THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

MAY 2015 PROFESSIONAL LEVEL EXAMINATIONS

Question Papers

Suggested Solutions

Plus

Examiners' Reports

FOREWORD

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

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

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

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

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

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

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

NOTES

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

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SUBJECT

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATIONS - MAY 2015

CORPORATE REPORTING

Time Allowed: 3 hours

ATTEMPT FIVE QUESTIONS IN ALL

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

1. Barewa Plc has two subsidiary companies and one associate. Since the adoption of International Financial Reporting Standards (IFRS) by companies listed on the Nigeria Stock Exchange, Barewa has been preparing its consolidated financial statements in accordance with the provisions of International Financial Reporting Standards (IFRSs). The draft Statements of Financial Position of Barewa and its two subsidiaries as at 31 May, 2013 are as follows:

	Barewa	Megida	Mindara
	₦'m	**₦'m**	**₦'m**
Assets:			
Non-current assets:			
Plant	2,650	2,300	1,610
Investments - Megida	3,000		
Mindara	1,280		
Associate Calamari	200		
Available for sale	510	60	50
	7,640	**2,360**	**1,660**
Current assets:			
Inventory	1,350	550	730
Trade receivables	910	450	320
Cash and cash equivalent	1,020	1,000	80
	3,280	**2,000**	**1,130**
Total assets	**10,920**	**4,360**	**2,790**
Equity and liabilities:			
Share capital	5,200	2,200	1,000

Retained earnings	2,400	1,500	800
Other components of equity	120	40	70
Total equity	**7,720**	**3,740**	**1,870**
Non-current liabilities:			
Long-term loans	1,200	150	50
Deferred tax	250	90	30
Total non-current liabilities	**1,450**	**240**	**80**
Current liabilities:			
Trade Payables	1,150	300	600
Current tax payables	600	80	240
	1,750	380	840
Total equity and liabilities	**10,920**	**4,360**	**2,790**

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

(i) On 1 June 2012, Barewa acquired 80% of the equity interest of Megida plc. On the date of acquisition, the retained earnings of Megida was ₦1.36billion and other components of equity was ₦40million. There had been no new issue of share capital by Megida since the date of acquisition. The consideration comprised cash of ₦3billion whereas the fair value of the identifiable net assets of Megida on this date was ₦4billion. The excess of the fair value of the net assets is due to an increase in the value of non-depreciable land. An independent valuer has stated that the fair value of the non-controlling interest in Megida was ₦860million on 1 June, 2012. It is the policy of Barewa to measure non-controlling interest on the basis of their proportionate share (interest) in the identifiable net assets of the acquired subsidiary and not at fair value (full goodwill method).

(ii) Also on 1 June 2012, Barewa acquired 70% of the ordinary shares of Mindara. The consideration for the acquisition of these shares was ₦1.28billion. Under the purchase agreement of 1 June, 2012, Barewa is required to pay the former shareholders 30% of the profits of Mindara on 31 May, 2014 for each of the financial years to 31 May, 2013 and 31 May, 2014. The fair value of this arrangement was estimated at ₦120 million at 1 June, 2012. This value had not changed and has not been included in the financial statements.

The fair value of the identifiable net assets at 1 June, 2012 of Mindara was ₦1.76 billion, and the retained earnings and other components of equity were ₦550 million and ₦70 million respectively. There had been no new issue of share capital by Mindara since the date of acquisition and the excess of the fair value of the net assets is due to an increase in the value of property, plant and equipment (PPE). The fair value of the non-controlling interest in Mindara was ₦530 million on this date. PPE is depreciated on a straight-line basis over seven years.

(iii) Barewa acquired a 10% interest in Calamari, a public limited company on 1 June, 2011 for ₦80million. The investment was accounted for as an available-for-sale investment and at 31 May 2012, its value was ₦90 million. On 1 June, 2012, Barewa acquired an additional 15% interest in Calamari for ₦110million and achieved a significant influence. Calamari made profits after dividends of ₦60million and ₦100million for the years to 31 May, 2012 and 31 May, 2013.

(iv) Finally, on 1 June, 2012, Barewa purchased an equity instrument of 100 million pesos which was its fair value. The instrument was classified as available-for-sale. The relevant exchange rate is as follows:

	₦ to pesos	**Fair value of instrument-pesos (million)**
31 May 2012	5.1	100
31 May 2013	5.0	90

Barewa has not recorded any change in the value of the instrument since 31 May, 2012. The reduction in fair value as at 31 May, 2013 is deemed to be as a result of impairment.

(v) The directors have included a loan to a director of Barewa in cash and cash equivalents of ₦10million. The loan has no specific repayment date on it but is repayable on demand. The directors feel that there is no problem with this accounting entry as there is a choice of accounting policy within International Financial Reporting Standards (IFRS) and that showing the loan as cash is their choice of accounting policy as there is no IFRS which states that this policy cannot be utilised.

(vi) There is no impairment of goodwill arising on the acquisitions.

Required:

Prepare a consolidated statement of financial position as at 31 May, 2013 for the Barewa Group. (30 Marks)

SECTION B - ATTEMPT ANY TWO OUT OF THREE QUESTIONS IN THIS SECTION (40 Marks)

QUESTION 2

The following transactions relate to Alilerimba Limited:

(i) Alilerimba Limited issued 400,000 convertible bonds on July 1, 2011. The bonds had a 3-year tenure and were issued with a total fair value of ₦4million which is also the par value. Interest is paid annually in arrears at a rate of 16% per annum and bonds, without the conversion option, attracted an interest of 19% per annum on July 1, 2011. The company incurred 10% issue costs. If the investor did not convert to shares they would have been redeemed at par.

At maturity, all the bonds were converted into 1 million ordinary shares of ₦4 of Alilerimba, no bonds could be converted before that date.

The directors are uncertain on how the bonds should have been accounted for up to the date of the conversion on June 30, 2014 and have been told that the impact of the issue costs is to increase the effective interest rate to 24.00%.

(ii) Alilerimba Limited purchases telephone handsets from a manufacturer for ₦120,000 each and sells the handsets directly to customers at ₦90,000 if they purchase credit card in advance on a prepaid phone. The costs of selling the handsets are estimated at ₦600 per set. The customers using a prepaid phone pay ₦12,600 for each credit card at the purchase date. Credit card expires after 6 months from the date of sale. Cards are activated when sold, the average unused credit card is ₦1,800 per card after 6 months.

Alilerimba Limited, also sells handsets to dealers for ₦50,000 and invoices the dealers for those handsets. The dealer can return the handset up to a service contract being signed by a customer. When the customer signs a service contract, the customer receives the handset free of charge.

Alilerimba Limited allows the dealer a commission of ₦168,000 on the connection of a customer and the transaction with the dealer is settled net by a payment of ₦78,000 by Alilerimba Limited being the cost of the handset to the dealer (₦90,000) deducted from the commission (₦168,000).

The handset cannot be sold separately by the dealer and the service contract lasts for a 12-month period. Dealers do not sell prepaid phones, and Alilerimba Limited receives monthly revenue from the service contract.

The Chief Operating Officer, a non-accountant has asked for an explanation of the accounting principles and practices which should be used to account for the above events on the purchase of handsets and the recognition of revenue from customers and dealers.

(iii) Alilerimba Limited issued 8% preference shares which entitles the holders to receive cash, with a redemption feature.

Required:

Advise the directors of Alilerimba Limited on:

a. Accounting for the convertible bonds. (12 Marks)

b. The principles and practices which should be used for the purchase of handsets and the recognition of revenue from customers and dealers. (6 Marks)

c. The provisions of IAS 32 on the presentation in financial statements of financial instruments which entitle the holder to receive cash with a redemption feature.
(2 Marks)
(Total 20 Marks)

QUESTION 3

Real Expansion Plc is a large group that seeks to grow by acquisition. The directors have identified two potential entities and obtained copies of their financial statements. The accountant of the company computed key ratios to evaluate the performance of these companies relating to:

- Profitability and returns;
- Efficiency in the use of assets;
- Corporate leverage; and
- Investor based decision

The computation generated hot arguments among the directors and they decided to engage a Consultant to give expert advice on which of the companies to acquire.

Extracts from these financial statements are given below:

	COMPANY A (₦'000)			COMPANY B (₦'000)		
	2014	**2013**	**2012**	**2014**	**2013**	**2012**
Revenue	77,888,548	64,088,879	59,864,385	14,096,123	12,932,549	12,726,227
Results from operating activities	9,130,834	5,526,734	4,802,379	1,795,956	1,868,652	2,600,357
Profit before taxation	7,616,444	3,262,719	2,558,644	2,043,293	1,857,089	2,300,357
Profit for the year	6,434,601	2,856,504	1,678,471	1,467,344	1,328,580	1,774,660
Total comprehensive income for the year	6,160,014	2,928,875	1,678,471	1,467,344	1,328,580	1,443,990
Share capital	320,295	320,295	320,295	249,986	249,986	249,986
Share premium	299,140	299,140	299,140	312,847	312,847	312,847

Retained earnings	16,709,260	11,958,545	9,688,160	10,764,382	9,463,028	8,334,437
Equity	17,328,695	12,577,980	10,307,595	13,753,157	12,455,803	11,327,212
Current liabilities	29,867,824	27,862,495	29,670,126	9,693,313	4,760,565	3,650,513
Non-current liabilities	8,666,690	10,929,695	8,507,941	3,990,011	5,240,199	3,043,865
Total non-current assets	38,238,065	35,873,744	33,480,167	9,693,742	9,891,975	9,113,908
Total Current assets	17,625,144	15,496,426	15,055,492	17,472,739	12,564,592	8,907,682
Share price at year-end (₦)	90	49	42	14.43	10.50	9.50

Required:

a. As the Consultant to the company, carry out a financial analysis on the financial statements and advise the company appropriately. (15 Marks)

b. State the major limitations of ratio analysis for performance evaluation. (5 Marks)

(Total 20 Marks)

QUESTION 4

LIKELY EFFECT LIMITED

Likely Effect Limited has shown a sincere intention to be IFRS compliant. Among a number of events and transactions, there is the need to change the accounting policies of the company in trying to comply with a few other standards. As the Consultant of the company, your attention was drawn to the fact that prior to 2013, the company had capitalised training costs.

According to IAS 38, training cost is regarded as an internally generated intangible asset and cannot be capitalised. Therefore, there is the need for a change of accounting policy which must be applied retrospectively.

The training costs capitalised in 2012 was ₦6m while the total for periods before 2012 was ₦12m.

Training costs incurred in 2013 is ₦4.5m. Retained earnings were ₦600m and ₦649m at the beginning and end of 2012 respectively. The corporate income tax rate is 30% for the relevant periods. Additional information available is given below:

	2013	**2012**
	(₦'M)	**(₦'M)**
Income tax expense	24	21
Profit after tax	56	49
Share capital	50	50

Required:

a. Advise the directors on the implication of the change in accounting standard relating to treatment of intangible assets and tax effect on the company. (5 Marks)

b. Prepare statements of profit or loss and other comprehensive income and changes in equity showing a retrospective application of the change in policy. (7 Marks)

c. Analyse the effects of the change in accounting policy on periods before 2013. (8 Marks)

(Total 20 Marks)

SECTION C - ATTEMPT ANY TWO OUT OF THREE QUESTIONS IN THIS SECTION (30 Marks)

QUESTION 5

International Financial Reporting Standards (IFRS) for small and medium size entities (SMEs) was mandatorily adopted in Nigeria as at January 1, 2014. Entities that do not meet the IFRS for SME criteria shall report using Small and Medium size Entities Guidelines on Accounting (SMEGA).

Jossy Limited has total costs excluding land of two-hundred million naira. Being a family business, the labour force totalled 150 workers with an annual turnover of ₦18 million. The management of this company sought your advice to have better understanding of some of the recognition and measurement principles of SMEs.

Required:

a. Justify the need for IFRS for SMEs financial statements. (6 Marks)

b. Assess the circumstances of Jossy Limited and advise on the principal recognition and measurement principles that will reduce the companyȣs reporting burden. (9 Marks)

(Total 15 Marks)

QUESTION 6

NICE & DICE is a large charity located in Abuja and set up to provide support and assistance to disadvantaged people in major cities. Most of the charityȣs income comes from members of the public through direct cash collections and regular monthly payments from donors. The other source of funding comes from government bodies who give grants to support specific projects that are recognised as being beneficial to the public good.

The charity publishes a detailed annual report. Performance is described largely in terms of an analysis of income received and the manner in which it has been spent. The trustees are concerned that this type of analysis does not really reflect the performance of the charity. They would like to report performance in terms of the work done rather than in terms of cash inflows and outflows. They want donors to appreciate how efficient the charity is.

The statement of financial position of the charity is a typical one for a large organisation. Nice & Dice owns numerous properties in Abuja, some of which have been owned for many years. These are shown at historical cost less depreciation. The trustees does not wish to revalue the properties because this will create the impression that the charity is wealthy and that it does not require further financial support.

You are required to:

a. Prepare a report to the trustees of Nice & Dice advising them on the reasons why specialised entities are required to publish detailed information about their activities. (5 Marks)

b. Analyse the problems of quantifying and reporting the efficiency of not-for-profit organisations such as Nice & Dice. (5 Marks)

c. Discuss the decision of the trustees to value its properties at cost less deprecation rather than at fair value. (5 Marks)

(Total 15 Marks)

QUESTION 7

ONDO TELECOMS LIMITED

Ondo Telecoms Limited is one of the biggest telecoms companies in Abuja. One month after the year-end, the Chief Finance Officer (CFO), while reviewing the companyꞌs activities came up with the following issues for the year ended 30 September, 2014.

a. The Board of Directors is not impressed with the performance of the Home Broadband operating segment which posted a loss of ₦1.7billion in 2014 financial year following another loss of ₦0.8billion in the 2013 financial year.

b. The carrying amount of the assets in the segment is ₦4.3billion as at 30 September, 2014 and ₦4.5billion as at 30 September, 2013. Professional valuers were engaged and they came up with fair value of ₦4.2billion as at 30 September, 2013.

c. The Board of Directors made the final decision in June 2014 to sell off the assets in this segment and concentrate on other business lines. Since the beginning of September, four serious bidders have been negotiating with Ondo. The board anticipates the sale to be concluded by end of May 2015 with the transaction cost of ₦0.3million.

d. On 1 November 2013, Ondo Telecoms Limited acquired a block of flats with an estimated useful life of 50 years at a total cost of ₦225million. The blocks of flats are to be rented out to its employees and engineers at market prices. The decision to acquire the block of flats was made by the board due to the need to have the engineers close to the head office to attend to technical issues immediately they arise.

e. Professional valuers were engaged to value the flats as at 30 September, 2014 and a fair value of ₦232million was determined.

f. International Telecom Limited which acquired Edo Communications Limited during the year has just published its results. Edo Communications Limited was a direct competitor to Ondo Telecom Limited and does similar business. The CFO noted that International Telecom Ltd. shows an asset of ₦110million arising from Edo Communication Limited customer listsû This made the CFO realise how valuable the customer details are and has engaged a professional valuer who valued them at ₦98million.

g. Over the years, Ondo Telecoms Limitedôs main business has been provision of mobile and fixed landlines services as well as broadband services. In July 2013 Ondo Telecoms Limited bid for the award of a subscription television licence from government.

h. Ondo Telecoms Limited won the bid and paid ₦560million for a five-year licence beginning 1 October, 2013. The licence is transferred and at the time of winning the bid, the fair value of the licence was estimated at ₦580million. Due to the slow uptake of the television business, the licence was revalued at ₦420million as at 30 September, 2014 by a professional valuer.

Required:

Advise with suitable computations, how the above transactions should be accounted for in the financial statements of Ondo Telecoms Limited under IFRS for the year ended 30 September, 2014. **(Total 15 Marks)**

SOLUTION 1

BAREWA PLC AND ITS SUBSIDIARIES
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MAY 2013

	WORKINGS	₦M	₦M
Assets			
Non-current assets			
Property, plant and equipment (2,650 + 2,300 +1,610 +400 + 140 -20)	6		7,080
Goodwill	2		168
Investment in Associate	3		225
Available for sale financial assets (510 + 60+ 50 ï 60)	4		560
			8,033
Current Assets			
Inventories (1,350 + 550 + 730)		2,630	
Trade receivables (910 + 450 + 320)		1,680	
Loans receivable		10	
Cash and cash equivalent (1,020 + 1,000 + 80 ï 10)		2,090	**6,410**
Equity and liabilities			**14,443**
Equity attributable to owners of the parent			
Share capital			5,200
Retained earnings	4		2,848
Other component of equity (120 ï 10)	3		110
			8,158
Non-controlling interest	5		1,425
			9,583
Non-current liabilities			
Long term liabilities (1,200 + 150 + 50)		1,400	
Deferred tax (250 + 90 + 30)		370	
		1,770	
Current liabilities			
Trade and other liabilities (1,150 + 300 + 600 + 120)		2,170	
Current tax payable (600 + 80 + 240)		920	
		3,090	4,860
			14,443

Workings

(1) **Purchase of Megida**

		Barewa	NCI
	₦M	₦M	₦M
Consideration		3,000	
Fair value of assets acquired:			
Share capital	2,200		
Retained earnings	1,360		
Other components of equity	40		
FV Non-depreciable land (balancing figure)	400		
Total fair value of net assets	4,000		
Barewa (80% of 4,000)/NCI (20% of 4,000)		3,200	800
Gain on bargain purchase		-200	
Gain on bargain purchase is taken to retained earnings going by IFRS 3			

(2) **Purchase of Mindara**

		Barewa	NCI
	₦M	₦M	₦M
Consideration		1,280	
Contingent consideration		120	
Total consideration FV		**1,400**	
Fair value of assets acquired:			
Share capital	1,000		
Retained earnings	550		
Other components of equity	70		
	1,620		
FV PPE (balancing figure)	140		
Total fair value of net assets (given)	1,760		
Barewa (70% of 1,760)/NCI (30% of 1,760)		1,232	528
Goodwill		**168**	

(3)

Investment in Associate - Cambari	₦M
1st Acquisition 10%	90
2nd Acquisition 15%	110
Total acquisition 25% now valued at	**200**

Add post acquisition retained profit		
25% x 100	25	Dr inv in Ass. Cr P or L
To Statement of Financial Position	**225**	

There is a movement from ₦80million to ₦90million (i.e. ₦10million gain):

Dr Inv in Associate	10
Cr Other Component of equity	10

On acquisition of further shares the N10 million is realised:

Dr Other component of equity	10
Cr Profit or loss	10

(4) **Retained earnings**

	Barewa	**Megida**	**Mindara**	**NCI**
As at 31/05/2013	2,400	1,500	800	
At acquisition		(1,360)	(550)	
Gain on bargain purchase	200			
Realised gain of inv in associate-other component of equity	10			
Share of post acquisition retained profit from Associate	25			
Additional dep PPE fair value			(20)	
Impairment AFSFA	(60)			
Post acquisition retained profit	**2,575**	140	230	
Barewa Share of post acquisition Prof in Megida (80% x 140)	112			28
Barewa share of post acquisition Prof in Mindara (70% x 230)	161			69
	2,848			97

(5) **Non-controlling interest**

	Megida	**Mindara**	
At acquisition	800	528	
Post acquisition	28	69	
NCI	**828**	**597**	
			1,425
Check: at consolidation date			
20% x 3,740	748		

30% x 1,870		561
Fair value Adjustment not yet accounted	80	36
NCI	828	597

(6) **Fair value adjustment**

	₦M
Megida – land	400
Mindara – PPE	140
Less Under depreciation $^{140}/_{7}$	-20
	120

EXAMINER'S REPORT

The question tests candidates understanding of IFRS provisions and principles on consolidation of group accounts with associate. Candidates are expected to prepare consolidated statement of Financial Position together with relevant notes and schedules.

Almost all candidates attempted the question but performance was very poor. The commonest pitfalls were candidates' inability to compute non-controlling interest, group reserve and goodwill on consolidation.

Candidates are enjoined to appreciate that while the emphasis in Financial Reporting is on compliance with regulations enunciated in IFRS and NGAAP, Corporate Reporting emphasises their competence to evaluate acceptability of alternatives from both IFRS compliance and reporting perspectives as well as their effects on results, position and risks disclosed by entities.

QUESTION 2

(i) **ALILERIMBA LIMITED**

CONVERTIBLE BOND

Some compound instruments have both a liability and an equity component from the issuer's perspective.

In this case, IAS 32 (Financial Instruments Presentation) requires that the component parts be accounted for and presented separately according to their substance based on the definitions of liabilities and equity.

The split is made at issuance and not revised for subsequent changes in market interest rates, share prices, or other events that change the likelihood that the conversion option will be exercised.

A convertible bond contains two components. One is a financial liability, namely the issuerõs contractual obligation to pay cash in the form of capital, and the other is an equity instrument, which is the holderõs option to convert into shares.

When the initial carrying amount of a compound financial instrument is required to be allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole, the amount separately determined for the liability component.

In the case of the bond, the liability element will be determined by discounting the future stream of cash flow which will be the interest to be paid and the financial capital balance assuming no conversion. The discount rate used will be 19% which is the market rate for similar bonds without the conversion right.

The difference between cash received and the liability component is the value of the option.

Present value of Interest at end of:	**₦ M**
Year 1 June 2012 (₦4m x 16%) ÷ 1.19	537,815
2 June 2013 (₦4m x 16%) ÷ 1.19^2	451,968
3 June 2014 (₦4m + (₦4m x 16%) ÷ 1.19^3)	2,753,376
Total liability component	3,743,159
Total equity component	256,841
Proceed of issue	4,000,000

The issue cost will have to be allocated between the liability and equity components in proportion to the above proceeds.

	Liability	**Equity**	**Total**
	₦	**₦**	**₦**
Proceeds	3,743,159	256,841	4,000,000
Issue cost	374,315	25,685	400,000
	3,368,844	231,156	3,600,00

The credit to equity of ₦231,156 would not be re-measured. The liability component of ₦3,368,844 would be measured at amortised cost using the effective interest rate of 24%, as this spreads the issue costs over the tenure of the bond. The interest payments will reduce the liability at the year-end.

The initial entries would have been:

Financial Instrument	**₦**	**Interest**	**₦**
Dr Cash	4,000,000	Cr Cash	400,000
Cr Liability	3,743,159	Dr Liability	374,315
Cr Equity	256,841	Dr Equity	25,685

The liability component balance on 30 June 2014 becomes ₦4m as a result of the effective interest rate of 24% being applied and cash flows at 16% based on nominal value.

B/FWD	**Effective Interest at 24%**	**Cash flow 16%**	**C/FWD**
₦	₦	₦	₦
3,368,844	808,522	640,000	3,537,366
3,537,366	848,967	640,000	3,746,333
3,746,333	899,120	640,000	3,995,453

On conversion of the bond on 30 June 2014. ALILERIMBA Limited would issue 1 million ordinary shares of N4 each and the Original Equity Component together with the balance on the liability will become the consideration.

	₦
Share capital	4,000,000
Share premium	231,156
Equity and liability component (₦4,000,000 + ₦256,841 ï ₦25,685)	4,231,156

(ii) IAS 18 - óREVENUEô

IAS 18 requires the recognition of revenue by reference to the stage of completion of the transaction at the reporting date.

Revenue associated with the provision of services should be recognised as the services are rendered.

ALILERIMBA Limited should record the receipt of ₦12,600 per credit card as deferred revenue at the point of sale.

Revenue of ₦10,800 (i.e. ₦12,600 ï ₦1,800) should be recognised over the six months period from the date of sale.

The unused credit card of ₦1,800 would be recognised when the credit card expires as that is the point at which the obligation of ALILERIMBA Limited ceases.

Revenue is earned from the provision of services and not from the physical sale of credit cards.

IAS 18 does not deal in detail with agency arrangements, but says the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity.

The amounts collected on behalf of the principal are not revenue.

Revenue is the amount of ócommissionô.

Additionally, where there are two or more transactions, they should be taken together if the commercial effect cannot be understood without reference to the series of transactions as a whole.

Consequent upon the above, the company should not recognise revenue when the handset is sold to the dealer as the dealer is acting as an agent for the sale of the handset and the service contract.

The company has retained the risk of the loss in value of the handset as they can be returned by the dealer and the price set for the handset is under the control of the company.

The handset sale and the provision of the service would have to be assessed as to their separability. However, the handset cannot be sold separately and is commercially linked to the provision of the service.

The company would therefore recognise the net payment of ₦78,000 as a customer acquisition cost which may qualify as an intangible asset under IAS 38, and the revenue from the service contract will be recognised as the service is rendered.

The intangible asset would be amortised over the 12 months contract.

The cost of the handset from the manufacturer will be charged as cost of goods sold (₦120,000).

(iii) IAS 32 - (FINANCIAL INSTRUMENTS: PRESENTATION)
IAS 32 - (Instruments: Presentation) Outlines the two options:

- Recognise the financial liability as debt
- Recognise the financial liability as equity

In this case, IAS 32 states that when a financial instrument entitles the holder to receive cash or contains a redemption feature, such instruments are classified as debts.

This is because the substance, not the legal form, is reflected in the financial statements.

A contractual obligation exists to deliver cash and this obligation gives rise to a liability (debt).

When a financial instrument does not entitle the holder to receive cash or does not contain a redemption feature, you recognise these types of instruments in equity.

EXAMINER'S REPORT

The question tests the requirements, principles and practices of accounting for convertible bonds, revenue recognition and presentation of financial instruments based on IFRS.

About 20% of the candidates attempted the question and performance was poor. Candidates' major challenge was their lack of in-depth knowledge of the provisions and applications of IAS 18-Revenue recognition and IAS 32- Financial Instruments (Presentation).

Candidates are advised to thoroughly study and practice questions on relevant provisions of the International Financial Reporting Standards (IFRS) to enhance their performance in this paper in future.

SOLUTION 3

(a) Expected ratios and their formulae are:

1. Profitability and returns:

i) Profit margin $= \frac{PBIT}{Revenue} \times 100$

PBIT is Profit before interest and tax

ii) Returns on Capital Employed (ROCE)

$\frac{PBIT}{Capital\ Employed} \times 100$

Capital employed = Total assets less current liabilities

2. Efficiency in the use of assets

Asset Turnover ratio = $\frac{\text{[illegible]}}{\text{[illegible]}}$

3. Corporate leverage

Debt Equity ratio

$= \frac{\text{[illegible]}}{\text{[illegible]}}$

Alternatively

$= \frac{\text{[illegible]}}{\text{[illegible]}}$

4. Investors Based Ratios:

(i) EPS = Earnings Per Share = $\frac{\text{[illegible]}}{\text{[illegible]}}$

PAT is Profit after Taxation

(ii) PE = Price Earnings = $\frac{\text{[illegible]}}{\text{[illegible]}}$

(iii) NAPS = Net Asset Per Share = $\frac{\text{[illegible] \& [illegible]}}{\text{[illegible]}}$

(iv) EY = Earnings Yield = $\frac{\text{[illegible]}}{\text{[illegible]}}$

Ratio Computation

	Company A			Company B		
	2014	**2013**	**2012**	**2014**	**2013**	**2012**
Total liabilities (₦)	38,534,514	38,792,190	38,178,067	13,683,324	10,000,764	6,694,378
Total assets (₦)	55,863,209	51,370,170	48,485,662	17,473,168	17,696,002	14,371,077
Capital employed(₦)	25.995.385	23,507.675	18,815,536	17,473,168	17,696,002	14,371,077
No. of ord. share	640,590	640.590	640.590	499.972	499,972	499,972
Profit margin	0.10	0.05	0.04	0.15	0.14	0.18
ROCE	0.29	0.14	0.14	0.12	0.11	0.16
Asset turnover	3 times	2.7 times	3.18 times	0.8 times	0.73 times	0.89 times
Debt/Equity	0.69	0.76	0.79	0.50	0.45	0.37
NAPS	27.05	19.64	16.09	27.51	24.91	22.66
EPS	10.05	4.46	2.62	2.94	2.66	3.55
PE	8.96	10.99	16.03	4.92	3.95	2.68

Comments and advice on the Ratios.

Based on the financial statements of the two companies and the computed ratios, the following conclusions are made:

(i) Company A is bigger than Company B.

(ii) Although Company B seems to be more profitable having a higher profit margin, the returns on capital employed for Company A is higher.

(iii) Company A is more efficient in the use of assets than Company B.

(iv) The net asset per share for the two companies are very close, but the earnings per share and price earnings ratios for Company A is higher.

(v) Real Expansion Plc. should acquire company A based on the performance evaluation above.

(b) **LIMITATIONS OF RATIO FOR FINANCIAL ANALYSIS**

Traditional ratio analysis is becoming outdated because of a number of draw- backs identified with ratio analysis which include:

(i) Absence of valid universal definition of standard ratios

(ii) Dual meanings and implications of some ratios. This fact calls for the need for further enquiries or investigations before coming to conclusions when using ratios for financial analysis. Difference in meaning of certain terms e.g. profit (gross, net, before taxation or after taxation etc) assets (tangible or intangible), should preference share be part of debt?

(iii) Incomparable financial statements in the face of different accounting policies, degrees of diversification and other policies.

(iv) Impact of seasonality on accounting figures may render ratios based on those figures unreliable for comparative analysis.

(v) Management can easily manipulate accounting figures. Financial ratios are not very useful when viewed in isolation.

(vi) Accounting figures and valuations are affected by changes in price level resulting from inflation, hence ratios based on amalgam of currency values are not very reliable. Also changes in technology and environment affects accounting figures.

(vii) Information in annual report is in summary form and may be inadequate or unsuitable when detail analysis is needed.

(viii) Accounting information presented in annual report is historic, suffer short-term changes hence of little value for future decisions or predicting the future.

(ix) Basis of information is often out of date, therefore timeliness of information leads to problem of interpretation.

(x) Analysis of accounting information identifies symptoms and not causes.

EXAMINER'S REPORT

The question tests candidates competence in identifying, computing and interpreting relevant financial ratios for evaluation, profitability and efficiency in asset utilization, corporate leverage and investment decisions.

Almost all the candidates attempted the question but displayed poor understanding of the requirements of the question.

Most of the candidates could not identify the relevant ratios while others did not know appropriate formulae.

Candidates are advised to sustain knowledge acquired at the Financial Accounting and Financial Reporting stages of the examination.

SOLUTION 4

LIKELY EFFECT LIMITED

a. Users of financial statements need to be able to compare financial statements of an entity over time. This will be in agreement with consistency convention and in order to identify trends in its financial performance and financial position. Changes in accounting standards will therefore have significant impact on the choice of accounting policy adopted by entities and consequently cause major alterations in operating results in the financial statements.

Changes in accounting policies are rare but are allowed or permitted if and only if:

i. required by statute;
ii. occasioned by a change in standard e.g. a new IFRS replacing an existing one;
iii. the change would result in more reliable and relevant financial information (IAS 8)

Whenever there is a change in accounting policy, the change and its effects on the financial statements must be disclosed.

Since Likely Effect Limited has shown intention to be IFRS compliant, it is required that the entity must give appropriate effects to the treatment of its intangible assets. Therefore, its training costs which were previously capitalized as intangible assets would be derecognized in compliance with the requirements of IAS 38, because such cost will not qualify as intangible asset within the context of the standard.

The appropriate treatment is to carry out the derecognition in a retrospective manner. By retrospective application, it means that the entity should adjust the opening balance for each item of equity affected by the change for the earliest prior period presented and the other comparative amounts for each prior period presented as if the new accounting policy or standard had always been applied.

Arising from the foregoing, the directors of LIKELY EFFECT LIMITED will be required to adjust the net of tax effect of training cost capitalized for each of 2012 and 2013 with respect to IFRS Statement of Profit or Loss. However, the cumulative effect of previously capitalized amount of the same cost prior to 2012 will be adjusted from the retained earnings of the earliest comparative period net of tax (January 1, 2012).

b. (i) **LIKELY EFFECT LIMITED**

Statement of Comprehensive Income
for the Year ended 31 December, 2013

	2013	2012
	₦'000	₦'000
Profit before Income Tax	80,000	64,000
Less: Income Tax	24,000	19,200
Profit for the year	56,000	44,800
Other items of Comprehensive Income	-	-
Total Comprehensive Income	56,000	44,800

(ii) **Statement of Changes in Equity**
for the year ended 31 December, 2013

	Share Capital	Retained Earnings	Total
	₦'000	₦'000	₦'000
Balances previously reported as at 2011	50,000	600,000	650,000
Reduction in Retained Earnings resulting from change in Policy		(8,400)	(8,400)
Balances as at 31 December, 2011 (Restated)	50,000	591,600	641,600
Comprehensive Income for the Year ended 31 December, 2012 (Restated)		44,800	44,800
Balances as at 31 December, 2012	50,000	636,400	686,400
Comprehensive Income for the Year ended 31 December, 2013		56,000	56,000
Balance as at 31 December, 2013	50,000	692,400	742,400

Workings:

(i) Profit after income tax + Income tax = Profit before Income tax
= ₦56,000,000 + ₦24,000,000
= ₦80,000,000

			₦'000
(ii)	Profit after income tax in 2012	=	49,000
	Income tax	=	21,000
	Profit before income tax	=	70,000
	Less training cost capitalized in the period	=	6,000

64,000

(iii) Income tax payable should be reduced by the tax element on ₦6,000,000 overstatement of profit.

Income tax	=	₦21,000,000 ï (₦6,000,000 x 30%)
	=	₦21,000,000 ï 1,800,000
	=	₦19,200,000

(iv) Reduction = Retained Earnings as a result of change in capitalization of training costs

= ₦12,000,000 x (1 ï 30%)

= ₦ 8,400,000

c. Effects of change in Accounting Policy on previous periods:

Apart from restatement of comparative figures for 2012 on the Statement of Comprehensive Income, the following items will be affected as analysed below:

Effect on 2012 figures:		₦ó000
i.	Decrease in profit before tax (the amount of training cost)	(6,000)
ii.	Decrease in income tax expenses (30% of ₦6,000)	1,800
iii.	Decrease in profit for the period (₦6,000 - ₦1,800)	(4,200)
iv.	Decrease in comprehensive income	(4,200)
v.	Decrease in intangible assets	(6,000)
vi.	Decrease in deferred tax liabilities	1,800
vii.	Decrease in retained earnings at the end of the December 2012 (649,000 ï 636,400)	(12,600)

Effects on Period before 2012 ₦ó000

i.	Decrease in profit for the period (Total training cost before 2012 x (1 ï 30%) (₦12,000,000 x 1 ï 30%) = Net effect	(8,400)
ii.	Decrease in Comprehensive income	(8,400)
iii.	Decrease in intangible assets	(12,000)
iv.	Decrease in Deferred tax liabilities (30% of 12,000)	3,600

Judging from the above, the adoption or compliance with IFRS by LIKELY EFFECT LIMITED in Year 2013 will affect the entityôs prior periods information as presented under the old NGAAP or accounting policies.

Some of the likely effects may include the following:

Previous Retained Earnings:
The cumulative effect of the change would have been adjusted on the retained earnings available as at the beginning of earliest comparative period. As shown in the initial calculation, the cumulative effect of the change in treatment of training cost on the opening retained earnings as at 1 January, 2012 net of tax gives rise to a reduction in opening retained earnings by absolute figure of N8.4m. This reduction has inadvertently reduced the total equity thereby affecting all relevant ratios relating to equity in the entity. Ratio such as debt to equity, return on equity, return on capital employed, gearing, etc. previously computed will be affected by this change.

Comparative period profit for the year:
The effect of the change in the accounting policy will equally have directional effect on the adjusted profit for the year in respect of 2012 financial year-end. The amount of training expenses of ₦6m (₦4.2m net of tax) was adjusted to arrive at profit for the year thereby reducing the initial profit for the year of ₦49m to ₦44,8m after the said adjustment for the effect of the change in accounting policy. This will have an analytical effect of reduction in net profit margin, return on asset, etc. calculated.

EXAMINER'S REPORT

The question examines the implications of and applicable provisions for changes in accounting standard relating to intangible assets based on IAS 8-Accounting Policies, Changes in Accounting Estimates and Errors and IAS 38- Intangible Assets.

Most of the Candidates attempted the question but performance was generally poor. Candidates' major challenge was their lack of requisite knowledge of IFRS provisions and their application in the preparation of Statements of Profit or Loss and Other Comprehensive Income and Changes in Equity.

Candidates are advised to study diligently the provisions and application of various International Financial Reporting Standards.

SOLUTION 5

a. **JOSSY LIMITED**

International Financial Reporting Standards (IFRS) for SMEs aim to simplify financial reporting for SMEs by omitting irrelevant topics, reducing guidance and disclosure choice. It is designed to facilitate financial reporting by Small and Medium Size Entities in a number of ways.

The management of Jossy Limited should note the underlisted needs for IFRS for SMEs financial statements:

i. It provides significantly less guidance than full IFRS;
ii. It is structured according to topics which should make it practical to implement.
iii. There is need for considerable reduction in disclosure requirements;
iv. Guidance not relevant to private entities is excluded;
v. The standard has been written in a clear language that can easily be understood;
vi. Topics not relevant to SMEs are omitted.
vii. Where full IFRS allow accounting policy choices, the IFRS for SMEs allows only the easier option;
viii. Many of the principles for recognizing and measuring assets, liabilities, income and expenses in full IFRS are simplified.

b. Principal recognition and measurement principles that will reduce Jossy Limitedôs reporting burden as a SME are:

i. **IAS 38 – Intangible assets** requires internally generated assets to be capitalized if certain criteria (proven future economic benefits) are met. In reality, it is an onerous exercise to test these criteria for each type of internally generated asset and leads to inconsistency with some items being expensed and some capitalized.

The IFRS for SMEs removes these capitalization criteria and requires all internally generated research and development expenditure to be expensed through profit or loss.

ii. **IFRS 3 – Business Combinations** requires goodwill to be tested annually for impairment. In reality, it is difficult to ascertain the recoverable amount for goodwill, instead the assets of the business need to be combined into cash generating units or even a group of cash generating units in order to determine any impairment loss. The impairment then needs to be allocated to goodwill and the other individual assets. This is a complex exercise.

The IFRS for SMEs requires goodwill to be amortised instead. This is a much simpler approach and the IFRS for SMEs specifies that if an entity is unable to make a reliable estimate of the useful life, it is presumed to be ten years, simplifying things even further.

iii. **IAS 20 – Accounting for Government Grants and disclosure of Government Assistance** requires grants to be recognized only when it is reasonably certain that the entity will comply with the conditions attached to the grant and the grants will be received. Grants relating to income are recognized in profit or loss. Grants relating to assets are either netted off the cost of the asset (reducing depreciation by the amount of the grant over the assetøs useful life) or presented as deferred income (and released to profit or loss as income over the useful life of the asset).

The IFRS for SMEs simplifies this and specifies that where there are no specified future performance conditions, the grants should be recognized as income when it is receivable. Otherwise, it should be recognized as income when the performance conditions are met. This is more consistent with IASB Frameworkøs definition of income than the IAS 20 approach.

iv. **IAS 23 – Borrowing Costs** requires borrowing costs to be capitalized for qualifying assets for the period of construction. This involves a complex calculation particularly where funds are borrowed generally as a weighted average rate on loans outstanding has to be calculated in order to determine the amount of interest to be capitalized.

The IFRS for SMEs requires borrowing costs to be expensed, removing the need for such a complex calculation.

v. **IAS 36 – Impairment of Assets** requires annual impairment tests for indefinite life intangibles, intangibles not yet available for use and goodwill. This is a complex, time-consuming and expensive test. The IFRS for SMEs only requires impairment test where there are indicators of impairment.

The full IFRS requires impairment losses to be charged firstly to other comprehensive income for revalued assets then to profit or loss. The IFRS for SMEs requires all impairment losses to be recognized in profit or loss, given that tangible and intangible assets cannot be revalued under the IFRS for SMEs.

vi. **IAS 16 – Property, Plants and Equipment allows assets to be held under the cost or revaluation model.** The IFRS for SMEs does not permit the revaluation model to be used.

vii. **IAS 38 – Intangible Assets allows** either the cost model or revaluation model (where there is an active market). The IFRS for SMEs does not permit the revaluation model to be used.

Both of these eliminate the use of other comprehensive income, simplifying financial reporting and the need for costly revaluations.

viii. **IAS 40 – Investment Property** allows either the cost model or fair value model (through profit or loss) are permitted. The IFRS for SMEs requires the fair value model (through profit or loss) to be used as long as fair value can be measured without undue cost or effort. This promotes consistency in the treatment of investment properties between SMEs financial statements.

EXAMINER'S REPORT

The question examines the justification for and recognition and measurement principles of IFRS for SMEs.

It was attempted by most of the candidates but their performance was very poor.

Most of the candidates enumerated the potential benefits of IFRS vs NGAAP instead of specific need for IFRS for SMEs.

Candidates should learn to correctly identify the requirements of questions before attempting them.

SOLUTION 6

NICE & DICE

May 21, 2015

The Board of Trustees
Nice & Dice
Abuja

Dear Sirs,

REPORT ON THE OPERATIONS OF NICE & DICE

Specialised entities, such as Notï forï Profit Organizations (NFPOs) are not set-up to make profit. They are exempted from tax. Example of NFPOs include charities, professional organisations, trade unions, religious, arts, community, research and campaigning bodies.

a. The following are reasons why specialised entities are required to disclose detailed information about their activities:

   i. Specialized entities are subjected to a great deal of legislation and regulations in order to protect donors from being misled or deceived about the manner in which their gifts are being applied.

   ii. Charities must be adequately controlled to prevent fraudulent or dishonest ones from raising funds on false pretence.

   iii. Donors deserve to be protected having been persuaded to make gifts to pursue good works.

   iv. Charities that raise funds from government must be accountable. Government grants can be substantial and government always has a responsibility to ensure that its funds are put to good use.

   v. Members of the public must be protected even if their donations are not large.

   vi. Charities are exempted from Income tax and must disclose this fact in financial statements.

   vii. All other privileges granted them must be disclosed.

   viii. Anomalies in terms of trading activities must be prevented through disclosure.

   ix. Reporting and accountability can attract donations

b. Some of the problems of quantifying and reporting the efficiency of Notï forï Profit Organizations such as Nice & Dice are listed below:

i. The effects of the work done by most charities cannot be quantified in monetary terms.

ii. There is no equivalent of profit which balances income against expenses in order to determine whether there is a net gain or loss.

iii. Describing the application of funds does not indicate assurance that funds were spent on the aims of the charity.

iv. Measures of output can be difficult to determine and they can be open to misunderstanding or even distortion.

v. Efficiency can be difficult to measure because charities often have differing levels of non-financial inputs.

vi. Employment of professionals, administrators and financial staff may be difficult for some charities.

c. In evaluating decisions of the trustees to value its properties at cost less depreciation rather than fair value, we have to consider the underlisted points:

   i. Non-current assets must be stated at their fair value in the statement of financial position.

   ii. All portfolios of assets must be shown in the statement of financial position at their fair value and not book values.

   iii. Choosing not to attach a fair value to these properties compromises any attempt to measure the efficiency of an entity.

   iv. Fair value shows the efficient use of resources rather than book value.

   v. Showing properties at fair value might however create some misleading impression that the charity does not really need on-going financial support.

   vi. The provision of up-to-date information about fair value will also impose costs for the collection and audit of this information.

   vii. Fair values are of relatively little value unless there is a possibility that the assets will be sold.

viii. Commercial organisations realistically use fair value but charity organisations are less likely since the properties will be of no use in themselves without continuing financial support to meet running costs.

EXAMINER'S REPORT

The question tests candidates knowledge of the nature, operations and corporate reporting responsibilities of Not-for-Profit Organisations based on IFRS provisions.

About 50% of the candidates attempted the question but their performance was poor. They displayed a poor understanding of the requirements of the question.

Candidates are advised to ensure full coverage of all aspects of the syllabus in their preparation for the examination.

SOLUTION 7

ONDO TELECOMS LIMITED

Financial Statements (Under IFRS) for the year ended 30 September 2014

i. Non-current assets held for sale (or disposal):

The provision of IFRS 5 should be applied in handling this transaction. According to this standard, the conditions to be met before an asset could be classified as being held for sale include:

a. Availability for immediate sale in its present condition subject only to terms that are usual and customary for sale of such assets. This is evidenced by management seeking buyers as shown by the bids;

b. The sale must be highly probable; and

c. The sale is to be completed within a year from the date of classification.

Having negotiated with four serious bidders and expecting the sale to be concluded by May 2015, the above-stated conditions have been met.

✓ **Measurement**

- Such asset should be measured at the lower of carrying amount and fair value less cost to sell.

✓ **Computation**

- Carrying amount at 30 September, 2013 ï ₦4.5 million.
- Fair value less cost to sell (₦4.2 billion ï ₦O.3million)
- The lower of the two (as above) which is ₦4.1997 billion will serve as the carrying amount as at 30 September, 2014
- The difference between ₦4.5 billion and ₦4.1997 billion will be expensed during the year ended 30 September, 2014

✓ **Discontinued Operations**

- A discontinued operation is a component of an entity that either has been disposed or classified as held for sale.
- Since it is a whole segment classified as held for sale, it should also be shown as discontinued operations with the following disclosures:
- Loss for year 2014 is ₦1.7 billion should be shown separately in the Statement of Comprehensive Income.
- Prior year amount should also be represented to show the loss of ₦0.8 billion.

ii. The following computations are relevant:

- The block of flats should be accounted as Property, Plant and Equipment (PPE) under IAS 16.

The property does not qualify as investment property because it is occupied by staff even when they are paying market rate (IAS 40). Therefore, the following recognition and disclosure principles are detailed below:

- The block of flats could be carried:
  - At cost less depreciation; and
  - At revaluation model/basis.

Valuation at cost

	- Cost	₦225m
Less:	Depreciation	

$(N^{225}/_{50} \times {}^{11}/_{12})$	4.125m
Carrying amount	₦220.875m

Revaluation model:

- Revalued amount	₦232m

On revaluation, the following gain will appear under comprehensive income:

Revaluation amount	₦232m
Carrying amount of initial cost after 11 months depreciation	₦220.875m
Gain on Revaluation	₦11,125m

iii. **Valuation of Customer Balances (Lists):**

Ondoôs Telecon Limitedôs customer list of balances is an internally generated intangible asset that does not qualify for recognition under IAS 38 because the internal costs of producing these items cannot be distinguished separately from the costs of delivering and operating the business as a whole.

These items would have qualified for recognition if they were purchased separately as business acquisition as it happened in the case of International Telecom Limited which acquired Edo Communications Limited during the period under consideration.

It must be noted therefore that the CFO of Ondo Telecoms Limited would expect to continue to derive benefits from the customers, it cannot recognize the value in its financial statements because the entity does not have control over the loyalty of those customers hence, it remains an internally generated intangible asset until it is packaged and sold singly or separately to a buyer.

iv. At the end of the first year of its acquisition, due to slow uptake of the television business, the licence market value has reduced to ₦420million at 30 September 2014. If this fair value is synonymous to its recoverable amount as at this date, then it can be concluded that the asset has suffered an impairment and the impairment should be duly accounted for (IAS 36). In calculating the impairment, the carrying amount will be compared with the recoverable amount and the excess of carrying amount over the recoverable amount will be charged to income statement.

The computation is as follows:

	₦m
Cost of Acquisition	560
Amortization at 30/09/2014	
(560 / 5 x 1)	(112)
Carrying amount	448
Recoverable amount	(420)
Impairment loss	28

Subsequently, the carrying amount of the licence will change to N420m and amortised over the remaining useful life.

EXAMINER'S REPORT

The question tests candidates knowledge of IFRS provisions on classification of Non-Current Assets as held for sale, investment property based on IAS 16, 40 and 38.

Very few candidates attempted the question and performance was very poor.

Candidates commonest pitfalls were their lack of knowledge of the bases for classification of non-current assets held for sale, requirement of investment property, and calculations of impairment or revaluation gain.

Candidates should prepare and ensure good understanding of salient IFRS issues that may create reporting alternatives in the preparation of financial statements.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATIONS – MAY 2015

ADVANCED TAXATION

Time Allowed: 3 hours

ATTEMPT FIVE QUESTIONS IN ALL

SECTION A: COMPULSORY QUESTION (30 Marks)

QUESTION 1 CASE STUDY

The Senior Tax Manager of your firm of Tax Consultants has just finished a meeting with the Management of Emidans Nigeria Limited, Calabar. At that meeting, he was presented with the following facts:

Emidans Nigeria Limited was incorporated in 2006 and the main object clause is to operate in the Communications Sector of the economy. As a result of strategic management and interpersonal relationship of the Board of Directors, the Company recorded the understated revenue:

	₦ô000
Year ended 31 December, 2009	140,000
Year ended 31 December, 2010	160,000
Year ended 31 December, 2011	185,000
Year ended 31 December, 2012	210,000
Year ended 31 December, 2013	435,120

On 1 July, 2013, the Company acquired all the shareholdings in Megatek Systems Limited, whose operations are in horizontal integration with Emidans Nigeria Limited.

The Statement of Comprehensive Income of the Company for the year ended 31 December, 2013 was as follows:

	₦'000	**₦'000**
Revenue		435,120
Opening inventory	41,491	
Purchases	294,224	

Carriage Inwards	5,718	
	341,433	
Less: Closing inventory	36,633	
Cost of sales		(304,800)
Gross profit		130,320
Other income		9,530
		139,850
Deduct:		
Administrative expenses:		
Directors remuneration	20,720	
Motor running	10,660	
Transport	8,795	
Rent	8,000	
Office	4,190	
Salaries & wages	15,571	
Telephone	3,626	
Audit	5,180	
Maintenance	7,355	
Sundries	5,791	
Medical	1,890	
Printing & stationery	4,247	
Provision for bad debts	9,386	
Loss on sale of Non-current assets	3,771	
Depreciation	9,137	
		(118,319)
Net profit		21,531

Additional information:

i. 60% of Other Income was the personal rental income of the Managing Director.

ii. The Capital allowance for the year was ₦12,432,000.

iii. On 5 September, 2013 the Federal Inland Revenue Service (FIRS) discovered that Emidans Nigeria Limited had not registered with the Service since incorporation in 2006. The submission of the audited Financial Statements for the year ended 31 December, 2013 necessitated a Notice of Tax Audit by the Federal Inland Revenue Service.

You have just received an e-mail from the Senior Tax Manager in which the above details were included and you have been asked to prepare a Memo addressing the following issues:

a. Requirements for the registration of the Company for Tax purposes. (8 Marks)

b. Tax implication of Companies operating in the Communications sector of the economy. (5 Marks)

c. **FIVE** transactions for which Tax Identification Number (TIN) is required. (5 Marks)

d. **THREE** tax offences which the Company has committed and the corresponding Penalties. (3 Marks)

e. The Tax Liabilities of the Company for the relevant Year of Assessment. (9 Marks)

(Total 30 Marks)

SECTION B: ATTEMPT ANY TWO QUESTIONS IN THIS SECTION (40 Marks)

QUESTION 2

Endurance Petroleum Nigeria Limited has been in the Oil business for several years.

There was however, a dispute between the Companyôs Management and its External Auditors/ Tax Consultants on fees-related issues.

You have just received a letter from the Company Secretary of Endurance Petroleum Nigeria Limited, stating the Boardôs resolution appointing you as the Tax Consultant to the Company.

The following details were extracted from the Financial Records of the Company for the Accounting Year Ended 31 December, 2012.

	₦ô000
Custom Duties on essentials	3,125
Capital allowances	30,000
Fines for contravening traffic rules	350
Unabsorbed concession rental (Non-Productive rent)	1,500
Royalties on sales in Nigeria for local refining purposes	300
OPL and OML Rents and Royalties on export	13,500
Surveys preparatory to drilling	2,500
Loan interest (Parent Company)	2,750
Depreciation	12,000
Intangible drilling expenditure	10,000
Production and administrative expenses	15,000
Miscellaneous Income	200
Sales of Crude Oil and Gas within Nigeria	5,000
Chargeable Oil exported	107,500

You are required to:

a. Identify issues likely to result from your appointment as the Tax Consultant of Endurance Petroleum Nigeria Limited. (4 Marks)

b. Advise the Company on the Total Tax Liabilities for the relevant Year of Assessment. (16 Marks)

*Marks will be awarded for workings. **(Total 20 Marks)**

QUESTION 3

a. Tax Planning involves the taking of conscious steps to consider the tax that will be payable by a Taxpayer at a future date and how such tax can be minimised. In the light of the above, highlight and discuss the features of the following:

   i. Tax Havens. (5 Marks)

   ii. Thin Capitalisation. (5 Marks)

b. Ezenwatta Concepts Limited has been in the tourism business for many years. As a result of business expansion, the Company decided to diversify into Limestone extraction and acquired a property in Calabar.

   The Finance Director, on behalf of the Board of Directors has just concluded arrangements for a Loan facility from one of the Deposit Money Banks, to boost the Export business of the Company. As a Tax practitioner, you are required to evaluate the Tax Incentives of:

   i. Export Free Zone (EFZ)Enterprises (2 Marks)
   ii. Solid Minerals Mining (2 Marks)
   iii. Hoteliers and Tourism Service (2 Marks)
   iv. Research and Development (2 Marks)
   v. Interest earned from loans to Export-Oriented Companies (2 Marks)

(Total 20 Marks)

QUESTION 4

In order to give Investment incentives to certain Industries in Nigeria, the Industrial Development (Income Tax Relief) Act Cap 17 LFN 2004 was enacted. This was aimed at providing Tax reliefs for certain Industries that may be issued with Pioneer Certificates by the Minister and other ancillary matters.

In a bid to avail itself of such opportunity, Armani Nigeria Limited a Beauty Care outfit, started to produce Cosmetics, Perfumes and Spirit Lotions on 1 July, 2009. The commencement date was certified as Production Day for the Pioneer Certificate granted to the Company. The Adjusted Profits/Loss of the Company and the Qualifying Capital Expenditure with dates of acquisition, are as shown below:

		₦
(i)	Adjusted Profits/(Loss)	
	1 July, 2009 to 30 June, 2010	5,250,000
	1 July, 2010 to 30 June, 2011	(3,600,000)
	1 July, 2011 to 30 June, 2012	1,875,000
	1 July, 2012 to 30 June, 2013	3,615,000

(ii) Qualifying Capital Expenditure:

Assets	**Date of Acquisition**	**Amount/Cost**
		₦
Industrial Building	December 2009	6,750,000
Motor-Vehicles (3 buses)	December 2009	5,400,000
Non-Industrial Building	April 2011	8,400,000
Furniture & Fittings	December 2013	6,150,000

The Pioneer Status of the Company was not extended after the end of the first three years of operation.

As a Tax Consultant, you are requested to advise the Management of Armani Nigeria Limited on:

a. The Tax Liabilities for the relevant Years of Assessment. (16 Marks)

b. The Tax Relief period and restriction on trading prior to the period. (4 Marks)

(Total 20 Marks)

SECTION C: ATTEMPT ANY TWO QUESTIONS IN THIS SECTION (30 Marks)

QUESTION 5

Victor Peter & Co. Limited is an old established manufacturer of Kitchen Utensils. As a result of political crisis in its area of operation, the Management of the Company in May 2012, decided to relocate the organisation to another town, which it considered to be safer.

The Accounting Year-end of the Company is 31 December.

The following details were obtained from the Books of the Company:

i. 1 January, 2012: Cost of acquisition

	₦
Freehold Land & Buildings	12,100,000
Plant and Machinery	24,400,000
Motor Vehicles	14,000,000
Generator	3,000,000

ii. 31 May, 2012: Disposal of assets.

	₦
Freehold Land & Buildings	14,600,000
Plant and Machinery	23,500,000
Generator	4,000,000

iii. 3 July, 2012: Cost of acquisition of new assets:

	₦
Freehold Land & Buildings	15,600,000
Generator	1,800,000

As the newly appointed Tax Consultant to the Company, you are required to draft a Report to the Managing Director of the Company, showing explicitly, for the relevant tax year:

a. The relief, if any, available for the replacement of the Assets. (10 Marks)

b. Capital Gains Tax Payable. (5 Marks)

(Total 15 Marks)

QUESTION 6

a. The Nigerian Government, worried by the rising incidence of Transfer Pricing abuses by Multinational and Group Companies, issued, through the Federal Inland Revenue Service (FIRS), Income Tax (Transfer Pricing Regulations) 2012.

You are required to explain **FOUR** objectives of the guidelines.

(8 Marks)

b. On 22 August, 2014, your client HYDRO CARBONS OIL & GAS LIMITED, a subsidiary of a Multinational Company with head office in Germany, received a letter from the Transfer Pricing office of the Federal Inland Revenue Service (FIRS) requesting the Company to forward amongst other requirements, the following:

i. The Companyôs Transfer Pricing Policy; and
ii. Transfer Pricing Disclosure and Declaration Forms.

The Managing Director on reading the contents of the letter became worried as he could not understand the essence of such requests.

As the Tax Consultant to the Company, you are required to:

i. Explain what Transfer Pricing Policy is. (2 Marks)
ii. Outline **TEN** items to be included in the Transfer Pricing Disclosure and Declaration forms. (5 Marks)

(Total 15 Marks)

QUESTION 7

Toyosi Logistics Limited has Tax Liabilities of ₦10,550,210.38 comprising:

	₦
Companies Income Tax	2,541,395.73
Value Added Tax	7,324,283.50
Tertiary Education Tax	684,531.15

Since 31 December, 2010, the Federal Inland Revenue Service had sent Demand Notices four times without any positive response from the Company. In November 2012, a parastatal in the Federal Ministry of Works advertised through the Federal Tenders Board for a reputable Logistics Company to bid for the transportation of unused and unserviceable materials from all the liaison offices in the Country to Lokoja. Among the criteria for the bidding process was the submission of 3 years Tax Clearance Certificate and evidence of payments of Value Added Tax.

The Financial Controller wrote a memo to the Managing Director on the constraints the Company would encounter concerning the bidding process if the outstanding Tax liabilities were not paid.

Considering the revenue accruable to the Company if the contract is successful, the Managing Director immediately approved the payment of the outstanding Tax Liabilities of ₦10,550,210.38, which was effected via on-line payment.

As the existing Tax Consultant to Toyosi Logistics Limited, you applied for the Tax Clearance Certificate. At the end of 14 days, the application was queried on the grounds that the Company failed to honour the demand notices, hence there was no justification for the issuance of Tax

Clearance Certificate despite the fact that the Company had remitted the assessed amount on-line.

The Tax Controller referred the tax case to the Intelligence Unit of the Service, for further action.

The Company is worried about the proposed tax investigation and registered its interest to be proactive with a view to ensuring that all the necessary documents are kept handy.

You are required to:

Advise the company on the time-honoured procedures the Tax Officials will follow in carrying out their investigation. (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
Plant and Machinery	- Agricultural 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 exemptions have 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 RATE** (2% of Assessable Profit)

6. **CAPITAL GAINS TAX RATE** 10%

7. **VALUE ADDED TAX RATE** 5%

SOLUTION 1

CASE STUDY

MEMO

DATE: 22 May, 2015

FROM: Tax Manager

TO: Senior Tax Manager

SUBJECT MATTER: EMIDANS NIGERIA LIMITED-TAX MATTERS

(a) **Requirements for Registration with FIRS for Tax Purposes.**

Every company incorporated in Nigeria, whether liable to tax or not, is required to be registered with the FIRS to obtain a Tax Identification Number (TIN).

The following documents shall be required for the purpose of registration with the FIRS:

(i) Name of the Company.
(ii) Registered office of the Company.
(iii) Type of business the Company will engage in.
(iv) A copy of the Certified True Copy of the Memorandum and Articles of Association of the Company.
(v) Names and addresses of the Directors of the Company.
(vi) Names and addresses of the Bankers and Auditors of the Company.
(vii) The copy of the Certified True Copy of the Certificate of Incorporation of the Company.
(viii) Letter introducing the Tax Consultants
(ix) The date on which the Company commenced or will commence business.
(x) The date in each year to which Accounts will be made-up.
(xi) Particulars of the Shareholders stating names, addresses and amount of shareholding.

(xii) The names and addresses of the Principal Officers (i.e. Directors) of the Company.

(xiii) All other Directorships held by each Director, stating the registered address of each Company disclosed.

(b) **Tax implication for Companies operating in the Communications sector of the economy.**

(i) All Companies in the Communications Sector of the economy, like any Company in Nigeria, are required to file Returns with FIRS as prescribed and are liable to pay Income Tax at 30% of Taxable Profits, Tertiary Education Tax at 2% of Assessable Profits for the year and Information Technology Levy at 1% of Profit Before Tax.

(ii) For a Communications Company to be liable to Information Technology Levy, the Turnover for the year shall not be less than ₦100m (One hundred Million naira).

(iii) Companies in the Communications Sector are no longer eligible for Pioneer status.

(iv) All Communication Companies, like any other Company in Nigeria are required to charge VAT on their invoices and remit the VAT to the FIRS within 21 days of the end of each month.

(v) Communication Companies, as service providers are not allowed to recover Input VAT paid on their assets and operational expenses. However, in practice they are able to recover Input VAT on their inter-connect costs paid to other Networks.

(vi) VAT on their International calls is exempted as an Exported service. However, reverse VAT are to be charged and payable on International calls received in Nigeria on their Networks/Platforms as they are treated as Imported Services.

(vii) Internet providers being Communication Companies are also liable to pay Information Technology Levy where applicable.

(c) **Transactions for which Tax Identification Number (TIN) is required**

(i) Opening of Corporate Bank Accounts Bank Transfers and issuing of cheques.

(ii) All transactions with other Companies on Invoices, Statements and Returns.

(iii) All correspondences with Ministries and other Government Agencies.

(iv) All correspondences with the FIRS on all Returns and Audited Accounts.

(v) Importation of goods for the purpose of payment of Customs and other Duties.

(vi) Obtaining receipts for Tax payments.

(vii) Applications for Tax Clearance Certificates, Tax Refunds, Credit Notes etc.

(viii) Pre-qualification and bidding for Government Contracts.

(d) **Offences committed by the Company and corresponding penalties**

(i) Late or non-filing of Tax Returns ₦25,000 for the first month in which the default occurs and ₦5,000 for subsequent months in which the default subsists.

(ii) The officers may be liable to a fine of ₦ 20,000 or imprisonment for six months or both, upon conviction for the offence of late or non-filing of Returns after 18 months of commencement of business.

(iii) False Statements and Returns-upon conviction, a fine of ₦1,000 or imprisonment for five years or both-for the officers.

(iv) Failure to register for VAT - a fine of ₦10,000 for the first month of failure and ₦5,000 for each subsequent month in which failure continues.

(v) Failure to pay tax due - Penalty of 10% of the tax due per annum plus interest at the Bank lending rate.

(e) **Tax liabilities of the company for the relevant year of assessment**

EMIDANS NIGERIA LIMITED
COMPUTATION OF TAX LIABILITIES
FOR 2014 YEAR OF ASSESSMENT

	₦'OOO	**₦'000**
Net Profit per Accounts		21,531.00
Add back:		
Provision for bad debt	9,386.00	
Loss on sale of Non-Current Assets	3,771.00	
Depreciation	9,137.00	22,294.00
		43,825.00
Deduct:		
Managing Directorôs Personal Income		
(60% of ₦9,530,000)		5,718.00
Assessable Profit		38,107.00
Less: Capital Allowance		12,432.00
Total Profit		25,675.00
Income tax @ 30%		7,702.50
Education tax @ 2% of Ass. Profit		762.14
Information Technology levy (1% of PBT)i.e. (1% of ₦21,531,000)		215.31
Total tax liabilities		8,679.95

EXAMINER'S REPORT

The question tests candidates' knowledge and understanding of the requirements for Companies registration for Tax purposes, the Tax implications for Companies operating in the Communications Sector of the economy, transactions requiring Tax Identification Number (TIN), Tax Offences and related penalties, as well as the computation of Company Tax Liabilities of a Company.

Performance was just average as only about 30% of the candidates scored up to 50% of the marks allocated. Whilst majority of the Candidates did well in the computational aspects of the question, performance was poor in the theoretical aspects (a, b, c and d).

Candidates are advised to be more thorough in their preparations for future examinations.

SOLUTION 2

(a) The issues that are likely to result from my appointment as a Tax Consultant are:

(i) To inform the Company of the professional and ethical requirements of our appointment as the new Tax Consultant as well as to notify the previous Tax Consultant of our appointment as the new Tax Consultant.

(ii) Letter will have to be written to the previous Tax Consultant confirming our appointment and requesting for reasons (if any) why they think we should not accept our appointment.

(iii) A second letter may be written if no reply is received.

(iv) Whether or not a response is received from the previous Consultant, a decision to accept or reject the appointment will be taken.

(v) On acceptance, an Engagement letter will be prepared and signed by both parties.

(vi) A letter introducing us to the relevant Tax Authorities ï FIRS and relevant States Boards of Internal Revenue, will be obtained from the client for presentation to the relevant Tax Authorities.

(b) **Workings**

ENDURANCE PETROLEUM NIGERIA LIMITED
COMPUTATION OF ASSESSABLE PROFIT, CHARGEABLE PROFIT AND CHARGEABLE TAX FOR YEAR ENDED 31 DECEMBER, 2012

	₦'000	₦'000
Chargeable oil exported	107,500	
Sale of crude oil & gas within Nigeria	5,000	
Fiscal value of oil sold		112,500
Other income ï miscellaneous		200
Total income		112,700
Less: Allowable expenditure		
Custom Duties on essentials	3,125	
Non-productive rent	1,500	
Royalties on local sale	300	
OPL & OML rents & royalties on Export	13,500	
Surveys preparatory to drilling	2,500	
Intangible drilling expenditure	10,000	
Production & Admin expenditure	15,000	
		(45,925)
		66,775
Less: Tertiary Education Tax 2/102 x ₦66,775,000		1,309
Assessable profit		65,466
Less: Capital Allowance (Lower of ₦30,000,000 or 85% of ₦65,466,000 = i.e. ₦55,646,000)		30,000
Chargeable profit		35,466
Chargeable tax @ 85%		30,146
Tertiary Education tax		1,309
Total tax liabilities		31,455

M. O. OJUOLA & CO
(CHARTERED ACCOUNTANTS)
5, OLAWALE STREET, YABA, LAGOS STATE

Ref: 19 May, 2015

The Managing Director,
Endurance Petroleum Nigeria Limited,
45, Tony Avenue,
Ojodu Berger,
Lagos.

Dear Sir,

<u>TOTAL TAX LIABILITIES FOR 2012 TAX YEAR</u>

Further to your letter appointing us as your Tax Consultant and your request on the above subject matter, please find herewith the following Computations on:

i. Assessable Profit for the year
ii. Chargeable Profit for the year
iii. The Chargeable Tax.

From the computations, you will observe that the Assessable Profit is ₦65,466,000, the Chargeable Profit is ₦35,466,000 while the Total Tax liability is ₦31,455,000, comprising Chargeable Tax of ₦30,146,000 and Tertiary Education Tax of ₦1,309,000.

The computations are in line with the self assessment and payment earlier concluded at the beginning of the year.

We shall be glad to provide further clarifications as may be required by you.

Please find enclosed our bill for the service.

Thank you.

Yours faithfully,

Ayoola Jones (FRCN/.......)
For: M. O. OJUOLA & CO.
(Chartered Accountants)

EXAMINER'S REPORT

The question tests candidates' knowledge and understanding of the issues that are likely to confront a Professional Tax Consultant, in terms of Ethics and Competence.

A good number of the candidates attempted the question and performance was average.

Whilst a good attempt was made in the computational aspects of the question, performance in the report-writing was poor.

Candidates are advised to equip themselves better with a good understanding of the ethical requirements for practitioners in the profession.

SOLUTION 3

(a)

(i) A Tax Haven is a Country or Territory where no taxes or very low rates of taxes are imposed on certain categories of Income.

Features of a Tax Haven

- Low or zero effective tax rates on certain categories of Income
- Lack of transparency in legislative, legal or administrative tax provisions
- Lack of effective exchange of information with foreign tax jurisdiction
- Lack of adherence to international Transfer Pricing principles
- Tax base is artificially defined
- Tax rates can be negotiated
- Existence of bank-secrecy provisions

(ii) Thin Capitalisation is where a Company is heavily financed by Debt as against Equity Capital.

Where a Company has higher proportion of Debt to Equity Capital, the Profits of the Company will be eroded by the interest expense. Where the Debt is provided by a foreign Parent Company, then more of the Profits is repatriated out of the Country.

(b)

(i) **Export Free Zone (EFZ) Enterprises**

A Company which has incurred an expenditure on its qualifying Property, Plant and Equipment in an approved manufacturing activity in an Export Processing Zone (EPZ), shall be granted 100% Capital Allowance in any Year of Assessment.

The Profit shall be exempted from Tax for the first three years- provided the following conditions are met:

- 100% export oriented
- Undertaking not formed by splitting an existing business

- Manufactures and exports products accounting for not less than 73% of its Total Turnover

(ii) **Mining of Solid Minerals**

A new Company engaged in the mining of Solid Minerals is exempted from Tax for the first three years of its operations under CITA.

Initial Allowance of 95% is granted on qualifying mining expenditure, with retention of 5% in the books until disposal.

A Company which is engaged in mining of solid minerals and earns annual turnover of less than ₦1m is assessable to Income Tax at a lower rate of 20%.

(iii) **Hotel and Tourism Services**

25% of incomes in convertible currencies derived from tourists by a hotel shall be tax exempt, provided that such income is put in a reserve fund to be utilised within five years for the expansion of existing hotels and building of new Hotels, conference centers and new facilities for the purpose of Tourism development.

(iv) **Research and Development**

Companies and other organisations engaged in Research and Development activities for commercialisation are allowed 20% Investment Tax Credit on their qualifying expenditure for such purposes, in addition to Initial Allowance of 95% on qualifying research and development expenditure.

(v) **Interest earned from Loans to Export-Oriented Companies**

Interest earned by a Bank on a Loan granted to a Company engaged in manufacturing goods for Export shall be exempt from tax, if at least 50% of the manufactured goods sold were sold outside Nigeria and were not re-imported to Nigeria.

For exemption to be granted, the Bank must produce the Certificate of Export issued to the beneficiary Company by the Nigerian Export Promotion Council.

EXAMINER'S REPORT

The question tests candidates' knowledge and understanding of the concept of Tax Planning and the avenues for Corporate organizations to benefit from available Tax Incentives. Only a few of the candidates attempted the question and performance was poor.

The commonest pitfalls noticed include poor understanding of the concepts of Tax Havens and Thin Capitalisation, as well as selected sources of incomes that are subject to Tax Incentives.

Candidates are advised to note these pitfalls and study these new topics more deeply.

SOLUTION 4

Odiokoriko & co
(Chartered Accountants)
5, Soji Street, Yaba,
Lagos State.

Ref:............ 19 May, 2015

The Managing Director,
Armani Nigeria Limited,
15, Love Avenue,
Surulere,
Lagos State.

Dear Sir,

LETTER OF ADVICE

Further to your request in relation to the Tax Liabilities of your Company for the 2012 to 2014 Tax Years and brief in respect of some specific tax provisions of the Industrial Development Income Tax Relief Act, Please find our comments as stated below:

a) **Tax Liabilities**: Your company is liable to Tertiary Education Tax of ₦36,150 for 2012, ₦72,300 for 2013 and a Total Tax Liability of ₦191,808 for 2014 Tax Year.

b) **The relief period and restriction on trading prior to the period**: Like you have been granted, it is statutorily provided that three (3) years tax relief period is granted in the first instance. Additional two (2) years may be granted provided you have enough justifiable reasons acceptable to the relevant authority, making a total of 5 years.

Please find attached herewith, our computations that form the basis of our advice.

We will be glad to oblige you with any further information you may require.

Thank you.

Yours faithfully,

Abojosupo JP, FRCN...........
Partner
For: ODIOKORIKO & CO

(a)

Capital allowance Computations (New Business)

Rates		$^{15}/_{10}$	$^{50}/_{75}$	$^{15}/_{10}$	
Year of		**Ind. Building**	**MV**	**Non- Ind.**	**Total Capital**

Assessment				Building	Allowance
		₦	₦	₦	₦
2012	Cost	6,750,000	5,400,000	8,400,000	
	Initial allowance	(1,012,500)	(2,700,000)	(1,260,000)	4,972,500
	Annual all six months	(286,875)	(337,500)	(357,000)	981,375
2013	TWDV	5,450,625	2,362,500	6,783,000	
	Annual Allowance	(605,625)	(787,500)	(753,667)	2,146,792
2014	TWDV	4,845,000	1,575,000	6,029,333	
	Annual Allowance	(605,625)	(787,500)	(753,667)	2,146,792
	TWDV	4,239,375	787,500	5,275,666	

COMPUTATION OF TAX LIABILITY

2012 YEAR OF ASSESSMENT	**Basis Period - Actual 1/7/2012- 31/12/2012 (six months)**	
	₦	₦
Assessable profit	₦3,615,000	
	2	1,807,500
Less		
Capital allowance	5,933,875	
Absorbed	(1,807,500)	(1,807,500)
Capital allowance c/f	4,146,375	NIL
Total profit	-	NIL
Income tax @ 30%	-	NIL
Tertiary Education Tax @ 2% of Assessable Profit	-	36,150

2013 Year of Assessment		
	1st Twelve months 1/7/2012 ï 30/6/2013	
	₦	₦
Assessable profit		3,615,000
Less: Capital Allowance b/f	4,146,375	
For the year	2,146,792	
	6,293,167	
Absorbed	(3,615,000)	3,615,000
Capital Allowance c/f	2,678,167	
Total profit		NIL
Income tax @ 30%		NIL
Tertiary Education tax @ 2% of Assessable Profit		72,300

	₦	₦
2014 Year of assessment		

Preceeding year 1/7/2012 ï 30/6/2013		
Assessable Profit		3,615,000
Less: Capital Allowance b/f	2,678,167	
For the year	2,146,792	
	4,824,959	
Absorbed ($^2/_3$ of Capital allowance)	(3,216,639)	(3,216,639)
Capital Allowance c/f	1,608,320	
Total Profit		398,361
Income Tax @ 30%		119,508
Tertiary Education Tax @ 2% of Ass. Profit		72,300
		191,808

(b)

Prior to the tax relief period, there is no restriction on trading by the Company. The Company can engage in any trade or business. Profit of such trade or business shall be liable to Tax.

Prior to the expiration of the Tax Relief Period, that is, during the Pioneer period, the Pioneer Company shall not be engaged in any other trade or business outside the Pioneer trade or business. If any Profit is made from Non-Pioneer activity during the Pioneer Period, such profit shall be liable to Company Income Tax.

EXAMINER'S REPORT

The question tests candidates' ability to communicate as professionals and in an advisory capacity with clients, regarding Investment Incentives available to Companies granted the Pioneer Status.

Attempt at the question was average and performance was poor.

Whilst some of the candidates that attempted the question could not correctly compute the Assessable Profit, others failed to correctly compute the Capital Allowances claimable.

Candidates are advised to prepare better for future examinations and constantly update themselves with amendments to the Tax Laws.

SOLUTION 5

AJEYE & CO
TAX CONSULTANTS
2, Lucky Avenue,
Iyana Ipaja, Lagos

Ref:......................... 29 September, 2014

The Managing Director,
Victor Peter & Co Limited,
Lagos.

Dear Sir,

<u>REPORT ON CAPITAL GAINS TAX PAYABLE AND ROLL-OVER RELIEF AVAILABLE FOR 2012 YEAR OF ASSESSMENT</u>

Our oral discussion and subsequent professional engagement with you on the above subject matter now refers.

Based on our computations as detailed in Appendices I and II, (attached herewith), the Company is entitled to full Roll-Over Relief of ₦2,500,000 on the disposal and subsequent acquisition of Freehold Land and Buildings. There is no Roll-Over Relief on the Generator acquired, because the amount re-invested was less than the proceeds derived from the disposal of the assets.

In view of the above, the Company is liable to pay Capital Gains Tax of ₦100,000 for the 2012 Year of Assessment.

Should you still need further clarifications, please feel free to contact us.

Yours faithfully,

OMOBA AJEYE, FRCN..........
For: Ajeye & Co
Tax Consultants

Appendix I

Computation of the Roll-Over relief available for the replaced Assets:

	Freehold Land	Plant &	Generators

	& Buildings	Machinery	
	₦	₦	₦
Sales proceeds	14,600,000	24,400,000	4,000,000
Less: Cost of acquisition	12,100,000	23,500,000	3,000,000
Capital Gains	2,500,000	900,000	1,000,000
Capital Gains Tax		NIL	
Capital Gains	2,500,000		1,000,000
Deduct the lower of:			
(i) Sales proceeds	14,600,000		4,000,000
and(ii) Cost of new Assets	15,600,000		1,800,000
Less:			
Cost of acquisition	(12,100,000)		(3,000,000)
(a) Amount Rolled-Over	2,500,000		NIL

Appendix II

Computation of Capital Gains Tax payable for 2012 Year of Assessment

	Freehold Land & Buildings	Plant & Machinery	Generators
	₦	₦	₦
Capital Gains b/f	2,500,000	900,000	1,000,000
Amount Rolled-Over	2,500,000	-	NIL
Net capital gains	NIL	NIL	1,000,000
Capital Gains Tax @ 10%	NIL	NIL	100,000

(b) The total Capital Gains Tax payable by the Company for 2012 Year of Assessment is ₦100,000

EXAMINER'S REPORT

The question tests candidates knowledge and understanding of Capital Gains Tax computation and incidences of reliefs from the tax. A good number of the candidates attempted the question but performance was below average.

Many of the candidates could not present an appropriate Draft Report as required by the question, whilst a good number of them got the computation of Capital Gains Tax payable wrong.

Candidates are advised to prepare adequately for future examinations by devoting more time for working through recent past editions of the Institute's Pathfinder and other relevant study materials.

SOLUTION 6

(a) The Income Tax (Transfer Pricing Regulations) 2012 issued by the Federal Inland Revenue Service and gazetted in September 2012 as Income Tax Transfer Pricing Regulations Act of 2012 stated the objectives as:

(i) To ensure that Nigeria is able to tax on an appropriate taxable basis corresponding to the economic activities deployed by taxable persons in Nigeria, included in their transactions and dealings with associated enterprises.

(ii) To provide the Nigerian authorities the tools to fight tax evasion through over or under-pricing of controlled transactions between associated enterprises.

(iii) To reduce the risk of economic double taxation.

(iv) To provide a level playing field between multinational enterprises and independent enterprises doing business within Nigeria; and

(v) To provide taxable persons with certainty of transfer prising treatment in Nigeria.

(b) **CHIDIEBERE OIL & GAS LIMITED**

(i) **Transfer Pricing Policy**
This is a document required to be filed with the Transfer Pricing Unit of the FIRS. It contains information that guides the conduct of related partiesô transactions within a group of Companies.

There are two types of Transfer Pricing Policies namely:

(i) Group Transfer Pricing Policy

(ii) Local Transfer Pricing Policy

(ii) TRANSFER PRICING DISCLOSURE AND DECLARATION FORMS CONTENTS FOR SUBMISSION TO THE FIRS

The FIRS also requires affected Companies, in addition to developing appropriate Transfer Pricing Policies, to provide relevant information in specified manner in Transfer Pricing Disclosure and Declaration Forms which must contain the following:

- Particulars of Reporting Company or Entity.
- Particulars of immediate Parent Companies.
- Particulars of Directors of Reporting Companies.
- Particulars of five major Shareholders of Reporting Companies and Related Parties.
- Ownership Structure of Reporting Entity and Related Parties.
- Particulars of Subsidiary and other connected persons.
- Particulars of External Auditors of reporting entity.
- Particulars of Tax Consultant of the reporting entity.
- Particulars of Company Secretary of the reporting entity.
- Particulars of the person making the declaration.

EXAMINER'S REPORT

This question tests candidates' knowledge and understanding of the concept and impact of the Transfer Pricing Regulations in the Nigerian economy, in the attempt to mitigate the abuse of the Transfer Pricing practice.

Many candidates attempted the question but performance was poor.

The major pitfall was Candidates' mis-interpretation of the question as an Accounting issue.

Candidates are advised to be more discerning and painstaking in the process of ascertaining the requirements of a question, before attempting same.

SOLUTION 7

CAB TAX CONSULTANTS
10, Lambe Street,
Lagos.

Ref:.................... 12 May, 2015

The Managing Director,
Toyosi Logistics Limited,
Lagos.

Dear Sir,

RE: TAX INVESTIGATION PROCEDURE

We refer to the above subject-matter and your request for advice on the time ïhonoured procedure the tax official will follow in carrying out tax investigation and will like to comment as follows:

(a) Tax Investigation is, unlike normal Tax Audit, the procedure usually instituted by the Tax Authority to ascertain the level of compliance of a Company or individual with provisions of the tax laws. It is aimed at ascertaining the under-payment of tax in previous years.

(b) Tax Investigation is usually for prior years or back years which can cover as far as six years. However, where fraud, wilful default or evasions are involved, there is no time limit for conducting such back-duty investigation.

(c) The main triggers of Tax Investigation include the following:
   i. The obvious mistakes in Tax Returns
   ii. Filing Tax Returns late
   iii. Paying Tax late
   iv. Sending two Tax Returns at the same time
   v. Excessive claim for Tax Refund or Tax Credit

(d) The time-honoured procedure that will be followed by the Tax Officials is as follows:
   (i) The Company will be notified officially of the impending tax investigation exercise by the Tax Investigation Unit of the FIRS.
   (ii) The tax investigation notification letter will include a Questionnaire requesting for detailed information about the Company such as:
      - The group structure
      - The nature of business

- Main customers and contractors of the Company
- Details of the Bankers, Auditors, Tax Consultants and Legal Adviser
- The Tax Returns procedures, type of Accounting Systems/Software deployed

(iii) A preliminary meeting will be scheduled at the tax office to confirm information provided in the questionnaire and to provide hints as to the trigger of the Tax Investigation. The meeting is also expected to agree on the likely date of the Field Tax Investigation visit.

(iv) The tax official will carry out internal enquiry about the Company by reviewing the Returns filed, the web-portal information on payment of tax and credit notes.

(v) The tax official will most likely obtain third party information on the Company from Bankers, Major Vendors, Suppliers and Contractors.

(vi) Where cross-border transaction is involved, exchange of information under Tax Treaties will be exploited to gather additional information.

(vii) The tax investigators will conduct interviews to gather more information on the Company.

(viii) Detailed General Ledgers and other Accounting records and information will be obtained and reviewed.

(ix) At the conclusion of the field investigation, a preliminary report of findings will be prepared and made available to the Company to respond to the issues raised.

(x) Tax investigation reconciliation meeting will be scheduled to address all the issues raised and for the Company representative to defend their responses. At the meeting, additional information may be requested and subsequent meeting may be scheduled.

(xi) After several meetings and representations, the tax investigators will issue their final letter of intent. This contains their final decisions on all the issues and the tax implications and likely tax exposure of the Company.

(xii) Subsequent to the letter of intent, relevant assessments and demand notices are issued on the Company for payment to be made.

(xiii) On receipt of the assessment and demand notices, if the Company is aggrieved, the Company can object in writing, stating the grounds of objection.

In view of the above, the Company is advised to prepare adequately for the Tax Investigation exercise.

If you require further clarifications, do not hesitate to revert to the undersigned.

Thank you.

Yours faithfully,

A. O. OLANIYI
Senior Consultant

EXAMINER'S REPORT

The question tests candidates' knowledge and understanding of the detailed procedures and requirements of Tax Officials in the performance of their Tax Investigation assignments, especially where Tax Returns have not been filed for purposes of obtaining Tax Clearance Certificates.
About half of the candidates attempted the question and performance was below average.
The commonest pitfall of the candidates was their inability to profer their solutions in an appropriate Report format.
Candidates should understand that Tax Consultancy involves the computation of relevant data and communicating the results obtained.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION - MAY 2015

STRATEGIC FINANCIAL MANAGEMENT

Time Allowed: 3 hours

ATTEMPT FIVE QUESTIONS IN ALL

SECTION A: COMPULSORY QUESTION (30 Marks)

QUESTION 1

AB Limited is a private company owned by two families who started the business in 2009. The company produces organic food for distribution in the domestic market using food products from a number of firms across the country. The company is experiencing a period of rapid growth with revenue expected to rise by 15% in each of the succeeding five years after take off.

The company is hoping to retain a profit margin (profit before interest and taxes divided by revenue) of 30% throughout the next five years. The ratio of working capital to revenue is expected to remain constant (where working capital is inventories plus trade receivables less trade payables).

Interests paid on the overdraft and bank loan are at 6% per annum and calculated on the balance outstanding at the beginning of the year. Corporate income tax is paid one year in arrears at a rate of 30%. For simplicity, assume a 100% tax allowance for capital expenditure in the year in which it is incurred. In arriving at operating profit, depreciation is charged at 25 % on a reducing balance basis based on year-end balances.

Extracts from the management accounts of AB Limited on 30 June 2014 are as follows:

STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE, 2014

	₦'m
Non-current assets	300
Working Capital	180
	480
Share Capital (50 kobo ordinary shares)	200
Retained earnings	80
Non-current liability (bank loan)	160
Bank overdraft	20
Current tax payable	20
	480

INCOME STATEMENT FOR THE YEAR ENDED 30 JUNE 2014

	₦'m
Revenue	900
Profit before interest and taxes	270

Dividend paid in 2014 (Total)	200

Capital expenditure plans are ₦200m in 2015, ₦200m in 2016 and ₦140m in each of the years 2017 to 2019. No disposals of non-current assets are expected in this period.

Shareholders expect an annual increase in dividend of 5%. Any fund deficit in the year will be financed by overdraft and any surplus fund will be used to reduce the overdraft. However, with the increasing demand on the funds of the business to finance growth, the directors are concerned that the company may exceed the overdraft limit of ₦30m. They may, therefore, need to negotiate an increase in the bank loan, although the bank has indicated that it would not accept a gearing higher than 70% based on the book values where gearing is defined as non-current and current borrowings (including overdraft) divided by equity. The shareholders have indicated that they do not wish to inject additional capital into the business.

You are required to:

a. Prepare the Statement of Financial Position, Income Statement and Cash Flow Analysis of the company for each of the years 2015 and 2016 and advise the company on the extent of additional funding requirement in that period.

<u>Notes</u>

(i) All figures in your calculations should be rounded up to the nearest ₦1m.

(ii) Compliance with accounting standards is not necessary since these are management reports. (20 Marks)

b. Recommend and comment on actions the company can take to close the funding gap identified in (a) above (10 Marks)

(Total 30 Marks)

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

QUESTION 2

The Directors of Actuarial Plc., a conglomerate, is targeting Minororia Plc., an engineering machinery manufacturer, for possible acquisition of its entire share capital. They believe that the takeover will not affect their business risks. The statement of financial position of Minororia Plc. as at 31st December, 2014 is expected to be as follows:

Minororia Plc.

Projected Statement of Financial Position as at 31st December, 2014.

	₦'000	**₦'000**
Non-current asset (net of depreciation)		651,600
Current assets: Inventory and W.I.P.	515,900	
Receivables	745,000	
Bank balance	158,100	1,419,000
		2,070,600
Current liabilities:		
Payables	753,600	
Bank overdraft	862,900	1,616,500
		454,100
Representing:		
Capital and Reserves:		
Issued ordinary shares of ₦1 each		50,000
Distributable Reserves		404,100
		454,100

The summarised financial records of Minororia Plc. for five years to 31st December 2014 is as follows:

Minororia Plc.

Five years financial summary

Year ended 31st December	2010	2011	2012	2013	2014 (Estimated)
	₦'000	₦'000	₦'000	₦'000	₦'000
Profit before extraordinary items	30,400	69,000	49,400	48,200	53,200
Extraordinary items	2,900	(2,200)	(6,100)	(9,800)	(1,000)
Profit after extraordinary items	33,300	66,800	43,300	38,400	52,200
Dividend	(20,500)	(22,600)	(25,000)	(25,000)	(25,000)
	12,800	44,200	18,300	13,400	27,200

Additional information:

(i) There have been no changes in the issued share capital of Minororia Plc. during the past five years.

(ii) The estimated values of Minororia Plcôs. non-current assets, inventory and work-in-progress for the year ended 31st December 2014 will be as follows:

	Replacement Value	Realisable Value
	₦'000	₦'000
Non-current assets	725,000	450,000
Inventory and W.I.P	550,000	570,000

(iii) It is expected that 2% of Minororia Plcôs. receivables at 31 December, 2014 will become uncollectable.

(iv) The Cost of Capital of Actuarial Plc. is 9%. However, the shareholders of the company expect a minimum return of 12% per annum on their investment in the company.

(v) The current P/E ratio of Actuarial Plc. is 12.

Companies within the industry having similar profit levels with those of Minororia Plc. have P/E ratio of approximately 10, although these companies tend to be larger than Minororia plc.

You are required to:

a. Calculate the value of the total equity of Minororia Plc. using each of the following methods:

i.	Statement of Financial Position (net asset basis)	(1 Mark)
ii.	Replacement Costs	(4 Marks)
iii.	Realisable Value	(5 Marks)
iv.	Gordonôs Dividend Growth Model and	(4 Marks)
v.	P/E Ratio Model	(1 Mark)

b. State **ONE** limitation of each method in (a) above. (5 Marks)

(Total 20 Marks)

QUESTION 3

KING Plc. and QUEEN Plc. both manufacture and sell household equipment. The summarised Income Statements of the two companies for the year 2012 are as follows:

	KING Plc.	**QUEEN Plc.**
	₦'000	**₦'000**
Revenue	37,500	20,000
Operating expenses	(20,000)	(15,500)
	17,500	4,500

Each company has earned a constant level of profit for a number of years and both are expected to continue to do so for the nearest future. The policy of both companies is to distribute all profits as dividend to ordinary shareholders as they are earned. None of the companies has any fixed interest capital.

Details of the ordinary share capital of the companies are as follows:

	KING Plc.	**QUEEN Plc.**
	₦'000	**₦'000**
Share Capital:		
Ordinary shares of ₦1 each		
Authorised	125,000	50,000
Issued	50,000	25,000

The ordinary shares of KING Plc. have a current market value of ₦3.50 each ex-div, and those of QUEEN Plc. a current market value of ₦1.50 each ex-div.

The directors of KING Plc. are considering submitting a bid for the entire share capital of QUEEN Plc. They believe that if the bid succeeds, the combined sales revenue of the two companies will increase by ₦1,500,000 per annum and savings in operating expenses amounting to ₦1,250,000 per annum will be possible. Part of the machinery presently owned by KING Plc. would no longer be required and could be sold for ₦2,500,000.

Furthermore, the directors of KING Plc. believe that the takeover would result in a reduction of the returns required by the Ordinary Shareholders to 10%.

Required:

a. As a financial consultant to KING Plc., advise on the maximum price that the company should be willing to pay for the entire share capital of QUEEN Plc. showing clearly the basis of your advice. (6 Marks)

b. Show how the entire benefit from the takeover will accrue to the present shareholders of KING Plc. assuming that the takeover price is agreed at half of the figure you advised, and that the purchase consideration will be settled by an exchange of ordinary shares in QUEEN Plc. (4 Marks)

c. Discuss briefly any other factors that the directors and shareholders of both companies might consider in assessing the acceptability of the proposed takeover. (5 Marks)

d. List any **FIVE** defence tactics that could be used by QUEEN Plc. to frustrate the takeover bid of KINGS Plc. (5 Marks)

(Total 20 Marks)

QUESTION 4

Oseka Bags Limited is a chain of retail outlets, specialising in high quality leather bags and briefcases. One of the products purchased by Oseka Bags Limited for resale is an executive briefcase. The Company sells a fixed quantity of 100 briefcases per week and 50 weeks per year. The estimated holding cost of a briefcase is ₦100 per annum per briefcase.

Delivery to Oseka Bags Limited by the existing supplier takes two weeks and the purchase price per briefcase delivered to Oseka Bags Limited is ₦1,000. The current supplier charges a fixed ₦900 order processing charge for each order regardless of the order size.

Oseka Bags Limited has recently been approached by an alternative supplier of leather briefcase which are very similar to the existing briefcase range. It is expected that this alternative briefcase can be sold in the same quantity and price as the existing range.

The alternative supplierôs offer is as follows:

(i) The cost of each briefcase is ₦960
(ii) There will be a fixed order processing charge of ₦2,500, regardless of order size.
(iii) Delivery will take one week.
(iv) The annual holding cost for a briefcase remains ₦100 per annum.

Required:

a. Assuming Oseka Bags Limited continues to purchase from the existing supplier, calculate the:
   i. Economic Order Quantity (EOQ)
   ii. Total cost of stocking the briefcase for one year (6 Marks)

b. Assuming Oseka Bags Limited switches to the new supplier of briefcase, calculate the:
   i. Economic Order Quantity;
   ii. Total cost of stocking the alternative briefcase for one year and determine if it is financially viable to change to this new supplier.
(6 Marks)

c. Discuss **TWO** limitations of the above calculations and describe briefly **TWO** non-financial factors to be taken into account before a final decision is made.
(4 Marks)

d. Assuming there is an upfront investment cost for Oseka Bags Limited of ₦400,000, payable immediately and that the annual savings from switching to the new supplier arise at the end of the next three years, calculate the net present value of switching, if the cost of capital for the company is 10% per annum.
(4 Marks)
(Total 20 Marks)

SECTION C: ATTEMPT ANY TWO OUT OF THREE QUESTIONS IN THIS SECTION (30 Marks)

QUESTION 5

a. Globalisation has created more opportunities for money laundering with its associated risks, which government and international bodies are trying to combat through legislations.

Required:

   i. Explain the term money laundering and identify **TWO** major perpetrators.
(3 Marks)

Ii. State **FOUR** steps involved in assessing the risks associated with money laundering. (4 Marks)

iii. State **THREE** necessary steps in curbing the spread of money laundering. (3 Marks)

b. In recent times, there has been rapid expansion in the use of Islamic finance globally. You are required to identify FIVE major advantages of Islamic financing. (5 Marks)

(Total 15 Marks)

QUESTION 6

Your investment firm is a major player in the Nigerian Capital market. Following recent positive signs in the capital market, your firm has just recruited a number of young graduates. An in-house training programme is being planned for the young trainees and you are to facilitate on subject areas such as portfolio concepts, capital asset pricing model, etc.

a. Your Managing Director requires you to explain, without the use of graphs, Capital Market Line (CML) and the Security Market Line (SML). You are also required to highlight the difference between the two. (4 Marks)

b. Consider a client having a portfolio of three stocks. The various expectations and the current market situations are tabulated below (all annualised values). The current risk free interest rate is 6% per annum.

Stocks	Expected Return	Standard Deviation	Beta
Stock A	14%	35%	1.36
Stock B	9.4%	20%	0.52
Stock C	10%	18%	0.69
Market Index	12%	23%	

i. Calculate the required returns from the three stocks if they are correctly priced in accordance with the Capital Asset Pricing Model (CAPM). (5 Marks)

ii. Are there any discrepancies between the return based on the CAPM theory and your own expectations? If yes, advise on how to reshuffle the portfolio within these three stocks in order to profit from them. If no, explain why. (6 Marks)

(Total 15 Marks)

QUESTION 7

Finance Managers of Multinational Firms manage foreign exchange risks. In the light of the above statement, you are required to:

a. Explain what is meant by 'hedging'. (3 Marks)

b. Identify and explain **THREE** Internal Hedging techniques. (6 Marks)

c. On 31 December 2014, Famak Plc realised that it needs a ₦100million fixed rate loan on 1 April 2015, Famak Plc would want to hedge using Forward Rate Agreement (FRA). The relevant FRA rate will be 6% on 31 December, 2014. Determine the result of the FRA and the effective loan rate if the 6 month FRA benchmark moves to: (i) 5%; (ii) 9%. (6 Marks)

(Total 15 Marks)

Formulae

Modigliani and Miller Proposition 2 (with tax)

$$K_{eg} = K_{eu} + (K_{eu} - K_d)\frac{V_d}{V_{eg}}(1 - T)$$

Asset Beta

$$\beta_a = \left[\frac{V_e}{(V_e + V_d(1 - T))}\beta_e\right] + \left[\frac{V_d(1 - T)}{(V_e + V_d(1 - T))}\beta_d\right]$$

Equity Beta

$$\beta_e = \beta_a + (\beta_a - \beta_d)\frac{V_d}{V_e}(1 - T)$$

Growing Annuity

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

Modified Internal Rate of Return

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

The Black-Scholes Option Pricing Model

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

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

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

The Put Call Parity

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

Binomial Option Pricing

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

d = 1/u

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

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

The discount factor per step is given by = [illegible]

Annuity Table

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

Where r = discount rate

n = number of periods

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

Standard normal distribution table

	0·00	0·01	0·02	0·03	0·04	0·05	0·06	0·07	0·08	0·09
0·0	0·0000	0·0040	0·0080	0·0120	0·0160	0·0199	0·0239	0·0279	0·0319	0·0359
0·1	0·0398	0·0438	0·0478	0·0517	0·0557	0·0596	0·0636	0·0675	0·0714	0·0753
0·2	0·0793	0·0832	0·0871	0·0910	0·0948	0·0987	0·1026	0·1064	0·1103	0·1141
0·3	0·1179	0·1217	0·1255	0·1293	0·1331	0·1368	0·1406	0·1443	0·1480	0·1517
0.4	0.1554	0·1591	0·1628	0·1664	0·1700	0·1736	0·1772	0·1808	0·1844	0·1879
0·5	0·1915	0·1950	0·1985	0·2019	0·2054	0·2088	0·2123	0·2157	0·2190	0·2224
0·6	0·2257	0·2291	0·2324	0·2357	0·2389	0·2422	0·2454	0·2486	0·2517	0·2549
0·7	0·2580	0·2611	0·2642	0·2673	0·2704	0·2734	0·2764	0·2794	0·2823	0·2852
0·8	0·2881	0·2910	0·2939	0·2967	0·2995	0·3023	0·3051	0·3078	0·3106	0·3133
0·9	0·3159	0·3186	0·3212	0·3238	0·3264	0·3289	0·3315	0·3340	0·3365	0·3389
1·0	0·3413	0·3438	0·3461	0·3485	0·3508	0·3531	0·3554	0·3577	0·3599	0·3621
1·1	0·3643	0·3665	0·3686	0·3708	0·3729	0·3749	0·3770	0·3790	0·3810	0·3830
1·2	0·3849	0·3869	0·3888	0·3907	0·3925	0·3944	0·3962	0·3980	0·3997	0.4015
1·3	0.4032	0.4049	0.4066	0.4082	0.4099	0.4115	0.4131	0.4147	0.4162	0.4177
1.4	0.4192	0.4207	0.4222	0.4236	0.4251	0.4265	0.4279	0.4292	0.4306	0.4319
1·5	0.4332	0.4345	0.4357	0.4370	0.4382	0.4394	0.4406	0.4418	0.4429	0.4441
1·6	0.4452	0.4463	0.4474	0.4484	0·4495	0.4505	0.4515	0.4525	0.4535	0.4545
1·7	0.4554	0.4564	0.4573	0·4582	0·4591	0.4599	0·4608	0·4616	0.4625	0.4633
1·8	0.4641	0.4649	0.4656	0.4664	0.4671	0.4678	0.4686	0.4693	0.4699	0·4706
1·9	0.4713	0.4719	0.4726	0.4732	0.4738	0.4744	0.4750	0.4756	0.4761	0.4767
2·0	0.4772	0.4778	0.4783	0.4788	0.4793	0.4798	0.4803	0.4808	0·4812	0.4817
2.1	0.4821	0.4826	0.4830	0.4834	0.4838	0.4842	0.4846	0·4850	0.4854	0.4857
2·2	0.4861	0.4864	0.4868	0·4871	0.4875	0.4878	0.4881	0·4884	0.4887	0.4890
2·3	0.4893	0·4896	0.4898	0.4901	0.4904	0.4906	0.4909	0.4911	0.4913	0.4916
2·4	0.4918	0.4920	0.4922	0.4925	0.4927	0.4929	0·4931	0.4932	0.4934	0.4936
2·5	0.4938	0.4940	0.4941	0.4943	0.4945	0.4946	0.4948	0.4949	0.4951	0.4952
2·6	0.4953	0.4955	0·4956	0.4957	0.4959	0.4960	0.4961	0·4962	0.4963	0·4964
2·7	0.4965	0.4966	0.4967	0.4968	0.4969	0.4970	0.4971	0.4972	0.4973	0·4974
2·8	0.4974	0.4975	0.4976	0.4977	0.4977	0·4978	0.4979	0.4979	0.4980	0.4981
2·9	0·4981	0.4982	0.4982	0.4983	0.4984	0.4984	0.4985	0.4985	0.4986	0·4986
3·0	0·4987	0.4987	0·4987	0.4988	0.4988	0.4989	0.4989	0·4989	0.4990	0·4990

SOLUTION1

(a)

(i) **INCOME STATEMENT FOR THE YEAR ENDED 30TH JUNE**

	2015	2016	COMMENTS
	₦m	₦m	
Revenue	1,035	1,190	Increase by 15% p.a
EBIT (earnings before interest & tax)	311	357	30% of revenue
Interest on bank loan	(10)	(10)	6% of ₦160m
Interest on overdraft	(1)	(3)	6% x opening O/Draft
Profit before tax	300	344	
Tax	(68)	(86)	See (W2)
Profit after tax	232	258	
Dividend	210	221	
Retained earnings	22	37	
Retained earnings b/f	80	102	
Retained earnings c/f	102	139	

(ii) **STATEMENT OF FINANCIAL POSITION AS AT**

	2015	2016	Comments
	₦m	₦m	
Non-current Assets			
Plant etc	375	431	See (W1)
Working capital	207	238	20% of revenue
	582	669	
Equity			
Share capital	200	200	
Retained earnings	102	139	
Non-current liabilities			
Bank loan	160	160	
Current liabilities			
Bank overdraft	52	84	See cash flow statement
Tax payable	68	86	See (W2)
	582	669	

(iii) **CASH FLOW ANALYSIS**

	2015	2016
	₦m	₦m
EBIT	311	357

Add back depreciation	125	144
Increase in working capital	(27)	(31)
Net cash flow from operations	409	470
Interest paid	(11)	(13)
Dividends paid	(210)	(221)
Tax paid	(20)	(68)
Capital expenditure	(200)	(200)
Net cash flow	(32)	(32)
Overdraft b/fwd	(20)	(52)
Overdraft c/fwd	(52)	(84)

Note: Alternative presentation in the form of receipts and payments is allowed.

(iv) **Funding requirement in 2015 and 2016**

Comparing 31 December 2014, 2015 and 2016, the maximum funding requirement in 2015 and 2016 appears to arise on 31 December, 2016:

	₦m	₦m
Maximum funding requirement:		
- Bank loan	160	
- Overdraft	84	244
Available facility (160 + 30)		190
Funding gap		54

However, it should be noted that we do not have any information about intra-year cash flows; these need to be examined to determine whether a greater funding shortfall arises at some other point during the period.

Working Notes

1. **Non-current assets**

	₦m	₦m
Property, etc b/fwd	300	375
Capital expenditure	200	200
Net total	500	575

Depreciation at 25%	(125)	(144)
Property etc c/fwd	375	431

2. **Calculation of taxes**

	₦m	₦m
30% of revenue	311	357
Less: Capital allowance	(200)	(200)
Add: Depreciation	125	144
Interest on bank loan	(10)	(10)
Interest on overdraft	(1)	(3)
Taxable profit	225	288
Taxes 30%	68	86

(b) As indicated in (a) above, a funding gap of ₦54million exists at the end of 2016. Management may consider the following options in order to close the funding gap.

(i) **INCREASE THE BANK LOAN**

The additional funding requirement of ₦54million would result in gearing level in excess of the bankøs minimum gearing level of 70%:

$$(84 + 160)/(200 + 139) = \frac{244}{339} = 72\%$$

However, the ₦54million shortfall is only likely to be temporary and approximately 80% of the loan could be repaid by the end of 2017, so the bank would be more likely to provide the additional loan if it accepts the companyøs forecasts for 2017 onwards. If the targets for 2017 are achieved, the company can expect positive cash flows in 2017, as shown below:

	₦M	
EBIT	411	357 x 1.15
Add depreciation	143	25% (431 + 140)
Net cash from operations	554	
Interest	(15)	6% (160 + 84)
Dividend	(232)	
Tax paid	(86)	
Capital expenditure	(140)	
Estimated net cash flow in 2017	81	

(ii) **REDUCE OR DELAY CAPITAL EXPENDITURE**

Reducing or delaying investment and thereby slowing down the growth of the company could jeopardise the success of the company. A decision would depend on the nature of the capital expenditure and what impact a delay or reduction would have on the performance and growth of the business. Alternative ways of funding the investment such as the use of leasing or sale and leaseback of non-current assets could also be considered.

(iii) **REDUCE OR POSTPONE DEVIDEND**

Cutting dividend levels is more easily achieved in a private company such as AB Ltd. This would create a potential problem if the company were preparing for floatation and needed to build up a good track record of dividend payments. However, this may not be acceptable to shareholders who may be dependent on dividend income.

(iv) **EXPLORE INSTALMENTAL PAYMENTS OF TAX**

The company may arrange with the tax authorities to pay their assessable tax in instalments.

(v) **OTHER POSSIBLE ACTIONS**

- Explore the use of the services of a factor as necessary
- Speed up cash collection from customers
- Delay payments to suppliers taking into consideration the suppliers credit terms

RECOMMMENDATION

A bank loan would enable dividend and investment strategies to remain unchanged and hence protect the future expansion plans of the business and meet shareholder payout expectations. If it is not possible to borrow the whole amount needed, it may be possible to borrow a substantial proportion of the amount required. Any remaining amount should be obtained by delaying capital expenditure plans or, if that is not feasible or would damage business prospects, reduce dividend payouts in 2017.

EXAMINER'S REPORT

The question tests candidates' ability to prepare projected financial statements, including projected cash flows.

In view of the fact that the question is compulsory, almost all the candidates, that is, over 90% of them attempted it, but only a very few appear to understand its requirements, hence performance was poor.

Candidates' commonest pitfall was their lack of indepth knowledge of the requirements of the question, hence their failure to proffer correct solutions to all the parts, particularly Part 'b', where they failed to identify the funding gap and how the gap can be closed.

Candidates are advised to take time to read, understand and interprete questions appropriately and note their specific requirements before attempting them. They should also endeavour to improve their knowledge on the preparation of projected financial statements by revising other subject linkages such as performance management, financial reporting, etc.

SOLUTION 2

(a) **VALUATION OF MINORORIA PLC.**

i)	**Statement of Financial Position (net asset) basis**		**₦454,100**
		₦	₦
ii)	**Replacement value**		
	Net assets		454,100
	Replacement costs	725,000	
	Less: Book value	651,600	73,400
	Inventory and W. I. P		
	Replacement costs	550,000	
	Less: Book value	515,900	34,100
			561,600
iii)	**Realisable value**		
	Net assets		454,100
	Realisable value	450,000	
	Less: Book value	651,600	(201,600)
	Inventory and W. I. P		
	Realisable value	570,000	
	Less: Book value	515,900	54,100
			306,600
	Less: Uncollectable receivables		
	2% of ₦745,000		(14,900)
			291,700

iv) **Gordon (rb) model**

Average proportion of earnings retained =

$$b = \frac{[illegible]}{[illegible]} = \frac{[illegible]}{[illegible]} = \quad 0.495 \text{ 0r } 50\%$$

r = minimum returns required by Minororia Plc. = 12%

growth rate (g) = rb = 0.5 x 0.12 = 0.6 or 6%

Market value of equity = $\frac{D_o(1+g)}{K_E - g}$, [illegible]

K_E = Cost of equity capital = 12%

D_o = dividend as at 31/12/2014 = 25,000
g = growth rate in dividend = 6%
Thus, total value of equity as at 31/12/14 is:

$= \frac{\text{[illegible]}}{\text{[illegible]}}$ = ₦441,667

Note
In answering this part of the question, candidates are likely to come up with different but acceptable assumptions. Some of these include:

- No growth in dividend- because dividend has been constant for the last two years and it is also projected at the same level for year 2014. In that case the formula to use is:

  D/r

- The retention rate, b, can be calculated using the 2014 projected results rather than using average.

- The return on equity (ROE) can be computed as

  ROE = $\frac{\text{[illegible]}}{\text{[illegible]}}$, using results for 2014 or the average for the period given.

  P/E ratio model
  Since Monororia is not quoted on the stock market, it does not have a P/E ratio. We make use of the P/E ratio of similar but quoted companies in the industry. However, since the company is not quoted, it is assumed that it has a higher risk and lower P/E ratio.

v) A P/E ratio of 8 is assumed.

Therefore total value = 8 x ₦53,200 = ₦425,600

(b) **LIMITATIONS**

(i) **Net Asset Basis**

- Book values are unlikely to relate closely to economic values of assets.
- The sum of the value of the business component parts may not be the same as the value of the business as going concern.

(ii) **Replacement Cost**

- An asset that is out of production may not have a replacement cost.

(iii) **Net Realisable Value**

- The market value may not exist or where it does exist, it might be unreliable.

(iv) **Gordon Dividend Growth Model**

- Cannot be used to value non-dividend paying companies.
- Where the growth rate is higher than the cost of equity, the method breaks down.
- It assumes that dividend will grow at a constant rate to infinity. In practice, this may not hold.
- For an unquoted company, it could be difficult to identify the relevant cost of equity to use in the valuation.

(v) **P/E Ratio Method**

- There are difficulties in finding a quoted company sufficiently similar to the company being valued.
- Earnings do not necessarily reflect cash generating potential. It is the latter which is more likely to bear on value than the former.
- The P/E ratio calculation is meaningless when the earnings of a firm are negative. While using the normalised or average earnings in the recent past as a proxy for current earnings can reduce this problem, it cannot be eliminated.
- The volatility of a firmǒs earnings can cause wild swings in the P/E ratio estimates from period to period.
- Earnings per share of a firm depend on the accounting principles used. Differences in accounting for inventories, depreciation and research and development may lead to vastly different values for earnings (and therefore, their P/E ratios) for two firms that may actually be exactly alike.

ALTERNATIVE SOLUTION

i. **Replacement cost**	₦	₦
Non-current assets		725,000
Inventory and W.I.P		550,000
Add: Book value: Receivables		745,000

Bank balances		158,100
		2,178,100
Less: Current liabilities		1,616,500
Replacement costs		561,600

ii. **Realisable value**

Non-current assets		450,000
Inventory and W. I. P		570,000
Add: Book value: Receivable	745,000	
Less: Uncollectible	14,900	730,100
Bank balances		158,100
		1,908,200
Less: Current liabilities		1,616,500
Realisable value		291,700

EXAMINER'S REPORT

The question tests candidates' knowledge of the various methods of valuing a company's equity and the validity of each method.

More than 80% of the candidates attempted the question and performance was average. Most of the candidates have good understanding of sections (i), (ii) and (iii) of part 'a' of the question, but demonstrated poor understanding of sections (iv) and (v). Part 'b' of the question was fairly attempted.

Candidates' commonest pitfalls were their inability to calculate dividend growth rate and their limited knowledge of the limitations of the various valuation methods.

Candidates are advised to always cover the syllabus adequately by giving considerations to all sections of the syllabus in their preparation for the Institute's examinations. They should also improve their knowledge on the valuation of a company's equity and the limitations of each of the valuation methods.

SOLUTION 3

(a)

	KING Plc.	QUEEN Plc.
	₦000	**₦000**
Total market value of equity	175,000	37,500
Value of KING Plc. after the acquisition		
Sales (37,500 + 20,000 + 1, 500)		59,000
Opening expenses (20,000 + 15,500 – 1,250)		34,250
Profit (dividends)		24,750
		₦
Present Value (PV) of future earnings (dividends)		
$\frac{[illegible]}{[illegible]} = \frac{₦24{,}750{,}000}{0.10} =$		247,500,000
Add cash flow from sale of machine		2,500,000
Total value of KING Plc. after merger		250,000,000

Therefore, the maximum price payable by the directors of KING Plc. is the increase in the value arising from the merger i.e. ₦250,000,000 – ₦175,000,000 = 75,000,000

KING Plc. is advised to pay maximum of ₦75million for the acquisition.

(b) The takeover price agreed is ½ of ₦75million i.e. ₦37.5million. Let x represent the number of new shares to be issued to QUEEN Plc.

Therefore, total number of shares in issue after takeover becomes

50,000,000 + x shares.

Total value of KING Plc. after acquisition = ₦250m

For the entire benefit from the acquisition to accrue to the present shareholders of KING Plc., value of KING Plc.'s shares issued to QUEEN Plc.'s shareholders must equal the agreed take-over price i.e.

$\frac{[illegible]}{[illegible]}\ [illegible]250[illegible] = 37.5m$

250,000,000 x = 37,500,000 (50,000,000 + x)

$$\frac{250x}{37.50} = 50,000,000 + x$$

1,875,000,000 + 37.50x = 250x
x = 8,823,529 Shares

The market value per share after the acquisition or take-over

$$= \frac{250,000,000}{50,000,000 + 8,823,529}$$

$$= \frac{250,000,000}{58,823,529} = ₦4.25$$

Gain to shareholders of KING Plc. (₦4.25 ï ₦3.50) x 50m = ₦37,500,000. Thus, the entire benefit from the take-over will accrue to the present shareholders of KING Plc.

(c) The shareholders of QUEEN Plc. should negotiate a takeover price higher than the agreed ₦37.5million, At a takeover price of ₦37.5m, the shareholders of Queen Plc will not get any benefit from the takeover. Therefore, they may not agree to the takeover.

The directors of QUEEN Plc. might believe from the proposal that the increase in profits after the acquisition and the sale of assets are indications that they are effectively utilising their assets hence the company may decide to put them (the assets) to better usage rather than sell them.

The directors of KING Plc. will have to reassess their estimates. How realistic is the increase in sales revenue of ₦1,500,000 p.a. and a reduction in expenses of ₦1,250,000.

Furthermore, will the reduction in expenses involve retrenchment of staff and what effect will this have on the morale of the remaining staff? Also if staff are to be laid off, what about the redundancy payment?

What about the transaction costs of the acquisition? If the takeover is resisted by the directors of QUEEN Plc or other interested buyers, then the cost of the acquisition could be quite high.

Further, since KING Plc. and QUEEN Plc. both manufacture and sell household items; the attitude of the government or trade unions to forestall a monopoly situation may not have been considered.

(d) If the director of QUEEN Plc. considered the takeover bid unfriendly, the following defence tactics are available:

i. Seek Government injunction i.e. restricting the predator company under anti-monopoly or anti-trust law where this is in existence.

ii. Embark on effective public promotion.

iii. Appeal to shareholders not to sell their shares by promising them better prospect and share appreciation

iv. **White knight Defence**: The target company may seek for a friendly company whose offer is more appealing for the takeover bid.

v. **'Crown Jewel' Defence**: This is a strategy that is employed by the management of the target company whereby a third party is granted the right to buy the firmôs assets in order to discourage the predator firm from going ahead with the bid.

   The plan is particularly effective when the target company offers for sale its crown jewel ï the target firm most valued asset.

vi. Litigation

vii. **Asset Restructuring**: The target firm purchases assets that effectively restructure its statement of financial position. These assets may simply be ones that are unattractive to the bidder or may cause anti-trust problems if the merger creates significant monopoly power.

vii. **Green mail**: This technique involves an agreement allowing the target company to repurchase its own shares back from the acquiring company, usually at a premium to the market price. It is the termination of a hostile take-over through a payoff to the acquirer.

ix. **Share repurchase**: Rather than repurchasing only the shares held by the acquiring company as a greenmail, a target company might initiate a cash tender offer for its own outstanding shares.

x. **Pacman Defense**: This is called after the video game in which characters try to eat each other before they are eaten themselves, that is, the firm under attack from a hostile bidder turns the table by bidding for the aggressor.

xi. **White Squire Defence**: This is similar to white knight defence in that the two parties, target firm and white squire, seek to implement a strategy to preserve the target firmôs independence. This is done by placing shares in the hands of a friendly firm or investor who is not interested in acquiring control of the target firm and will not sell out to the predator.

EXAMINER'S REPORT

The question tests candidates' understanding of the valuation of a company for a take-over and their knowledge of the various post takeover defence strategies.

Over 80% of the candidates attempted the question but most of them did not have a clear and accurate understanding of parts 'b' and 'c' while the 'd' part was fairly attempted hence performance was poor.

Candidates' commonest pitfalls were their inability to price the given company and differentiate between post takeover and pre-takeover defensive tactics.

Candidates are advised to study extensively and adequately cover the syllabus when preparing for the Institute's examinations.

SOLUTION 4

(a) **OSEKA BAGS LIMITED**

EXISTING SUPPLIER

(i) Economic Order Quantity will be assessed using the following formula:

$\therefore$ EOQ = $\sqrt{\frac{2DK}{H}}$

Where D = Annual demand (units)
K = Cost per order
H = Unit holding cost per annum

$\therefore$ EOQ = $\sqrt{\frac{2 \times 100 \times 900 \times 50}{100}}$ = 300 briefcases

The existing optimal order quantity is 300 units

(ii) **Total cost**

Part (b) of the question involves quantity discount and as a result the total relevant cost must include purchase cost.

Holding cost = Average stock x unit holding cost

			₦
	$= \frac{300}{2} \times$ ₦100	=	15,000
Ordering cost = No of orders x Cost per order			
	$= \frac{100 \times 50}{300} \times$ ₦900	=	15,000
Purchase cost = Annual demand x Unit price			

	100 x 50 x ₦1,000	= <u>5,000,000</u>
Total annual cost		= <u>5,030,000</u>

(b) **NEW SUPPLIER**

(i) Economic order quantity

$\therefore$ EOQ = $\sqrt{\dfrac{2DK}{H}}$

$\therefore$ EOQ = $\sqrt{\dfrac{2 \times 5{,}000 \times 2{,}500}{100}}$ = 500 briefcases

(ii) Total cost

The total cost of stocking briefcases for the year will be

		₦
Holding cost = $\dfrac{500}{2}$ x ₦100	=	25,000
Ordering cost = $\dfrac{5,000}{500}$ x ₦2,500	=	25,000
Purchase cost = 5,000 x ₦960	=	<u>4,800,000</u>
Total annual cost		<u>4,850,000</u>

On financial grounds, it would be beneficial by
₦180,000 (₦5,030,000 - ₦4,850,000)

Recommendation: The supplier should be changed.

(c) **Limitations of the analysis**

The above computations dealt with only the financial aspect of the decision and are based on simplified assumptions which may not be valid in reality.

Over simplified assumptions are:

(i) **Constant demand**

The EOQ model assumes a constant annual demand which may not be the case at all times. There could be variation in annual demand due to seasonal variations e.g. sales may be higher in Christmas and other festive periods.

(ii) **Reliability of suppliers**
It was assumed that both suppliers were totally reliable, particularly in terms of delivery times. In reality, it is more likely that there may sometimes be inadvertent delays in lead times.

(iii) **Credit terms**
It was assumed that both suppliers offered similar credit terms. No allowance was made, as no information was given for the financial effect of suppliers allowing different credit periods.

(iv) **Storage space**
An EOQ of 500 briefcases requires increase in storage space over the current EOQ of 300 briefcases. Is the extra space available at no extra cost?

Other non-financial factors to consider are:

(i) **Quality**
It will need to be determined whether the two suppliers can provide the same consistency of quality. Where there are lapses in quality, Oseka Limited will need to be reassured of the after sale service consistency of the two suppliers.

(ii) **Reliability and flexibility**
Will the two suppliers be consistently reliable and flexible?

(iii) **Presentation and packaging**
Customersô perceptions can be significantly influenced by product presentation and packaging. Information about the leather quality of both briefcases is required for effective decision.

(iv) **Colour range or options**
Oseka Limited will need to ensure that both existing briefcases are both available in the same range of colours and having similar male and female versions in order that sales volume can be maintained.

(d) **Net present value**

Item	Year	Cash flow	PVF at 10%	PV
				₦
Investment	0	(400,000)	1.000	(400,000)
Cash savings	1 - 3	180,000	2.487	447,660
NPV				47,660

Based on the above financial analysis, even with a ₦400,000 immediate investment cost, it is financially viable to switch to new supplier.

EXAMINER'S REPORT

The question tests candidates' knowledge of inventory control with emphasis on the Economic Order Quantity (EOQ) Model.

Over 75% of the candidates attempted the question and the general performance was average. Some of the candidates understood the question and therefore performed brilliantly, but others did not understand the import of the question, hence they performed below average.

Candidates' commonest pitfalls were their inability to produce the correct EOQ formula, calculate EOQ and total cost and discuss the limitations of the EOQ model

Candidates' are advised to take time to read, understand and interprete questions appropriately and note their specific requirements before attempting them. They should also pay attention to an understanding of key formulae and their applications in some aspects of the syllabus.

SOLUTION 5

(a) (i) Money laundering constitutes any financial transactions whose purpose is to conceal the identity of the parties to the transaction or to make the tracing of the money difficult.

Money laundering is used by:
- Corrupt officials
- Terrorist organisations
- Tax evaders
- Distorters of accounting information

(ii) **Steps involved in assessing the risks associated with money laundering:**
- Identifying the money laundering risks that are relevant to the business.
- Carrying out a detailed risk assessment on such areas as customer behaviour and delivery channels.
- Designing and implementing controls to manage and reduce any identified risks.
- Monitoring the effectiveness of these controls and make improvements where necessary.
- Maintaining records of actions taken and reasons for these actions.

(iii) **Steps involved in curbing money laundering:**
- Legislation
- Information and education
- Identifying the likely businesses such as new customers carrying out large one-off transactions
- Probing suspicious deals and lodgements
- Prosecution
- On-going monitoring of businesses
- Introduction of Bank Verification Number

(b) **Advantages of Islamic Finance:**

(i) Following the principles of Islamic finance, it allows access to a source of worldwide funds. Access to Islamic finance is also not just restricted to Muslim communities which may make it appealing to companies that are focused on investing ethically.

(ii) *Gharar* (uncertainty, risk or speculation) is not allowed, reducing the risk of losses.

(iii) Excessive profiteering is also not allowed, only reasonable mark-ups are allowed.

(iv) Banks cannot use excessive leverage and are therefore less likely to collapse.

(v) The rules encourage all parties to take a longer term view and focus on creating a successful outcome for the venture, which should contribute to a more stable financial environment.

(vi) The emphasis of Islamic finance is on mutual interest and cooperation, with a partnership based on profit creation through ethical and fair activity benefiting the community as a whole.

EXAMINER'S REPORT

The question tests candidates' understanding of money laundering and their knowledge of Islamic Finance.

Over 90% of the candidates attempted the question and performance was poor. Most of the candidates lacked an understanding of part 'a' of the question, while some demonstrated a fair knowledge of part 'b'.

Candidates' commonest pitfall was their inability to interprete the question correctly.

Candidates' are advised to study extensively and adequately cover the syllabus when preparing for the Institute's examinations. They should also endeavour to take time to read, understand and interprete questions appropriately and note their specific requirements before attempting them.

SOLUTION 6

(a) Capital Market Line (CML) is the line that represents the expected returns of the efficient portfolios as a function of volatilities measured by the standard deviations of their returns.

Security Market Line (SML) is the line which measures the expected returns of individual securities as a function of their sensitivity to market fluctuations (i.e. beta factor).

The difference between the two lies in the fact that while CML represents only efficient portfolios, SML represents all portfolios as well as individual securities. Thus all portfolios lying on the CML are also lying on the SML, but not all portfolios lying on the SML are efficient and hence need not lie on the CML.

(b)

(i) Based on CAPM, the return expected from each stock is computed as follows:

R_i: = $R_f + \beta_i (R_m - R_f)$

R_f = Risk free rate

β_i= Portfolio risk (Beta)

R_m = Market returns

R_i = Expected return

$R_i = 6 + \beta_i (12 - 6) = 6 + 6\beta_i$

Stock	A	6 + 6 (1.36) = 14.16%
	B	6 + 6 (0.52) = 9.12%
	C	6 + 6 (0.69) = 10.14%

(iii) To reshuffle the portfolio within these three stocks, we need to know if the theoretical returns using the CAPM theory are in accordance with the expected returns based on our forecasts. The difference between the two is calculated using alphas. Hence, we first need to calculate the alpha of each of the stocks in order to find out which stocks are underpriced/overpriced.

Accordingly, we will decide which stocks need to be bought/sold.

α_i = Expected Return - Required Return

Stock A = 14% - 14.16% = -0.16%

B = 9.5% - 9.12% = 0.28%

C = 10.0% - 10.14% = -0.14%

Stocks with negative alphas are over-valued and stocks with positive alphas are under-valued. Thus, Stocks A and C are over-valued and should be sold. Stock B with positive alpha is under-priced and more should be bought.

EXAMINER'S REPORT

The question tests candidates' knowledge of Portfolio Concept and Capital Asset Pricing Model (CAPM),

The level of attempt was low as the number of candidates that attempted the question was below 50%. It therefore appears that most of the candidates that sat for the examination

did not understand the import of the question. The few candidates that attempted the question only have just a fair knowledge of it, hence, performance was poor.

Candidates' commonest problem was their inability to differentiate between Security Market Line (SML) and Capital Market Line (CML), and correctly apply the Capital Asset Pricing Model (CAPM) formula. Hence they were unable to calculate the alpha values.

Candidates' are advised to cover the syllabus adequately, work on past questions, make use of the Institute's Pathfinder and Study Packs in their preparations for the Institute's examinations for better results. They should also endeavour to remember key formulae and their applications in solving problems.

SOLUTION 7

(a) Hedging is risk management strategy used in limiting or off-setting probability of loss from fluctuations in the prices of commodities, currencies or securities. In the context of this question, hedging can be defined as seeking protection against unexpected future changes in exchange rate.

Finance managers do manage exchange rate risks through hedging. This implies that finance managers would anticipate the risk, recognise it, quantify it and taking appropriate actions to reduce it, if not, totally eliminate it.

(b) Internal Hedging Techniques includes the following:

(i) Leading and lagging
Leading involves accelerating payments to avoid potential additional cost due to currency rate movements.

Lagging is the practice of delaying payments if currency rate movements are expected to make the later payment cheaper.

(ii) Invoicing in local currency
This is where an exporter invoices oversees customers in its own domestic currency or for an importer to arrange with its overseas supplier to be invoiced in its home currency. Although either the exporter or the importer avoids transaction risk, the other party to the transaction will bear the full risk.

(iii) Matching receipts with payments

This is where a company that expects to make payments and have receipts in the same foreign currency should plan to off-set its payments against its receipts in that currency. The process of matching is made simpler by having foreign currency account with a bank.

(iv) Netting

This is a process in which credit balances are netted off against debit balances so that only the reduced net amounts remain due to be paid by actual currency flows. Netting has the objective of saving transaction cost not transaction risk. Netting could be bilateral or multilateral.

(v) Protection clauses

This is a situation where an export or import contract is given a protection clause, whereby sale prices in the foreign currency or the adjusted exchange rate moves outside a defined range.

(vi) Pricing policy

A company can anticipate adverse exchange rate movements by building an extra óprofitô margin into the selling price to act as a cushion in the event that exchange rates do in fact move adversely.

(vii) Do nothing

This is usually the cause of action of most importers and exporters. They will accept whatever comes their way whenever conversion is to be made.

(c) If actual rate is 5%

	₦
FRA payment = ₦10million x (6% - 5%) x $^{6}/_{12}$	500,000
Payment on underlying loan 5% x ₦100million x $^{6}/_{12}$	2,500,000
Net payment on loan	3,000,000
Effective Interest rate on loan = 6%	

If actual rate is 9%

the bank will pay Famak Plc.	₦
FRA receipt ₦100million x (9% - 6%) x $^{6}/_{12}$	(1,500,000)
Payment on underlying loan at market rate	
net 9% x ₦100million x $^{6}/_{12}$	4,500,000
Net payment on loan	3,000,000
Effective Interest rate on loan = 6%	

EXAMINER'S REPORT

This question tests candidates' knowledge of foreign exchange hedging techniques and Forward Rate Agreement (FRA) calculations.

Many candidates, that is, over 70% attempted the question but performance was generally poor. Most of the candidates did not have a good understanding of the question hence they gave wrong answers while the few candidates that appear to understand it seem to lack the technical ability to handle it.

Candidates' commonest pitfalls were their inability to explain concept of hedging, differentiate between internal and external hedging and their lack of indepth knowledge of this area of the syllabus.

Candidates' are advised to always give adequate considerations to all sections of the syllabus in their preparations for the Institute's examinations. They should also improve their knowledge on foreign exchange transactions.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2015

ADVANCED AUDIT AND ASSURANCE

Time Allowed: 3 hours

ATTEMPT FIVE QUESTIONS IN ALL

SECTION A: COMPULSORY QUESTION (30 Marks)

QUESTION 1

You are the manager responsible for four audit clients of Nnamdi & Co., a firm of Chartered Accountants. The year end in each case is 31 December, 2014.

You are currently reviewing the audit working paper files and the audit seniorsô recommendations for the auditorsôreports. Details are as follows:

(a) Ray Company Limited is a subsidiary of Sun Group Plc. Serious going concern problems have been noted during this yearôs audit. Ray Company Limited will be unable to trade for the foreseeable future unless it continues to receive financial support from the parent company. Ray Company Limited has received a letter of comfort from Sun Group Plc.

The audit senior has suggested that, due to the seriousness of the situation, the audit opinion must at least be qualified õexcept forö.

(b) Intangibles Limited has changed its accounting policy for goodwill during the year from amortisation over its estimated useful life to annual impairment testing. No disclosure of this change has been made in the financial statements. The carrying amount of goodwill in the statement of financial position as at 31 December, 2014 is the same as at 31 December, 2013 as managementøs impairment test show that it is not impaired. The audit senior has concluded that a modification to the opinion is not required but suggests that attention can be drawn to the change by way of an õemphasis of matterö paragraph.

(c) The directorsö report of Shelter Limited states that investment property rental forms a major part of revenue. However, a note to the financial statements shows that property rental represents only 1·6% of total revenue for the year. The audit senior is satisfied that the revenue figures are correct. The audit senior has noted that an unmodified opinion should be given as the audit opinion does not extend to the directorsö report.

(d) Audit work on the after-date bank transactions of Star Limited has identified a transfer of cash from Twinkle Limited. The audit senior assigned to the audit of Star Limited has documented that Starøs finance director explained that Twinkle Limited commenced trading on 7 January 2015, after being set up as a wholly-owned foreign subsidiary of Star Limited. The audit senior has noted that although no other evidence has been obtained, an unmodified opinion is appropriate because the matter does not impact on the current yearøs financial statements.

Required:

For each situation above, comment on the suitability or otherwise of the audit seniorøs proposals for the auditorsö reports. Where you disagree, indicate what audit modification (if any) should be given instead. **(Total 30 Marks)**

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

QUESTION 2

One of the techniques used by auditors in arriving at final audit opinion is analytical review. Preliminary analytical procedures are often performed using accounting ratios.

Required:

Explain the possible reasons for the following changes found at the planning stage of the audit:

a. an increase in capital gearing **(4 marks)**
b. an increase in dividend cover **(4 marks)**
c. an increase in the current ratio **(4 marks)**
d. a decrease in the gross profit margin **(4 marks)**
e. an increase in the inventory holding period **(4 marks)**

(Total 20 marks)

QUESTION 3

a. Discuss the following **FIVE** elements of good quality control in a firm of Chartered Accountants:

i. Independence **(2 Marks)**
ii. Personnel management **(2 Marks)**
iii. Acceptance of and continuance with client **(2 Marks)**
iv. Engagement performance **(2 Marks)**
v. Monitoring **(2 Marks)**

b. As the Audit Manager in charge of Silver Limitedôs audit for the year ended 31 December, 2014, state and explain **FOUR** quality control procedures you will apply for the effective management of the audit. **(10 Marks)**

(Total 20 Marks)

QUESTION 4

ICAN has an ethical guide, its *Professional Code of Conduct and Guide for Members*. These rules are applicable to all members. If these rules are not complied with, disciplinary action may result which could lead to a reprimand, fine or delisting.

Required:

a. Explain why you think ICANôs fundamental principles are so important to auditing. **(6 Marks)**

b. Explain how a member can demonstrate that he is truly independent in carrying out the work he performs and why it is important that he should do so. **(6 Marks)**

c. Set out the circumstances under which it is permissible to disclose confidential clients information. **(8 Marks)**

(Total 20 Marks)

SECTION C: ATTEMPT ANY TWO OUT OF THREE QUESTIONS IN THIS SECTION (30 Marks)

QUESTION 5

Auditing standards require auditors to carry out procedures designed to obtain sufficient and appropriate audit evidence. In order to do this, the auditor may require the services of a specialist. In respect of specialists whose work may be relied upon by the auditor, you are required to:

a. Describe a specialist and give **FOUR** examples of specialists. **(6 Marks)**

b. State the circumstances under which an auditor may need the work of specialists. **(6 Marks)**

c. How will an auditor determine the competence and objectivity of a specialist? **(3 Marks)**

(Total 15 Marks)

QUESTION 6

Forensic audit covers a broad spectrum of activities whose terminology is not strictly defined in regulatory guidance.

Required:

a. What is Forensic Audit? **(2 Marks)**

b. State **TEN** situations which might require the services of a forensic auditor. **(5 Marks)**

c. State **FIVE** qualities of a forensic auditor. **(5 Marks)**

d. State **THREE** differences between forensic audit and financial audit. **(3 Marks)**

(Total 15 Marks)

QUESTION 7

You have been appointed Auditor of a company whose accounting transactions are processed using the computer. You have decided to use Computer-Assisted Audit Techniques (CAAT) to generate evidence for the audit assignment.

Required:

a. State **FOUR** advantages and **THREE** disadvantages of using test data in compliance testing of application controls. **(7 Marks)**

b. List **FOUR** activities for which audit software may be used to perform substantive tests by the auditor. **(4 Marks)**

c. List **TWO** advantages and **TWO** disadvantages of the use of audit software. **(4 Marks)**

(Total 15 Marks)

SOLUTION 1

(a) Ray Company Limited

If a letter of comfort had not been received, then a modified opinion on the grounds of a material misstatement, disagreement about the appropriateness of the going concern assumption would be required. As the matter is likely to be pervasive, an adverse opinion would be appropriate (ISA 570 *Going Concern*).

However, the company has received a letter of comfort from its parent company to the effect that it will enable the company to continue trading. If this evidence, together with other evidence such as managementôs representations are considered to be sufficient to support the appropriateness of the going concern presumption, a modified opinion will not be necessary provided that the support is adequately disclosed as a note in the financial statements. If the evidence is sufficient but the disclosure is inadequate, a qualified (óexcept forô) opinion or adverse opinion would be required.

If the letter of comfort does not provide sufficient evidence (e.g. if there are doubts about Sunôs ability to provide the required finance), the significant uncertainty arising should be drawn to the usersô attention in an óemphasis of matterô paragraph in the auditorsô report. This would not result in a modified opinion, unless the disclosure relating to the uncertainty were considered inadequate.

Conclusion

The audit seniorôs proposal is unsuitable. The auditorsô opinion should be unmodified if the disclosures are adequate.

(b) Intangibles Limited

In order to show fair presentation in all material respects, the financial statements of an entity should contain not only accurate figures, but also sufficient disclosure in relation to those figures in order to allow the users to understand them. As required by IAS 1 *Presentation of Financial Statements*, items should be treated on a consistent basis from year to year. If this is not the case, then any change, together with the financial impact of this change, will need to be disclosed as a note in the financial statements.

Failure to disclose the reasons for change in policy (i.e. to comply with IFRS 3 *Business Combinations*) and its effects (e.g. the lack of annual amortisation) means that the financial statements do not comply with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. A modified opinion is therefore required on the grounds of a material misstatement (disagreement on disclosure (IAS 1 and IAS 8)). Assuming the matter to be material (but clearly not pervasive), a qualified óexcept forô opinion should be expressed.

The main purpose of an óemphasis of matterô paragraph is to describe a matter which the auditor considers fundamental to an understanding of the financial statements, for example to draw attention to a major catastrophe which has had a significant effect on the entityøs financial position. Such a paragraph highlights a note in the financial statements that more extensively discusses such a matter, which has been taken into account in forming the audit opinion ï it does not modify that opinion. An óemphasis of matterô paragraph cannot therefore be used to make good a lack of disclosure.

IFRS 3 also requires disclosure of a reconciliation of the carrying amount of goodwill at the beginning and end of the year. This should show no movement for the year ended 30 June 20X4.

Conclusion

The audit seniorøs proposal is unsuitable. Unless all aspects of the change including reasons and effects, are adequately disclosed, an óexcept forô qualification will be required on the grounds of a material misstatement.

(c) Shelter Limited

The audit opinion states whether the financial statements:

- for a ñfair presentationò framework are presented fairly, in all material respects or give a true and fair view in accordance with the applicable financial reporting framework; and
- for a ñcomplianceò framework comply with the applicable financial reporting framework.

The directorsô report is not a part of financial statements prepared under International Financial Reporting Standards (IFRS). However, auditors have a professional responsibility to read other information in documents containing audited financial statements e.g. the directorsô report in an annual report to identify material inconsistencies with the audited financial statements or material misstatements of fact.

A material inconsistency exists when other information contradicts information contained in the audited financial statements. Clearly, the word ómajorô is inconsistent with 1.6%.

If the inconsistency is resolved e.g. because the directorsô report is corrected to state ó.. major part of other income...ô an unmodified audit opinion will be given.

If the inconsistency is not resolved, the audit opinion on the financial statements cannot be modified because the inconsistency is in the directorsô report. In this case, an óother matterô paragraph may be used to report on this matter that does not affect the financial statements (ISA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditors' Report*).

Conclusion

An unmodified opinion on the financial statements is appropriate. If, however, the inconsistency is not resolved, it should be reported in a separate óother matterô paragraph, immediately after the opinion paragraph.

(d) Star Limited / Twinkle Limited

The cash transfer is a non-adjusting event after the reporting period. It indicates that Twinkle Limited was trading after the end of the reporting period. However, that does not preclude Twinkle having commenced trading before the year-end.

The finance directorôs oral representation is wholly insufficient evidence with regard to the existence (or otherwise) of Twinkle Limited at 31 December 2014. If it existed at the end of the reporting period its financial statements should have been consolidated, unless considered immaterial.

The lack of evidence that might reasonably be expected to be available (e.g. legal papers, registration payments, etc.) suggests a limitation on the scope of the audit. If such evidence has been sought but not obtained then the limitation is imposed by the entity rather than by circumstances.

Whilst the transaction itself may be immaterial, the information concerning the existence of Twinkle Limited may be material to users and should therefore be disclosed as a non-adjusting event. The absence of such disclosure, if the auditor considered necessary, would result in óexcept forô, opinion.

Tutorial note: Any matter that is considered sufficiently material to be worthy of disclosure as a non-adjusting event must result in such a modified opinion if the disclosure is not made.

If Twinkle Limited existed at the end of the reporting period and had material assets and liabilities, then its non-consolidation would have a pervasive effect. This would warrant an adverse opinion.

Also, the nature of the limitation (being imposed by the entity) could have a pervasive effect if the auditor is suspicious that other audit evidence has been withheld. In this case, the auditor should express a disclaimer in the audit report.

Conclusion

Additional evidence is required to support an unmodified opinion. If these were not forthcoming a disclaimer may be appropriate.

EXAMINER’S REPORT

The question tests candidates understanding of scenarios that will give rise to different audit opinions in the auditors’ report.

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

The commonest pitfall of the candidates was lack of understanding of the type of audit opinion vis-à-vis a given scenario. Also, the inability of candidates to analyse scenarios using accounting standards or other literature concerning scenarios for arriving at adequate opinion in audit reports.

This is a practical question that is very relevant at this level. It depicts the kind of situation that candidates will be exposed to after qualifying as Chartered Accountants. Candidates are enjoined to strive to be familiar with this area of the syllabus.

SOLUTION 2

Accounting Ratios

Possible reasons for changes:

(a) Increase in capital gearing: High gearing generally indicates that the company has increased its loan profile. The loan must be serviced. This includes payment of interest on fixed interest borrowings. This means that there are fewer funds available for distribution to shareholders. It may also mean that the company is expanding. This also means greater returns for shareholders in the future. A high gearing ratio may also mean that the company is at risk of going concern.

(b) Increase in dividend cover: This shows how many times a company could pay the dividend it has decided to pay to shareholders. If a company's dividend cover is increasing, it may simply mean that it is making greater profits in relation to the dividend it pays out.

It may also mean that the company could pay out more dividends in future or that the company is paying out a reduced dividend and is investing more in the business.

(c) Increase in current ratio: An increase in current ratio may indicate increased inventory, cash or receivables.

The implication of this may be that the company is expanding or alternatively that it is experiencing trading difficulties and is unable to sell its inventory or to collect its receivables.

An increase may also be due to a decrease in trade payables or other current liabilities.

(d) Decrease in gross profit margin: A decrease in gross profit margin may indicate that the cost of raw materials or bought-in goods has increased or that discount allowed have increased or selling prices have decreased.

(e) Increase in inventory holding period: The inventory holding period indicates the number of days the company could continue to trade if supplies were to cease.

The longer the period, the higher the level of inventory held. Inventory holding involves expenditure. Generally, the lower the figure the better, provided that the company does not run out of inventory.

- An increase may indicate that the Company is unable to sell its inventory
- An increase may also indicate that the company is expecting additional sales or simply that the business is expanding.

- Many businesses are cyclical (seasonal) and increases and decreases are to be expected.
- Increase in the value of non-moving and/or obsolete stock.

EXAMINER'S REPORT

The question tests candidates' ability to interpret changes in financial ratios arising from analytical review of financial statements.

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

The commonest pitfall of the few candidates that performed poorly was that rather than explaining reasons for changes, they were defining the formulae.

Candidates are advised to read more, prepare adequately for examinations and ensure that they read questions properly so as to understand the requirements of the question before attempting them.

SOLUTION 3

Good Quality Control

(a)

(i) Independence

The auditor must be free from any bias in giving an opinion. The auditor should not allow himself to be put in a situation where any third party could put pressure on him to change his opinion or to compromise his objectivity.

(ii) Personnel Management

Management of personnel is the most important function and key to the successful conduct of a business. Therefore, the staff manager should be able to plan, organize, lead a team, control, establish credibility and build commitment. A firm should have in place a partner, called the staff partner, who will be in charge of staff matters. He should ensure that all staff receive due attention on matters affecting them. Staff training and capacity building should be provided to build skill and competence.

(iii) Acceptance of and continuance with clients

The firm should be satisfied that potential or new clients comply with the terms and conditions of the practice before acceptance. Where they become aware of some information that may prevent the practice from acting for such a client or even continuation of relationship with an existing clients, they should readily disclose such information so that a decision may be taken in time by the practice. If there is any development affecting the relationship, the firm should consider its position in relation thereto and take appropriate measures.

(iv) Engagement performance

The practice should constantly review the responsibilities of the audit engagement partners which include direction, supervision, review, consultations and quality control policies.

Assignments should be planned in such a way that all resources required for the successful performance of the audit are made available e.g. Audit Planning Memorandum, audit programmes, etc.

(v) Monitoring

This is to ensure that the controls put in place by the firm are working. This involves day-to-day or periodic review by managers and partners. The practice should ensure that its quality control and procedures are regularly reviewed and updated to ensure compliance with set standards, both within the practice and general standards set by the profession as a whole.

(b) System of Quality Control

Quality controls are all the measures, controls, procedures, pronouncements, etc., put in place by the firm to ensure that the tasks of audit are effectively, efficiently and economically carried out; and by extension ensure an objective audit opinion that reflects the true and fair view of the financial statements being audited.

Quality control measures include:

- Audit planning
- Audit Programme drafting and usage
- Checklist (completion checklist)
- Staff allocation
- Documentation
- Staff briefing
- Matters for next audit
- Work acknowledgement
- Audit review
- Peer review
- Supervision

EXAMINER'S REPORT

The question tests candidates understanding of quality control in a firm of Chartered Accountants.

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

The commonest pitfall of the candidates was the misinterpretation of the (b) part of the question which made them to write out of context; not being able to identify quality control measures.

Candidates are advised to read and understand questions before attempting them.

SOLUTION 4

ICAN Professional Code of Conduct and Guide for Members

(a) Importance of the fundamental principles of professional conduct

These principles are considered to be so fundamental because they underpin the way in which ICAN members should act during the course of their professional work and they specify behaviour expected from members during the course of their work. ICAN is a professional body and has a high reputation which can only be maintained if its members also adhere to the high standards that are set by it.

Furthermore, any individual or organisation that employs the services of an ICAN member should be able to expect a certain level of service from that member. By stating the fundamental principles of professional conduct within their rules of professional conduct, ICAN is requiring its members to adhere to those standards. If those standards are subsequently breached then disciplinary action, followed by a reprimand, fine or expulsion can follow.

These principles are therefore clearly fundamental to auditing as a profession, as ICAN members who are acting as auditors have certain responsibilities and obligation to their clients and third parties when conducting their work. These principles further demand high standards of conduct from such a person acting as auditor.

(b) **Importance of independence and how it can be demonstrated**

Independence of auditors is a key area within the ICAN rules of professional conduct. It is vital that not only is a member independent but he must be seen to be independent if he is to act as an auditor ï his objectivity must be beyond question.

There are many situations which may give the appearance that a member is not independent. Such situations should be safeguarded against and avoided by the auditor if he is to be seen as truly independent. Examples include:

- Firms should not be overly dependent on the fee income from one client or group of connected clients. The code requires extra safeguards if income from a client exceeds 15% of gross practice income for two consecutive years. An audit firm should have procedures in place to ensure that existing clients do not go over this threshold.

- An audit firm should avoid auditing clients where a "close connection" exists with that client or with an officer or employee of the client. In addition, if an officer or employee is closely connected with a partner or member of staff of the audit firm then audits of that client should be avoided. Also, a person in an audit firm should not be involved in the audit of a client if he has been an officer or employee of that client up to two years previous to the audit.
- An audit firm should not audit a company in which it has a financial interest. Similarly, if a member of staff at the firm has a financial interest then he should not be involved in the audit.
- An audit firm or anyone closely connected with it should not, either directly or indirectly, give a loan to or guarantee borrowings by an audit client or accept a loan from such a client or have borrowings or other obligations guaranteed by such a client except the client is a loan-giving institution such as a bank, finance house, etc.
- Accepting goods, services or hospitality from a client can threaten or appear to threaten independence and these should be avoided unless clearly insignificant.
- An audit firm may provide other services, such as taxation, consultancy as well as audit services to a client. Although ICAN does not object to this in principle, it is stressed that the auditor should not participate in executive decisions, or perform management functions. Care should always be taken by any firm which is providing additional services to clients to ensure that it maintains its independence. Many of the larger auditing firms do this by having different departments with different staff who work on the different types of assignment.
- Independence could be put at risk where there is actual or potential litigation between the auditor and his client. It could be difficult for the auditor to report fairly and impartially on the client's financial statements and the client's management may be unwilling to disclose all relevant information.
- If an audit firm has an associated firm supplying other services e.g. insurance services, management consultancy, then it could be considered to influence the audit firm's actions when auditing a particular firm with a view to obtaining additional work for the associated firm. The audit firm should be aware of this threat to its independence and ensure that the situation is regularly reviewed to maintain objectivity. Factors that need to be considered include the closeness of the association and the degree to which the associate firm wants the audit firm to retain the client.
- If an auditor has to perform an asset valuation assignment for a client then they should ensure that they maintain their independence.
- If a member's view is requested on the appropriateness of an accounting standard, he should ensure that he has all the information that is necessary, as the opinion

may influence the auditorsô judgement. Furthermore, if a member is asked for a second opinion on the accounting treatment of items then he should ensure that he contacts the present auditor to obtain all necessary information and facts.

It is important to demonstrate Independence in order to:

- ❑ ensure credibility
- ❑ avoid liability
- ❑ avoid damage to firmsô reputation

(c) **Circumstances in which confidential clients' information may be disclosed**

The general rule is that clientsô information is confidential and may not be disclosed unless the client gives his permission. However, there are exceptions to this rule.

The auditor may be obliged to disclose clientøs information in the following circumstances:

- ❑ Where he is ordered to do so by a court order.
- ❑ Where he suspects his client to be undertaking activities such as drug trafficking, terrorism or money laundering.
- ❑ If, according to the Banking, Insurance, Insolvency and Financial Services legislation, the auditor considers that the client has been acting recklessly or is not a fit and proper person to be managing a business.
- ❑ If the auditor becomes aware of a suspected or actual non-compliance with laws and regulations. This will give rise to a statutory right or duty to report. He should report this to the proper authority immediately.

Even if the auditor is wrong in his suspicions, he will be protected against defamation claims by the client under the legal principle of ógeneral privilegeö. In such cases, he will have to prove that his suspicions are justified and should be able to provide relevant evidence to support his claim.

The auditor may *voluntarily disclose* relevant information in order to protect himself in legal proceedings, if authorised by statute, to sue for fees or when he considers it appropriate to report in the public interest in which case the following circumstances should apply:

- ❑ He must report to an appropriate authority.
- ❑ Members of the public are likely to be affected.

- The matter is serious and likely to be repeated.

In such circumstances, the auditor should also consider:

- The relative size of the amounts involved
- The extent of the likely financial damage
- The clientôs reasons for being unwilling to disclose the matters to the appropriate authority.

If a member is approached by any authority where prosecution is the main intention, he should act very carefully. He should seek legal advice before disclosing clientôs information and ascertain whether the enquirer has sufficient authority to request such information.

If the auditor discloses client information recklessly, then he will be in breach of his contractual duty of confidentiality and could be sued by the client.

EXAMINER'S REPORT

The question tests candidates' understanding in respect of ethical issues as contained in ICAN's Professional Code of Conduct and Guide for Members.

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

The commonest pitfall of some of the candidates was that they were writing on threats to independence rather than ways of ensuring independence.

Candidates need to prepare adequately before sitting for examinations and also read and interprete questions properly before attempting them.

SOLUTION 5

Specialists

(a) A specialist is an expert who is a knowledgeable person or firm that has acquired specialist knowledge and skills and obtained experience and competence in a discipline and is respected as one held in public reckoning, whose opinion on issues in their respective disciplines, is held to be authoritative and reliable as a basis for decisions on consequential matters. Examples of specialists include:

Legal practitioners, Forensic Accountants, Estate Surveyors, Medical Practitioners, Architects, Pharmacists, Quantity Surveyors, Mechanical, Electrical, Civil, Electronic Engineers, Actuarists, etc.

(b) The circumstances under which an auditor needs a specialist are:

(i) When he needs to express an opinion on areas that he has no skill or competence to resolve.

(ii) Where it is not convenient or appropriate for him to provide the required service.

The services of specialists could be required in the following circumstances:

- determining the outcome of a litigation
- valuation of assets ï e.g. buildings
- determining actuarial value of gratuities
- determining value of work of art and antiquity
- geological determination of mineral resources
- assessment of work done on long-term contracts

(c) The expert is expected to be a member of a recognized professional body or a Trade Group. He must be certified to render the service by an authoritative body and must have some years of experience. The auditor would need to consider the following:

- Qualification of the specialist
- Independence and
- Technical competence

To be objective, the specialist should not be employed by the client and must not be related to the client.

EXAMINER'S REPORT

The question tests candidates' understanding of the work of a specialist and how it relates to the work of the auditor.

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

The commonest pitfall among the candidates who did not do well was their inability to state precisely when an auditor may require the services of a specialist.

Candidates need to read and understand questions before attempting to answer them.

SOLUTION 6

Forensic Audit

(a) Forensic audit refers to the procedures carried out in order to obtain reliable and acceptable evidence for anticipated disputes or litigation. It involves the use of auditing and investigative techniques to identify and gather evidence. The forensic auditor is often required to act as an expert witness when matters are brought up in court.

(b) **Situations requiring the services of a forensic auditor include:**

(i) Theft and frauds
(ii) Bribery allegations
(iii) Tax evasion
(iv) Insider dealings
(v) Wrongful dismissals
(vi) Business interruptions
(vii) Property losses
(viii) Insurance claims
(ix) Personal liability claims
(x) Construction claims
(xi) Bankruptcies
(xii) Breach of contract
(xiii) Stock market manipulations
(xiv) Arson
(xv) Matrimonial divorce claims
(xvi) Investment scam
(xvii) Management/employee wrong doing
(xviii) Royalty audits
(xix) Expert witness testimony

(c) **Qualities of a forensic Auditor**

(i) Ability to identify fraud with minimal information

(ii) Identification of financial issues significant to the matter

(iii) Knowledge of investigative techniques

(iv) Knowledge of the rules of evidence in court

(v) Ability to interpret financial information

(vi) Ability to communicate findings in a language that is understandable by a layman

(vii) Possession of investigative skills

(viii) Possession of investigative mentality

(ix) Computer literacy

(d) **Differences between Forensic Audit and Financial Audit**

(i) Financial audit aims at giving an audit opinion on the financial statements while forensic audit aims at detecting material frauds and misstatements

(ii) Financial audit depends on examination of audit trail while forensic audit depends on examination of events and activities behind the documents

(iii) Financial audit is conducted strictly according to standards, guidelines and applicable legislations whereas no such restriction is placed on the scope of forensic audit

(iv) Financial audit is usually statutory whereas forensic audit is on ad hoc basis

(v) The financial auditor reports to members of the auditee while forensic auditor reports to the persons who appointed him

EXAMINER'S REPORT

The question tests candidates understanding of forensic audit.

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

The commonest pitfall of the candidates was that some misconstrued forensic audit to mean forex (bureau - de - change). Others who had some idea of the topic could not give detailed explanation.

Candidates are advised to cover the syllabus thoroughly before entering for examinations. They should also read the questions carefully and interprete it correctly before attempting it.

SOLUTION 7

CAATs

(a) (i) **Advantages of test data include**:

- They provide a positive assurance on the correct functioning of the program controls actually tested;
- They can be used on a continuing basis until the programs are changed;
- Once set up, running costs from year to year are low;

- They require less detailed knowledge of data processing; and
- They are cheap to install and easy to implement as their contents can be moderated at will.

(ii) **Disadvantages**

- The possibility of data files corruption where ólive ô test data is used
- It is time-consuming
- Where ódeadô test data is used, the auditor requires a reasonable assurance that the programs being used are those in normal processing
- Gives an indication of correct or improper functioning of controls only at the time of the test which may change thereafter.

(b) **Activities for which audit software may be used during substantive tests by the auditor include:**

(i) Re-perform calculations;

(ii) Select individual transactions for subsequent manual substantive tests;

(iii) Extract list of exceptional items;

(iv) Obtain information relevant to analytical review; and

(v) Used to scrutinize large volumes of data.

(c) **Advantages of the use of Audit Software**

(i) It can be used to analyse voluminous data.

(ii) The search is more accurate and faster than when software is not applied.

(iii) The running costs are usually low.

(iv) It can be used for other transactions

Disadvantages

(i) Has a high set-up cost.

(ii) Usually not available for small companies.

(iii) Requires considerable level of knowledge in data processing.

(iv) Consumes a lot of computer time which may not be acceptable to clients.

EXAMINER'S REPORT

The question tests candidates understanding of the use of audit software for audit assignments.

About 20% of the candidates attempted the question and performance was poor.

The commonest pitfall of the candidates was their lack of understanding of the use of audit software.

Candidates are enjoined to cover all aspects of the syllabus before writing future examinations.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL EXAMIANTION LEVEL – MAY 2015

CASE STUDY

Requirement

You are Adebo Muta, a newly qualified Chartered Accountant in Dawodu & Dawodu, a firm of Chartered Accountants. You are to prepare a draft report to Michael Jelili, the Finance Director of a client company, Ice Age Manufacturing Limited, as set out in the email **(Exhibit 1)** from Tola Dawodu, one of the Partners of the Audit service line of the firm Dawodu & Dawodu (Chartered Accountants). Your firm only provides consulting (non-audit) services to Ice Age Manufacturing Limited.

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	Email from Tola Dawodu, Partner in Dawodu & Dawodu (Chartered Accountants) to you, Adebo Muta.
2	Email from Michael Jelili, Finance Director of Ice Age Manufacturing Limited, your client, to Tola Dawodu.
3	2-year summarised financial statements of Ice Age Manufacturing Limited to 31 December 2014.
4	Notes, comprising a summary of significant accounting policies and other explanatory notes to the Ice Age Manufacturing Limited Financial statements.
5	Production information of Ice Age Manufacturing Limited.
6	Industry information.

EXHIBIT 1

Dawodu & Dawodu (Chartered Accountants)

Email

From: Tola Dawodu

To: Adebo Muta

Re: Ice Age Manufacturing Limited

Date: 21 April, 2015

We have received an email from Michael Jelili, the Finance Director of one of our clients, Ice Age Manufacturing Limited, which I have attached to this email (**Exhibit 2)** together with all the attachments which he sent to me (**Exhibits 3-6**).

The attachments include a summary set of Ice Age Manufacturing Limitedôs financial statements for the two years ended 31 December 2014 (**Exhibit 3**) together with notes, comprising a summary of significant accounting policies and other explanatory notes to the financial statements (**Exhibit 4**).

The Finance Director of Ice Age Manufacturing Limited in his email expresses his concern about the deteriorating financial and liquidity position of the company. He is of the view that the worsening general economic condition, rise in inflation and interest rates, and changing consumer preferences have resulted in a drastic reduction in demand ï the details of the production information are shown in **Exhibit 5**. The Finance Director has also sent an extract of a report on Ice Age Manufacturing Limited which was posted recently on a widely read and subscribed online blog **(Exhibit 6).**

After a long phone call with the Finance Director today, an agreement has been reached to prepare a report identifying any weakness and lapses in its value chain and suggesting ways to overcome them. The Finance Director is also of the view that some of the losses suffered were either avoidable or manageable and would like some advice on risk management strategies.

Required

Using the attached information, prepare a draft report to Michael Jelili. Your report should comprise:

1. An analysis of the value chain of the business and operational strengths and weaknesses as shown in the information provided in the case. You are expected to use the Porter's Value Chain model (or a similar appropriate model) for your analysis.
   Your analysis should only focus 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; and

2. Analysis of the financial situation of Ice Age Manufacturing Limited. Your analysis should take into consideration all the concerns raised by Michael Jelili in his email (Exhibit 2). You are also expected to advise on the possible sources of obtaining financing open to the client, giving your views on the most appropriate with reasons for or against each source of finance.

EXHIBIT 2

ICE AGE MANUFACTURING LTD

Email

From: Michael Jelili

To: Tola Dawodu

Re: Business and Financial Situation

Date: 19 April, 2015

Dear Tola Dawodu,

Please find attached a summary set of Ice Age Manufacturing Limitedôs financial statements for the two years ended 31 December, 2014, together with a set of explanatory notes to the financial statements. The figures in these financial statements are unaudited but I am of the view that they will give you a strong indication of our financial performance, financial position and cash flows for the years presented. There has been an unresolved issue with the auditors since the last reporting period and at this time I am of the view that we can get the audit carried out as soon as the auditors agree to see things our way.

Ice Age Manufacturing Limited– Supplier Relationship

Ice Age is currently undergoing temporary difficulties in its production function. However, the issues are not of serious concern because I am confident we will turn this around very soon. Our suppliers are in very good terms with us and are willing to continue the good business relationship we have built up over the years. A particular supplier who also supplies our major competitors have proved a bit difficult to deal with and we are considering switching to a new supplier as soon as we improve our economic situation. Our reliance on this supplier for a large percentage of our raw materials has proved a bit difficult especially when the supplier experiences unforeseen delays and/or when we have minor óshort-termô liquidity issues.

Ice Age Manufacturing Limited– Production Unit

Our production unit has been undermanned lately and we have failed to hire new hands simply because we are in the process of downsizing. Cost cutting at this time is very critical to our survival. The minimum wage law put in place by the government is unrealistic and in my opinion not sustainable. We have been able to pay below the minimum wage in the past with very little convincing needed for employees because the level of unemployment is quite high. I have attached some production information **(Exhibit 5)** for your use and would be happy to provide more information should you require. As you would notice, our material price variance has improved but this is mainly because we were able to get other smaller suppliers to sell some raw materials needed at a bargain price. The quality was not as good and one is not sure if it meets the required certification standard but it should do for the time being since our customers are not complaining yet.

Ice Age Manufacturing Limited– Distribution and Sales Network

As you know, we have been quite successful in our early years because we were able to reach the customers in any part of the country. In my opinion, our distribution network is still the best around as we partner with registered transporters to ensure that we have a wider geographical coverage. Recently, I have noticed that there have been unexpected coverage delays which have gone unreported and we are unable to bring all of these under control. I think it is important if we remain in control of our distribution network, it would be easier to manage and any gap can immediately be bridged. Our competitors use registered distributors but we are yet to open up to this idea.

There are a lot of decision makers within Ice Age who are óstuck in their old waysô and are very slow to consider new ideas. A simple example would be the lack of an automated inventory/sales system. A lot of information (for possible cost savings) slips through our fingers unnecessarily.

Ice Age Manufacturing Limited– People

Our company at start- up invested in highly skilled workforce but recently quite a few have left for similar organisations within our industry. A few argue that they are paid better and an appropriate work/life balance is struck. The mention of a salary/wage rise is considered a taboo at Ice Age Manufacturing and I am particularly worried that we might lose our best hands in the sales/marketing, finance and production departments. Investment in staff training has been halved three years ago. This in my opinion has affected basic customer relationships. Recently a potential major customer was told that after sales service was to be paid for when we have a well-advertised policy of free after sales service for three (3) months after purchase. The customer sourced his products elsewhere.

Ice Age Manufacturing Limited– Financing

Ice Age Manufacturing Limited recently issued a 6% Corporate Note at a par value of ₦8million naira. There were issue costs of ₦500,000. I made a decision to charge the contractual rate of 6% as finance costs to the income statement because I think it is the logical thing to do. We are in dire need of additional finance but cannot afford to raise additional loan finance at this time.

Instructions

The Board of Ice Age Manufacturing Limited would like your firm to:

1. Analyse the value chain of Ice Age Manufacturing Limited and advise on the strengths and weaknesses and how this can be managed; and
2. Analyse the financial situation of Ice Age Manufacturing and advise on the suitable ways to overcome its current situation. Our company would also like some Financial Reporting advice on the Corporate Note as raised in my email.

I look forward to receiving your report in the near future.

Yours Sincerely,

Michael Jelili

Finance Director, Ice Age Manufacturing Limited.

Exhibit 3

Ice Age Manufacturing Limited 2 - Year Financial Summary (to 31 December, 2014)

Ice Age Manufacturing Limited

Extracts from summary financial statements for the 2 years ended 31 December, 2014

Statement of profit or loss

Year ended 31 December		**2014**	**2013**
	Notes	**₦'000**	**₦'000**
Revenue	**1**	**10,900**	**8,560**
Cost of sales	**2**	(7,630)	(5,821)
Gross profit		**3,270**	**2,739**
Administrative expenses	**3**	(1,566)	(1,135)
Distribution expenses	**4**	(1,089)	(805)
Operating profit		**615**	**799**
Finance costs		(480)	(480)
Profit before tax		**135**	**319**
Tax expense		(40)	(96)
Profit from continuing operations		**95**	**223**
Profit from discontinued operations		-	-
Profit for the year attributable to equity shareholders		**95**	**223**

Ice Age Manufacturing Limited
Statement of financial position
As at 31 December

	Notes	2014	2013
		₦'000	**₦'000**
ASSETS			
Non-current assets:			
Property, Plant & Equipment		24,260	20,560
Intangible assets		3,000	3,000
Investment Property	**5**	7,500	7,500
		34,760	31,060
Current assets:			
Inventories	**6**	2,485	1,950
Trade and other receivables		5,300	1,375
Cash and short-term deposits		40	2,300
		7,825	5,625
Total assets		**42,585**	**36,685**
EQUITY AND LIABILITIES:			
Equity:			
Ordinary share capital	**7**	20,000	20,000
Retained earnings		600	505
Total shareholders' equity		20,600	20,505
Non-current liabilities:			
Financial liabilities ï Long-term borrowings	**8**	12,520	13,000
Deferred tax liability		2,750	1,200
Total non-current liabilities		15,270	14,200
Current liabilities:			
Trade payables		5,830	1,115
Tax liability		885	865
Total current liabilities		6,715	1,980
Total shareholders' equity and liabilities		**42,585**	**36,685**

Ice Age Manufacturing Limited

Statement of Changes In Equity

December 2014

	Ordinary Shares	Share Premium	Retained Earnings	Total Equity
	₦'000	**₦'000**	**₦'000**	**₦'000**
As at 31 December, 2013	**20,000**	**-**	**505**	**20,505**
				-
Issue of Share Capital	-	-	-	-
Profit for the year	-	-	95	95
Revaluation of PPE	-	-	-	-
Dividends	-	-	-	-
				-
31 December, 2014	**20,000**	**-**	**600**	**20,600**

December 2013

As at 31 December, 2012	**20,000**	**-**	**282**	**20,282**
				-
Issue of Share Capital	-	-	-	-
Profit for the year	-	-	223	223
Revaluation of PPE	-	-	-	-
Dividends	-	-	-	-
				-
31 December, 2013	**20,000**	**-**	**505**	**20,505**

EXHIBIT 4

ACCOUNTING POLICIES AND NOTES TO THE FINANCIAL STATEMENTS

Year ended 31 December, 2014

Accounting Policies

Basis of preparation

The companyǒs financial statements have been prepared on a historical cost basis. They are presented in Naira and all values are rounded to the nearest thousand (₦'000) except where otherwise indicated.

The financial statements of Ice Age Manufacturing Limited have been prepared in accordance with IFRS.

Property, plant and equipment (PPE)

PPE is stated at cost less accumulated depreciation and any impairment losses.

Depreciation is calculated to write off the cost (less residual value) of PPE, excluding freehold land, on a straight-line basis over the estimated useful lives of the assets as follows:

Freehold buildings: 30 years

Office equipment: 5 years

Plant and equipment: 10 years

Motor Vehicles: 4 years

Borrowing costs

Borrowing costs directly attributable to the acquisition, construction or production of an asset that necessarily takes a substantial period of time to get ready for its intended use are capitalised as part of the cost of the respective assets.

All other borrowing costs are recognised as an expense in the period they occur.

Inventories

Inventories are measured at the lower of cost and net realisable value. Cost includes the purchase price of raw materials (on a FIFO basis), direct labour and a proportion of manufacturing overheads, based on normal operating capacity, incurred in bringing each product to its present location and condition.

Revenue

Revenue on sale of products is recognised on delivery. Revenue comprises the invoiced value for the sale of goods net of value added tax, rebates and discounts.

Financial assets

The Group and Company classify financial assets that are within the scope of IAS 39 as:

- financial assets at fair value through profit and loss;
- available-for-sale financial assets;
- held-to-maturity investments; and
- loans and receivables.

The company determines the classification of financial assets at initial recognition and re-evaluates this designation at each financial year-end. When financial assets are recognised initially, they are measured at fair value. The company currently holds only loans and receivables.

Notes to the Financial Statements

Ice Age Manufacturing Limited
Notes to the Financial Statements

1 Revenue

	2014	2013
	₦'000	**₦'000**
Gross Revenue	12,674	9,407
Returns	(1,774)	(847)
Net Revenue	**10,900**	**8,560**

2 Cost of sales	**2014**	**2013**
	₦'000	**₦'000**
Inventories at 1 Jan	1,950	3,120
Purchases	8,165	4,651
Inventories at 31 Dec	(2,485)	(1,950)
Cost of sales	**7,630**	**5,821**

3 Administrative expenses	**2014**	**2013**
	₦'000	**₦'000**
Personnel costs	650	600
Depreciation & amortisation	450	140
Rent & rates	312	280
Repairs & maintenance	65	43
Internet and telephone	39	22
Insurance	50	50
	1,566	**1,135**

4 Distribution expenses	**2014**	**2013**
	₦'000	**₦'000**
Sales commission	769	605
Other distribution costs	320	200
	1,089	**805**

Investment property	**2014**	**2013**

5

	₦'000	₦'000
	7,500	7,500

Investment Property is accounted for under the fair value model under IAS 40 (Investment Property).

At year end, the value of investment property had fallen by 30%. This has not been reflected in the financial statements as Management is of the view that the fall in value is only temporary and it is expected to reverse in the next accounting period.

6 **Inventories**	**2014**	**2013**
	₦'000	**₦'000**
Raw materials & consumables	1,740	1,365
Finished goods	746	585
	2,486	**1,950**

7 Share capital

The Ordinary share capital is represented by 20 million ordinary shares at ₦1 per share. There were no new issues during the year.

8 Financial liability

The financial liability is represented by the 6% ₦8m Corporate Loan Notes issued during the year. The issue was at a discount of ₦500,000. The effective interest rate was determined to be 8%.

Exhibit 5

Ice Age Manufacturing Limited

Production Information

	2014	**2013**
Production (units)	20,000	21,800
Demand (units)	18,770	19,600

Material Cost (per unit) in Naira

	2014	2013
	₦	₦
Standard cost	190.00	195.00
Actual cost	171.50	176.00

EXHIBIT 6

Industry Information- Industry Mean Ratios

Return On Equity(ROE)	7.10%
Gross profit margin	43.00%
Net profit margin	9.60%
Current ratio	1.9: 1.0
Inventory turnover period	62 days
Payablesô turnover period	50 days
Gearing ratio (Debt/Equity)	30%

ICAN CASE STUDY 2015

SUMMARY OF SCORES

DATE		MARKERôS NUMBER	

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

SUPERVISORôS SIGNATURE		CHECKERôS SIGNATURE	

Changes made? ☐

<u>NOTE:</u>

S.A = Superior achievement

C.A = Competent achievement

B.C = Below competent achievement

N.C = Non-competent achievement

V = Void

REQUIREMENT 1- Value Chain Analysis

USES DATA AND INFORMATION APPROPRIATELY • Uses (Ice Age Manufacturing Limitedôs (IAMLôs) financial statements - Profit or loss statement - Statement of financial position • Uses notes on IAMLôS financial statements (Exhibit 4) • Uses information in email from IAML (exhibit 2) • Identifies wider context for IAMLôs business - A non-listed company (market expectations)	**USING ANALYTICAL SKILLS** • Identifies the inbound logistics issues • Identifies the operational issues • Identifies the outbound logistic issues • Identifies the marketing and sales issues • Identifies the service (after sales) issues
USES PROFESSIONAL TOOLS AND KNOWLEDGE • Recognises the Value Chain Model • Considers the primary activities of the model. • Considers the support activities of the model • Applies the model using information from the case to determine the companyôs strengths and weaknesses	**IDENTIFYING ISSUES AND OPTIONS** • Identifies that the model may have its limitations • Identifies the possibility of passing increased production costs(due to inflation) to customers • Identifies the possibility of advertisement to regain customer attention. • Identifies the possibility of modifying products to suit changing consumer preferences. • Identifies the need for a proper customer and competitor analysis

APPLYING PROFESSIONAL SCEPTICISM AND ETHICS • Identifies that the information provided by the Finance Director may not be accurate. • Identifies other possible sources of getting more information. • Identifies the ethical issues in the case • Identifies the risk of supplier replacement	**CONCLUSIONS** • Draw distinct conclusions under a heading • Concludes on the overall business model • Concludes on cash flow/ liquidity and management. • Concludes on possible effect on external factors (positive and /or negative) • Concludes on the possible use of other business analysis models to properly analyse the external environment, e.g PESTEL,SWOT, etc.
EVALUATIVES SKILLS AND JUDGEMENT • Recognises the possible need for hiring and retaining higher skilled staff • Recognises the possible lack of integrity of IAMLôs management (conflict with auditors) • Recognises the need for good Customer Relationship Management (CRM) • Recognises the danger inherent in using low quality materials	**RECOMMENDATIONS (commercial/relevant) to include the need for:** • Better Customer Relationship Management • Adequate economic and business planning • Negotiation and better management of relationship with suppliers • Consideration of other possible targets (untapped) markets to improve sales • Using output of the Value Chain model to identify and minimize weaknesses • Consideration of the external environment

REQUIREMENT 2- Analysis of IAML's Financial Statements.

USES DATA AND INFORMATION APPROPRIATELY • Uses IAMLôs Financial Statements - Profit or loss statement - Statement of financial position • Uses notes on IAMLôS financial statement • Uses information in email from IAML (Exhibit 2) • Identifies wider context for IAMLôS Business /economic environment •	**USING ANALYTICAL SKILLS (Material points) written report** • Increasing revenue trends discussion. (Positive despite all the difficulties faced as raised in the case) • IAML trends: absolute increase; % decrease (discuss) • Increase in payables, receivables and inventory discussion. Justify • Profit after tax discussion (net income analysis) dropped by 57% • Sources of finance-discussion
USES PROFESSIONAL TOOLS AND KNOWLEDGE • Analyses revenue trend and changes (absolute and %) • Analyses profit (gross and net) changes in absolute and % terms • Analyses inventory increase/decrease in absolute and % terms • Analyses changes in profit before and after tax in absolute and % terms • Analyses liquidity/cash flow in absolute and % terms. • Analyses possible(viable) sources of finance for IAML	**IDENTIFYING ISSUES AND OPTIONS** • All figures should be discussed in the context of the case • Comparison with prior year and industry mean • Need to justify increase in payables, receivables and inventory in the context of a struggling economy • Need to discuss factors affecting operating profit (OP) and net profit (NP) in the context of increasing gross profit (GP)% • Need to identify high gearing as reason why debt finance may not be a suitable/viable option • Need to discuss falling return on equity/net profit as a cause for concern to shareholders

APPLYING PROFESSIONAL SCEPTICISM AND ETHICS	CONCLUSIONS
• Identifies the fact that unaudited financial statements are less reliable • Identifies unresolved issues with external auditors. • Identifies the perceived lack of integrity of management and the effect on relationships with customers/suppliers/bankers/general public etc. • Identifies the possibility of withheld/incomplete information	(Draws distinct conclusions under a heading) • Concludes on slight revenue trend; growth and possible positive indicator • Concludes on gross profit/ net profit trend; variable/declining but substantial • Concludes on payables, receivables and inventory • Concludes on sources of finance-e.g equity (loss of control and valuation issues), sale and leaseback under an operating lease (no additional effect on gearing), invoice discounting and debt factoring. • Concludes on sources of finance that minimize financial risk while providing the much needed cash injection.

EVALUATIVE SKILLS AND JUDGEMENT	RECOMMENDATIONS (commercial/relevant)
(uses analytical headings) • Revenue increases largely caused by individual customer increase? Or inflation? • Justifies gross profit trend: absolute increase (good) - Hard to increase gross profit % and absolute revenue together. • Operating profit and net profit decrease in absolute terms: - Decrease in % medium/long terms? - What other factors have been considered? • Identifies the increase in the following: - Accounts receivable(dumping goods on customers with relaxed credit terms?) - Possible impaired receivables - Accounts payable ï suppliers concern - Inventory-good sign for the future? Or unable to sell the inventory?	• Understands and rehearses IAMLõs financial statements analysis. Emphasizes the positive aspects of the analysis to current and potential providers of funds. • Discusses that IAML must appreciate and manage less positive elements of its operations: - Decline in profitability in % - Decline in customer demand - Staff turnover and the financial implication of recruiting and retaining new/qualified staff • Discusses the need for IAML to control all the components of its working capital. • Discusses the need for IAML to operate budgets and adhere to the budget for self monitoring and control.

Appendices		Main Report
Appendices R1: Content and style • Tabulated and mix of numbers and percentages (%) • Performance (P&L) analysis and trends for		**Report: Structure** • Sufficient appropriate headings • Appropriate use of paragraphs/sentences

IAML

- No unnecessary immaterial detail
- Shows Porterøs Generic Value Chain diagram

V	NC	BC	CA	SA

Appendices R2: Content and style

- Logical approach and numbers clearly derived.
- Analysis of changes in IAMLøs financials for 2013 and 2014.
- Well presented ratios analysis
- Calculates financial liability balance for IAML
- Calculates Investment property balance for IAML

V	NC	BC	CA	SA

- Legible
- Correctly numbered pages

V	NC	BC	CA	SA

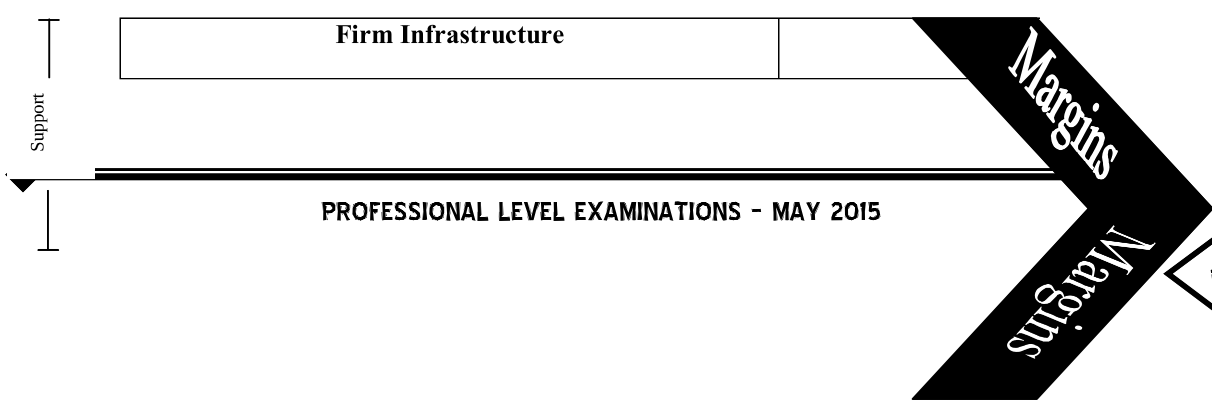
Report: Style and language

- Relevant disclaimer (external report)
- Suitable language for the board
- Tactful/ethical comments
- Acceptable spelling and punctuation

V	NC	BC	CA	SA

Appendix 1

Figure 1 : Porterøs Generic Value Chain



Human Resource Management				
Technology Development				
Procurement				
Inbound Logistics	Operations	Outbound Logistics	Marketing& Sales	Services

Primary Activities

Appendix 2

COMPUTATION OF RATIOS

	2014	**2013**	**% CHANGE**	**Ind mean**
Ratio				
ROE	0.46%	1.09%	- 57.80%	7.10%
Gross profit margin	30.00%	32.00%	-6.25%	43.00%
Net profit margin	0.87%	2.61%	-66.7%	9.60%
Current ratio	1.17	2.84	-58.80%	1.9
Inventory turnover period	118.88	122.28	-2.78%	62
Payablesô turnover Period(using cost of sales)	278.89	69.92	298.87%	50
Payable turnover period (using purchases)	260.62	87.50	197.85%	
Gearing ratio	60.78	63.40	-4.13%	30

	2014	**2013**	**% CHANGE**
Net income	95	223	-57.40%
Equity	20,600	20,505	0.46%
Gross profit	3,270	2,739	19.38%
Revenue	10,900	8,560	27.34%
Current assets	7,825	5,625	39.11%
Current liabilities	6,715	1,980	239.14%
Inventory	2,485	1,950	27.44%
Cost of sales	7,630	5,821	31.08%
Trade payables	5,830	1,115	422.87%
Long term debt	12,520	13,000	-3.69%
Capital employed	33,120	33,505	-1.15%
Assets	42,585	36,685	16.08%
Operating profit	615	799	-23.05%

Appendix 3

Amortised Cost Table for Financial Liability (IAS 39)

Cash Flow	Opening Balance	Interest Expenses (8%)	Interest paid	Closing Balance 2014
7,500	7,500	560	480	7,580

Investment Property (IAS40)

Year	**Opening Balance**	**Impairment During the year**	**Closing Balance**
2014	₦7,500,000	₦2,250,000	₦5,250,00

Appendix 4.

Computation of Price Variances for 2013 and 2014 based on production units

Material price variance = Actual production x (Actual price ï standard price)

2013 = 21,800 (₦176 ï ₦195)

= 21,800 X ₦19

= N414,200 Favourable

2014 = 20,000 (N171.50-N190)

= 20,000 x N18.50

= N370,000 favourable

Examiner's Report

The case study is on a company facing problems in its operations and in raising funds. The narratives show the strengths and weaknesses in the company's processes and financials.

The Candidates were expected to:

- **carry out the business analysis of the company using Porter's Value Chain Model and/or any other appropriate model; and**

- **carry out financial analysis of the company by using ratios and trend analysis showing changes in absolute and percentage terms.**

Based on the above analyses, the candidates were to write a draft report to the company's board showing the strengths and weaknesses of the company and proffering solutions on how best to ameliorate the weaknesses and leverage on its strengths. The candidates were also required to point out any ethical issues in the company.

The candidates' performance was not encouraging as only about 30% of the candidates scored 50% and above.

The candidates' commonest pitfalls were:

- **Inability to write a business advisory report properly structured and numbered with appropriate appendices;**
- **Inadequate understanding and interpretation of Porter's Value Chain Model; and**
- **Inability to appreciate the uses of the tools for business and financial analysis studied at the skill level.**

Candidates are therefore advised to study and understand the various strategic and financial analysis models in the Institute's syllabus. They should also remember that all the tools previously studied at the skill level of the Institute's examinations will be needed to carry out the analysis required in Case Study examination. Candidates should also improve on their report writing skills.