital gains tax (if any) and the capital gains tax payable on disposal of plant and machinery**		
	Memo	½	
	Cost of part disposed (₦70,750,172)	½	
	Sales proceeds	½	
	Cost of acquisition	½	
	Capital gains	½	
	Capital gains tax	½	
	Cost of remaining assets (July 2021)	½	
	Sales proceeds	½	
	Cost of acquisition	½	
	Incidental expenses	½	
	Capital gains	½	
	Capital gains tax	½	**6**
(iii)	**The capital gains tax (if any) and the capital gains tax payable on disposal of factory equipment**		
	Memo	½	
	Sales proceeds	½	
	Cost of acquisition	½	
	Refurbishment expenses	½	
	Capital gains	½	
	Capital gains tax	½	**3**

b.	**Due dates for filing of self-assessment return and payment of tax computed on each of the assets disposed of**		
	Industrial building (June 30, 2021)	½	
	Plant and machinery:		
	1st disposal (June 30, 2021)	½	
	2nd disposal (December 31, 2021)	½	
	Factory equipment (December 31, 2021)	½	2
c.	**Comments on the provisions of the Act in respect of compensation for loss of office to be paid to the two staff disengaged by the company**		
	Discussion of provisions of the law	1	
	Implications on compensation made to the relieved staff	1	2
	Total		**20**

SOLUTION 4

(a) **The significance of transfer pricing to both the taxpayers and tax authorities include:**

(i) They impact on the income and expenses as well as taxable profits of related companies in different tax jurisdictions in which the enterprises and multinationals operate; and

(ii) Transfer pricing mechanism is usually adopted by many companies to boost their head office profits which may be at the disadvantage of subsidiaries or associated companies which operate in other countries with different tax jurisdictions.

(b) **In complying with arm's length principle, the guiding actions which enterprise and multinationals must follow in dealings between them include:**

(i) Where a connected person has entered into a transaction or series of transactions to which these regulations apply, the person shall ensure that the taxable profits resulting from the transactions are ascertained in a manner that is consistent with the arm's length principle;

(ii) A controlled transaction is at arm's length if the conditions of the transaction do not differ from the conditions that would have applied between independent persons in comparable transactions carried out under comparable circumstances; and

(iii) Where a connected person fails to comply with the provisions of transfer pricing regulations, the Service shall make adjustments, where necessary, in order to bring the taxable profits resulting from the transactions in conformity with the arm's length principle.

(c) **Ways which multinational companies adopt in financial dealings with their associated or subsidiary entities that are not consistent with the arm's length principle include:**

(i) **Different pricing of goods/services at purchase cost:** In any multinational group, a member of the group in one country may supply goods or services to another member in another country. By implications, the prices charged often create revenue for the company selling the goods or services, whilst its cost of purchase for the company buying the goods or services;

(ii) **Tax avoidance:** When companies operating under different jurisdictions belong to the same group, they may decide depending on what they want to achieve, under price or over price inter group transactions. The tax implication of the foregoing is that multinational transfer pricing can provide an avenue for tax avoidance;

(iii) **Custom duties and tariff manipulation:** Custom duties paid on imports and exports are usually based on transfer prices. For instance, if the transfer prices on imports into a country are low-priced, the import duties and other tariffs on the imports will equally be reduced;

(iv) **Dividends manipulation:** An instance of dividends manipulation is when a country A restricts an amount that can be paid as dividends to another company in country B, the company in country B may decide to overprice goods and services transferred to its subsidiary in country A.

The implication of the foregoing is that more funds will be remittable to the other company in country B without any violation on restriction of dividend; and

(v) **Imposition of excessive charges**: The parent company can also impose excessive charges (e.g. royalties) on its foreign subsidiaries, associates, etc. in respect of the provision of intangibles, such as patents, licenses, trademarks, etc. and use these avenues to extract profits to a tax haven or jurisdiction with favourable tax requirement. Where the head office of the multinational or a member of the group incurs expenses which are for the benefits of all or many members of the group, the allocation of the joint costs to members of the group will certainly affect their profits and taxes.

(d) **Fundamental areas to be noted and complied with by the taxpayers and tax practitioners as enshrined in Transfer Pricing Regulations 2018 are:**

(i) **Annual transfer pricing returns:** A connected taxable person must submit transfer pricing document annually to FIRS not later than 6 months after the end of each accounting year or 18 months after the date of incorporation, whichever is earlier. Transfer pricing disclosure and declaration forms are to be attached to the annual tax returns;

(ii) **Extension of filing annual transfer pricing returns:** A connected person may apply in writing to the Service for an extension of the time within which to file returns and where the Service is satisfied with the reasons stated in the application made, it may grant the extension. Where the taxable person fails to meet the extended submission date granted by the Service, the administrative penalty shall apply as if no extension of period was granted;

(iii) **Administrative procedures:** Transfer Pricing Department of FIRS shall review transfer pricing documents submitted and carry out a review of transactions verifying the appropriateness of transfer pricing methods adopted; and

(iv) **Burden of proof:** Transfer pricing document must demonstrate sufficient information and analysis to verify consistency of the taxable profits derived from its controlled transactions with the arm's length principle.

(e) Disputes that arise between the taxpayer and tax authorities under the Transfer Pricing Regulations 2018 are resolved through the following ways:

(i) A taxpayer who has any objection on assessment cannot approach the Decision Review Panel for a review of the assessment received from FIRS;

(ii) Taxpayers are now expected to lodge their complaints with the Head, FIRS Transfer Pricing Unit within 30 days after the date of receipt of the assessment notice; and

(iii) Effective March 12, 2018, the Head of Transfer Pricing Unit has the prerogative to decide whether or not to refer the taxpayer's objection to the Decision Review Panel.

Examiner's report

The question tests the candidates' knowledge of provisions of Income Tax (Transfer Pricing) Regulations, 2018, in respect of significance of transfer pricing to both taxpayers and tax authorities, principles of arm's length, and administration of transfer pricing.

About 50% of the candidates attempted the question, and they exhibited a clear understanding of its requirements. The performance was above average.

The commonest pitfall was the inability of some candidates to identify correctly and explain the areas to be noted and complied with by taxpayers as well as tax practitioners in the administration of the Regulations.

Candidates are advised to pay attention to transfer pricing by reading the Institute's Study Text, other relevant textbooks and the Income Tax (Transfer Pricing) Regulations 2018.

Marking guide

		Marks	Marks
(a)	**Significance of transfer pricing to both the taxpayers and tax authorities**		
	2 marks for the discussion of significance of transfer pricing to both the taxpayers and tax authorities, subject to a maximum of 1 point		2
(b)	**Guiding actions which enterprises and multinational companies must follow in dealings between them**		
	1½ marks for each discussion of the guiding actions which enterprise and multinationals must follow in dealings between them, subject to a maximum of 2 points		3
(c)	**Ways which multinational companies adopt in financial dealings with their associated or subsidiary entities that are not consistent with the arm's length principle**		
	½ mark for each identification of financial dealings not consistent with the arm's length principle, subject to a maximum of 4 points	2	
	1 mark for each discussion of financial dealings not consistent with the arm's length principle, subject to a maximum of 4 points	<u>4</u>	6
d)	**Fundamental areas to be noted and complied with by taxpayers and tax practitioners in the administration of transfer pricing**		
	2 marks for each discussion of fundamental areas to be noted and complied with by the taxpayers and tax practitioners in the administration of 2018 Regulations, subject to a maximum of 3 points		6
(e)	**How disputes that arise between a taxpayer and tax authorities are resolved under the Transfer Pricing Regulations 2018**		
	1½ marks for each discussion of dispute resolution methods, subject to a maximum of 2 points		<u>3</u>
	Total		**20**

SOLUTION 5

Danny & Co (Tax Consultants)
Tonadey Road, Abeokuta

Date ……

The Managing Director
Yemmysea Beverages Limited
Abeokuta

Dear Sir

RE: TAX IMPLICATIONS ON MERGER AND ACQUISITION ARRANGEMENTS AND POWERS OF FEDERAL INLAND REVENUE SERVICE

I refer to your request on advice on tax implications on merger and acquisition under three different arrangements and powers of the FIRS on merger and acquisition issues. My comments are as follows:

(a) **The tax implications when an existing company absorbs another existing company include:**

(i) The company absorbed will be deemed to have ceased business and the cessation rules will apply to it;

(ii) The company that absorbs will not be deemed to have commenced a new business as far as the nature of business carried on by it before and after absorption is not different from that of the company absorbed or taken over. Therefore, commencement provisions will not apply to it and tax returns will be filed as an ongoing company;

(iii) The surviving company will not be entitled to investment allowance and initial allowance on the assets transferred to it through absorption. The annual allowance will be based on the tax written down values;

(iv) The unabsorbed losses and capital allowances of the individual merging companies may not be allowed to be carried forward and set off against assessable profits of the surviving company after the merger;

(v) Fees payable for professional services in connection with the merger will be subject to value added tax and withholding tax; and

(vi) Any increase in share capital as a result of a merger will attract payment of stamp duties.

(b) **The tax implications when merger results in the cessation of business include:**

(i) The cessation provisions will only apply to those companies which have ceased business permanently;

(ii) Any unrelieved capital allowances at cessation can be carried backward and set off against assessable profits of five years preceding the year of cessation;

(iii) Any unrelieved losses at cessation cannot be carried backward to be set off against the assessable profits of the preceding years of assessment; and

(iv) Any sum received or paid by the company, its receivers or liquidators after the date of cessation will be deemed to have been received or paid on the last day before such cessation occurred.

(c) **The tax implications when a business is sold or transferred**

If a trade or business is sold or transferred to a Nigerian company together with any asset employed therein and the FIRS is satisfied that one of the companies has control over the other or that both are controlled by some other person or are members of a recognised group of companies, the FIRS may at its discretion direct that:

(i) The commencement and cessation provisions are not applied;

(ii) For capital allowances purpose, the assets sold or transferred shall be deemed to have been sold for an amount equal to the residue of qualifying capital expenditure thereon on the day following such sale or transfer;

(iii) The company acquiring the assets shall not be entitled to any initial allowance thereon and shall be deemed to have received all allowance already granted to the vendor company up to the date of the sale or transfer;

(iv) There is no reference to unutilised losses incurred in the old trade. Such losses cannot be transferred to the new business and may not be relieved in any other way; and

(v) In order to benefit from the unutilised losses incurred in the old trade, the company acquiring the old trade may leave some business in the old trade that will produce small profits annually which will gradually use up the losses over a number of years, before that part of the trade is transferred to the new trade.

(d) **The powers of the Federal Inland Revenue Service on issues that concern mergers and acquisition of companies include:**

(i) The consent of the FIRS, including clearance with respect to any capital gains tax that may be due and payable must be obtained before any merger, sales, takeover, transfer, or restructuring of a business carried on by a company can take place;

(ii) The CITA 2004 (as amended) gave the FIRS powers to the extent that no merger can be consummated without obtaining the consent or direction of the FIRS; and

(iii) Under CITA, no merger, takeover or transfer can take place without having obtained the FIRS's direction and clearance with respect to any tax that may be due and payable.

We hope this presentation satisfies your requirements. Should you still need any further clarification on this, please do not hesitate to contact us.

Yours faithfully

Akin Bode

Examiner's report

The question tests candidates' understanding of tax treatments of merger or acquisition arrangements between entities in the same business line.

About 60% of the candidates attempted the question, and they showed a fair understanding of the question and performance was average.

The commonest pitfall was the inability of the candidates to state correctly the powers of the Federal Inland Revenue Service on issues that concern mergers or acquisition of companies.

Candidates are advised to read the Institute's Study Text and other relevant laws on the issues in respect of merger or acquisition arrangements when preparing for future examinations.

Marking guide

		Marks	Marks
(a)	**Tax implications when an existing company absorbs another existing company**		
	Heading/title	1	
	1 mark for each discussion on tax implications when an existing company absorbs another existing company, subject to a maximum of 4 points	4	5
(b)	**Tax implications when merger results in the cessation of business**		
	1 mark for each discussion on tax implications when merger results in the cessation of the merging companies, subject to a maximum of 3 points		3
(c)	**Tax implications when a business is sold or transferred**		
	1 mark for each discussion on tax implications when merger results in the cessation of the merging companies, subject to a maximum of 3 points		3
(d)	**Powers of the Federal Inland Revenue Service (FIRS) on issues that concern mergers and acquisition of Companies**		
	2 marks for each discussion on powers of FIRS on merger and acquisition issues, subject to a maximum of 2 points		4
	Total		**15**

SOLUTION 6

(a) The main objective of double taxation agreement (DTA), as contained in the preamble to the agreements is the elimination of double taxation, without creating an opportunity for non-taxation or reduced taxation. Thus, a tax treaty does not primarily create exemption from taxation in the Source State.

While the Resident State has an unlimited right to tax its residents, the Source State is allowed some taxing rights under the treaty in many instances, and on those occasions, it will have the prior right to tax, whereas the Resident State must eliminate double taxation in those instances.

Double taxation agreement (DTA) does not exempt a company from payment of tax on income or profit derived from a Source country, but gives the company opportunity to claim a credit (double taxation relief) in its home country in respect of double taxation suffered on its operation in another tax jurisdiction.

In Nigeria, the provision where there is double taxation agreement is only applicable to a resident taxpayer.

I disagree with the company because Singapura PTC Limited is a non-resident company that derives incomes from Nigeria.

The company shall be liable to tax on incomes which are deemed to be derived from Nigeria, while the DTA between Nigeria and Singapore shall only be applicable to resident companies in Nigeria.

(b) **A resident of Nigerian treaty partner may enjoy any of the following benefits, depending on the provisions of the DTA:**

(i) Relief from double taxation (elimination of double taxation);

(ii) Reduced tax rates on income derived by airlines or shipping companies or exemption of their income from tax in Nigeria;

(iii) Reduced withholding tax rates on passive income or fees for technical service;

(iv) Requirement for permanent establishment (PE) before taxation in Nigeria;

(v) Access to mutual agreement procedure (MAP) for dispute resolution; and

(vi) Non-discrimination in taxation matters.

(c) **A company registered in Singapore may be liable to tax in Nigeria under the DTA between Nigeria and Singapore where the company:**

(i) Is also a resident of Nigeria (dual resident of both countries) and determined to be resident of Nigeria under the tie-breaker rule in Article 4(3) of the Agreement;

(ii) Derives business profit which is attributable to a permanent establishment it has in Nigeria;

(iii) Derives a passive income from Nigeria (dividend, interest, royalties);

(iv) Has an immovable property in Nigeria from which an income is derived

(v) Derives capital gains from Nigeria;

(vi) Carries on the business of international traffic (shipping or airline transportation) and derived income from Nigeria from that activity; and

(vii) Receives a payment or income in respect of a performance exercised in Nigeria by an entertainer or sportsperson.

Examiner's report

The question tests candidates' understanding of tax implications on profit made by a non-resident company in line with the provisions of Companies Income Tax Act 2004 (as amended).

About 60% of the candidates attempted the question, and they showed a fair understanding of it, hence the performance was average.

The commonest pitfall was the candidates' inability to identify correctly the benefits that are available to residents of Singapore under the double taxation agreement between Nigeria and Singapore.

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

Marking guide

a.	**Qualification or otherwise of a company resident in Singapore for tax exemption in Nigeria**	
	1 mark for each discussion of the qualification or otherwise of the company for tax exemption in Nigeria, subject to a maximum of 5 points	5
b.	**Benefits that may be available to a resident of Singapore under the double taxation agreement between Nigeria and Singapore**	
	1 mark for each benefit available to a resident company with double taxation agreement between Nigeria and Singapore, subject to a maximum of 5 points	5
c.	**Circumstance under which a company registered in Singapore will be liable to tax in Nigeria**	
	1 mark for each circumstance under which a company registered in Singapore will be liable to tax in Nigeria, subject to a maximum of 5 points	5
	Total	**15**

SOLUTION 7

AY& Co (Chartered Accountants)

Coleng Road, Ibadan

INTERNAL MEMO

Date: ....

From: Assistant Tax Manager

To: Principal Partner

RE: Report on Tax Liabilities and Deferred Tax Provisions of ICTREC Mining Company Limited

I refer to our client's request on computations of tax liabilities payable for 2021 assessment year and deferred tax provisions for the 2021 and 2022 assessment years. I hereby present a report for your review before same is presented to the client.

The adjusted profit of the company for the assessment year under review was ₦34,210,000. The profit made was able to relieve unabsorbed loss brought forward of ₦2,800,000 as well as utilisation of the capital allowances for the year, ₦7,250,000. The total profit of ₦24,160,000 resulted thereof. The company is therefore liable to pay companies income tax of ₦7,248,000 and tertiary education tax of N855,250. This gives total tax liabilities of ₦8,103,250. These results are provided in attached appendix I.

Appendix 2 shows how the deferred tax provisions for assessment years 2021 and 2022 were computed. The deferred tax provisions revealed ₦3,516,000 and ₦4,173,000 for 2021 and 2022 assessment years, respectively.

Thank you.

Ola Dejo

Appendix 1: Computation of tax liabilities

	₦'000	₦'000
Net profit as per accounts		30,320
Add back: Disallowable expenses:		
Depreciation (mining plant)	2,500	
Depreciation (other non-current assets)	7,840	
Loss on disposal of old mining plant	200	10,540
		40,860
Less: Non-taxable income:		
Dividends	3,900	
Interest on foreign deposit	2,750	6,650
Adjusted profit		**34,210**
Less: Unrelieved loss b/f		2,800
		31,410
Less: Capital allowances for the year		7,250
Total profit		**24,160**
Companies income tax @ 30%		**7,248**
Tertiary education tax @ 2½% of adjusted profit of ₦34,210		**855.25**
Total tax liabilities payable		**8,103.25**

Note:

The Finance Act 2021, is effective January 1, 2022.

The internal circular issued by the Executive Chairman, FIRS, dated January 25, 2022, provides that financial statements with accounting years ended from July 1, 2021 to December 31, 2021, the tax returns of which are due for filing from January 1, 2022 to June 30, 2022, shall reflect the new tertiary education tax rate of 2½% of adjusted/assessable profit.

Appendix 2: Computation of deferred tax

	2022			2021		
	₦'000	**₦'000**	**₦'000**	**₦'000**	**₦'000**	**₦'000**
TWDV			35,110			42,620
Less: Net book values		23,700			33,900	
Deduct:						
Revaluation surplus	5,000			5,000		
Depreciation	(2,500)w1	(2,500)	21,200	(2,000) w2	(3,000)	30,900
Timing difference			**13,910**			**11,720**
Deferred tax @ 30%			**4,173**			**3,516**

Workings

(1) Depreciation (2022)

= ₦5,000,000 x 10% x 5 years
= ₦2,500,000

(2) Depreciation (2021)
= ₦5,000,000 x 10% x 4 years
= ₦2,000,000

Examiner's report

The question tests candidates' knowledge of computations of tax liabilities and deferred tax provisions.

About 50% of the candidates attempted the question. Candidates displayed very poor understanding of the question, and performance was below average.

The major pitfall was the inability of some candidates to correctly determine the value of depreciation, which was necessary in the computation of deferred tax provisions.

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

Marking guide

		Marks	Marks
(a)	**Computation of tax liabilities for the relevant year Assessment**		
	Heading/address	½	
	Discussion (memo)	½	
	Net profit as per account	½	
	Depreciation (mining plant)	½	
	Depreciation (other non-current assets)	½	
	Loss on disposal of old mining plant	½	
	Dividends	½	
	Interest on foreign deposit	½	
	Adjusted profit	½	
	Unrelieved loss b/f	½	
	Capital allowances for the year	½	
	Total profit	½	
	Companies income tax	½	
	Tertiary education tax	½	7
(b)	**Computation of deferred tax provisions for 2021 and 2022**		
	Deferred tax	½	
	2022	½	
	TWDV	½	
	Net book values	½	
	Revaluation surplus	½	
	Depreciation (₦2,500)	½	
	(₦2,500)	½	
	(₦21,200)	½	
	Timing difference	½	
	Deferred tax provision	½	
		½	
	2021	½	
	TWDV	½	
	Net book values	½	
	Revaluation surplus	½	
	Depreciation (₦2,000)	½	
	(₦3,000)	½	
	(₦30,900)	½	
	Timing difference	½	
	Deferred tax provision	½	8
	Total		**15**

ICAN/222/V/C3 Examination No...........................

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2022

STRATEGIC FINANCIAL MANAGEMENT

EXAMINATION INSTRUCTIONS

PLEASE READ THESE INSTRUCTIONS BEFORE THE COMMENCEMENT OF THE PAPER

1. Check your pockets, purse, mathematical set, etc. to ensure that you do not have prohibited items such as telephone handset, electronic storage device, programmable devices, wristwatches or any form of written material on you in the examination hall. You will be stopped from continuing with the examination and liable to further disciplinary actions including cancellation of examination result if caught.

2. Write your **EXAMINATION NUMBER** in the space provided above.

3. Do **NOT** write anything on your question paper **EXCEPT** your examination number.

4. Do **NOT** write anything on your docket.

5. Read all instructions in each section of the question paper carefully before answering the questions.

6. Do **NOT** answer more than the number of questions required in each section, otherwise, you will be penalised.

7. All solutions should be written in **BLUE** or **BLACK INK**. Any solution written in **PENCIL** or **RED INK** will not be marked.

8. A formula sheet and discount tables are provided with this examination paper.

WEDNESDAY, NOVEMBER 16, 2022

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2022

STRATEGIC FINANCIAL MANAGEMENT

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Abayomi Plc (AP) is a major electrical company in Nigeria. The directors have recently identified Togo as a priority location for business expansion. Togo uses currency T$. Assume today is 30 August 2021.

Company K3, located in Togo, has been identified as a potential acquisition target. AP already manages two business units in Togo, named K1 and K2, and these have shown strong performance under AP's ownership.

K3 is particularly attractive to AP because it has its own warehouse, distribution and logistics network, all of which could be used by K1 and K2, if the acquisition goes ahead. Currently, K1 and K2 send goods to customers from AP warehouses located in Ghana. This involves considerable cost and delay in delivery.

K3 is a private company and 100% of its shares are owned by the family that founded it. Many shareholders are keen to realise their investment by selling the company to AP.

Both companies are working towards an effective date for the sale of K3 to AP on 1 January 2022.

Financial data for K3 for 2020

The statement of financial position of K3 as at 31 December 2020 showed the following balances:

	T$ million
Long term borrowings	375
Share capital (T$1 ordinary shares)	90
Reserves	200
	665

Additional information:

- K3 reported an operating profit of T$75 million in the year ended 31 December 2020. It declared a dividend of T$30 million on 20 December 2020 which was paid on 30 January 2021.
- K3 pays 7% interest on long term borrowings.
- The corporate income tax rate in Togo is 30%.

Forecast financial data for K3 for year 2022 onwards, following acquisition by AP

Following consultation with the directors of K3, AP's Finance Director has prepared the following forecast data for K3 assuming it is acquired on 1 January 2022.

Forecast data for K3:

- Free cash flow to the firm, ignoring synergistic benefits, of T$54.6 million in 2022, growing by 4% a year in perpetuity.
- One-off synergistic cash flow benefit of T$8.0 million after tax in 2022.
- After tax annual synergistic cash flow benefit, starting with T$5.0 million in 2023 and then increasing by 4% a year in perpetuity.

In any discounted cash flow analysis, cash flows should be assumed to arise at the end of the year to which they relate.

On acquisition, K3 would be transferred to AP free of debt because K3's lenders would only agree to the sale on condition that their borrowings are repaid prior to the sale. After acquisition, new borrowings would be arranged in addition to the equity investment by AP and structured so that K3 would have approximately the same capital structure as AP. That is, gearing (debt/debt+equity) would be 25% based on market values. AP would guarantee K3's new debt which can be assumed to have the same risk profile as AP's debt.

A proxy company has been identified which is also located in Togo and has a similar business model to K3.

Proxy company data

- P/E ratio of 12.
- Equity beta of 1.7 and debt beta of 0.4.
- Gearing (debt/debt+equity) based on market values of 35%.

Togo has a risk free rate of 5% and a market risk premium of 4%.

Financial data for AP

Latest data available for AP shows:

- P/E ratio of 14.
- Equity beta of 1.5 and debt beta of 0.3.
- Gearing (debt/debt+equity) based on market values of 25%.

- AP pays 6.2% interest on its long term borrowings.

Tax rate in Nigeria is 30%.

The spot rate for T$ against Naira, today is T$7/₦ (that is, ₦1 = T$7.00) and is not expected to change in the foreseeable future.

Assume that Nigeria has the same risk free rate and market risk premium as Togo.

Required:

Assume you are the Finance Director of AP.

a. **Advise on:**

   i. The types of synergistic benefit that might arise from the acquisition of K3. (8 Marks)

   ii. Possible reasons why both one-off and ongoing synergistic benefits might not be achieved to the extent expected. (4 Marks)

b. i. Calculate a Weighted Average Cost of Capital (WACC) for use in valuing K3 based on the proxy company's business and country risk and AP's capital structure. (6 Marks)

   ii) Calculate a range of values for the equity of K3 in T$ as at 1 January 2022 using the following methods:

   - Asset basis. (2 Marks)
   - P/E (including bootstrapping). (5 Marks)
   - DCF (with and without synergistic benefits) (5 Marks)

(Total 30 Marks)

SECTION B OPEN-ENDED QUESTIONS (40 MARKS)

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

QUESTION 2

Balama Plc. (Balama) is a listed manufacturer of dairy products. In recent years the company has experienced only modest level of growth, but following the recent retirement of the chief executive, his replacement is keen to expand Balama's operations.

The board of directors has recently agreed to support a proposal by the new chief executive that the company purchase new manufacturing equipment to enable it to expand its range of dairy products. The new equipment will cost ₦50 million and the company is seeking to raise new finance to fund the expenditure in full. However, the board of directors is undecided as to how the new finance is to be raised. The directors are considering either a 1 for 5 rights issue at a price of ₦2.50 per share with a theoretical ex-rights' price of ₦2.92 or a convertible loan of ₦50 million.

The loan will be secured against the company's freehold land and buildings. The company's share is presently quoted at a price of ₦3.00 per share.

Required:

a. Explain the terms 'rights issue' and 'convertible loans.' (3 Marks)

b. Explain how 'theoretical ex-rights' price of ₦2.92 is calculated and why the actual price might be different.

Show your workings. (4 Marks)

c. Prepare a report for the board of directors that fully evaluates the two potential methods of financing the company's expansion plans. (13 Marks)

(Total 20 Marks)

QUESTION 3

Zakai (ZK) Plc is a listed company that owns and operates a large number of farms throughout the country. A variety of crops are grown.

Financing structure

The following is an extract from the statement of financial position of ZK Plc at 30 September 2021.

	₦'million
Ordinary shares of ₦1 each	200
Reserves	100
9% irredeemable ₦1 preference shares	50
8% loan stock 2022	250
	600

The ordinary shares were quoted at ₦3 per share ex div on 30 September 2021. The beta of ZK Plc's equity shares is 0.8; the annual yield on treasury bills is 5%, and financial markets expect an average annual return of 15% on the market index.

The market price per preference share was ₦0.90 ex div on 30 September 2021. Loan stock interest is paid annually in arrears and is allowable for tax at 30%. The loan stock was priced at ₦100.57 ex interest per ₦100 nominal on 30 September 2021. Loan stock is redeemable on 30 September 2022.

Assume that taxation is payable at the end of the year in which taxable profits arise.

A new project
Difficult trading conditions have caused ZK Plc to decide to convert a number of its farms into camping sites with effect from the 2022 holiday season. Providing the necessary facilities for campers will require major investment, and this will be financed by a new issue of loan stock. The returns on the new campsite business are likely to have a very low correlation with those of the existing farming business.

Required:

a. Using the capital asset pricing model, calculate the required rate of return on equity of ZK Plc at 30 September 2021. Ignore any impact from the new campsite project. (3 Marks)

b. Briefly explain the implications of a beta of less than 1, such as that for ZK Plc. (2 Marks)

c. Calculate the weighted average cost of capital of ZK Plc at 30 September 2021 (use your calculation in answer to requirement (a) above for the cost of equity). Ignore any impact from the new campsite project. (10 Marks)

d. Without further calculations, identify and explain the factors that may change ZK Plc's equity beta during the year ending 30 September 2022. (5 Marks)

(Total 20 Marks)

QUESTION 4

Tayo Kayode (TK) is a highly successful beverage company listed on the Nigerian stock market. Its products are particularly attractive to the younger generation.

Eko Laboratory (EL) has developed an innovative synthetic, alcoholic beverage – the Younky.

It is believed that the product, if manufactured commercially, will be popular among the youths.

TK has been offered a licence to produce the Younky on the condition that it commences production within the next twelve months. In the last board meeting, the Marketing Director, Kehinde Kay, presented the following preliminary evaluation of the project.

	₦'million
Net present value	-250
Present value of future cash flows	4,500

Kehinde recommended that the project should thus be rejected.

However, the Finance Director (FD), Ben Okon, argued that conventional NPV analysis undervalues projects with high uncertainty as the value of embedded real options is often ignored. He suggested that the possibility of delaying the project for up to twelve months effectively gives TK a call option on development and that if market forecasts improve over the next year, then the company can benefit. To get the 'right answer', he concluded, option values must be incorporated.

The current long-term government bond yield is 5%. The expected standard deviation of future cash flows is estimated to be 35%.

Required:

a. Comment on the views of the Marketing and Finance Directors. (5 Marks)

b. Using the Black-Scholes option pricing model for an European call option, estimate the value of the option to commercially develop and market the Younky. Provide a recommendation as to whether or not TK should manufacture the Younky. (10 Marks)

c. Comment on modeling the possibility of delay as a European call option. (5 Marks)

(Total 20 Marks)

SECTION C: OPEN-ENDED QUESTIONS (30 MARKS)

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

QUESTION 5

ADERUPOKO PLC

Aderupoko Plc (ADP), a large listed media group, has been the holding company of Adamu Publishers Limited. (APL) since 2015. The publishing company (APL) is 100% owned by ADP since inception.

Recently the directors of APL informed ADP's board of their readiness to make a management buy-out (MBO) of APL. Accordingly, ADP's board decided to value APL using the shareholder value analysis method (SVA). ADP's board estimates that APL has a four-year competitive advantage over its competitors (to 30 September, 2024) and the following data regarding APL's value drivers and additional financial information has been collected.

Sales for the current year to 30 September, 2020	₦80 Million
Annual depreciation (equal to annual replacement of non-current asset expenditure	₦2.0 Million
Par value of 6% debentures in issue (current market value ₦95.00) nominal value ₦100	₦10.0Million
Short-term investments held	₦0.8Million
Company tax rate	20%
Current WACC	10%

Year to 30 September budgeted

	2021	2022	2023	2024	2025+
Sales growth	5%	4%	3%	2%	0%
Operating profit margin	8%	9%	10%	10%	10%
Incremental non-current asset Investment (as a % of sales increase)	5%	6%	3%	2%	0%
Incremental working capital Investment (as a % of sales increase)	6%	5%	4%	4%	0%

Required:

a. Calculate the value of APL's equity using SVA (12 Marks)

b. Outline **THREE** methods by which APL's directors might raise the funds necessary for the proposed MBO of the company (3 Marks)

(Total 15 Marks)

QUESTION 6

Companies A, B and C are in the food retailing sector of the stock market. The following key stock market statistics are provided.

Food Retailers: Ordinary Shares, Key Stock Market Statistics

	Share price (kobo)			Dividend	P/E
Company	Current	52 week high	52 week low	Yield (%)	ratio
A	63	112	54	1.8	14.2
B	291	317	187	2.1	13.0
C	187	201	151	2.3	21.1

Required:

a. Illustrating your answer by use of data from the table above, define and explain the term P/E ratio, and comment on the way it may be used by an investor to appraise a possible share purchase. (8 Marks)

b. Using data in the above table, calculate the dividend cover for C and B, and explain the meaning and significance of the measure from the point of view of equity investors. (7 Marks)

(Total 15 Marks)

QUESTION 7

The Chairman of Opeyemi plc, a company listed on the Alternative Investment Market, has circulated a memorandum to the company's directors and senior managers which contains the following statements.

'Looking to the year ahead, there are a number of measures which I propose to increase the company's earnings per share (EPS).

Payments to trade creditors should be made as late as possible, even if this means extending our credit beyond the terms allowed by our suppliers. The company currently runs a substantial overdraft and this measure will cut the level of bank interest and charges.

Relatively high capital expenditure in recent years has resulted in substantial depreciation charges in the profit or loss account. All capital spending, including that on the Oloro II project – designed to reduce toxic emissions from the manufacturing plant - should be postponed except where such spending can be shown to be essential to current operations.

Staff pay should be frozen at this year's level for the forthcoming year. The company's sponsorship of the local charity events run by the Staff Social Club should also, regrettably be ended.

By boosting profits and therefore EPS, these measures will help us to achieve the highest possible stock market capitalisation.'

Required:

a. Prepare a response to the Chairman's proposals which examines the possible consequences of the proposals for the price of the company's shares and for the company's stakeholders. (9 Marks)

b. Discuss **FOUR** ways that encourages managers to achieve stakeholder objectives. (6 Marks)

(Total 15 Marks)

Formulae

Modigliani and Miller Proposition 2 (with tax)

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

Asset Beta

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

Equity Beta

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

Growing Annuity

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

Modified Internal Rate of Return

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

The Black-Scholes Option Pricing Model

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

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

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

The Put Call Parity

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

Binomial Option Pricing

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

$$d = 1/u$$

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

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

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

Annuity Table

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

Where r = discount rate

n = number of periods

Discount rate (r)

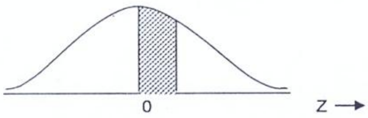
Periods

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

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

NORMAL DISTRIBUTION

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



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

SOLUTION 1

a.(i) **Types of synergistic benefit**

Synergistic benefits can generally be broken down into three main types, which are

- Revenue synergies;
- Cost synergies; and
- Financial synergies.

These can be considered in the context of the acquisition of K3 by AP.

Revenue synergies: These result in higher revenues for the combined entity and higher return on equity. Examples of these include:

- Elimination of inefficiency – The greater strength of AP's marketing department could also help to enhance K3's market penetration;
- Market Power - Horizontal combinations (the type in the scenario) can enable a company to dominate a market. This is one of AP's main objectives in acquiring K3, to become the market leader in the region; and
- Customer satisfaction – customers will benefit from speedier deliveries, leading to increased customer satisfaction and growth in sales.

Cost synergies: These result mainly from reducing duplication of functions and related costs. In this scenario:

- Economies of scale - Savings could be made in respect of existing operations in Togo by using K3's distribution network to service customers of K1 and K2, saving transport costs and reducing delivery times. Savings could also be made by removing some local administration in areas such as marketing and finance, combining these operations more efficiently on a centralised basis;
- Complementary resources – Increases in efficiency may also be possible by using AP's knowledge and expertise to improve the efficiency of operation of K3; and
- Bulk purchase of key supplies – leading to bulk purchase discount.

Financial synergies: These are the type of synergies that result from lowering the cost of capital, which include:

- Diversification: Given that K3 is in a market in which AP already operates it is unlikely that there will be any significant benefit of diversification;
- Debt finance: It is possible that post acquisition K3 may be able to secure cheaper debt finance as a result of being part of a larger group. This would lead to an increase in earnings and a reduction in the cost of capital;

- Surplus cash: AP has significant cash in its statement of financial position at 31 December 2020 and therefore, acquiring K3 enables AP to obtain higher returns from this surplus cash.

(ii) **Possible reasons for failure to achieve expected benefits**

Reasons why the acquisition might fail to meet expectations are:

Lack of fit syndrome

The success of the acquisition depends on the ability of the current management of K3 to work within AP's management structure and culture.

Lack of industrial or commercial fit

There is also a risk that K3's reputation/intangible value is not as high as anticipated or that the distribution network cannot easily be adapted to accommodate the needs of K1 and K2.

Integration costs too high

Turn-around costs to adapt the distribution network and integrate K3 management and systems might prove to be considerably higher than estimated, undermining the expected financial benefits of the acquisition.

Price paid too high

It would clearly also affect expected returns if the price agreed proves too high in relation to the actual value of K3 to AP. There is a risk that AP over-values K3, especially given the assumption of growth in perpetuity – the longer the time frame, the less reliable the forecast.

Failure to integrate

There may be technical or logistic reasons why the distribution networks could not be integrated or management and systems combined.

Inability to manage change

Careful planning and management is required to oversee the change process. AP has much experience of acquiring companies and managing change and so it is likely that it would have the necessary expertise to be able to manage change effectively.

a) i) **WACC for use by K3 following acquisition**

- Ungear the proxy company's equity beta i.e. convert equity beta to asset beta.

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

$$= \frac{65 \times 1.7}{65 + 35(1-0.30)} + \frac{35(1-0.3) \times 0.4}{65 + 35(1-0.30)} = 1.3441$$

- Regear beta i.e. convert the asset beta to equity beta – using AP's D:E ratio and its debt's beta:

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

$$= 1.3441 + (1.3441 - 0.3)\left(\frac{25}{75}\right)(1-0.3) = 1.5877$$

- Use CAPM to calculate cost of equity (K_E)

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

  $= 5 + (1.5877 \times 4) = 11.35\%$

- Compute WACC

  WACC = $(11.35 \times 0.75) + 6.2(1 - 0.3)(0.25) = 9.60\%$

Alternative approach to calculating WACC

- First ungear the proxy company's asset beta as above = 1.3441
- Use CAPM to calculate K_{EU}, i.e. the cost of equity if the company has no debt finance: $K_{EU} = R_F + \beta_A(R_M - R_F)$

  $= 5 + 1.3441(4) = 10.376\%$

- Calculate $WACC_g$ – using the formula:

$$WACC_g = K_{EU}\left(1 - \frac{V_D t}{V_g}\right)$$

$$= 10.376\left(1 - \frac{25 \times 0.3}{75 + 25}\right) = 9.60\%$$

(Notes: $K_{EU} = WACC_U$, $V_g = V_{EG} + V_D$, using the given D:E ratio of AP)

ii) **Calculate a number of values for K3**

Asset based approach	T$ million
Net asset value:	665
Less borrowings	(375)
Book value of equity	290

Alternative approach	T$ million
Share capital	90
Reserves	200
Book value of equity	290

P/E based approach

The P/E valuation is based on earnings (profit after financing costs and tax), so first calculate earnings:

	T$ million
Operating profit	75
Less financing costs	(26) (= T$375 million x 7%)
	49
Less tax at 30%	(15)
Earnings	34 (= profit after tax)

	Value of K3 in T$ million
At the proxy company's P/E of 12:	408 (= 12 x 34 m)
At AP's P/E of 14 (bootstrapping):	476 (= 14 x 34 m)

DCF approach

- **Excluding synergy (T$ million)**

PV of free cash flow to the firm (FCFF) = $FCFF_1$/(WACC - g)

= 54.60/(0.096 – 0.04) = 975

Less borrowings		375
Total value of equity		600

- **Including synergy (T$ million)**

Total as above		600
- One-off synergy = 8/1.096 =	7.3	
- Perpetual synergy = (5/(0.096 – 0.04))/1.096 =	81.5	88.80
		688.80
Or (say)		689

Summary of results

Method	Value of equity T$ million
Asset	290
P/E (using proxy company's P/E)	408
P/E (using P plc's P/E, ie bootstrapping)	476
DCF excluding synergistic benefits	600
DCF including synergistic benefits	689

Examiner's report

The question tests many aspects of acquisition and related business valuation. In part (a) (i), candidates are expected to identify the types of synergistic benefits expected from the given acquisition. In part (a) (ii), candidates are expected to explain why it might be difficult to achieve synergistic benefits in practice.

In question (b) (i), candidates are expected to calculate risk-adjusted WACC needed for the valuation. In question (b) (ii), candidates are expected to value the equity of the company using different valuation methods.

Being a compulsory question, large number of the candidates attempted it but the level of performance was disappointingly low.

Question (a) (i) that was designed to be mark booster was badly attempted in the sense that candidates provided generic solutions having no bearing to the scenario painted in the question.

In question (b) (i), candidates lost easy marks due to the following factors:

- Use of wrong formulae in the process of **'ungearing'** (computing asset beta) and **'regearing'** (computing equity beta); and
- Poor understanding of the various financial gearing formulae: D/E ratio, D/(E + D) ratio, etc. and when to use each one of them.

In question (b) (ii), candidates lost marks due to their:

- Failure to adjust the operating earnings (i.e. EBIT) for interest and tax, when doing valuation using P/E ratio; and
- Failure to make use of the appropriate formulae when discounting the cash flows with delayed growth.

Candidates are advised to practise past questions, using the pathfinder and cover the syllabus comprehensively, when preparing for future examinations.

Marking guide

			Marks	**Marks**
a.	(i)	Explanation on types of Synergistic benefits	8	8
	(ii)	Discussion on possible reasons for failure to achieve expected benefits	4	4
b.	(i)	Ungearing the proxy company's equity beta to get asset beta	2	
		Regearing the above asset beta	2	
		Computation of CAPM to get cost of equity	1	
		Computation of WACC	1	6
	(ii)	Computation of value of equity using asset based approach	2	
		Computation of value of equity using P/E approach	5	
		Computation of value of equity using DCF approach	5	12
		Total		**30**

SOLUTION 2

a) **Rights issue**

A rights issue is an issue of new shares for cash to existing shareholders in proportion to their existing holdings.

Convertible loans

A convertible loan (or bond) is a loan stock that can be converted, at the option (but not the obligation), of the holder (i.e. the lender) into ordinary shares of issue (i.e. the borrower) on or before the maturity of the loan.

b) The theoretical ex-rights price is computed as follows:

	₦
5 existing shares@₦3 =	15.00
1 new share@₦2.50 =	2.50
6	17.50

Ex – right price ₦17.50/6 = ₦2.92

The actual market value of the shares may be different from the theoretical price for the following reasons:

- The existence of specific information (positive or negative) regarding the company or its sector at the time of the issue;
- The information regarding the use to which the proceeds will be put and the market's reaction to that information; and
- The expectations of investors/ the stock market regarding the company's future.

c) **REPORT**

To	The Board of Balama Plc
From	Goodhead Kay, Financial Consultant
Date	16 November 2022
Subject	Financing expansion plans

Rights issues

For an established listed company, rights issues are much more popular for the following reasons:

- Rights issues are relatively cheap to make, perhaps less than half as expensive as a public issue;
- The issue price is relatively unimportant. Since all existing shareholders benefit from the cheap price in proportion to their shareholding, there is no disproportionate gain. The company needs to make the rights price significantly cheaper than the market price. This puts pressure on shareholders to take up the shares or to sell them to an investor who will. Thus, rights issue tend not to fail, i.e. the shares tend to be issued and the required cash raised;
- Control tends to stay with the existing shareholders;

- The need to discount the offer price to ensure that the issue is fully subscribed and to cover the possibility that the market price of shares might fall between the announcement of the rights issue and its conclusion; and
- The use of rights issue leaves the credit line free to finance further expansion and enables the non-current assets to be used to secure other lines of finance, if required.

It seems as if a rights issue would provide a cheaper and more practical way for the company to raise the funds for the expansion.

Convertible loan stock issue

Convertibles are a mixture of loan and equity financing. They are issued as loan stocks with the right to convert them into equity shares of the same company at some pre-determined rate and date.

From the investors' point of view they are relatively safe, in that there is a close-to guaranteed interest payment periodically and a right to convert to equity, if it is beneficial to do so.

From the company's viewpoint they are attractive because:

- Cheap to issue: Loan stock is generally cheap to issue, so it becomes, if all goes well, a cheap way of issuing equity;
- Loan finance is relatively cheap to service because of the tax-deductibility of interest charges; and

- They are self-liquidating, provided the holders convert, the loan liquidates itself through an equity issue, which saves the company the problem of raising the cash to replace the expiring loan stock.

Disadvantages of any type of loan financing include:

- The likely need to provide security for the loan; and
- The possibility that lenders will impose covenants, for example, restricting the level of dividends and/or insisting on a minimum liquidity ratio.

Raising finance, unless it is from a mixture of debt and equity, will affect the level of gearing, with probable implications for the risk/return profile and the cost of capital.

Examiner's report

The question tests the candidates' knowledge of rights issues and convertible loans. The candidates are expected to compare rights issues and convertible loans as sources of finance.

Almost all the candidates attempted the question.

Most of the candidates did fairly well in parts (a) and (b) of the question but performance in part (c) was far below expectation.

Candidates failed to gain good marks because they were discussing equity finance (rather than rights issue) and debt finance (rather than convertible loans).

At this level of the examination, candidates must understand that they are required to answer the question asked and not the question they wanted.

Marking guide

		Marks	Marks
a.	Explanation of Right Issues	1½	
	Explanation of Convertible loans	1½	3
b.	Computation of the theoretical ex-rights	2	
	Discussion on why the actual price might be different	2	4
c.	Report address	1	
	Evaluation of the right issues financing method	6	
	Evaluation of the convertible loan financing method	6	13
	Total		**20**

SOLUTION 3

a) Required return on equity = 5% + 0.8(15% - 5%) = 13%

b) The beta is a measure of the extent to which historic movements in ZK's share price have correlated with average market returns. A beta of less than 1 means that the share price is less volatile than the market. Thus, at 0.8, it means that if the market index rises by 10% then on average the share price of ZK would be expected to increase by 8%.

   This argument does not however mean that the required rate of return on ZK's shares also moves in direct proportion to the required return on the market as this is also affected by the risk free rate.

c) Cost of preference shares = $\frac{9}{90} = 10\%$

   Total value = ₦50m × 0.9 = ₦45m

   Cost of debt

   Working with face value of ₦100 nominal

   With 1 year to redemption, the following formula can be used to calculate the cost of debt:

$$K_D = \frac{EV}{BV} - 1, \qquad \text{where:}$$

   EV = total cash flow expected in year 1

   = redemption value (₦100) + year 1's interest, net of tax (₦5.60) = ₦105.60

   BV = current market value = ₦100.57

   ∴ K_D = (105.60/100.57) – 1 = 5%

   Total value = ₦250m × (100.57/100) = ₦251.43m

   Calculation of WACC

Capital	**Total value**	**Cost**	**Hash total**
	₦m	**%**	**₦m**
Equity	600.00	13	78.00
Pref shares	45.00	10	4.50
Loan stock	251.43	5	12.57
	896.42		95.07

   WACC = 95.07/896.43 = 10.61%

d) There are three major factors occurring during 2021 which may impact upon the beta of ZK Plc. These are:

   - The opening of a new business venture in campsites;
   - The financing of the new venture with a new issue of bonds; and
   - The refinancing of the existing debt which is redeemable in 2021.

The new business venture

The new business venture is significantly different from the existing business. This is indicated by the low correlation of the returns of the two businesses.
The low correlation may diversify the unsystematic risk of the business, but its impact on the beta of the company is uncertain. This will depend on the correlation of the returns on the campsite project with the market portfolio - not their correlation with existing company returns.

Ignoring the impact of debt financing, this new equity beta will be the weighted average of the existing beta and the beta of the new project.

Financing for the new project

The new debt finance will increase financial gearing and thus increase the variability of equity returns on the project and for the company as a whole. If the equity returns become more variable in relation to the market index, then this will increase the equity beta, although the total risk to debt and equity will be unaffected.

Refinancing existing debt

The impact of refinancing on the beta will depend on the type of financing used to redeem the existing debt - if any. If there is like-for-like replacement with new debt, then there will be a minimal impact on the beta, although the terms of the replacement debt instruments may differ.
If however, the debt is redeemed - totally or partially - with new equity then this will reduce gearing, reduce the volatility of equity returns and thus lower the beta.

Other factors

Betas are based on historic returns and may not be stable over time. Past betas are, thus, not necessarily a good guide to the future, as they are affected by random events in relation to the company and the market. Even without the significant operational and financial changes in ZK plc in 2021, the beta would thus be likely to change anyway through normal ongoing events in the farming industry. The direction of change would, however, be indeterminant.

Summary

The new beta will be the weighted average of the beta on the existing farming business and the beta of the new leisure business. Both of these may change over time.

Examiner's report

This four-part question tests candidates' knowledge of various aspects of cost of capital.

In part (a), candidates are expected to compute cost of equity, using CAPM.

In part (b), candidates are expected to interpret beta factor of 1.

Part (c) tests candidates' knowledge of the calculation of WACC.

Finally, part (d) demands that candidates should identify specific factors that drive beta factor.

A very high proportion of the candidates attempted the question but performance was only average.

Almost all the candidate that attempted the question scored the full marks of part (a). On the contrary however, none of the candidates could give meaningful interpretation of beta of 1 in part (b).

About 40% of the candidates did very well in part (c).

Candidates that lost marks in this part of the question did so because of the following common errors:

- Computations based on book values rather than market values;
- Wrong calculations of market values;
- Candidates ignoring tax when computing cost of debt; and
- Some candidates applying tax to the calculation of cost of preference shares, etc.

Large number of the candidates could not provide acceptable solutions to part (d).

It is important that candidates should make efforts to solve past examination questions when preparing for the examination in the future.

Marking guide

		Marks	Marks
a.	Computation of required return on equity	3	3
b.	Explanation of the implication of beta less than 1	2	2
c.	Computation of cost of preference share	1	
	Computation of total value of preference share	1	
	Computation of the total cash flow expected in year 1 loan stock	1	
	Computation of cost of debt	2	
	Computation of the total value of loan stock	1	
	Calculation of WACC	4	10
d.	Identification and explanation of factors that may change equity beta	5	5
	Total		**20**

SOLUTION 4

a) Both Directors are correct to a point but are failing to see the whole picture.

The Marketing Director is correct in her interpretation of the calculated NPV. The NPV can normally be interpreted as showing the impact of a project on shareholder wealth, so a negative NPV would indicate that the investment would erode shareholder value and should thus be rejected.

The Finance Director (FD) is correct to point out a weakness of conventional NPV analysis. High uncertainty is usually reflected in a higher discount rate and hence a lower NPV. However, greater uncertainty will usually result in higher option values, so the FD is correct to suggest that option values must be incorporated and that TK has an option to delay investment, giving a call option.

The FD is wrong to suggest that ignoring options is the only weakness of NPV. A more complete analysis would also try to incorporate non-financial factors such as the possible implications for TK's image with alcoholic research laboratories (targeting the younger generation). Some investors and customers may object to this link and hence future sales would be compromised.

b) Using the Black-Scholes model for European call options (₦million)

- Time, t = 1
- S_0 = PV of future cash flows = 4,500
- E = the exercise price = cost of investment = 250 + 4,500 = 4,750
- Interest rate = 0.05
- Volatility = 0.35

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

$$= \frac{\text{In}\,(4500/4750) + (0.05 + 0.5 \times 0.35^2)(1)}{0.35 \times \sqrt{1}} = 0.1634$$

$d_2 = d_1 - \sigma\sqrt{T} = 0.1634 - 0.35 \times \sqrt{1} = -0.1866$

$N(d_1) = 0.5 + [0.0636 + 0.34\,(0.0675 - 0.0636)] = 0.5649$

$N(d_2) = N(-0.1866) = 1 - N(0.1866)$

$= 1 - [0.5 + [0.0714 + 0.66\,(0.0753 - 0.0714)]]$

$= 1 - 0.5740 = 0.4260$

Inputting data into call formula:

$C_0 = S_0\,N(d_1) - Ee^{-rt}N(d_2)$

$= 4{,}500\,(0.5649) - 4750e^{-0.05\,(1)} \times 0.426 = 617.24$

Recommendation

The high value of the call option would suggest that the offer of a licence should be accepted.

c) The Black - Scholes model was developed for European options. As production could commence at any time during the 1 year period the option is an American option rather than a European option.

It can be argued that, where there is no dividend payable and where time value still exists, it is worthwhile holding an American option to expiry and thus the valuation as a European call is valid.

In this case, however, it is likely that investment would be commenced (i.e. the call option exercised) as soon as the forecast NPV became positive due to revised forecasts. The valuation as a European call would thus give a lower limit on the value of the option to delay.

Examiner's report

The entire question 4 tests candidates' knowledge of real options.
In part (a), candidates are expected to explain the impact of real option on net present value of a capital project. In part (b), candidates are expected to value a call option on a capital project – using Black-Scholes Option Pricing Model.
Part (c), tests the candidates' knowledge on the practical limitations of the above model.

Less than 5% of the candidates attempted the question. Their performance indicates lack of knowledge of this area of the syllabus.

It is recommended that students preparing for the Institute's examination should not neglect any section of the syllabus.

Marking guide

		Marks	Marks
a.	Commenting on the marketing and finance Directors views	5	5
b.	Stating time correctly	½	
	Stating PV of future cash flows	½	
	Computation of exercise price	½	
	Stating interest rate correctly	½	
	Stating volatility rate correctly	½	
	Computation of d_1	2½	
	Computation of d_2	½	
	Computation of $N(d_1)$	1½	
	Computation of $N(d_2)$	1½	
	Computation of call options	1	
	Recommendation	½	10
c.	Explanation on modelling the possibility of delay as a European call option	5	5
	Total		**20**

SOLUTION 5

a)

Year	**1**	**2**	**3**	**4**	**5 – Infinity**
	₦m	**₦m**	**₦m**	**₦m**	**₦m**
Sales (see workings)	84.00	87.40	90.00	91.80	91.80
Operating profit	6.72	7.87	9.00	9.18	9.18
Tax at 20%	(1.34)	(1.57)	(1.80)	(1.84)	(1.84)
Depreciation	2.00	2.00	2.00	2.00	2.00
Operating cash flow	7.38	8.30	9.20	9.34	9.34
Replacement non-current assets	(2.00)	(2.00)	(2.00)	(2.00)	(2.00)
Capital expenditures	(0.20)	(0.20)	(0.08)	(0.04)	(0.00)
Working capital	(0.24)	(0.17)	(0.10)	(0.07)	(0.00)
Free cash flow	4.94	5.93	7.02	7.23	7.34
PVF at 10%	0.909	0.826	0.751	0.683	6.830*
PV	4.49	4.89	5.27	4.94	50.10

	₦m
Total PV	69.69
Add short-term investment	0.80
Less market value of debentures = ₦10m × 95/100 =	(9.50)
Total value of equity	60.99

(* Annuity factors at 10% years 5 – infinity)

Workings

Year	0	1	2	3	4	5 - Infinity
	₦m	₦m	₦m	₦m	₦m	₦m
Sales*	80.0	84.0	87.4	90.0	91.8	91.8
Sales increase	-	4.0	3.4	2.6	1.8	0
Capital expenditure*	-	0.20	0.20	0.08	0.04	0
Additional working capital*	-	0.24	0.17	0.10	0.07	0

(* applying the given rates)

b) An MBO can be financed using the following methods

i) **Private loan**

Members of the buyout team use unsecured and secured personal loans to fund the MBO. For secured lending, team members will provide their homes, pension plans and other non-cash assets as collateral;

ii) **Business loan**

Business loans from bank or finance companies may be obtained to fund the transaction. Depending on the track record and the type of business being purchased, unsecured lending may be possible. However, unsecured lending is generally much smaller than secured lending and, in many cases, the lender will take a lien on the company and all its assets, including its sales ledger, to secure the borrowing. Loan terms are typically 3 to 5 years.

iii) **Asset finance**

Leveraging against the assets in the company, such as property, stocks, or receivables. If the business owns substantial assets, those assets may be used as collateral for borrowing. This type of arrangement is called a leveraged buy-out, as the company's assets are leveraged to buy out the old owner.

iv) **Private equity (PE)**

This is a steadily increasing source of finance even at the smaller end of the market. Cash is provided by venture capitalists, hedge funds and private investors in exchange for shares, board seats, dividends, fees, and varying degrees of control.

v) **Mezzanine finance**

A hybrid of debt and equity financing that gives the lender the right to convert to an equity interest in the company in case of default, generally, after venture capital companies and other senior lenders are paid.

vi) **Seller loan**

Also called vendor loans. The seller helps to fund the transaction by leaving some of their consideration in the company as loan notes to be repaid over time. In effect, their ownership reduces over an extended period. The old owner may retain a degree of control until they are completely paid out.

(Note: For a question of 3 marks, the above points are certainly too detailed. They are included for educational purposes).

Examiner's report

This question tests candidates' knowledge of the computational aspect of shareholder value analysis (SVA). Candidates are expected to calculate the freecash flow using SVA and value the company.

Only very few candidates attempted the question. Based on the candidates performance level, it is clear that candidates do not have any knowledge of the subject matter. Performance in the question was therefore extremely poor.

It cannot be overstated that students need to cover the syllabus comprehensively before presenting themselves for the examination in the future.

Marking guide

	Marks	**Marks**
Computation of sales	1	
Computation of operation profit	1	
Computation of tax	1	
Computation of depreciation	1	
Computing replacement of non-current assets	1	
Computation of capital expenditure	1	
Computation of working capital	1	
Computation of free cashflow	1	
Computation of PVF	1	
Computation of PV	1	
Computation of value equity	2	12
Discussion on methods of raising funds for the proposed MBO of the company	3	3
Total		**15**

SOLUTION 6

a) **Price-earnings ratio**

The price earnings (P/E) ratio is regarded by many as the most important yardstick for assessing the relative worth of a share. It is calculated as:

$$\frac{\text{Market price of share}}{\text{EPS}} = \frac{\text{Total market value of equity}}{\text{Total earnings}}$$

The P/E ratio is a measure of the relationship between the market value of a company's shares and the earnings from those shares. It is an important ratio because it relates two key variables for investors, the market price of a share and its earnings capacity.

Stock market appraisal

The value of the P/E ratio reflects the market's appraisal of the share's future prospects. In other words, if one company has a higher P/E ratio than another it is because investors either expect its earnings to increase faster than the other's, or they consider that it is a less risky company or in a more secure industry.

Influence of market efficiency

The level of the ratio will change directly in response to changes in the share price and may vary widely during the course of the year as events alter investors' perceptions. The extent and timing of changes will depend on the efficiency of the market; the stronger the level of efficiency, the more the market will be able to anticipate events.

Comparisons

Earnings potential is strongly related to the sector in which the business operates, and therefore P/E comparisons are only valid in respect of companies in the same market sectors. They can be used in this case since all the companies are publicly quoted food retailers.

Price earnings ratios of companies being compared

Using the information given in the table, the P/E ratio for B is 13.0. This means that it would take thirteen years for the earnings from the share to equal the price paid for it. The ratio for C is 21.1, the higher ratio meaning that the time taken for the earnings to equal the price of the share is 21.1 years. The reason for the higher level is that investors expect earnings from C to rise at a faster rate than those from B. The P/E ratio gives no indication of itself as to why earnings are expected to increase at different rates, although possibilities include superior management quality or more aggressive investment plans.

A has a current share price of 63 kobo and a P/E ratio of 14.2. Earnings for last year were therefore 4.437 kobo per share (63/14.2). At its high point for the year when the share price was 112, the P/E ratio was 25.2, while at its low point, the

P/E ratio was 12.2. The figures also demonstrate that C has the lowest level of volatility, B the highest. This appears to reinforce the point made above that investors are confident about C's prospects (hence the P/E ratio has not altered much over the year), but are rather less sure about B's future.

b) **Dividend cover**

The dividend cover is the number of times that the actual dividend could be paid out of current profits. It indicates the proportion of distributable profits for the year that is being retained by the company and the level of risk that the company will not be able to maintain the same dividend payments in future years, should earnings fall.

Calculation of dividend cover

In this case, the ratio must be approached by means of the dividend yield and the P/E ratio:

$$\frac{P}{E} = \frac{\text{Market share price}}{\text{Earnings}}$$

$$\text{Div yield} = \frac{\text{Dividend paid}}{\text{Market share price}}$$

$$P/E \times \text{Div yield} = \frac{\text{Dividend paid}}{\text{Earnings}} \text{(since the market share price cancels out)}$$

This is the inverse of the dividend cover, and therefore:

Dividend cover = 1÷ (P/E × div yield)

a.	P/E	Div yield	P/E × div yield	Dividend cover
b.	21.1	2.3%	0.4853	2.06 times
c.	13.0	2.1%	0.2730	3.66 times

Comparisons

As, with the P/E ratio, comparisons with other companies in the same sector are a lot more valuable than comparisons with companies in different sectors, as the 'typical rate' for different business sectors will vary widely.

Dividend covers of companies being compared

The lower level of dividend cover for C means that the company has paid out nearly half of its earning in the form of dividends, while B has only paid out less than one third. This suggests that B has retained a higher proportion of profits for reinvestment within the business. If earnings are very volatile, the figures could suggest that C might have problems in continuing to payout dividends at this level in the future.

However as indicated above, the market appears confident about C future, and rates C rather lower despite B retaining more funds for future expansion.

Examiner's report

This question tests candidates' knowledge of key capital market financial ratios. Part (a) of the question asks the candidates to explain and illustrate P/E ratio. Part (b) asks candidates to calculate and explain dividend cover.

More than 80% of the candidates attempted the question and surprisingly the level of performance was very poor.

Almost all the candidates who attempted the question could not correctly calculate dividend cover. More disappointly however, very large proportion of the candidates could not give meaningful interpretation of the two ratios.

It is recommended that candidates should always practise with past questions and, in addition, read financial papers when preparing for future examination.

Marking guide

		Marks	Marks
a.	Definition and explanation of P/E ratio	2	
	Comment on the way P/E ratio may be used by investor to appraise a possible share purchase	6	8
b.	Meaning of dividend cover	1	
	Calculation of dividend cover for C and B	4	
	Significance of the measure of dividend cover for C and B for investment purpose	2	7
	Total		**15**

SOLUTION 7

a) To: Chairman

From: Finance Director

Date: 15 June 2021

Subject: Proposals aimed at maximisation of the share price

Further to our recent discussions, I agree fully with your desire to seek the maximisation of the company's share price and therefore its market capitalisation.

However, although I agree that a relationship does exist between reported profits, earnings per share and the share price, short-term are not in themselves the principal driver of the share price.

In reality, assuming a reasonably efficient market, the maximisation of the share price will be brought about by the maximisation of the present value of the future cash flows. The most effective way to increase the share price therefore is to concentrate on making investments that generate a positive net present value (NPV) when discounted at the cost of capital.

I believe that some of the current proposals could damage the position of some of the groups of stakeholders in the firm and could even have a negative impact on the share price.

i) Delaying payments to creditors beyond the terms allowed could have a number of damaging effects, which include:
   - Valuable discounts may be lost and credit charges incurred;
   - The credit rating of the company could be damaged making it difficult to obtain further credit from new suppliers in the future, or from other sources of finance; and
   - Supplies of materials could be jeopardised if the company's orders are moved down the priority list or even placed 'on stop'.

ii) As explained above, it is necessary to undertake investments that generate a positive NPV in order to maximise the share price. Minimising capital expenditure in order to boost short-term profits could therefore mean that some important opportunities are missed. This in turn means that the value of the company will be lower than it could be, which will impact badly on the share price. It could also adversely affect the position of other stakeholders such as employees and suppliers.

iii) Regarding the Oloro II project, stringent controls on pollution exist, and the company must be certain that any delay in expenditure on measures to reduce pollution will not result in environmental standards such as discharge consents being breached. If this does happen, then the company will be liable for financial penalties, and again the standing in the local community will be damaged. If the problems are severe, then the company could come under pressure from environmental pressure groups which could result in more widespread damaging publicity.

iv) Pegging back wages is likely to damage the morale of the employees, and could result in good employees being lost, while at the same time making it harder to recruit the right people. If morale is badly affected this could also affect both quality and the efficiency of production. Abandonment of charity sponsorship is likely to meet with opposition, not only from employees involved in the events, but also from the wider community which has previously relied on the company's support. This will in turn damage the standing of the firm in the local community.

I would be pleased to discuss these issues with you further, and to consider some alternative approaches to increasing the share price.

Signed
Finance Director

b) The achievement of stakeholder objectives by managers can be encouraged by managerial reward schemes, for example, share option schemes and performance-related pay (PRP), and by regulatory requirements, such as corporate governance codes of best practice and stock exchange listing regulations.

Share option schemes

The agency problem arises due to the separation of ownership and control, and managers pursuing their own objectives, rather than the objectives of shareholders, specifically the objectives of maximising shareholder wealth. Managers can be encouraged to achieve stakeholder objectives by bringing their own objectives more in line with the objectives of stakeholders such as shareholders. This increased goal congruence can be achieved by turning the managers into shareholders through share option schemes, although the criteria by which shares are awarded need very careful consideration.

Performance-related pay

Part of the remuneration of managers can be made conditional upon their achieving specified performance targets, so that achieving these performance targets assists in achieving stakeholder objectives. Achieving a specified increase in earnings per share, for example, could be consistent with the

objective of maximising shareholder wealth. Achieving a specified improvement in the quality of emissions could be consistent with a government objective of meeting international environmental targets.
However, PRP performance objectives need very careful consideration if they are to be effective in encouraging managers to achieve stakeholder targets. In recent times, long-term incentive plans (LTIPs) have been accepted as more effective than PRP, especially where a company's performance is benchmarked against that of its competitors.

Corporate governance codes of best practice

Codes of best practice have developed over time into recognised methods of encouraging managers to achieve stakeholder objectives, applying best practice to many key areas of corporate governance relating to executive remuneration, risk assessment and risk management, auditing, internal control, executive responsibility and board accountability. Codes of best practice have emphasised and supported the key role played by non-executive directors in supporting independent judgement and in following the spirit of corporate governance regulations.

Stock exchange listing regulations

These regulations seek to ensure a fair and efficient market for trading company securities such as shares and loan notes. They encourage disclosure of price-sensitive information in supporting pricing efficiency and help to decrease information asymmetry, one of the causes of the agency problem between shareholders and managers. Decreasing information asymmetry encourages managers to achieve stakeholder objectives as the quality and quantity of information available to stakeholders gives them a clearer picture of the extent to which managers are attending to their objectives.

Monitoring

One theoretical way of encouraging managers to achieve stakeholder objectives is to reduce information asymmetry by monitoring the decisions and performance of managers. One form of monitoring is auditing the financial statements of a company to confirm the quality and validity of the information provided to stakeholders.

Note: Only four ways to encourage the achievement of stakeholder objectives were required to be discussed.

Examiner's report

This is a two-part question. Part (a) tests candidates' knowledge of the concept of short-termism in finance. In part (b), candidates are expected to discuss ways and means of reducing agency problems in finance.

Almost all the candidates attempted the question and the level of performance was above average.

Effective revision, using past questions and the pathfinder will always enhance candidates' performance in the examination.

Marking guide

		Marks	Marks
a.	Report on the possible consequences of the proposal	9	9
b.	Discussion on ways that encourage managers to achieve stakeholders objectives	6	6
	Total		**15**

ICAN/222/V/C2 Examination No..........................

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA | Accuracy and Integrity

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2022

ADVANCED AUDIT AND ASSURANCE

EXAMINATION INSTRUCTIONS

PLEASE READ THESE INSTRUCTIONS BEFORE THE COMMENCEMENT OF THE PAPER

1. Check your pockets, purse, mathematical set, etc. to ensure that you do not have prohibited items such as telephone handset, electronic storage device, programmable devices, wristwatches or any form of written material on you in the examination hall. You will be stopped from continuing with the examination and liable to further disciplinary actions including cancellation of examination result if caught.

2. Write your **EXAMINATION NUMBER** in the space provided above.

3. Do **NOT** write anything on your question paper **EXCEPT** your examination number.

4. Do **NOT** write anything on your docket.

5. Read all instructions in each section of the question paper carefully before answering the questions.

6. Do **NOT** answer more than the number of questions required in each section, otherwise, you will be penalised.

7. All solutions should be written in **BLUE** or **BLACK INK**. Any solution written in **PENCIL** or **RED INK** will not be marked.

WEDNESDAY, NOVEMBER 16, 2022

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2022

ADVANCED AUDIT AND ASSURANCE

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

1. Mr. Johnson is the Senior Partner of Johnson, Odewole, Thomas & Co., Chartered Accountants. During the last audit of Mandarin Manufacturing Plc, which the firm did with Messrs Ark Professional Services (APS) for the year ended 30 September, 2020, Mr. Johnson expressed displeasure on some of the conclusions reached by APS on some of the audit areas. In putting the work together, Mr. Johnson's manager in charge of the audit had drawn his attention to matters which had been marked "For Partner's Attention". His discussions on the treatment of these matters with the corresponding partner of APS was considered unsatisfactory.

   The view of Mr. Johnson was significantly different from that of the corresponding partner of APS. It was agreed to proceed to the board meeting where these disputed positions would be presented and discussed with the directors before final position would be reached. Of significance to the issues is the acquisition of a property from a former staff for the opening of a new branch warehouse. The acquisition process was hurriedly done and with an amount in excess of the capital expenditure provisions for the period. The view of Mr. Johnson's team is that the acquisition is a fraud on the company while APS aligns with the director of finance that it is a normal transaction.

   At the board meeting to discuss the financial statements, members were divided on the sides of the two firms and the chairman asked for a rescheduling of the meeting to enable him to be furnished with additional information on the basis of the positions of both parties and for both parties to harmonise their positions prior to a subsequent meeting the following day.

Required:

a. Evaluate the justification or otherwise of an entity having joint auditors. (8 Marks)

b. Following the concerns of Johnson, Odewole, Thomas & Co., present the options available to the firm. (5 Marks)

c. Discuss the points on which the Chairman needs to base his decision, according to standard acquisition procedures. (7 Marks)

d. If the Chairman agrees with the position of Johnson, Odewole, Thomas & Co, determine the reporting requirement and draft an appropriate report for inclusion in the auditors' report. (6 Marks)

e. Discuss the composition of items that could be marked "For Partner's Attention" during the conclusion of an audit process. (4 Marks)

(Total 30 Marks)

SECTION B: OPEN-ENDED QUESTIONS (40 MARKS)

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

QUESTION 2

The Financial Controller (FC) of Poki Limited made an observation on the draft engagement letter sent by the external auditors to the company, an extract of which is as stated below.

"The responsibility for safeguarding the assets of the company and for the prevention and detection of fraud, error and non-compliance with laws or regulations rests with the company's directors. In accordance with auditing standards, we shall endeavour to plan our audit so that we have a reasonable expectation of detecting material misstatements in the financial statements or accounting records (including any material misstatements resulting from fraud, error or non-compliance with laws or regulations). However, because any internal control structure, no matter how effective, cannot eliminate the possibility that errors or irregularities may occur and remain undetected and because we use selective testing in our audit, we cannot guarantee that errors or irregularities, if present, will be detected. Accordingly, our audit should not be relied upon to disclose all such material misstatements or frauds, errors or instances of non-compliance as may exist. The best safeguard against irregularities and fraud is a sound system of internal control.

We will report to you from time to time on any significant weaknesses in controls which come to our notice and which ought to be brought to your attention. The matters raised in any report to you are not necessarily a comprehensive statement of all weaknesses that exist or of all improvements that should be made".

The FC accused the auditors of running away from their responsibilities of exposing to the owners of the company fraudulent financial reporting and misappropriation of assets. To him, what is the purpose of audit when fraud and errors could not be discovered. He has threatened to discuss with the Board of Directors and insists that the engagement letter will not be signed until those sections are removed. You are a senior member of the audit team.

Required:

a. Outline the objectives of auditors in relation to fraud. (6 Marks)

b. Explain fraudulent financial reporting and misappropriation of assets. (7 Marks)

c. State the procedures auditors should perform to identify the risks of material misstatement due to fraud. (7 Marks)

(Total 20 Marks)

QUESTION 3

During the audit of Kofo Plc in 2018, it was observed that there was an omission of liability to the tune of ₦2 billion. Upon investigation, it was discovered that the error was as a result of unrecorded liability relating to unremitted statutory taxes to the government in prior years. A compensating error was noticed in unsubstantiated investment and receivables balances schedule provided by the management.

The explanation provided by management for this error was that having noted this disparity, the internal audit team was commissioned to reconcile the ledger balances to establish the actual payment to be made to government. The result of that exercise led to an initial adjustment of ₦500 million. However, upon further review by the Internal Audit and Risk Management team, the total disparity noted was ₦5 billion as opposed to the ₦2 billion initially noted. The reason being that the report with which the Internal Audit Team carried out the reconciliation was understated. Some liability balances were excluded from the report as a result of the approach used to set-up the Information System (I.T) System. Therefore, the general command entered into the system to spool the report did not capture the entire transactions. To gain comfort, the audit team:

(i) Reviewed the reconciliation memo to have an understanding of management's thought process;

(ii) Requested for the updated spool of ledger balances from the I. T system;

(iii) Asked the Information Technology team to perform walkthrough test of the transaction spool;

(iv) Requested for the breakdown of the excluded balances and traced them to the supporting documents to which they relate; and

(v) Checked to see that there were no unusual remittances from the bank statements.

You are a member of the audit team which reviewed Kofo Plc's compliance with International Standards on Auditing (ISA 250) on Non-Compliance with Laws and Regulations (NOCLAR).

Required:

a. Outline the audit procedures to be performed to help identify instances of non-compliance with laws and regulations. (5 Marks)

b. State what the auditor should do when he becomes aware of issue of non-compliance with laws and regulations. (5 Marks)

c. State the types of policies and procedures the entity may implement to assist in the prevention and detection of non-compliance with laws and regulations. (4 Marks)

d. Discuss what auditor should do under the following situations:

   i. Reporting non-compliance to those charged with governance (2 Marks)

   ii. Reporting non-compliance in the audit report (2 Marks)

   iii. Reporting non-compliance to the authorities (2 Marks)

(Total 20 Marks)

QUESTION 4

Two accountancy students from a University have been asked to write a term paper on "the reasons why external auditors resort to sampling when conducting the audit of a large entity". The students are of the opinion that they do not understand why this should be the case, if auditors focus on their work.

They believe statistical sampling is not always good for auditing especially when a population consists of a small number of large items. It may be appropriate to apply audit tests to the entire population as all the items in the population may not share common characteristics. Added to this, they do not agree that samples could be representatives of the population and also reflect the characteristics of the population. There is therefore the risk that the auditors may not reach a correct decision as against when the entire population is tested.

Furthermore, they said that they were confused on how the auditors will work on samples in such a way that all items in the population will be given equal chance of being selected and the key decision that needs be to made for effective sample design.

As an ICAN Professional examination's candidate who have just finished reading Audit Sampling (ISA 530), you now saw it as an opportunity to recall and explain what you have read. You are excited to explain the above to the students.

Required:

a. Highlight key decisions to be made to influence the sample size. (4 Marks)

b. Outline the advantages and disadvantages of using statistical sampling. (8 Marks)

c. Explain the sample selection methods that will give equal chance to all the items in the population. (3 Marks)

d. Illustrate what the auditors should do when performing procedures on the samples. (5 Marks)

(Total 20 Marks)

SECTION C: OPEN-ENDED QUESTIONS (30 MARKS)

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

QUESTION 5

At the weekly meeting of an audit firm, it was reported that a new audit client (Salisa Limited), has just been won. An implementation team has been constituted with a manager as the head. At the meeting of the implementation team, the manager stated that there is the need for the team to work on the audit planning strategy; the contents of which will form the audit planning memorandum that will be presented to the audit committee. He stated further that a professional clearance has to be sent to the former auditor after which, background check will be performed on the directors and other principal officers of the company. It is also believed that for proper risk assessment, there is the need to understand the business operations of the company. He stated further that the audit will be structured into both interim and final audits.

An experienced member of the team also mentioned the need for the auditor to adopt attitude of professional skepticism, hence the planning should be done in such a way that the audit can be executed in an effective manner. He stated further that 'planning the audit will involve the whole engagement team to establish an understanding of the terms of the engagement as required by ISA 210 and this will help to establish an overall strategy for the audit. The development of the audit plan will include the nature, timing and extent of planned risk assessment procedures. This will enhance further audit procedures and documentation of the overall audit strategy.'

As an experienced auditor in the firm, you have been approached by some junior staff at the meeting to explain further to them on the discussion held with the manager.

Required:

a. Explain professional skepticism. (2 Marks)

b. State how adequate planning can benefit the audit team. (3 Marks)

c. Explain and illustrate what the establishment of the overall audit strategy involves. (3 Marks)

d. Discuss the elements of interim and final audits. (7 Marks)

(Total 15 Marks)

QUESTION 6

The Internal Audit Unit of Oluvia Bank Limited has been accused of collusion with staff in committing monumental fraud. The following types of fraud were found to be common - cheque suppression, fraudulent bookkeeping to overstate income and inflation of the worth of the company's assets, intercepting replaced customers' cards, fraudsters impersonating Senior Managers or Chief executive officer, online banking fraud, such as phishing, malware attacks and clone websites, impersonating owner of an account or using fake document to open account under someone else name (no proper Know Your Customer conducted). The bank examiners came and were surprised at the level of fraud in the bank and requested management to do something about it urgently.

After the supervisory visit, the board of directors discussed the issue with the bank's external auditors who suggested that the bank can outsource the internal audit functions. The Board of Directors looked at the suggestion as being better, and mandated the Managing Director to act fast and give them details of this at the next board meeting. The Managing Director has requested your firm to write a report to enable him forward the issue to the Board of Directors.

Required:

a. Discuss the main reasons for outsourcing internal audit functions. (3 Marks)

b. Outline the advantages and disadvantages of outsourcing. (10 Marks)

c. Discuss which part of internal audit function that cannot be outsourced. (2 Marks)

(Total 15 Marks)

QUESTION 7

The audit plan and scope was presented to the Audit Committee of Deinde Limited for the year ended December 31, 2020. The external auditors of the company stated "we would estimate materiality using profit before tax for the full year. We would estimate our preliminary materiality based on expected results for the full year. We will perform a materiality re-assessment at year end to confirm adequacy or otherwise of our preliminary materiality. We will report to the Audit Committee on all unadjusted misstatements greater than our established threshold unless they are qualitatively immaterial".

Your uncle who is a member of the Audit Committee discussed with you and requested that you explain further on the issue.

Required:

a. Explain the concepts of materiality and performance materiality in an audit of financial statements. (3 Marks)

b. Explain the benchmark for determining materiality. (5 Marks)

c. Discuss the factors that may affect the identification of an appropriate benchmark. (7 Marks)

(Total 15 Marks)

SOLUTION 1

a. The justification or otherwise of an entity having joint auditors is revealed in the advantages and disadvantages of joint audit.

Advantages

The reasons why joint auditors might be appointed are as follows:

i. The client company may be so large that it requires the services of more than one firm of auditors;
ii. After the acquisition of a large subsidiary, using joint auditors may help the transition process while the group auditors become familiar with the new subsidiary. The "old" auditors should be familiar with the business of the subsidiary and should pass those knowledge over to the parent company's auditors. For the parent company auditors, this should accelerate the process of getting to know the business of the subsidiary;
iii. Joint auditors may provide a higher level of technical expertise than either audit firm could provide individually;
iv. It has been suggested that medium-sized accountancy firms might join forces and tender for the audit of a company for which the auditors would normally be one of the "Big 4" accountancy firms. This is possibly a way in which medium-sized firms might try to 'break the monopoly'of the Big 4 on large companies' audits; and
v. In a group situation, improved geographical coverage may be obtained for the audit, where each of the joint auditors on its own does not have offices that cover all the geographical locations of the component companies in the group.

Disadvantages

Possible disadvantages of joint audits include the following:

i. The extra cost to the client. It is likely to cost more to use two accountancy firms than to use one;
ii. Possible inconsistencies between the two joint auditors in the audit methods that they use. If so, there may be problems in reaching agreement on whose audit method to use;
iii. The possible difficulty the two firms may have in agreeing the division of work;
iv. Additional problems that will arise in monitoring and controlling the audit work of two different firms;
v. The two firms may find it difficult to work well together, and each firm may try to become the leading firm in the joint audit. If there is a claim against the auditors for negligence in the conduct of the audit,

there may be some difficulty in identifying which of the joint auditors is potentially liable;

vi. Experience and quality of audit personnel: Personnel presented by each firm may possess different experience and quality especially between small and large firms acting as joint auditors therefore makes it difficult for them to work together;

vii. Exposure to liability: Each of the two firms is potentially liable for the negligence of the other; and

viii. Independence of each auditor: It may be difficult at times to maintain a reasonable level of objectivity if one of the firms is highly dependent on the client.

b. **The options available to Johnson, Odewole, Thomas & Co. (the leading auditor) are as follows:**

i. Submit the details of their position to the Chairman for consideration at the reconvened board of directors meeting;

ii. Compile the basis of the faulty decision of the component auditor with appropriate explanations of the weaknesses contained in the respective positions;

iii. Consider appropriate modifications of the auditors' opinion on the financial statements;

iv. Draft notes on the subject for inclusion in the "Notes to the Financial Statements" for explanation of the action taken by management;

v. Have critical meeting with the partners of Ark Professional Services on the issues raised;

vi. Consider disengaging from the audit of the client if attempts to ensure a proper reflection of the true state of affairs of the client's financial statements fails; and

vii. Review the issues with the directors of Mandarin Manufacturing Plc.

c. **The procedures for proper acquisition to guide the Chairman are as follows:**

i. Ascertain the need for the additional property;

ii. A request is raised and considered by the management team and approved for inclusion in the budget;

iii. The building is subsequently included in the budget;

iv. Provision for capital expenditure is made and cash for purchase set aside to avoid disrupting the operational activities by the purchase;

v. Procurement bid or tender is advertised with specifications and details necessary;

vi. Interested suppliers/contractors submit their bids to the tender's board or procurement committee;

vii. The committee evaluates the bids taking cognisance of the specifications and offer prices;

viii. The best in the specification and cost is selected to supply and a local purchase order (LPO) is issued to the supplier;
ix. The supply is made with appropriate documents;
x. The building is delivered with appropriate inspection by the purchasing committee; and
xi. The payment is approved when the property is released, and relevant receipts are documented by the accounts department.

d. This is an item in the subsection of the financial statements. The consideration to take is based on the materiality of the item relative to the financial statements as a whole. Materiality would have also been the basis of disagreement by the firms.

Considering that the item of the building acquired is material to buildings, an **emphasis of matter paragraph** would be included in financial statements as follows:

Auditors' Report

Emphasis of Matter:

"Without modifying our opinion, we draw attention to Note X to the financial statements on non-current assets which indicates that the cost of building acquired during the year was not in line with standard practice and company procurement practices. The effect of the cost of the building on non-current assets of building is ₦.........."

e. The composition of items which could be included in "Matters for Partner's Attention" include:

i. Contingent items for which further evaluation needs to be made;
ii. Matters of recurring nature which needs discussion at senior management levels;
iii. Risk items which appear in the previous domestic report or management letter without adequate attention by the client;
iv. Matters of policy on which some expenditure has been incurred but the details were yet to be incorporated into the financial statements;
v. Auditing and reporting issues which need to affect the nature of opinion based on the classification of the issues concerned;
vi. Items of test for which further materials need to be provided at the conclusion of the audit exercise;
vii. Items in the letter of representation for which decisions or opinions need to be made on their evaluation at the reporting stage;

viii. Issues relating to non-compliance with rules and regulations: these issues may demand for partner's attention especially where it affects the financial statements;

ix. Matters relating to money laundering: Such issues need to be reported to the appropriate authority and as such needs partner's attention;

x. Suspicion of directors' involvement in fraudulent activities: A situation where directors of an entity are involved in fraudulent activities needs to be discussed by the partners;

xi. Issues relating to non adoption of relevant accounting standards: Non-compliance with the accounting standards in the preparation of the financial statements is a serious issue that warrants serious attention by the partners;

xii. Material transactions that were not backed up with proper documentation; and

xiii. Material misstatement in the financial statements that may be due to fraud or error. Discovery of material misstatement will call for partner's attention.

Examiner's report

This question tests the candidates' knowledge of joint audit activities, the problems associated with working on joint audit engagements, and the treatment of complex issues by audit staff which could be referred to higher audit level personnel for resolution.

This being a compulsory question, all the candidates attempted it, but the performance was poor.

The commonest pitfall of the candidates was their lack of understanding of the ways of conducting joint audits, resolving issues and conflicts that arise in joint audit process.

Candidates are advised to farmiliarise themselves with the practical aspects of audit engagements and also read the Institute's Study Text and Pathfinders when preparing for future examination.

Marking guide

		Marks	Marks
a.	**Justification or otherwise of having more than one firm to work on the audit of an entity at a particular time**		
	1 mark each for any 4 advantages	4	
	1 mark each for any 4 disadvantages	4	8
b.	**Stating the options available for the firm**		
	1 mark each for any 5 options		5
c.	**Stating the points on which the Chairman needs to base his decision according to standard acquisition procedures**		
	1 mark each for any 7 points		7
d.	**Determining the reporting requirement and drafting an appropriate report for inclusion in the auditors' report**		
	2 marks for appropriate report	2	
	2 marks each for any of 2 key features	4	6
e.	**Discussion of the composition of items that could be marked for "For Partner's Attention"**		
	1 mark each for any 4 points		4
	Total		**30**

SOLUTION 2

a. The objective of external auditors in relation to fraud prevention and detection should be considered as secondary. However, ISA 240 requires the external auditor to design and perform procedures that will help to detect material misstatements in the financial statements that may occur as a result of fraud.

The objective of the auditor as regards fraud is to detect material misstatements that will affect the financial statements due to the occurrence of fraud. This implies that external auditors are not primarily responsible for the prevention and detection of fraud that may exist in the client's financial statement but should:

i. Plan the audit and carry out a proper fraud risk assessment;
ii. Apply professional skepticism and remain alert to the possibility of material misstatements due to fraud;
iii. Act on those material frauds discovered during the performance of normal audit procedures that affect the financial statements;
iv. Discuss with the engagement team, the susceptibility of the client's financial statements to material misstatements due to fraud; and

v. Enquire of the client's management, those charged with governance and their internal auditor on whether they are aware of any actual or suspected cases of fraud in the organisation.

b. **Fraudulent financial reporting involves:**

i. Management override of controls;
ii. Falsification of records or documents;
iii. Misrepresenting or intentionally omitting transactions from the financial statements; and
iv. Intentionally misapplying accounting policies.

(ii) **Misappropriation of assets involves:**

i. Embezzling receipts (for example, diverting them to personal bank accounts);
ii. Stealing physical assets (such as inventory) or intellectual property (for example, by selling "trade secrets" to a competitor);
iii. Causing an entity to pay for goods and services not received (for example, by the creation of fictitious suppliers); and
iv. Using an entity's assets for personal use.

c. **Procedures the auditor should perform to identify the risks of material misstatement due to fraud include:**

i. Making enquiries of management in respect of:
- their assessment of the risk of material fraud;
- the process in place for identifying and responding to the risks of fraud;
- any specific risks of fraud identified or likely to exist; and
- any communications within the entity in respect of fraud (including to employees regarding management's views on business practices and ethical behaviour).

ii. Making inquiries of management and others within the entity as to whether they have any knowledge of any actual, suspected or alleged frauds and to obtain views about the risks of fraud;
iii. Evaluating any unusual or unexpected relationships identified in performing analytical procedures, which might indicate a risk of material fraud; and
iv. Evaluating information obtained from other risk assessment procedures to see if any **fraud risk factors** are present.

Examiner's report

This question tests the candidates' knowledge of objectives of an auditor in relation to fraud and misstatements in the financial statements.

The question was attempted by about 80% of the candidates and the overall performance was above average.

The commonest pitfall was their lack of understanding of the detailed aspects of the responsibility of various parties in relation to the financial statements.

Candidates are advised to pay close attention to the requirements of the question and understand responsibilities of various parties to the financial statements. In addition, they should also read the Institute's Study Text and Pathfinders when preparing for future examination.

Marking guide

		Marks	Marks
a)	**Stating the objectives of auditors in relation to fraud**		
	1 mark for stating the primary objective in relation to fraud prevention and detection	1	
	1 mark each for steps the auditor should take to defect material misstatements to prevent fraud, subject to a maximum of 5 points	5	6
b) i.	**Explanation of fraudulent financial reporting**		
	1 mark each for any 3 points	3	
ii.	**Explanation of misappropriation of assets**		
	1 mark each for any 4 points	4	7
C)	**Stating the procedures auditors should perform to identify the risk of material misstatement due to fraud**		
	(1 mark each for any 7 points)		7
	Total		**20**

SOLUTION 3

a. **Audit procedures for the identification of non - compliance with laws and regulations by companies include:**

i. Identifying all relevant laws and regulations and discuss with management to understand those laws and regulations that may have fundamental effect on their operations;
ii. Enquiring from both management and client compliance officer on whether all cases of non- compliance have been identified;
iii. Enquiring from their solicitor on any known case of non- compliance;
iv. Reviewing the client's bank statement and cash book for evidence of penalties paid;
v. Circularising the industries regulator for evidence of any incidence of non-compliance;
vi. Reviewing correspondence with industry regulator and solicitor- Review registers of complaint;
vii. Obtaining written representation from management or where appropriate those charged with governance that all known instances of non-compliance or suspected non-compliance have been disclosed to the auditor;
viii. Enquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations;
ix. Reviewing correspondence, if any, with the relevant or regulatory authorities; and
x. Ensuring disclosure on any contravention or non-compliance on the opinion page as required by the Central Bank of Nigeria (if a bank).

b. **If the auditor identifies material areas of non-compliance by the company, the following procedures are required:**

i. Obtain an understanding of the nature of the act and the circumstances under which it has occurred;
ii. Evaluate the possible effects of the non-compliance on the financial statements;
iii. Discuss the matter with management for subjected non-compliance. If compliance is not demonstrated, take legal advice;
iv. Consider the impact on the audit report (this would constitute a "limitation on scope" of work), if there is insufficient evidence of a suspected non-compliance;
v. Consider whether or not the non-compliance impacts on other areas of the audit (for example, on the overall risk assessment); and
vi. Consider how to report the non-compliance to those charged with governance and/or to members and/or to the authorities.

c. **Policies and procedures that an entity may implement to assist in the prevention and detection of non-compliance with rules and regulations, include:**

i. Designing operating procedures to ensure compliance with rules and regulations;
ii. Establishing a register and record of complaints;
iii. Undertaking constant monitoring of the regulatory environment to identify new laws and regulations and any changes to the existing ones;
iv. Engaging a solicitor to help in environmental scanning and review;
v. Ensuring regular training of management and staff on the need to be compliance conscious;
vi. Establishing and maintain a comprehensive register of all relevant laws and regulations which impact on the company's operations;
vii. Instituting, develop, publicise and operate appropriate system of internal control; and
viii. Monitoring compliance with the code of conduct and act appropriately to discipline employees who fail to comply with it.

d. i. **Reporting non-compliance to those charged with governance. The auditor should:**

- Communicate these matters to those charged with governance unless all of those charged with governance are also involved in management of the entity and are therefore already aware of these matters;
- Communicate as soon as practicable if the non-compliance is intentional and material; and
- Communicate to the committee. If the auditor suspects that those charged with governance are involved in the non-compliance. If no audit committee exists, the auditor must consider taking legal advice.

ii. **Reporting non–compliance in the audit report**

If the auditor concludes that the non-compliance has a material effect on the financial statements and has not been adequately reflected in them, then he must give a modified or adverse opinion.

If the scope of the auditor's work is restricted by management such that he cannot reach an opinion, then he must give a modified opinion or disclaim his opinion.

If the auditor cannot decide whether non-compliance has occurred due to the nature of the circumstances, rather than because of any restriction imposed on him by management, he must consider the impact on his audit report.

iii. **Reporting non-compliance to the authorities**

- Where management refuses to make the necessary amendments to the financial statements due to non-compliance with rules and regulations, the auditor should report to the appropriate authorities.

- Due to change made by IESBA in July 2017, professional accountants are no longer required to seek legal advice before reporting NOCLAR to the appropriate authorities.

Examiner's report

This question tests the candidates' knowledge of concept of non-compliance with laws and regulations as in ISA 210 and reporting it to various parties.

The question was attempted by less than 50% of the candidates and performance was less than average.

The commonest pitfall was the candidates' inability to explain the requirements of ISA 210.

Candidates are advised to pay close attention to the provisions of ISAs in their preparations for subsequent examinations.

Marking guide

		Marks	Marks
a.	Stating the audit procedures to be performed to help identify instances of non-compliance with laws and regulations 1 mark each for any 5 audit procedures outlined		5
b.	Stating what the auditor should do when he becomes aware of issue of non-compliance with laws and regulations 1 mark each for any 5 actions the auditor should take		5
c.	Stating the types of policies and procedures the entity may implement to assist in the prevention and detection of non-compliance with laws and regulations 1 mark each for any 4 types of policies and procedure listed		4

d.	Discussion on what an auditor should do in the following situations		
i.	In reporting non-compliance to those charged with governance	2	
ii.	Reporting non-compliance in the audit report	2	
iii.	Reporting non-compliance to the authorities	2	6
	Total		**20**

SOLUTION 4

a. Key decisions to be made to influence the sample size

If an audit sampling exercise is to be effective and if sampling risk is to be reduced and therefore, detection risk reduced, the sample must be designed in an appropriate way.

When designing a sample, the auditor is **required** by ISA 530 to:

i. Consider the purpose of the audit procedure and the population from which the sample will be drawn;
ii. Determine a sample size sufficient to reduce sampling risk to an acceptably low level;
iii. Select items for the sample in such a way that each sampling unit in the population has an equal chance of selection;
iv. Determine the sampling approach to be used (statistical or non-statistical);
v. Assess/evaluate the characteristics of the population from which the sample is to be drawn;
vi. Decide the sample selection method;
vii. Evaluate what constitutes a misstatement or deviation;
viii. Determine the 'tolerable' misstatement or rate of deviation; and
ix. Determine the 'expected' misstatement or rate of deviation.

b. The advantages of using statistical sampling techniques are as follows:

i. Statistical sampling provides an objective, mathematically precise basis for the sampling process;

ii. There may be circumstances where statistical sampling is the only means of auditing efficiently (for example, in the case of very large 'populations' of items);

iii. The cost will be lower if data is collected for a sample of population which is a big advantage. Sampling is therefore economical in respect of resources; Study of samples involves less space and equipment;

iv. The process of sampling makes it possible to arrive at generalisations by studying the variables within a relatively small proportion of the population. The required sample size can be calculated precisely (using statistical probability techniques); and

v. Where limited resources exist, use of sampling is an appropriate strategy. Manageable samples permit the auditor to establish adequate rapport with the client.

The **disadvantages** of statistical sampling techniques are as follows:

i. A degree of training and technical expertise is required if auditors are to use statistical sampling techniques effectively. If the auditor lacks specialised knowledge in sampling, he may commit serious mistakes. Consequently, the results of the sample picked will be misleading;

ii. In population that are heterogeneous and requiring a very high standard of accuracy, the sampling method may be unsuitable. This requires an investment in the necessary training for audit staff;

iii. Sample sizes may be larger than under a judgemental approach, thus increasing the time (and the cost) involved in the audit;

iv. Selection is of a complex nature. Some auditors take the view that it is preferable to rely on the skill, experience and judgement of the auditor, rather than on mathematical/statistical models; and

v. Bias arises when the method of selection of sample employed is faulty.

(c) **A number of sample selection methods which are available to the auditor include:**

i. **Random sampling:** All items in the population have an equal chance of selection. This is typically achieved by the use of random numbers to select items for testing;

ii. **Systematic sampling:** With systematic sampling, a random starting point is chosen from the population and then items are selected with a standard gap between them (for example, every 10^{th} item). For example, suppose that a sample will be 10% of the items in a population and the items in the population can be arranged in a sequence, such as listed in invoice number order, or account number order or date order. A systematic sample would be to select one of the first 10 items in the list at random, and then to select every 10^{th} item in the list for testing in order to obtain the 10% sample; and

iii. **Haphazard sampling:** The auditor selects the sample on an arbitrary basis, for example, choosing any 100 invoices from a file. This is not a scientifically valid method and the resulting sample may contain a degree of bias. It is therefore not recommended for use with statistical sampling techniques.

(d) **When performing procedures on a sample, the auditor is required to:**

i. Perform appropriate audit procedures on each item selected;
ii. Perform the procedure on a replacement item if the audit procedure is not applicable to the selected item. For example, the auditor might select a sample of cheques to test for evidence of authorisation. One of these might be a cheque which has been cancelled. Provided the cheque has been legitimately and properly cancelled then the auditor may choose another cheque number to test in its place;
iii. If the auditor is unable to apply the procedure (or a suitable alterative) to the selected item (for example, because a document has been lost), that item must be treated as a deviation;
iv. Investigate the nature and cause of any misstatements/deviations and evaluate their possible effects; and
v. Obtain a high degree of certainty about this and perform additional audit procedures to obtain sufficient evidence that the deviation does not affect the rest of the population, if the auditor considers the misstatement or deviation to be an anomaly.
Investigation of the nature and cause of the deviations may lead the auditor to conclude that the problem lies within one time period, type of transaction, or location (for example, perhaps when a temporary member of staff was being employed). In this case, he might decide to extend audit procedures performed on that time-period/type of transaction/location.

Examiner's report

This question tests the candidates' knowledge on how to use sampling methods to select materials for testing in auditing and the related issues of selecting appropriate samples to ensure fair representation of the population.

The question was attempted by about 80% of the candidates and the performance was average.

The commonest pitfall was the candidates' inability to explain audit sampling techniques.

Candidates are advised to pay close attention to the requirement of a question before attempting it so as to earn more marks.

Marking guide

		Marks	Marks
a.	Highlighting the key decisions to make to influence the sample		
	1 mark each for any 4 points listed		4
b.	Outlining the advantages and disadvantages of statistical sampling		
	1 mark each for any 4 advantages and	4	
	1 mark each for any 4 disadvantages listed	4	8
c.	Explanation of the sample selection methods that will give equal chance for all items in the population		
	1 mark each for three sample selection methods		3
d.	Illustrating what the auditor should do when performing procedures on the samples		
	1 mark each for any 5 points listed in accordance with the requirements of ISA 530		5
	Total		**20**

SOLUTION 5

a. **Professional skepticism:** "An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence"

Professional skepticism includes the following:

i. Audit evidence that contradicts other audit evidence obtained;
ii. Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence;
iii. Conditions that may indicate possible fraud or irregularities; and
iv. Circumstances that suggest the need for audit procedures in addition to those required by the ISAs.

b. **Adequate planning benefits the audit team in various ways, such as:**

i. Helping the auditor to devote appropriate attention to important areas of the audit;
ii. Helping the auditor to identify and resolve potential problems on a timely basis;
iii. Helping the auditor to properly organise and manage the audit engagement so that it is performed in an effective and efficient manner;
iv. Assisting in the selection of engagement team members with appropriate levels of experience capabilities and competence to

respond to anticipated risks, and the proper assignment of work to them;

v. Facilitating the direction and supervision of engagement team members and the review of their work; and

vi. Assisting, where applicable, in the coordination of work done by experts and components.

c. **The establishment of the overall audit strategy involves the following:**

i. Determining the characteristics of the engagement that define its scope, such as:
The financial reporting framework to be used;

- Any industry specific reporting requirements; and
- The location of the components of the entity (for example, there might be overseas branches);

ii. Ascertaining the reporting objectives of the engagement, such as reporting deadlines and the nature of communication required;

iii. Considering important factors which will determine the focus of the audit team's efforts, such as:

- Materiality thresholds;
- High risk areas of the audit e.g key audit matters;
- The audit approach;
- The auditors evaluation of the entity's' internal control; and
- Any recent developments in relation to the entity, the industry environment or financial reporting requirements.

iv. The nature, extent and timing of resources needed to perform the engagement. In particular, the auditor should consider:

- Where experienced members of staff may be needed (for example, on high risk areas);
- The number of staff to be allocated to specific areas (for example, extra staff may be needed for attendance at the year-end inventory count);
- Attendance locations (if the client has more than one location).
- When the resources are needed (for example, are more staff needed at the final audit than at the interim audit?); and
- How such resources are to be managed, directed and supervised (for example, the timing of team briefing meetings and manager and partner reviews of work performed by other members of the audit team).

d **Interim audit**

An interim audit involves preliminary audit work that is conducted prior to the fiscal year-end of a client. The interim audit tasks are conducted in order to compress the period needed to complete the final audit. In simple terms, interim audits are done on interim periods, such as monthly, quarterly, bi-annual or any period in between the starting accounting period and the end of the accounting period.

Interim audit includes:

i. Understanding the entity, assessing inherent risk and identifying significant matters which will be reflected in the subsequent audit strategy and audit plan;
ii. Considering going concern;
iii. Recording, evaluating the design and testing the entity's system of internal control; and
iv. Performing substantive testing to ensure the books and records are a sound basis for performing the year end audit e.g. on loans and advances, receivables, etc.

Final audit

Audit done at the year end is known as final audit. Final Audit is also known as annual audit or periodical audit balance sheet audit. A final audit is one which is started at the end of a financial year when financial statements are prepared and is carried out until completion.

Final auditing includes:

i. Substantive testing: Note that where substantive testing was performed at the interim phase, auditors typically test the subsequent period between interim audit and period end;
ii. Tests to ensure conclusions formed at interim audit remain valid;
iii. Obtaining third party confirmations, such as bank letters and trade receivables confirmations;
iv. Analytical review;
v. Subsequent events review;
vi. Obtaining written representations;
vii. Agreeing the financial statements to the accounting records;
viii. Examining adjustments made during the course of preparing the financial statements;
ix. Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts or transactions may not have been finalised;

x. Contingent liabilities; and
xi. Reporting on the engagement

Examiner's report

This question tests the candidates' knowledge of the expectations of an auditor on professional skepticism, planning of audit, and the development of appropriate strategy for audit.

The question was attempted by about 60% of the candidates but the performance was average.

The commonest pitfall was the candidates' inability to adequately explain professional practice management, Institute's Code of Ethics, and professional conduct.

Candidates are advised to read thoroughly and understand the Institute's Professional Code of Ethics when preparing for future examination.

Marking guide

		Marks	Marks
a.	**Explanation of professional skepticism**		
	1 mark for correct explanation of professional scepticism	1	
	1 mark for any illustration	1	2
b.	**Stating how adequate planning can benefit the audit team**		
	1 mark each for any 3 benefits of adequate planning by audit staff		3
c.	**Explanation of what the establishment of the overall audit strategy involves**		
	1 mark each for any 3 points explained		3
d.	**Discussion of the elements of:**		
	Interim audit procedure		
	1 mark each for any three points	3	
	Final audit procedure		
	1 mark each for any 4 points	4	7
	Total		**15**

SOLUTION 6

a. **Reasons for outsourcing internet audit functions**

Some entities outsource the work of the internal audit function. When this happens, the service provider is often the accountancy firm that provides the entity with its external audit services. The reasons for this are:

i. The accounting firm may be sued for breach of contract or for negligent work and should have professional indemnity insurance to meet claims for losses due to negligent work;

ii. Professional codes of conduct and standards of behaviour will regulate the accounting firm. This might not be the case with an in-house internal audit department;

iii. The accounting firm may have access to more highly trained specialist employees;

iv. The accounting firm will have greater number of employees available for any urgent internal audit assignments; and

v. The accounting firm must have a greater level of independence than the entity's own internal audit staff. If external audit firm is not properly independent from the executive management of the entity, it should not be given any internal audit work.

b. **Advantages and disadvantages of outsourcing:**

i. **Advantages**
These include:

- **Cost savings:** It may be cheaper to outsource work to an external service provider than to do the work in-house;

- **The skills of the external agency or service provider:** An external service provider may have skills and expertise for doing the work that the entity itself does not have 'in house';

- Access to the most up-to-date techniques and technology might not be readily available within the entity, but the external agency may have them; and

- The management of the entity is able to focus its time and efforts on "core activities", and do not have to spend as much time monitoring the outsourced activities.

ii. **Disadvantages**

These include:

- The management of the entity needs to make sure that the service provider understands the requirements of the entity in respect of the service that it is providing. If the work is not properly specified, the service provider may fail to do everything that the entity requires it to do;

- The entity relies on the service provider to do its work on time and have it ready at the time that the entity requires it. This is particularly important, for example, when payroll operations are outsourced;

- There may be problems with negotiating an appropriate fee for the work with the service provider; and

- Management needs to ensure that the service provider gives the organisation an appropriate level of priority and 'customer care'. This means that management must carry out regular reviews of the service level and service quality provided;

c. **Part of internal audit function that cannot be outsourced**

The oversight and responsibility for the internal audit function should not be outsourced. The board, through the audit committee or those charged with governance, is ultimately responsible for oversight of internal audit. Their oversight responsibility cannot be outsourced.

Consequently, there is a need for more formal documentation and channels of reporting and approval when a large part of the internal audit function is outsourced.

Examiner's report

This question tests candidates' knowledge of reasons for outsourcing of internal audit functions by entities and the associated advantages and disadvantages.

About 80% of the candidates attempted the question but the performance was average.

The commonest pitfall was the candidates' inability to explain the concept of outsourcing.

Candidates are advised to read the Institute's Study Text and Pathfinders to enhance better performance in future.

Marking guide

		Marks	Marks
a.	**Main reasons for outsourcing: Internal audit functions**		
	1 mark each for any 3 reasons listed		3
b.	**Advantages and disadvantages of outsourcing**		
	2 marks each for any 3 advantages	6	
	2 marks each for any 2 disadvantages identified correctly	4	10
c.	**Explaining part of internal audit function that cannot be outsourced**		
	1 mark each for any 2 parts of internal audit function that cannot be outsourced		2
	Total		**15**

SOLUTION 7

a. **Materiality and performance materiality**

Information is considered material if its misstatement or omission could influence the economic decisions of users taken on the basis of the financial statements.

At the planning stage, the auditor must determine materiality for the financial statements as a whole. This is often set as materiality thresholds. If lower thresholds are required for some areas, these must also be set at this stage.

Performance materiality recognises the fact that if all areas of the audit are carried out to detect all errors/omissions under the (overall) materiality level, that objective could be achieved, but when all the individual immaterial errors/omissions are added together, overall materiality could in fact be breached. Performance materiality is a way of taking this risk into account and will be set at a lower figure than overall materiality.

b. **The benchmark for determining materiality**

The materiality benchmark refers to the threshold used to obtain reasonable assurance that an audit does not detect any material misstatement that can significantly impact the usability of financial statements.

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses and total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

Materiality thresholds vary from one firm to another, but will typically fall within the following ranges:.

i. **Revenue: 1% – 2%**
An item of revenue is material if it is between 1% and 2% of annual sales revenue.

ii. **Pre-tax profit: 5% – 10%**
An item is material if it is between 5% and 10% of reported pre-tax profit.

iii. **Total assets 1% – 2%**
A balance is material if it represents between 1% and 2% of total assets.

The revised ISA makes it clear that materiality depends on the size and nature of an item judged in the surrounding circumstances. There are guidelines on materiality – but no rules.

c. **Factors an auditor should consider in the identification of an appropriate benchmark include:**

i. **The nature of the item involved** – The valuations and presentations of some items in the financial statements are more subjective than others, and depend on estimation. The more subjective the item, the more flexible the auditor should be in assessing the materiality of possible misstatements. The auditor will have to take a very different view on materiality when considering a warranty provision (which is a subjective estimate), compared with the approach taken when auditing share capital, which is capable of precise measurement;

ii. **The value of the item** – The value of the item determines its relative significance in the financial statements;

iii. **The significance of the item** – Some items may be insignificant in terms of their monetary amount, but may nevertheless be of particular interest to the users of the financial statements. An example might be bonus payments to directors; and

iv. **The impact of the item on the view presented by the financial statements**. A small and apparently insignificant error or omission may be material if, by correcting it:

- A reported profit is converted into a reported loss; or
- The correction significantly alters the trend of profits (growth rate in profits over the past few financial years).

Examiner's report

This question tests the candidates' knowledge of the concept of materiality in the audit of financial statements.

About 50% of the candidates attempted the question but the performance was below average.

The commonest pitfall was the candidates' inability to explain materiality at various stages.

The candidates are advised to read the Institute's Study Texts and Pathfinders in their preparations for future examinations.

Marking guide

		Marks	Marks
a.	**Explanation of materiality**		
	Explanation of materiality	1	
	Stating explanation of materiality at planning	1	
	Performance materiality	1	3
b.	**Explanation of the benchmark for determining materials**		
	Any 3 benchmarks at 1 mark each	3	
	Any 2 thresholds at 1 mark each	2	5
c.	**Discussion of the factors that may affect the identification of an appropriate benchmark**		
	Stating 3 factors at 1 mark each	3	
	Discussion on factors stated at 1 mark each	3	
	More than 1 discussed point on any of the 3 factors	1	7
	Total		**15**

ICAN/222/V/C5 Examination No..........................

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2022

CASE STUDY

EXAMINATION INSTRUCTIONS

PLEASE READ THESE INSTRUCTIONS BEFORE THE COMMENCEMENT OF THE PAPER

1. Check your pockets, purse, mathematical set, etc. to ensure that you do not have prohibited items such as telephone handset, electronic storage device, programmable devices, wristwatches or any form of written material on you in the examination hall. You will be stopped from continuing with the examination and liable to further disciplinary actions including cancellation of examination result if caught.

2. Write your **EXAMINATION NUMBER** in the space provided above.

3. Do **NOT** write anything on your question paper **EXCEPT** your examination number.

4. Do **NOT** write anything on your docket.

5. Read all instructions in each section of the question paper carefully before answering the questions.

6. Do **NOT** answer more than the number of questions required in each section, otherwise, you will be penalised.

7. All solutions should be written in **BLUE** or **BLACK INK**. Any solution written in **PENCIL** or **RED INK** will not be marked.

THURSDAY, NOVEMBER 17, 2022

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE IN/STITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA
PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2022
CASE STUDY

Time Allowed: 4 hours (including reading time)

INSTRUCTION: YOU ARE TO USE CASE STUDY ANSWER BOOKLET FOR THIS PAPER

PRE-SEEN

This material is issued prior to the examination to enable candidates familiarise themselves with the case scenario so as to undertake any research and analyses they think fit. This Pre-seen part of the case study examination is also published on the Institute's Website **www.icaniq.org/student**.

You **MUST NOT** bring this material with you to the Examination Hall. On receipt of the material, you are to spend few days to the examination date to familiarise yourself with information provided, carry out additional research and analyses 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 analyses 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 any other paper **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 use of information	20%
- Structuring problems and solutions	20%
- Applying judgement	20%
- Drawing conclusions and making recommendations	20%
- Demonstrating integrative and multi-disciplinary skills	10%
- Presenting appropriate appendices	10%

Of the total marks available, 20% are awarded for executive summary and approximately 10% for relevant discussions of ethical issues within your answers to the requirements. Although ethical issues do not form a specific requirement, as this is deemed to have been tested in other subjects of the ICAN professional examination, but will be tested within a requirement which may include the following areas:

- Lack of professional independence or objectivity;
- Conflict 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 analyses of the issues involved and suggest feasible solutions to problems identified;
- Demonstrate ability to make informed judgement on the basis of analyses carried out; and
- Generate reasoned conclusion upon which relevant recommendations are made.

Candidates that omit any one of these will have a slim chance of success in the examination.

Case study: Kudi Microfinance Bank Limited

List of exhibits

1. About you (AbdulRaman Ismaila) and your employer Hexalinks Consulting Associates (HCA).
2. Overview of Microfinance Sector of the banking industry in Nigeria.
3. Categories of Microfinance Banks (MFBs) according to CBN guidelines.
4. Kudi Microfinance Bank Limited (MFBs) (About us).
5. Extract of financial statements for year 2020 (including previous year's figures).
6. Central Bank of Nigeria (CBN) circular to all Microfinance Banks.

Exhibit 1

About you (AbdulRaman Ismaila) and your employer (Hexalinks Consulting Associates – HCA)

You are AbdulRaman Ismaila, writing the professional level examination of the Institute of Chartered Accountants of Nigeria (ICAN). You are employed as a trainee consultant at Hexalinks Consulting Associates (HCA). You are reporting to Dr. Munir Oyemilokan, the partner in charge of business advisory services of the consulting firm.

One of your clients is Kudi Microfinance Bank (KMB) Limited, a state microfinance bank under the direct supervision of Other Financial Institutions Supervision Department of Central Bank of Nigeria (CBN). KMB Limited customers' deposits are insured by the Nigeria Deposit Insurance Corporation (NDIC).

The bank has its head office in Abeokuta, the capital of Ogun State and branches in fifteen (15) local government areas of the state.

Since your engagement in HCA, your responsibilities include:

- Reviewing financial statements (including audited and management accounts) of clients to identify trends and key issues in order to make informed decisions about their businesses.
- Providing clear evaluation of the client, based on analysis of both opportunities and threats, and the impact on both profitability and stability of the organisation.
- Assessing operational and strategic business proposals to see how each aligns with the client's objectives and their impact on HCA's business and financial risks.
- Analysis of your clients' financial statements to identify areas of weakness and proffering likely solutions to correct any anomalies.
- Drafting reports for the partner's perusal and approval before sending them to your clients.

Exhibit 2

Overview of microfinance sector of the banking industry in Nigeria

- Microfinance, also called microcredit, is a type of banking service provided to low income earners or groups, who otherwise would have no access to formal financial services.
- Institutions or banks participating in microfinance most often provide lending in form of microloans. Other banks offer additional services such as current and savings accounts, as well as, micro-insurance products. Some even provide financial and business education. The goal of microfinance is to ultimately give indigent people opportunity to become self-sufficient.
- Microfinance services are provided to low-income individuals who have limited financial resources, or, do not have enough income to do business with traditional financial institutions.
- Despite being excluded from banking services, some of those who live on as little as ₦2,000.00 a day do attempt to save, borrow, acquire credit, or insurance and they also make payments on their debts. Thus, poor individuals typically look to family, friends and even money lenders (who often charge exorbitant interest rates) for help.
- Microfinance allows people to take reasonable small business loans safely and in a manner that is consistent with ethical lending practices. Although microfinance exists all around the world, majority of microfinancing operations occur in developing nations, such as Nigeria, Ghana and Senegal. Many Microfinance institutions focus on helping women in particular.
- In Nigeria, a large percentage of the population is still excluded from financial services. In 2010, a study revealed marginal increase in the percentage of those served by formal financial markets from 35% in 2005 to 36.3% in 2010; five years after launching of the microfinance policy.
- Against the backdrop of concerns expressed by stakeholders and need to enhance financial services delivery, the CBN issued a Microfinancing Policy Regulation and Supervising Framework in 2005. It was revised in April 2011 and improved upon in January 2020 with the issuance of the Guidelines for Regulation and Supervision of Microfinance Banks in Nigeria by the Central Bank of Nigeria.

Exhibit 3

Classification of microfinance banks in accordance with Central Bank of Nigeria guidelines for MFBs

There are four (4) categories of microfinance banks in Nigeria, as follows:

- **Tier 1 Unit Mfb**

A unit microfinance bank with urban authorisation (tier 1) shall operate in the banked and high density areas and is allowed to open NOT more than four (4) branches outside its head office within five (5) contiguous Local Government Areas, subject to the approval of the CBN.

- **Tier 2 Unit Mfb**

A unit microfinance bank with rural authorisation (Tier 2) shall operate only in the rural, unbanked or underbanked areas and is allowed to open one branch outside its head office within the same Local Government Area, subject to the approval of the CBN.

- **State Microfinance Bank**

A state Microfinance bank is authorised to operate in one state or the Federal Capital Territory (FCT). It is allowed to open branches within the same state or FCT, subject to prior written approval of the CBN for each new branch or cash centre. It shall not be permitted to open more than two branches in the same Local Government area (LGA), unless it has established at least one branch or cash centre in every LGA of the state.

A newly licensed state MFB shall not commence operations with more than ten (10) branches.

- **National Microfinance Bank**

A National Microfinance Bank is authorised to operate in more than one state, including the FCT. A newly licenced National MFB shall not commence operations with more than ten (10) branches.

Exhibit 4

Kudi Microfinance Bank Limited (About us)

Kudi Microfinance Bank Limited is a leading Microfinance Bank in Ogun State, South West of Nigeria with excellent service culture, hinged on working with each customer to create a name and be a reference point in grassroot banking.

The bank was licenced by Central Bank of Nigeria in 1991 as a community bank. It became a unit Microfinance bank under the CBN revised policy of 2005 for the subsector.

The bank was later up-graded by CBN from unit MFB in year 2020 after partly meeting the minimum capital requirement for state microfinance bank.

The head office of the bank is on Bank Road, Oke Ilewo, Ibara, Abeokuta, Ogun State with branches in fifteen (15) local government areas out of the twenty (20) local government areas in the state.

Our Vision: Pursuant to the strategic objective of becoming a leading Microfinance bank, the KMB Limited is now better positioned to deliver on its brand promise, which is aptly captured in our vision statement, thus:

"To make our customers happy by providing reference point microfinance banking while creating wealth for the stakeholders".

Mission Statement: Our mandate is to partner with each customer for the realisation of defined objectives with the promise of delivering an enduring, pleasurable and seamless banking experience in the manner of our mission statement which is:

"To be an institution known for character, service delivery and efficiency".

Core Values: Our core values ensure that while our experience centres and points of reference are strategically deployed across selected locations around Ogun State, our philosophy is to bring banking services to our customers with guaranteed convenience, riding on the platform of simplified service innovation, leading technology solutions and experience-driven relationship management.

Kudi MFB products & services

1. Deposit products/services

(a) **Savings accounts**

Features:

(i) Minimum opening balance of ₦1,000; and

(ii) Attracts interest rate of 4% per annum.

Requirements:

- Duly completed application form;
- 2 recent passport-size photographs;
- Current utility bills; and
- A valid means of identification (National I.D., drivers licence, voter's card or international passport).

(b) **Current account**

Features:

(i) Minimum opening balance of ₦2,000;

(ii) ₦5,000 for corporate organisation; and

(iii) Availability of credit facility or overdraft facility.

Requirements:

- Duly completed application form;
- 2 recent passport-size photographs;
- Current utility bills; and
- A valid means of identification (National I. D., driver's licence, voter's card or international passport).

(c) **Daily contribution accounts**

Features:

(i) Free daily contribution card;

(ii) Save a minimum of ₦100 per day for 30 days; and

(iii) One day contribution is the bank's commission.

(d) **Target savings accounts**

Features:

(i) This product is designed to meet up with a particular project.

(ii) Minimum opening balance of ₦1,000;

(iii) 6% interest on the savings; and

(iv) Easy access to the account.

(e) **Other deposit products/services**

(i) Happy savers accounts

(ii) Fixed deposit accounts

(iii) Mutual fund accounts

2. Loan products/services

(a) **Kudi micro loans**

Features:

(i) Minimum opening balance for individual current account is ₦2,500;
(ii) Customers must have run the account for 6 weeks;
(iii) Interest rate is 5% flat per month;
(iv) Tenor: maximum of 6 months;
(v) Repayment pattern: monthly repayment; and
(vi) Maximum loan disbursement of ₦250,000

(b) **Kudi SME loans**

Features:

(i) Opening balance for individual current account is ₦5,000 and ₦10,000 for corporate;
(ii) Customer must have maintained the account for 6 weeks;
(iii) Maximum loan disbursement is ₦250,000 for individual and ₦1,000,000 for corporate;
(iv) Interest rate is 5% flat per month;
(v) Tenor: maximum of 6 months;
(vi) Repayment: Monthly repayment; and
(vii) Security: 2 guarantors, undated cheque leaves and any other good physical property. Inventory hypothecation form must be completed by traders.

(c) **Kudi group business support loan**

Features:

(i) Opening minimum balance of ₦1000 for each member of the group;
(ii) Loan application form for each member;
(iii) Insurance on loan for each member - 1% of loan amount;
(iv) Compulsory saving of 3% of loan disbursed to each member of the group;
(v) Weekly repayment starts a week after disbursement;
(vi) Maximum loan disbursement to each member is ₦100,000.
(vii) Tenor: 24 weeks;
(viii) Interest rate on each member loan is 5%; and
(ix) Group membership, minimum of 5 members; maximum of 10 members.

3. Other loan products/services

(a) Kudi Sure Loan
(b) Kudi 1 for 3 Loans
(c) Kudi Salary Advance Facility

Board of directors and management staff

Kudi Microfinance Bank Limited is led by highly competent and experienced board of directors. Members of the board are people with outstanding success in their various fields of endeavour, who ensure good corporate governance, strict compliance with regulatory guidelines and good corporate citizenship. The current board members and management staff are:

Directors

Dr. Benjamin Yemi	-	Chairman
Rev. Valentine Rasak	-	Director
Mrs. Ebun Akintunde	-	Director
High Chief Victor Olu	-	Director
Malam Ibrahim Kawu	-	Director
Lady Joyce Olaniyan	-	Director
Mr. Adewale Akinyemi	-	Managing Director/CEO

Management staff

- Mr. Adewale Akinyemi - MD/CEO
- Mr. Adedeji Idowu - Head of Admin
- Mr. Kolawole Oluyemi - Head of Credit and Marketing
- Mrs. Aminat Falade - Head of Department-Computer Operations
- Mr. Abiodun Saheed - Head of Department-Accounts and Finance
- Mr. Habeeb Olalekan - Head of Internal Audit/Risk Mgt Department
- Mrs. Oluwakemi Akinsola - Head of Banking Operations

The following directors have shareholding as stated below:

	31 December, 2020 ₦'000	31 December, 2019 ₦'000
Dr. Benjamin Yemi – (Chairman)	70,000	70,000
Mrs. Ebun Akintunde	140,000	100,000
Rev. Valentine Rasak	50,000	25,000
High Chief Victor Olu	16,000	10,000
Malam Ibrahim Kawu	100,000	100,000
Lady Joyce Olaniyan	32,500	32,500
Mr. Adewale Akinyemi (MD/CEO)	45,000	40,000

The authorised share capital of the bank is ₦1.5billion of ₦1 each, out of which ₦1billion have been issued as at December 31, 2020.

Substantial interest in shares

According to the register of members as at December 31, 2020 the following shareholders held 5% and above of the issued share capital of the bank.

	No of Ordinary Shares Held ₦'000	Percentage Holding (%)
Dr. Benjamin Yemi	70,000	7.0%
Mrs. Ebun Akintunde	140,000	14%
Rev. Valentine Rasak	50,000	5%
Malam Ibrahim Kawu	100,000	10%
Jolmarg Investment Limited	240,000	24%
Grafold Star Ventures	150,000	15%

Exhibit 5

Kudi Microfinance Bank Limited statement of profit or loss and other comprehensive income for the year ended December 31:

	2020 ₦'000	2019 ₦'000
Interest income	191,292	147,740
Interest expense	(31,600)	(13,332)
Net interest income	159,692	134,408
Fee and commission income	128,952	32,312
Fee and commission expenses	(4,648)	(3,984)
	124,304	28,328
Other income	62	1,672
Operating income	284,058	164,408
Net impairments loss on financial assets	(292)	(33,444)
	283,766	130,964
Personnel expenses	(154,824)	(57,656)
Other operating expenses	(221,176)	(55,616)
Depreciation and amortization	(12,880)	(5,460)
Profit before income tax	(105,114)	12,232
Income tax expense	(12,906)	(5,744)
Profit/(loss) for the year	(118,020)	6,488
Other comprehensive income:		
Items to be reclassified to profit or loss	-	-
Total other comprehensive income for the year	-	-
Total comprehensive income for the year	(118,020)	6,488

Kudi Microfinance Bank Limited statement of change in equity for the year ended December 31, 2020

	Share capital ₦'000	Statutory reserve ₦'000	Regulatory risk reserve ₦'000	Retained earnings ₦'000	Total equity ₦'000
At January 1 2019	538,580	5,316	3,516	(371,700)	175,712
Profit/(loss) for the year	-	-	-	6,488	6,488
Comprehensive income	-	-	-	-	-
Total comprehensive income	-	-	-	6,488	6,488
Transfer between reserve and equity:					
Transfer to credit risk reserve	-	-	6,064	(6,064)	-
December 31, 2019	538,580	5,316	9,580	(371,276)	182,200
Profit for the year	-	-	-	(118,020)	(118,020)
Comprehensive income	-	-	-	-	-
Total comprehensive income			-	(118,020)	(118,020)
Transaction with owners:					
Share capital injection	461,420	-	-	-	461,420
Dividend paid	-	-	-	-	-
	461,420	-	-	-	461,420
At Dec. 31 2020	1,000,000	5,316	9,580	(489,296)	525,600

Kudi Microfinance Bank Limited
Statement of financial position as at December 31:

	2020	2019
Assets	**₦'000**	**₦'000**
Cash and cash equivalent	751,072	545,756
Investment securities	455,972	320,144
Loans and advances to customers	748,295	208,084
Other assets	11,460	10,696
Deferred tax assets	66,968	86,828
Intangible assets	7,658	692
Property plant and equipment	123,192	4,600
	2,164,617	1,176,800
Equity and Liabilities		
Deposit from customers	1,422,052	974,272
Current tax liabilities	15,996	1,924
Retirement benefit obligation	2,500	908
Other liabilities	198,469	17,496
	1,639,017	994,600
Equity		
Share capital	1,000,000	538,580
Retained earnings	(489,296)	(371,276)
Regulatory risk reserve	9,580	9,580
Statutory reserve	5,316	5,316
	525,600	182,200
Total liabilities and equity	**2,164,617**	**1,176,800**

Exhibit 6

Central Bank of Nigeria
Circular to all microfinance banks

Date: April 2019

Circular Number: MFB/JOL/02/04/2019

Re: Review of minimum capital requirements for microfinance banks in Nigeria

Further to our previous circulars on the above subject, the CBN has revised the categories of microfinance bank with a view to ensuring continued operations of microfinance banks in the rural, unbanked and under-banked areas of the economy. Accordingly, Unit Microfinance Banks shall comprise of two tiers: Tier 1 Unit Microfinance Bank, which shall operate in the urban high density banked area of the society and Tier 2 Unit Microfinance Bank, which shall operate only in the rural, unbanked or under-banked areas.

Following from the above, the minimum capital requirements for the categories of microfinance banks have also been revised as follows:

(1) Tier 1 unit microfinance bank ₦200 million Naira;
(2) Tier 2 unit microfinance bank ₦50 million Naira;
(3) State microfinance bank ₦1 billion Naira; and
(4) National microfinance bank ₦5 billion Naira.

To aid the process of recapitalisation, all microfinance banks shall be required to comply with the following:

(1) Tier 1 unit microfinance banks shall meet a capital threshold of ₦100 million by April 30, 2021 and ₦200 million by April 30, 2022;
(2) Tier 2 unit microfinance bank shall meet capital threshold of ₦35million by April 30, 2021 and ₦50 million by April 30, 2022;
(3) A state microfinance bank shall increase its capital to ₦500 million by April 30, 2021 and ₦1 billion by April 30, 2022; and
(4) A National microfinance bank shall hold a capital of ₦3.5 billion by April 30, 2021 and ₦5 billion by April 30, 2022.

This revised circular supersedes all our previous circulars.

Prof. Theo Ojukwu
Director Financial Policy and Regulatory Department

UN-SEEN

November 2022 Case Study – Kudi Microfinance Bank Limited (KMB)

List of exhibits:

The following exhibits are newly provided and did not form part of the materials provided as PRE-SEEN.

Exhibit

7 – Email from Dr. Munir Oyemilokan to AbdulRaman Ismaila.
8 – Email from Managing Director/CEO of KMB to Dr. Munir Oyemilokan, Partner of Hexalink Consulting Associates.
9 – Letter of non-compliance with minimum capital requirement from CBN to MD/CEO of KMB.
10a – Draft domestic report of the external auditors on draft audited financial statement of KMB for the year ended December 31, 2021.
10b – Draft audited financial statements of KMB for the year ended December 31, 2021.
11 – Summary of Board Paper CM/FA 1241 prepared by credit and marketing, and Finance Accounts Departments of KMB.
12 – Proposals for acquisition/merger with KMB.

Kudi Microfinance Bank Limited Case Study requirement:-

You are AbdulRaman Ismaila, a professional level candidate of ICAN examination, working as trainee consultant at Hexalink Consulting Associates.

You report to Dr. Munir Oyemilokan, the partner in charge of business advisory services of the firm.

Requirement

You are required to prepare a draft report, as set out in the e-mail dated May 5, 2022 from Dr. Munir Oyemilokan to you (Exhibit 7). Your report should comprise the following:

- An executive summary; and
- Your responses to the detailed requirements set out in Exhibit 7, including appropriate appendices.

State clearly any assumptions that you make. All workings should be attached to your answer.

Your reports should be balanced across detailed requirements and the following time allocation is suggested:

•	Reading and planning	1 hour
•	Performing calculations and financial analyses	1 hour
•	Drafting your report	2 hours

Marks allocation

All the marks in the case study are awarded for 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 conclusion and making recommendations	20%
		80%

Applied to your report as a whole:

•	Demonstrating integrative and multi disciplinary skills	10%
•	Presenting appropriate appendices	10%
		100%

Ensure that you address all the 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 skill areas will be addressed under each of the four elements of your report. Accordingly, not demonstrating your judgement or failure to include appropriate conclusions and/or recommendations in each of your reports will also adversely affect your chances of success.

Exhibit 7

E-mail from Dr. Munir Oyemilokan to AbdulRaman Ismaila

Date: May 5, 2022

From: muniroyemi@hexalinks.com

To: AbdulRamanIsmaila@hexalinks.com

Subject: Kudi Microfinance Bank Limited (KMB)

There has been a number of significant issues arising from the above named client, and I have just received a mail from the Managing Director of Kudi Microfinance Bank Limited.

The bank is requesting for our professional advice on how to overcome some of their present challenges, particularly, as relating to meeting the minimum capital requirement by the regulatory authority, the Central Bank of Nigeria and other related financial reporting challenges which the bank is currectly battling with. In addition, the Managing Director would want us to review the performance of the bank and make necessary recommendations and/or suggestions that would guide the board on the way forward.

I forward herewith relevant emails and exhibits in respect of the bank, while additional information may be obtained from their correspondence files. I would like you to draft a report from me to the Board of Directors of KMB for my review.

Your report should comprise the following:

1. An analysis of the financial performance of the bank for the year ended December 31 2021, making use of the draft audited accounts and domestic report as at that date (Exhibits 10a and 10b) and previous years' accounts for years 2020 and 2019 (Exhibit 5). Your analysis should focus on the bank's financial soundness, earnings capacity, profitability and other prudential indicators; and
2. An evaluation of the options available to the bank for recapitalisation purpose. Your evaluation should cover operational and strategic issues relating to each option available, where appropriate. You should provide brief calculations to support your arguments.

I look forward to receiving your draft report soon.

Exhibit 8

Email from managing director of Kudi Microfinance Bank (KMB) to Dr. Munir Oyemilokan (Partner, Hexalinks Consulting Associates)

Date: May 2, 2022

From: Mr. Adewale Akinyemi – MD KMB

To: Dr. Munir Oyemilokan (Business Advisory Partner HCA)

Subject: Financial Advisory Service for KMB

Sir,

You will recall that we had discussions on the recapitalisation of our bank and other financial reporting issues. Our bank is currently experiencing downturn, despite recent recapitalisation by directors and current shareholders. The recent CBN circular requesting us to beef-up our capital with the aim of meeting the minimum share capital requirement for state microfinance bank on or before April 30, 2022 has put tremendous pressure on the board members.

The board of directors is therefore desperately looking for ways of meeting this minimum capital requirement, in order to avoid sanctions from the regulatory authority, CBN. Therefore, our board has approved that you carry out a review of the bank's financial and operational activities in the last three (3) years, so as to advise on the way forward and how to address the problem. You already have our financial statements for the years 2019 and 2020 in your office files, I therefore forward herewith the draft audited financial statements and domestic reports for year 2021 (Exhibit 10a and 10b). These will be discussed at the next meeting of the board of directors, coming up on May 12, 2022.

Please note that we have just received another letter from CBN **(Exhibit 9)** requesting that we comply with the minimum requirement, as there would be no extension of the deadline.

In addition, the management of the bank has received two proposals **(Exhibit 12)** which will also be presented at the next board meeting, in addition to external auditors request on the draft financial statements **(Exhibit 11).**

We however require your input, as this will go a long way in guiding the board in taking appropriate decisions with respect to the recapitalisation exercise. You should therefore evaluate the pros and cons of the available proposals. You may also carry out necessary data analysis to justify your position.

I look forward to receiving your report on the above issues and I hope you will speed up action on it, in order to meet up with the date of the board of directors meeting.

Thank you.

Yours faithfully,

Adewale Akinyemi
MD/CEO

Exhibit 9

Letter of non-compliance with minimum capital requirement from CBN To MD/CEO of KMB Limited

April 30, 2022

The Managing Director,
Kudi Microfinance Bank Limited
Bank Road,
Oke Ilewo, Abeokuta,
Ogun State.

Dear Sir,

Compliance with the new minimum capital requirement for microfinance banks

You will recall that the Central Bank of Nigeria, vide circular number MFB/JOL/02/04/2019 dated April 2019, reviewed the minimum capital requirement for microfinance banks (MFBs) in Nigeria. The circular categorised the MFB licences into four and required each bank to attain the minimum adjusted capital (shareholder's fund unimpaired by losses) of its category into two phases with deadlines of April, 30 2021 and April 30, 2022 respectively.

A reminder circular number MFB/XYZ/CIR/GEN/2021 dated February 10, 2021 also provided additional information and guidance to MFBs on the available options to meet the prescribed capital and the documentation required to obtain regulatory approval for each option.

Based on the above requirements, we have reviewed the adjusted capital position of your bank as at December 31, 2021 (from recent examination of the bank by CBN examiners) and we observe that your adjusted capital is below the minimum capital requirement to be attained by a STATE MFB by the deadline of April 30, 2022.

In view of the foregoing, your bank would require additional fresh capital injection to comply with the final recapitalisation requirement for MFBs.

You are advised to work towards the fulfillment of the requirement, as there would be no extension of the deadline.

Yours faithfully,

Mr. Micheal Ajalekoko
Director Other Financial Institutions Supervision Department

Exhibit 10A

Draft management letter (domestic report) on the draft audited accounts of Kudi Microfinance Bank Limited for the year ended December 31, 2021

The Chairman Board of Directors,
Kudi Microfinance Bank Limited,
Bank Road, Oke Ilewo,
Abeokuta,
Ogun State.

Dear Sir,

Re: Draft audited accounts for the year ended December 31, 2021

1.0 Introduction

Having completed the audit of your bank, we hereby highlight our observations, implications and recommendations for your review and necessary actions.

2.0 Adoption of IFRS 9

2.1.1 Observation

We observe that your bank is yet to adopt IFRS 9 – Financial Instrument, for the preparation of your financial statements as required by Central Bank of Nigeria.

2.1.2 Implication

Failure to adopt IFRS 9 implies that your bank has not carried out the necessary evaluation of the impairments of risk assets, such as, loans and advances, using the expected credit loss model.

2.1.3 Recommendations

We hereby recommend that the Credit and Marketing Unit and the Finance and Accounts Departments of your bank should prepare necessary schedules that will facilitate the making of necessary provisions on all doubtful and bad loans and advances. This should be forwarded to us for review, to enable us incorporate the impairment losses into the financial statements before the final copies are produced.

3.0 Minimum share capital

3.1 Observations

Despite the fact that we are yet to make provisions for loan losses in accordance with IFRS 9, your bank's shareholders fund un-impaired by losses is yet to meet the minimum capital requirement for state MFBs as required by CBN. The deadline for the recapitalisation is April 30, 2022.

3.2 Implication

Failure to meet the minimum capital requirement may lead to CBN withdrawing your bank's operational licence. Incorporation of the loan losses impairment as a result of compliance with IFRS 9 will lead to further depletion of your bank's shareholders' fund.

3.3 Recommendation

We advise the Board of Directors of the bank to adopt strategies that will facilitate injection of fresh capital in order to meet the CBN deadline for recapitalisation.

4.0 Schedule of loan classification

4.1 Observation

As stated in paragraph 2 of this report, your Credit and Marketing Unit is yet to provide us with details or breakdown of your doubtful loans and advances.

4.2 Implication

Non-availability of the schedule has also prevented us from making necessary loan losses provisions in accordance with the CBN prudential guidelines in the draft audited accounts. This may make the accounts unacceptable to the CBN.

4.3 Recommendation

We advise that this schedule should be made available to enable us complete our audit work and produce the final copy of the audited accounts.

5.0 Conclusion

We use this opportunity to thank the managing director and all members of staff for their cooperation during the audit. We look forward to attending to all issues raised to enable us finalise and produce the final copies of the audited accounts.

Thank you.

Yours faithfully,

Engagement Partner Mr. Eze Mohammed
FRCN/ICAN/00000012xxx
for: Wazobia & Co.
(Chartered Accountants)

Exhibit 10B

Kudi Microfinance Bank Limited draft statement of profit or loss and other comprehensive income for the year ended Dec. 31, 2021

	2021	2020
	₦'000	**₦'000**
Interest income	285,000	191,292
Interest expense	(52,665)	(31,600)
Net interest income	232,335	159,692
Fee and commission income	95,620	128,952
Fee and commission expense	(9,620)	(4,648)
	86,000	124,304
Other income	590	62
Operating income	318,925	284,058
Net impairment loss on loans and financial assets	(12,235)	(292)
	306,690	283,766
Personnel expenses	(195,265)	(154,824)
Other operating expenses	(285,655)	(221,176)
Depreciation and amortisation	(18,775)	(12,880)
Net (loss) before tax	(195,005)	(105,114)
Income tax expense	(5,722)	(12,906)
Profit for the year	**(200,727)**	**(118,020)**
Other comprehensive income:		
Gain on financial assets	2,300	-
Total other comprehensive income	2,300	-
Total comprehensive income	(198,427)	(118,020)

Kudi Microfinance Bank Limited
Draft statement of change in equity for the year ended Dec. 31, 2021

	Share capital ₦'000	Statutory reserve ₦'000	Regulatory risk reserve ₦'000	Retained profit ₦'000	Total equity ₦'000
Jan. 1 2020	538,580	5,316	9,580	(371,276)	182,200
Profit for the year	-	-	-	(118,020)	(118,020)
Other comprehensive income	-	-	-	-	-
Share capital injection	461,420	-	-		461,420
Transaction with owners:					
At Dec. 31, 2020	1,000,000	5,316	9,580	(489,296)	525,600
Jan.1, 2021	1,000,000	5,316	9,580	(489,296)	525,600
Profit or loss	-	-	-	(200,727)	(200,727)
Other comprehensive income	-	-	-	2,300	2,300
Total comprehensive income	-	-	-	(198,427)	(198,427)
Transaction with owners					
Share capital injection	-	-	-	-	-
Dividend paid	-	-	-	-	-
	-	-	-	-	
At Dec. 31, 2021	1,000,000	5,316	9,580	(687,723)	327,173

Kudi Microfinance Bank Limited
Draft statement of financial position as at Dec. 31, 2021

	2021 ₦'000	2020 ₦'000
Assets		
Cash and cash equivalent	489,210	751,072
Investment in securities	444,600	455,972
Loans and advances to customers	625,625	748,295
Other assets	42,653	11,460
Deferred tax assets	82,650	66,968
Intangible assets	25,640	7,658
Property plant & equipment	192,607	123,192
	1,902,985	2,164,617
Equity and Liabilities		
Deposit from customers	1,353,999	1,422,052
Current tax liabilities	15,656	15,996
Retirement benefit obligations	4,508	2,500
Other liabilities	201,649	198,469
	1,575,812	1,639,017
Equity		
Share capital	1,000,000	1,000,000
Retained earnings	(687,723)	(489,296)
Regulatory risk reserve	9,580	9,580
Statutory reserve	5,316	5,316
	327,173	525,600
Total liabilities and equity	1,902,985	2,164,617

Exhibit 11

Summary of board paper CM/FA 1241: prepared by credit and marketing unit and finance and accounts department of KMB

As requested by the external auditors, we forward herewith the following to assist the board in decision-making process.

Statement 1

Statement of reconciliation of impairment based on IAS 39 to IFRS 9

The following table shows a comparison between IAS 39 (used) as at December 31 2020 and IFRS 9 (requested) to be adopted during the year ended December, 31 2021 as impairment provisions of the financial instruments.

	Total for IAS 39 as at Dec. 31 2020	IFRS 9 Impairment impact for the year	Total for IFRS 9 as at Dec. 31 2021
	₦'000	₦'000	₦'000
Financial assets @ amortised cost	17,008	5,625	22,633
Loans and advances	25,630	100,246	125,876
Others assets	725	4,236	4,961
Commitment and guarantees granted	-	6,250	6,250
	43,363	**116,357**	**159,720**

We also forward herewith the prudential requirement for making provisions for loan losses and other known losses in accordance with CBN prudential guidelines (statement 2).

Statement 2

Statement of loan losses provisions in accordance with CBN prudential guidelines for MFB loans and advances

		Dec. 31 2021		Dec. 31 2020	
		(Gross) Principal	Accumulated Provisions	(Gross) Principal	Accumulated Provisions
	%	₦'000	₦'000	₦'000	₦'000
Performing loans	1	92,120	921	410,876	4,109
Non-performing loans:					
Pass and watch	5	-	-	202,800	10,140
Substandard	20	205,000	41,000	177,982	35,596
Doubtful	50	207,240	103,620	-	-
Lost	100	133,500	133,500	-	-
		637,860	279,041	791,658	49,845
Other known losses		-	12,235	-	-
Total loan losses		-	291,276	-	49,845

CONCLUSION

We are of the opinion that the above financial data will go a long way in assisting the board of directors in taking the necessary decisions.

Exhibit 12

Proposals for acquisition/merger with KMB

The following proposals were presented by potential investors of the bank on April 3, 2022 for discussions:

1st Proposal

Olowolagba Family
Eko-Akete,
Lagos.

Confidential

Date: March 29, 2022

The Chairman, Board of Directors,
Kudi Microfinance Bank Limited (KMB),
Oke-Ilewo, Abeokuta,
Ogun State.

Dear Sir,

Introduction

We submit this preliminary non-binding proposal to acquire all ordinary shares of KMB. We believe that our proposal which would involve injection of ₦1.5 billion equity would be acceptable to you.

The terms and conditions upon which we are prepared to pursue the acquisition are summarised below. We have confidence in your ability to consummate an acquisition as outlined below:

1. **Buyer:** Olowolagba family intends to use a special purpose vehicle for the purpose of pursuing the acquisition of the KMB;

2. **Purchase price:** Our proposed consideration payable for the equity shares is ₦1.5 billion Naira cash injection;

3. **Financing:** We are confident that we can timely secure adequate financing to consummate the acquisition;

4. **Definitive agreement:** We are prepared to finalise definitive agreement on the condition that you obtain a **No Objection Letter from the CBN**;

5. **About Olowolagba family:** Olowolagba family is a well-known family in Nigeria that has business interests in various sectors of the economy; and

6. **Non-Binding Commitment:** This proposal constitutes only a preliminary indication of our interest and does not constitute a binding commitment with respect to the acquisition of the bank. Such a commitment will result only from the execution of a definitive agreement and will be on terms provided in such documentation.

Thank you.

Sincerely yours,

High Chief Akintunde Olowolagba

2nd Proposal

Date: March 28, 2022

E-mail: Chukwuemeka@yahoo.com (Chairman Networth Microfinance Bank Limited)

To: AdewaleAkinyemi@KMB.com (KMB MD/CEO)

Dear Sir,

We are writing to provide a letter of intent from Networth Microfinance Bank (State) MFB to merge with your bank, Kudi Microfinance Bank (KMB).

Based on our preliminary review of information from your bank, we are putting up a proposal for a merger of the two banks. Our head office is in Ikeja, capital of Lagos State and we currently have branches in 20 local government areas of the State.

The summary of our bank's financials as at December 31, 2021 is stated below. More details will be provided, if considered necessary.

(1) Shareholders fund unimpaired by losses is ₦550 million Naira.
(2) Total assets of the bank is ₦1.2 billion.
(3) Liability of ₦400 million is due for payment to Lagos State Government in respect of empowerment fund for women, injected by the state five (5) years ago.
(4) Credit portfolio at risk of the bank as at the above date is 25%.

We shall provide more details if you give our letter of intent a favourable consideration.

Mr. Chukwu Emeka
for: Networth Microfinance Bank Limited.

KUDI MICROFINANCE BANK LIMITED					
First Marking					
DATE		**CANDIDATE NO.**			
TIME		**MARKER NUMBER**			
	Exc Sum	**Req 1**	**Req 2**	**Overall**	**TOTAL**
SA					
CA					
BC					
NC					
V					
Total	**5**	8	8	4	25
SUPERVISOR SIGNATURE			**CHECKER SIGNATURE**		
Changes made? ☐					

Executive Summary: Kudi Microfinance Limited

1. **General**

- States the purpose of the report
- States the summary on the two requirements
- States the assumptions
- States reservations, e. g. scepticism

V NC BC CA SA

2. **Requirement 1: Conclusions**

- Concludes on the shareholders equity has been eroded
- Concludes on the bank inabilty to manage risk assets & non-performing loans
- Concludes on the bank's total revenue increases
- Concludes on the increasing operational cost and interest expenses

4. **Requirement 2: Conclusions**

- Concludes on the unfeasible proposal from Olowolagba family
- Concludes on the non-binding terms and conditions from Olowolagba family
- Concludes on the unrealistic merger proposal with Networth Microfinance Bank
- Concludes on KUDI not meeting-up with CBN capital base requirements

NC BC CA SA

5. **Requirement 2: Recommendations**

- Recommends on dowmscaling from State MFB to Unit Tier 1 MFB
- Recommends that directors and sharesholder's should inject more fund
- Recommends on the bank's need to have wide-spread ownership
- Recommends that the bank shuold not accept the proposal from olowolagba family as it will not solve tha bank's capitilisation problem

- Concludes on the capital adequacy problem of KUDI

NC	BC	CA	SA

3. Requirement 1: Recommendations

- Recommends that there is the need for cost control
- Recommends on collecting non-performing loans
- Recommends on the need to inject more funds
- Recommends on revenue generation measures
- Recommends on changing the bank's management restructure

NC	BC	CA	SA

- Recommends that the merger is not viable, since the two banks operate in two different States

NC	BC	CA	SA

V

NC	BC	CA	SA

REQUIREMENT 1: Financial statement analysis - Kudi Microfinance Limited

1. **USES DATA AND INFORMATION APPROPRIATELY**

- Uses information on exhibit 5 on financial statements
- Uses information on exhibit 10A
- Uses information on exhibit 10B
- Uses information on exhibit 11- statement 1 - on reconciliation of impairment
- Uses information on exhibit 11- statement 2- on Loan Loss Provision

V		NC	BC	CA	SA

2. **USES PROFESSIONAL TOOLS AND KNOWLEDGE**

- Calculates the capital adequacy ratios
- Calculates the assets quality ratios
- Calculates the earnings/profitability ratios

4. **IDENTIFIES ISSUES AND OPTIONS**

- Identifies that the shareholders fund has been eroded
- Identifies the poor application of the provisions of IFRS 9
- Identifies that the operating profit margin has been declining and negative
- Identifies that non-performing loans have been increasing
- identifies that the liquid assets of the bank have continued to detoriorate over the period
- Identifies that the number of branches and products is not commensurate with performance
- Identifies the Inability to control operational expenses
- Identifies that capital adequacy has shown no improvement
- Identifies a decline in the cash position, despite the injection of money in 2020

V		NC	BC	CA	SA

5. **APPLIES PROFESSIONAL SCEPTICISM AND ETHICS**

- Recognises that there is a possibility of non-compliance to CBN Guidelines by KMB
- Recognises that there is a possibility of non-adherence to IFRS 9 by Kudi

- Calculates the liquidity ratios

V		NC	BC	CA	SA

3. **USES ANALYTICAL SKILLS (material points) written report**

- Determines trend in the capital adequacy of Kudi
- Determines the trends in risk assets of KMB
- Determines trend in non-performing loans to total loans of Kudi.
- Determines trend in ROE and ROA of Kudi
- Determines trend in operating profit margin of Kudi
- Determines trend in other profitability ratios.
- Determines trend in liquidity ratios.
- Determines the updated shareholders fund

V		NC	BC	CA	SA

- Recognises that the 2021 financial report is not audited
- Recognises that non-performing loans have not been adequately provided for

V		NC	BC	CA	SA

6. **EVALUATIVE SKILLS AND JUDGEMENT**

- Recognises that license of the bank may be withdrawn
- Recognises that the Tier 1 capital has drastically reduced
- Recognises that the operational cost and interest expenses of the bank were not adequately managed.
- Recognises that the non-performing loans have been increasing, thereby affecting the liquidity position of the bank

V		NC	BC	CA	SA

REQUIREMENT 2 - APPRAISAL OF CAPITALISATION OPTIONS

1. **USES DATA AND INFORMATION APPROPRIATELY**

- Uses information on exhibit 6
- Uses information on exhibit 9
- Uses information on exhibit 12
- Uses information on exhibit 5
- Uses information on exhibit 10B

V	NC	BC	CA	SA

2. **USES PROFESSIONAL TOOLS AND KNOWLEDGE**
(written into report)

- Calculates the combined statement of Financial position
- Calculates the combined total assets

4. **IDENTIFIES ISSUES AND OPTIONS**

- Identifies that CBN may not be favourably disposed to the family acquisition of KMB
- Identifies that the acquisiton proposal by Olowolagba Family is not a definite agreement
- Identifies that if the merger is consumated, there will be need to close down branches in one of the States in line with the CBN Guidelines
- Identifies that despite the merger, KMB may not meet the Capital requirements

V	NC	BC	CA	SA

5. **APPLYING PROFESSIONAL SCEPTICISM AND ETHICS**

- Recognises that the acquistion may not solve the capitalisation problem of the Bank since they are in two States
- Recognises that the Account on which the acquisiion decision is based is a draft account

- Calculates the combined equity
- Calculates the combined customer deposit
- Calculates the combined other liabilities

V	NC	BC	CA	SA

3. USES ANALYTICAL SKILLS (material points)

(written in report)

- Discusses the combined statement of Financial position
- Discusses the combined total assets
- Discusses the combined equity
- Discusses the combined total customer deposit
- Discusses the combined total other liabilities

V	NC	BC	CA	SA

- Recognises that CBN may not approve family acquisition of KMB
- Recognises that the Bank may have been window-dressing its accounts
- Recognises that the Bank ownership structure is not wide spread

V	NC	BC	CA

EVALUATIVE SKILLS AND JUDGEMENT

(uses analytical headings)

- Evaluates the combined statement of Financial position
- Evaluates the combined total asset
- Evaluates the combined equity
- Evaluates the combined total customers deposit
- Evaluates combined other liabilities

NC	BC	CA	SA

Appendices

Appendix R1: Content and style

- Shows the capital adequacy ratios
- Shows the asset quality ratios
- Shows the earnings/profitability ratios
- Shows the liquidity ratios

V	NC	BC	CA	SA

Appendix R2: Content and style

- Shows the combined statement of Financial position
- Shows the combined total asset
- Shows the combined equity
- Shows the combined customers deposit
- Shows the combined total other liabilities

NC	BC	CA	SA

Main Report

Report: Structure

- Sufficient appropriate headings
- Appropriate use of paragraphs / sentences
- Legible/clear hand writing
- Correctly numbered pages

V	NC	BC	CA	SA

Report: Style and language

- Relevant disclaimer (external report)
- Suitable language for the board
- Tactful / ethical comments
- Acceptable spelling and punctuation

V	NC	BC	CA	SA

CC	
SC	
IC	
ID	
NA	
Total	

Appendix 1

A. **Capital Adequacy**

1. Regulatory capital to Risk weight Assets = $\frac{\text{Total Quality capital}}{\text{loan}} \times \frac{100}{1}$

= $\frac{\text{Equity}}{\text{loan}}$

	2021	2020	2019
	327,173	525,600	182,200
	625,625	748,295	208,084
≈	0.5230	0.7024	0.8756
	0/52	0.70	0.88
	52%	70%	88%

2. **Capital to Assets**

	2021	2020	2019
Total qualifying capital =	327,173	525,600	182,200
Total Assets	1,902,985	2,164,617	1,176,800
	0.1719	= 0.2428	0.1548
≈	0.17	0.24	0.15
	17%	24%%	15%
or (327,173/1,798,863) = 0.18= 18%			

B. **Assets Quality**

3.

	2021	2020	2019
Risk Asset Ratio =			
Total loan/ Total Assets	625,625	748,295	208,084
	1,902,985	2,164,617	1,176,800
=	0.3288	0.3457	0.1768
=	0.33	0.35	0.18
≈	33%	35%	18%
or (625,625/1,798,863) = 0.35			

4. **Non-performing loans (NPL) to Total Loans**

NPL/Gross loans =	545,740	380,782
	637,860	791,658
=	0.8556	0.4810
≈	0.86	0.48

5.

Interest margin to Gross Income	2021	2020	2019
= Net Interest Income/Gross Income	232,335	159,692	134,408
	381,210	320,306	181,724
	0.6095	0.4986	0.7396
	0.61	0.50	0.74

C. **Profitability**

6.

Non-interest Expenses to/ Gross Income	2021	2020	2019
Non-interest Expenses/Gross Income =	492,540	380,648	117,256
	381,210	320,306	181,724
=	1.2920	1.1884	0.6452
≈	1.29	1.19	0.65

7.	Net Interest margin	2021	2020	2019
	Net Interest Income =	232,335	159,692	134,408
	Total interest income	285,000	191,292	147,740
	=	0.8152	0.8848	0.9098
	≈	0.82	0.83	0.91

8.

Operating profit margin	2021	2020	2019
Operating profit (PBT)/ Gross Earnings =	(194,005)	(105,114)	12,232
	381,210	320,306	181,724
=	(0.5089)	(0.3282)	(0.0673)
	(0.51)	(0.33)	(0.07)

9.	Staff costs to non-interest	2021	2020	2019
	Expenses			
	Staff cost/other Operating Expenses	197,265	154,824	57,656
		285,655	221,176	55,616
		0.6906	0.7000	1.0367
	≈	0.69	0.70	1.04

10.	Staff costs to non-interest	2021	2020	2019
	Expenses			
	Staff cost/offer operating expenses	197,265	154,824	57,656
		285,655	221,176	55,616
		0.6906	0.7000	1.0367
	≈	0.69	0.70	1.04

11.					
	ROA =	PAT	2021	2020	2019
		Total Asset	304,849	(118,020)	6,488
			1,798,863	2,164,617	1,176,800
			-16.9%	-5.5%	0.6%

12.					
	ROE =	PAT	2021	2020	2019
		Shareholder fund	(304,849)	(118,020)	6,488
			223,051	525,600	182,200
			-136.7%	-22.5%	3.6%

D. Liquidity

1	Loan to deposit ratio	Total loans	625,625	748,295	208,084
		Total deposit	1,353,999	1,422,052	974,272
			46.2%	52.62%	21.36%

2	Liquid Assets to Total Assets	Specialised Liquid Assets/ Total Assets	489,210 / 902,985	751,072 / 2,164,617 x 100 / 1	545,756 / 1,176,800 x 100 / 1
			25.71%	34.70%	46.38%

Appendix 2

ADJUSTMENT FOR IFRS 9 IMPACTS ON 2021 AUDITED FINANCIAL STATEMENTS			
			2021
			₦'000
IFRS 9 (ECL Model) Impairment Impact on Profit/Loss for the year			116,357
Less: IAS 39 (Incurred Loss) Impairment Impact on Profit/Loss for the year			12,235
			104,122
Accounting Entry to Effect Adjustment:			
Debit: Net impairments loss on financial assets (Profit or Loss)			104,122
Credit: Loans and advances to customers			

Adjustment for Effecting Regulatory/Credit Risk Reserve			
			₦'000
CBN Prudential Guideline on Provision for Loans & Advances			291,276
IFRS 9 (ECL Model) Impairment Impact on Profit/Loss for the year			159,720
			131,556
Debit: Retained Earnings (Profit or Loss)			131,556
Credit: Regulatory Risk Reserve			

ADJUSTMENT OF APPROPRIATE CLASSIFICATION OF GAIN ON FAIR VALUE ON FINANCIAL ASSETS MEASURED AT FAIR VALUE THRUGH OTHER COMPREHESNIVE INCOME		
Accounting Entry to Effect Adjusment:		
Debit: Retained Earnings (Profit or Loss)		2,300
Credit: Other Component of Equity		

Appendix 3

(UPDATED) DRAFT STATEMENT OF CHANGES IN EQUITY

KUDI MICRO-FINANCE BANK LIMITED						
UPDATED) DRAFT STATEMENT OF CHANGES IN EQUITY						
	Share capital	**Statutory Reserve**	**Regulatory Risk Reserve**	**Retained Earning**	**Other Component of Equity**	**Total**
	N'000	**N'000**	**N'000**	**N'000**	**N'001**	**N'000**
As @ January, 2019	538,580	5,316	3,516	(371,700)	0	175,712
Profit/(loss) for the year				6,488		6,488
Other comprehensive income					0	0
Total comprehensive income				6,488	0	6,488
Transactions within Equity:						0
Transfer from/(to) Credit Risk Reserve			6,064	(6,064)		0
As @ 31 December 2019	538,580	5,316	9,580	(371,276)		182,200
As @ 1 January, 2020	538,580	5,316	9,580	(371,276)	0	182,200
Profit/(loss) for the year				(118,020)	0	(118,020)
Other comprehensive income						0
Total comprehensive income				(118,020)		461,420
Transactions within Equity:						525,600
Share capital injection	461,420					525,600
As @ 31 December 2020	1,000,000	5,316	9,580	(489,296)	0	(304,849)
As @ 1 January 2021	1,000,000	5,316	9,580	(489,296)		2,300
Profit/(loss) for the year				(304,849)		(302,549)
Other comprehensive income					2300	0
Total comprehensive income				(304,849)	2300	(302,549)
Transactions within Equity:						0
Transfer from/(to) credit Risk Reserve			131,556	131,556		
As @ 31 December 2021	1,000,000	5,316	141,136	(925,701)	2300	223,051

Appendix 4

KUDI MICRO-FINANCE BANK LIMITED
(MERGED/COMBINED) DRAFT STATEMENT OF FINANCIAL POSITION (EXTRACT)

	KUDI	NETWORTH	COMBINED
ASSETS	**₦'000**	**₦'000**	**₦'000**
Total Assets	1,798,863	1,200,000	2,998,863
EQUITY & LIABILITIES			
Liabilities:			
Customers Deposits (derived as Bal. Fig.)	1,353,999	250,000	1,603,999
Women Empowerment fund of the LASG	0	400,000	400,000
Other Liabilities	221,813	0	221,813
Total Liabilities	1,575,812	650,000	2,225,812
Total Equity	223,051	550,000	773,051
Total Equity and Liabilities	1,798,863	1,200,000	2,998,863

Examiner's report

The Case Study is about a microfinance bank operating in Abeokuta. As usual, there are two requirements that students are to address. These are:

- An analysis of the financial performance of the bank for the year ended December 31 2021, making use of the draft audited accounts and domestic report as at that date (Exhibits 10a and 10b) and previous years' accounts for years 2020 and 2019 (Exhibit 5). The analysis is to focus on the bank's financial soundness, earnings capacity, profitability and other prudential indicators; and
- An evaluation of the options available to the bank for recapitalisation purpose.

To perform very well in the Case Study, candidates must prepare the following appendices:

- Various ratios (capital adequacy, assets quality, profitability and liquidity);
- Adjustment of impacts of IFRS 9 on the audited financial statements;
- Updated statement of changes in equity; and
- Combined statement of financial position, if proposed merger is consummated.

Candidates' performance was very poor as only very few candidates scored up to 50%.

The commonest pitfalls of the candidates are:

- 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 specific requirements of each Case Study and ensure they bring to bear the knowledge they gained in other subjects when preparing for future examination.

Marking guide

The case scenario is on Kudi Microfinance Bank Limited, which was having problem with the Central Bank capitalisation requirement. The case scenario shows that the bank has not also complied with IFRS 9 and Prudential regulation in its provisions on its risk assets, and its auditors have recommended that these two issues be regularised.

We noted that the case scenario has some limitations and did not provide adequate information that will enable us populate all the marking key boxes appropriately and requirement 2, business analysis was not adequately covered in the case scenario. The requirement 2 of the Case Study was based on a single exhibit, which is on proposal to increase the bank's level of capitalisation.

Therefore, assistant examiners and team leaders need to exercise tremendous caution when assessing the candidates' scripts. The following appendices are required:

Requirement 1:

Appendix 1: Various ratios (capital adequacy, assets quality, profitability and liquidity);

Appendix 2: Adjustment for impacts of IFRS 9 on the audited financial statements; and

Appendix 3: Updated statement of changes in equity.

Requirement 2:

Appendix 4: Combined statement of financial position, if proposed merger is consummated.

Assessment procedure
As usual, candidates may not provide all the ratios in appendix 1 before scoring the allocated points. They only need to provide some of the key ratios under each heading. To score the points under box 2 of requirements 1 and 2, all the required ratios or statements must be correctly done. While to score the points on requirements 1 and 2, the calculated ratios/statement must be correctly interpreted and discussed.
Also, to score points under conclusions and recommendations, boxes 7 and 8 of requirements 1 and 2, specific conclusions and recommendations provided on the marking key must be stated in the candidates reports.

To score the points under appendices for requirements 1 and 2 under the overall, the required ratios/statement must be in the appendices provided by the candidates in their reports.

Each box contains at least four points, the marks for each box are allocated as follows:

1. At least four points correct – 4 marks;
2. Three (3) points correct – 3 marks;
3. Two (2) points correct – 2 marks;
4. One (1) point correct – 1 mark; and
5. Zero (0) point correct – 0 mark.

Please take note that there is no compassionate mark under the marking key as marks awarded are based on competency.