

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA



PATHFINDER

NOVEMBER 2015 PROFESSIONAL EXAMINATION

Question Papers

Suggested Solutions

Plus

Marking Guide

Examiners' Reports

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PROFESSIONAL LEVEL - NOVEMBER 2015

CORPORATE REPORTING

Time Allowed: 3 hours

ANSWER FIVE QUESTIONS IN ALL

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

The following financial statements relate to Abia, a public limited company.

Abia Group: Statements of comprehensive income for the year ended April 30, 2015.

	Abia N'm	Banye N'm	Choba N'm
Revenue	1,620	470	284
Cost of sales	<u>(1,372)</u>	<u>(274)</u>	<u>(168)</u>
Gross profit	248	196	116
Other income	62	34	24
Distribution costs	(60)	(42)	(52)
Administrative expenses	(110)	(58)	(24)
Finance costs	<u>(16)</u>	<u>(12)</u>	<u>(16)</u>
Profit before tax	124	118	48
Income tax expense	<u>(42)</u>	<u>(46)</u>	<u>(20)</u>
Profit for the year	<u>82</u>	<u>72</u>	<u>28</u>
Other comprehensive income for the year, net of tax:			
Available-for-sale financial assets (AFS)	40	18	12
Gains (net) on PPE revaluation	24	12	–
Actuarial losses on defined benefit plan	<u>(28)</u>	–	–
Other comprehensive income for the year, net of tax	<u>36</u>	<u>30</u>	<u>12</u>
Total comprehensive income for the year	<u>118</u>	<u>102</u>	<u>40</u>

The following information is relevant to the preparation of the group statement of comprehensive income:

- (i) On May 1, 2013, Abia acquired 70% of the equity interests of Banye, a public limited company. The purchase consideration comprised cash of ₦300 million and the fair value of the identifiable net assets was ₦320 million at that date. The fair value of the non-controlling interest in Banye was ₦108 million on May 1, 2013. Abia wishes to use the 'full goodwill' method for all acquisitions. The share capital and retained earnings of Banye were ₦110 million and ₦170 million respectively and other components of equity were ₦20 million at the date of acquisition. The excess of the fair value of the identifiable net assets at acquisition is due to an increase in the value of plant, which is

depreciated on the straight-line method and has a five year remaining life at the date of acquisition. Goodwill has been impairment tested annually and as at April 30, 2014 had reduced in value by 15% and at April 30, 2015 had lost a further 5% of its original value. The goodwill impairment should be allocated between group and NCI on the basis of equity shareholding.

- (ii) Banye acquired 80% of the equity interests of Choba, a public limited company, on May 1, 2013. The purchase consideration was cash of ₦272 million. Choba's identifiable net assets were fair valued at ₦230 million and the NCI of Choba attributable to Abia had a fair value of ₦52 million at that date. Goodwill had been impairment tested and no impairment had occurred. Choba's profits are deemed to accrue evenly over the year.
- (iii) Abia has sold inventory to both Banye and Choba in October 2014. The sales price of the inventory was ₦20 million and ₦10 million respectively. Abia sells goods at a gross profit margin of 20% to group companies and third parties. At the year-end, half of the inventory sold to Banye remained unsold but the entire inventory sold to Choba had been sold to third parties.
- (iv) Abia sold ₦10 million worth of goods to a customer who recently made an announcement that it is restructuring its debts with its suppliers including Abia. It is probable that Abia will not recover the amounts outstanding. The goods were sold after the announcement was made although the order was placed prior to the announcement. Abia wishes to make an additional allowance of ₦16 million against the total receivable balance at the year end, of which ₦10 million relates to this sale.
- (v) Abia owned a piece of property, plant and equipment (PPE) which cost ₦24 million and was purchased on May 1, 2013. It is being depreciated over 10 years on the straight-line basis with zero residual value. On April 30, 2014, it was revalued to ₦26 million and on April 30, 2015, the PPE was revalued to ₦16 million. The whole of the revaluation loss had been posted to the statement of comprehensive income and depreciation has been charged for the year. It is Abia's company policy to make all necessary transfers for excess depreciation following revaluation.

Required:

- a. Compute the goodwill on acquisition of the subsidiaries, showing amount attributable to the group and the NCI respectively (8 marks)
 - b. Prepare a consolidated statement of comprehensive income for the year ended April 30, 2015 for the Abia Group and show all workings. (22 marks)
- (Total 30 Marks)**

SECTION B: ANSWER TWO OUT OF THREE QUESTIONS IN THIS SECTION (40 MARKS)

QUESTION 2

Megida Plc is in the hospitality industry. The specified ratios and the average figures for the hospitality industry as at December 31, 2014 are stated below:

Return on capital employed	22.1%
Net assets turnover	1.8 times
Gross profit margin	30%
Net profit before tax	12.5%
Current ratio	1.6:1
Quick ratio	0.9:1
Inventory holding period	46 days
Receivables collection period	45 days
Trade payable period	55 days
Debt to equity	40%
Dividend yield	6%
Dividend cover	3 times

Megida's statement of profit or loss for the year ended December 31, 2014 is as follows:

	₦'000
Revenue	2,425
Cost of sales	<u>(1,870)</u>
Gross profit	555
Other operating expenses	<u>(215)</u>
Operating profit	340
Interest payable	(34)
Loss on sale of equipment	<u>(120)</u>
Profit Before Tax	186
Taxation	<u>(90)</u>
Profit for the year	<u>96</u>
Profit for the year	96
Dividends	<u>(90)</u>
Retained profit for the year	6
Retained profit brought forward	<u>179</u>
Retained profit c/f	<u>185</u>

Statement of financial position as at December 31, 2014	N'000	N'000
Non-current assets (Note 1)		540
Current Assets:		
Inventory	275	
Receivables	<u>320</u>	
	<u>595</u>	
Less: Current Liabilities:		
Bank overdraft	35	
Trade payables	350	
Proposed dividend	30	
Taxation	<u>85</u>	
	<u>500</u>	
Net Current Assets		<u>95</u>
		635
8% Loan Stock		<u>(300)</u>
		<u>335</u>
Capital and reserves		
Ordinary shares (N0.5 each)		150
Profit and loss accounts		<u>185</u>
		<u>335</u>

Notes to the accounts

1. Non-current assets

	N'000
Cost	3,600
Accumulated depreciation	<u>(3,060)</u>
Carrying amount	<u>540</u>

2. The Stock Exchange quotation of Megida shares throughout the year averaged ~~N~~6 per 50k share.

Required

- State **THREE** uses and **THREE** limitations of ratio analysis. (6 marks)
 - Comment briefly on the company's performance when compared with the industry average in the areas of liquidity and gearing. (14 marks)
- (Total 20 Marks)**

QUESTION 3

Mimiko is a major property developer, which buys land for the construction of housing.

- a. **Mimiko** took out a foreign currency loan of 5 million Diran at a fixed interest rate of 8% on May 1, 2014. The interest is paid at the end of each year. The loan will be repaid after two years on April 30, 2016. The interest rate is the current market rate for similar two-year fixed interest loans.

Mimiko has a financial statement for year ended April 30, 2015 and the average currency exchange rate for the year is not materially different from the actual rate.

Exchange rates	₦1 = Diran
May 1, 2014	5
April 30, 2015	6
Average exchange rate for year ended April 30, 2015	5.6

Required:

Advice Mimiko on how to account for the loan and interest in the financial statements for the year ended April 30, 2015. (6 Marks)

- b. One aspect of Mimiko's business is to provide low-cost homes in Abuja through the establishment of a separate entity, known as a housing association due to the high cost of rents in that city. Mimiko purchases land and transfers ownership to the housing association before construction starts. Mimiko sells rights to occupy the housing units to members of the public but the housing association is the legal owner of the building. The housing association enters into loan agreements with the bank to cover the costs of building the homes. However, Mimiko negotiates and acts as guarantor for the loan, and bears the risk of increases in the loan's interest rate above a specified rate.

Currently, the housing rights are normally all sold out on the completion of a project. Mimiko enters into discussions with a housing contractor regarding the construction of the housing units but the agreement is between the housing association and the contractor. Mimiko is responsible for any construction costs in excess of the amount stated in the contract and is responsible for paying the maintenance costs for any units not sold. Mimiko sets up the board of the housing association, which comprises one person representing Mimiko and two independent board members.

Mimiko recognises income for the entire project when the land is transferred to the housing association. The income recognised is the difference between the total sales price for the finished housing units and the total estimated

costs for construction of the units. Mimiko argues that the transfer of land represents a sale of goods which fulfils the revenue recognition criteria in IAS 18 *Revenue*. (8 marks)

- c. Mimiko leased its head office during the current accounting period and the agreement terminates in six years' time. There is a clause in the operating lease relating to the internal condition of the property at the termination of the lease. The clause states that the internal condition of the property should be identical to that at the outset of the lease. Mimiko has improved the building by adding another floor to part of the building during the current accounting period. There is also a clause which enables the landlord to recharge Mimiko for costs relating to the general disrepair of the building at the end of the lease. In addition, the landlord can recharge any costs of repairing the roof immediately. The landlord intends to replace part of the roof of the building during the current period. (6 marks)

Required:

Discuss how items b & c above should be dealt with in the financial statements of Mimiko. (Total 20 Marks)

QUESTION 4

- a. The Abuja Municipal Development Authority has mapped out a development strategy for the development of the Municipal. A certain area was marked "Model Area A" which allows companies to use the area for two years and dismantle all constructions made on the allocated space.

Because of the strategic location of this Model Area, Mafowosere Plc, a company operating in the office furniture and interior decoration industry, feels that this can help to promote its merchandise. It therefore pays for all the costs of the "model area" including design, and construction costs. The company plans to use the area for the allowed period and dismantle all constructions and installations thereafter.

The costs of dismantling the 'model area' are normally 15% of the original construction cost and the elements of the area are worthless when dismantled. The current accounting practice adopted by Mofowosere Plc is to charge the full cost of the "model area" against the statement of profit or loss and other comprehensive income in the year when the area is dismantled. The accumulated cost of the "model area" shown in the statement of financial position at December 31, 2014 is ₦38 million. The company has estimated that the average age of the "model area" is 10 months at December 31, 2014.

Assume a discount rate of 12%, if necessary. (7 Marks)

- b. Mafowosere Plc recently undertook a sales campaign whereby customers can obtain free 3 after sales maintenance service, by presenting a coupon, which has been included in an advertisement in a national newspaper, on the purchase of the company's furniture. The offer is valid for a limited time period from September 1, 2014 to December 31, 2014.

The management are unsure as to how to treat this offer in the financial statements for the year ended December 31, 2014. (5 Marks)

- c. The Abuja Municipal Development Authority, in order to encourage the flow of direct foreign investment into the "model area", decided to subsidise the cost of production of any foreign company that invests in the "model area". Mafowosere Plc, through its foreign wholly owned subsidiary claimed the sum of ₦100 million subsidy.

During an audit exercise, this anomaly was discovered and a fine of ₦10 million was imposed on Mafowosere Plc. The company is to repay the ₦100 million subsidy plus ₦12 million interest. The total repayment has been regarded as an intangible asset which has to be amortised. (3 Marks)

- d. Mafowosere Plc gives a standard six months warranty to all its customers. The company has extended the warranty to one year for certain major customers and has insured against the cost of the six months extended period of the warranty. The warranty has been extended at nil cost to the customer.

The claims made under the extended warranty are made in the first instance against Mafowosere Plc and then Mafowosere Plc in turn makes a counter claim against the insurance company. Past experience has shown that 85% of their furniture will not be subject to warranty claims in the first six months, 10% will have minor defects and 5% will require major repair. Mafowosere estimates that in the second six months of the warranty, 15% of the furniture sold will have minor defects and 10% will require major repair.

In the year to December 31, 2014 the following information is relevant:

	Standard Warranty (Units)	Extended Warranty (Units)	Selling Price Per Unit of Warranty (₦)
Sales	3000	7000	2000
		Major Repair	Minor Defect
		₦	₦
Cost of repair (average)		600	150

Assume that sales of furniture are on December 31, 2014 and any warranty claims are made on December 31 in the year of the claim. Assume a risk adjusted discount rate of 5%. (5 Marks)

Required:

Discuss how items (a & d) above should be dealt with in the financial statements of Mafowosere Plc for the year ended December 31, 2014 under International Financial Reporting Standards.

(Total 20 Marks)

SECTION C: ANSWER ANY TWO OUT OF THREE QUESTIONS IN THIS SECTION
(30 MARKS)

QUESTION 5

Global Electricity Plc specialises in the generation and supply of electricity and gas. The directors have reviewed the Financial Statements and feel that there is very little information about their corporate environmental governance and human capital management.

The company discloses the following social and environmental information in the financial statements.

- (i) Corporate Environmental Governance
 - the highest valuation dosage to a member of the public
 - total acid gas emissions and global warming potential
 - contribution to clean air through emission savings
- (ii) Human Capital Management
 - investments in the training and development of staff;
 - full commitment to equal opportunities
 - the number of employees injured at work in the year

The company wishes to enhance its disclosures based on the current best practices in these areas.

Required:

- a. Advise the Directors of Global Electricity on **FIVE** areas each of corporate environmental governance and human capital management to measure and report the company's performance apart from their disclosures. (10 Marks)
- b. Identify and explain five benefits that companies derive from disclosure of social and environmental information in their annual reports. (5 Marks)

(Total 15 Marks)

QUESTION 6

- a. At December 31, Year 1, Haruna owned 90% of the shares in Satima. At this date the carrying amount of the net assets of Satima in the consolidated financial statements of Haruna Group was ₦800 million. None of the assets of Satima are re-valued.

On January 1, Year 2, Haruna sold 80% of the equity of Satima for ₦960 million in cash.

The remaining shares in Satima held by Haruna are estimated to have a fair value of ₦100 million.

Required:

Explain how the disposal of the shares in Satima should be accounted for in the consolidated financial statements of Haruna Group. (7 marks)

- b. H Plc acquired 90% of the equity shares of S Limited for ₦120 million. Goodwill on consolidation was ₦18 million. There had been no impairment of goodwill since the date of acquisition. H Plc sold a 50% holding (leaving it with a 40% holding) for ₦100 million. This transaction resulted in H plc losing control of S Limited. The fair value of the residual investment (i.e. the remaining 40%) was estimated to be ₦70 million. The carrying value of the net assets of S Limited at December 31, was ₦124 million.

Required:

Calculate the gain or loss on disposal.

(8 Marks)

(Total 15 Marks)

QUESTION 7

- a. The principal aim when developing accounting standards for small and medium-sized enterprises (SMEs) is to provide a framework that generates relevant, reliable and useful information which should provide a high quality and understandable set of accounting standards suitable for SMEs. There is no universally agreed definition of SMEs and it is difficult for a single definition to capture all the dimensions of a small or medium-sized business. The main argument for separate SME accounting standards is the undue cost burden of reporting, which is proportionately heavier for smaller firms.

Required:

Discuss the main differences and modifications to IFRS which the IASB made to reduce the burden of reporting for SMEs, giving specific examples where possible. (8 Marks)

- b. Wamako Sokoto has met the definition of an SME in its jurisdiction and wishes to comply with the IFRS for 'Small and Medium-Sized Entities'. The entity wishes to seek advice on how it will deal with the following accounting issues in its financial statements for the year ended November 30, 2014. The entity currently prepares its financial statements in accordance with full IFRS.
- (i) Wamako Sokoto purchased 90% of Muktar Gongora, a SME, on December 1, 2013. The purchase consideration was ₦11.4 million and the value of Muktar Gongora's identifiable assets was ₦12 million. The value of the non-controlling interest at December 1, 2013 was estimated at ₦1.4 million. Wamako Sokoto wishes to use the full goodwill method, if allowed. The estimated life of goodwill cannot be estimated with any accuracy. Wamako Sokoto wishes to know how to account for goodwill under the IFRS for SMEs.
 - (ii) Wamako Sokoto has incurred ₦2 million of research expenditure to develop a new product in the year to November 30, 2014. Additionally, it incurred ₦1 million of development expenditure to bring another product to a stage where it is ready to be marketed and sold.

Required:

Discuss how the above transaction should be dealt with in the financial statements of Wamako Sokoto with reference to the IFRS for Small and Medium-Sized Entities

(7 Marks)

(Total 15 Marks)

SOLUTIONS

SOLUTION 1

(a) Abia Plc

i. Purchase of Banye

	N'M	Group N'M	NCI N'M	Total N'M
Fair Value of consideration paid by Abia/NCI		300.0	108.0	
Fair value of Net asset acquired				
Share capital	110.0			
Retained earnings	170.0			
Other components of equity	20.0			
Fair value adjustment plant (balancing figure)	<u>20.0</u>			
Fair value of net asset acquired	<u>320.0</u>			
Share thereon: Abia 70% and NCI 30%		<u>224.0</u>	<u>96.0</u>	
Goodwill		<u>76.0</u>	<u>12.0</u>	<u>88.0</u>

ii Purchase of Choba

	Group 70%	NCI 30%	Total
Value of cash consideration	190.4	81.6	
Fair value NCI to Abia	<u>-</u>	<u>52.0</u>	52.0
	190.4	133.6	
Fair value of asset: Choba	<u>230</u>		
Share thereon: Abia 56% and NCI 44%	<u>(128.8)</u>	<u>(101.2)</u>	
Goodwill	<u>61.6</u>	<u>32.4</u>	<u>94.0</u>

b. Aba Group

Statement of Comprehensive Income for the year ended 30 April, 2015

	N'M
Revenue	2,334.0
Cost of sales	<u>(1,786.0)</u>
Gross profit	548.0
Other income	<u>120.0</u>
	668.0
Distribution cost	(154.0)
Admin expenses	(203.6)
Impairment of receivable	<u>(6.0)</u>
Operating profit	304.4
Finance cost	<u>(44.0)</u>
Profit before tax	260.4

Tax	<u>(108.0)</u>
Profit for the year	<u>152.4</u>

Other comprehensive income

Available for sale financial asset	78.0
Revaluation PPE	39.2
Actuarial loss defined benefit	<u>(28.0)</u>
Other comprehensive income for the year	<u>89.2</u>
Total comprehensive income for the year	<u>241.6</u>

Profit for the year attributable to:

Owners of the parent	121.0
Non-controlling interest (Wk 8a)	<u>31.4</u>
	<u>152.4</u>

Total comprehensive income attributable to:

Owners of the parent	192.4
Non-controlling interest (Wk 8b)	<u>49.2</u>
	<u>241.6</u>

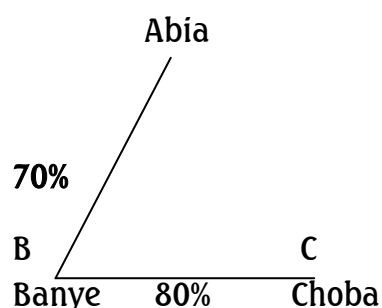
Workings

1. Consolidation Schedule for statement of comprehensive income

	Abia N'm	Banye N'm	Choba N'm	CPL N'm
Revenue	1,620.0	470.0	284.0	
Intragroup sales (wk 3)	(30.0)			
Revenue bankrupt customer (wk 5)	<u>(10.0)</u>			
Net Revenue	<u>1,580.0</u>	<u>470.0</u>	<u>284.0</u>	<u>2,334.0</u>
Cost of sales	(1,372.0)	(274.0)	(168.0)	
Intragroup cost of sales	30.0			
Unrealised prof (wk 4)	<u>(2.0)</u>			
Net cost of sales	<u>(1,344.0)</u>	<u>(274.0)</u>	<u>(168.0)</u>	<u>(1,786.0)</u>
Gross profit	236.0	196.0	116.0	548.0
Other income	62.0	34.0	24.0	120.0
Distribution cost	(60.0)	(42.0)	(52.0)	(154.0)
Admin expenses	(110.0)	(58.0)	(24.0)	
Depreciation (wk 2)		(4.0)		
Loss on revaluation of PPE (wk 6)	(3.2)			
Impairment of goodwill (see A part)		(4.4)		
Total admin expenses				(203.6)
Impairment of trade receivable	<u>(6.0)</u>			<u>(6.0)</u>
Operating profit	118.8	121.6	64.0	304.4
Finance cost	<u>(16.0)</u>	<u>(12.0)</u>	<u>(16.0)</u>	<u>(44.0)</u>
Profit before tax	102.8	109.6	48.0	260.4
Tax	<u>(42.0)</u>	<u>(46.0)</u>	<u>(20.0)</u>	<u>(108.0)</u>
Profit for the year	<u>60.8</u>	<u>63.6</u>	<u>28.0</u>	<u>152.4</u>

Other comprehensive income				
Available for sale financial asset	40.0	18.0	20.0	78.0
Gain PPE revaluation	24.0	12.0		
Revaluation adjustment (wk 6)	3.2			39.2
Losses defined benefit	<u>(28.0)</u>	—	—	<u>(28.0)</u>
Other comprehensive income for the year	<u>39.2</u>	<u>30.0</u>	<u>20.0</u>	<u>89.2</u>
Total comprehensive income for the year	<u>100.0</u>	<u>93.6</u>	<u>48.0</u>	<u>241.6</u>

2. Group Structure



Abia in Banye is 70% and so NCI is 30%

Abia in Choba is 70% of 80% ie

56%

NCI in Choba direct is 20%

Indirect is 30% of 80% i.e. 24%

44%

Total

100%

- | | | | |
|---|--|----------|----|
| 3 | Depreciation on fair value adjustment of plant ₦ 20 m (see (a) part of the solution) divided by 5 years (This will affect both 2014 and 2015 statement of profit or loss) | 4 | |
| 4 | Intra-group sales/cost of sales | 30 | |
| 5 | Unrealised profit on intra-group sales (20% x 20 x 50%) = | | 2 |
| 6 | Revenue (bankrupt customer) | 10 | |
| | Allowance for doubtful receivables | <u>6</u> | 16 |

The ₦10million revenue should not be recognized in the first instance as it is not probable that the economic benefit attaching to the sales will flow to the entity

7	Revaluation of PPE	₦'M
	Cost 01.05.2013	24.00
	Depreciation to 30.04.2014	(2.40)
	Carrying amount 30.04.2014	21.60
	Revalued to	<u>26.00</u>
	Revaluation Reserve OCI	<u>4.40</u>
	01.05.2014 Bal b/f	26.00
	30.04.2015 Dep 26/9 (No of years remaining life of PPE)	(2.89)
	Carrying amount 30.04.2015	3.11
	Revalued to	(<u>16.00</u>)
	Revaluation loss	(7.11)
	OCI (4.4 - 0.49)**	<u>3.91</u>
	Balance to profit or loss	<u>(3.20)</u>

****Note:** Adjustment for excess depreciation following revaluation(i.e. depreciation charged before and after revaluation) (2.89-2.4)) i.e. 0.49

8(a) Profit or loss attributable to NCI:
 NCI in profit for the year (30% x 63.6 + 44% x 28) = **31.40**

8(b) NCI in total comprehensive income
 30% x 93.6 + 44% x 48) = **49.20**

Marking Guide	Marks	Marks
(a) i. Calculation of goodwill on acquisition of Banye		
Fair Value of considerations (Abia & NCI @ $\frac{1}{2}$ Mark each)	1	
Fair value of net assets ($\frac{1}{2}$ mark for each component)	2	
Share of fair value of net assets (Abia & NCI @ $\frac{1}{2}$ Mark each)	<u>1</u>	4
ii. Calculation of goodwill on acquisition of Choba		
Value of cash consideration - (Group & NCI @ $\frac{1}{2}$ mark each)	1	
Fair value of NCI to Abia	$\frac{1}{2}$	
Fair value of net asset – Choba	$\frac{1}{2}$	
Share of fair value of net asset - (Abia & NCI @ $\frac{1}{2}$ mark each)	1	
Group/NCI of respective percentages ($\frac{1}{2}$ Mark each)	<u>1</u>	4
(b) Statement of comprehensive income		
(18 entries @ $\frac{1}{3}$ mark each)		6
Workings (48 entries @ $\frac{1}{3}$ mark each)		<u>16</u>
Grand total		<u>30</u>

EXAMINER'S REPORT

The question tests candidates understanding of the computation of goodwill on acquisition of a direct and indirect subsidiary and the preparation of consolidated statement of comprehensive income.

Being a compulsory question, all the candidates attempted the question and most of them exhibited an average understanding of the question some performed relatively well with about 30% of those who attempted the question scoring 50% and above.

Some of the candidates were unable to compute non-controlling interest and/or identify relevant components of statement of comprehensive income meant for consolidation. Dealing with non-controlling interest in the indirect subsidiary as well as the group's policy on valuing non-controlling interest at fair value was difficult to majority of the students. Adjustment for the revaluation of Property, Plant and Equipment is another area that requires care especially for the depreciation adjustment following revaluation. Only few students were able to deal with this adjustment. This has been well explained in the solution.

Candidates are advised to deepen their understanding of group relationship, the relevant IFRSs dealing with this as well as the adjustments and treatment of non-controlling interest. In consolidated statement of comprehensive income, students are advised to pay attention to calculation of profit for the year attributable to NCI and the parent.

SOLUTION 2

Megida Plc

(a) i. Usefulness of Ratio Analysis

1. **Performance Measurement:** It provides indication of a firm's performance and current financial position. It also measures performance of managers.
2. **Liquidation/Reorganisation Decision:** It helps in identifying whether or not to liquidate or reorganise a business in form of a business combination, merger, acquisition or internal reconstruction.
3. **Investment/Divestment Decisions:** It guides investment decisions as to whether to further invest or divest where such investments is not performing satisfactorily.
4. **Trend Analysis:** It aids in the construction of a pattern of a firm's performance behavior and financial position.
5. **Forecasting:** It helps in predicting the firm's future performance.
6. **Assets Utilization:** It facilitates the assessment of the efficiency with which the firm is utilizing assets for income generation.
7. **Liquidity:** It helps to determine the ability of the firm to meet its current obligations as they fall due.
8. **Comparative Analysis:** It facilitates inter-firm and intra-firm comparison.
9. **Market valuation:** Some ratios are useful in determining the value of a company (e.g. the use of EPS x PE to derive Market Value).

ii. Limitations of Ratio Analysis:

1. Comparison of ratios can be misleading unless they are calculated from financial statements prepared under uniform accounting policies.
2. Due to impact of inflation, ratios calculated from financial statements prepared on historic cost basis cannot give a true picture of yearly trends.
3. There are no generally accepted formulas for calculating certain ratios thereby making it difficult for inter-firm comparison.

4. Only items that can be measured in monetary/quantitative terms are included in financial statements. For instance, non-financial corporate strengths or weaknesses are not incorporated.
5. For purposes of overall assessment of the financial strength or weakness of a firm, the fact that there is no ideal ratio makes the task difficult. For example, a current ratio of less than 2 could be dangerous for many firms, but quite acceptable for others.
6. The factors influencing the performance of a firm in one year may change in another, thus rendering horizontal analysis misleading.
7. The statements of financial position prepared at different points in time are static in nature and therefore cannot give much information about the pre and post statement of financial position events.
8. Ratios on their own are meaningless without a basis of making comparison.
9. Incidence of creative accounting can give misleading ratios.
10. Some items used in the financial statements are subjective since some are provisions made based on management judgment. Thus, ratio computation based on them would also be subjective.

(b) Megida Plc's performance compared with industry average:

i. **Liquidity**

The company shows real cause of concern because:

- Its current and quick ratios are worse than the industry average and are far below expected level.
- Current liquidity problems appear to be due to high level of trade creditors and huge bank overdrafts.
- High level of inventory contributes to the poor quick ratio.
- Receivables collection period is unreasonably long.
- It takes longer days for Megida Plc to settle its payables than industry average, which might damage relationship with suppliers leading to curtailment of further credit.

ii. **Gearing:**

Gearing (as measured by debt/equity ratio) is higher than twice the level of the sectoral/industry average.

Summary

The company's liquidity and gearing position is quite poor and give cause for concern. If it is to replace its old assets in the near future, it will need to raise finance. With the current high level of borrowing, this may be a serious problem for the company. Whilst the gearing level may be at an uncomfortable level, it is currently beneficial to shareholders. The company is making an overall return of 34.6% based on its return on capital employed, but only paying 8% interest before tax, on its loan stock. The gearing level may become a serious issue if Megida Plc becomes unable to meet the finance costs. The company already has an overdraft and the ability to make further interest payments could be in doubt.

Workings:

Calculation of relevant ratios		Unit	Industry Average	Megida Plc's
Return on capital employed (ROCE)	$(186 + 34)/635 \times 100$	%	22.1	34.6
Current ratio	$(595/500)$	Ratio	1.6:1	1.19:1
Quick ratio	$(320/500)$	Ratio	0.9:1	0.64:1
Inventory holding period	$(275/1870 \times 365)$	Days	46	54
Debt collection period	$(320/2425 \times 365)$	Days	45	48
Credit payment period	$(350/1870 \times 365)$	Days	55	68
Debt/equity ratio	$(300/335 \times 100)$	%	40	90

Marking Guide	Marks	Marks
(a) (i) Uses of ratios (Any 3 @ 1 mark each)	3	
(a) (ii) Limitations of ratios (any 3 @ 1 mark each)	3	
(b) Formula for six ratios at 1 mark each		6
- Computation of ratios (6 at ½ mark each)		3
- Comparison with industry average (6 at ½ mark each)		3
- Implication/benefit of liquidity and gearing in relation to ROCE		<u>2</u>
Grand total		<u>20</u>

EXAMINER'S REPORT

The question tests candidates' understanding of the use of ratios to assess the financial state of a company. As such it requires candidates to be able to identify the relevant ratios to use, knowing the correct formula, picking the correct figures from the financial statements and computing correctly. Finally they are expected to make relevant comments using the computed ratios comparing with the industry average.

It was the most popular question of choice after the compulsory question and most of those who attempted the question did very well with about 40% scoring 50% and above. Poor performance by some candidates can be attributed to their inability to limit themselves to the relevant ratios needed to make informed comments as required by the questions as some went ahead to compute all ratios given thereby wasting valuable time that would have been used to address other parts of the question. There were instances where candidates did not get the formulas for the ratios correct, and some got the formulas right but picked wrong figures from the financial statement and even where they got both formulas and figures correct computed wrongly. This may be attributable to examination pressure. Finally some students who got all the above correct were unable to make informed comments on liquidity and gearing of the company.

Candidates should familiarise themselves with what is involved in answering questions on ratios as outlined in this guide for future diets knowing that they should be able to:

- identify the relevant ratios to use,
- know the correct formulae,
- pick the correct figures from the financial statements,
- compute correctly, and
- make informed comments using the computed ratios compared with industry average.

SOLUTION 3

Mimiko

(a) The foreign currency loan will be accounted for as follows:

- i) On the date the 5 million Diran loan was obtained, that is May 1, 2014, Mimiko will have to convert it to naira at the exchange rate ruling on this date which is 5 Diran to N1. This means $5,000,000/5 = \text{N}1,000,000$. It will be recognized as a liability and the receipt into bank account.

Dr Bank	1,000,000	
Cr Loan - Financial Liability		1,000,000
Being foreign currency loan obtained		

- ii) Interest is calculated on due date as $8\% \times 5,000,000$ i.e. 400,000 Diran which in turn will be converted at the average exchange rate for the year, 5.6 Diran. ($400,000/5.6$) which is N71,429.00. It will be recognized as an expense in the statement of profit or loss.

Dr Income statement Finance Cost	71,429	
Cr Loan - Finance Cost payable		71,429
Being interest on loan recognized		

- iii) On payment of interest at year end the 400,000 Diran paid will be converted at the rate ruling on that day which is 6 Diran to the N (that is $400,000/6 = \text{N}66,667$). As interest had earlier been recognized at N71,429, there will be an exchange gain of N4,762. Accounting entry in the financial statements will be:

Dr Finance Cost payable	71,429	
Cr Bank		66,667
Cr Profit or loss - Exchange gain		4,762
Being payment of interest on foreign loan & exchange gain thereon		

- iv) At year end, the liability is translated at closing rate which is 6 Diran to N1 i.e. $5,000,000/6 = \text{N}833,333$. This had already been recognized at N1,000,000. Therefore there is an exchange gain of N166,667. Accounting entry will be:

Dr Loan - Financial Liability	166,667	
Cr Profit or loss - Exchange gain		166,667

Being gain on restatement of foreign currency loan

- (b) The consideration should be whether or not the recognition of income for the entire project by Mimiko on transfer of land to the Housing Association is in line with the provisions of IAS 18 Revenue. According to IAS 18, revenue arising from the sale of goods should be recognised when all of the following conditions have been satisfied (IAS 18.14):
- (i) The seller has transferred to the buyer the significant risks and rewards of ownership;
 - (ii) The seller retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
 - (iii) The amount of revenue can be measured reliably;
 - (iv) It is probable that the economic benefits associated with the transaction will flow to the seller; and
 - (v) The costs incurred or to be incurred in respect of the transaction can be measured reliably.

The key issue is whether Mimiko has transferred the risks and reward of the project to the housing association and does not retain control usually associated with ownership. The following help to determine the true position, Mimiko:

- provides a guarantee as regards the maintenance costs,
- is liable for certain increases in the interest rate over expectations,
- is responsible for financing variations in the procurement and construction contract which the contractor would not cover.
- negotiates and guarantees loan and its repayment for the housing association.
- is exposed to risk as if he had built the housing units himself because he gives guarantees in respect of the construction process.
- determines the membership of the board of the housing association and thus it is questionable whether the board is independent of Mimiko or not.
- guarantees that the housing association would not be liable if budgeted construction costs are exceeded, so Mimiko is exposed to financial risk in the construction process.

On the whole therefore Mimiko can be said to have retained the significant risks and had effective control of the land transferred and also the entire construction process. Consequently, the revenue recognition criteria under IAS 18 Revenue are not met on the transfer of the land. Mimiko should account for the whole project as if he had built the housing units himself. Accordingly, revenue should be recognised when the housing units are finished and delivered to the buyers in accordance with IAS 18. This will be only when the project is completed.

- (c) The issues to be addressed are the treatment of:
- Cost to be incurred at the end of the lease to restore the internal condition of the property to its identical state at the outset of the lease

- Cost incurred to add another floor to the building
- Cost chargeable by the landlord for general disrepair of the building at the end of the lease
- Cost of immediate repair of the roof rechargeable by the landlord

The cost incurred by Mimiko to add additional floor to the building should be capitalised in accordance with IAS 16 *Property, Plant and Equipment* and amortised over the six years of the lease. As Mimiko has an obligation to restore the internal condition of the property to its identical state at the outset of the lease, the additional floor creates an obligating event requiring a provision in line with IAS 37. A provision should be made for the present value of the cost of removal of the floor in six years' time. At the same time, Mimiko should recognise an asset for the cost of removal. The cost should be recovered from the benefits generated by the new floor over the remainder of the lease. The asset should be amortised over the six-year period. In effect, this is in substance a decommissioning activity.

As regards the disrepair of the building, the **estimated costs** should be spread over the six years of the agreement. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* would indicate that Mimiko has a present obligation arising from the lease agreement because the landlord can recharge the costs of any repair to Mimiko. The obligating event is the wear and tear to the building which will arise gradually over the tenancy period and its repair can be enforced through the legal agreement. The wear and tear will result in an outflow of economic benefits and a reliable estimate of the yearly obligation arising from this will be made.

As regards the roof repair, it is clear from the lease terms that an obligation exists and therefore a provision should be made for the whole of the rectification work when the need for the repair is identified.

Marking Guide		Marks	Marks
(a)	Foreign loan/interest conversion/translation and recognition		6
(b)	Revenue recognition criteria (Any 4)	4	
	Key issues on transfer of risks and rewards attaching to ownership (Any 4)	<u>4</u>	8
(c)	Identification of lease terms that results in assets, provisions, expenses	4	
	Comment on IAS 16 and IAS 37	<u>2</u>	<u>6</u>
	Grand total		<u>20</u>

EXAMINER'S REPORT

The (a) part of the question tests candidates understanding of the treatment of the principal and interest component of foreign currency loan in line with IAS 21 – Effect of Changes in Foreign Exchange Rates, while the (b) part examines the practical application of principles around IAS 18 - Revenue, IAS 16 - Property, Plant and Equipment and IAS 37 - Provisions, Contingent Liabilities and Contingent Assets and finally the (c) part tests candidates' understanding of treatment of Operating Leases where the terms contain provisions that alter the nature of the lease.

Many candidates attempted the question and their performance was just average. The major weakness observed on the part of candidates is lack of in-depth knowledge of the principles of IFRSs and their practical application to scenario based transactions. For example many candidates could not apply the principles of what constitutes sale under IAS 18 and conditions under which income can be deemed to have been earned on transfer of land to the housing estate. Also many struggled with understanding the difference between conversion and translation. The most difficult bit appeared to be the treatment of modification and restoration of an item of operating lease where again the candidates can apply knowledge of IAS 16 - Property, Plant and Equipment and IAS 37 - Provisions, Contingent Liabilities and Contingent Assets to resolve the issues raised by the question.

The need for candidates to have a deeper working knowledge of the principles of IFRSs for Corporate Reporting examinations cannot be overemphasized. Candidates are advised to familiarize themselves with this aspect of the syllabus as it will continue to be a constant feature in future diets given the adoption of IFRS in Nigeria.

SOLUTION 4

MAFOWOSERE

- (i) The cost of the model area should be accounted for as Property, Plant and Equipment in accordance with IAS 16 - Property, Plant and Equipment. Property, Plant and Equipment are tangible assets that are held for use in the production or supply of goods and services, for rental to others or for administrative purposes, and are expected to be utilized in more than one accounting period.

The model area meets this definition since it will be in use for more than one accounting year, and customers will be able to view the furniture items in the area. The costs of the model area should be depreciated over their expected useful life to their expected residual value.

MAFOWOSERE Plc, after initial recognition could use the cost model or revaluation model for the measurement of the model area. It would, however, be difficult to use the revaluation model as it would not be possible to measure fair value reliably. Market based information normally will have to be used.

MAFOWOSERE Plc has an obligation to dismantle the model area after two years. The company should assess whether it has a present obligation as a result of past event. The assessment should be carried out in accordance with IAS 37 - Provisions, Contingent Liabilities and Contingent Assets. In this instance, it would seem that a provision should be set up and the amount added to the cost of the asset. The costs of dismantling to be recognized are an initial estimate of the obligations which arises when Property, Plant and Equipment is acquired and as a consequence of using the asset.

With the approximate age of the Property, Plant and Equipment of 10 months and the 15% of cost of dismantling, the cost shown in the statement of financial position of December 31, 2014 should be ~~₦42.51m~~ (₦38m + 15% of ₦38m discounted for two years at 12%). The accumulated depreciation should be ~~₦17.71~~ (~~₦42.51m~~ × $\frac{10}{24}$). The discount ~~₦0.45m~~ (~~₦4.51m~~ × 12% × $\frac{10}{24}$) should be unwound over the two year period as a finance cost in the statement of profit or loss and other comprehensive income.

A provision for the dismantling costs will be set up for ~~₦4.51 m~~ plus the unwound discount of ~~₦450, 000~~ totaling ~~₦4.561m~~.

- (ii) An obligation should not be recognized for the coupons and no provision created under IAS 37 (Provision, contingent liabilities and contingent assets). A provision should only be recognized where there is an obligating event. There has to be a present obligation (legal or constructive), the probability of an outflow of resources and the ability to

make a reliable estimate of the amount of the obligation. These conditions do not seem to have been met. Until the company's furniture is purchased, the free 3 after sales maintenance service cannot be obtained, as this is the point at which the present obligation arises, the probable outflow of resources occurs and an estimate of the amount of the obligation can be made.

When the company's furniture is purchased, the service maintenance becomes part of the cost of the sale. The revenue recognized will be the amount received from the customer (the sales price). The revenue will not be grossed up to include the value of the maintenance service.

- (iii) The payment of the fine constitutes a cost to the company and is not an intangible asset. An intangible asset is a resource controlled by the company as a result of past events and from which future economic benefits are expected to flow (IAS 38 – Intangible Assets). This payment does not meet this definition. The fine should be charged against current year's profits and disclosed as a separate line item under IAS 1 (Presentation of Financial Statements, para 97/98).
- (iv) The cause of the obligation is the initial sale of this furniture product with the warranty given at that time. It would be appropriate for the company to make a provision for the year made up of the 6 monthly warranty of ₦225,000 and ₦577,500 (appendix 1) respectively which represents the best estimate of the obligation.

Only if the insurance company has validated the counter claim will MAFOWOSERE Plc be able to recognize the asset and the income. The company has to be virtually certain. If it is, then MAFOWOSERE Plc may be able to recognize the asset. Generally, contingent assets are never recognized, but disclosed where an inflow of economic benefit is probable.

The company could discount the provision if it was considered that the time value of money was material. The majority of provisions will reverse in the short-term (within 2 years) and therefore, the effects of discounting are likely to be immaterial. In this scenario, using risk adjustment rate (IAS 37), the provision would reduce to ₦219, 510 in the first six months and ₦563, 410 (Appendix 1) in the second six months. The company will have to determine whether this is material or not.

APPENDIX I

1 st Six month warranty	EXPECTED VALUE N'000	DF	DISCOUNTED EXPECTED VALUE (5%) N'000
85% x Nil			
10% x 10,000 x N150 x $\frac{6}{12}$	75		
5% x 10,000 x N600 x $\frac{6}{12}$	<u>150</u>		
	<u>225</u>	(1.025)	<u>219.51</u>
2 nd Six month extended warranty			
15% of N7,000 x 150	157.5		
10% of N7,000 x 600	<u>420.0</u>		
	<u>577.5</u>	(1.025)	<u>563.41</u>

Marking Guide	Marks	Marks
(i) Cost of model accounted under IAS 16	1	
Specification of measurement model after initial recognition	1	
Assessment of obligation arising under IAS 37	1	
Cost in SOFP calculation	1	
Depreciation	1	
Discount as a finance cost in SCI	1	
Provision for dismantling	<u>1</u>	7
(ii) Conditions under which obligation is recognised	1	
Relevance of the IAS 37 to the case	2	
Treatment of cost of sale/revenue	<u>2</u>	5
(iii) Definition of Intangible asset and relevant IAS	1	
Accounting treatment of fine and repayment	<u>2</u>	3
(iv) Calculation of 1 st six months warranty	2	
Calculation of 2 nd six months warranty	2	
Explanation	<u>1</u>	<u>5</u>
Grand total		<u>20</u>

EXAMINER'S REPORT

The question specifically requires the candidates to apply the principles of IAS 16- Property, Plant and Equipment, IAS 37- Provisions, Contingent Liabilities and Contingent Assets including warranty and IAS 38 -Intangible Assets. Candidates are expected to demonstrate knowledge of the standards covering issues of measurement, recognition, capitalisation of dismantling cost, depreciation and unwinding of interest.

Most of the candidates did not attempt the question and those who did performed below average. The candidates were unable to relate and apply the relevant IAS to the question.

Candidates are advised not only to study the IFRS, but to deepen their knowledge in the practical application of its principles in different scenario based situations and cases.

SOLUTION 5

GLOBAL ELECTRICITY PLC

a. From: The Consultant,
Corporate Environmental Governance and Human Capital
Management

To: The Managing Director/Chief Executive Officer,
Global Electricity Plc

Dear Sir,

Advice on Corporate Environmental Governance and Human Capital Management

Further to the meeting of last week between your company's representatives and our firm, we hereby highlight additional areas you can consider on the above-stated subject matter.

Corporate Environmental Governance

The areas that further disclosures can be made, among others, are:

- (i) Use of energy, emissions and waste disposal
- (ii) Environmental remediation expenditure
- (iii) Environmental disclosure assurance
- (iv) Progress in addressing changes in legal requirements that are not yet effective.
- (v) Investment in local community initiatives
- (vi) Accidents affecting the environment, such as, oil spillage, water pollution and toxic waste
- (vii) Transportation of products
- (viii) Gas pipeline vandalism

Human Capital Management

For human capital management, some areas where further disclosures can be made are:

- (i) The size and composition of the workforce
- (ii) Retention and motivation of employees
- (iii) Remuneration and fair employment practices
- (iv) Leadership and succession plan
- (v) Accidents affecting the community
- (vi) Policy for employing physically-challenged persons
- (vii) Congruence of employee and organizational goals
- (viii) Job rotation for experience acquisition
- (ix) Mutual trust and confidence

If you need further clarification on any of these areas, please contact the undersigned.

Yours faithfully,

Signed

Managing Consultant

- (b) Benefits that companies derive from disclosure of social and environmental information in annual reports:
- (i) **Top Management/Board of Directors:** top Management needs the disclosure to respond to press criticisms, answer shareholders' questions and ensure that company policies are followed.
Board of Directors, because of their growing legal liability, needs to know in some details what social programmes the company undertakes.
 - (ii) **Environmentalist and other stakeholders:**
Management can disclose social and environmental information to satisfy the above groups.
 - (iii) Social and environmental disclosures influence some investor's decisions
 - (iv) Disclosures also differentiate a company from its competitors.
 - (v) It can confer on the firm, some level of acceptability within the local environment.
 - (vi) It may indicate the ability to manage key resources, risks and relationship

Marking Guide		Marks	Marks
(a)	Presentation	2½	
	Relevant points on corporate environmental governance (Any five points at 1½ marks each)	7½	10
(b)	Relevant points on human capital management (any 5 @ 1 mark)		5
	Grand total		15

EXAMINER'S REPORT

The question examines issues described as “Beyond Financial Reporting” in the syllabus covering corporate environmental governance and human capital management and disclosure of social and environmental information.

Most of the candidates attempted the question because they felt they could deal with the issues raised by the questions. Unfortunately their performance was not too good.

The commonest pitfall was their inability to highlight the relevant issues on corporate environmental governance and human capital management as well as disclosure of social and environmental information. Another contributory factor was the failure to present their recommendations in a report format.

Candidates are advised to properly cover all aspects of the syllabus in their preparation to enhance better performance in future diets.

SOLUTION 6

HARUNA GROUP

- (a) In accounting for this in the Consolidated Financial Statements of Haruna Group, the gain or loss on disposal will be recognised in group income statement. This is calculated as follows

	N'M
Fair value of consideration received (Sales proceeds)	960
Fair value of retained interest	<u>100</u>
	1,060
Less: Carrying amount of Satima at the date of disposal (800 x 90%)	<u>(720)</u>
Gain on disposal to be credited to profit and loss	<u>340</u>

Explanation:

If a part disposal results in loss of control the parent must recognise a profit or loss on disposal in the consolidated statement of comprehensive income.

A part disposal which does not result in loss of control is a transaction between the owners of the subsidiary.

In this case, the parent company should recognise the profit on disposal in the consolidated statement of comprehensive income.

- (b) The gain on disposal recognised in the statement of comprehensive income should be calculated as follows:

		N'M
Consideration received for shares in Satima Limited		100.0
Fair value of residual investment		<u>70.0</u>
		170.0
Net assets de-recognised	124.0	
NCI (10% x ₦124 million)	<u>(12.4)</u>	
	111.6	
Goodwill derecognized	<u>18.0</u>	
Net assets sold		<u>(129.6)</u>
Gain on disposal, reported in profit or loss		<u>40.4</u>

Marking Guide	Marks	Marks
(a) i) Calculation of Gain or Loss on disposal (5 entries @ 1 Mark each)	5	
ii) Explanation on treatment of profit or loss on disposal (2 points @ 1 mark each)	<u>2</u>	7
(b) Calculation of Gain or Loss on disposal (8 ticks @ 1 mark each)		<u>8</u>
Grand total		<u><u>15</u></u>

EXAMINER'S REPORT

The question tests candidates' knowledge of the computation and treatment of profit or loss on disposal of interests in subsidiaries that results in loss of control.

This question was in fact the example on page 777 of the Study Text.

Almost all the candidates attempted the question and most of them displayed clear understanding of the requirement with above average performance.

SOLUTION 7

IFRS FOR SMEs

(a) Differences

In deciding on the changes made to IFRS for SMEs, the needs of the users have been taken into account, as well as the costs and other burdens imposed upon SMEs by IFRS. Relaxation of some of the measurement and recognition criteria in full IFRS has been made in order to achieve the reduction in these cost and burdens. Some disclosure requirements in full IFRS are intended to meet the needs of listed entities, or to assist users in making forecasts of the future. Users of financial statements of SMEs often do not need such detailed information.

Small companies have different strategies with survival and stability rather than profit maximization being their goals. The stewardship function is often absent in small companies, thus there are a number of accounting practices and disclosures which may not provide relevant information for the users of SME financial statements. As a result the standard does not address the following topics:

- (i) Earnings per share
- (ii) Interim financial reporting
- (iii) Segment reporting
- (iv) Insurance (because entities that issue insurance contracts are not eligible to use the standard); and
- (v) Assets held for sale

Modifications

In addition there are certain accounting treatments, which are not allowable under the standard. Examples of these disallowable treatments are the revaluation model for property, plant and equipment and intangible assets.

Generally there are simpler and more cost effective methods of accounting available to SMEs than those in full IFRS accounting practices, which have been disallowed.

Additionally, the IFRS for SMEs makes numerous simplifications to the recognition, measurements and disclosure requirements in full IFRSs.

Examples of these simplifications are:

- (i) Goodwill and other indefinite-life intangibles are amortized over their useful lives, but if useful life cannot be reliably estimated, then the useful life is presumed to be 10years.

- (ii) A simplified calculation is allowed if measurement of defined benefit pension plan obligation (under the projected unit credit method) involves undue cost or effort.
- (iii) The cost model is permitted for investments in associates and joint ventures.

As a result of the above-stated differences and modifications, SMEs do not have to comply with over 90% of the volume of accounting requirements applicable to listed companies. If an entity opts to use the IFRS for SMEs, it must follow the standard in its entirety and it cannot cherry pick between the requirements of the IFRS for SMEs and those of full IFRSs.

(b) i) **Business Combination**

IFRS 3 - Business Combinations allows an entity to adopt either the full or partial goodwill in its consolidated financial statements. However, the IFRS for SMEs only allows the partial goodwill method. As a result, IFRS for SMEs does not require SME to determine the fair value of the non-controlling interests not purchased when undertaking a business combination.

Beside, IFRS 3 - Business Combinations requires goodwill to be tested annually for impairment, but IFRS for SMEs requires goodwill to be amortised annually within the period of its useful life. This is a much simpler approach. The standard also specifies that, when the useful life of the goodwill cannot be reliably estimated, it should be presumed to be ten years.

Arising from the foregoing, the goodwill of Wamako Sokoto on acquisition of 90% interest in Muktar Gongora will be as follows:

	N'000
Consideration furnished	11,400
Fair value of identifiable net assets acquired (90% of N12,000)	<u>10,800</u>
Goodwill on acquisition	<u>600</u>

The above-calculated goodwill of N600,000 will be amortised for a period of ten years at N60,000 per annum.

(ii) **Research and Development Expenditure**

IFRS for SMEs requires that all internally generated research and development expenditure shall be expensed through profit or loss in the year in which it arises. Unlike full IFRS under IAS 38 –

Intangible Assets which requires that expenses in relation to internally generated research and development should be expensed at research stage and capitalized at development stage. The development stage requires a specified requirement to be met before such capitalization can take place. Sometimes, these requirements are difficult to determine. With the simplified approach adopted under IFRS for SMEs, it has taken away the burden of determining the development stage criteria. As a result of the above, Wamako Sokoto total expenditure on research and development of ₦2million and ₦1million respectively must be written off to profit or loss for the year, resulting in write-off of total sum of ₦3million.

Marking Guide	Marks
(a) Differences between Full IFRS and IFRS for SMEs covering Earnings per share, Interim financial reporting, Segment reporting, Insurance, Assets held for sales	5
Modifications of Full IFRS to suit SMEs on Goodwill and other intangibles, Defined Benefit plan and Cost model for investments	3
(b) i) No fair value for goodwill and Computation of goodwill	4
ii) Full IFRS – Research and Development and SMEs R & D	<u>3</u>
Grand total	<u>15</u>

EXAMINER'S REPORT

The question requests candidates to discuss and demonstrate the main differences and modifications made to full IFRS to reduce the burden of reporting for SMEs.

Only some of the candidates attempted the question and their performance was poor. Majority of the candidates could neither state the differences nor the modifications.

With the relevance and quantum of the SMEs in Nigeria's business environment, candidates need to ensure proper understanding of the provisions of IFRS for SMEs.

PROFESSIONAL LEVEL EXAMINATION - NOVEMBER 2015

ADVANCED AUDIT AND ASSURANCE

Time Allowed: 3 hours

ANSWER FIVE QUESTIONS IN ALL

SECTION A: COMPULSORY QUESTION (30 Marks)

QUESTION 1

- a. Gnasher Investigations is an entity specialising in conducting investigations for corporate clients. It employs ex-police officers, security consultants, IT and fraud specialists. Gnasher Investigations recently dropped its firm of auditors and has approached your firm to undertake the audit. You have been provided with the following information:

- ☐ Gnasher Investigations is a major service provider to your firm, particularly in the provision of IT and fraud consultancy.
- ☐ Gnasher Investigations has acrimoniously dropped their previous auditors and are withholding fees, pending the resolution of a number of issues in particular relating to their accusations on the competence of the auditors.
- ☐ Gnasher Investigations is facing a hostile take-over at present from Technical Investigations Group, a company you also audit.

Required

- i. Explain the impact of each of the three pieces of information provided above and how these would influence your decision to accept the nomination as auditors for Gnasher Investigations. (5 Marks)
 - ii. Describe other factors that you would consider in taking a decision as to the acceptance of Gnasher Investigations as a client. (5 Marks)
 - iii. Describe the steps you would take if you decided to accept the nomination as auditors for Gnasher Investigations. (5 Marks)
- b. You are required to discuss the following **FIVE** elements of good quality control in a firm of Chartered Accountants:
- (i) Independence
 - (ii) Personnel management
 - (iii) Acceptance and continuance of client
 - (iv) Engagement performance
 - (v) Monitoring (10 Marks)

- c. Why does the Institute of Chartered Accountants of Nigeria place much emphasis on the requirement that all member firms put in place a system of quality control? (5 Marks)
(Total 30 Marks)

SECTION B: ANSWER ANY TWO OUT OF THREE QUESTIONS IN THIS SECTION (40 Marks)

QUESTION 2

- a. Analyse and evaluate any **FOUR** fundamental principles of ethical standards as provided in the Institute of Chartered Accountants of Nigeria's Code of Professional Conduct for Accountants. (8 Marks)
- b. Outline the penalties for a member's unethical behaviour. (4 Marks)
- c. Outline the powers available to the Institute to enforce the ethical standards. (8 Marks)
(Total 20 Marks)

QUESTION 3

EBOLA SANITIZER LIMITED

You have been appointed as the auditor of Ebola Sanitizer Limited for the year ended 31 December 2014. The principal activity of the company is the development, manufacture and sale of Ebola-testing equipment for health care sector.

During the planning meeting with the Company's Chief Finance Officer, the following matters were brought to your attention:

- (i) Inventories include ₦1.5million in respect of the cost of instruments made to a customer's specification. The customer is based in a country which recently imposed trading sanctions against your country.
- (ii) Work-in-progress includes ₦2.5million in respect of an equipment being manufactured for Hazard Care Plc. Labour has been charged at daily rates, which include direct costs and appropriate overheads.
- (iii) In October 2014, the company commenced construction of an assembly line for its new range of testing machines. The line is due to be completed in February 2015. The costs recorded in the non-current assets register include materials, labour, overheads and loan interest.

Required:

- a. Prepare an audit planning memorandum (extract) setting out specific audit work to be carried out in respect of the matters stated in (i – iii) above.
(10 Marks)
 - b. Advise on audit adjusting entries to be raised to correct any material misstatements in the financial statements.
(10 Marks)
- (Total 20 Marks)**

QUESTION 4

There are occasions when company directors might want to conceal documents or records. For example, if the company is facing litigation for a considerable sum of money, they may not wish to disclose this fact in their financial statements since the appropriate treatment could well be the recording of a liability. Documents showing that a company's assets are not worth as much as they are stated in the statement of financial position may also be suppressed by the directors.

It is likely that company directors will attempt to conceal a matter where it will have an adverse effect on the company's financial statements. There may also be occasions when directors do not disclose matters that might improve a company's profit figure. For example, directors might be intent on "income smoothing" or shareholding directors in small companies may wish to minimise their profits for tax purposes.

Required:

- a. Analyse **THREE** circumstances under which company directors may portray the company's performance as better than it actually is. (6 Marks)
 - b. Assess and advise on any **TWO** audit procedures required to deal with identified misstatements in various account balances and other financial statements disclosures. (4 Marks)
 - c. Develop audit procedures the auditor should adopt where he has identified the risk of material misstatements in the financial statements arising from fraud. (10 Marks)
- (Total 20 Marks)**

SECTION C: ANSWER ANY TWO OUT OF THREE QUESTIONS IN THIS SECTION

(30 Marks)

QUESTION 5

An installed software programme that can process accounts receivables was presented to the auditor of Yes Limited. The aging, which indicates how long the customers' balances were outstanding, is useful when evaluating the collectability of those accounts.

In order to test whether the age analysis was done correctly, the auditor decided to test the clients' schedules. He used the audit firm's software to recalculate the aging. He reasoned that if the aging of accounts receivables produced by his audit software was in reasonable agreement with the clients figures, he would have evidence that the client's aging was reliable.

However, the auditor was shocked when he found material differences between the balances he arrived at using his Audit software and the client's balances. The client's information technology manager investigated the discrepancies and discovered that programme errors occurred while designing the software. This outcome caused the auditor to substantially increase the level of his review of the year-end balances which eventually resulted in significant audit adjustments to the financial statements.

Required:

- a. Assess and advise on any **THREE** ways information technology improves internal control. (6 Marks)
- b. Evaluate **SIX** risks specific to accounting systems in IT environment. (9 Marks)

(Total 15 Marks)

QUESTION 6

B Plc, a leader in the manufacture of beverages has been in crisis since its shareholders' loss of confidence in its management. The predecessor of B Plc which was a partnership between two friends metamorphosed into a private company after 15 years of operation. Two years later, it became a public company. The erstwhile partners had substantial interest and control in the company. The way the affairs of the company were being conducted was not much different from the partnership business which was the progenitor of the public company. This overbearing influence of the former partners caused disaffection among the other shareholders.

Your audit firm has just been appointed as the auditors of the company and you found out that many internal and accounting control systems are being short circuited by management.

Required:

- a. As the leader of the team in charge of the audit of the company, assess the attitude of management vis-a-vis spirit of good governance. (9 Marks)
 - b. Evaluate **SIX** matters of importance requiring the auditors of a public company to communicate with those charged with governance of the company. (6 Marks)
- (Total 15 Marks)**

QUESTION 7

Mystical Perfumes has been in existence importing perfume for a number of years. The managing director had built up the business using contacts he already had in the industry. The company imports only one brand of perfume which is manufactured exclusively by one company. The perfume is distributed via 'shops within shops' at 20 branches of a well-known store. Under this agreement, Mystical Perfumes pays a percentage of its takings to the store, with a minimum annual payment of ₦100,000 per store.

The audit is nearing completion but you have just heard that the Tanzanian manufacturer is facing serious financial difficulties and that supplies have ceased.

Required

- a. Set out additional information that the auditor would require before reaching his audit opinion. (7 Marks)
 - b. Set out the possible forms of report that the auditor may issue. (8 Marks)
- (Total 15 Marks)**

SOLUTIONS

SOLUTION 1

Based on first Scenario

- (a) i. Since Gnasher Investigation is a major service provider to our firm, the issue of independence is of great concern which may not allow us take up the audit.

Based on second Scenario

If the reason of parting ways with the old audit firm is incompetence and there is no independence issue, we can take up the audit and press for the payment of the withheld fees on behalf of the previous auditors.

Based on third Scenario

As auditors to Technical Investigation Group which is considering taking over Gnasher Investigations, it will not be advisable for our firm to take over the audit of Gnasher, since the company is facing a hostile take-over by the Technical Investigation Group and this could cause conflict of interest.

- ii. Other factors to be considered before accepting the nomination as auditors for Gnasher Investigations include:
- Assessment of whether there are any professional problems attached to accepting the engagement, e.g. problems of lack of independence, lack of technical expertise or conflict of interest.
 - Ensuring that resources are available to complete the audit assignment, especially the right number and quality of staff.
 - The need to carry out risk assessment of the assignment.
 - Taking up references on the proposed client company and its directors, if they are not already known to the firm. This is known as client screening.
 - Communicating with the existing auditors to discuss the appointment, the client and the audit work, to establish if there are any matters that we should be aware of when deciding whether or not to accept the appointment.
 - Whether a partner or anyone closely connected with a partner has a beneficial interest in Gnasher. This may be particularly relevant in view of the existing relationship with Gnasher.
 - Fees in relation to overall income of the firm.

- iii. Once we have decided to accept the nomination as auditors for Gnasher Investigations, we will ascertain that suitable procedures are carried out to ensure that:
- The firm will be independent and there will be no conflict of interest.
 - The firm has the technical competence to do the work.
 - Professional clearance has been sought for and obtained from the previous auditors.
 - Appropriate anti-money laundering procedures are performed i.e. client identification.
 - Letter of engagement is sent to the client and duly signed by the appropriate authority.
 - The audit will not impact on the consultancy service relationship already being provided.

(b)

i. **Independence**

For an audit opinion to be of value, the auditor must be independent and seen to be independent. This means that the auditor must have independence of mind and in appearance. He is not affected by influences or prejudices that compromise his professional judgment. This allows the auditor to act with integrity and exercise objectivity and professional skepticism.

ii. **Personnel Management**

This centres on the direction and supervision of staff, and review of their work.

Direction:

- The audit team should be informed of the work they are expected to carry out and the objectives that the work is intended to achieve.

There should be a well prepared audit work programme

- Staff should be familiar with the overall audit plan.
- Staff should understand:

Their responsibilities:

Nature of the business of the client

Risk related issues

Detailed approach to the performance of the audit

Review of work

This may take the following forms:

- Peer review
- Engagement quality control review
- Hot review
- Monitoring review or cold review

The purpose of audit review is to check whether:

- The audit work was carried out to proper professional standard
- The objectives of the audit have been achieved
- The work carried out during the audit and the audit evidence are suitably documented and that the audit evidence supports the conclusions that have been reached.

iii. Acceptance and continuance of client

ISQC 1 requires that the firm should establish policies and procedures to provide it with reasonable assurance that the firm will only take on or continue work where the firm

- Is competent to perform the engagement
- Has the capabilities, including the necessary resources to do so
- Can comply with the relevant ethical requirements,
- Has considered the integrity of the client and does not have information which would lead it to conclude that the client lacks integrity
- Is sure that there will be independence and there are no conflicts of interest
- Professional clearance is received from previous auditors in the case of new client

iv. Engagement performance

Policies and procedures are required to include:

- Those that will ensure consistent quality engagement performance
- Supervision responsibilities
- Review responsibilities
- Appropriate consultation takes place on difficult or contentious matters
- Sufficient resources are available for such consultation
- The nature, scope and conclusions of the consultation are documented
- Conclusion arising from the consultation are implemented

- Guidance on engagement quality control reviews should be put in place

v. Monitoring

The firm is required to establish a monitoring process designed to provide it with reasonable assurance that its quality control system is relevant, adequate and operating effectively. This process should include inspecting, on a cyclical basis, at least one completed engagement for each engagement partner.

Responsibility for the monitoring process should be given to a partner or other appropriate persons with sufficient experience and authority. When monitoring review which is also known as cold review is carried out, it should not be performed by those involved with the engagement or the engagement quality control review.

The practice should ensure that its quality control and procedures are regularly reviewed and updated to ensure compliance with set standards both within the firm and generally by the profession as a whole.

- (c) The Institute of Chartered Accountants of Nigeria places much emphasis on the requirement that all member firms put in place a system of quality control because IFAC to which ICAN belongs, requires that members should perform their professional work with due skill and care and with proper degree of technical competence.

To satisfy the professional requirements for due skill, care and technical competence, audit firms need to have a strong system of quality control.

Good procedures for quality control reduces the risk for the audit firm to:

- issue an incorrect audit opinion
- be sued for negligence, and payment of damages
- avoid adverse publicity and damage to the reputation of the firm
- avoid loss of client

Marking Guide		Marks	Marks
a)(i)	Stating of impact	1	
	Decision arrived at based on impact	$\frac{1}{2}$	
	2 nd Scenario – as above	1	
		$\frac{1}{2}$	
	3 rd Scenario		
	Stating of impact	1	
	Stating of hostility of takeover	<u>1</u>	5
(ii)	Stating any five factors mentioned	1 mark each	5
(iii)	Stating any steps	1 mark each	5
(b)(i)	Independence:		
	Stating of independence of mind and appearance		
	Not affected by influences or prejudices		
	Acting with integrity		
(ii)	Personnel Management:		
	Direction and supervision of staff		
	Audit programme and working papers		
	Review of work		
(iii)	Acceptance and continuance of client:		
	Establishment of policies and procedures to ensure that the firm is competent and capable		
	Assurance of independence		
(iv)	Engagement performance:		
	- Policy in place for supervision, review of quality control		
	- Availability of resources		
	- Internal and external consultations		
	- Conclusions arising from the consultation & implementation		
(v)	Monitoring:		
	Establishment of monitoring policies	2 marks each for any	
	Responsibility for monitoring – engagement partner	(i) – (v)	
	Regular update of quality control procedures		10
(c)	Stating of due care and skill		1
	Stating of any two risks that will be reduced by good quality control	2 Marks each	4
	Total		<u>30</u>

EXAMINER'S REPORT

The question is in three parts. Part (a) tests audit engagement issues, part (b) tests element of good quality control in an audit firm, while part (c) tests the importance of quality control as enunciated by ICAN.

Being a compulsory question, it was attempted by all the candidates, but performance was poor.

The commonest pitfall of the candidates was their inability to relate part (b) of the question to quality control.

Candidates are advised to read the Study Pack thoroughly before embarking on the examination.

SOLUTION 2

- (a) Fundamental Principles of ethical standards as provided in the Institute of Chartered Accountants of Nigeria's Code of Professional Conduct for Accountants are:

i) **Integrity**

A Chartered Accountant should be straightforward and honest in all professional and business relationships. Integrity implies not merely honest, but fair dealing and truthfulness.

ii) **Objectivity**

Objectivity is the state of mind, which has regard to all considerations relevant to the task at hand, but no other consideration. A Chartered Accountant should not allow bias, conflict of interest or undue influence to override his professional or business judgment.

iii) **Professional Competence and Due Care**

A Chartered Accountant has a continuing duty to maintain professional knowledge and skills at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A member should not accept or perform work, which he is not competent to undertake unless he obtains such advice and assistance as will enable him to do so. A Chartered Accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services. A member should carry out his professional work with due skill, care, diligence and expedition and with proper regard for the technical and professional standards expected of him as a member.

iv) **Confidentiality**

A Chartered Accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any of such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the Chartered Accountant or third party.

v) **Professional Behaviour**

A Chartered Accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

A member should conduct himself with courtesy and consideration towards all with whom he comes in contact with in the course of performing his work.

(b) Penalties for a member's unethical behavior include:

- Fines
- Suspension from membership of the Institute for a period of time
- Expulsion from membership of the Institute
- Withdrawal of Certificate and Licence to Practice
- Reprimand
- Payment of costs associated with the investigations and meetings

(c) Enforcement of ethical standards

- (i) The power of the Institute to enforce ethical standards is derived from the Institute of Chartered Accountants of Nigeria Act No 15 of 1965. This power is conferred on the Accountants Disciplinary Tribunal. The Tribunal in this respect is independent of Council.
- (ii) The Investigating Panel considers complaints against the conduct of members, and is empowered to initiate disciplinary action by referring appropriate cases to the Disciplinary Tribunal for adjudication.
- (iii) Where a complaint is against the conduct of a firm having more than a partner, the complaint shall be deemed to have been made against each and every member who was partner in the said firm at the material time for the purposes of this scenario.
- (iv) Any failure to follow the guidance in fundamental principles or in the statements shall also be taken into account by the Committee of the Institute responsible for regulating the work of members and member firms.

Marking Guide		Marks	Marks
(a)	Stating any of the fundamentals of ethical standard Integrity, objectivity, professional competence and due care, confidentiality, professional behaviour	1 Mark each 4	4
	Development of each fundamental	1 point each 4	
(b)	Any four penalties	1 Mark each <u>4</u>	8
(c)	Analysing the powers of the Institute in enforcing the ethical standards	2 Marks for 4	<u>8</u>
	Total		<u>20</u>

EXAMINER'S REPORT

The question tests ethical standard fundamentals, penalties for unethical behavior by members and the powers available to the Institute on the enforcement of ethical standards.

About 90% of the candidates attempted the question and performance was good.

SOLUTION 3

(a) Extracts of Audit Planning Memorandum:

- (i) - Confirm trading sanctions against your country/client noting when this could be lifted.
- Verify/compute inventory valuation report in respect of the specific inventory of ₦1.5m made to customer's specification.
- Obtain/verify customer's request for the production.
- Trace funds already received on the contract to the financial records and determine amount outstanding.
- (ii) - Verify and recompute work-in-progress sheets/reports in respect of manufacture of equipment for Hazard Care Plc.
- Agree labour charge out rate
- Compute and compare apportionment of overheads
- (iii) Verify cost records for non-current assets, noting
 - Valuation of materials
 - Valuation for labour/charge-out-rate
 - Apportionment of overheads
 - Whether loan interest is directly related to the loan obtained for the manufacture/construction of the assembly line only
 - Verify/review loan document
 - Check interest computation and compare with what is charged to non-current assets register.

(b) Areas of Audit Adjustments

- Audit journal will be raised in respect of the inventory of ₦1.5m which belonged to a customer whose country has imposed trading sanctions against our client's country.
- Where no amount has been received on the contract, write off the full amount already incurred against income.
- Where part payment has been made, write off the inventory value of ₦1.5m, but make provision for the amount paid.
- If interest calculations by the firm are materially different from client's calculation, appropriate correcting journal should be raised.

Marking Guide		Marks	Marks
(a)	1 mark for any 10 points raised	10	10
(b)	2½ marks for any four areas of audit adjustments listed	<u>10</u>	<u>10</u>
			20

EXAMINER'S REPORT

The question tests candidates understanding in respect to preparation of audit planning memorandum and adjustments needed to be made by auditors to correct material misstatement in financial statements.

About 40% of the candidates attempted the question and performance was poor.

The commonest pitfall of candidates was their lack of understanding of the question.

Candidates are advised to read the Study Pack very well before writing the examinations.

SOLUTION 4

(a) Company directors may wish to portray the company's performance as better than it actually is under the following circumstances:

- i. Where directors are entitled to bonus based on higher profit before tax or higher turnover.
- ii. When there is a plan to sell the company or a merger is envisaged.
- iii. Where they intend to influence creditors or lenders particularly where the company is seeking for facilities.
- iv. Where retaining one or more directors is based on performance.
- v. Where there has been some sort of embezzlement on the part of the directors and there is need to cover up.
- vi. Where the company wants to offer its shares to the public.

(b) Steps to be taken when misstatements are identified in various account balances and other financial statements are:

- discuss the matter with management regarding its effect on the accounts
- if the auditor considers that there is an apparent material misstatement of fact, he should request management to take legal advice and thereafter consider the legal advice received by the entity
- notify those charged with governance and explain what the auditor's action will be concerning the misstatement
- take any further appropriate action (such as taking legal advice about the matter)
- where management refuses to adjust the financial statements, the auditor should modify its report based on appropriate circumstances.

(c) The audit procedures to be adopted include the following:

- Deploy experienced personnel in key areas of the clients audit e.g. Revenue, bank balances, receivables, payables and assets.
- Obtain external confirmation in respect of certain balances – banks, receivables and payables.
- Obtain expert advice/confirmation with experts in respect of plant and equipment.
- Carry out an analytical review
- Discuss with those charged with governance.
- Evaluate the internal control system of the company
- Carry out detailed substantive tests

Marking Guide	Marks
(a) Any three circumstances where the Directors may wish to portray better performance than actual	6
(b) Assess and advice on any two procedures	4
(c) Any four audit procedures to be adopted when fraud is identified	<u>10</u> <u>20</u>

EXAMINER'S REPORT

The question tests candidates knowledge on the manipulation or window dressing of financial statements to show better performance than actual and procedures to be adopted by auditors when faced with such circumstances.

About 90% of the candidates attempted the question and performance was below average.

The commonest pitfall of the candidates was their confusing issues to be discussed in Part B for Part C and vice-versa.

Candidates are enjoined to cover the Study Pack adequately before examinations.

SOLUTION 5

- (a) Information technology improves internal control in the following ways:
- i. If correct data is presented to the machine and faultless computer programs are used, the output will be error free.
 - ii. Passwords ensure that only those authorized can handle particular transactions.
 - iii. Access is usually restricted to computer environment.
 - iv. Completeness of recording is assured by the design of programs and procedures that allow only complete documentation to be entered into the system.
- (b) Risks specific to accounting system in an IT environment include:
- i. Human error.
 - ii. Over-riding of controls by management for fraudulent acts.
 - iii. Possibility of collusion and fraud by members of staff particularly computer staff.
 - iv. Failure to apply control properly
 - v. Poor program set-up
 - vi. Unauthorised access to master-file
 - vii. Unexpected systems break down through virus or other means
 - viii. Loss of audit trail

Marking Guide		Marks	Marks
(a)	Any three points how IT improves internal control e.g. password, access restriction, etc	6	
(b)	Any six points on specific risks to Accounting system in an IT environment	<u>9</u>	<u>15</u>

EXAMINER'S REPORT

The question tests candidates understating of how IT improves internal control of an accounting system. It also tests the risks associated with accounting system in IT environment.

About 70% of the candidates attempted the question and performance was poor.

The pitfall of the candidates was stating the benefits of IT instead of stating how Information Technology improves internal control.

Candidates are enjoined to familiarise themselves with their Study Pack more comprehensively.

SOLUTION 6

- (a) The attitude of management of B Plc is at variance with the spirit of good governance for the following reasons:

Corporate governance is the way in which companies are managed and controlled. In particular, it focuses on the role of directors and their responsibilities to shareholders and other stakeholders.

As a form of business entity, an important feature of companies is the divorce of ownership from management. Good governance requires that every company should:

- Be headed by an effective board which is collectively responsible for the success of the company.
- Have a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one should have unfettered powers of decision.
- Have a board that includes a balance of executive and non-executive directors and in particular, independent non-executive directors such that no individual or small group of individuals can dominate the board's decision makings.
- Put in place a formal and transparent procedure for the appointment of new directors to the board.
- Ensure that the board is supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.
- Ensure that the board undertake a formal and vigorous annual evaluation of its own performance and that of its committees and individual directors.

- (b) Matters of importance that are required to be communicated to those charged with governance of a public company by its auditors include:

- i. The responsibility of the auditors in relation to the financial statements.
- ii. Planning, scope and timing of the audit
- iii. Significant findings from the auditors
- iv. Material weaknesses, if any in the design, implementation or operating effectiveness of internal control
- v. Written representations required by auditors
- vi. Auditors' independence
 - A statement that relevant ethical requirements regarding independence have been complied with.

- All relationships (including total fees for audit and non-audit services) which may reasonably be brought to bear on independence.
- The related safeguards that have been applied to eliminate/reduce identified threats to independence.

Marking Scheme		Marks	Marks
(a)	Any six points on good governance 1½ mark for each point.	9	
(b)	Any six points on matters of importance 1 mark per point	<u>6</u>	<u>15</u>

EXAMINER'S REPORT

The question tests candidates' knowledge of Corporate Governance.

About 80% of the candidates attempted the question and performance was poor.

The commonest pitfall of the candidates was their lack of understanding of the requirements of the question which bothers on Corporate Governance.

Candidates are advised to familiarise themselves with the Study Pack.

SOLUTION 7

(a) Further information that the auditor would require before reaching his audit opinion include:

- Obtaining sufficient evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements.
- Checking whether a material uncertainty exists that may cast significant doubts on the entity's ability to continue as a going concern.
- Performing risk assessment procedure to determine whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
- Enquire for written representation from management and where appropriate, those charged with governance, regarding their plan for future action and the feasibility of these plans.
- Enquire from the entity's legal counsel regarding litigation and claims.
- Enquire from management the possibility of getting suppliers from other sources.
- Whether management has been able to determine how long the financial difficulties of their supplier will last
- Enquire about the current level of inventory and determine whether it will be sufficient for the company until supplies resume, or alternative found.
- Confirm whether there is in place Loss of Income Insurance Policy.

(b) Possible forms of opinion

Where the going concern assumption is appropriate but a material uncertainty exists the auditor must consider whether the financial statements:

- Adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with those events or conditions and
- Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

If there is adequate disclosure then the auditor should express an unqualified opinion but should use an "emphasis of matter" paragraph to highlight the

uncertainty and to draw attention to the relevant note in the financial statements.

If there is no adequate disclosure then the auditor should express a “qualified or adverse” opinion.

Where the going concern assumption is inappropriate the auditors should express:

- an adverse opinion if the financial statements have been prepared on a going concern basis.
- an unqualified opinion if the financial statements have been prepared on an alternative acceptable basis (e.g. break-up basis) and there is adequate disclosure of this basis. An “emphasis of matter” paragraph may be required.

Marking Guide	Marks	Marks
(a) Any seven additional information one mark for each point		7
(b) Reference to Going Concern		1
Reference to “Uncertainty –subject to”		2
Stating adequate disclosure, unmodified opinion and emphasis of matter paragraph		2
Stating that there is no adequate disclosure, then there is adverse opinion if financial statements are prepared in line with going concern.		2
Unmodified opinion where the financial statements are prepared on break-up basis.		<u>1</u>
		<u>15</u>

EXAMINER'S REPORT

The question tests candidates' knowledge on the various forms of audit report.

About 80% of the candidates attempted the question and performance was fair.

The commonest pitfall of the candidates was their inability to identify the problem in the question to be able to come up with relevant audit report.

Candidates are advised to cover the syllabus and study the Pack properly.

PROFESSIONAL LEVEL EXAMINATION - NOVEMBER 2015
STRATEGIC FINANCIAL MANAGEMENT
Time Allowed: 3 hours
ANSWER FIVE QUESTIONS IN ALL

QUESTION 1 COMPULSORY QUESTION (30 Marks)

SECTION A

Kay Plc. has been expanding rapidly through mergers and acquisitions. Currently, it is considering a bid for Y Plc. a company whose shares are not traded. The latest Statement of Financial Position of Y Plc. is summarised below:

	₦'m	₦'m
Non-current assets		378
Current assets:		
Inventory	242	
Receivables	163	
Cash	<u>21</u>	<u>426</u>
Total assets		<u>804</u>
Current liabilities	242	
Non-current liabilities	<u>106</u>	348
Share capital	120	
Reserves	<u>336</u>	<u>456</u>
Capital and liabilities		<u>804</u>

Y Plc. has 120million ~~₦1~~ shares issued and fully paid. The non-current assets shown in the Statement of Financial Position above include a property with a book value of ~~₦80~~million. The agreed market value of this property is ~~₦136~~million. The current market values of the remaining assets and liabilities are estimated not to be substantially different from the figures included in the Statement of Financial Position above.

Y Plc's latest Income Statement is summarised below:

	₦'m
Revenue	756
Cost of sales	<u>(544)</u>
Gross profit	212
Administrative cost	<u>(77)</u>
Operating profit	135
Financing costs	<u>(12)</u>
Profit before tax	123
Tax	<u>(39)</u>
Profit after tax	84
Dividend	<u>(18)</u>
Retained profit	<u>66</u>

No interim dividend has been paid. Kay Plc. believes that if the bid succeeds, it can reduce financing and operating costs by ₦14,550,000 per annum (after tax). Kay Plc. further believes that the annual cash flow it will derive from ownership of Y Plc. over the next ten years will be approximately equal to that company's current after tax profit plus the forecast cost savings. Kay Plc considers that cash flows after year ten should be ignored in any valuation of potential acquisitions.

Kay Plc. has an issued share capital of 80,000,000 ₦1 shares with a current market value of ₦32 per share (ex div). Current earnings per share amount to ₦4 and current dividend per share is ₦1.20. The company's asset beta is 0.8. Kay Plc. has no prior charge on capital and no other non-current liability. The risk free rate of interest is 8% and the return on the market portfolio is 13%. Kay Plc. uses the Capital Asset Pricing Model (CAPM) to estimate its cost of capital. The bid will be in the form of a share exchange.

Required:

- a. Explain, in general terms, the criteria a company should use in assessing a potential company for takeover.
(6 Marks)
 - b.
 - i. Calculate the maximum price Kay Plc. should offer per share in Y Plc. to avoid diluting current earnings per share after the takeover.
(3 Marks)
 - ii. Estimate the price Kay Plc. must offer per share in Y Plc. in order to maintain dividend levels to shareholders in that company. You must assume that Kay Plc. does not intend to change its own dividend per share.
(3 Marks)
 - iii. Suggest two other bases of valuing the shares in Y Plc. and calculate the price per share on those bases.
(5 Marks)
 - c. Estimate Kay Plc.'s share prices after the takeover for each of the offer prices calculated in (b) above, assuming that Kay Plc. retains its current P/E ratio after the takeover.
(8 Marks)
 - d. Advise the directors of Kay Plc. on steps that could be taken to minimise the risk of failing to realise the potential synergistic benefits arising from the takeover.
(5 Marks)
- (Total 30 Marks)**

SECTION B: ANSWER ANY TWO OUT OF THREE QUESTIONS IN THIS SECTION

(40 MARKS)

QUESTION 2

Corporate failure is never the result of a random set of events. It is normally a reflection of deep-seated corporate shortcomings.

- a. Identify and discuss the financial symptoms of corporate failure in Nigeria. (6 Marks)
 - b. Discuss **SEVEN** general causes of corporate failure in Nigeria. (14 Marks)
- (Total 20 Marks)**

QUESTION 3

Gazoline Plc., a public limited company with a market value of ₦7billion, is a major supplier of gas to both business and domestic customers. The company also provides maintenance contracts for both gas and central heating customers using the well-known brand name "Gas For All".

Customers can call emergency lines for assistance for any gas-related incident, such as a suspected leakage. Gazoline Plc. employs its own highly trained work force to deal with all such situations quickly and effectively. The company also operates a major new credit card scheme, which has been extensively marketed and is designed to give users concessions such as reductions in their gas bills.

The company has recently bid ₦1.1billion for Smooth Car, a long established mutual organisation (i.e. it is owned by its members) that is the country's leading motoring organisation. Smooth Car is financed primarily by an annual subscription of its 4.4million members. In addition, the organisation obtains income from a range of other activities such as a high profile car insurance brokerage, a travel agency and assistance with all types of travel arrangements. Its main service to members is the provision of a roadside break-down service which is now an extremely competitive market with many other companies involved. Although many of its competitors use local garages to deal with break-downs, Smooth Car uses its own road patrols.

Smooth Car members have to approve the takeover which, once completed, would provide them each with a windfall of around ₦300 each.

Gazoline Plc. intends to preserve the Smooth Car name which is well-known by customers.

Required:

- a. Examine the possible reasons why Gazoline Plc. is seeking to buy Smooth Car. (8 Marks)
 - b. Discuss how the various stakeholders of Smooth Car might react to the takeover. (6 Marks)
 - c. Explain the potential problems that Gazoline Plc. may face in running Smooth Car now that the takeover has been achieved. (6 Marks)
- (Total 20 Marks)**

QUESTION 4

The latest Statement of Financial Position of Kilanko Nigeria Limited is summarised below:

	N'000	N'000	N'000
Non-current assets at net book value			28,500
Current assets:			
Inventory and work-in-progress		17,500	
Receivables		<u>9,000</u>	
		26,500	
Less: Current liabilities:			
Unsecured payables	20,000		
Bank overdraft (unsecured)	<u>8,000</u>		
		<u>28,000</u>	
Working capital			<u>(1,500)</u>
Total assets less current liabilities			27,000
Liabilities falling due after more than one year			
10% Secured Debentures			<u>15,000</u>
Net assets			<u><u>12,000</u></u>
Capital and reserves:			
Called up share capital			20,000
Statement of profit or loss			<u>(8,000)</u>
			<u>12,000</u>

Kilanko Nigeria Limited's called up capital consists of 20million ₦1 Ordinary Shares issued and fully paid. The non-current assets comprise Freehold Property with a book value of ₦15,000,000 and Plant and Machinery with a book value of ₦13,500,000. The debentures are secured on the Freehold Property.

In recent years, the company suffered series of trading losses which have brought it to the brink of liquidation. The directors estimate that in a forced sale of the assets, they will realise the following amounts:

	₦
Freehold premises	10,000,000
Plant and machinery	5,000,000
Inventory	8,500,000
Receivables	8,500,000

The costs of liquidation are estimated at ~~₦~~3,850,000. However, trading conditions are now improving and the directors estimate that if new investments in Plant and Machinery, costing ~~₦~~12,500,000, were undertaken, the company should be able to generate annual profits before interest of ~~₦~~8,750,000. In order to take advantage of this, they have put forward the following proposed reconstruction scheme:

- (i) Freehold premises should be written down by ~~₦~~5,000,000, plant and machinery by ~~₦~~5,500,000, inventory and work-in-progress by ~~₦~~4,000,000 and receivables by ~~₦~~500,000.
- (ii) The Ordinary Shares should be written down by ~~₦~~15,000,000 and the debit balance on the Statement of Profit or Loss written off;
- (iii) The secured debenture holders would exchange their debentures for ~~₦~~7,500,000 ordinary shares and ~~₦~~6,500,000 14% unsecured loan stock repayable five years' time.
- (iv) The bank overdraft should be written off and the bank should receive ~~₦~~6,000,000 of the 14% unsecured loan stock repayable in five years time as compensation.
- (v) The unsecured payables should be written down by 25%.
- (vi) A rights issue of 1 for 1 at par is to be made on the share capital after the above adjustments have been made; and
- (vii) ~~₦~~12,500,000 will be invested in new plant and machinery.

Required:

- a. Prepare the Statement of Financial Position of the company after the completion of the reconstruction.
(6 Marks)
- b. Prepare a report, including appropriate calculations, discussing the advantages and disadvantages of the proposed reconstruction from the point of view of:
 - i. The Ordinary Shareholders.
 - ii. The Secured Debenture holders
 - iii. The Bank.

(14 Marks)

(Total 20 Marks)

SECTION C: ANSWER ANY TWO OUT OF THREE QUESTIONS IN THIS SECTION**(30 MARKS)****QUESTION 5**

The working capital cycle of a business is the length of time between payment for inventory entering into inventory and receipt of the proceeds of sales.

The table below gives information extracted from the Statement of Comprehensive Income and the Statement of Financial Position of Bright Sum Plc. for the years 2012 to 2014.

	2012	2013	2014
Inventory:	₦'000	₦'000	₦'000
Raw materials	1,080	1,458	1,800
Work-in-progress	756	972	933
Finished goods	864	1,296	1,428
Purchases	5,184	7,020	7,200
Cost of goods sold	7,560	9,720	10,983
Revenue	8,640	10,800	11,880
Trade receivables	1,728	2,592	2,970
Trade payables	864	1,053	1,260

You are required to:

- Calculate the working capital cycle for each of the 3 years. (9 Marks)
 - Explain **THREE** possible actions that might be taken to reduce the length of the cycle and **TWO** possible disadvantages of each. (6 Marks)
- (Total 15 Marks)**

QUESTION 6

- In recent years, one of the major problems faced by treasurers of multinational companies has been the fluctuating value of the Naira against other currencies and the difficulty of predicting future movements in the rate of exchange. A treasurer has especially two important functions to perform in a situation of rapid currency movements. firstly, to be clear as to the nature of his company's exposure in terms of exchange transactions and secondly, to minimise the risk from such exposure.

Required:

Describe **TWO** types of foreign exchange exposures which can arise in respect of transactions involving a foreign currency. (6 Marks)

- b. Owiya Osese Plc. a Nigerian Company is due to receive 500,000 Waka, the currency of an African country, in 6 months time for goods supplied. The company decided to hedge its currency exposure by using the forward market.

The short-term interest rate in Nigeria is 15% per annum and the equivalent rate in the African country is 18%. The spot rate of exchange is 2.50 Waka to the Naira.

You are required to calculate how much Owiya Osese Plc. actually gained or lost as a result of the hedging transaction, if at the end of 6 months, the Naira in relation to Waka has:

- i. Gained 4%
- ii. Lost 2%
- iii. Remained stable

NOTE: You may assume that the forward rate of exchange simply reflects the interest rate differential in the two countries (i.e. it reflects the interest rate parity analysis of forward rates).

(9 Marks)

(Total 15 Marks)

QUESTION 7

Assume you are the Finance Director of a large multinational company listed on a number of international stock markets. The company is reviewing its corporate plan and also focuses on maximising shareholder wealth as its major goal. The Managing Director thinks this single goal is inappropriate and therefore asks his co-directors for their views on giving greater emphasis to the following:

- (i) Cash flow generation.
- (ii) Profitability as measured by profits after tax and return on investment.
- (iii) Risk-adjusted returns to shareholders; and
- (iv) Performance improvement in a number of areas such as concern for environment, employees' remuneration, quality of working conditions and customers satisfaction.

Required:

- a. Provide the Managing Director a report for presentation at the next board meeting which evaluates the argument that maximisation of shareholders' wealth should be the only true objective of a company.

(8 Marks)

- b. Discuss the advantages and disadvantages of the Managing Director's suggestions about alternative goals.

(7 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

$$C_0 = S_0 N(d_1) - E e^{-rt} N(d_2)$$

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

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

The Put Call Parity

$$C + E e^{-rt} = S + P$$

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

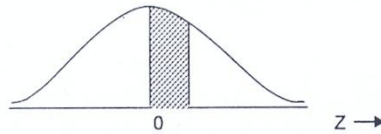
Discount rate (r)

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	.1480	.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									

This table can be used to calculate N(d) the cumulative normal distribution

SOLUTIONS

SOLUTION 1

- (a) The criteria that should be used to assess if a target is appropriate will depend on the motive for the acquisition. The main criteria that are consistent with the underlying motive include:

Benefit for acquiring undervalued company

The target firm should trade at a price below the estimated value of the company when acquired. This is true of companies which have assets that are not exploited.

Diversification

The target firm should be in a business which is different from the acquiring firm's business and the correlation in earnings should be low.

Operating synergy

The target firm should have the characteristics that create operating synergy. Thus, the target firm should be in the same business in order to create cost savings through economies of scale or it should be able to create a higher growth rate through increased monopoly power.

Tax savings

The target company should have large claims to be set off against taxes and not sufficient profits. The acquisition of the target firm should provide a tax benefit to the acquirer.

Increase the debt capacity

This happens when the target firm is unable to borrow money or is forced to pay high rates. The target firm should have capital structure such that its acquisition will reduce bankruptcy risk and will result in increasing its debt capacity.

Disposal of cash slack

This is where a cash rich company seeks a development target. The target company should have highly profitable projects with positive net present value but no funds. This happens when for example the target company has some exclusive right to product or use of asset but no funds to start activities.

Access to cash resources

A company with a number of cash intensive projects or products in their pipeline, or heavy investment in R&D might seek a company that has significant cash resources or highly cash generating product line to support their own needs.

Control of the Company

In this case the objective is to find a target firm which is badly managed and whose stock has underperformed the market. The management of an existing company is not able to fully utilize the potential of the assets of the company and the bidding company feels that it has greater expertise or better management methods. The bidding company therefore believes that the assets of the target company will generate for them a greater return than for their current owners. The criterion in this case is a market valuation of the company that is lower than, for example the value of its assets.

Access to key technology

Some companies do not invest significantly in R&D but secure their enabling technologies by acquisition. Pharmaceutical companies who take over smaller biotechs in order to get hold of the technology are good examples of this type of strategy.

b. i) **Purchase consideration per share.**

If Kay Plc.'s share capital is 80 million ~~£~~1 shares and its current earnings per share is ~~£~~4 then its total earnings will be:

$$(80 \text{ million} \times \text{£}4) = \text{£}320 \text{ million}$$

If Y Plc's total earnings is ~~£~~84 million as per income statement and the additional earnings after takeover is ~~£~~14.55 million then total expected earnings after merger will be:

	£
Kay Plc. existing earnings	320,000,000
Y Plc.'s existing earnings	84,000,000
Expected additional earnings	<u>14,550,000</u>
Total expected earnings	<u><u>418,550,000</u></u>

Required Earnings Per share = ~~£~~4

Therefore, total number of post acquisition shares

$$\text{£} \left(\frac{418,550,000}{4} \right) = 104,637,500 \text{ shares}$$

$$\text{Less: Existing share of Kay Plc.} = \underline{80,000,000} \text{ shares}$$

∴ No of shares to be issued to

$$\text{Y Plc.'s shareholders} = \underline{24,637,500} \text{ shares}$$

If the market value of Kay Plc. is ~~£~~32 per share ex-div, purchase consideration for Y Plc. will therefore be:

$$\begin{aligned} & 24,637,500 \text{ shares} \times \text{£}32.00 \\ & = \text{£}788,400,000 \end{aligned}$$

Since the existing number of shares of Y Plc. is 120 million, then the purchase consideration per existing share in Y Plc. will be:

$$= \frac{\text{N}788,400,000}{120,000,000} = \text{N}6.57$$

ALTERNATIVE METHOD

Let x represent the post-acquisition number of shares in Kay Plc.

Post –acquisition total earnings:

	N
Kay Plc's existing earnings	320,000,000
Y Plc's existing earnings	84,000,000
Synergy	<u>14,550,000</u>
	<u>418,550,000</u>

$$\text{EPS} = \frac{\text{N}418,550,000}{x}$$

$$\text{That is } \text{N}4 = \frac{\text{N}418,550,000}{x}$$

$$\text{Therefore } 4x = \text{N} 418,550,000$$

$$x = 104,637,500 \text{ shares}$$

$$\begin{aligned} \text{Shares issued to Y Plc. will be } & (104,637,500 - 80,000,000) \\ & = 24,637,500 \text{ Shares} \end{aligned}$$

$$\text{Total value placed on Y Plc. will be } 24,637,500 \times \text{N}32 = \text{N}788,400,000$$

Value per existing share of Y Plc. will therefore be:

$$= \text{N}788,400,000 \div 120,000,000$$

$$= \text{N}6.57$$

Thus maximum price payable per share is N6.57

ii) Purchase consideration per share.

Total dividend paid to the Shareholders of Kay Plc. is 80 million x N1.20 = N96million

$$\text{Existing dividend paid by Y Plc.} = \text{N}18\text{million}$$

$$\begin{aligned} \text{Total dividend paid by Kay Plc. \& Y Plc.} \\ \text{to their shareholders before merger} & = \text{N}114\text{million} \end{aligned}$$

$$\text{Required dividend per share after merger} = \text{N}1.20$$

Therefore, total number of shares after merger is

$$\frac{\text{N}114 \text{ million}}{\text{N}1.20} = 95,000,000 \text{ shares}$$

$$\begin{aligned}
\text{Total number of post - acquisition shares} &= 95,000,000 \\
\text{Current number of shares – Kay Plc.} &= \underline{(80,000,000)} \\
\text{Number of shares to be issued to shareholders of Y Plc.} &= \underline{15,000,000}
\end{aligned}$$

If the market value of Kay Plc's share is ~~₦~~32.00
Therefore total purchase consideration for Y Plc.'s
will be 15 million x ~~₦~~32 = ~~₦~~480,000,000

Since number of shares in Y Plc. is 120 million, then
the purchase consideration for Y Plc. will be

$$= \frac{\text{₦}480 \text{ million}}{120 \text{ million shares}} = \text{₦}4 \text{ per share}$$

ALTERNATIVE METHOD

Let x represent total shares issued by Y Plc.

∴ Total dividend receivable in Kay Plc by Y Plc. shareholders will be ~~₦~~1.20 x
This should equal total current dividend in Y Plc, ~~₦~~18,000,000.

Thus: $\text{₦}1.20x = \text{₦}18,000,000$

$$x = \frac{\text{₦}18,000,000}{\text{₦}1.20}$$

$$= 15,000,000 \text{ shares}$$

Total purchase consideration will therefore be:

$$15,000,000 \times \text{₦}32 = \text{₦}480,000,000$$

Thus, amount payable per existing share in Y Plc. will be:

$$\text{₦}480,000,000 / 120,000,000 = \text{₦}4$$

(iii) Two other possible valuation methods in this question are:

Asset Basis and Discounted Cashflow method.

Asset Basis

Value of Y Plc's equity as per its statement of financial position is ~~₦~~456 million

Add: Increase in value of property (~~₦~~136- ~~₦~~80) million = ~~₦~~56 million

Asset value of Y Plc. will therefore be (~~₦~~456 + ~~₦~~56) million = ~~₦~~512 million

Since the number of shares held by the shareholders of Y Plc is 120 million, then
the purchase consideration for Y Plc. using the assets basis will be:

$$\begin{aligned}
&\frac{\text{₦}512,000,000}{120,000,000} = \text{₦}4.26667 \text{ per share} \\
&= \text{₦}4.27 \text{ per share}
\end{aligned}$$

Discounted Cash Flow (DCF) Method:

	N
Annual cash flows from Y Plc.	84,000,000
Expected savings-Financing/Operation Cost	<u>14,550,000</u>
Total Expected annual Cash flows	<u>98,550,000</u>

Therefore expected annual cash flows for the next ten years is ~~N~~98.550,000.

Kay Plc's cost of capital using CAPM is

$$\begin{aligned}K_e &= R_f + \beta(R_m - R_f) \\&= 8\% + 0.8(13\% - 8\%) \\&= 12\%\end{aligned}$$

Therefore, purchase consideration for Y Plc. will be:

~~N~~98,550,000,000 discounted @ 12 percent for 10 year period

i.e ~~N~~98,550,000,000 x 5.65 = ~~N~~556,807,500

Since the number of existing shares held by the shareholders of Y Plc. is 120 million, then the value per share to Y Plc. will be:

$$\frac{\text{N}556,807,500}{120,000,000} = \text{N}4.64006 = \text{N}4.64$$

c) Kay Plc.'s current P/E ratio is

$$\frac{VPS}{EPS} = \frac{\text{N}32}{\text{N}4} = 8$$

If the P/E ratio is maintained, the value will be:

Post- acquisition earnings of Kay Plc x P/E ratio

i.e ~~N~~418,550,000 x 8 = ~~N~~3,348,400,000

Therefore calculations of new value per share of Kay Plc's will be as follows:

	b (i)	b(ii)	Assets Basis	DCF Method
	N'000	N'000	N'000	N'000
Post acquisition Value of Kay Plc.	3,348,400	3,348,400	3,348,400	3,348,400.0
Purchase consideration for Y Plc.	<u>(788,400)</u>	<u>(480,000)</u>	<u>(512,000)</u>	<u>(556,807.5)</u>
New value of Kay Plc	<u>2,560,000</u>	<u>2,868,400</u>	<u>2,836,400</u>	<u>2,791,592.5</u>
Existing number of shares	80,000	80,000	80,000	80,000
Share Price:	N32	N35.855	N35.455	N34.895

- d) The steps that could be taken to minimize the risk of failing to realize the potential synergistic benefits from the takeover include:
- i. **Integration Plan:** The acquiring company should prepare a detailed strategic plan for integration based on its own and the acquired company's strengths and weaknesses. The plan should highlight the objectives and the process of integration.
 - ii. **Communication:** Management should inform employees about their involvement in making the integration smooth and easy and remove any ambiguity and fears in the mind of the staff
 - iii. **Authority and responsibility:** Management should take the employees into confidence and decide the authority and responsibility relationships. The detailed organizational structure can be decided later to avoid confusion and indecisiveness.
 - iv. **Cultural integration:-** Management should focus on cultural integration of the employees of the merged companies. There is a need for understanding of the cultures of the two organizations. Clear communication and training can help to bridge the cultural gaps.
 - v. **Skills and competences upgrading:** Management should prepare and immediately implement a plan for skill and competencies upgrading through training.
 - vi. **Structural adjustment:** Management should be prepared to make adjustments to accommodate the aspiration of the employees of the acquired company.
 - vii. **Control systems:** Management should ensure that it is in control of all resources and activities of the merged firm. It must put proper financial control in place so that resources are optimally utilized and wastage avoided.
 - viii. Kay Plc. should respect the products, markets and customers of Y. Plc.
 - ix. Retention of key personnel (especially of Y.Plc) possibly by offering them enhanced packages.

Marking Guide	Marks
(a) 1 mark for each valid point	6
(b) (i) Post-acquisition total earnings	1
No of shares issued to Y. Plc.	1
Total value placed on Y. Plc.	$\frac{1}{2}$
Maximum price payable per share to Y. Plc.	$\frac{1}{2}$
	3
(ii) Post-acquisition dividend	1
No of shares issued to Y. Plc.	1
Total Price payable	$\frac{1}{2}$
Maximum price payable per share to Y. Plc.	$\frac{1}{2}$
	3
(iii) Asset Method	
Total value of Equity	1
Value per share payable to Y. Plc.	1
DCF Method	
Calculation of cost of equity using CAPM method	$\frac{1}{2}$
Annual total cashflow expected from takeover	1
Identifying correct discount factor.	$\frac{1}{2}$
Total value	$\frac{1}{2}$
Value per share	$\frac{1}{2}$
	5
(c) Calculation of P/E ratio	$\frac{1}{2}$
Stating the post-acquisition earnings of Kay Plc.	$\frac{1}{2}$
Calculation of the expected total value of Kay Plc.	1
- Post-acquisition	
Using the total post acquisition value of Kay Plc. as the opening figure of the 4 scenarios	1
Amount paid for Y Plc for the 4 scenarios ($\frac{1}{2}$ mark each)	2
Total value of existing shares in Kay Plc for the 4 scenarios ($\frac{1}{2}$ mark each)	1
Value per existing share in Kay Plc, for the 4 scenarios ($\frac{1}{2}$ mark each)	2
	8
(d) 1 mark for each valid point (max of 5 points)	5
Total marks	30

EXAMINER'S REPORT

The question tests candidates' knowledge of the issues involved in strategic acquisition and the different methods of valuing companies for takeover.

Being a compulsory question, almost all the candidates attempted it but most of them did not understand its requirements. They therefore performed poorly.

Candidates' commonest pitfall was their failure to answer the question correctly which may be due to their inadequate knowledge of the different methods of valuing companies for a takeover.

Candidates are advised to always cover the syllabus adequately by giving consideration to all sections of the syllabus in their preparation for the Institute's examinations. They should also improve their knowledge on mergers and acquisitions.

SOLUTION 2

(a) Financial symptoms of corporate failure

- i) **Declining profitability:** Low, negative and/or an adverse trend in operating profitability figures normally represent a distress situation;
- ii) **Declining liquidity:** Unless timely stemmed, declining profitability inevitably turns into decreased ability to generate cash and cash crisis.
- iii) **Declining solvency:** Declining profitability sooner or later leads to declining solvency when liabilities exceed assets. A solvency crisis triggers action by banks and other lenders concerned about lack of cover for their exposure; and
- iv) **Inadequate capital:** When a company's capital is not adequate for the business it is engaged in, the company is likely to fail. In a similar vein, if a company's gearing/leverage ratio is high and level of income is not enough to meet the interest payments on the debts, that is, when the interest cover and the liquidity is low, it may lead to problem in meeting the payment of interest on loans.

(b) General Causes of corporate failure in Nigeria

- i) **Bad management:** Management is the process of combining, allocating and utilizing an organizations input(men, materials and funds) by planning, organizing, directing and controlling for the purpose of producing output-goods and services- desired by customers in order to accomplish organizational objectives. Towards achieving this objective, it will be necessary to watch the cost, sales, profit margin etc of the organization;

The end-result of all these management tasks and processes will show in the financial ratios like cash flow to total debt ratio, return on assets ratio, stability of the earnings and the interest coverage ratio, the retained earnings to total assets ratio, the current ratio, and the size of total assets which are some of the ratios that indicate corporate success or failure. From this, it can be safely concluded that how well managers do their work determines whether a company will fail or not.

- ii) **Technology:** Although investment in technology is a management decision some companies lack the resources to acquire the right technology for their industry. This sometimes increases their overhead and their unit cost when compared with their competitors who are able to acquire such modern technology. Since technology assists in the price of goods and service delivery time, companies that are not able to move with the new technological developments are bound to lose out even though acquiring new technology goes a little beyond management decision. Investment in new technology depends on the resource available to the company.

- iii) **Frauds:** Although many companies invest in internal control to avoid or prevent fraud, it still occurs. Corporate fraud has assumed an alarming proportion in Nigeria today despite the legal provisions made against it. It has led to the failure of companies by depleting their resources.
- iv) **Political & Environmental factors:** These are factors that impact negatively or otherwise on the company beyond the control and even sometimes the cognitive forecast of its management. It has to do with political factors such as political turmoil and environmental factors such as the Boko Haram Insurgency.
- v) **Cost of funds:** Companies raise short term funds for working capital from the banks (money market) while they raise long term funds from the capital market. Since cost of funds in Nigeria is very high firms find it very difficult to source funds for their operations from banks and this has been having negative effect on their operations.
- vi) **Inflation:** This has made the cost of goods to be high and since the incomes of the consumers are not moving at the same rate the suppliers increase the price of their products, it has become difficult for consumers to buy the products. Many companies' warehouses are therefore overstocked with unsold goods thereby affecting their operational performance.
- vii) **Poor infrastructural facilities:** The poor level of infrastructural facilities in the country creates additional costs for organizations in the form of provision of electricity, water, transportation , security, communication, etc.
- viii) **Multiple Taxation:** Businesses in Nigeria are exposed to multiple taxation from Local Government level to Federal Government level thereby creating additional cashflow burden. Furthermore, a large number of illegal charges are imposed on organizations by corrupt government officials at the various ports, all of which add to the cost of doing business in the country.
- ix) **Government Foreign Exchange Policy:** This is also an area that contributes to corporate failure in the country. For example, the recent Central Bank guidelines on foreign exchange is adversely affecting many industries as they are now having a shortage of foreign currency to import necessary inputs.

Marking Guide		Marks
(a)	1 mark for each valid point identified(Max 3 points)	3
	1 mark for the discussion (3 marks max) of the valid points identified	<u>3</u>
		6
(b)	1 mark for each valid point (max 7 points)	7
	1 mark for the discussion of the valid points	<u>7</u>
		<u>14</u>
Total		<u>20</u>

EXAMINER'S REPORT

The question tests candidates' understanding of the analysis and evaluation of the symptoms and causes of corporate failure.

About 90 Percent of the candidates attempted the question and performance was average. Most of the candidates that attempted the question showed some understanding except for a few that could not differentiate between the symptoms and causes of corporate failure.

Candidates' commonest pitfall was their inability to express themselves well. They are therefore advised to improve their communication skills.

SOLUTION 3

- (a) The objective of a takeover should be consistent with the overall objective of the firm making the takeover, which in most cases should be to increase the wealth of the shareholders.

However, there are good and bad reasons behind a takeover. Among the good reasons is the possibility of creating synergy, that is increasing the wealth of the shareholders. Although Gazoline Plc. and Smooth Car are in different market sectors, there is a link between the two. It is possible for Gazoline Plc. to make use of the services of Smooth Car in their travelling arrangement for the supply of gas to their customers. They may also use the services of Smooth Car to transport their staff for their maintenance contracts. This is also applicable for the insurance of their staff, their assets and the business. It could therefore be said that the services provided by Smooth Car are complementary to the business of Gazoline Plc.

In this respect, some possible reasons why Gazoline Plc. may seek to buy Smooth Car include:

- i To create synergy, that is to increase the wealth of its shareholders;
- ii. To achieve diversification – spreading its risk. The most obvious being the marketing systems, the call centre system and local offices and training facilities for mobile repair/emergency staff;
- iii. Elimination of duplicate and competing facilities;
- iv. To ensure availability of efficient and reliable transport systems for its staff on maintenance contracts and the supply of gas;
- v. To take advantage of the stable earnings of Smooth Car;
- vi. To take advantage of the cash flow profile of Smooth Car, that is, to reduce the risk of the company's (Gazoline Plc.) cashflow profile;
- vii. To take the opportunity of the takeover to create a new outlet for its product by marketing it to the customers on the data base of Smooth Car (the target company); and
- viii. The take over of Smooth Car will abolish its mutual status and will allow equity funds for expansion to be raised more easily, by share issues made by the parent company, thus, reducing the cost of capital.

- b) The various stakeholders of Smooth Car are its members, who are the owners, directors and senior managers, other employees, customers and creditors.
- i) **Members:** They are likely to be happy with the takeover in view of the promised wind fall. However, they will be interested also in the future direction of the new company, its earning capacity and the financial benefits that may accrue to them. They will also be interested in the consideration for the takeover apart from the wind fall. Since Smooth Car brand name will be retained, members will like to ensure that the company is well managed and its culture of quality services maintained so as to preserve the good name for which it is known. It is also likely that some members may not feel comfortable with the takeover as the organisation has always been part of them. These are the people that may not like change. They may therefore likely look elsewhere for the maintenance of their vehicles.
 - ii) **Directors and Senior Managers:-**These are the members that have been operating the business of the organisation. While they may not be comfortable with the takeover because of the likelihood of losing their jobs, they are expected to act in the best interest of the organisation and ensure that the takeover is in the interest of their members. However, some of them may be interested in what they will benefit from the takeover and therefore, will like to know what the acquirer(Gazoline Plc) has in stock for them with respect to retention or redundancy. They will also want to know the ex-gratia payment that will be due to them in case of redundancy.
 - iii) **Creditors :** The creditors will be interested in their payments and when this are likely to be made, by ensuring that adequate arrangement is made for their settlement. This will be done by making sure the acquirer, that is Gasoline Plc., is financially sound.
 - iv) **Government/Regulatory Authorities:** Government through the Security and Exchange Commission, may be interested in the proposed takeover if it creates monopolistic situation.
- c). Gazoline Plc.may face a number of problems after the takeover has been achieved. These include:
- i) Former members of Smooth Car who did not agree with the takeover, and who may have been actively resisting it, may decide to change their service provider to another organisation. The parent company (Gazoline Plc.) will have to be pro-active in giving confidence to all its Smooth Car Customers;

- ii). The two organisations probably had different management styles; Gazoline Plc. being a stock exchange quoted company with a clear need for financial results and Smooth Car being more oriented to serving its customers and acting as a pressure group to represent their needs, conflicts may arise between directors, managers and employees of Smooth Car after the takeover as a result of an enforced change in management style from Gazoline Plc,
- iii). Actual and feared redundancy, relocations, changes in work practice, training methods and other problems may demotivate Smooth Car employees, causing resistance and a drop in productivity. In this respect, delays in information provision and decision making can make the situation worse, and.
- iv). Competitors may take advantage of re-organisation at Smooth Car in order to gain market share.

Marking Guide	Marks
a) 2 marks for each valid reason identified (maximum of 4 reasons)	8
b) $\frac{1}{2}$ mark for various stakeholders identified (Maximum 4)	2
1 mark each for stating the likely reactions of the identified 4 stakeholders	<u>4</u>
	6
c) 2 marks for each identified potential problem/discussion(maximum of 3 identified problems)	<u>6</u>
Total marks	<u>20</u>

EXAMINER'S REPORT

The question tests candidates understanding of the issues in strategic merger. These include the benefits of mergers and acquisitions to the acquiring company.

Candidates are expected to give reasons for acquisitions and discuss the integration challenges that may be faced after acquisition. About 90% of the candidates attempted the question and performance was good. However, few candidates could not differentiate between 'Shareholders' and 'Stakeholders'.

Candidates are advised to read, understand and interpret questions appropriately and note their specific requirements before attempting them.

SOLUTION 4

(a)

KILANKO NIGERIA LIMITED STATEMENT OF FINANCIAL POSITION

	₦'000	₦'000
Non-current assets:		
Freehold Property (W1)		10,000
Plant & Machinery (W1)		<u>20,500</u>
		30,500
Current assets:		
Inventory & work in progress (W2)	13,500	
Receivables (W2)	<u>8,500</u>	
	22,000	
Less: Current liabilities		
Unsecured payables (W4)	<u>15,000</u>	
Working Capital		<u>7,000</u>
Total assets less current liabilities		37,500
Liabilities falling due after 1 year		
14% unsecured Loan Stock (Secured Debenture Holders)		(6,500)
14% unsecured Loan Stock (Bank)		<u>(6,000)</u>
		<u>25,000</u>
 Called up share capital (original Shareholder W3)	5,000	
Called up share capital (secured debenture holders)	7,500	
 Rights issues (original Shareholders & Debenture holders)	<u>12,500</u>	<u>25,000</u>

Workings

- Non-current assets:
 Freehold property (~~₦15~~ million – ~~₦5~~ million) = ~~₦10~~ million
 Plant and machinery (~~₦13.5~~-~~₦5~~) million + ~~₦12.5~~ million) = ~~₦20.5~~ million
- Current assets
 Inventory & Work in progress (~~₦17.5~~ –~~₦4~~) million = ~~₦13.5~~ million
 Receivables (~~₦9~~ - ~~₦0.5~~ million) = ~~₦8.5~~ million
- Ordinary Share Capital
 Called up share capital
 (~~₦20~~ - ~~₦15~~) million = ~~₦5~~ million (Original Shareholders
~~₦7.5~~million (Secured Debenture holders)
 Total capital before the rights issue = (~~₦5~~ + ~~₦7.5~~) Million = ~~₦12.5~~ million
 Rights issue 1 for 1 = ~~₦12.5~~ million

Therefore Total Capital will be
($\text{N}12.5 + \text{N}12.5$) million = $\text{N}25$ million

4. Unsecured payables
 $\text{N}20 \text{ million} \times 0.75 = \text{N}15 \text{ million}$

b) **OMO FINANCIAL SERVICES LTD**
10 Adedeji Street, Lagos

3/12/2015

The Managing Director
Kilanko Nigeria Limited,
20, Mawamiwa Street,
Odi-Olowo,
Mushin, Lagos.

Sir,

PROPOSED LIQUIDATION/RESTRUCTURING OF KILANKO NIGERIA LTD

In order to be able to make a critical review of the proposed reconstruction of your company from the point of view of the following stakeholders,

- i. Ordinary Shareholders
- ii. Secured Debenture Holders and
- iii. The Bank

it will be necessary to prepare detailed analysis of the reconstruction under liquidation and under the suggested restructuring.

In case of liquidation- The position of the company will be as follows:

	Realisable Value
	₦
Plant and machinery	5,000,000
Inventories	8,500,000
Receivables	<u>8,500,000</u>
	22,000,000
Less: Liquidation Expenses	<u>3,850,000</u>
Amount available to Creditors	<u>18,150,000</u>
10% Secured Debenture	₦15,000,000

This is secured with the freehold property whose book value of **₦15** million could only realise **₦10** million.

Therefore the 10% secured debenture holders will realize the security for ~~₦~~10 million and thereafter claim the balance of ~~₦~~5 million along with other creditors. In this case the total outstanding liability payable will be as follows:

	(₦)
Unsecured payables	20,000,000
Bank overdraft (Unsecured)	8,000,000
Balance payable to secured debenture holders	<u>5,000,000</u>
	<u><u>33,000,000</u></u>

These Creditors will have to share the sum of N18,150,000 which is the amount available to creditors as earlier calculated

Therefore, the proportional amount available to the creditors per naira will be

$$\frac{\text{₦}18,150,000}{\text{₦}33,000,000} = 0.55 \text{ or } 55\text{k}$$

The sharing of the available fund will be as follows:

- i) Ordinary shareholders-They will receive nothing
- ii) The 10% secured debenture holders will receive ~~₦~~10,000,000 that is from the realised asset and $0.55 \times \text{₦}5,000,000 = \text{₦}2,750,000$ from the proceeds of the other assets. They will therefore receive a total amount of ~~₦~~10 million + ~~₦~~2.75 million = ~~₦~~12.75 million i.e ~~₦~~12,750,000. They will therefore lose (~~₦~~15- ~~₦~~12.75) million i.e ~~₦~~2.25 million.
- iii) The bank will receive:
 $0.55 \times \text{₦}8,000,000 = \text{₦}4,400,000$
 Losing (~~₦~~8 - ~~₦~~4.4) million i.e ~~₦~~3.6 million

If the reconstruction succeeds as recommended, the Statement of Financial Position of the reconstructed company as attached (solution to the part.

However, should the proposed annual profit before interest of ~~₦~~8,750,000 be achieved, the company's Statement of Profit or Loss will be as follows:

	₦
Profit before tax and interest	
8,750,000	
Less: Interest on 14% ₦ 6.5 million unsecured loan stock	
(910,000)	
Bank – 14% N6 million unsecured loan stock	
<u>(840,000)</u>	
	<u><u>7,000,000</u></u>

The Earnings Per Share (EPS) will therefore be $\frac{\text{₦}7,000,000}{25,000,000} = 0.28 \text{ or } 28\text{k}$

In this case, the position of the stakeholders will be as follows should the reconstruction succeed.

- i. The original shareholders will earn 28k per share after investing an additional capital of ₦5 million. In effect they will only own 10 million out of the 25 million shares of the company making them non-controlling shareholders. However their share of 28k earning on the old shares will be $\text{₦}0.28 \times 5 \text{ million}$ and their share on the rights issue will also be $\text{₦}0.28 \times 5 \text{ million}$. These will be $\text{₦}1.4 \text{ million} + \text{₦}1.4 \text{ million}$ i.e $\text{₦}2.8 \text{ million}$.
- ii. The secured debenture holders will receive ₦10 million being the proceeds of the security. They will also receive ₦910,000 interest per annum on the unsecured loan stock for 5 years and at the end of the fifth year, they will receive ₦6.5 million being the proceeds of the insured loan. They will in addition receive ₦0.28 on the 7.5 million ordinary shares allotted to them and ₦0.28 on the rights issue. In effect they will earn $\text{₦}2.1 \text{ million} + \text{₦}2.1 \text{ million} = \text{₦}4.2 \text{ million}$ on the shares held.

Their annual earnings will therefore be:

Interest on the 14% unsecured Loan Stock	₦ 910,000
Earnings per share on their shareholdings	<u>₦ 4,200,000</u>
Total yearly earnings	<u>₦ 5,110,000</u>

- iii. The bank – The bank will receive a yearly interest of ₦840,000 for 5 years after which they will receive the sum of ₦6 million being the principal value of the 14% unsecured loan stock. However, the bank will lose ₦2 million immediately.

In conclusion, it is clear from the two cases that the secured debenture holders benefit most whether on liquidation or on reconstruction.

However, the restructuring is the best option for the company and should therefore be pursued.

Thanks

Yours faithfully

Signed

For:Omo Financial Services Ltd

Marking Guide	Marks
a) Calculation of Non-current assets–Freehold Property/Machinery	1
b) Current assets – Inventory & work in progress and Receivables ½ mark each	1
Unsecured payables	½
Total assets less current liabilities	½
Unsecured loan – Debenture holders/Bank (½ each)	1
Called-up share capital (original Shareholders /secured Debenture holders ½ each	1
Rights issue (original Shareholders/Secured debenture holders) ½ each	<u>1</u>
	6
b. Date, address, subject matter etc	2
Working – liquidation Account	1
Secured Debenture (Stating the fact that the secured Debentures holders would realize the secured assets and then claim for the balance along with other creditors)	2
Workings of the dividend available to creditors	<u>1</u>
	6
Stating the entitlements of each of the shareholders i.e ordinary shareholders, the secured debentures and the bank in case of liquidation.	3
Calculation of the Earnings per share in case of reconstruction	1
Stating the entitlements of each of the Stakeholders i.e Ordinary Shareholders, the secured debenture holders and the bank in case of restructuring	3
Conclusion	<u>1</u>
	<u>8</u>
Total Marks	<u>20</u>

EXAMINER'S REPORT

The question tests candidates' knowledge of the principles of reconstruction.

About 50% of the candidates attempted the question but performance was poor. Candidates are expected to prepare the Statement of Financial Position after the reconstruction and also evaluate the scheme of reconstruction but they showed lack of understanding of the requirements of the question hence the poor performance.

Candidates' commonest pitfall was their lack of understanding of the requirements of the question.

Candidates are advised to read wide and cover the syllabus adequately for better result. They should endeavour to remember the laws guiding liquidation and also improve their knowledge of corporate restructuring.

SOLUTION 5

(a) Working Capital Cycle

		2012	2013	2014
i)	Raw material Inventory (R.M Inventory) =	$\frac{R.M.Inventory}{Purchases} \times \frac{365}{1}$ = $\frac{1,080}{5,184} \times \frac{365}{1} = 76$	$\frac{1,458}{7,020} \times \frac{365}{1} = 76$	$\frac{1,800}{7,200} \times \frac{365}{1} = 91$
ii)	Trade Payable (TP)	$\frac{TP}{Purchases} \times \frac{365}{1}$ = $\frac{1,864}{5,184} \times \frac{365}{1} = (61)$	$\frac{1,053}{7,020} \times \frac{365}{1} = (55)$	$\frac{1,260}{7,200} \times \frac{365}{1} = (64)$
iii)	Work in Progress (WIP)	$\frac{WIP}{Cost.ofSales} \times \frac{365}{1}$ = $\frac{757}{7,560} \times \frac{365}{1} = 37$	$\frac{972}{9,720} \times \frac{365}{1} = 37$	$\frac{933}{10,983} \times \frac{365}{1} = 31$
iv)	Finished Goods Inventory (F.G. Inventory)	$\frac{F.G.Inventory}{Cost.ofSales} \times \frac{365}{1}$ = $\frac{864}{7,560} \times \frac{365}{1} = 42$	$\frac{1,296}{9,720} \times \frac{365}{1} = 49$	$\frac{1,428}{10,983} \times \frac{365}{1} = 47$
v)	Trade Receivable (TR)	$\frac{TR}{Revenue} \times \frac{365}{1}$ = $\frac{1,728}{8,640} \times \frac{365}{1} = 73$	$\frac{2,592}{10,800} \times \frac{365}{1} = 88$	$\frac{2,970}{11,880} \times \frac{365}{1} = 91$
	Working Capital Cycle in days	167	195	196

(b) Possible actions that might be taken to reduce the length of the working capital cycle and their disadvantages include:

i) Raw Material Inventory

Reducing Raw Materials Inventory: This could be achieved by reducing safety stock, making orders for small quantity of raw materials, GIT purchases, etc.

Disadvantages include:

- Probability of stock outs;
- Increased order cost; and
- Probable delay in manufacturing

- ii) **Trade Payable:** This could be done by delaying payment to the creditors.

Disadvantages include:

- Loss of goodwill,
- Loss of suppliers; and
- Loss of cash discounts.

- iii) **Work-in-progress:** This could be achieved by improved technical know how and the introduction of new technology that is, introducing newly developed efficient machines.

Disadvantages include:

- Cost of capital investment as a result of the need for injection of new capital;
- Need to hire experienced and innovative staff hence an increase in salary cost may occur;
- Increased capital may be required; and
- Possible increase in cost of research and development

- iv) **Finished goods:** This could be done by reducing the inventory of finished goods.

Disadvantages include:

- Possibility of stock out;
- Loss of sales; and
- Customers' loss of interest in the goods and possible search for alternatives.

- v) **Trade Receivable** – This could be achieved by offering cash discounts and improvement in the collection of overdue balance by factoring or engaging debt collectors.

Disadvantages include:

- Cost of discounts;
- Possibility of customers taking the discount and not making early payment;
- Cost of collection in case of debt collectors or Factors;
- Reduction of customers goodwill; and
- Loss of sales

Marking Guide	Marks
a. $\frac{1}{2}$ mark for each element of the working capital cycle correctly computed- 15 in all	$7\frac{1}{2}$
$\frac{1}{2}$ mark for each working capital cycle for 3 yrs	<u>$1\frac{1}{2}$</u>
	9
1 mark for each possible action suggested(Max 3)	3
$\frac{1}{2}$ mark for each disadvantage given(2 disadvantages are to be stated for each possible action suggested	<u>3</u>
	<u>6</u>
Total	<u>15</u>

EXAMINER'S REPORT

The question tests candidates' knowledge of management of working capital.

Candidates are expected to calculate the working capital cycle and to explain the possible policies required to reduce it. About 90% of the candidates attempted the question and performance was good. However, a few of the candidates confused working capital with working capital cycle and therefore performed poorly.

Candidates are advised to always cover the syllabus adequately for better results. They are also advised to take time to read, understand and interpret questions appropriately and note their specific requirements before attempting them.

SOLUTION 6

- (a) Types of foreign exchange exposures which could arise in respect of transactions involving foreign currency include: Translation Exposure, Transaction Exposure and Economic Exposure.

(i) **Translation exposure**

This is the risk of losses or gains arising on the translation of the Financial Statements of foreign subsidiaries into the currency of the parent company for the purpose of preparing consolidated accounts. It arises in international companies with foreign subsidiaries. Statement of Profit or Loss and Statement of Financial Position will be denominated in the local currency of the subsidiary and on consolidation will be translated into the currency of the holding company. On translation of the Financial Statements from one currency to another, losses or gains arise due to exchange rate movements.

(ii) **Transaction exposure**

This is the foreign exchange risk that arises in transactions between two parties where the normal transaction currency of each party is different and when the transaction involves a future receipt/payment between the two parties. The amount received in domestic currency might be different from the amount originally expected because of movements in the exchange rate between the date of the initial transaction and the date of settlement (payment/receipt).

(iii) **Economic exposure**

This refers to the long term movement in exchange rates caused by changes in the competitiveness of a country. It is therefore the risk that a company might choose to locate its operations in a country whose currency gains in value over time against the currencies of its competitors in world markets. The consequence of an increase in the value of the domestic currency is a loss of competitiveness.

- (b) **Owiya Osese Plc.**

Using Direct Quote

Interest rates in Nigeria over 6 months will be $\frac{1}{2} \times 15\%$ = 7.5%

Interest rates in the African country over 6 months will be $\frac{1}{2} \times 18\%$ = 9%

Implied forward rate using Interest Rate parity theory:

$$\text{i.e. } \frac{1 + R_F}{1 + R_D} = \frac{F}{S}$$

Where: R_D = Domestic rate of interest

R_F = Foreign rate of interest

S = Spot exchange rate stated in terms of domestic currency (DC) per unit of foreign currency (FC).

F = Forward exchange rate

Substituting figures for the formula, the position will be:

$$\frac{1.09}{1.075} = \frac{F}{2.5} \therefore 1.075 = 1.09 \times 2.5$$

$$F = \frac{2.725}{1.075} = 2.5349$$

Gain/Loss from hedging

i) if the Naira has gained 4%:

Waka actual rate will be $2.5 \times 1.04 = 2.6$

\therefore the unhedged receipt = $\frac{500,000}{2.6} = \text{N}192,308$

Whilst the hedged receipt will be = $\frac{500,000}{2.5349} = \text{N}197,246$

\therefore Gain from hedging = $\text{N}197,246 - \text{N}192,308$
= $\text{N}4,938$

ii) If the Naira has lost 2%

Waka actual rate will be = $2.5 \times 0.98 = 2.45$

Unhedged receipt will be = $\frac{500,000}{2.45} = \text{N}204,082$

Whilst the hedged receipt will be $\frac{500,000}{2.5349} = \text{N}197,246$

\therefore Loss from hedging = $\text{N}204,082 - \text{N}197,246$
= $\text{N}6,836$

iii) If the Naira has remained stable

Waka actual rate is still 2.5

Unhedged receipt = $\frac{500,000}{2.5} = \text{N}200,000$

Whilst the hedged receipt is $\frac{500,000}{2.5349} = \text{N}197,246$

\therefore Loss from hedging = $\text{N}200,000 - \text{N}197,246$
= $\text{N}2,754$

ALTERNATIVE METHOD

Direct Quote

The interest rates for 6months investment are:

$$* \text{ Naira } 15 \div 2 = 7.5\%$$

$$* \text{ Waka } 18 \div 2 = 9\%$$

Implied forward rate:

$$\frac{1 + R_F}{1 + R_D} = \frac{S}{F}$$

$$S = \frac{1}{2.5} = 0.4000 (\text{N/Waka})$$

$$R_F = 0.09$$

$$R_D = 0.075$$

$$\frac{1.09}{1.075} = \frac{0.40}{F}$$

$$F = 0.3945 (\text{N/Waka})$$

Evaluation

i)	Naira gained 4%	N/Waka
	Actual rate = $\frac{1}{2.50 \times 1.04} =$	0.3846
		N
	Hedged receipt (500,000 x 0.3945)	197,250
	Unhedged receipt (500,00 x 0.3846)	(191,300)
	Gain from hedging	<u>4,950</u>
ii)	Naira lost 2%	N/Waka
	Actual rate = $\frac{1}{2.50 \times 0.98} =$	0.4082
		N
	Hedged receipt	197,250
	Unhedged receipt (500,000 x 0.4082)	(204,100)
	Loss from hedging	<u>6,850</u>
iii)	Naira remains stable	N/Waka
	Actual rate = (N/Waka)	0.4000
		N
	Hedged receipt (500,000 x 0.3945)	197,250
	Unhedged receipt (500,000 x 0.4)	<u>200,000</u>
	Loss from hedging	<u>2,750</u>

Marking Guide	Marks
a. 1 mark for each identified exposure(max 2)	2
2 marks for the description/explanation of each identified exposure	<u>4</u>
	6
b. Calculation of the interest rate for 6 months both domestic and foreign.	$\frac{1}{2}$
Stating the formula applied in the calculations of the implied forward rate.	$\frac{1}{2}$
Calculation of the implied forward rate	2
Calculation of the gain/loss from hedging when the Naira gained 4%	2
Calculation of the gain/loss from hedging if naira lost 2%	2
Calculation of the gain/loss from hedging if naira remains stable	<u>2</u>
Total	<u><u>9</u></u> <u>15</u>

EXAMINER'S REPORT

The question tests candidates understanding of management of financial risk with emphasis on the different foreign exchange risks and the use of currency forward contract, to hedge foreign exchange risk.

Candidates are expected to give two types of foreign exchange risk and calculate the opportunity cost / gain of hedging. About 15% of the candidates attempted the question and performance was poor

Candidates' commonest pitfalls were their inability to understand foreign exchange risk and the various hedging instruments. They also failed to remember the interest rate parity formula needed to calculate the implied forward rate.

Candidates are advised to always cover the syllabus adequately in their preparations for the Institutes' examinations. They should also endeavour to remember key formulae and improve their knowledge on the management of financial risk section of the syllabus for better result in future.

SOLUTION 7

(a)

To: The Managing Director

From: The Finance Director

ARGUMENT ON SHAREHOLDERS' WEALTH MAXIMISATION OBJECTIVE OF A COMPANY

The memorandum is meant to educate you on the debate on shareholders' wealth maximization objective as the only true objective of a company.

What is shareholders' wealth maximization? Shareholders' wealth maximization objective concept means maximizing the return to ordinary shareholders as measured by the sum of dividends and capital appreciation. It means maximizing the net present value of a course of action to shareholders, that is, the difference between the present value of its benefits and the present value of its costs. A financial action that has a positive Net Present Value (NPV) creates wealth for shareholders. It also seeks to maximize the value of a firm or its share price. Though, the share price is determined by a general consensus among market operators, regarding the value of companies and mirrors its expectation concerning the current and anticipated future profits of the firms, it reflects the time value of money to them and the risk attached to those profits.

Shareholders' wealth maximization may have some practical difficulties in selecting a suitable measurement for growth in shareholders' wealth, financial targets such as profit maximization and growth in earnings per share might be used but no financial target on its own is ideal.

Financial performance may be assessed in a variety of ways by the actual or expected increase in the share price, growth in profits, growth in earnings per share and so on. Companies may also adopt profit maximization (accounting profit), profitability maximization (Return on Capital Employed (ROCE), Return on Equity (ROE), Return On Investment (ROI), growth, long-term stability and so on as their objective, but all these objectives ignore risk and time value of money which are taking care of in the shareholders' wealth maximization objective. In practice, however, companies might have other stated objectives, but these can usually be justified in terms of the pursuit of wealth maximization. Therefore, the shareholders wealth maximization objective is an appropriate and operationally feasible criterion to choose among the alternative objectives.

However, shareholders' wealth maximization objective should not be adopted in isolation without considering other objectives such as, profit

maximization and earnings growth, in the expectation that if these objectives are achieved shareholders' wealth maximization will be increased by an optimal amount.

It is therefore recommended that companies should assume and follow this objective in their financial decision making, but they should balance it with those of other stakeholders in the firm. It is theoretically logical and operationally feasible normative goal for guiding financial decision-making. It is also all embracing, that is, it takes care, in the long run, all other company objectives including maximization of profits, sales revenue, market share, level of employee turnover, satisfaction of management staff and so on.

Signed

Finance Director

(b) i) **Cash flow generation**

Cash flow generation is one of the main sources of liquidity; it is a short-term objective which should be pursued only in a period of economic meltdown. During this period, it is the 'survival instinct' that is critical. Shareholders are not likely to put their funds in a company whose management lacks the required aggressiveness for long-term profitability and growth. However, if the aim of the firm's management is to maximize the net present value of the cash flows generated in the medium to long term, then this objective will effectively be the same as maximizing shareholders' wealth.

ii) **Profitability as measured by profit after tax and return on investment**
This is a better objective than profit maximization (accounting profit) as it takes into account both profits and the assets utilized in generating such profits.

Measures of profitability include return on capital employed (ROCE) or return on investment (ROI) or return on equity (ROE) and earnings per share (EPS) and so on. This objective has something short coming namely:

- i) Problem of definition, that is, which profits and capital are to be used.
- ii) The uncertainty that goes with the earning of the profits (risk) is ignored;
- iii) Time value of money is also ignored and
- iv) It fails to provide an operational feasible measure for ranking alternative courses of action in terms of their economic efficiency.

However, companies use it to assess performance and control in their organisations. It is useful for the comparison of widely differing divisions within a diverse multinational company and can provide something approaching a 'level playing field' when setting targets for the different branches of the organisation. It is important, however, that the measurement techniques to be used in respect of both profits and the asset base are very clearly defined and that there is a clear and consistent approach to accounting for inflation to be able to solve the problem of definition. The selection of the time frame is also important in ensuring that the selected objectives work for the long-term health of the business.

iii) Risk adjusted returns to shareholders

It is assumed that the use of risk adjusted returns in this question relates to the criteria used for investment appraisal rather than to the performance of the firm. As such, it cannot be pursued solely as an organizational objective, but used as a tool in achieving it.

It provides a useful input to the goal setting process as it focuses attention on the company's policy on making risky investments. Since investment decisions usually affect the value of the firm if the investments are profitable and add to shareholders' wealth, it is important that they are evaluated on a criteria which is compatible with the objective of the shareholders' wealth maximization.

However, it is fundamental that a company uses the right technique to avoid wrong decisions, bearing in mind the financial implication such decisions can bring to the company. It should also be noted that an investment must firstly be properly evaluated before selection. It is the acceptable investments that should be included in the capital expenditure programme of the company. Thus, investments should be evaluated on the basis of a criterion, which is compatible with the objective of the shareholders' wealth maximization bearing in mind that an investment will add to the shareholders' wealth if it yields benefits in excess of the minimum benefits as per the opportunity cost of capital.

iv) Performance improvement in non-financial areas

Aside from the financial objectives which firms pursue, there are other objectives which are critical to the achievement of the shareholders' wealth maximization and which should also be of concern to corporate organizations. These are the non-financial objectives. A company as an integral part of the society cannot be separated from the environment (internal and external) in which it operates. It therefore owes stakeholders, both within and outside the company, certain social and ethical obligations among which are:

- **employees:** to provide a conducive work environment, job satisfaction and job security;
- **customers:** to produce good quality product(s) at affordable prices and devoid of any health hazards; good service and communication and open and fair commercial practice.
- **suppliers:** to pay as at and when due and avoid exploitation; and
- **local community:** protect the environment from pollution of the air or water through industrial wastage and oil spillages. Give financial aids to charities and support sports development programmes. Set up schools and colleges to enhance educational opportunities of the children in the community etc.

However, the non-financial objectives stated above may often work indirectly to the financial benefit of the firm in the long term, but in the short term they do often appear to compromise the primary financial objectives. It should be noted that a company does not stand alone; it forms part of the society and the environment in which it operates, hence it owes certain social and ethical obligations to the people in its environment to be able to survive.

Marking Guide	Marks
a) Title –Date, to whom addressed, from whom etc	1
Subject matter	$\frac{1}{2}$
Definition of wealth maximisation	1
How is Wealth maximization determined.	1
Comparative analysis vis-a vis profit growth, growth in earnings per share etc	1
Arguments for wealth maximization objective over other objectives apart from profitability objective	1
Recognising the fact that wealth maximization objective should not be pursued in isolation of other objectives	1
Conclusion/Recommendation	1
Signing of the report	$\frac{1}{2}$
	8
b.(i) Definition	$\frac{1}{2}$
Arguments for and against	<u>1</u>
(ii) Definition	$\frac{1}{2}$
Arguments for and against	$1\frac{1}{2}$
(iii) Definition	$\frac{1}{2}$
Arguments for and against	$1\frac{1}{2}$
(iv) Definition	$\frac{1}{2}$
Arguments for and against	$\frac{1}{2}$
	<u>7</u>
	<u>15</u>

EXAMINER'S REPORT

The question tests candidates' knowledge of corporate objectives and their impact on various stakeholders.

About 90% of the candidates attempted the question and performance was poor. Candidates are expected to assess the shareholders wealth maximization objective but evaluate the alternative corporate objectives but most of them did not have a clear and accurate understanding of the question hence the poor performance.

Candidates' commonest pitfalls were their misinterpretation of the question and their failure to present the solution in a report format.

Candidates are advised to read, understand and interprets questions appropriately and note their specific requirements before attempting them. They should also learn report writing. The usage of the Institutes' Pathfinder and study packs in their preparations for the examinations of the Institute will assist in this area.

PROFESSIONAL LEVEL EXAMINATION - NOVEMBER 2015

ADVANCED TAXATION

Time Allowed: 3 hours

ANSWER FIVE QUESTIONS IN ALL

SECTION A:

COMPULSORY QUESTION

(30 Marks)

QUESTION 1

Taxes matter for any economy. They provide funding needed for the sustainable growth of social programmes, public investments, economic growth and development to build a prosperous and orderly society.

However, a recent survey on **“Paying Taxes 2015: The global picture. The changing face of tax compliance in 189 economies worldwide”** which was commissioned by the World Bank and conducted by the renowned global accounting firm PricewaterhouseCoopers, ranked Nigeria as 187 out of 189 countries covered by the survey. Among the things assessed in this survey are the period it takes a tax payer to prepare, file and pay due taxes; the number of taxes that a tax payer has to pay; the method of payment and the total tax liability as a percentage of the taxable profits.

The report indicated that while worldwide compliance benchmark is 268 hours, it takes 908 hours, which is more than three times of the world benchmark, for companies and other taxable persons in Nigeria to comply with tax laws and tax payment requirements.

Some commentators have argued that the outcome of the survey is a good indication of why the country is not earning as much as it should from taxation and that this unhealthy situation is due to the lax tax administration in the country, which makes it possible for companies and individual taxpayers to either underpay or evade paying their taxes.

Whatever the case may be, Nigeria's poor tax compliance rate has one major implication, and that is, no country that tolerates a high level of tax evasion can generate the revenue needed for its economic growth and development especially at this time of dwindling revenue from crude oil, which is the nation's main revenue earner.

From the foregoing, it is obvious that if Nigeria is to achieve the desired economic growth and development, its tax policy makers need to urgently put in place measures aimed at expanding non-oil tax base, improving collection, encouraging tax compliance and strengthening tax enforcement by sanctioning defaulters.

Required:

- a. As a Tax Consultant, you have been invited to make a presentation at a joint meeting of the National Economic Council and the Joint Tax Board. Your presentation should highlight **SIX** of the extant measures the government has put in place to reduce tax evasion and enforce tax compliance. (12 Marks)
- b. Recommend **TWO** tax policy measures the government can take to expand non-oil tax revenue base. (8 Marks)
- c. Briefly discuss **FOUR** incentives that are available to local and foreign investors in gas utilisation (downstream operations) under the Companies Income Tax Act CAP C21 LFN 2004 (as amended). (10 Marks)

(Total 30 Marks)

**SECTION B: ANSWER ANY TWO OUT OF THREE QUESTIONS IN THIS SECTION
(40 MARKS)**

QUESTION 2

Ramsgate Company Limited has been in the business of manufacturing Plastic Baby Toys for a number of years. In recent years, however, the fortunes of the Company began to dwindle as a result of the activities of merchants who import container loads of Toys from China and dump them in the market at prices below Ramsgate Company Limited's cost of production. The Company's financial year-end is December 31, annually.

The Tax Consultant to the Company made spirited efforts to convince the Managing Director of the benefits that await the Company if it could apply for Pioneer Status.

The benefits include tax holidays granted to Companies in the industries that meet the conditions of being designated as Pioneer Industries. For such Companies to qualify for Pioneer Status, the President must be satisfied that:

- (i) Such industry is not already being carried on in Nigeria at all, or it is being carried out but not on a scale suitable for the economic development of Nigeria, or
- (ii) There are favourable prospects for further developments of such industries in Nigeria, or
- (iii) It is expedient in the public interest to encourage the development or establishment of such industry and declare the Industry a Pioneer Industry and Products of the Industry Pioneer Products.

Based on the above clarifications by the Tax Consultant, the management decided to take advantage of the benefits of Pioneer Status, hence the decision to carry out

some modifications to its plant and machinery to enable it manufacture special type of high pressure pipes. The Company applied for and was subsequently granted Pioneer Status, effective 1 January 2011.

The following information was extracted from the Company's records:

	Assessable Profits ₦	Capital Allowances ₦
For the year ended 31 December, 2007	712,500	157,500
For the year ended 31 December, 2008	309,000	135,375
For the year ended 31 December, 2009	(367,500)	120,308
For the year ended 31 December, 2010	(902,250)	67,815
For the year ended 31 December, 2011	(424,200)	262,875
For the year ended 31 December, 2012	1,425,000	181,125
For the year ended 31 December, 2013	2,800,575	162,015

Note: An extension of the Initial Pioneer period was neither sought nor granted.
Assume a tax rate of 30% for all tax years.

You are required to:

Compute the Tax liabilities of Ramsgate Company Limited for the relevant Assessment Years and advise the management of Ramsgate Company Limited on the tax savings from the Pioneer Status.

(Total 20 Marks)

QUESTION 3

a. Define the following in relation to Petroleum Profits Tax Act CAP P13 LFN 2004.

- i. The Board
- ii. Chargeable Natural Gas
- iii. Casing Head Petroleum Spirit
- iv. G-Factor

(4 Marks)

b. SSV Nigeria Ltd engaged a firm of Tax Consultants – KMK and Associates – to compute its Petroleum Profits Tax payable for the year ended 31 December 2014. The Petroleum Profits Tax was computed at ₦680,000,000 after the following deductions have been made:

	₦
Royalties on domestic sales	100,000,000
Customs Duties on Plant and Machinery	160,000,000
Capital Allowances b/f	40,000,000
Capital Allowances for current year	90,000,000
Agreed loss b/f	100,000,000

The following additional information is also relevant:

	₦	₦
(i) Memorandum of Understanding (M.O.U.) credit		46,000,000
(ii) Royalties on Export Sales		200,000,000
(iii) Other incomes		
• Transportation of crude oil	4,000,000	
• Disposal of fixed assets	2,000,000	
• Others	<u>20,000,000</u>	26,000,000
(iv) Tangible drilling expenses (capitalised)		120,000,000
(v) Intangible expenses		100,000,000
(vi) Non-productive rent		10,000,000
(vii) Additional assets for off-shore operations		30,000,000

You are required to:

Compute the Petroleum Profits of SSV Nigeria Limited for the year ended 31 December, 2014.

(16 Marks)

(Total 20 Marks)

QUESTION 4

Tolaju Petroleum Limited was incorporated in 1992 and has been involved in winning and obtaining Chargeable Oil for its own account by drilling, mining and extracting Chargeable Oil in Nigeria.

The Managing Director was confused on how the Chargeable Tax was computed on the operations of the Company during the Accounting Year ended 31 December 2012. Considering the Profit as per the Financial Statements, he could not ascertain the bases of computations of Assessable Profit and Chargeable Profit.

The Company sold 30,000 barrels of Crude Oil in the international market while 15,000 barrels were sold in the domestic market during 2012 financial year. The Posted Price for Crude Oil exported was USD\$25 per barrel and Exchange Rate was ₦156 per USD\$1, while Posted Price for domestic Crude Oil sold was ₦1,500 per barrel.

The Company incurred ₦5million on administrative and operational expenses. The sum of ₦4.5million was paid as royalty on Exported Crude Oil, while Customs and other Duties amounted to ₦1.5million. Royalty on local Crude Oil sold was ₦1million and total sum of ₦0.5million was incurred on Intangible Drilling.

The capitalised expenditure for 2012 were ₦7million and ₦5million on On-shore and Off-shore activities respectively. The Company purchased Qualifying Capital Expenditure in the sum of ₦15million to improve its Property, Plant and Equipment, while the Capital Expenditure written down value (net of 1% retention) were ₦4million and ₦3million for 2008 and 2009 respectively.

Other incomes received were ₦2.5million from interest on bank placements and ₦3million net dividend on quoted investments.

Required:

As a Tax Consultant to the company, compute the Assessable Tax of the Company for the relevant tax year, showing clearly the fiscal value of Chargeable Oil, Total Profit, Assessable Profit and the Chargeable Profit.

(20 Marks)

SECTION C: ANSWER ANY TWO OUT OF THREE QUESTIONS IN THIS SECTION

(30 MARKS)

QUESTION 5

In its efforts to improve the Corporate image of Soloke Limited, the Board of Directors approved the relocation of its Corporate Head Office from Lagos Mainland to Ikoyi with effect from 1 December, 2013. The ultra modern Corporate Head Office was acquired for ₦320million on 15 July, 2013 and the sum of ₦140million incurred on improvement and renovation.

The old Corporate Office in Lagos Mainland built at a total cost of ₦200million in 2006 had carrying value of ₦300million as at 31 December, 2012 and was disposed of on 27 June, 2013 for ₦280million.

You are required to:

- a. **Outline** the tax implications of the disposal of Lagos Mainland office and **compute** the relevant tax payable on disposal. (9 Marks)
- b. Ascertain the cost of the new ultra modern head office for the purposes of Capital Gains Tax and Capital Allowance. (3 Marks)
- c. Explain briefly the concept of Capital Gains arising on assets on which Roll-Over Relief had been granted. (3 Marks)

(Total 15 Marks)

QUESTION 6

Medicap Healthcare Limited was incorporated in 2002 as an HMO under the Nigerian Health Insurance Scheme. The Company operates from its Corporate Head Office located in Central Business District, Abuja, built in 2003 at a cost of ₦600million.

The Company invested in other buildings in Lagos and Port Harcourt, where it earns rental income. The building in Lagos was acquired in September 2008 for ₦350 million with annual rental income of ₦42million.

The Company acquired its Port Harcourt building in 2012 for ₦218million, where it earned rental income of N10million in that Financial year. These buildings were recorded at cost in the books as at 31 December, 2012.

In line with the directives of the Federal Government, the company adopted IFRS with effect from 1 January, 2013 and opted for the revaluation model for its land and buildings. The Firm of Austine & Partners did the valuation of the buildings as at 31 December, 2013 as follows:

	₦' Million
Abuja office building	720
Lagos building	470
Port Harcourt building	300

The revaluation surplus on Lagos and Port Harcourt buildings were included in the Statement of Profit or Loss based on re-classification of the buildings as investment properties in the Financial Statements. The Board proposed a dividend of N100million to members at the Annual General Meeting which was approved for distribution.

The Finance Director expressed concern over dividend distribution from unrealised profit arising from revaluation of buildings and fair value gains on quoted equities classified as Financial Assets – Fair value through Profit or Loss.

You are required to:

Prepare a report to the Board highlighting the tax implications of the actions taken by the Board.

(15 Marks)

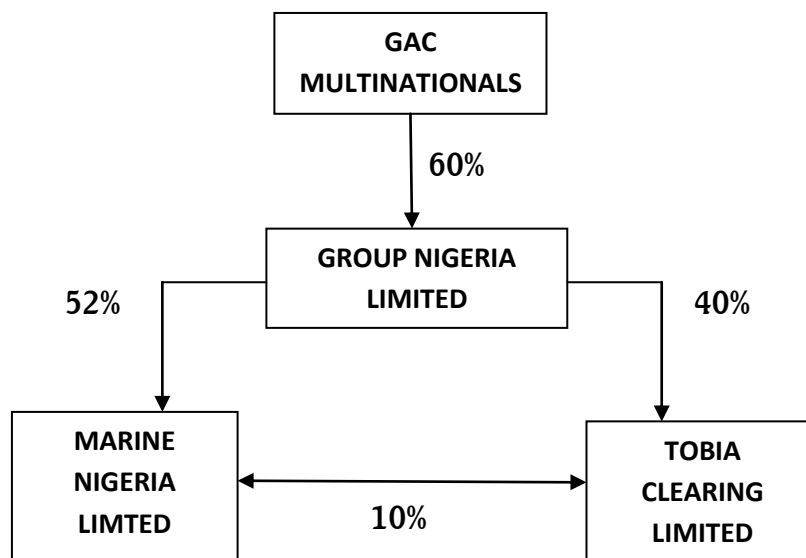
QUESTION 7

You are the consultant to Group Nigeria Limited and two of its subsidiaries known as Marine Nigeria Limited and Tobia Clearing Limited.

Group Nigeria Limited is engaged in shipping business, while Marine Nigeria Limited renders crew training and handling services. Tobia Clearing Limited only provides clearing and forwarding services to the Group and other third parties on regular basis.

Apart from the structure stated above, Group Nigeria Limited is affiliated to GAC Multinationals, a renowned shipping outfit which operates as a holding company in Dubai. GAC Multinationals has been operating from Dubai since 1982 to take advantage of the tax free policy.

The structure of the company is shown thus:



From enquiry, you discovered that:

- (i) GAC Multinationals provides technical and management services to all its affiliates in many countries, where it has interest.
- (ii) Apart from the provision of general services mentioned above, it also grants long and short term loans to the Nigerian group of companies when the need arises.
- (iii) In January 2008, Group Nigeria Limited obtained a long-term loan of ₦125,000,000 from the holding company in Dubai at an annual interest rate of 21%. The balance outstanding as at 31 December, 2013, was ₦50,000,000.
- (iv) Interests on the loan were either credited to the current account of the lender or remitted on quarterly basis in line with the standing agreement.
- (v) Transfer pricing regulations in Nigeria came into effect in 2012, this could not be applied in the determination of interest charged within the Group.
- (vi) Certain services are commonly utilised amongst the Nigerian Companies who share the same office accommodation in Lagos, Nigeria. These transactions include:
 - Lease of office space and
 - Provision of drivers

The cost of the services stated above are paid by Group Nigeria Limited and allocated to users using some parameters.

Your clients are faced with problems of identifying, correct Transfer Pricing Methods (TPM) and policies to be adopted in Nigeria.

In relation to the Income Tax (Transfer Pricing) Regulation No 1 of 2012,

You are required to:

- a. Explain Connected Taxable Persons to the Chief Executive Officer of Group Nigeria Limited and its Subsidiaries.
(7 Marks)
- b. Classify Transfer Pricing Methods into Traditional Transaction Methods and Transactional Profit Methods.
(3 Marks)
- c. Which of the methods mentioned above will you recommend for adoption for the treatment of loan interest payable to the Holding Company and common transactional costs in respect of lease of office space and provision of drivers within Nigerian Companies?

Give reasons for your recommendations.

(5 Marks)

(Total 15 Marks)

NIGERIAN TAX RATES

1. CAPITAL ALLOWANCES

	Initial %	Annual %	
Office Equipment	50	25	
Motor Vehicles	50	25	
Office Buildings	15	10	
Furniture and Fittings	25	20	
Industrial Buildings	15	10	
Non-Industrial Buildings	15	10	
	- Agricultural		
Plant and Machinery	Production	95	Nil
	- Others	50	25

2. INVESTMENT ALLOWANCE 10%

3. RATES OF PERSONAL INCOME TAX

Graduated tax rates with Consolidated Relief Allowance of ₦200,000 or 1% of Gross Income whichever is higher + 20% of Gross income.

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

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

- | | | |
|----|----------------------------------|-------------------------|
| 4. | COMPANIES INCOME TAX RATE | 30% |
| 5. | TERTIARY EDUCATION TAX | 2% of Assessable Profit |
| 6. | CAPITAL GAINS TAX | 10% |
| 7. | VALUE ADDED TAX | 5% |

SOLUTIONS

SOLUTION 1

Tax Evasion is the act whereby Individuals or Organisations (Corporate and Non-Corporate) engaged in Business Activities deliberately refuse or fail to maintain any financial records regarding their Business Activities. Tax Evasion is outright fraud and illegal.

Failure to register with the Relevant Tax authorities and failure to render Tax Returns regularly, translates to Tax Evasion, which is outrightly illegal.

Considering the large civil population and the inadequacy of Tax Revenue personnel, a huge amount of Revenue from Taxes is lost through Evasion.

It becomes imperative that Governments at various levels put in place extant measures to eradicate/curtail the phenomenon.

The measures the government has put in place to reduce Tax Evasion with a view to ensuring high revenue from taxes are as follows:

(i) TAX CLEARANCE CERTIFICATE

A Tax Clearance Certificate is to be submitted to any Ministry, Department, Commercial Bank or any Agency of Government with whom a Tax Payer has any dealings. The Certificate must be produced for key issues like appointments by Government as Chairman of Membership by Public Boards, Institutions, and Commission or to any other similar positions created by Government.

Tax Clearance Certificates are also required to be tendered by an applicant to the Departments of Foreign Exchange Control for permission to remove funds to a non-resident recipient in respect of income accruing from Rent, Dividends, Interest on which tax has been paid and in respect of which the application is sought or that no tax is payable whichever is the case.

(ii) STIPULATED PENALTIES

There are stipulated penalties in place, to serve as punishment for tax payers who evade tax, to serve as deterrent to others.

(iii) WITHHOLDING TAX

Withholding tax is an advance payment of tax which is deducted at source on certain transactions. Where it is not a final tax, it is treated as a Tax credit in the settlement of the Income Tax Liability for the year to which the payment that suffered the deduction relates.

Withholding tax deductions help to capture obscure transactions, thus bringing unknown tax payers into the Tax Net and it also enhances involuntary compliance.

(iv) TAX EDUCATION

The Government has set in motion continuous education of the citizenry on the evils of Tax Evasion through continuous workshops and seminars for tax payers.

(v) TAX AUDITS AND INVESTIGATIONS

In order to ascertain the correctness of audited financial statements forwarded to the tax office, the Revenue Authority in its wisdom, created a Resident Tax audit unit in each of its integrated Tax office (ITO's).

The audits are similar to special audits. They are additional to statutory audits and are carried out by the tax officials from the relevant tax office.

Investigations as distinct from Tax Audits are called for, when there are problems for example, when a large fraud is suspected or when evidence of mismanagement abounds.

(vi) INTELLIGENCE UNIT

The main function of this unit is to gather and analyse information and thus maintain a good database of information for civil/criminal investigation in respect of Tax-payers, through interviews and publications.

(vii) THE INTRODUCTION OF TIN

The Tax Identification Number (TIN) is a unique sequential fourteen digit number generated electronically as part of the registration process and assigned to a Taxpayer (Company, Enterprise or Individual) for Identification. This number eases tracking of taxpayers and access to their tax history and records. This is done in collaboration with the States' Board of Internal Revenue to enhance exchange of information. This has led to the discovery of fake Tax Clearance Certificates and other ploys to evade tax by Taxpayers.

(viii) THE INTEGRATED TAX ADMINISTRATION SYSTEM

This is geared towards simplification of processes and systems for ease of use by Taxpayers. It will engender the adoption of best practices by the FIRS, in the areas of business processes, taxpayer identification and the automation of core tax processes with a comprehensive taxpayer database as an enabler. It will enhance and simplify Tax administration, provide requisite support to critical tax administration functions-such as Returns and payment processing procedures, revenue and taxpayer accounting, Tax audit and investigation, Tax policies and research forecasting etc in a manner that would otherwise be difficult or tedious using a manual system.

(ix) PRESUMPTIVE TAX

Presumptive Tax is a form of tax regime designed to bring taxpayers operating in the informal sector e.g. Artisans, Traders etc into the tax net. It is predicated on a taxpayer's presumed (not actual) income, which may not

be easy to determine because records are not adequate. The method of taxation is thought to be effective in reducing tax evasion as well as equalizing the distribution of the tax burden. The FIRS believe that the implementation of a workable presumptive tax regime will engender easy access to the large pool of taxpayers in the informal sector and bring them into the Tax Net. This will enable the government not only to grow the tax base across the three tiers of government, but more importantly, improve tax collection from non-oil tax revenue. If this is done successfully, it will contribute to the overall development of the tax system and the economy. The government has also tightened the laws of Tax Evasion and severe punishment for tax officials that collude with individuals and organizations to fleece the treasury. Greater efforts should be made by the various governments to expand the Tax Net beyond the few Tax Payers captured by the Pay-As-You-Earn system and ensure that all taxable adults are captured under the Personal Income Tax regime. The waivers on Companies Income Tax should be streamlined to plug the leakages and their rampant abuse.

(x) TAX EDUCATION

The Government through various means such as seminars, educational programs and social media enlighten Taxpayers on the importance of paying taxes and its relevance to the development and growth of the Country.

(xi) ESTABLISHMENT OF TAX CONSULTANTS WITHIN THE TAX SYSTEM

The Government through the tax authorities has put in place enough Tax Agents to administer taxes and ensure appropriate collection of taxes. Government has ensured that loopholes are blocked to reduce Tax Evasion.

(xii) INTRODUCTION OF FINANCIAL TRANSPARENCY

Government has introduced financial transparency requiring public disclosure of the ultimate human beneficiaries of Companies, Trusts and Foundations. This is to prevent the further subversion of Countries' tax bases whether by high net-worth individuals, businesses, criminals or terrorists. It is also required to restore faith in the rule of law and the democratic process as the current non-disclosure of beneficial ownership is corruption's best friend.

(xiii) INTRODUCTION OF TAX INCENTIVES

The Federal Government has developed various incentives for various sectors of the economy as part of the efforts to provide an enabling environment that is conducive to the growth and development of Industries, inflow of foreign Direct Investments, shield existing Investments from unfair competition, and stimulate the expansion of domestic production capacity. This is to ensure that Taxpayers take advantage of the Incentives and invariably reduce Evasion of Tax.

(b) TAX POLICY MEASURES THE GOVERNMENT CAN TAKE TO EXPAND NON-OIL TAX REVENUE BASE

(i) AGRICULTURE

- (a) The Federal Government should put in place policies that will encourage high participation of the citizens in the agricultural sector, as that will reduce unemployment and increase the tax revenue.
- (b) Government should establish an Agricultural Financing Bank, to provide Loans for short-term and long-term financing that will be accessible to the youths/unemployed graduates and professionals.
- (c) Invest in modern mechanized equipment that can be affordable to encourage farming through hiring processes.

(ii) MANUFACTURING

- (a) Implement the National Industrial Revolution Plan (NIRP) aimed at industrializing and diversifying the economy.
- (b) Continuous support for the private sector, particularly the SMEs
- (c) Review and restructuring the Export Expansion Grant Scheme (EEG) for sustainability through creation of Export Free Zones.
- (d) Review and restructuring of the Export Expansion grant scheme (EEG) for sustainability.

(iii) TRANSPORTATION

- (a) Repair major roads to allow easy flow of traffic. This will help businesses to thrive and so indirectly increase the tax revenue.
- (b) Improve aviation transportation facilities to increase patronage.
- (c) Improve road and rail transportation.

(iv) REGISTRATION OF BUSINESS NAMES

Most tax payers have now realized that it is better to run their businesses as Partnerships, Sole traders etc., to reduce their tax liabilities because, most State Governments raise assessment for tax payers without requesting for audited accounts. CAC now demands for TIN number from new individuals for registration purposes.

(v) CONFIRMATION OF TAX CLEARANCE CERTIFICATES

It is mandatory for officials of Ministries, Departments, Agencies of Government as well as Commercial Banks to demand for Tax Clearance Certificates for registration of licences or contracts, but in

practice fake Tax Clearance Certificates are sometimes submitted as genuine ones E.g. Genuineness of drivers licences by law enforcement agencies.

(c) INCENTIVES AVAILABLE TO INVESTORS IN GAS UTILIZATION (DOWNSTREAM OPERATIONS) UNDER CITA CAP C21 LFN 2004 (AS AMENDED)

The following are some of the available Tax Incentives:

- i. An initial tax-free period of three years, which may, subject to satisfactory performance of the business, be renewed for an Additional two years.
- ii. As an alternative to the tax-holiday, an additional Investment allowance of 35%, which shall not reduce the value of the asset.
- iii. Tax-free dividend during the initial Tax-Free period where:
 - The investment in the business was in foreign currency
 - The introduction of imported Plant and Machinery during the period was not less than 30% of the Equity Share Capital of the Company
- iv. Accelerated Capital Allowance after the Tax-free period, are as follows:
 - An Annual Allowance of 90%, with 10% retention for investment in Plant and Machinery
 - An additional Investment Allowance of 15%, which shall not reduce the value of the asset.
- v. Interest payable on any loan obtained with the prior approval of the Minister for a Gas project, shall be deductible.

MARKING GUIDE

		MARKS
(a)(i)	Definition and Explanation of Tax Evasion	3
(ii)	Measures put in place by Government to reduce Tax Evasion and enforce Tax Compliance <ul style="list-style-type: none">- Submission of Tax Clearance Certificate- Withholding Tax- Stipulated Penalties put in place by legislation- Tax Education- Tax Audit and Investigation- Intelligence Unit- Introduction of Tax Identification Number (TIN)- Introduction of Integrated Tax Administration System ITAS- Presumption Tax- Financial Transparency- Introduction of Tax Incentives <p>(3 marks each for any THREE Points)</p>	9
		12
(b)	Tax Policy Measures for Expansion of Non-Oil Tax Revenue base	
(i)	<u>Agriculture</u> <ul style="list-style-type: none">- Participation of Citizens in Agriculture to enhance employment especially for youths- Agricultural Financing loans on short or long term basis- Introduction of Mechanised farming	
(ii)	<u>Manufacturing</u> <ul style="list-style-type: none">- Industrialization and diversification of the economy through Productive Sector of the economy- Active Support for Private Sector through SMEs- Export Expansion Grant Scheme through Creation of Export Free Zones (EPZ)- Government efforts in providing conducive environment in terms of Infrastructure	
(iii)	<u>Transportation</u> <ul style="list-style-type: none">- Road maintenance- Implementation in aviation transportation- Improvement in Rail transportation	
(iv)	<ul style="list-style-type: none">- Tax payers registration as Partnership and Sole traders- Corporate Affairs Commission insistence on TIN from individuals for registration	
(v)	<ul style="list-style-type: none">- Demand for Tax Clearance Certificate (TCC) by Government agencies, Banks and other corporate bodies- Genuineness of TCC by law enforcement agencies <p>(2 marks each for any FOUR Points with Explanation)</p>	8

(c) Incentives Available to Investor in Gas Utilization (Downstream Operations)

- Tax free Period of 3 years with renewal of additional two years
- Investment Allowances of 35%
- Tax free Dividend
- Accelerated Capital Allowances
- Interest on loan allowed as tax deductible

(2½ marks for Each correct Points)

	10
Total	<u>20</u>

EXAMINER'S REPORT

This compulsory question was designed to examine candidates' knowledge and understanding of issues on the high rate of poor Tax Compliance in Nigeria, its consequences and measures being put in place by Government to check the trend.

It also examined Candidates' knowledge of Tax Incentives available to both Local and Foreign Investors in the Gas Utilization (Downstream Operations Sector) under the Companies Income Tax Act (CAP C21 LFN 2011).

Majority of the Candidates displayed below-average knowledge and understanding of the requirements of the question.

Performance was consequently below average.

Candidates are advised to be more thorough in their preparations for future Examinations and to be more discerning when addressing the requirements of a question. Candidates are advised to make good use of the Institute's Study Pack on Advanced Taxation, in their preparations for future examinations.

SOLUTION 2

RAMSGATE COMPANY LIMITED COMPUTATION OF THE TAX LIABILITIES FOR THE RELEVANT YEARS OF ASSESSMENT

a) Pre-Pioneer Period

	N	N
<u>2008 Tax year</u>		
Assessable profit		712,500.00
Capital Allowance	157,500.00	
Absorbed	(157,500.00)	
		<u>(157,500.00)</u>
Total profit		<u>555,000.00</u>
Income tax @ 30%		<u>166,500.00</u>
Tertiary Education Tax		<u>14,250.00</u>
<u>2009 Tax year</u>		
(i) Penultimate year (1/1/08 -31/12/08)		
Assessable profit		309,000.00
Capital Allowance	135,375.00	
Capital Allowance Absorbed	(135,375.00)	(135,375.00)
		<u>173,625.00</u>
Total Profit		<u>173,625.00</u>
Income tax @ 30%		<u>52,087.50</u>
Tertiary Education Tax @ 2%		<u>6,180.00</u>
(ii) Actual Basis (1/1/09 -31/12/09)		
Loss		<u>(367,500.00)</u>
Capital allowances		<u>120,308.00</u>
Total Profit		<u>Nil</u>
Income Tax Payable		<u>Nil</u>
<u>2010 Assessment Year</u>		
Loss		<u>(902,250.00)</u>
Capital Allowance		<u>67,815.00</u>
Total Profit		<u>Nil</u>
Tax Payable		<u>Nil</u>

From the above, the following should be noted:

- i) The old business was deemed to have ceased by 2010 year end, prior to the year the Pioneer status was granted. Cessation provision was thus applied.

- ii) The total loss of ~~₦~~1,269,750 (~~₦~~367,500 + ~~₦~~902,250) cannot be relieved in the Pioneer period.
- iii) A total of ~~₦~~188,123 (~~₦~~120,308 + ~~₦~~67,815) Capital Allowances can no longer be utilised in the Pioneer Period.

The amount is expected to be carried backward for a maximum of five years prior to year of cessation to reduce total profit of the years i.e. to eliminate the total profit of both 2009 assessment year (Preceding Year Basis and that of 2008 assessment year)

Ramsgate Company Limited will not pay any tax during the period of 2011 2013

(b)

2009 Assessment Year	₦	₦
Total profit		173,625.00
Tax Refundable @30%		52,087.50
		<u>53,088.00</u>
2008 Assessment Year		₦
Total profit		555,000.00
Amount Recouped		
₦ (188,123 – 173,625)		14,498.00
Tax Refundable @ 30%		<u>4,349.40</u>

Pioneer Period

Period	Assessable (Loss)/Profit	Capital allowances
2011	(424,200)	262,875
2012	1,425,000	181,125
2013	<u>2,800,575</u>	<u>162,015</u>
	<u>3,801,375</u>	<u>606,015</u>

The Net Assessable Profit of N3,801,375 and accumulated Capital Allowances of ~~₦~~606,015 would have resulted in a Net Total Profit of ~~₦~~3,195,360. This would have resulted in an Income Tax of N958,608 and Tertiary Education Tax charged on Assessable Profit. The Total liability comprising the Income Tax and Tertiary Education Tax are saved by Ramsgate Company Limited.

MARKING GUIDE

	MARKS
Appropriate Heading	1
Pre-Pioneer Period Assessment	
- 2008 Assessment Year	1
Total Profit	1
Income Tax	1
Tertiary Education Tax	1
	<hr/>
	4
- 2009 Assessment Year	1
Total Profit	1
Income Tax	1
Tertiary Education Tax	1
Working of 2009 on Actual Basis with Correct Total Profit and Tax Payable	1
	<hr/>
	5
- 2010 Assessment Year	
Total profit	1
Tax payable	1
Comment on Cessation Rule	1
Comment on the Total loss	1
Comment on Capital Allowance	2
Calculation of Tax Refundable	2
Comment on Post Pioneer Period, Capital Allowance and Non-payment of Tax from 2011 – 2013	2
	<hr/>
	10
Total	<hr/> <hr/>
	20

Appropriate Heading is very essential to identify candidates' understanding of what is required

- 2008 – Calculation of Total Profit from which Income Tax and Tertiary Education Tax are calculated.
- 2009 – Determination of the Total Profit based on Preceding Year and Actual bases are very essential
- 2010 Assessment Year – Understanding the determination of Total Profit and Tax Payable.

Comment

- Understanding the fact of deemed cessation of the business prior to commencement of Pioneer Period
- The fact of the loss prior to Pioneer Period
- Not being relieved in Pioneer Period is essential
- The Pre-Pioneer Period Utilised Capital Allowance being carried backward to eliminate or reduce Total Profits for a maximum period of 5 years
- The need to mention the fact that Unutilized Capital Allowances are to be carried to Post Pioneer Period.

EXAMINER'S REPORT

This question dwells on the conditions for obtaining the designation of a Pioneer Status by Companies Operating in Nigeria, as well as the benefits accruing therefrom.

The question also examines Candidates' knowledge and understanding of the Computation of Tax Liabilities from relevant Financial results of a Pioneer Company and the resulting Tax Savings

Only about 60% of the Candidates attempted the question. Less than 30% of the candidates that attempted the question scored more than 50% of the 20 marks obtainable.

Candidates are advised to be more painstaking in their preparations for future Examinations by practising with several worked examples, to ensure they have better understanding of a question's requirement.

SOLUTION 3

a)

(i) **Board**

The Federal Inland Revenue Service Board which shall have overall supervision of the Federal Inland Revenue Service. It consists of the Executive Chairman of the Service and other members from Federal Government agencies as contained in Federal Inland Revenue Service (Establishment Act 2007)

(ii) **Chargeable Natural Gas**

This in relation to a Company engaged in Petroleum Operations means Natural Gas actually delivered by such a Company to the Nigerian National Petroleum Corporation under a Gas Sales Contract, but does not include Natural Gas taken by or on behalf of the Government of the Federation of Nigeria.

(iii) **Casinghead Petroleum Spirit**

Any liquid hydrocarbons extracted in Nigeria from Natural Gas by a process of separation or by any other chemical or physical process but before the same has been refined or otherwise treated in any other way.

(iv) **G-Factor**

Gas Production Cost adjustment factor

b)

**SSV Nigeria Limited
Petroleum Profits Tax Computation
Accounting Year Ended 31 December 2014**

	<u>N'000</u>	<u>N'000</u>
Petroleum Profits Tax as computed		<u>680,000</u>
(This represents 85% of Chargeable Profit i.e. $\text{N} \left(\frac{680,000}{85} \times 100 \right) = \text{SSS} \text{N}800,000,000$		800,000
Add back straight deductions:		
Royalties on domestic sales	100,000	
Custom Duties on P & M	160,000	
Capital Allowance brought fwd	40,000	
Capital Allowance for current yr	90,000	
Agreed loss brought fwd	<u>100,000</u>	<u>490,000</u>
		1,290,000
Add Other income		<u>20,000</u>
		1,310,000

	<u>N'000</u>	<u>N'000</u>
Less: Section 10 Allowable expenditure:		
Royalty on domestic sales	100,000	
Custom duties on P & M	160,000	
Royalties on export sales	200,000	
Intangible drilling expenses	100,000	
Non-productive rent	<u>10,000</u>	<u>(570,000)</u>
		740,000
Less: Education Tax $\text{N}(\frac{2}{102} \times 740,000)$		<u>(14,509)</u>
Adjusted profit		725,491
Less: Loss brought fwd		<u>(100,000)</u>
Assessable Profit		625,491
Less: Capital Allowance:		
brought forward	40,000	
for the current year	90,000	
Lower of:		
Petroleum Investment Allowance:		
	<u>N'000</u>	
Additional Assets for Off-Shore operation	30,000	
Tangible drilling expenses	<u>120,000</u>	
	<u>150,000</u>	
Allowance @ 15% assuming the depth is between 100 – 200 metres	<u>22,500</u>	
	<u>152,500</u>	

OR

85% of Assessable profit (85% of N 625,491)	531,667	
Less: 170% of PIA (170% x N 22,500)	<u>(38,250)</u>	
	<u>493,417</u>	
Capital Allowance claimable (PIA)		<u>(152,500)</u>
Chargeable Profit		<u>472,991</u>
Assessable Tax @ 85%		402,042
Less: MOU Credit		<u>(46,000)</u>
Chargeable Tax		<u>356,042</u>

Note:

15% was used in calculating the Royalty for Deep Off-shore operation since the depth was not given. The Royalty rates are as follows:

(i)	On-shore operations	5%
(ii)	Operations in territorial waters and continental shelf areas up to and including 100 metres depth	10%
(iii)	Operations in territorial waters and continental shelf areas in water depth between 100 metres and 200 metres	15%
(iv)	Beyond 200 metres water depth	20%

MARKING GUIDE

		MARKS
(a)	Definitions (One mark for each, i.e. 1 x 4)	4
(b)	- Correct Heading	1
	- Determination of Chargeable Profit	2
	- Add back deductions: (Any 4 deductions added back)	2
	- Any 4 (Section 10 Allowable Expenditure)	2
	- Correct determination of Tertiary Education Tax	2
	- Determination of Adjusted Profit	1
	- Determination of Assessable Profit	1
	- Capital Allowance	
	- Determination of Petroleum Investment Allowance	1
	- Determination of Capital Allowance	1
	- Claimable Capital Allowance	1
		<hr/>
		3
	- Assessable Tax	1
	- Chargeable Tax	1
		<hr/>
		1
	Total	<hr/>
		20

NOTES

- (a)(i) Emphasis of supervisory role of the FIRS
- (ii) Natural Gas delivered by a Petroleum Company to NNPC under Gas Sales Contract
- (iii) Liquid Hydro Carbon from Natural Gas by Chemical or physical process of separation before it is refined or
- (iv) Gas Production Cost Adjustment Factor
- (b)
- Determination of Chargeable Profits by grossing up the Petroleum Profits Tax
 - The need to recognize the fact that the deduction should be added back before Other Income to arrive at Total Income
 - The need to recognize the Section 10 Allowable Expenditure
 - Tertiary Education Tax calculation in order to arrive at Adjusted Profit
 - Determination of Assessable Profit by deducting loss brought forward
 - Determination of Chargeable Profit
 - Calculating the 85% of the Chargeable Profit to give an Assessable Tax @ 85%
 - Calculating the Chargeable Tax by deducting MOU

EXAMINER'S REPORT

The question tests Candidates' knowledge of some technical terms under the Upstream Operations of the Petroleum Profits Tax Act and ability to distinguish between Allowable and Disallowable expenses.

A good number of the candidates attempted the question, but performance was generally below average in both sections of the question.

The major pitfall in part (b) of the question was candidates' inability to distinguish between allowable expenses and non-allowable expenses in the computation of Petroleum Profits Tax.

Petroleum Profits Tax Act constitutes a major part of the Subject and it is therefore expected that candidates should prepare very well on questions therefrom.

Candidates are advised to prepare better for future examinations, by practising several worked examples both in past editions of the Institute's Pathfinder publications and other relevant Textbooks.

SOLUTION 4

TOLOJU PETROLEUM LIMITED PETROLEUM PROFITS TAX COMPUTATION YEAR ENDED 31 DECEMBER 2012

	₦	₦
Fiscal value of oil sold:		
Value of Crude oil Exported (W1)	117,000,000	
Value of Domestic sales (W2)	<u>22,500,000</u>	
		139,500,000
Other income:		<u>2,500,000</u>
		142,000,000
Less: Expenditure:		
Admin and Operational expenses	5,000,000	
Royalty on Exported crude oil	4,500,000	
Royalty on local oil sold	1,000,000	
Customs and other duties	1,500,000	
Intangible drilling Expenditure	<u>500,000</u>	
		<u>(12,500,000)</u>
Adjusted profit		129,500,000
Less: Tertiary Education Tax		<u>(2,539,216)</u>
Assessable profit		126,960,784
Less: Capital Allowance:		
Lower of (A) or (B)		
(A) Petroleum Investment Allowance (W4)	1,350,000	
Capital Allowance for the year (W5)	<u>10,900,000</u>	
	<u>12,250,000</u>	
OR		
(B) Restriction (W6)	<u>105,621,666</u>	
Capital Allowance claimable (A)		<u>(12,250,000)</u>
Chargeable profit		<u>114,710,784</u>
Assessable Tax @ 85%		97,504,166
Tertiary Education Tax @ 2% of Assessable Profit (W3)		<u>2,539,216</u>
Total Tax liability		<u>100,043,382</u>

W1:	₦30,000 x 25 x 156	Exported Crude
=	₦30,000 x 3,900	
=	₦117,000,000	
W2	₦15,000 x 1,500	Local Sales
=	₦22,500,000	

Other Income:

Only interest on Bank Placement is used since the dividend on quoted Investment is regarded as Franked Investment Income

W3 - Tertiary Education Tax

$$= \frac{2}{102} \times \text{N}129,500,000$$

$$= \text{N}2,539,216$$

W4

Petroleum Investment Allowance (PIA):	N
- on-shore operations – N 7,000,000 @ 5%	350,000
- off-shore operations – (Beyond 200 metres) @ 20% of N 5,000,000	<u>1,000,000</u>
Total PIA	<u>1,350,000</u>

The improvement in Property and Plant of ~~N~~15,000,000 was not used for the Petroleum Investment Allowance because the year of acquisition was not mentioned.

W5	Qualifying Capital Expenditures:	N	N
	on-shore	7,000,000	
	off-shore	5,000,000	
	Improvement on Property, Plant & Equipment	<u>15,000,000</u>	
		<u>27,000,000</u>	
	Capital Allowance @ 20%		5,400,000
	Tax written down value:		
	2008 = <u>N 4,000,000</u>		
	5 – 4years	=	N 4,000,000
	2009 = <u>N 3,000,000</u>		
	5 – 3years	=	<u>N1,500,000</u>
			<u>5,500,000</u>
	Total		<u>N10,900,000</u>

W6	Restricted:	N
	85% of Assessable Profit of N 126,960,784	107,916,666
	Less: 170% of Petroleum Investment Allowance N (1,350,000 x 170%)	<u>2,295,000</u>
		<u>105,621,666</u>

MARKING GUIDE

		MARKS
Correct Heading stating the Year end		1
Fiscal Value of Crude Oil Exported	2	
Fiscal Value of Domestic Sale	<u>1</u>	3
Other Income (Interest on Bank Placement)		2
Deductable Expenses {Any four (4)}		4
Determination of Tertiary Education Tax		1
Determination of Claimable Capital Allowance		
- Petroleum Investment Allowance	2	
- Restriction (85%)	<u>1</u>	
- Capital Allowance Claimable	<u>1</u>	4
Chargeable Profit		2
Assessable Tax		2
Total Tax Liability		<u>1</u>
	Total	<u><u>20</u></u>
<ul style="list-style-type: none"> - Heading of the solution with correct year-end is desirable - Determination of Exported Crude using the posted price and rate - Determination of Domestic Sale - Other income: Only interest on Bank Placement is used because Dividend Income is regarded as Franked Investment Income which had been taxed at source. Hence, it does not come into the calculation of Other Income. - There is need for Candidates to understand the allowable expenses - Determination of Tertiary Education Tax which is $(\frac{2}{102} \times \text{Assessable Profit})$ - Determination of Claimable Capital Allowance Understanding the computation of Capital Allowance from the On-Shore, Off-Shore and improvement in Property & Plant - Using the Tax Written Down Value of 2008 and 2009, for calculation of Petroleum Investment Allowances - Using all the above calculations to determine the Chargeable Profit - Determination of Assessable Tax - Determination of Total Liability to include the Assessable Tax and Tertiary Education Tax 		

EXAMINER'S REPORT

This question on the Petroleum Profits Tax Act test candidates' knowledge of the correct bases for computing the Fiscal Value of Chargeable Oil, Assessable Profit and Chargeable Profits as well as the correct identification of Deductable Expenditure, the incidence/treatment of Capital Allowance and Petroleum Investment Allowance.

A fair number of candidates attempted the question and performance was generally below average.

The commonest pitfalls noticed included the wrong computation of Fiscal Value of Chargeable Oil, Assessable Profit and Chargeable Profit and correctly identifying Deductable Expenditure as well as the incidence/treatment of both Capital Allowance and Petroleum Investment Allowance.

Working through several worked examples in both the Institute's Study Packs and past editions of the Pathfinder, will improve performance by Candidates.

SOLUTION 5

Soloke Limited

- a) Tax implications of the Disposal of Lagos Mainland office
- i) If there is a Chargeable Gain resulting from the Disposal of the Lagos Mainland Head Office building, the Gain will be subject to Capital Gains Tax.
 - ii) Capital Gains Tax is chargeable on the Gain at 10%.
 - iii) Where the sales proceeds of the building is re-invested in the purchase of a new building of the same class as the one sold, a Roll-over relief is granted.

**TAX PAYABLE ON DISPOSAL OF
LAGOS MAINLAND HEAD OFFICE BUILDING
COMPUTATION OF CAPITAL GAINS TAX FOR 2013 TAX YEAR**

i)	Assuming no Roll-over relief claim is made:	₦'000
	Sales proceeds	280,000,
	Less: Cost of acquisition	<u>(200,000)</u>
	Capital Gains Chargeable	<u>80,000</u>
	Capital Gains Tax @ 10%	<u>8,000</u>
ii)	Assuming Roll-over relief claim is made	₦'000
	Sales proceeds	280,000
	Less: Cost of Acquisition	<u>(200,000)</u>
	Capital Gains - Chargeable	80,000
	Less: Roll-over Relief:	₦'000
	Amount Re-invested	280,000
	Less: Cost of Sold Building	<u>(200,000)</u>
	Gain Rolled-over	<u>(80,000)</u>
	Capital Gains - Chargeable	<u>Nil</u>
	Capital Gains Tax @ 10%	<u>Nil</u>

If a full Roll-over relief as claimed, is granted, there will be no Chargeable Capital Gain, and therefore, no Capital Gains Tax is payable for the 2013 Tax year.

b) For the purposes of Capital Gains Tax Computation, the cost of the New Head Office shall be as follows:

(i) If no claim was made for Roll-over Relief:

	₦'000
Cost of Building	320,000
Renovation Cost	<u>140,000</u>
Carrying Cost for Capital Gains Tax	<u>460,000</u>

(ii) If claim was made for Roll-over Relief

	₦'000
Cost of Building	320,000
Renovation Cost	<u>140,000</u>
	<u>460,000</u>

₦'000

Less: Amount Rolled-over	
Proceeds of Old Asset Sold	280
Less: Acquisition Cost	<u>(200)</u>
Carrying Costs for Capital Gains Tax	<u>(80,000)</u>
	<u>380,000</u>

(iii) Cost for Capital Allowance Purposes:

	₦'000
Cost of Building	320,000
Add Renovation Cost	<u>140,000</u>
Cost for Capital Allowance Purposes	<u>460,000</u>

c) The concept of Capital Gains arising on Assets on which Roll-over Relief has been granted include:

- i. Capital Gains on disposal is the difference between the Sales Proceeds and the Carrying Cost.
- ii. The Carrying Cost of an Asset is the Actual Cost of acquisition of the Asset Less any Chargeable Gain Rolled-over.
- iii. The cost of the New Asset for Capital Gains Tax and Capital Allowances purposes, is the difference between the amount re-invested and the amount Rolled-over. Therefore, for Roll-over Relief to be applicable, the cost of the New Asset must be higher than the cost of the old asset.

MARKING GUIDE

		MARKS
(a)	Basic theory of Tax consequence of Disposal	
	Of Fixed/Capital Assets	1
	Nature of Tax and Rate	1
	Incidence of Roll-over Relief	1
		<u>3</u>
	Computation of CGT assuming no Roll-over Relief Claim	1/2
	Correct computation of Chargeable Capital Gain	1/2
	Correct Computation of Capital Gains Tax	1/2
	Computation of CGT assuming Roll-over Relief Claim is made	1/2
	Correct computation of Chargeable Capital Gain	
	- before claim is made	1
	Correct computation of Roll-over Relief	1
	Correct computation of Chargeable Capital Gain	1/2
	Correct computation of Capital Gains Tax	1/2
		<u>5</u>
	Summary of consequences of claiming full Roll-over Relief	1
		<u>9</u>
(b)	Correct computation of Carrying Cost for CGT purposes, if no Roll-over Relief is claimed	1/2
	Correct computation of Carrying Cost for CGT purposes, if Roll-over Relief is claimed	1/2
	- Cost of Building before claim	1/2
	- Amount Rolled –Over.	
	Carrying Cost for Capital Gains Tax	1/2
	Correct computation of Cost for Capital Allowance Purposes	1
		<u>3</u>
(c)	The incidence of Capital Gains arising on Assets on which Roll-over Relief has been granted	
	- What constitutes the Capital Gain?	1
	- What is Carrying Cost of such an Asset?	1
	- Cost for Capital Gains Tax and Capital Allowances Purposes	1
		<u>3</u>
	Total	<u>15</u>

EXAMINER'S REPORT

This is a question on Capital Gains Tax, testing Candidates' knowledge and understanding of the incidence and treatment of Roll-over Relief as well as the concept of Carrying Cost of an Asset in the computation of Capital Gains Tax.

Over 90% of the Candidates attempted the question and performance was below average.

Candidates are advised to be more painstaking in acquiring better understanding of concepts they come across in the course of their preparations for future Examinations.

SOLUTION 6

The Board Members
Medicap Healthcare Limited
Central Business District
Lagos

Dear Sirs/Madams

TAX IMPLICATIONS OF DECLARING DIVIDEND OUT OF UNREALIZED PROFITS/FAIR VALUE GAINS ON QUOTED SECURITIES

We write to update you on the above subject matter, following the recent action by your honourable Board that proposed a Dividend of ₦100 million to members at the Annual General Meeting.

The main objective of your Company is to engage in Health Management under the Nigerian Health Insurance Scheme. That notwithstanding, the Company also invested in Properties in order to generate additional Income.

Since the Company has adopted the International Financial Reporting Standards (IFRS), in line with the Federal Government directive, the Company's buildings in Lagos and Port-Harcourt were re-classified from Property, Plant and Equipment, to Investment Properties in line with the provisions of International Accounting Standards (IAS) 40 – (Investment Property), based on the use of those buildings to generate Rental Income.

The revaluation surpluses on the Investment Properties have been included in the Statement of Profit or Loss in the Financial Statement. Such revaluation surpluses are non-taxable incomes that should be deducted from the Accounting Profit for Tax Computation purposes.

Similarly, the Fair Value Gains from Quoted Securities classified as Financial Assets, and also included in the Profit or Loss Statement for the financial year, are also non-taxable items, which should be deducted from Accounting Profit for Tax Computation purposes.

The Dividend declared for distribution by the Company is liable to Withholding Tax at 10%, payable to the relevant Tax Authority whilst the Net Dividend is paid to Shareholders.

The Withholding Tax is payable to the relevant Tax Authority within 30 (thirty) days from the date of deduction or from the time the duty to deduct arose, whichever is earlier.

The penalty for failure to remit such withheld taxes is a fine of 200% of the Tax withheld and not remitted, plus interest at prevailing commercial rate, in addition to the Tax withheld and not remitted to the State's Internal Revenue Service.

In the same vein, failure to deduct or remit Withheld Taxes from Corporate Bodies is an offence punishable on conviction to a fine of N5,000 (Five thousand naira) in addition to the Tax withheld and not remitted with interest at the prevailing commercial rate.

It is important to note that Investment Properties could be treated as stocks held for sales, therefore, for such unrealized profits from such Properties to be declared as Dividends, provision should be made for Deferred Tax for such unrealized Profits/Gains.

In conclusion, we need to emphasize that Cash Dividend should only be declared from realized Profits from actual transactions during the Accounting year and NOT from revaluation of assets, etc.

Yours faithfully,

Signed

XYZ & Co.

MARKING GUIDE

	MARKS
Correct Addressee	½
Correct Subject-Matter of Letter	½
Main Objective of Company	1
Consequence of adopting IFRS	1
Consequence of complying with Provisions of IAS 40 regarding Investment Properties	1
Revaluation surpluses on Investment	
- Properties – included in P & L	1
- To be deducted for Tax Purposes	1
Incidence of Fair Value Gains/Treatment	2
Incidence of Withholding Tax Payment	1
Time-frame for Payment of Withholding Tax	1
Penalties for failure to remit Withholding Tax from Dividends	2
Penalties for failure to deduct or remit Withholding Taxes for Corporate Bodies	1
Incidence of Unrealised Profits from Investment Properties	1
Conclusion	
- Condition for Payment of Cash Dividend	1
Total	15

EXAMINER'S REPORT

The question tests candidates' knowledge of the Tax Implications of the declaration of Dividend out of Unrealized Profits, arising from the revaluation of Fixed Assets of a Company, as well as from Fair Value Gains on quoted Equities classified as Financial Assets. It also tests candidates' knowledge and understanding of the provisions of the International Financial Reporting Standards (IFRS) regarding the Board's proposal.

Less than 40% of the Candidature attempted the question and performance was below average. Majority of the Candidates did not present their solutions in a Report Format and the few that did, displayed lack of knowledge of the IFRS provisions regarding such proposal by the Board of the Company.

Candidates are advised to update themselves better with knowledge of this and other provisions of the IFRS, impacting on Tax Administration and Practice.

SOLUTION 7

a. CONNECTED TAXABLE PERSONS

- Connected Taxable Persons within the context of the TP Regulation 2012 include, individuals, Entities, Companies, Partnerships, Joint Ventures, Trusts or Associations involved in the control and management of such Groups/Bodies/Organisations. In summary, such 'persons' include:
 - (i) Any entity dealing with related Parties (Associates, Subsidiaries, Joint Ventures);
 - (ii) A member of a Local Group of Companies;
 - (iii) Members of a Conglomerate;
 - (iv) Multinationals;
 - (v) An Entity in a group located in the Free Trade Zone;
 - (vi) An Entity with a Pioneer status;
 - (vii) Any Loss making entity within a Profitable Group;
 - (viii) Related Parties subject to Tax at different rates;
 - (ix) Permanent Establishments.

b. TRANSFER PRICING METHODS ARE CLASSIFIED INTO TRADITIONAL TRANSACTION AND TRANSACTIONAL PROFIT METHODS AS FOLLOWS:

- i. Traditional Transaction Methods
 - a. The Comparable Uncontrolled Price (CUP) Method
 - b. The Resale Price Method
 - c. The Cost-Plus Method
 - ii. Transactional profit methods
 - a. The Transactional Net Margin Method
 - b. The Transactional Profit-Split Method
- c. The most appropriate method recommended for adoption for the treatment of Loan Interest Payable to a Holding Company and Common Transactional Costs in respect of lease of office space, etc. within Nigerian Companies, is the Comparable Uncontrolled Price (CUP) Method.

The CUP method is recommended because:

- It compares the price charged for transactions between Associated Organisations (i.e. Related Parties) with prices charged for similar transactions between Unrelated Parties under similar circumstances.
- It can also be used for Interest on Loans granted by GAC Multinationals, as the Loans were granted in the past (January 2008), and were backed-up with valid agreement binding on both Parties.

- The Loan came into effect before the commencement of the Income Tax (Transfer Pricing) Regulations Act 2012.

For lease of office space, the most appropriate method is the Comparable Uncontrolled Price (CUP) method, because the external CUP method will be available for bench-marking. At the same time, the rateable value as provided by Government for the purpose of Property Tax (e.g. Land Use Charge or Tenement Rates), could be used as comparisons

(b) The provision of Drivers

This relates to Intra-Group Services. The Most Appropriate Method (MAP) is the Transactional Net Margin (TNM) Method.

The method examines a Net Profit indicator which is a ratio of Net Profit relative to a base such as Cost, Sales, Assets, Capital Invested, etc. that the taxpayer realizes from a controlled transaction with the Net Profit earned from comparable uncontrolled transactions. The method is considered the Most Appropriate Method (MAP) as Net Margins are less affected by transactional differences as against Price.

It is also less affected by functional differences than Gross Margins.

In the same vein, Service /Product and functional comparability are less crucial in applying Transactional Net Margin (TNM) Method.

MARKING GUIDE

	MARKS
(a) Connected Persons	$\frac{1}{2}$
- Individuals	
- Entities in a group, the free Trade Zone/Pioneer Status	
- Companies – Members of Conglomerates	
- Partnerships	
- Joint Ventures	
- Trusts or Association	
- Members of a Local Group of Companies	
- Associates, Subsidiaries	
- Multinationals	
- Permanent Establishments	
(A mark each for any seven (7) correct points)	7
(b) Traditional Transaction Methods	
- Comparable Uncontrolled Price	
- Resale Price	
- Cost Plus	
Transactional Profit Methods	
- Transactional Net Margin	
- Transactional Profit Split	
(Three (3) marks for all the above)	3
(c) Recommended Methods for Adoption	
- Comparable Uncontrolled Price (CUP) Method for loan Interest Payable to a Holding Company and common Transactional Costs in respect of lease of office space	
- For the Provision of drivers, since this relates to Intra-Group Services, the Method to use is the Transactional Net Margin Method	
(Full mark for correct recommendation and explanation)	5
Total	<u>15</u>

EXAMINER'S REPORT

The question was designed to test Candidates' knowledge of the provisions of Transfer Pricing Regulations in Nigeria, as contained in the Income Tax (Transfer Pricing) Regulation No. 1 of 2012, and their applications.

Performance by the Candidates that attempted the question was very poor, as majority of them could not correctly identify Connected Persons.

Candidates displayed scanty knowledge of the concept of Connected Taxable Persons and Traditional Transaction as against Transactional Profit Methods of Transfer Pricing classifications. At this level, candidates should spend some quality time comprehending key concepts in various sections of the Syllabus.

Candidates are advised to devote more quality time in analysing concepts as specified in the Institute's Study Packs and other relevant Textbooks, whilst preparing for future Examinations.

PROFESSIONAL LEVEL EXAMINATION - NOVEMBER 2015

CASE STUDY

Time Allowed: 4 hours (including reading time)

Requirement

NOTE: Ensure you use the Case Study answer booklet for this paper.

You are Chika Ahmad a partly qualified Chartered Accountant with one paper left to complete the Professional (Final) Level Examinations. You are currently employed as an Associate Analyst with Phoenix-Adele Global Partners (PAGP) an Accounting and Advisory firm based in Lagos Nigeria.

Magic Network Communications Limited (MNC) provides telephone and internet services to the Nigerian telecommunications market. The company is fast growing and has significantly increased its subscriber base since it began operations six (6) years ago after being granted operational licence. The Nigerian Communications Commission (NCC), is the independent regulatory body for the Nigerian telecommunications industry and responsible for granting operational licence.

You are required vide an e-mail from your Partner, Muri Adele (**Exhibit 1**), to draft a report to Adesua Thomas, Finance Director at MNC, a client company. Your report is to be submitted to the Partner for his review and is to be discussed at a presentation meeting with the client next week.

The following overall time allocation is suggested:

Reading	1 hour
Planning and calculations	1 hour
Drafting report	2 hours

LIST OF EXHIBITS

Exhibit	Description
1	E-mail from Muri Adele, Partner, Phoenix-Adele Global Partners (PAGP) to you, Chika Ahmad.
2	Letter from Adesua Thomas, Finance Director at Magic Network Communications Limited (MNC), to Muri Adele.
3	Extract of the Chairman's Statement from the 2015 Annual Report of Magic Network Communications Limited.
4	Financial Information Extract of Magic Network Communications Limited for the years 2014 and 2015.
5	Magic Network Communications Limited's Call Centre operations information.

Phoenix-Adele Global Partners

E-mail

From: Muri Adele – Partner
To: Chika Ahmad – Associate Analyst
Date: November 17, 2015
Re: Magic Network Communications Limited

As a follow up to the meeting, I and your good self held yesterday with Adesua Thomas (Finance Director) of Magic Network Communications Limited (MNC), one of our biggest clients. I will require you to draft a report for my urgent review. The draft report should address all of Adesua's concerns as discussed during our meeting which are explained in greater detail in the letter sent to me by Adesua (**Exhibit 2**). The matters raised in the attachments to this e-mail, (**Exhibits 3 – 5**) should also be taken into consideration in your draft report. I am available to provide any additional information or clarification you may require.

The attachments include an extract of the Chairman's Statement from the 2015 Annual Report (**Exhibit 3**), relevant financial information extract (**Exhibit 4**) and MNC's call centre operations information (**Exhibit 5**).

Adesua is particularly interested in some analysis that relates to both financial and non-financial performance measures. A detailed analysis of the call centre's operations and relevant professional advice are also required. This is as a result of the Chief Executive Officer's (CEO's) concern about the call centre and how to operate it more efficiently and profitably, otherwise the company may consider the possibility of shutting it down.

I will ask you to treat this report with all the urgency and confidentiality that it requires because as you know, MNC is one of our biggest clients and we will like to keep them happy. I will be expecting your draft report by the close of business today.

Finally, I have just learnt that MNC is in breach of some regulatory requirements in its operations and as a result have been fined a substantial sum of money for this non-compliance. I understand that MNC intends to contest this in court but it is rather worrisome that Adesua Thomas failed to mention this during our meeting. It is surely an information we should be put in the know especially because there are rumours that the CEO is seriously considering tendering his resignation as a result of the matter. I got to know about it just this afternoon from Kunle Esan, the former Chief Auditor at MNC and he also mentioned another problem about the

state of low staff morale at MNC especially due to the long hours being worked without additional incentives for such efforts.

Thanks

Muri Adele
Partner, PAGP

Required:

Using the information in the attachments, draft a report addressed to Adesua Thomas, Finance Director at MNC. Your report is to be submitted to Muri Adele (Partner, PAGP) today and it is to be discussed at a presentation meeting with the client next week.

Your report should comprise:

1. An analysis of the strategic performance of Magic Network Communications Limited (MNC). As part of your analysis of the financial performance of MNC, you are expected to take into consideration the comments by the Chairman in his statement (**Exhibit 3**) and the relevant financial information provided in (**Exhibit 4**) by coming up with suitable ratios that you deem meaningful in MNC's industry for your analysis.

You are expected to use the Balanced Scorecard Model for your analysis; and

2.
 - i. An analysis and determination of the product mix that will maximise the margin of MNC call centre, if no staff was to switch position. Also calculate the total margin from your suggested product mix (**Exhibit 5**).
 - ii. Advise on how to allocate the existing staff between the two roles (operators and consultants) in order to satisfy the market demand working with the assumption that MNC cannot hire new call centre staff. Your advice should also include other business/managerial factors that should be taken into account when considering your recommendations.

Note: Your report should only concentrate on the key figures and issues, and should provide a clear explanatory commentary together with your judgement and conclusions on the key items which you identify.

Magic Network Communications Limited

November 16, 2015

Partner
Phoenix-Adele Global Partners
Accounting House
1, Communication Road
Lagos
NIGERIA

ATTENTION: MURI ADELE

Dear Sir,

RE: CONSULTANCY SERVICES

As you are aware we are currently undergoing some restructuring and as always, would need your professional input in the ongoing process.

The Board of Directors has been concerned about our insistent focus on financial performance measures and is of the view that consideration should be given to non-financial measures as well as the potential of helping and understanding our customers' requirements to serve them better.

After our discussions, we have agreed that the Balanced Score Card is an appropriate model for use in this analysis and I have provided some information that may be useful to your firm in conducting this analysis.

In addition, the Chairman in his statement (**Exhibit 3**) in the most recent Annual Report (2015) highlighted the need for looking at different measures of profitability on a per customer basis and I hope you can include this in your analysis.

Finally, the call centre which we operate is an important part of the business, as it is a window for fast growing customer base to reach out to us and for us to understand their needs and of course serve them better. I have provided relevant information about the call centre and its operations (**Exhibit 5**) and I do hope you find it useful.

MNC Limited – Capital Projects

MNC has recently been involved in several expansion projects and quite a few seem to be profitable. Two major projects (Project Venice and Project Oluno) making up 89.4% of our total projects in the last few years have returned a combined Net Present Value of ~~₦~~308.52 billion i.e. ~~₦~~201billion and ~~₦~~107.52 billion respectively.

The initial investments were ~~₦~~190billion and ~~₦~~85billion while the Return on Capital Employed (ROCE) on these projects were 29.4% and 31.35% respectively.

MNC Limited – Customer Focus

Recently we have seen our customer base grow quite rapidly every year since we began operations six years ago, however, our last financial year 2015 has been the year that has seen the highest growth rate in customers. We currently serve approximately 5 million customers that cut across the entire country and this is something we are very proud of as we can confidently say that we are the fastest growing telecommunications company in the country. Whereas last year, we had only 3.56 million customers in our subscriber base.

However, due to the increase in customers we have been encountering certain difficulties as you might expect. Our systems and staff have been struggling to cope even after being stretched to the limit. We have recently undertaken a massive recruitment drive to ensure that we have adequate staff to support our operations. I must tell you that some of the staff hired lack the necessary skills needed to serve our customers but at this time we have very little choice.

A recent customer satisfaction survey conducted by our sales and marketing team has provided the following results:

	2015	2014
Number of customer complaints	753,661	131,456
Percentage of customer complaints resolved	63.0%	90.0%
Average service delivery rating *	5.7	7.9
Recommend MNC **	5	9

* Scale of 1-10 with 10 being the highest rating and 1 being the lowest rating.

** Scale of 1-10 with 10 being “Very likely to recommend” and 1 being “Will not recommend”.

MNC Limited – Strategic Planning

The Board of Directors has recently approved the funding required for our research centre which would focus on seeking new ways to provide our service in a cost effective and efficient manner. We need to get some of our technical staff who understand the business and can provide further insight on our need and quite importantly, our customers’ needs and how to organise customer services for the next decade and beyond involved in this project. We understand how quickly technology is evolving and we do not intend to play catch up as our competitors are also investing quite heavily in Research and Development (R & D).

The research team has discovered some interesting, innovative and possibly market changing ideas. No patents have been filed as it is still very early and a lot needs to be tested realistically before any of these innovative products become commercially available.

Our training and development costs have also increased significantly as expected, since we are providing training for our newly hired staff to enable them meet the challenges of providing extraordinary service to our customers.

I hope you find the information provided useful and I will be happy to provide further information or respond to any question you might have.

I will look forward to receiving your draft report as agreed.

Yours sincerely

Adesua Thomas

Finance Director
Magic Network Communications Limited

EXTRACT OF CHAIRMAN'S STATEMENT FOR YEAR ENDED 30 SEPTEMBER, 2015**Overview**

I am pleased to report that the trading momentum across the company remained positive in 2015 with the company enhancing its competitive position. As a result, the company reported strong growth in profit. National and International recognition for our brand was reflected in the many prestigious awards the company received during the year as recognition for our increasingly excellent services as the company celebrated its 6th anniversary in Nigeria.

Performance

At MNC, our customers always come first and we increased both the value delivered to each of our customers and the overall reach and power of our platform. We added 1.42 million new customers, growing our customer base by 40% to 4.98million. This increase in customer base has resulted in increase in operating profit to ₦28.45billion, from ₦19.67billion in the previous year, 2014.

Over the course of the year, we launched and improved several key products. Our call centre now provides services in five (5) different Nigerian languages used by 92% of the country's population in addition to English and French.

Business Developments

The company has invested in research and development of new internet based products and is looking forward to launch some of these products in the next few years. This will add to the company's other investment projects that have yielded positive results and contributed to the profitability of the company in the past year.

Corporate Developments

The company has announced its intention to be listed on the Nigerian Stock Exchange, subject to shareholders' approval. We see this as the next step in our strategic plan as it will present further opportunities for MNC to raise fund from the general investing public.

People

On behalf of the directors, I would like to thank all our employees throughout the company and acknowledge their contributions and continued commitment to serving our teeming customers. As we always say at MNC, we are partners in progress.

Future Outlook

While the economic outlook can be quite unpredictable, the company remains strong in competitive and financial positions. Over the long term, MNC will continue to benefit from the strength of its growing brand and as the customer base continues to grow, we intend to provide the highest quality of service now and into the future.

Chairman, MNC Limited
October 31, 2015

Financial Information Extracts

Statement of Financial Position as at 30 September

	2015	2014
	N'billion	N'billion
Non-current assets		
Property, plant and equipment	257.00	119.92
Intangible assets	<u>40.00</u>	<u>45.00</u>
	<u>297.00</u>	<u>164.92</u>
Current assets		
Trade and other receivables	35.50	43.50
Cash and cash equivalents	<u>21.59</u>	<u>14.06</u>
	<u>57.09</u>	<u>57.56</u>
Total assets	<u>354.09</u>	<u>222.48</u>
Current liabilities		
Trade and other payables	67.77	52.41
Current tax payable	<u>37.90</u>	<u>21.00</u>
	<u>105.67</u>	<u>73.41</u>
Non-current liabilities		
Finance debt	<u>80.00</u>	-
	<u>80.00</u>	<u>-</u>
Total liabilities	<u>185.67</u>	<u>73.41</u>
Equity		
Ordinary share capital	100.00	100.00
Retained Earnings	<u>68.42</u>	<u>49.07</u>
Total equity	<u>168.42</u>	<u>149.07</u>
Total Liabilities and Equity	<u>354.09</u>	<u>222.48</u>

Statement of Comprehensive Income

	2015	2014
	N'billion	N'billion
Revenue	522.28	243.39
Cost of Sales	431.18	197.54
Gross Profit	<u>91.10</u>	<u>45.85</u>
Selling, Distribution and Administrative Costs	<u>62.65</u>	<u>26.18</u>
Profit before Interest & Tax	28.45	19.67
Taxation	<u>9.10</u>	<u>6.24</u>
Profit for the year	<u>19.35</u>	<u>13.43</u>

Statement of Changes in Equity

	Share Capital	Share Premium	Retained Earnings	Other Comprehensive Income	Total
	₦'billion	₦'billion	₦'billion	₦'billion	₦'billion
September 30, 2015					
At Opening	100.00	-	49.07	-	149.07
Issue of Shares	-	-	-	-	-
Profit for the year	-	-	19.35	-	19.35
Dividend	-	-	-	-	-
Prior period adjustments	-	-	-	-	-
At Closing	100.00	-	68.42	-	168.42
September 30, 2014					
At Opening	100.00	-	36.84	-	136.84
Issue of Shares	-	-	-	-	-
Profit for the year	-	-	13.43	-	13.43
Dividend	-	-	-	-	-
Prior period adjustment	-	-	(1.20)	-	(1.20)
At Closing	100.00	-	49.07	-	149.07

Other relevant information:

	2015	2014
Cash Flow from Operations	134.34	55.35
Number of Subscribers	4.98 million	3.56 million

	Project Venice	Project Oluno
Net Present Value (NPV)	₦201billion	107.52billion
Initial Investment	₦190billion	₦85billion
ROCE (%)	29.4	31.35
Number of Years	5	5
Discount Rate (%)	10	10
Profitability Index (PI)	1.06	1.26

EXHIBIT 5

The following internal information relates to the Call Centre operations by MNC.

Type of service for which queries are received	Demand (Number of enquiries)	Operator minutes (Per enquiry)	Consultant minutes (Per enquiry)
Mobile Telephony (MT)	2,500	16	0
Mobile Internet Service (MIS)	1,000	12	8
Home Internet Service (HIS)	2,000	12	28
Business Internet Service (BIS)	250	6	54

MNC's call centre currently operates with a total of 185 staff of whom:

- 100 are operators who work fifteen hours per day and are paid ₦60 per worked hour; and
- 85 are consultants who work fifteen hours per day and are paid ₦90 per worked hour.

Both operators and consultants are required to take a mandatory one hour break each working day.

However, with a relatively insignificant cost of training, an operator can be transformed into a consultant, with a resulting pay rise. Consequently, a consultant can also be transformed into an operator, but there is no decrease in pay.

Pricing of Call Centre Service information is provided below:

Type of Service	Price of service per enquiry (₦)
Mobile Telephony (MT)	40
Mobile Internet Service (MIS)	220
Home Internet Service (HIS)	180
Business Internet Service (BIS)	300

All enquiries for the service provided are charged automatically to each customer's account.

SOLUTIONS

CASE STUDY NOVEMBER 2015

Marking Key

	Req 1	Req 2	Overall	TOTAL
SA				
CA				
BC				
NC				
V				
Total	8	8	4	20

NOTE

SA	Superior Achievement
CA	Competent Achievement
BC	Below Competent Achievement
NC	Non-Competent Achievement
V	Void

REQUIREMENT 1 – Balanced Scorecard/Ratios

USES DATA AND INFORMATION APPROPRIATELY <ul style="list-style-type: none">▪ Uses MNC's Financial Statements:<ul style="list-style-type: none">- Income statement- Statement of financial position▪ Uses other relevant information (Exhibit 4)▪ Uses information in Chairman's statement▪ Uses information in letter from MNC (Exhibit 2)▪ Identifies wider context for MNC's business - A non-listed company (market expectations)	USES ANALYTICAL SKILLS (material points in the written report) <ul style="list-style-type: none">▪ Identifies the financial perspectives issues▪ Identifies the customer perspectives issues▪ Identifies the learning and growth perspectives issues▪ Identifies the internal processes perspectives issues▪ Identifies the ratios relevant to MNC's industry that need to be computed
USES PROFESSIONAL TOOLS AND KNOWLEDGE <ul style="list-style-type: none">▪ Recognises the Balanced Scorecard Model▪ Considers the four perspectives of the model▪ Considers the usefulness of the model▪ Applies the model using information from the case	IDENTIFIES ISSUES AND OPTIONS <ul style="list-style-type: none">▪ Identifies that the model may have its limitations▪ Identifies the possibility of using other models to meet the needs of MNC▪ Identifies the possibility of outsourcing some staff rather than hiring full time, less qualified staff▪ Identifies the opportunities that the increased subscriber base brings and how to leverage on this▪ Identifies the need for a detailed and formal customer and competitor analysis

<p>APPLYING PROFESSIONAL SCEPTICISM AND ETHICS</p> <ul style="list-style-type: none"> ▪ Identifies the accuracy of the information provided by MNC ▪ Identifies the ethical issues in the case, e.g. non disclosure of fine from the regulatory authority. ▪ Identifies other issues that need to be considered e.g. government policy, industry regulators. ▪ Identifies the possibility of unsatisfied subscribers moving to other Networks. 	<p>CONCLUSIONS (Draws distinct conclusions under appropriate heading)</p> <ul style="list-style-type: none"> ▪ Concludes on the overall business model ▪ Concludes on ratios and the additional information it might provide to MNC ▪ Concludes on possible effect of external factors (positive and/or negative) e.g. government policy, industry regulators, unexpected situations ▪ Concludes on the possible use of other business analysis models to properly analysis the company's operations.
<p>EVALUATIVE SKILLS AND JUDGEMENT</p> <ul style="list-style-type: none"> ▪ Recognises the possible need for hiring and retaining higher skilled staff to relate with customers/subscribers ▪ Recognises the need to update customer database and the use of artificial intelligence tool to better understand its customers ▪ Recognises the need to arrange training for call centre operators and consultants for effective service delivery. ▪ Recognises the need to carry out a competitive analysis to understand the company's competitors. 	<p>RECOMMENDATIONS</p> <ul style="list-style-type: none"> ▪ Better Customer Relation Management ▪ Adequate economic and business planning ▪ Consider other possible targets (untapped) markets to increase revenue ▪ Use information from the Balanced Scorecard model to better advise MNC on improvement in financial and non-financial areas

REQUIREMENT 2–Product Mix

USES DATA AND INFORMATION APPROPRIATELY <ul style="list-style-type: none">▪ Uses MNC's Financial Information:<ul style="list-style-type: none">- Call centre information (Exhibit 5)▪ Uses other relevant information▪ Uses information in the letter from MNC (Exhibit 2)▪ Identifies wider context for MNC's business/economic environment	USES ANALYTICAL SKILLS (material points in the written report) <ul style="list-style-type: none">▪ Determines the contribution for each service▪ Determines the excess resource (operators' hours)▪ Determines the scarce resource (consultants' hours)▪ Determines the contribution per limiting factor▪ Determines the appropriate ranking▪ Determines the product mix
USES PROFESSIONAL TOOLS AND KNOWLEDGE <ul style="list-style-type: none">▪ Analyses the revenue for each service▪ Analyses the costs for each service▪ Analyses contribution for each service▪ Analyses the contribution per limiting factor for each service▪ Analyses the number of operators to be upgraded or consultants to be downgraded	IDENTIFIES ISSUES AND OPTIONS <ul style="list-style-type: none">▪ All figures should be discussed in the context of the case▪ Negotiate and manage relationship with consultants possibly considering being available for more hours at a slightly reduced/increased wage per hour▪ Need to discuss the effect of the increased wage bill of hiring/ additional consultants' on MNC's profitability▪ Need to discuss the effect of the upgrade on the morale of consultants/operators who may be more qualified/experienced▪ Need to discuss the possibility of operators not being ready for an upgrade

<p>APPLYING PROFESSIONAL SCEPTICISM AND ETHICS</p> <ul style="list-style-type: none"> ▪ Identifies that internal financial information may not always be reliable ▪ Identifies effect of decisions on staff morale/customers etc. ▪ Identifies the need for adequate training of staff to ensure that the subscriber base is maintained or increased ▪ Identifies that the survey carried out by the company's marketing department might have been padded. 	<p>CONCLUSIONS (Draws distinct conclusions under appropriate heading)</p> <ul style="list-style-type: none"> ▪ Concludes on scarce resource ▪ Concludes on product mix and total contribution therefrom ▪ Concludes on number of staff required to be upgraded to consultants ▪ Concludes on other issues to be considered
<p>EVALUATIVE SKILLS AND JUDGEMENT</p> <ul style="list-style-type: none"> ▪ Recognises the possibility of call service system to enable customers resolve routine enquiries using an automated assistant based on similar cases ▪ Recognises the need for hiring the right staff with appropriate training and qualifications ▪ Recognises and discusses the use of other ways of analysing financials for decision making e.g. common size analysis, trend analysis etc. ▪ Recognises the use of external consultant to carry out subscribers data. 	<p>RECOMMENDATIONS</p> <ul style="list-style-type: none"> ▪ MNC should consider the information and how accurate it is ▪ MNC should use the financial information and conclusions drawn alongside non-financial ▪ MNC must keep up to date data and use this for resource allocation and other decision making ▪ MNC should prepare budgets and adhere to it for self-monitoring.

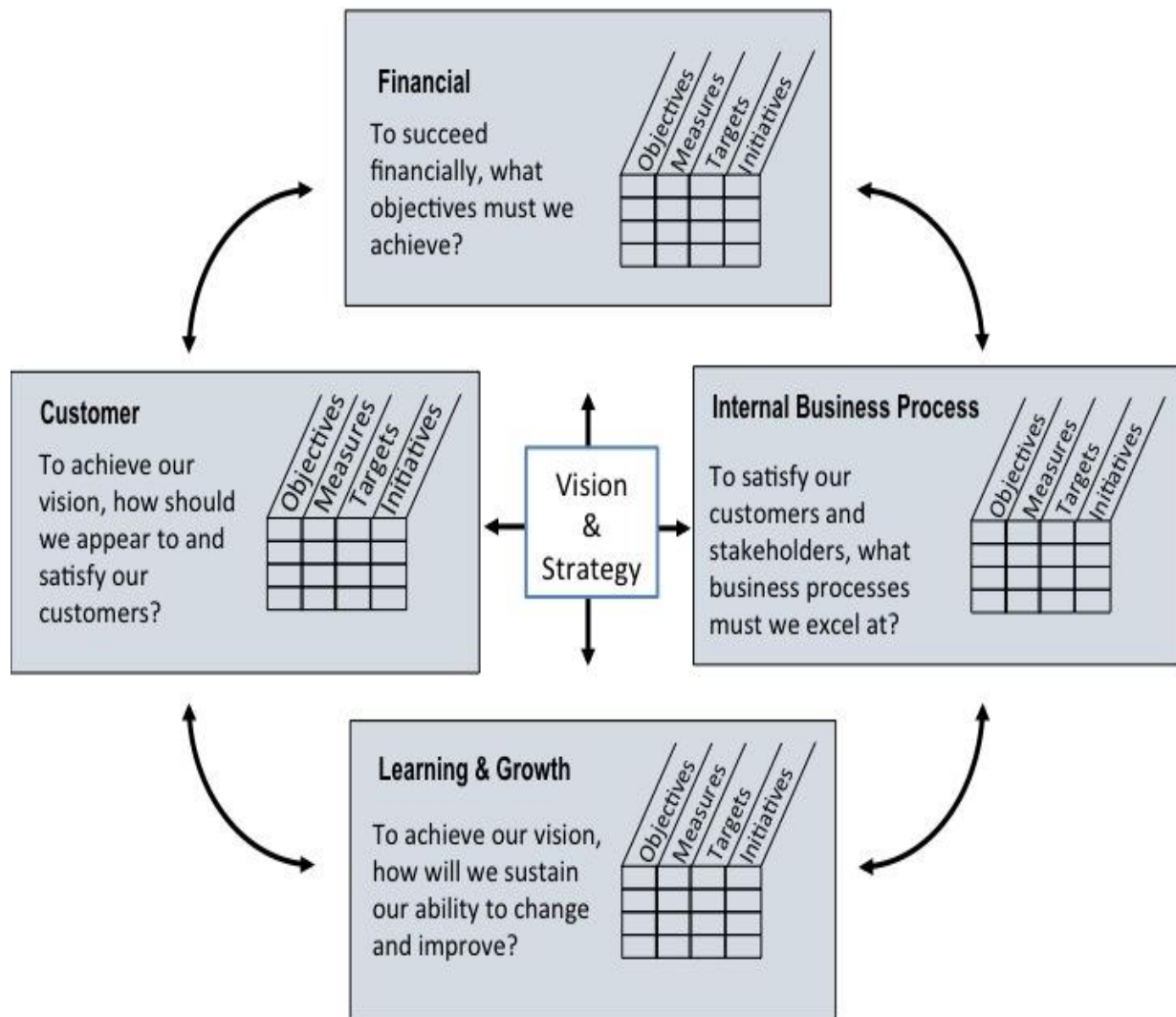
Appendices	Main Report																				
Appendices R1: Content and style <ul style="list-style-type: none">• Tabulated and mix of numbers and percentages (%)• Performance (P or L) analysis and trends for MNC• No unnecessary immaterial detail• Shows balance scored card model. <table><tr><td>V</td><td>NC</td><td>BC</td><td>CA</td><td>SA</td></tr></table> Appendices R2: Content and style <ul style="list-style-type: none">• Logical approach and numbers clearly derived.• Analysis of changes in MNC's financials for 2013 and 2014.• Well presented ratios analysis• Shows detailed contribution analysis of MNC's call centre operations• Shows the determination of limiting factor <table><tr><td>V</td><td>NC</td><td>BC</td><td>CA</td><td>SA</td></tr></table>	V	NC	BC	CA	SA	V	NC	BC	CA	SA	Report: Structure <ul style="list-style-type: none">• Sufficient and appropriate headings• Appropriate use of paragraphs/sentences• Legible• Correctly numbered pages <table><tr><td>V</td><td>NC</td><td>BC</td><td>CA</td><td>SA</td></tr></table> Report: Style and language <ul style="list-style-type: none">• Relevant disclaimer (external report)• Suitable language for the board• Tactful/ethical comments• Acceptable spelling and punctuation <table><tr><td>V</td><td>NC</td><td>BC</td><td>CA</td><td>SA</td></tr></table>	V	NC	BC	CA	SA	V	NC	BC	CA	SA
V	NC	BC	CA	SA																	
V	NC	BC	CA	SA																	
V	NC	BC	CA	SA																	
V	NC	BC	CA	SA																	

NOTE

R1: Requirement 1

R2: Requirement 2

Requirement 1: Balanced Scorecard Model



Appendix II

Statement of Comprehensive Income

	2015	2014	CHANGE	PERCENTAGE
	₦'billion	₦'billion	₦'billion	CHANGE
Revenue	522.28	243.39	278.89	114.59
Cost of Sales	<u>431.18</u>	<u>197.54</u>	<u>233.64</u>	<u>118.28</u>
Gross Profit	91.10	45.85	45.25	98.70
Selling distribution and Administration	<u>62.65</u>	<u>26.18</u>	<u>36.47</u>	<u>139.31</u>
Profit before Interest & Tax	28.45	19.67	8.78	44.64
Taxation	<u>9.10</u>	<u>6.24</u>	<u>2.86</u>	<u>45.84</u>
Profit for the year	<u>19.35</u>	<u>13.43</u>	<u>5.92</u>	<u>44.08</u>
Cash Flow from Operations (CFO)	134.34	55.35	78.99	142.71
Number of Subscribers (billion)	4.98	3.56	1.42	39.89

Ratios to consider:

1.	Revenue per subscriber	104.88	68.37
2.	Operating profit per subscriber	5.72	5.53
3.	Net Profit per subscriber	3.89	3.78
4.	CFO per subscriber	26.98	15.55

Other Ratios

Note: All figures in the calculation are in N'billion

Ratio	Formula	2015	2014
Gross Margin	$\frac{\text{Gross profit/sales}}{100\%} \times 100\%$	$\frac{(91.10/522.28)}{100\%} \times 100\%$ = 17.5%	$\frac{(45.85/243.39)}{100\%} \times 100\%$ = 18.8%
Net Margin	$\frac{\text{PBIT/sales}}{100\%} \times 100\%$	$\frac{(28.45/522.28)}{100\%} \times 100\%$ = 5.5%	$\frac{(19.67/243.39)}{100\%} \times 100\%$ = 8.1%
Return on Capital Employed	$\frac{\text{PBIT/capital employed}}{100\%} \times 100\%$	$\frac{(28.45/248.42)}{100\%} \times 100\%$ = 11.5%	$\frac{(19.67/149.07)}{100\%} \times 100\%$ = 13.2 %
Current Ratio	Current assets/Current Liabilities: 1	$(57.09/102.67): 1$ = 0.5:1	$(57.56/73.41): 1$ = 0.8:1
Gearing	$\frac{\text{Prior charge capital/Capital employed}}{100\%} \times 100\%$	$\frac{(80/248.42)}{100\%} \times 100\%$ = 32.2%	Not Applicable
Proprietary's Ratio	$\frac{\text{Equity/Total capital}}{100\%} \times 100\%$	$\frac{(168.42/354.09)}{100\%} \times 100\%$ = 47.57%	$\frac{(149.07/222.48)}{100\%} \times 100\%$ = 67.0%
Debt Ratio	$\frac{\text{Non-current liabilities/Total Assets}}{100\%} \times 100\%$	$\frac{(80/354.09)}{100\%} \times 100\%$ = 22.60%	Not Applicable

Appendices: Requirement II

Type of service for which queries are received

	Demand (Number of queries)	Operator minutes (Per query)	Consultant minutes (Per query)	Revenue (₦)	Total Operator Cost (₦)	Total Consultants cost (₦)	Contribution ₦	Limiting factor	Cont/Limiting factor ₦	Ranking
Mobile TelePhony (MT)	2,500	16	-	100,000	40,000	-	60,000			
Mobile Internet Service (MIS)	1,000	12	8	220,000	12,000	12,000	196,000	8,000	24.50	1 st
Home Internet Service (HIS)	2,000	12	28	360,000	24,000	84,000	252,000	56,000	4.50	2 nd
Business Internet Service (BIS)	250	6	54	<u>75,000</u>	<u>1,500</u>	<u>20,250</u>	<u>53,250</u>	<u>13,500</u>	3.94	3 rd
				<u>755,000</u>	<u>77,500</u>	<u>116,250</u>	<u>561,250</u>			

	Operator Mins	Consultants Mins
Mobile Telephony (MT)	40,000	-
Mobil Internet Service (MIS)	12,000	8,000
Home Internet Service (HIS)	24,000	56,000
Business Internet Service (BIS)	<u>1,500</u>	<u>13,500</u>
Available Minutes	<u>77,500</u>	<u>77,500</u>
No of Workers	100	85
Rate per hour	60	90
Number of hours worked	<u>14</u>	<u>14</u>
Required Minutes	<u>84,000</u>	<u>71,400</u>
Scarce resource	Not applicable	Scarce

EXAMINER'S REPORT

This case study has two requirements. Candidates are expected to first use the Balanced Scorecard Model to analyse and report on the performance of the Company discussed in the case. They are then required to use the marginal costing decision making approach, contribution analysis, to advise the company on profitable product mix based on the limiting factor.

As expected, all the candidates attempted the question. However, performance was very poor.

The commonest pitfalls of candidates are:

- ❖ Lack of understanding of the Balanced Scorecard Model as a performance measurement tool;
- ❖ Candidates seem to have forgotten that it is the contribution analysis that is suitable for making product mix decision when there is a limiting factor. Most of the candidates used the profit or loss approach; and
- ❖ Inability of the candidates to write a good and well arranged report with appropriate headings, appendices and disclaimer.

Candidates are advised that in preparing for future examination they should;

- Familiarise themselves with important strategic and performance measurement models they have earlier learnt; and
- Learn the act of report writing, with appropriate appendices and disclaimer.