

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA



PATHFINDER

MAY 2016 PROFESSIONAL EXAMINATION

Question Papers
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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL

CORPORATE REPORTING

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

SECTION A

COMPULSORY

(30 Marks)

QUESTION 1

Given that accrual accounting tends to mask actual cash flow performance, stock analyst and rating agencies are generally more interest in cash flow. The directors of Joy-land Plc, have called for the cash flow statement of the group so as to have a view of earnings performance devoid of accruals. The following draft group financial statements relate to Joy-land Plc.

Joy-land Plc Group: Statement of financial position as at November 30

	2015	2014
	N'm	N'm
Assets		
Non-current assets	1,308	1,016
Property, plant and equipment	32	24
Investment property	192	272
Goodwill	340	288
Intangible assets	216	-
Investment in associate	<u>376</u>	<u>360</u>
Available for-sale financial assets	<u>2,461</u>	<u>1,960</u>
Current assets		
Inventories	420	512
Trade receivables	248	452
Cash and cash equivalents	<u>928</u>	<u>572</u>
	<u>1,596</u>	<u>1,536</u>

Total assets	4,060	3,496
Equity and liabilities		
Equity attributable to the owners of the parent:		
Share capital	1,160	1,100
Retained earnings	1,404	1,296
Other components of equity	<u>60</u>	<u>80</u>
	2,624	2,476
Non-controlling interest	<u>220</u>	<u>144</u>
	<u>2,844</u>	<u>2,620</u>
Non-current liabilities		
Long term borrowings	268	282
Deferred tax	140	164
Long term provisions – pension	<u>100</u>	<u>88</u>
Total non-current liabilities	<u>508</u>	<u>536</u>
Current liabilities		
Trade payables	576	220
Current tax payable	<u>132</u>	<u>120</u>
Total current liabilities	<u>708</u>	<u>340</u>
Total liabilities	<u>1,216</u>	<u>876</u>
Total equity and liabilities	<u>4,060</u>	<u>3,496</u>

Joy-land Group: Statement of comprehensive income for the year ended November 30, 2015.

	₦'m
Revenue	1,728
Cost of sales	<u>(1,268)</u>
Gross profit	460
Distribution costs	(222)
Administrative expenses	(144)
Other income	100
Operating profit	194

Finance cost paid	(18)
Gains on property	36
Share of profit of associate	<u>24</u>
Profit before tax	236
Income tax expense	<u>44</u>
Profit for the year	192
Other comprehensive income	
Items that will not be re-classified to profit or loss	
Losses on property revaluation	<u>(28)</u>
Actuarial losses on defined benefit plan	<u>(24)</u>
Total items that will not be classifies to profit or loss	(52)
Items that may be reclassified to profit or loss	
Gain on available for sale financial assets (AFS)	8
Other comprehensive income for the year, net of tax	<u>(44)</u>
Total comprehensive income for the year	<u>148</u>
Profit attributable to:	
Owners of the parent	152
Non-controlling interest	<u>40</u>
	<u>192</u>
Total comprehensive income attributable to	
	N'm
Owners of the parent	108
Non-controlling interest	<u>40</u>
	<u>148</u>

Joy-land Group: Statement of changes in equity for the year ended November 30, 2015

	Share	Retained	AFS	Revaluation	Total	NCI
		Earnings	Financial	Surplus		
	N'm	N'm	Assets	PPE	N'm	N'm
Balance 1 Dec 2014	1,100	1,296	16	64	2,476	144
Share capital issued	60				60	
Dividends		(20)			(20)	(52)
Right issue						8
Acquisition						

Total comp. inc for the year		128	8	(28)	108	40
Balance Nov 30, 2015	1.160	1.404	24	36	2.624	220

The following additional information relates to the financial statements of Joy-land

- (i) On December 1 2013, Joy-land acquired 8% of the ordinary shares of Talk-peace. Joy-land had treated this investment as available for sale in the financial statement to November 30, 2014. On December 1, 2014. Joy-land acquired a further 52% of the ordinary shares of Talk-peace and gained control of the company, the consideration for the acquisitions was as follows:

	Holding	Considerations N'm
December 1, 2013	8%	16
December 1, 2014	<u>52%</u>	<u>120</u>
	<u>60%</u>	<u>136</u>

At December 1, 2014 the fair value of the 8% holding in talk peace held by Joy-land at the time of the business combination was ~~N~~20 million and the fair value of the non-controlling interest in Talk-peace was ~~N~~80million. no gain or loss on the 8% holding in Talk-peace had been reported in the financial statement at December 1, 2014, the purchase consideration at December 1, 2014 comprised cash of ~~N~~60 million and share of N60million.

The fair value of identifiable net assets of Talk-peace at the date of acquisition comprised the following:

	N'm
Property, plant and equipment	50
Intangible assets	52
Inventories	30
Trade receivables	20
Cash	28

- (ii) Goodwill relating to all subsidiaries had been impairment tested in the year to November 30, 2015 and any impairment accounted for. The goodwill impairment related to those subsidiaries which were 100% owned.

- (iii) Joy-land purchase a research project from a third party including certain patents on December 1, 2014 for ₦32million and recognised it as an intangible asset, which is acceptable under IAS 38. During the year, Joy-land incurred further costs, which included N8million on completing the research phase. ₦16million in developing the product for sale and N4million for the initial marketing costs. The initial marketing cost has correctly been accounted for. there were no other additions to intangible assets in the period other than those on the acquisition of Talk-peace.
- (iv) On November 30, 2015, Talk-peace made a rights issue on a 1 for 4 basis. The issue was fully subscribed and raised ₦20million in cash.
- (v) Joy-land owns an investment property. During the year, part of the air-conditioning system of the property, which had been a carrying value of ₦2million, was replaced by a new system, which cost ₦4million. Joy-land uses the fair value model for measuring investment property.
- (vi) Joy-land sold off surplus land with a carrying amount of N40 million for cash of ₦60million and in addition accepted plant valued N16million as part of the disposal agreement with the buyer. Necessary accounting entry had already been passed for this, resulting in the gain on property shown in the income statement above. Depreciation for the year to November 30, 2015 for property, plant and equipment was ₦108million.
- (vii) Although, Joy-land Plc has a contributory pension in line with Pension Act 2004, it also operates a defined benefit scheme for few elected top executives and expatriates which figures for the current year as follows:

	₦'m
Balance at the beginning, December 1, 2014	88
Charge to profit or loss for the year	16
Pension contributions paid during the year	(28)
Actuarial loss to other comprehensive income	<u>24</u>
Balance at the end, November 30 2015	<u>100</u>

- (viii) The associate company did not pay any dividends in the year.
- (ix) Deferred tax of ₦40million arose on the gains on available for sale investments in the year.

Required

- (a) As the CFO of the group, briefly explain to the legal and engineer directors what is meant by earnings management giving **TWO** examples of how accruals could be employed in the earning management. (3 marks)

- (b) Determine the goodwill arising on the acquisition of the subsidiary on December 1, 2014 and total goodwill impairments of the group as at November 30, 2015 statement of cash flow on the assumption that it is the policy of Joy-land Plc to value Non-controlling interest at full fair value. (3 marks)
- (c) Prepare a consolidated statement of cash flows for the Joy-land Group for the year ended November 30, 2015 using the indirect method under IAS 7 'statement of Cash flow.

Note; Ignore deferred taxation other than where is mention in the question.

(Total 30 Marks)

SECTION B: ANSWER TWO OUT OF THREE QUESTIONS IN THIS SECTION (40 Marks)**QUESTION 2**

Ehis Marvel, a public company, is a high street retailer that sells clothing and food. The managing director is very disappointed with the current year's result. The company expanded its operations and commissioned a famous designer to restyle its clothing products. This has led to increased sales in both retail lines, yet overall profits are shown.

Extract from the Income Statement for the two years to March 31 2016 are shown.

Income statements	Year to March 31, 2016		Year to March 31, 2015	
	₦'000	₦'000	₦'000	₦'000
Revenue -clothing	16,000		15,600	
- food	<u>7,000</u>	23,000	<u>4,000</u>	19,600
Cost of sales- clothing	14,500		12,700	
- food	<u>4,750</u>	<u>(19,250)</u>	<u>3,000</u>	<u>(15,700)</u>
Gross Profit		<u>3,750</u>		<u>3,900</u>

Ehis Marvel Plc – Statement of cash flow for the year to March 31, 2016

₦'000 ₦'000

Note: figures in brackets are ₦'000

Cash flow from operating activities:	700
Net Profit before tax	
Adjustment for:	
Depreciation - non-current assets	3,800
Loss on disposal of fixtures	1,250
Interest expenses	<u>300</u>
Operating profit before working capital changes	6,050
Increase in inventory (2,900 - 1,500)	(1,400)
Increase in trade receivables (100 - 50)	(50)
Increase in trade payables (3,100 - 2,150)	<u>950</u>
Cash generated from operations	5,550
Interest paid	(300)
Income tax paid	<u>(480)</u>
Net cash from operating activities	4,770

Cash flow from investing activities:

Purchase of property, plant and equipment	(10,550)	
Disposal cost of fixtures	<u>(50)</u>	<u>(10,550)</u>
		(5,780)

Cash flows from financing activities:

Issue of ordinary shares (2,000 + 1,000)	3,000	
Long term loans (3,000 - 1,000)	2,000	
Equity dividend paid	<u>(600)</u>	<u>4,440</u>
Net decrease in cash and cash equivalents		(1,380)
Cash and cash equivalents at beginning of period		450
Cash and cash equivalents at end of period		<u>(930)</u>

The following ratios have been calculated:	2016	2015
Returns on capital employed	9.3%	33.9%
Net assets turnover	2.1 times	3.3 times
Gross profit margin		
- clothing	9.4%	18.6%
- food	32.1%	25%
Net profit (after tax) margin	2.0%	7.1%
Current ratio	0.71.1	0.71.1
Inventory holding period		
- clothing	68 days	39 days
- food	15 days	17 days
Accounts payable period	59 days	50 days
Gearing	28%	17%
Interest cover	3,3%	25 times

The following information is relevant

(i) The floor areas (in squares metres) occupied were: March 31,

	2016	2015
Clothing	48,000	35,000
Food	<u>6,000</u>	<u>5,000</u>
	<u>54,000</u>	<u>40,000</u>

- (ii) The share price of Ehis Marvel Plc averaged N6.00 during the year to March 31, 2015, but was only N3.00 at March 31, 2016.

Required:

Write a report analysing the financials of Ehis Marvel Plc, utilising the above ratios and the information in the statement of cash flows for the two years ended March 31, 2016. Your report should refer to the relative performance of the clothing and food sales and be supported by any further ratios you consider appropriate.

(Total 20 Marks)

QUESTION 3

Limelight, a public limited company, is a major player in commodity brokerage and supplies. The following transactions relate to the year ended December 31, 2014. Profit before taxation for the year was N487.5m. Taxable profit for the same period was N131.25m. The balances of non-current assets of the company, at December 31, 2014.

	N'000
Accounting carrying amount	937,500
Tax written down value	637,500

The balances above do not include a freehold building purchase in February 2014 for N750m. This building was revalued to N985m on December 31, 2014. Accrued rental income on investment property at December 31, 2014 amounted to N9.75m. This income was credited to statement of profit or loss as at year end but was not received until three months after. Rental income is taxed by the Federal Inland Revenue Service on actual basis when it is received.

No other temporary differences exist at December 31, 2104, income tax and Withholding taxes on rental income are paid at 30% and 10% respectively six months after the year.

Required:

- a) Discuss the conceptual basis for the recognition of deferred taxation by Limelight Plc using the temporary difference approach in accordance with IAS 12, arising from the above transactions.
- b) (i) Outline how the above transactions should be accounted for using journal entries where appropriate, and
- (ii) Calculate the provision for deferred tax after any necessary adjustments to the financial statements at December 31, 2014, use journal entries

QUESTION 4

- a) LALUPON Plc was incorporated on January 3, 2010 in Nigeria with ₦250m authorized and fully paid share capital. As part of its initial capital, the company issued a 10% debenture bond. It also agreed to the appointment of a trust manager who was charged with the responsibility that the bond indentures is faithfully kept. The indentures among others provided for:
- Bond amount ₦100m (2020)
 - Yearly payment of interest and principal due
 - Crystallization of the whole loan (Principal and interest and all incidental expenses) on default.
 - Discretionary waiver of any term of the bond only at the instance of the bond holder.

On January 4, 2013, the Trust manager informed the bond holder of a default in servicing the loan. After a meeting of all stakeholders. The bond holder agreed to a waiver postponing the payment till December, 2014. On June 3, 2014 because of the down turn in business activities LALUPON Plc felt a further waiver was required. After another round of a meeting, the bond holder consented to a waiver till December 2015, when LALUPON Plc was confident it could make the payment. On December 31, 2014, LALUPON Plc classified the loan as long-term debt in its statement of financial position on the basis that the loan was not in default at the end of their reporting period as the bond holder had issued waivers and had not sought redemption.

Required:

Discuss. How the above events should be accounted for in the financial statements of LALUPON (6 Marks)

- b) LALUPON Plc owns a piece of land in a residential area. PONJEB Ltd has leased the piece of land from LALUPON Plc using it to store and dispense gas. The Federal government has announced its intention to enact environmental legislation requiring property owners to accept liability for environmental pollution. As a result, LALUPON Plc introduced a hazardous policy and has begun to apply the policy to its properties.

LALUPON Plc has had a report of a gas leakage and subsequent fire outbreak which damaged surrounding properties but no life was lost. LALUPON Plc, has no right of recourse against PONJEBE Ltd or its insurance company for the clean-up and compensations to owners of properties destroyed. At April 30, 2014, it is virtually certain that draft legislation requiring a clean-up of the land and payment of compensations to victims will be enacted.

Required:

Discuss how the above events should be accounted for in the financial statements of LALUPON Plc. (6 Marks)

- c. On May 1, 2011, Yerokun limited granted 500 share appreciation rights (SARs) to its 300 managers. All of the rights vested on April 30, 2013 but they can be exercised from May 1, 2013 up to April 30, 2015. At the grant date, the value of each SAR was ₦10 and it was estimated that 5% of them an agers would leave during the vesting period. The fair value of the SARs is as follows:

Date	Fair Value of SAR
April 30, 2012	₦9
April 30, 2013	₦11
April 30, 2014	₦12

All of the managers who were expected to leave employment did not leave the company as expected before April 30, 2013. On the April 30, 2015, 60 managers exercised their options when the intrinsic value of the right was ₦10.50 and were paid.

Yerokun Limited is confused as to whether to account for SARs under IFRS 2 share-based payment or IFRS 13 Fair Value measurement and would like to be advised as to how the SARs should have been accounted for from the grant date to April 30, 2014.

SECTION C: ANSWER ANY TWO OUT OF THE THREE QUESTIOS IN THIS SECTION**QUESTION 5**

Umu Amaeshi Plc is conglomerate that that has diverse businesses cutting across some social and environmental sensitive sectors listed on the Nigeria Stock Exchange. In compliance with financial reporting regulatory directives of Nigeria, it has adopted IFRS in preparing its financial statements. The board is aware that this step will enhance the transparency of its reporting and assist in attracting foreign institutional investors who may be desirous of investing in Nigeria. However, in one of the company's board meetings the CFO briefed members that given the social and environmental sensitive nature of its operation, the adoption of IFRS may not be good enough to bring that transparency relating to its policies and practices relating to social and environmental disclosures. He makes reference to Para 14 of IAS 1 – presentation of Financial Statement which clearly stated that

“Many entities also present, outside the financial statements, report and statements such as environmental reports and value added statements, particularly in industries in which environmental factors are significant and when employees are regarded as an important user group. Reports and statements presented outside financial statements are outside the scope of IFRS.”

The board does not want to engage in social and environmental reporting disclosures since many who do engage in what the business community see as marketing and the report filled with rhetoric. The CFO has therefore suggested the use of Management commentary.

Required:

- a) Briefly explain the purpose of Management Commentary and why it was not made a mandatory requirement for all companies by IASB. (6 marks)
- b) Identify the three most relevant elements of Management Commentary that Umu Amaeshi Plc should focus on in its management commentary and explain how they will assist the company to achieve the above objectives given that it does not want to engage in social and environmental disclosure.

(9 Marks)

(Total 15 marks)

QUESTION 6

Corporations are realising that in this 21st century, firms' intangible assets and human capital are the most important assets for value creation, production or rendering of services. A recent OECD report in 2006 attests to this and points to an emerging knowledge economy, human capital and intangible assets lie at the core capabilities and competencies for innovation and business sustainability. There is therefore the general feeling and perception that traditional corporate reporting do not meet the capital allocation needs of providers of financial capital. One development has been the emergence of Integrated Reporting (IR) being promoted by International Integrated Reporting Council (IIRC) supported by IFAC and most professional accounting bodies globally. The framework issued in 2013 like IASB's Conceptual Framework is principles based and as such does not prescribe KPLs but has some guiding principles and key content elements. Golden path Plc is desirous of employing IR to overcome the present limitations of its traditional corporate reporting.

- a) Write a report to the board of Golden Path Plc:
Advising them on why their financial statements may not meet the capital allocation needs of providers of financial capital in 21st century firms given the limitations of traditional corporate reporting which integrated reporting aims to address. (5 marks)

- b) Briefly state why integrated reporting may still not resolve the main limitations identified above. (1 mark)

(Total 15 marks)

QUESTION 7

- a) IBRO Plc provided the remuneration of its management board made up of executive and non-executive directors (2 foreign nationals inclusive) viz-a-viz:
Annual basic salary
Bonus scheme (Annual compensation)

Four of the directors of IBRO Plc. Obtained loans from the company at concessional rates while 2 directors are part of the bondholders of the company's loan stock with convertible features to their advantage.

In group financial statements with the related parties note under IAS 24 (related Party Disclosures). IBRO Plc disclosure the total remuneration paid to directors and non-executive directors. No further breakdown of the remuneration was provided. The remuneration of the non-executive Directors, however, was not included in the key management disclosures.

IBRO Plc was of the opinion that in its jurisdiction, providing information about individual director's remunerations would be a disservice to them especially, because they have served the company meritoriously. Consequent upon this the CFO of the company is proposing to disclose the related party information in the annual financial statements in an ambiguous manner to prevent users of the financial statements from facing remuneration information back to specific individual directors.

Discuss the appropriate disclosure for the above transactions within the context of IAS 24 in the financial statements of IBRO Plc, for the year ended December 31, 2014. (7 marks)

- b) KOKORO JOBIJOBI group wishes to expand its operations. As part of this expansion, it has granted options to employees of its subsidiaries GBANJA and GORO over its own shares as at March 31, 2015. The awards vest immediately.

KOKORO JOBIJOBI is not proposing to make a charge to the subsidiary for these options.

KOKORO JOBIJOBI does not know how to account for this transaction in its own the subsidiaries and the group financial statements.

Required:

Explain to KOKORO JOBIJOBI how the above transactions should be dealt with in its own, the subsidiaries and the group financial statements.

(8 marks)

(Total 15 marks)

SOLUTION 1

(a) Earnings Management

Earnings management can be viewed as attempt by management to influence or manipulate the entity's reported earnings by using specific accounting methods or policies or changing them to achieve that objective. In specific terms, earnings management techniques involve deliberate effort by management to defer or accelerate recognition of expense or revenue transactions designed to influence short-term earnings. It could also take the form of using other methods designed to influence short-term earnings.

Aggressive earnings management results in stakeholders being misled to some extent about an entity's profitability and by extension financial position.

Examples of how accruals could be employed in earnings management are:

- Recognition of invoices issued for goods not yet delivered or when revenue recognition criteria had not been met which are reversed in subsequent year.
- Reduction in accruals for expenses incurred but not yet paid at end of the reporting period.
- Accruing for a liability that never occurred in the reporting year using provision of IAS 37 - *Provisions, Contingent Assets and Contingent Liabilities* which may be reversed in subsequent accounting year.
- Not accruing for expenses incurred, but not paid for in a given accounting year.

(b) Goodwill on acquisition of subsidiary/ total impairment

		NCI	Joy-land
Fair value NCI/Existing AFS		80	20
Fair value of new consideration paid (60+60)		<u>0</u>	<u>120</u>
		80	140
Fair value of Net Asset acquired			
Property, plant and equipment	50		
Intangible assets	52		
Inventories	30		
Trade receivables	20		
Cash	<u>28</u>		
	<u>180</u>		
Share of fair value of NA (NCI 40% & Joyland 60% (180))		(72)	(108)
Goodwill		<u>8</u>	<u>32</u>
Total goodwill			40
Impairment of Goodwill			
Balance at the beginning	272		
Purchase of subsidiary	<u>40</u>		
	312		
Balance at the end of the year	<u>(192)</u>		
Total impairment	<u>120</u>		

(c) Joy-land Plc Group

Cash Flow Statement for the year ended 30 November 2015

	Workings	N'm	N'm
Operating activities			
Profit before tax			236
Adjustments to operating activities:			
Associate profit		(24)	
Gain on disposal of property	10	(36)	
Finance cost		18	
Fair value gain Investment Property	9	(6)	
Impairment of goodwill	(a)	120	
Depreciation on PPE	note v	108	
Amortisation of intangible assets	1	48	
Defined benefit charge to profit or loss	note vi	16	
Defined benefit scheme paid	note vi	(28)	
Loss on replacement of investment property component part		<u>2</u>	<u>218</u>
Cash flow before working capital changes			454
Changes in working capital			
Decrease in inventory (420-512-30)		122	

Decrease in receivables (248-452-20)		224	
Increase in trade payables (576-220-0)		356	
Tax paid	2	(60)	
Interest paid (finance cost as above)		<u>(18)</u>	624
Net cash inflow from operating activities			1,078
Investing activities			
Purchase of subsidiary	3	(40)	
Purchase of associate	4	(192)	
Purchase of PPE	5	(402)	
Purchase of intangible assets	1	(48)	
Additions to investment property		(4)	
Purchase of AFS financial asset	6	(24)	
Proceed sale of property		<u>60</u>	
Net Cash flows used by investing activities			(650)
Financing activities			
Rights issue NCI		8	
Dividend to shareholders		(20)	
Long term loan repayment	7	(16)	
Dividend to NCI	8	<u>(44)</u>	
Net cash flows used by financing activities			(72)
Net increase in cash and cash equivalent for the year			<u>356</u>
Cash and cash equivalent 1 Dec, 2014			<u>572</u>
Cash and cash equivalent 30 Nov, 2015			<u>928</u>

Workings

(1)

Intangible Assets

	N'm		N'm
Bal b/d	288	Amortisation	48
Bank (32+16)	<u>48</u>	Bal c/d	<u>340</u>
	<u>388</u>		<u>388</u>

(2)

Tax paid

	N'm		N'm
Bank- Tax paid (bal.)	60	Bal c/d - coy tax	120
Bal c/d- coy tax	132	Deferred tax	164
deferred tax	140	P or L- coy tax	44
	<u>332</u>	Gain AFS - Deferred Tax	<u>4</u>
			<u>332</u>

(3) Purchase of Subsidiary

This is based on cash that changed hands (68 - 28) = N40m

4) Purchase of Associate

	N'm		N'm
Bal b/d	0		
Share of prof. of associate	24		
Bank (bal. figure)	<u>192</u>	Bal c/d	<u>216</u>
	<u>216</u>		<u>216</u>

(5) Property, Plant & Equipment

	N'm		N'm
Bal b/d	1,016	Disposal	40
Talk –Peace	50	Depreciation	108
Disposal – plant	16	Revaluation	28
Bank - Additions (Balancing)	<u>402</u>	Bal c/d	<u>1,308</u>
	<u>1,484</u>		<u>1,484</u>

(6) AFS Financial Assets

	N'm		N'm
Bal b/d	360	Talk-Piece reclassified	20
Talk-Piece	4		
Other AFS	8		
Bank (balancing fig.)	<u>24</u>	Bal c/d	<u>376</u>
	<u>396</u>		<u>396</u>

(7) Long Term Loan

	N'm		N'm
Bank (bal. fig.)	16	Bal b/d	284
Bal c/d	<u>268</u>		
	<u>284</u>		<u>284</u>

(8) Dividend to NCI

	N'm		N'm
Bank (balancing figure)	44	Bal b/d	144
		Rights Issue	8
		Acq. Talk-peace (a)	72
Bal c/d	<u>220</u>	Income statement	<u>40</u>
	<u>264</u>		<u>264</u>

(9) Investment Property	
	N'm
Bal b/d	24
Cash paid	4
Fair value gain	<u>6</u>
	<u>34</u>

	N'm
Disposal of Air- conditioner	2
Bal c/d	<u>32</u>
	<u>34</u>

(10) Sales of Land	
	N'm
Land	40
P or L	<u>36</u>
	<u>76</u>

	N'm
Bank	60
Plant Trade-in	<u>16</u>
	<u>76</u>

Marking Guide

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EXAMINER'S REPORT

The question tests candidates' knowledge of preparation of consolidated statement of cash flows, along with earnings management and goodwill computation. This would have been predictable, given that the examiner has tested group statement of financial position and comprehensive income, while almost all the candidates did well in computing the goodwill, earnings management could not be explained by the students.

Major pitfalls of most of the candidates were their inability to determine the right figures for components of the statement of cash flows, correct application of group's policy of valuing non-controlling interest at full fair value, and explaining Earnings Management.

Candidates need to fully understand the provisions of the relevant IFRSs on consolidated financial statements and how individual component items of the consolidated cash flow items are determined but in particular the effect of the assets & liabilities of subsidiary purchased at the beginning of or during an accounting year. Earnings Management is expected to feature in future examination and could be a full 15 marks question given its potential to distort reported financial performance and position.

SOLUTION 2

Date: 17/05/2016

The Managing Director
Ehis Marvel Plc.

Dear Sir,

Subject: The financial performance of Ehis Marvel Plc for the two years ended 31 March 2016

Introduction

Our discussion on the above subject matter refers. The report assesses the overall performance of Ehis Marvel plc. This is subdivided into operational performance, liquidity/solvency and share price/dividend, ending with a concluding remark.

Operating Performance

The overall performance of a firm is usually measured by its return on capital employed (ROCE). Applying this to Ehis Marvel plc, this ratio has seen a significant deterioration from 33.9% in 2015 to a low 9.3% in 2016. The cause of this deterioration can further be broken down into the component parts of the ratios making up the ROCE which are asset turnover and profit margins. The asset turnover (which measures the effectiveness of the firm in utilising its assets to generate income) fell from 3.3 times in 2015 to 2.1 times in 2016. This can be interpreted to mean increased inefficiency in asset utilisation partly contributing to the deterioration in ROCE. However the company embarked on a huge investment, acquiring five new stores which must have significantly increased net asset. It may be that this new investment has not started to generate sales at the level of existing capacity. As such, asset turnover may not be as bad as it appears and is bound to improve in future. The gross profit margin for the clothing sales appears to be the major issue with deteriorating ROCE as it dropped by about 98%; from 18.6% in 2015 to 9.4% in 2016. The effect of this appears more pronounced in terms of its huge impact on ROCE because clothing sales accounted for about 70% ($16,000/23,000 \times 100\%$) of the company's total sales in the year. In addition there has been a noticeable increase in the inventory holding period of the clothing products to 68 days in the current year up from 39 days in 2015. This may be interpreted to mean a deliberate policy on the part of the company to stockpile in order to attract and meet more sales, but may in the alternative be seen as evidence of obsolete and slow-moving inventory. One other concern with the clothing sales is its being exposed to changes in fashion. This has implication on its sales and inventory given that there may be new designs that may fail to gain acceptance in the

market. On the other hand, profit margin for food sales has witnessed a moderate improvement by about 28%; increasing from 25% in 2015 to 32.1% in 2016. This has helped to reduce the impact of the fall in the profit margin of the clothing sales and hence the overall effect on ROCE.

Engaging in a deeper comparative departmental analysis confirms the above position. For example there has been an increase of 35% in total sales floor area that has resulted in a mere increase in total sales of 17.3%. A further break down of this on a departmental basis shows that for the clothing department, an increase in floor area capacity of 37% resulted in a mere increase in sales of 2.6% while a smaller 20% increase in food sales area produced an impressive 75% sales increase.

Likewise, there has been deterioration in clothing sales per square metre this year to ₦333,000 down from ₦446,000 in 2015 and this is in sharp contrast to the substantial increase in food sales per square metre of ₦1,167,000 up from ₦800,000 in 2015. This resulted in overall total sales per square metre of ₦426,000 down from ₦490,000 in 2015.

Not unexpectedly, the firm's net profit margin fell from 7.1% in 2015 to a mere 2.0% in 2016. This is an indication that overhead expenses increased substantially as a result of the additional sales outlets and their attendant marketing costs.

Taken together, the insights gained from the above further analysis, point to food sales delivering increasingly more profitable returns on investment than clothing sales, but the firm has invested more in clothing floor area than food area. Therefore focusing more on clothing sales for capacity increase rather than on food sales appears misplaced.

Liquidity/Long term solvency

Overall short term liquidity position as measured by current ratio shows a slight deterioration to 0.71:1 in the current year from 0.77:1 in 2015. Ability to meet short term obligations out of liquid assets is another measure that could assist in gauging the firm's liquidity position but this may not help much here as the firm is a retail company. It is generally agreed that it is difficult assessing the liquidity ratios for retail companies as the bulk of their sales are in cash and the normal liquidity benchmark employed for other companies may not be suitable for them. A far more reliable way to assess their liquidity is looking at cash flow generated from operation in the cash flow statement. This reveals a healthy figure of N5.55 million, which comfortably can finance the tax liability and dividend payments of the firm. No doubt, it has also contributed immensely in funding the expansion acquisition of the five retail stores. However it can be seen that the expansion has significantly impacted negatively on the bank balance which fell from N450, 000 bank balance to overdraft of ₦930, 000. By inference, it may also explain why the accounts payable period increased marginally from 50 days in 2015 to 55 days in the current year.

Long term solvency is assessed by looking at the company's gearing which has increased from 17% in 2015 to 28% in the current year. This increase is explained by the firm's borrowing of additional long term loan of ₦2 million to partly fund the investment in the new stores and refurbishing existing ones, having issued ₦3 million in equity to also support this. However, at its current level, the company's gearing is still considered low, but what appears to be the worrying effect of the increased gearing is a dramatic fall in interest cover from a very comfortable level of 25 times in 2015 to a very low level of 3.3 times in the current year. This may however be mitigated by the fact that cash flow from operation can finance the interest amount as pointed out above.

Share price and dividends

The firm's share price lost almost half of its market value falling from ₦6.00 to ₦3.00 in the year under consideration. The loss in share price can partly be explained by the dilutive effect of the firm issuing two million shares at ₦1.50 to raise ₦3 million. This has the potential of reducing the unit market price to ₦4.20. However a firm's market share price at any point in time represents market participant's expectation of its future performance. Thus the other component of this fall in price can be located within market expectation of Ethis Marvel's performance which in this instance is not better than previous year. It is surprising that with after tax profit of ₦450, 000, the firm still went ahead to maintain its dividends at ₦600, 000. This cannot be considered sustainable in the long run unless the after tax profits exceeds ₦600, 000. It may be that this is a strategic decision aimed at maintaining the market price of the shares or arresting its downward slide. It may also mean market signalling by management whereby it aims to communicate a message of optimistic future earnings of the firm. Whichever way, it does not represent true performance.

Conclusion

The above detailed analysis appears to convey mixed message about the operational performance of the company. First, in spite of its heavy investment in new and refurbished sales stores, there was relative reduction in overall operational performance. There is evidence of misplaced focus on clothing sales expansion instead of food sales, and the overall impact has been an adverse effect on its share price. On the other hand, it could be that it takes time for the expansion investment to start yielding expected result given a gestation period and that current performance can be linked to the state of the present wider economy that may improve in future. It should be noted that the ability of the company to generate cash from its operating activities remains strong. If it continues at this rate, it has the tendency to ameliorate the current poor liquidity position of the company.

Yours faithfully

For:

Signed

Chief Financial Officer

Appendix

The following additional Ratios can be calculated:

	<i>Clothing</i>		<i>Food</i>		<i>Overall</i>
Increase in sales area (13,000/35000)	37%	(1,000/5,000)	20%	14,000/40,000	35%
Increase in revenue (400/15,600)	2.6%	(3,000/4,000)	75%	(3,400/19,600)	17.3%

	<i>Sales per sqmtr</i>	<i>2016</i>	<i>Sales per sqmtr</i>	<i>2015</i>
		₦'000		₦'000
Overall	(23,000/54)	426	(19,600/40)	490
Clothing	(16,000/48)	333	(15,600/35)	446
Food	(7,000/6)	1,167	(4,000/5)	800

Marking Guide

Commentary on Operating Performance	5
Commentary on Liquidity/Solvency	5
Commentary on Share price and Dividends	5
Summary/overall comments	1
Computation of additional Ratios	3
Presentation in report format	<u>1</u>
	<u>20</u>

EXAMINER'S REPORT

The question examines candidates' ability to assess a company's overall operational performance using financial ratios, breaking it further into departmental analysis. Candidates are expected to critically evaluate comparative operational performance, liquidity/solvency and share price/dividend of a company using comparative ratios, extracts from statement of profit or loss and statement of cash flows. They are also expected to carry out further analysis that assesses the relative performance of the two departments of the company using any further comparative ratios considered appropriate for this purpose.

Most candidates attempted the question and performed very well as majority of them scored above 50% of the marks allocated to the question. The poor performance of the few candidates who attempted the question was due to their inability to make relevant deductions from the ratios and financial statement information provided. They were therefore unable to undertake informed comprehensive evaluation of the company's comparative operational performance and financial status. Most candidates in fact totally neglected to undertake appropriate comparative departmental performance evaluation which would have increased the depth of their analysis of the company's performance.

Candidates are advised to improve their analytical mind and understanding of the various aspects of financial statement interpretations and comparative ratio analyses using ICAN Study Manual and other appropriate standard texts as well as practice wide with past ICAN and equivalent examination questions.

Q2 Alternative Solution

Operating Performance

The return on capital employed is the overall measure of profitability. The return on capital employed has suffered a significant decrease from 33.9% to 9.3% due mainly to falling returns from the clothing sector and the investment in PPE. The increase in PPE attributable to acquisition of five new clothing stores may not yet have generated returns. The profit for the year margin has dropped from 7.1% to 2.0%. This is mainly as a result of the decrease in the gross margin of the clothing sector but is also affected by the increase in finance costs and the additional depreciation on PPE acquired during the year. Though there was a marked increase in the Food department gross profit margin from 25% to 32.5%, the fact that the sales of the Clothing department represents 70% of total sales with a decline of about 100% in profit margin affected profit margin and assets turnover ratios considerably. A 37% increase in the floor area of the clothing sector generated only increase in sales of 2.6%, whereas a modest increase in the food sector floor area generated a significant increase of 75%. This shows that the clothing department is responsible for the deterioration.

Working capital position:

It does look as if ETHIS MARVEL PLC'S needs to improve working capital as the company's liquidity position is below 1 and has deteriorated from 0.77:1 to 0.71:1. The receivables have increased in the year (from ₦50,000 to ₦100,000), though the amounts are characteristically low for Ehis Marvel Plc's, which is what would be expected for an entity in the retail sector, and it looks like the entity has in turn withheld payment to payables with an increase of ₦950,000. Payables are being settled 9 days later than in 2015. The increase in payables indicates that Ehis Marvel Plc's are using trade payables as a means of funding working capital. The increase in receivables may be a deliberate attempt to secure new customers by offering them

favourable credit terms but it is essential that good working capital management is not compromised.

The inventory holding period of clothing has increased significantly from 39 days to 68 days between 2015 and 2016. The increase in inventories has probably arisen in order to meet future expected demand from the expansion but it may also be an indication that there is some slow moving obsolete inventory. Given that Ehis Marvel operates in the retail sector, having inventories in stock for another 39 days is likely to be problematic and lead to obsolescence of out of trend items. The fashion industry is vulnerable to changes too often and too quickly as such Ehis should be cautious with holding too much inventory. The cash generation of the company is sound with a cash generated from operation of ₦5,550,000 the company would be able to service its tax and dividend payments

Long-term stability and solvency:

It is clear from the cash flows from financing that a share issue has been supported by the shareholders of Ehis Marvel Plc's. A good sign is that Ehis Marvel PLC'S has managed to fund the acquisition of the new stores by a modest increase of 11% (from 17% to 28%) in the overall gearing of the business, as more amounts of equity (₦3m) than debt (₦2m) have been raised as new finance. It indicates good stewardship of assets when long term expansion is financed by long term financing. Ehis Marvel PLC'S appear to have used a mixture of long term financing, bank overdraft and retained earnings generated in the year, to fund the expansion. However the fact that the interest cover has fallen from 35 times to 33 times calls for caution as with further falls in profitability may hamper the business from servicing interest from long term debts. On the other hand the dilution effect attributable to the additional shares issued and probably the market's expectation of the company's performance have contributed to the reduction in the share price by half (from ₦6 to ₦3).

Shareholders and market position:

The expansion and the dilution in shares are not to the detriment of shareholders as they have still received, during the year, the previous year's dividend at ₦600,000 despite an after tax profit of only ₦450,000. and it's possible that the new investments in the five stores and PPE will generate greater returns in the future. In times of expansion, however, a more modest dividend may have negated the need for long term financing and the interest costs associated with it. However, maintaining the dividend at the current level, the directors may be trying to convey to the market a feeling of confidence in the future profitability of the company. It should be also noted that although the total dividends have been maintained, the dividend per share will half due to the share issue during the year. Based on the latest share price, the share

price of Ehis Marvel has fallen by 100% (from ₦6 to ₦3) over the reporting period which indicates that the stock market has reacted to the decline in profitability.

Conclusion:

From the above analysis there is every indication that operating performance of the entity has declined considerably despite the huge investment in the food sector and consequently in property, plant and equipment. However, the cash generation position is quite sound, though the entity needs to worry about the operating capital cycle particularly at it relates to the inventory days. Ehis Marvels is in the process of expansion, the current investments in PPE due to the acquisition of the five retail stores may be able to generate significant increase in sales and returns in future if the company is well managed.

Yours faithfully

Signed

Chief Financial Officer

SOLUTION 3

LIMELIGHT PLC

a. Conceptual basis for the recognition of deferred taxation in accordance with IAS 12:

Deferred tax is the estimated future tax consequences of transactions and events recognized in the financial statements of the current and previous periods due to temporary differences. Temporary differences are differences between the carrying amount of an asset or liability in the financial statements and the value such an asset or liability is stated for tax purpose. Thus temporary differences arise when income or expenditure is recognised in the financial statements in one year, but is charged or allowed for tax in another year. It could also arise as a result of differences between the carrying amount of asset or liability in the statement of financial position and its tax base. Deferred tax should be recognised only in respect of those items where expense or income is recognised in both accounting and taxable profit but in different periods.

Examples of temporary differences (not exhaustive) that have deferred tax implications include the following:

I. Deductible temporary differences:

- Retirement benefit costs which are charged as an expense when incurred but may only be allowed by the tax authorities when paid;

- Revaluation losses which are recognised in the financial statements when they occur , but may only be allowed by the tax authorities when assets are sold;
- Research costs charged as an expense in computing accounting profit, but which may only be allowed by the tax authorities when paid;
- Unrealised profit on intra-group sales in the consolidated accounts of a group.

II. Taxable temporary differences

- Interest income recognised in the financial statements as it is earned ,which is taxed by the authorities when received;
- Revaluation gains;
- Interest capitalised in producing or constructing an asset. This interest is normally allowed by the tax authorities when it is incurred, but is charged against accounting profit as the related asset is depreciated or amortised.

III. Temporary differences which can be either taxable or deductible

- Accelerated capital allowances, where the carrying amount of an asset differs from its tax WDV. In this question, the carrying amount of the non-current assets is substantially different from the tax WDV.
- Current assets (e.g. investments) restated to market value where the change in value is recorded in accounting profit, but is included in taxable profit only on realisation.

The following measurement and recognition criteria are provided for deferred tax under IAS 12:

- (i) Deferred tax assets and liabilities should be measured using tax rates which are expected to apply when the asset is realised or the liability is settled, based on tax rates or laws that have been enacted or substantially enacted by the end of the reporting period.
- (ii) A deferred tax asset must be recognised for all deductible temporary differences to the extent that taxable profit will be available against which the deductible temporary difference can be utilized, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:
 - is not a business combination, and
 - at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss)
- (iii) IAS 12 does not permit deferred tax assets and liabilities to be discounted;

- (iv) A deferred tax asset should be recognised for deductible temporary differences, unused tax credits; but only to the extent that it is probable that taxable profit will be available against which they can be offset.
- (v) The carrying amount of deferred tax assets should be reviewed at the end of each reporting period. A previously unrecognised deferred tax asset should be recognised to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.
- (vi) Deferred tax assets and liabilities should be offset only if:
 - The entity has a legally enforceable right to set off current tax assets against current tax liabilities; and
 - The deferred tax assets and liabilities relate to income taxes levied by the same tax authority.

b. (1) Accounting for the transactions.

Profit before tax

Total income tax charge including deferred tax for year will be deducted from Profit before tax

(~~₦~~487.5m) to arrive at accounting period for the year.

Current tax liability

Current tax liability is obtained by applying the applicable tax rate on the taxable profit. The current tax liability for Limelight for the year ended December 31, 2014 will be ~~₦~~39.39m (30% of ~~₦~~131.25m) which will be accounted for as follows:

	Dr	Cr
	₦'000	₦'000
Current Tax Charge – profit or loss	39,375	
Current Tax Liability – SOFP		39,375

Being current tax on profits of the year ended Dec 31, 2014

Non-current Assets

Provision will be made for deferred tax on the temporary difference between the accounting carrying amount (~~₦~~937.5m) and tax written down value (~~₦~~637.5m) of non-current assets. The related deferred tax computation will be ~~₦~~(937.5 – 637.5) x 30%, which is ~~₦~~90m.

The Freehold building purchased in February 2014 for ₦750m and revaluation surplus of ₦235m ₦(985-750)m will have to be recognised in the financial statements along with related deferred tax ₦70.5m ₦(235 x 30%) on the revaluation surplus. The revaluation surplus and the related deferred tax will be recognised directly in equity as other comprehensive income not in income statement as follows:

	Dr	Cr
	₦'000	₦'000
Freehold building	750,000	
Bank		750,000
Being purchase of building in February 2014		
Freehold building	235,000	
Revaluation Surplus - OCI		164,500
Deferred tax - OCI		70,500
Being revaluation surplus of building and related		
Deferred tax on 31 December, 2014		

Marking Guide

a	Definition of deferred tax and temporary differences	2	
	Explanation of examples of temporary differences (any 2 @ 1 mark each)	2	
	Identification of measurement and recognition criteria for deferred tax under IAS 12 (any 4 @ 1/2 marks each)	<u>6</u>	
			10
b.i	Explanation of necessary accounting adjustments (any 4 @ 1/2 mark each)	2	
	Journal entries (6 @ 1/2 each)	3	
b.ii	Computation of deferred tax and journals (any 10 entries @ 1/2 each)	5	<u>10</u>
			<u>20</u>

EXAMINER'S REPORT

The question tests the principles of the provisions of IAS 12 – *Income Taxes* on deferred tax, requiring the identification of transactions resulting in temporary differences; measurement, recognition and accounting for deferred tax.

Most of the candidates attempted the question and performance was just above average. Most of those who attempted the question failed to identify the measurement and recognition criteria for deferred tax under IAS 12, thus losing valuable marks. They also displayed inability to correctly determine the accounting treatment and compute the related deferred tax of the specified transactions as required in part b. of the question.

It is very important for candidates to thoroughly understand the provisions and practical applications of the various IFRSs covered in the syllabus.

SOLUTION 4

(a) LALUPON Plc.

The loan should have been classified as short-term debt. According to IAS 1, *Presentation of financial statements*, a liability should be classified as current if it is due to be settled within 12 months after the date of the statement of financial position. If an issuer breaches an undertaking under a long-term loan agreement on or before the date of the statement of financial position, such that the debt becomes payable on demand, the loan is classified as current even if the lender agrees, after the statement of financial position date, not to demand payment as a consequence of the breach.

It follows that a liability should also be classified as current if a waiver is issued before the date of the statement of financial position, but does not give the entity a period of grace ending at least 12 months after the date of the statement of financial position. The default on the interest payment in January represented a default that could have led to a claim from the bondholders to repay the whole of the loan immediately, inclusive of incurred interest and expenses. As a further waiver was issued after the date of the statement of financial position, and only postponed payment for a short period, LALUPON PLC did not have an unconditional right to defer the payment for at least 12 months after the date of the statement of financial position as required by the standard in order to be classified as long-term debt.

Since the whole loan is repayable or crystallises upon a default, it means the annual 10% interest charges of ₦10m should be recognised as finance cost for years ended December 31, 2013 and December 31, 2014; accumulated liability (principal plus interest) of ₦110m and ₦120m should be recognised as current liabilities.

LALUPON PLC. should also consider the impact that a recall of the borrowing would have on the going concern status. If the going concern status is questionable, LALUPON PLC would need to provide additional disclosure surrounding the uncertainty

and the possible outcomes if waivers are not renewed. If LALUPON PLC ceases to be a going concern then the financial statements would need to be prepared on a break-up basis.

(b) LALUPON PLC

A provision shall be recognised under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* when there is a present obligation (legal or constructive) as a result of a past event; it is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation. If the above conditions are not met, no provision shall be recognised. In this case, the obligating event is the gas leakage and subsequent outbreak of fire which destroyed surrounding properties because of the virtual certainty of legislation requiring the clean-up and restoration. Additionally, there is probably going to be an outflow of resources embodying economic benefits, because LALUPON has no recourse against the entity or its insurance company. Therefore a provision is recognised for the best judgement or estimate of the costs of rectification of environmental damage or restoration work. As LALUPON has no recourse against PONJEBE, recovery of the costs of clean-up is not likely and hence no corresponding receivable should be recorded. According to IAS 37, the amount provided should be recognised as an expense in the income statement and as a liability in the profit or loss and as a liability in the statement of financial position.

(c) YEROKUN LTD

IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements). IFRS 13 specifically excludes transactions covered by certain other standards including share-based payment transactions within the scope of IFRS 2 *Share-based Payment* and leasing transactions within the scope of IAS 17 *Leases*.

Thus share-based payment transactions are scoped out of IFRS 13.

For cash settled share-based payment transactions, the fair value of the liability is measured in accordance with IFRS 2 initially, at each reporting date and at the date of settlement using an option pricing model. The measurement reflects all conditions and outcomes on a weighted average basis, unlike equity settled transactions. Any changes in fair value are recognised in profit or loss in the period. Therefore, the SARs would be accounted for as follows:

Year	Expense ₦	Liability ₦	Calculation
30 April 2012	641,250	641,250	$285 \times 500 \times \text{₦}9 \times \frac{1}{2}$ time apportioned over vesting period. Using the estimated (300 x 95%) = 285 managers
30 April 2013	926,250	1,567,500	$285 \times 500 \times \text{₦}11$ Expense is difference between Liabilities at 30 April 2013 and 30 April 2012
30 April 2014	97,500	1,350,000	$225 \times 500 \times \text{₦}12$ cash paid is $60 \times 500 \times \text{₦}10.50$ i.e. $\text{₦}315,000$. The liability has reduced by $\text{₦}217,500$ and therefore the expense is the difference of $\text{₦}97,500$

The liability has reduced by $\text{₦}217,500$ and therefore the expense is the difference of $\text{₦}97,500$.

The fair value of the liability would be $\text{₦}1,350,000$ at 30 April 2014 and the expense for the year would be $\text{₦}97,500$.

Tutorial note:

SARs exercised:

30 April 2014: $60 \times \text{₦}10.50 \times 500 = \text{₦}315,000$

30 April 2013: $60 \times \text{₦}11 \times 500 = \text{₦}330,000$

Therefore a gain of $\text{₦}15,000$ is made on these SARs.

Unexercised SARs:

30 April 2014: $225 \times \text{₦}12 \times 500 = \text{₦}1,350,000$

30 April 2013: $225 \times \text{₦}11 \times 500 = \text{₦}1,237,500$

Therefore a loss of $\text{₦}112,500$ is made on the remaining unexercised SARs.

This results in an overall charge to profit or loss for the year ended 30 April 2014 of $\text{₦}97,500$.

Marking Guide

A	Explanation of the relevance and provisions of IAS 1, <i>Presentation of financial statements</i>	2	
	Classification of loan as short-term debt	2	
	Identification of need for going concern assessment	<u>2</u>	6
B	Requirements of IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i> regarding provisions	3	
	Identification of:		
	- Obligating event	1	
	- Probable outflow of resources	1	
	- Non-recourse to insurance company	<u>1</u>	6
C	Determination of applicable IFRS	2	
	Computation of operating expenses and liabilities for the three years (6 entries @1mark each)	<u>6</u>	<u>8</u>
			<u>20</u>

EXAMINER'S REPORT

This question tests candidates knowledge and ability to apply the provisions of IAS 1 - *Presentation of Financial Statements* on classification of long-term loans; IAS 37 – *Provision, Contingent Liabilities and Contingent Assets* on recognition of provisions; and IFRS 2 – *Share-based Payment* vs. *IFRS 13 – Fair value Measurement* on share appreciation rights (SARs).

Most of the candidates did not attempt this question and the performance of those who attempted it was poor. Most of those who attempted the question displayed a poor understanding of the relevant provisions of the IFRSs. The candidates were especially unable to determine the appropriate provisions for the treatment of SARs and were further unable to compute the charge/liability for each reporting period/date in accounting for the SARs.

Candidates need to work harder to possess a deeper working knowledge of the provisions and applications of IFRSs for good performance in Corporate Reporting examination.

EXAMINER'S REPORT

(a) i) **PURPOSE OF MANAGEMENT COMMENTARY**

Management commentary is a narrative report that provides a context within which to interpret the financial position, financial performance and cash flows of an entity. It also provides management with an opportunity to explain its objectives and its strategies for achieving those objectives. Users routinely use the type of information provided in management commentary to help them evaluate an entity's prospects and its general risks, as well as the success of management's strategies for achieving its stated objectives. Thus:

Management commentary should provide users of financial statements with integrated information that provides a context for the related financial statements. Such information explains management's view not only about what has happened, including both positive and negative circumstances, but also why it has happened and what the implications are for the entity's future.

Management commentary complements and supplements the financial statements by communicating integrated information about the entity's resources and the claims against the entity and its resources, and the transactions and other events that change them.

Management commentary should also explain the main trends and factors that are likely to affect the entity's future performance, position and progress. Consequently, management commentary looks not only at the present, but also at the past and the future.

- ii) Management commentary was not made a mandatory requirement for all companies by IASB as it is not an IFRS. This implies that entities applying IFRS are not required to comply with the practice statement, unless specifically required by their jurisdiction. This is because:
- Laws regulating business are local, that is, business laws vary from country to country;
 - Actual business management practice regulation like corporate governance varies between countries;
 - Nature of businesses vary such that social and environmental concern are not issues in some businesses and therefore not material with social and environmental issues

- Size of business may be a factor. SMEs are unlikely to be concerned, while in unlisted companies it can be voluntary. It may be mandatory for listed companies. In Nigeria, it is not mandatory whereas it is, in EU.

(b) Elements of Management Commentary

Although the particular focus of management commentary will depend on the facts and circumstances of the entity, management commentary should include information that is essential to an understanding of:

- i) The nature of the business;
- ii) Management's objectives and its strategies for meeting those objectives
- iii) The entity's most significant resources, risks and relationships;
- iv) The results of operations and prospects; and
- v) The critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives

i) Nature of the business

Management should provide a description of the business to help users of the financial reports to gain an understanding of the entity and of the external environment in which it operates. The information serves as a starting point for assessing and understanding an entity's performance, strategic options and prospects. Depending on the nature of the business, management commentary may include an integrated discussion of the following types of information:

- Whether social and environmental issues are material to the operational activities of the industry it operates example oil & gas industry, chemical etc.
- The legal, regulatory and economic impact of social and environmental concern as they affect the business.

ii) Management objectives

To this end, management uses the medium to disclose information about how it intends to manage the risks and exploit the opportunities inherent in social and environmental concerns arising from its operation. Such information could also include success measurement criteria inform of KPLs.

iii) Entity's most significant resources, risks and relationships

Management commentary should include a clear description of the most important resources, risks and relationships that management believes can affect the entity's value and how those resources risks and relationships are managed. To this extent management commentary could be used to show how

social and environmental resources, risks and relationships affect the entity's value and are managed.

iv) Results of operations and prospects

Management commentary should include a clear description of the entity's financial and non-financial performance, the extent to which that performance may be indicative of future performance and management's assessment of the entity's prospects. Non-financial performance here could relate to social and environmental impact or its operation.

v) Critical performance measures and indicators

Performance measures are quantified measurements that reflect the critical success factors of an entity. Indicators can be narrative evidence describing how the business is managed or quantified measures that provide indirect evidence of performance. Management should disclose performance measures and indicators (both financial and non-financial) that are used by management to assess progress against its states objectives. Again non-financial performance measures could be framed as social and environmental performance measures.

Thus management commentary could be used in such a way as to serve the purpose of social and environmental reporting.

Marking Guide

a	Purpose of management commentary and why not mandatory (4 points @ 1.5 marks each)	6
b	Elements of management commentary (Any 3 points @ 1 mark each) Explanation of the usefulness of the elements for social and environmental disclosures (Any 3 points @ 2 marks each)	3 <u>6</u>
		<u>15</u>

EXAMINER'S REPORT

The question examines candidates understanding of management commentary and a practical application of how it can be used to serve the purpose of social and environmental reporting.

The major problem is its application to serve the purpose of social and environmental reporting. Majority of the candidates simply listed the content elements without

adapting them to the question asked forgetting they were not just asked to discuss the elements.

SOLUTION 6

a. Golden Path Plc - Report to Board of Directors

Date

The Chairman
Board of Directors
Golden Path Plc.

Dear Sir,

Introduction

Our discussions on the above subject matter refer. This report sets out the reasons why your financial statements may not meet the capital allocation needs of providers of financial capital in 21st century firms. It also identifies the most relevant content elements of Integrated Reporting and how they address the limitations of the financial statements earlier highlighted.

Limitations of financial statements in meeting capital allocation decision making needs

Providers of capital and other different users of financial statements have criticised the traditional corporate reporting based on its inability to meet their needs. The major limitations of financial statements in meeting the information needs of capital allocation in 21st century firms are:

- i. Historical performance- income, cash flows, earnings and statement of financial position are historical as opposed to future performance that investors are interested in.
- ii. Intangible assets such as internally generated goodwill, intellectual, human and social relationship capital are not recognised. These form the important assets for value creation in 21st century firms.
- iii. As a result of (ii) above, there may be misallocation of capital in 21st century firms. Reporting fails to incorporate or show the core capabilities and competences, hence the most important assets in value creation.
- iv. B Financial reporting suffer information overload, have become complex and increasingly cluttered because of too many disclosures that are boiler plates.

- v. Financial reporting is based on estimate and the subjective nature of estimates reduces relevance and usefulness
- vi. In reporting, management do exercise judgmental discretion on how certain transactions are accounted for. For example many standards allow judgment
- vii. Fair value improves reporting and yet the standards allow historical cost as the basis of initial recognition such as in IAS 16, 38 etc.

The content elements of Integrated Reporting that addresses some of the limitations of financial statements:

Integrated Reporting (IR) provides greater context for performance data, clarifies how value relevant information fits into operations or a business, and may help make company decision making more long-term. While the contents of IR will be of benefit to a range of stakeholders, they are principally aimed at providers of financial capital allocation decisions:

- i. Future outlook: IR is expected to show what challenges and uncertainties the organization is likely to encounter in pursuing its strategy, and what are the potential implications for its business model and future performance? This will address the historical nature of financial information.
- ii. Business model: IR is expected to show what the organization's business model is and to what extent it is resilient. The business model includes information on the capitals such as natural capital, human capital, intellectual capital and social and relationship capital thereby addressing the limitations of intangible assets and human capital.
- iii. Strategy and resources allocation: IR is expected to show where does the organization want to go and how does it intend to get there? This provide context to the future outlook and helps overcome the historic nature of financial reporting information, not recognised presently in Financial Reporting.
- iv. Opportunities and risks: IR is expected to show what are the specific risks and opportunities that affect the organization's ability to create value over the short, medium and long term, and how the organisation is dealing with them. This information helps providers of financial capital in assessing current historical and future performance.
- v. Performance: IR is expected to show to what extent the organization has achieved its strategic objectives for the period and what its outcomes in terms of effects on the capitals are.
- vi. Governance: IR is expected to show how the organization's governance structure supports its ability to create value in the short, medium and long term?
- vii. Organizational overview and external environment: IR is expected to show what the organization does and what are the circumstances under which it operates?

- viii. Basis of preparation and presentation: IR is expected to show how the organization determines what matters to include in the integrated report and how such matters are quantified or evaluated.

We hope the foregoing will be of benefit in your deliberations on the company's corporate reporting requirements.

Yours faithfully

Signed
The Reporting Consultants

b. Limitations of Integrated Reporting

Based on the foregoing, it is clear that integrated reporting will only address certain limitations whereas others will still remain, examples include judgement, clutter, estimates, etc.

Thus IR may still not address some of the limitations noted in traditional corporate reporting because different organisations may use different approaches in compiling their report so as not to reveal more information than required to competitors, for example on its strategies in creating value. Thus most entities that use IR may still not disclose details of some of the content elements of IR.

Marking Guide

a	i. Limitations of financial reporting (Any 5 points @ 1 mark each)	5	
	ii. Content Elements of Integrated Reporting (8 points @ 1 mark each)	8	
	Presentation in Report format	<u>1</u>	14
B	Limitations of Integrated Reporting		<u>1</u>
			<u>15</u>

EXAMINER'S REPORT

The question examines limitations of traditional financial reporting in meeting capital allocation decision making needs a 21st century firms. It then requires students to discuss the content elements of integrated reporting that addresses some of the limitations of traditional financial reporting and whether integrated reporting itself can resolve all the issues.

Most candidates attempted the question but their performance was not impressive. Most of them displayed a poor understanding of the nature, contents and limitations of both traditional financial and integrated reporting which cover more than fifty percent of the available scores.

Candidates are advised to adequately cover all aspects of the syllabus and ICAN Study Packs as well as practice past questions of ICAN and other appropriate examination.

SOLUTION 7

(a) IBRO PLC

The exclusion of the remuneration of the non-executive directors from key management personnel disclosures did not comply with the requirements of IAS 24 which defines key management personnel as those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity. IBRO PLC did not comply with paragraph 16 of the standard, which also requires key management personnel remuneration to be analysed by category. The explanation of IBRO PLC is not acceptable.

IAS 24 states that an entity should disclose key management personnel compensation in total and for each of the following categories:

- (i) short-term employee benefits;
- (ii) post-employment benefits;
- (iii) other long-term benefits;
- (iv) termination benefits; and
- (v) share-based payment.

Providing such disclosure will not give information on what individual board members earn as only totals for each category need be disclosed, which will not breach any cultural protocol. However legislation from local government and almost certainly local corporate governance will require greater disclosure for public entities such as IBRO PLC.

By not providing an analysis of the total remuneration into the categories prescribed by the standard, the disclosure of key management personnel did not comply with the requirements of IAS 24. The standard also requires IBRO PLC to disclose other

transactions like loans granted to directors at concessional rates and their dealing in the loan stock of the company.

(b) KOKORO JOBIJOBI GROUP

IFRS 2 *Share-based Payment* includes within its scope transfers of equity instruments of an entity's parent in return for goods or services. The standard provides a clear basis to determine the classification of awards in both consolidated and separate financial statements by setting out the circumstances in which group share-based payment transactions are treated as equity settled and cash settled. The entity receiving goods or services should assess its own rights and obligations as well as the nature of awards granted in order to determine the accounting treatment. The amount recognised by the group entity receiving the goods or services will not necessarily be consistent with the amount recognised in the consolidated financial statements. Group share-based payment transactions are treated as equity settled when:

- (i) the awards granted are the entity's own equity instruments, or
- (ii) the entity has no obligation to settle the share-based payment transaction.

In KOKORO JOBIJOBI GROUP accounts, the transaction is treated as equity settled as the group is receiving all of the services in consideration for the group's equity instruments. An expense is charged in the group statement of profit or loss for the fair value of the share-based payment at the grant date over the vesting period, with a corresponding credit in equity.

In the subsidiaries' accounts, the grant is treated as equity settled transaction as the subsidiaries do not have an obligation to settle the award. An expense is charged in the subsidiaries' statements of profit or loss for the fair value of the share-based payment at the grant date over the vesting period, with a corresponding credit in equity. The credit in equity is treated as a capital contribution as KOKORO JOBIJOBI is compensating the employees of GBANJA and GORO with no expense to the subsidiaries. In this case the shares vest immediately, therefore the expense recognised in GBANJA'S and GORO'S statement of profit or loss will be the full cost of the grant date fair value.

In the separate accounts of KOKORO JOBIJOBI, there is no share-based payment charge as there are no employees providing services to the parent. KOKORO JOBIJOBI would recognise an increase in its investment in the subsidiaries and a credit to equity.

The disclosure requirements of IAS 24 *Related Party Disclosures* by KOKORO JOBIJOBI should be applied if any of the employees are key management personnel.

Marking Guide

a	IAS 24 Definition of key management personnel	2	
	IAS 24 Disclosure requirements on key management personnel	2	
	Appropriate disclosure of specified transactions	<u>3</u>	7
B	Terms of IFRS 2	2	
	Treatment of transaction in Parent Coy Account	2	
	Treatment of transaction in Subsidiaries' Accounts	2	
	Treatment of transaction in Group Account	<u>2</u>	<u>8</u>
			<u>15</u>

EXAMINER'S REPORT

The question tests candidates' understanding of the principles and applications of IAS 24 – Related Party Disclosures and IFRS 2 – Share-based Payment. For IAS 24, candidates are specifically expected to understand the profile of key management personnel, disclosure requirements on key management personnel and appropriate disclosure of specified transactions. On IFRS 2, candidates are expected to explain the treatment of share options granted to employees of subsidiaries in the financial statements of the parent company, the subsidiaries and the group; without making a charge to the subsidiaries.

Only a few of the candidates attempted this question and their performance was below average. The major pitfall was their inability to properly account for the share options in the financial statements of the group, the parent company and the subsidiaries.

Candidates are advised to properly study IFRSs and master the practical application of the relevant principles in different scenarios and cases.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION- MAY 2016

ADVANCED TAXATION

Time Allowed: 3hours

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

SECTION A

COMPULSORY QUESTION

(30MARKS)

QUESTION 1

You have just received an e-mail from the Senior Manager of the Tax Division of your firm of Tax Consultants

The E-mail: "We have just received a memo from the Audit and Assurance Division with respect to two of our clients.

Curiously, the two companies have identical issues of Dividend Payments. The details are as follows:

- (1) XYBLEX (Nigeria) Limited is a Pharmaceutical Manufacturing company located in Otta, Ogun State, Nigeria. It is a Subsidiary of XYBLEX PHARMACEUTICALS in Europe. At its recent Board Meeting of February 15, 2016. Two resolutions were passed:
 - (a) A proposed dividend of 15kobo per share subject to appropriate withholding tax deduction for the year ended December 31, 2015 to be presented to members at its Annual General Meeting, of June 30, 2016
 - (b) That having obtained the Patent Rights for a new drug for Arthritis called "Arthritobex" the production is expected to commence in the third quarter of the year 2016.
- (2) KRYSTOL Limited, is a Trading Company located in Lokoja, Kogi State, Nigeria. The Board Resolution of January 29, 2016 proposed a Dividend of 25kobo per Share subject to appropriate Withholding Tax deduction for the year ended December 31, 2015 to be presented to members at its Annual General Meeting scheduled for May 5, 2016.

It is essential to state that Johnbull Martins. The new Trainee did make efforts to determine the Tax liabilities of the two Companies but these are to be properly checked.

You are to review the computation by Johnbull Martins and come up with a correct position of the Tax Liability of the two Companies.

It is also essential that you determine the adequacy of the proposed Dividend by the two Companies with the aim of making sure they are within the provisions of the Companies Income Tax Act Cap C21 LFN 2004.

Finally, since XYBLEX (Nigeria Limited is proposing to start production of "Arthritoblex" in the third quarter of the year the Managing Director would like to present to the Board, the Firm's opinion on Pioneer Products with specific reference to;

- Tax Relief Period and
- Profits and Dividend

Below are the relevant details in respect of both Companies with respect to the year ended December 31, 2015.

	XYBLEX (Nigeria) Limited	Krystol Limited
	₦	₦
Net Profit Per Account	20,025,420	40,251,240
Balancing charge	-	1,125,000
Investment Allowance	8,285,400	-
Profit on sale of Non-Current Assets	6,845,150	-
Capital Allowance for the year	18,329,700	19,684,850
Depreciation	10,052,500	7,250,600
Net Assets	350,000,000	326,250,000
Turnover	125,350,000	102,500,000
Paid up Capital (Ordinary shares of ₦1.0 each)	100,000,000	120,000,000
Gross Profit	75,000,000	62,000,000
Revenue Reserve	102,350,200	165,280,000

Required:

- a. Compute the tax liabilities of the two Companies. (8marks)
- b. Advise on the appropriateness of the Proposed Dividends with reference to the relevant provisions of the Law. (12 marks)
- c. Outline the Tax Relief Period and the relevant provisions with respect to Profits and Dividends of Pioneer Companies. (5 marks)
- d.
 - i. Explain briefly "Tax Avoidance"
 - ii. List THREE Anti-Avoidance measures put in place by the Government (Ignore Double Taxation Measures). (5 marks)

(Total 30 marks)

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

QUESTION 2

Sky Petroleum Plc commenced operations over ten years ago and makes up accounts to December 31 annually.

The following details have been extracted from the Accounting Records for the year ended December 31, 2014:

(i)	Crude Oil exported	3,500,000barrels
(ii)	Crude oil used locally	1,200,000 barrels at ₦100per barrel
(iii)	Incidental income from Petroleum operations	₦26,750,000
(iv)	Exploration and Drilling costs	₦30,000,000
(v)	Management and administration expenses	₦240,500,000
(vi)	Non-Productive rents	₦8,300,000
(vii)	Allowance for Bad Debts –General	₦7,500,000
	- Specific	₦11,200.000
(viii)	Depreciation	₦7,250,000
(ix)	Losses brought forward	₦13,200.00
(x)	Qualifying Capital Expenditure are as follows:	
	❖ Pipeline and Storage Tanks acquired in March 2014, located in the continental shelf of 190 metres water depth	₦48,000,000
	❖ Plant and Machinery acquired in June 2012, located in territorial waters of 90 meters water depth	₦63,800,000
	❖ Furniture and Fittings acquired in May 2011, located in territorial waters of 95 meters water depth	₦21,000,000
	❖ Building erected in April 2013, Located onshore	₦71,000,000

You were able to confirm that Management and Administration expenses comprised the following:

	₦
(i)	Donations to PPP political Party
(ii)	Expenditure relating to the acquisition of information relating to the existence and extent of Petroleum deposits
(iii)	Companies Income Tax of an Associated Company
(iv)	Interest on Inter-Company loans obtained under terms prevailing in the open market
(v)	Staff Salaries
(vi)	Royalties on Export sales
(vii)	Repairs and renewals expenses incurred on Property,

	Plant and Equipment for the purpose of carrying on Petroleum Operations	2,900,000
(viii)	Rents paid in respect of Land and Buildings occupied under Oil Prospecting license	3,600,000
(ix)	Other administrative expenses	32,000,000
		<u>240,500,000</u>

The International Market Price of Crude Oil in 2014 was USD \$75 per barrel and the exchange rate was USD \$1 = 280

You are required to compute the:

- | | |
|---------------------------|------------------|
| a. Assessable Profit | (11 marks) |
| b. Chargeable Profit | (5 marks) |
| c. Assessable Tax | (1 mark) |
| d. Chargeable Tax | (2 marks) |
| e. Tertiary Education Tax | (1 mark) |
| | (Total 20 marks) |

QUESTION 3

Ugheli Limited is operating a Joint venture with NNPC under the year 2000 Memorandum of Understanding while Eket Limited operates under the Sole Risk Operation agreement.

The following information mirrors the two Companies' operations' for the month of July, 2014.

Total Production	150,000 barrels
Total Export	150,000 barrels
Realisable Price	USD\$52,6542
Applicable Tax Reference Price	USD\$50,5842

	USD(\$)
Directing lifting cost	256,000
Exploration cost	27,000
Health, Safety & Environment	15,000
Direct Handling/Transportation cost	20,000
Intangible Drilling Cost	302,000
General & Administrative Expenses	230,000
Field Production Overhears	35,000
Capital Allowance	690,000
Investment Allowance	63,400
Personnel & Utilities	105,000

Material Handling	148,000
Appraisal Drilling Cost	77,000
Royalty Rate	23%

Required:

- (a) i. Using the above information, compare the effects of Incentives on Joint Venture Operation as against the Sole Risk Operation using the two Companies' operations. (7marks)
 - ii. What is the purpose of Tax Inversion Penalty (TIP)? (4marks)
 - iii. Determine the Tax Inversion Penalty and the Revised Government Take from the operations of the two Companies. (Tax Inversion Rate is 35%) (3marks)
 - (b) Explain the Term "Mineral Rights Acquisition Costs". (3marks)
 - (c) Explain briefly the differences between Joint Venture and Sole Risk Agreements under the year 2000 Memorandum of Understanding. (3marks)
- (Total 20 marks)**

QUESTION 4

- a. With respect to the Capital Gains Tax Act Cap C1 LFN 2004 (As Amended)
 - i. What is 'Disposal'? (2marks)
 - ii. When can an Acquisition/Disposal be said to be effective? (2marks)
- b. Your Tax Manager has just sent a memo in which you were asked to analyse the situation in a client's file with the sole aim of determining the Chargeable Gains:

Contents of Memo

- Dr. Alexander Bold purchased a Duplex in Parkview Estate at a cost of ~~₦80~~million on January 2009. It was used as a private residence. Another property was purchased in Banana Island in year 2012 and Dr. Bold transferred the Park View Estate ~~Property~~ to his wife as a Birthday present on August 12, 2013. The Market Value of the property was ~~₦140~~million. As a result of incessant flooding in Park View Estate, the property was finally disposed off or ~~₦200~~million on January 31, 2014 by the wife.
- An option on a piece of land in Magodo, Lagos State, was sold by Dr. Bold for a sum of ~~₦120~~million to Mr. Robert on July 1, 2010. Mr. Robert exercised the right to purchase the land for ~~₦150~~million in year 2013 and sold the property for ~~₦400~~million in year 2014.
- Mr. Clyde a friend of Dr. Bold, purchased a piece of property belonging to Bold and Wife Limited in Badagry at a cost of ~~₦240~~ million. The two parties agreed on

instalment payments starting with a 1st Instalment of ~~₦~~80million on July1, 2010, the balance of ~~₦~~80 million every 6 months thereafter. The last instalment could not be settled on time because of Mr. Clyde's illness who managed to pay ~~₦~~20million on January 1, 2013. The cost of the property to Bold and Wife Limited was ~~₦~~180million.

	₦
July1,2010	80,000,000
January1.2011	80,000,000
July2, 2011	40,000,000
January 1,2013	20,000,000

Mr. Clyde eventually died on March 5, 2013 hence the balance of ~~₦~~20Million could not be recovered and this was written off as Bad Debt with the consent of the Federal Inland Revenue Service.

Mr. Saxon (S.A.N) a Legal Practitioner from the Chambers of Saxon in Lagos was involved in a case on behalf of Dr. Bold's wife. The case lasted for about 4 years and judgement was received in favour of the client. The fees were settled partly by cash and partly with an acre of land belonging to Mrs. Bold at Lekki Phase Two in Lagos. Although the debt was ~~₦~~85million, the property was valued at the ~~₦~~60million. Mr. Saxon eventually sold the property for ~~₦~~220 million.

Required:

You are to prepare a memorandum on the above issues in respect of the following:

- i. Chargeable gains (5 marks)
 - ii. Opinion on all the above transactions (9 marks)
 - iii. The role of Federal Inland Revenue Service on the issue of Bad Debt on payment by Mr. Clyde (2 marks)
- (Total 20 marks)**

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

QUESTION5

Atlas Nigeria Limited is into sale of Mobile Phones and the Company's year –end is December 31 of each year. The Company's Annual Tax Returns for the year ended December 31, 2012, was submitted in January 2014. Tax officials found a number of irregularities during routine examination of the Tax Returns. They discovered that trade payables included ~~₦~~940,000 representing VAT for the two months to December 31, 2012. All sales attract VAT. There was no Input VAT during 2012. Tax officials were however of the opinion that the Income of the Company accrued uniformly throughout the 12 months of the year.

The accounts showed Adjusted Profits of ₦44,062,500 and Capital Allowances totaled ₦33,025,000. The tax Liability arrived at was ₦4,406,250. The Tax officials were not satisfied with the explanations received in connection with the Withholding Tax on the Director's fee of ₦1,562,500, as well as Consultancy fee of ₦812,500.

They also decided to write back 2/3 of the following expenses:-

- Printing and Stationery ₦168,750
- Donations and Subscription ₦1,320,620
- Losses claimed, amounting to ₦128,025 was disallowed. Included in the Adjusted profit figure is ₦6,962,500 for Depreciation.

REQUIRED:

- i. Show the computations resulting in Original Tax Liability of ₦4,406,250
(5mark)
- ii. Compute a revised Tax liability based on the findings of the Tax Officials
(10 marks)
(Total 15 marks)

QUESTION 6

YASSAR LIMITED imports Baby wears and has been in business for some years now. The company is doing very well and the Directors are impressed with the growth.

The company's Managing Director Chief Agbaegonkiti is a member of Enugu Sports Club. On January 14, 2015, after the morning aerobics in the club's gym, a friend of Chief Agbaegonkiti, who is also the Finance Director of a trading outfit narrated how the Company he works for, was subjected to a Tax Audit by the Federal Inland Revenue Service (FIRS) which resulted in payment of additional Tax Liabilities totaling ₦10.5million.

The Finance Director attributed their Company's ordeal to the Board's poor Understanding of key Tax related issues.

Chief Agbaegonkiti, after listening to his friend, was highly worried about such fate be falling his company. As a proactive move, he enquired for seasoned Tax Practitioners and your firm, Cutting-Edge & Co, Chartered Accountants, was referred to him.

As the Managing Partner, you are to make a present action to address the following;

- a. Briefly explain what you understand by the term Tax Avoidance and Tax Evasion. (2 marks)
- b. State FIVE differences between Tax Avoidance and Tax Evasion (5 marks)
- c. Outline the key stages in Tax Audit process. (5 marks)
- d. State SIX objectives of a Tax Audit exercise. (3 marks)

(Total 15 Marks)

QUESTION 7

- a. Tax planning involves making conscious efforts to arrange a Taxpayer's affairs in ways that will minimise Tax liabilities. It requires detailed knowledge of Tax Legislations and the application of same to particular circumstances; identifying and taking advantage of loopholes, if any.

The tax-conscious Taxpayer and the expert Tax Adviser working together can often times significantly reduce the Tax Liability that would have been otherwise payable.

You are required to:

Provide adequate Checklist of any SEVEN Documents/Information to be considered for effective Tax Planning strategies. (7 marks)

- b. Apex Communications Limited is a British Company engaged in the business of transmission of messages by Cable or any other form of wireless technology.

Its worldwide operating results for the year ended December 31, 2014 are as follows:

	₦'000	₦'000
Income from Cable messages originating in Nigeria	250,000	
Income from Cable messages routed through Nigeria	320,000	
Income from Cable messages terminating in Nigeria	<u>400,000</u>	970,000
Less:		
Salaries and wages	280,000	
Overhead expenses	160,000	
Depreciation	4,200	
Purchase of equipment	<u>3,500</u>	<u>(447,70)</u>
Surplus for the year		

You are provided with the following information:

- (i) The British Tax Authority has certified the Adjusted Profit and Depreciation allowance ratios;
- (ii) Included in Overhead expenses are disallowable items totalling ₦12,500,000; and
- (ii) Federal Inland Revenue Service is satisfied that tax is computed and assessed in Britain, the home Country of the foreign Company, on the same basis as Nigeria.

You are required to:

Compute the Tax Liabilities payable by the Company in Nigeria for the relevant Assessment Year. (8 marks)

(Total 15marks)

SOLUTION 1

(a) TAX COMPUTATIONS

	XYBLEX (Nig.) LIMITED TAX COMPUTATION ASSESSMENT YEAR 2016	KRYSTOL LTD TAX COMPUTATIONS ASSESSMENT YEAR 2016
	₦	₦
Net profit	20,025,420	40,251,240
Add. Depreciation	<u>10,052,500</u>	<u>7,250,600</u>
	30,077,920	47,501,840
Less:		
Profit on sale of Fixed Asset	<u>(6,845,150)</u>	<u>-</u>
Assessable Profit	23,232,770	47,501,840
Add: Balancing charge	<u>-</u>	<u>1,125,000</u>
	23,232,770	48,626,840
Less:		
Investment Allowance	<u>(8,285,400)</u>	<u>-</u>
	14,947,370	48,626,840
Less:		
Capital Allowance (Note 1)	<u>(18,329,700)</u>	<u>(19,684,850)</u>
Total Profit	NIL	<u>28,941,990</u>
Income Tax @ 30%	NIL	8,682,597
Tertiary Education Tax @2% of 23,232,770	<u>464,655</u>	<u>950,037</u>
		2% of ₦47,501,840
Total liability	<u>464,655</u>	<u>9,632,634</u>
Capital Allowance c/f ₦(18,329,700 – 14,947,370)	<u>3,382,330</u>	<u>NIL</u>

Note 1

XYBLEX (NIG.) LIMITED

Capital allowance: ₦18,329,700
 Since this is a manufacturing concern,
 The whole amount is allowed

KRYSTOL LIMITED

Capital allowance for the year	}	<u><u>₦19,684,850</u></u>
2/3 of Assessable Profit of ₦47,501,840 is ₦31,667,893		

The whole amount is allowed

XYBLEX (NIG) LIMITED (DIVIDEND PROPOSED)

The dividend of 15 kobo per ordinary share of ~~₦1.0~~ each amounts to ~~₦15~~ million and this is in contradiction with section 19 (1) (a) of CITA Cap C21 LFN 2004, which states that where a dividend is paid out of profit on which no tax is payable due to no total profit,

- Total profit which is less than the amount of dividend which is paid, whether or not the recipient of the dividend is a Nigerian company, is paid by a Nigerian company, the company paying the dividend shall be charged to tax at the rate prescribed as if the dividend is the total profit of the company for the year of assessment to which the accounts out of which the dividend is declared, relates.

In this case, there is no total profit for the year in question. So the dividend of ~~₦15~~, million becomes the total profit

So the liability of XYBLEX is as follows:

	₦
30% of ₦15,000,000	4,500,000
Tertiary Education Tax	<u>464,655</u>
Total Liability	<u><u>4,964,655</u></u>

Minimum tax provision section 33 (1) of CITA is ignored. However, if the minimum tax were to be computed, the highest would have been 0.5% of net assets.

$$= 0.5\% \text{ of } \del{₦350,000,000}$$

$$= \del{₦1,750,000} \text{ plus } \del{₦156,062.50} = \del{₦1,906,062.50} \text{ (Note2)}$$

So dividend provision is used and a total liability of ~~₦4,964,655~~ is payable

NOTE 2

Tutorials On

Minimum Tax Workings Xyblex (Nig) Limited

$$0.5\% \text{ of } \del{₦75,000,000} = \del{₦375,000}$$

0.5% of ₦350,000,000 = ₦1,750,000

0.25% of ₦100,000,000 = ₦250,000

0.25% of ₦500,000 = ₦1,250

Since the turnover exceeds ₦500,000

∴ The minimum tax is the highest of the above four plus 0.125% of the difference between the turnover and ₦500,000

∴ ~~₦1,750,000~~ + (0.125% of ~~₦(125,350,000 - 500,000)~~)

= ~~₦1,750,000~~ + ₦156,062.50 = ₦1,906,062.50

Krystol Limited

0.5% of ₦62,000,000 = ₦310,000

0.5% of ₦326,250,000 = ₦1,631,250.00

0.25% of ₦120,000,000 = ₦300,000

0.25% of ₦500,000 = ₦1,250

∴ ~~₦1,631,250.00~~ + 0.125% of ~~₦(102,500,000 - 500,000)~~

= ~~₦1,631.250~~ + ₦127,500 = ₦1,758,750

(iii) KRYSTOL LIMITED

The dividend proposed by Krystol which is 25 kobo per ordinary share amounts to ₦30,000,000.

This amount is more than the total profit of ₦28,941,990 for the year,

hence the dividend is deemed to be the total profit as Section 19 (1) (b) of CITA CAP C21 LFN 2004 applies.

	₦
Income Tax = 30% of ₦30,000,000	9,000,000
Tertiary Education Tax	<u>950,037</u>
Total Liability	<u><u>9,950,037</u></u>

On the issue of minimum tax, the highest would have been 0.5% of the Net Assets i.e. 0.5% of ₦326,250,000 = ₦1,631,250. Add (~~₦102, 500,000 - ₦500,000~~) x 0.125% ~~₦1,758,750~~. (See Note 2 Tutorial).

NB: The two companies may wish to prove to the tax authority that the dividends were paid out of the reserves. This may be a herculean task for the directors of the companies.

(c)

(i) **Pioneer Product Tax Relief Period**

Tax Relief Period of 3 years in the first instance commencing from the date of the production day of the company unless cancelled or restricted in any manner by the National Council of Ministers

This can be extended at the end of the 3 years for:*

- Two periods of 1 year each
- One period of two years each

This application for extension should be done in writing within one month of the expiration of the initial 3 years tax relief period or of any extension period. It is to contain details of all capital expenditure incurred by the company at the expiry date.

(ii) **Profits and Dividend**

Profit shown on the statement issued by the Federal Inland Revenue Service in respect of the income of a pioneer company for each of the accounting periods of its tax relief period, shall not form part of the Assessable Profits or Total Profits of the pioneer company for any year of assessment and shall be tax exempt.

Such amount of profit that is exempt from tax should be credited by the pioneer company to any account to be kept for the purpose of dividend distribution by the company.

Dividend thus declared by the company out of such profit shall be tax exempt in the hands of the shareholders and shall for the purpose of CITA and PITA be deemed to be out of profits on which tax is not paid or payable.

***Prohibition during the Tax Relief Period**

- Distribution to shareholders in form of dividends or bonus shares in excess of the amount by which the account maintained for the exempt profits is in credit at the date of such distribution.
- Granting of loan without first obtaining the consent of the Minister which shall only be given if satisfied that the pioneer company is obtaining adequate security and a reasonable interest for any such loan.

(d) (i) **Tax Avoidance**

Tax avoidance arises in a situation where the taxpayer arranges his or her financial affairs in a form that would give rise to the least possible amount of tax payable. The taxpayer implements devices to exploit loopholes in the tax laws that would result in avoiding or minimising tax liability.

This is a legal act as it is done within the limits permissible by the tax laws.

(ii) **The following are anti-avoidance measures**

(i) **Section 19 (Dividend Payment)** (a) (b) and section 20 (b) (c) stipulate that where: Dividend is paid out of a profit on which no tax is payable due to no total profit or total profit is less than dividend paid (by a Nigerian company to a Nigerian Company/Companies) the company paying the dividend shall be charged to tax at the rate of 30% as if the dividend is the total profit of the Company, for the year of assessment to which the accounts, out of which the dividend is declared relates.

(ii) **Section 21 (Undistributed Profit)**

Certain undistributed profits may be treated as distributed in respect of a "close company". A close company is that where the directors are shareholders, subjects, to a maximum of five.

(iii) **Sections 22 (Arm's Length)**

Where the Board is of opinion that any disposition is not in fact given effect to or that any transaction which reduces or would reduce the amount of any tax payable is fictitious or artificial, it would disregard the disposition and assess it at the market value of the transaction.

(iv) **Section 30 (Turnover Assessment)**

For a trade or business, where the Revenue Board feels that the trade or business produces either no assessable profit or assessable profit that is less than expected of the trade or business, the Board may raise assessment on the following basis

- If it is a Nigerian company, a reasonable percentage of the turnover
- If it is a Non-Nigeria company, that part of the turnover attributable to the fixed base of the business or that part of the profit attributable to the business or trade carried on through a Nigerian representative.

(v) **Section 29 (9) (Trades or businesses sold or transferred)**

The Board has the discretion not to grant the company applicable sections of commencement and cessation clauses and the grant of initial allowance where

sale or transfer of business is between connected persons and the transaction is not done at arm's length.

- Each asset shall be deemed to have been sold for an amount equal to the residue of the qualifying expenditure on the day following such sale or transfer.
- The company acquiring any of the asset shall not be entitled to any initial allowance on that asset.

(vi) Transfer Pricing

Income Tax Transfer Pricing Regulation Act of 2012 with commencement date of 2 August 2012. The Act was put together to fight amongst other issues Tax Avoidance.

This principle of transfer pricing is basically hinged on Arm's length price. This is to ensure that prices charged by associated enterprises for the transfer of goods, services and intangible property between connected taxable persons are done at arm's length i.e: A price that would have been charged by independent persons under similar circumstances.

MARKING GUIDE FOR SOLUTION 1

a	XYBLEX (NIG) LTD	Marks
	Headings	$\frac{1}{2}$
	Depreciation	$\frac{1}{2}$
	Assessable Profit	$\frac{1}{2}$
	Investment Allowance	$\frac{1}{2}$
	Capital Allowance	$\frac{1}{2}$
	Income Tax	$\frac{1}{2}$
	Tertiary Education Tax	$\frac{1}{2}$
	Capital Allowance	$\frac{1}{2}$
		<hr/>
		4
	Krystol Limited	
	Headings	$\frac{1}{2}$
	Depreciation	$\frac{1}{2}$

	Assessable Profit	1/2	
	Balancing Charge	1/2	
	Capital Allowance	1/2	
	Income Tax	1/2	
	Capital Allowance c/f	1/2	
	Tertiary Education Tax	<u>1/2</u>	4
bi	XYBLEX (NIG) LTD		
	Explanation of Dividend Provision	2	
	Calculating the total liability from income tax @ 30% of 15,000,000		
	Tertiary Education Tax	2	
	Explanation of Minimum Tax	2	
		<u> </u>	6
ii	Krystol Limited		
	Explanation of Dividend Provision	2	
	Calculating the total liability from Income Tax of 30% of ₦30,000,000		
	Tertiary Education Tax of 910.037	2	
	Explanation of Minimum Tax Provision	2	
		<u> </u>	6
c.	Pioneer Product of Tax Relief Period	3	
	Explanation on the Tax Relief Period		
	Explanation of Profit	1	
	Explanation Dividend	<u>1</u>	5

d	Explanation of Tax Avoidance as a legal Act by the Exploitation of loopholes in the Tax laws	3½
	Sitting 3 Provisions out of five stated	<u>1½</u>
		5
		<u>30</u>

EXAMINER'S REPORT

The question test candidates' knowledge and understanding of Tax Computation of companies entitled to the benefits accruing from a Tax Relief Period. (Pioneer Companies), proposed dividend, tax avoidance issues and measures put in place by Tax authorities to mitigate Tax Avoidance.

All the Candidates attempted the question. Performance was generally poor as less than a fifth of the Candidates scored up to half of the marks allocated to the question.

Some of the commonest pitfalls include – the fact that most of the candidates wrongly restricted capital allowance computation, whilst some candidates displayed ignorance of the provision that profits and dividends of any company still subject to the pioneer companies' tax relief period are not subject to tax.

Candidates are advised to spend valuable part of their study time identifying tax computation peculiarities of organisations based on sector or nature of their operations.

SOLUTION 2

SKY PETROLEUM PLC COMPUTATION OF PETROLEUM PROFITS TAX FOR 2014 ASSESSMENT YEAR

	₦'000	₦'000
Crude oil exported (3,500,000 x ₦75 x ₦280)		73,500,000
Local sale of crude oil (1,200,000 x ₦100)		120,000
Incidental income from Petroleum operations		<u>26,750</u>
Total Income		73,646,750
Exploration and Drilling costs	30,000	
Interest on inter-company loans obtained under terms prevailing in the open market	2,600	
Staff salaries	175,000	
Royalties on Export sales	6,200	
Repairs and renewals	2,900	
Rents paid	3,600	
Other administrative expenses	32,000	
Non-productive rents	8,300	
Specific provision for bad debts	11,200	<u>(271,800)</u>
Adjusted Profits		73,374,950
Deduct: Losses brought forward		<u>(13,200)</u>
Profit before Tertiary Education Tax		73,361,750
Deduct: Tertiary Education Tax (2/102 x ₦73,361,750,000)		<u>(1,438,466)</u>
(a) Assessable Profit		71,923,284
Deduct: Capital Allowances:		
Capital allowances for the year	40,760	
Petroleum Investment Allowance (see workings)	<u>7,200</u>	
	<u>47,960</u>	
Restricted to:		
85% Assessable Profit (85% x ₦71,923,284)	61,134,791	
Less: 170% of Petroleum Investment Allowance	<u>(12,240)</u>	
	<u>61,122,551</u>	
Capital allowances claimed (as above)		<u>(47,960)</u>
(b) Chargeable Profit		<u><u>71,875,324</u></u>

(c) Assessable Tax (85% of Chargeable Profit)	61,094,025
Less: Section 20 deductions (see Note below)	-
(d) Chargeable Tax	61,094,025
(e) Tertiary Education Tax (2% of Assessable Profit)	1,438,466

Note:

There is no indication in the question that this company operates under the Deep Offshore and Inland Basin Production Sharing Contracts, hence no section 20 deductions are applicable.

Workings

Computation of Capital Allowances and Petroleum Investment Allowance

Assets	Year of Acquisition	Cost	Rate	Capital Allowance	Investment Allowance between 100m to 200m @15%
		₦'000		₦'000	₦'000
Pipeline and storage Tanks	2014	48,000	20%	9,600	7,200
Plant and Machinery	2012	63,800	20%	12,760	-
Furniture and Fixtures	2012	21,000	20%	4,200	-
Buildings	2013	71,000	20%	14,200	-
		<u>203,800</u>		<u>40,760</u>	<u>7,200</u>

MARKING GUIDE FOR SOLUTION 2

	Marks
Heading of solution	1
Derivation of Total income	3
Allowable Expenses (1/2 mark each for 9 expenses)	4½
Losses brought forward	1

Tertiary Education Tax	1
Assessable Profit	$\frac{1}{2}$
Total Capital Allowances for the year (see workings)	$\frac{1}{2}$
Petroleum Investment Allowance	$\frac{1}{2}$
Restriction of 85% of Assessable Profit	$\frac{1}{2}$
170% of Petroleum Investment Allowance	$\frac{1}{2}$
Capital Allowance claimed (as above)	$\frac{1}{2}$
Chargeable Profit	$\frac{1}{2}$
Assessable Tax	1
Section 20 deductions (see note below)	$\frac{1}{2}$
Chargeable Tax	1
Tertiary Education tax	1
Capital allowance computed for each asset (1/2 mark per asset for 4 assets)	2
Computation of Investment Allowance	$\frac{1}{2}$
	<hr/> 20 <hr/>

EXAMINER'S REPORT

The question tests computations of assessable/chargeable profits, Assessable/Chargeable Taxes and Tertiary Education Tax in Petroleum Profit Tax.

A very high proportion of the candidates attempted the question. Performance was generally poor as less than 40% scored up to 50% of the marks

The major pitfall was the poor understanding of what constitutes allowable expenses as against disallowable expenses.

Candidates are advised to prepare better and be more discerning in appreciating the requirements of questions in future examinations.

SOLUTION 3

a)

(i)

	Ugheli Limited	Eket Limited
	\$	\$
Export Value	7,587,630	7,898,130
Royalty	(1,745,155)	(1,816,570)
	<u>5,842,475</u>	<u>6,081,560</u>
Section 10 deduction (W ₁)	(809,000)	(809,000)
Adjusted Profit	5,033,475	5,272,560
Tertiary Education Tax	(98,696)	(103,384)
Assessable Profit	<u>4,934,779</u>	<u>5,169,176</u>
Deduct:		
Capital Allowance	(690,000)	(690,000)
Investment Allowance	(63,400)	(63,400)
Chargeable Profit	<u><u>4,181,379</u></u>	<u><u>4,415,776</u></u>
Assessable Tax @ 85%	<u><u>3,554,172</u></u>	<u><u>3,753,410</u></u>
Government Take (W ₂)	<u><u>5,299,327</u></u>	<u><u>5,569,980</u></u>

From the results of the operations of the two Companies, the following are the incentives for Ugheli Limited.

- The Royalty payable is less than that of Eket Limited
- Assessable Profit of Eket Limited is higher than that of Ugheli Limited
- The applicable Tax Reference Price is less than the Realizable Price for Eket Limited
- Tertiary education tax of Eket Limited is higher
- Assessable tax of Eket Limited is higher, so also is the government take

(ii) One of the objectives of the 2000 MOU is to encourage investments in the Petroleum Industry and- maintain unit cost efficiency. For this purpose, Tax Inversion Penalty (TIP) was introduced to the extent that production operating expenses (T₁) is less than \$1.70/bbl for any calendar year.

$$TIP = (TR - TIR) \times (TI - LTIT) \times V$$

TIP = Tax Inversion Penalty

TIR = Tax Inversion Rate

TR = Application Tax Rate

LTIF = Lower Tax Inversion Threshold - \$1.70/bbl

V= Company's crude oil and condensate production

To the extent that TI is higher than \$2.30/bbl for a calendar year for companies producing above average of 175000bbls/day in the same calendar year, then UTIT will be substituted for LTIT

UTIT means Higher Tax Inversion Threshold

iii)

$$\text{Tax Inversion Penalty} \\ \text{TIP} = (\text{TR} - \text{TIR}) \times (\text{TI per barrel lost} - \text{TIT}) \times V$$

TR = Applicable Rate

TIR = Tax Inversion Rate

TI = Allowance deduction/Barrel

TIT = \$3.00/bbl for Companies below an average of 175,000 bbls/day in the same calendar year or \$2.30/bbl for companies above an average of 175,000 bbls/day in the same calendar year.

TI = $809,000/150,000 = 5.40$

TIP = $(0.85 - 0.35) \times (5.40 - 3.0) \times 150,000$
= $0.50 \times 2.4 \times 150,000$
= \$180,000

Tax Inversion Penalty = \$180,000

Revised Government Take - This will be applicable to Ugheli Limited only

$\text{RGT} = \text{Roy}_{(\text{TRP})} + \text{PPT}_{(\text{TRP})} + \text{TIP}$

This is only applicable to Ugheli Limited

	Ugheli Limited
	\$
Royalty	1,745,155
PPT	3,554,172
TIP	180,000
	<u>5,479,327</u>

Even with the Tax Inversion Penalty, the Revised Government Take in Eket Limited is still higher.

Mineral Rights Acquisition Costs

Mineral Rights Acquisition costs are incurred in acquiring concession rights to a lease area. They include Signature Bonus (initial consideration paid by the lessee to the lessor), legal fees, local statutory land acquisition fees/levies, reserves value fees, etc.

Acquisition costs may relate to proved or unproved properties, costs incurred to purchase,

lease, or otherwise acquire an item (whether proved or unproved) are initially capitalised when incurred. They include the following cost:

- Oil prospecting licence (to search for oil)
- Oil exploration licence (to explore for petroleum)
- Oil mining lease (to win, work, carry away and dispose of petroleum)
- Bonuses and options to purchase or lease properties
- Minerals, when land including mineral rights are purchased
- Recording fees, legal and other costs incurred in acquiring properties

Pre-licensing costs are those incurred in the period, prior to the acquisition of a legal right to explore for oil and gas in a particular location. Such costs include those incurred in the acquisition of speculative seismic data and expenditure on the subsequent geological and geophysical analysis of the data.

W₁

Section 10 deduction

	\$
Direct lifting cost	256,000
Health, safety and environment	15,000
Direct handling/transportation cost	20,000
General & Admin expenses	230,000
Field production overheads	35,000
Personnel & utilities	105,000
Materials handling	148,000
	<u>809,000</u>

W₂

Government Take

Ugheli Limited

Assessable Tax	3,554,172
Royalty	1,745,155
	<u>5,299,327</u>

Eket Limited

Assessable Tax	3,753,410
Royalty	1,816,570
	<u>5,569,980</u>

W₃

Export Value

Ugheli Limited - $150,000 \times \$50.5842 = \$7,587,630$

Eket Limited - $150,000 \times \$52.6542 = \$7,898,130$

Royalty

Ugheli Limited

$150,000 \times \$50.5842 \times 23\% = \$1,745,155$

Eket Limited

$150,000 \times \$52.6542 \times 23\% = \$1,816,570$

(c) **Joint Venture**

Joint venture is a contractual agreement whereby two or more parties undertake an economic activity which is subject to contractually agreed basis of sharing of control.

Under the Joint venture contract (JVC), each company is required to enter into joint contract agreement with the NNPC in respect of the company's operations in a particular oil field. The basis of the right and obligation are spelt out in the agreement.

A party in the agreement is given the concession to conduct the operations of drilling of a well/and/or the production of Oil.

Each party is allowed to lift from the crude oil produced, its equity share. NNPC equity contribution to the cost of operation is regarded as cash call.

Sole Risk Operation

Under the Sole Risk Operation, the operator (mostly indigenous operators) is allowed to operate on its own. The operator bears the cost of operations and when it discovers and produces oil in commercial quantity, it pays tax and royalty to the government. In most cases, the indigenous operators always go into technical agreements with overseas technical partners. As the name implies the operator bears the entire 100% risk.

MARKING GUIDE FOR SOLUTION 3

	Marks
a. i Computation of assessable Tax of two companies	2
Government Take	2
Comparison of two results(any three)	3
	<hr/> 7
ii Explanation of the objectives	1
Formula for Tax invasion Penalty	1
Explanation of Components of formula	1
Difference between LTIT and UTIT	1
	<hr/> 4
iii Calculation of the Penalty	1
	1
	<hr/> 2
Computation of Revised Government Take	1
b. Definition of Mineral Rights Acquisition Costs	1
Components of Acquisition costs (4 at least	1
Pre-licensing Cost	1
	<hr/> 3
c. Joint Venture Definition	1
Contribution of cash call	1
Sole Risk definition and Technical Cooperation	1
	<hr/> 3
	<hr/> 20

EXAMINER'S REPORT

The Question tests candidates' knowledge and understanding of the effects of incentives on joint ventures operations between two companies operating under a Memorandum of Understanding with the NNPC: as well as the knowledge and objectives of both the Tax Inversion Penalty (TIP), and the Revised Government Take.

Candidates were also expected to provide brief explanations on both the Mineral Rights Acquisition Costs, as well as the differences between Joint Ventures and Sole Risk Agreements under the year 2000 Memorandum of Understanding.

Many candidates did not attempt this question.

The major pitfall of the few that attempted the question is poor knowledge and understanding of the terminologies under the MOU.

Students are advised to familiarize themselves with the details of the year 2000 MOU.

SOLUTION 4

(a)

Date: xxxxxxxxx

From: Tax Senior

To: Tax Manager

Subject: Analysis of Issues in Dr. Bold's file

As requested sir, I have reviewed the different transaction as detailed in Dr. Bold's file

Please find below my response.

- (i) Disposal is made where any capital sum is derived from a sale, lease, transfer, assignment, compulsory acquisition or any other disposition of assets notwithstanding that no assets is acquired by the person paying the capital sum.
- where any capital sum is derived by way of compensation for any loss of office or employment.
 - where any capital sum is received in return for forfeiture or surrender of rights or from refraining from exercising any rights.
 - where any capital sum is received under a policy of insurance and the risk of any kind of damage or inquiry to or the loss or depreciation of assets.
 - where any capital sum is received as consideration for use or exploitation of any asset (e.g. right to exploit copy right).
 - where any capital sum is received in connection with or arises by virtue of any trade, business, profession or vocation.
- (ii) An acquisition/disposal is said to take effect on the date of the contract to acquire/dispose off the asset or on a date at which there is an enforceable right to acquire or a binding duty to dispose of the asset or any right or interest therein, and in particular.
- where any contract is to be performed subject to any condition, the date of acquisition/disposal shall be the date when the condition is satisfied, but where a consideration of such contract does not depend solely or mainly on the value of the asset at the time the condition is satisfied, the acquisition/disposal shall be treated as if the contract had never been conditional in which case the effective date shall be the date of the contract.
 - where an option is conferred by virtue of any contract, the date of the acquisition or disposal of asset shall be the date when the option is exercised.

b)

(i)	N	N
<u>ParkView Estate Duplex</u>		
Cost Price of the property		80,000,000
Less: Deemed disposal proceeds		<u>(80,000,000)</u>
Chargeable gain		<u>Nil</u>
 <u>Park view Estate duplex transferred to Mrs. Bold – by Husband</u>		
Disposal proceeds		200,000,000
Less: Cost		<u>(80,000,000)</u>
Chargeable gain		<u>120,000,000</u>
 <u>(Magodo Land) Sale of option</u>		
Sales proceeds		<u>120,000,000</u>
Chargeable gain		<u>120,000,000</u>
 <u>Badagry Land Sale to Mr. Clyde</u>		
Sales proceeds		240,000,000
Cost acquisition		<u>(180,000,000)</u>
Chargeable gain		<u>60,000,000</u>
 <u>(Magodo Land) Sale by Mr. Roberts</u>		
Sales proceeds		400,000,000
Less: Cost of land	120,000,000	
Cost of option	150,000,000	
		<u>(270,000,000)</u>
Chargeable gain		<u>130,000,000</u>

The Chargeable Gain will be assessed as follows:

Year of Assessment	Chargeable Gain Computation	Chargeable Gain
	N	N
July 2010	<u>80,000,000</u> x 60,000,000 240,000,000	20,000,000
01/01/2011	<u>80,000,000</u> x 60,000,000 240,000,000	20,000,000
01/07/2011	<u>40,000,000</u> x 60,000,000	10,000,000

240,000,000

01/01/2012	<u>80,000,000</u>	x 60,000,000	<u>10,000,000</u>
	240,000,000		<u>60,000,000</u>

Acquisition of Property in satisfaction of Debt	₦
Sales proceeds	220,000,000
Value of debt	(85,000,000)
Chargeable gain	<u>135,000,000</u>

(ii) **Opinion**

- Since the transaction was between spouses by way of gift, the consideration is deemed to be of such amount as would secure the disposal, neither gain nor a loss would accrue to Dr. Alexander Bold.

However, since Mrs. Bold disposed of the property to a third party, there is a Chargeable Gain for the period of ownership by Dr. Alexander Bold and the wife.

- When an option is exercised, consideration given for it is incorporated with the consideration for the asset itself so as to form part of a single transaction for both parties concerned.

However, where the grantee makes a loss on disposal of such option, it will not be an allowable loss unless the disposal was made at arm's length to a person not connected to the grantee.

- Where consideration or part thereof taken into account in computing Capital Gains is payable by instalments over a period exceeding 18 months from the date of disposal, Chargeable Gain is deemed to accrue in proportionate parts over the period of payments. The Chargeable Gain deemed to accrue in each year of assessment is calculated thus:

<u>Consideration payable in the period</u>	Total Chargeable Gain
Total Consideration	x

It should be noted that the CGT Act provides that full amount of consideration for the disposal should be brought into account.

- without any discount for postponement of the right to receive any part of the consideration.
- without regard to a risk of any part of the consideration being irrecoverable.
- without regard to the right to receive any part of the consideration taken

into account in the computation

- Where chargeable gains have become bad debt, necessary adjustments are to be made by way of discharge or repayment of tax or otherwise, if it is later proved to the satisfaction of the relevant tax authority that part of the consideration is taken into account in the computation.
 - When a property is acquired by a creditor in satisfaction of his debt, the property will not be treated as disposed of by the debtor or acquired by the creditor (Mr. Saxon) for a consideration greater than its market value at the date of acquisition.
 - Where the creditor eventually disposes of the property, if no chargeable gains accrue on disposal of the debt by the original creditor and a chargeable gain accrues when upon disposal of the property, the gain shall where necessary be reduced so as not to exceed the gain which would have accrued if he had acquired the property for a consideration equal to the amount of the debt.
- (iii) On the issue of bad debt payment by Mr Clyde, Bold and wife Limited would need to convince the Federal Inland Revenue Service that ₦20 million of the sales proceeds has become bad debt, the company will be given tax credit or tax refund of ₦500,000 being the capital gains tax on the chargeable gain arising from bad debt of ₦20 million.

Workings:

$$10\% \text{ of } \text{₦} \left(\frac{20,000,000}{240,000,000} \times \frac{60,000,000}{1} \right) = \text{₦}5,000,000$$

10% of ₦5,000,000

Tax Credit/Tax Refund = ₦500,000

MARKING GUIDE FOR SOLUTION 4

		Marks
A	(i) Definition of Disposal Listing any four points	2
	(ii) Two major factors of acquisitions/disposal	2
b	(i) Correct chargeable gain (1/2 mark each)	3
	Mode of assessing chargeable gain in respect of Badagry Land (1/2 mark for each correct year of assessment	2
		<hr style="width: 50px; margin-left: auto; margin-right: 0;"/> 5

(ii)	Correct opinion (1 Mark each)	8	
	Memo presentation	<u>1</u>	
			9
(iii)	Explanation on FIRS	1	
	Correct Tax Credit	<u>1</u>	
			2
			<u>20</u>

EXAMINER'S REPORT

This question tests candidates' knowledge and understanding of some concepts under the Capital Gains Tax Act as well as the incidence of bad debt arising from a transaction under the Act.

Majority of the candidates did not attempt the question. Performance was generally poor as majority of the candidates that attempted the question scored less than 50% of the marks allocated.

The major pitfall was the failure to correctly identify the timing of disposal of an asset as well as the relevance of the computation of Capital Gains.

Candidates also performed poorly whilst addressing the issue of proffering a Memorandum in the (b) part of the question.

Candidates are advised to consider the need to be well grounded in the preparation of Reports/Memoranda in support of proffered computations, whilst preparing for examinations.

SOLUTION 5

ATLAS NIGERIA LIMITED

COMPUTATION OF TAX LIABILITY FOR ASSESSMENT YEAR 2013

(a) ORIGINAL TAX LIABILITY COMPUTATION:

	₦
Original Adjusted Profit	44,062,500
Capital allowance (₦ 33,025,000) to be restricted to 2/3 of Adjusted profit	(29,375,000)
(44,062,500)	<u>14,687,500</u>
Income tax at 30%	<u>4,406,250</u>

(b)REVISED TAX LIABILITY:		₦
Adjusted Profit		44,062,500
Add Back (Disallowable expenses)	₦	
Printing and stationery cost (2/3 x ₦168,750)	112,500	
Donation and subscription (2/3 x ₦1,320,620)	880,413	
Disallowed loss claim	128,025	
		<u>1,120,938</u>
Assessable Profit		45,183,438
Less:		
Capital allowances (₦33,025,000)		
-Restricted to 2/3 of Adjusted profit (2/3 x ₦45,183,438)		(30,122,292)
∴ Revised total profit is		<u>15,061,146</u>
Income tax at 30%		4,518,344
Tertiary education tax (2% of ₦45,183,438)		903,669
		<u>5,422,013</u>
Other Liabilities:		
-VAT outstanding	₦940,000 x 12	5,640,000
-Withholding tax on consultancy fee (5% of ₦812,500)		40,625
-Withholding tax on Directors' Fee (10% ₦1,562,500)		156,250
Revised total liability		11,258,888
Less: Original tax computed		(4,406,250)
		<u>6,852,638</u>

Summary of Revised Tax Liability

	₦
Income Tax	4,518,344
Tertiary education tax	903,669
VAT outstanding	5,640,000
Withholding tax on consultancy fee	40,625
Withholding tax on directors' fee	<u>156,250</u>
	11,258,888
Less: original tax assessed	<u>(4,406,250)</u>
Additional assessment	<u>6,852,635</u>

MARKING GUIDE FOR SOLUTION 5

	Marks	
Heading		1/2
Computation of original total profit	1	
Computation of tax liability	<u>1</u>	

Revised tax liability		
Disallowable expenses ₦1,120,938	1	
Assessable profit	$\frac{1}{2}$	
Capital allowance		
Restricted figure of ₦30,122,292	1	
Total profit	1	
Revised income tax ₦4,518,344	1	
Revised income tax of ₦4,518,344	1	
Other Liabilities		
VAT outstanding	2	
Withholding tax on consultancy fee	1	
Withholding tax on director's fee	1	
Correct revised total liability	$1\frac{1}{2}$	
Correct additional assessment	<u>$1\frac{1}{2}$</u>	<u>$12\frac{1}{2}$</u>
		<u>15</u>

EXAMINER'S REPORT

This question tests candidates' understanding of the consequences of filing incorrect set of Annual Tax Returns, as highlighted by Tax officials.

Majority of the students attempted the question and performance was poor.

The commonest pitfall is that the candidates could not provide correct treatment of the incidence of capital allowances, withholding tax on director's fee, consultancy fees, as well as depreciation.

Candidates are advised to be more painstaking and thorough in their presentations for future.

SOLUTION 6

YASSAR LIMITED

(a) Tax Avoidance and Tax Evasion

Tax avoidance refers to a situation where the taxpayer arranges his/her financial affairs in such a way as would make him/her pay the least possible tax. The taxpayer after a critical review of the existing tax laws, exploits loopholes in the tax laws, which would enable him/her avoid or minimize tax Liability. It is Legal, once it is done within the limits permissible by the existing Tax Laws.

Tax evasion is the act whereby a taxpayer takes steps to minimize his/her tax liabilities, through illegal means. Tax evasion involves outright breach of the law, which is fraudulent and deceitful, such as deliberate omission of a source of the taxpayer's income from filed Returns. The Revenue Authorities view any case of evasion seriously and if discovered the Service will proceed to re-open the relevant assessments of such a taxpayer, beyond the official statutory limit of six years.

Differences between Tax Avoidance and Tax Evasion

	TAV AVOIDANCE	TAX EVASION
1	Legal	Illegal
2	Achievable through the exploitation of loopholes in the tax laws	Achievable through deliberate action of fraud and deceit or rendering incorrect returns
3	Results in the taxpayer paying minimum tax possible without breaking the provisions of existing tax laws	Results in taxpayer paying incorrect tax or paying tax through illegal means
4	Supported by the Law Courts in decided cases	Not supported by the law courts
5	No criminal liability	Tax Evader is criminally liable and could be charged to court with consequent fines, penalties and sometimes imprisonment
6	If stretched to the extreme the scheme could be disregarded by the Tax Authorities	At any level, Revenue Service will frown at tax evasion
7	No Revenue Service Investigation and prior years' assessment will not be re-opened	Revenue Service investigation will be instituted and has the power to re-open prior years' assessments beyond the statutory six-year limit.

(b) Stages in the Tax Audit Process

- (i) Selection of the taxpayer to be audited
- (ii) Preliminary review of the taxpayer's file
- (iii) Notification of the taxpayer

- (iv) Pre-audit meeting
- (v) Field work
- (vi) Post-audit meeting
- (vii) Interim audit report
- (viii) Post audit review by the Regional /Headquarters' Audit Units
- (ix) Reconciliation meetings:-
 - Payment of relevant tax/objections to assessment
 - Revised assessment/notice of refusal to amend
- (x) Final audit report
- (xi) Payment of tax or appeal against assessment

(c) Objectives of Tax Audit Exercise

The objectives are to enable the tax auditors determine whether or not:-

- (i) Adequate accounting books/records exist for the purpose of determining the taxable profits or loss of the taxpayer and consequently the tax payable.
- (ii) The tax computations submitted to the tax authority by the taxpayer agree with the underlying records.
- (iii) All applicable tax legislations have been complied with; and to also make provisions of an avenue to educate taxpayers on various provisions of the tax laws
- (iv) Discourage tax evasion and /or
- (v) Detect and correct accounting/arithmetic errors in the tax returns
- (vi) Provide feedback to the management on various provisions of the Law and recommend possible changes
- (vii) Identify cases involving tax fraud and recommend them for investigation
- (viii) Forestall taxable persons rendering incomplete or inaccurate Returns and
- (ix) Encourage voluntary compliance, which is one of the strong reasons in support of the self-assessment scheme

MARKING GUIDE FOR SOLUTION 6

	Marks	
1	Explanation of tax avoidance as tax planning of financial affairs to pay the least possible amount of tax	1
2	Explanation of tax evasion as criminal offence	<u>1</u> 2
3	Tabulation of differences between tax avoidance and tax evasion (one mark each for any five Points)	5
4	Stages in tax audit powers (1/2 mark each for ten points)	5
5	Objectives of tax audit process exercise (1/2 mark each for six points)	<u>3</u>
		<u>15</u>

EXAMINER'S REPORT

This question tests issues relating to tax avoidance and tax evasion especially in recognition of the possibility of tax audits.

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

The commonest pitfalls were that some candidates had issues differentiating between (i) Tax evasion and tax avoidance; as well as (ii) between statutory audit and tax audit.

Candidates are advised to be more thorough in their preparations for future examinations, by spending part of their study time identifying key material differences between tax concepts and their relevance.

SOLUTION 7

a) For effective tax planning strategies, knowledge of the following documents / information should be considered:

- i. List of approved taxes and levies ;
- ii. Timing of the dates of acquisitions of Property, Plant and Equipment ;
- iii. Timing of the dates of disposals of Property, Plant and Equipment in view of balancing adjustments ;
- iv. Timing an amount of capital allowances claimable
- v. Hire of assets as alternative to outright purchase – full hire charge is tax deductible;
- vi. Where to invest;
- vii. Making specific as against of General Provisions;
- viii. Accurate deduction of PAYE (Pay As You Earn) Tax
- ix. Accurate deduction of Withholding tax
- x. Knowledge of critical dates for:
 - ❖ Filing of tax returns
 - ❖ Filing of notice of objection
 - ❖ Monthly remittances of PAYE
 - ❖ Year-end Returns and final payment of PAYE
 - ❖ Remittance of Withholding tax to revenue authorities
 - ❖ VAT returns and remittances to Revenue Authorities

- ❖ Remittances to National Social Insurance Trust Fund (NSITF)
 - ❖ Remittances to National Housing Fund (NHF)
 - ❖ Income Tax Payment due to avoid paying penalty and interest.
- xi. Roll-over Relief in Capital Gains Tax (CGT)
- xii. Invest in stocks and share rather than in properties as stocks and shares are exempted from Capital Gains Tax (CGT) and are taxed at 10%
- xiii. Consider Current Tax Incentives
- ❖ Pioneer Companies
 - ❖ Rural Investment Allowance
 - ❖ Investment Tax Credit
 - ❖ Export Processing Zone (EPZ) Reliefs
 - ❖ Export Free Zone – Tax Holiday from all Federal, States and Local Government Taxes, Rates and Levies
 - ❖ Exemption of profits from solid minerals mining activities of (3- 5 Years Tax Holiday)
 - ❖ Hotel income exempt from tax – 25% of Income derived from Tourists in Convertible Currencies
 - ❖ Investment Tax credit on spare parts fabrication
 - ❖ Investment Tax Credit on replacement of obsolete plant and machinery
 - ❖ Gas utilization incentives
- xiv. Consider exempt income and profits of companies (Section 19 CITA)
- xv. Investment options – low or no tax on investment opportunities ; and
- xvi. Dividend distribution out of Frank Investment Income. (7 marks)

(b) **APEX COMMUNICATION LIMITED**

(i) **COMPUTATION OF ADJUSTED PROFIT FOR ASSESSMENT YEAR 2015**

	N'000	N'000
Net Profit per Account		522,300
Add:		
Depreciation	4,200	
Purchase of equipment	3,500	
Other disallowable items	<u>12,500</u>	<u>20,200</u>
Adjusted Profit		<u>542,500</u>

(ii) **COMPUTATION OF ADJUSTED PROFIT AND DEPRECIATION**

Computation of Adjusted Profit Ratio

$$\frac{\text{N}542,500,000}{\text{N}979,000,000} \times 100 = 55.93\%$$

Computation of Depreciation Ratio

$$\frac{\text{N}4,200,000}{\text{N}970,000,000} \times 100 = 0.43\%$$

(iii) **COMPUTATION OF COMPANIES INCOME TAX PAYABLE**

	N'000
Assessable Profit (N 250,000,000 x 55.93%)	139,825
Deduct: Capital Allowances (N 250,000,000 x 0.43%)	1,075
Total Profit	<u>138,750</u>

Companies Income Tax Liability	N
(30% of Total Profit = 30% x N 138,750,000)	41,625,000
2% of Assessable Profit)	<u>2,796,500</u>

Minimum Tax Liability (2% of N 250,000,000)	<u><u>N5,000,000</u></u>
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Note:

Since the companies income tax computed under normal assessment is greater than the minimum tax liability, the companies income tax of ~~N~~41,625,000 is payable.

MARKING GUIDE FOR SOUTION 7

	Marks
1 Mark for each correct document/information provided out of any	7
Appropriate heading	½
Net profit per account	½
Disallowable - ½ mark each (3)	1½
Adjusted profit	½
Heading for the adjusted profit and depreciation	½
Adjust profit ratio	½
Adjusted depreciation ratio	½

Correct heading for the Income tax computation	½
Assessable profit	½
Capital allowance	½
Total profit	½
Income tax	½
Tertiary education tax	½
Minimum tax liability	½
	<hr/>
	8
	<hr/>
	15

EXAMINER'S REPORT

This questions tests candidate's knowledge and understanding of Documents/Data required for Effective Tax Planning.

About 50% of the candidates attempted the question and performance was very poor.

The commonest pitfall was that majority of the candidates displayed scanty knowledge of tax planning strategies.

Candidates are advised to be more discerning in analyzing questions in order to have a better understanding of the distinction between concepts, their relevance and computations.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2016

STRATEGIC FINANCIAL MANAGEMENT

Time Allowed: 3 hours

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

A COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Katam Pie has adopted a strategy of diversification into many different industries in order to reduce risk for the company's shareholders. This has resulted in frequent changes in the company's gearing level and widely fluctuating risks of individual investments. Presently, the company has a target debt-to-asset ratio i.e. $D/(E + D)$ of 255, an equity beta of 2.25 and a pre-tax cost of debt of 5%.

On January 1, 2016, Katam Plc with a year end of December 31, is considering the purchase of a new machine costing ₦750million, which would enable it to diversify into a new line of business. The new business will generate sales of ₦522.50million in the first year, growing at 4.5% p.a. A constant contribution margin ratio of 40% can be expected throughout the 15-year life of the project. Incremental fixed cash costs will be ₦84.32million in the first year growing by 5.4%p.a.

A regional development bank has offered a 10-year loan of 3% interest to finance 40% of the cost of the machine. The balance of 60% will be financed equally by a 10-year commercial loan (with annual interest of 5%) and a fresh round of equity.

The issue cost on the commercial loan will be 1% and the new equity will incur issue cost of 3%. All issue costs are on the gross amount raised for the respective capital. Issue costs on debt are allowed to tax purposes.

A firm that is already in the business of the new project has a gearing ratio of 20% (debt to asset) and cost of equity of 18.1%. Its corporate debt is risk-free.

Tax rate is 30% payable in the year the profit is made. Tax depreciation of 20% on cost is available on the new machine. Katam Pie has weighted average cost of capital of 14% and cost of equity of 17.5%. The risk-free rate is 4% and the market risk-premium is 7%.

You are required to:

- a. Estimate the Adjusted Present Value (APV) and advise whether the project should be accepted? (21 Marks)
 - b. Explain:
 - i. The circumstances under which the use of APV is appropriate.
 - ii. The major advantages and limitations of the use of APV method. (9 Marks)
- (Total 30 Marks)**

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

QUESTION 2

BeeJay Plc is a medium-sized manufacturing company which is considered a 1 for 5 rights issue at a 15% discount to the current market price of ₦4.00 per share. Issue costs are expected to be ₦220,000 and these costs will be paid out of the funds raised. It is proposed that the funds raised from rights issue will be used to redeem some of the existing debentures at par. Financial information relating to BeeJay Plc is as follows:

Statement of Financial Position

	₦'000	₦'000
Non-current assets		6,550
Current assets:		
Inventory	2,000	
Receivables	1,500	
Cash	<u>300</u>	<u>3,800</u>
Total assets		<u>10,350</u>
Current liabilities:		
Trade payables	1,100	
Overdraft	1,250	2,350
Non-current liabilities: 12% debentures		4,500
Equity:		

Ordinary shares (50k per value)	2,000	
Reserves	<u>1,500</u>	<u>3,500</u>
Total Equity and Liabilities		<u>10,350</u>

Other information:

Price/earnings ratio of Beejay Plc	15.24
Overdraft interest rate	7%
Income Tax rate	30%
Sector average: Debt/equity rate (book value)	100%
Interest cover	6 times

Required:

- a. Ignoring issue costs and any use that may be made of the funds raised by the rights issue, calculate:
 - i. the theoretical ex-rights price per share
 - ii. the value of the rights per existing share (3 Marks)
- b. Calculate the current earnings per share and the revised earnings per share if the proceeds of the rights issue are used to redeem some of the existing debentures. (4 Marks)
- c. Evaluate whether the proposal to redeem some of the debentures would increase the wealth of the shareholders of BeeJay Plc. Assume that the price/earnings ratio of BeeJay Plc remains constants. (2 Marks)
- d. Discuss the reason why a right issue could be an attractive source of finance for BeeJay Plc. Your discussion should include an evaluation of the effect of the rights issue on the debt/equity ratio and interest cover.

(11 Marks)

(Total 20 Marks)

QUESTION 3

Skylet Limited is a major player in the aviation industry with a credit rating of AA. The company plans to raise ₦5billion from the bond market. The features of the bond are:

- Maturity 4 years
- Coupon payment Annual
- Coupon rate 5%
- Redemption value par

The current annual spot yield curve for government bonds is as follows:

One-year	3.3%
Two-year	3.8%
Three-year	4.5%
Four-year	5.3%

The following table of spreads (in basis points) is given for the aviation industry.

Rating	1 Year	2 Year	3 Year	4 Year
AAA	12	23	36	50
AA	27	40	51	60
A	43	55	67	80

You are required to calculate:

- the issue price of the bond; (6 Marks)
 - the yield to maturity and (3 Marks)
 - the duration (6 Marks)
- Discuss why conflicts of interest might exist between shareholders and bond holders. (5 Marks)

(Total 20 Marks)

QUESTION 4

Eko Product Plc (EP Plc) is a producer of a variety of vegetable oil and other household products in Lagos. The company presently faces a significant competition in the market of one of its major raw materials – palm oil. To secure regular flow of the raw material, the Directors of EP Plc are now considering making an offer for the entire share capital of Benin Oil Plc (BO Plc) a palm oil producing company in Benin.

The following financial information is provided for the two companies:

	EP Plc	BO Plc
Equity beta	1.2	1.2
Asset beta	0.9	1.2
Number of shares (million)	210	200
Current share price	₦29	₦12

It is thought that combining the two companies will result in several benefits. It is estimated that combining the two companies will generate free cash flow to the firm (FCFF) of ₦1,080 million in current value terms, but these will increase by an annual growth rate of 5% for the next four years, before reverting to an annual growth rate of 2.25% in perpetuity. In addition to this, combining the companies will result in cash synergy benefits of N100million per year, for the next four years. These synergy benefits are not subject to any inflationary increase and no synergy benefits will occur after the fourth year. The debt-to-equity ratio of the combined company will be 40:60 in market value terms and it is expected that the combined company's cost of debt will be 4.55% before tax.

The income tax rate is 20%, the current risk free rate of return is 2% and the market risk premium is 7%. It can be assumed that the combined company's asset beta is the weighted average of EP Plc's and BO Plc's asset betas weighted by their current market values. EP Plc has offered to acquire BO Plc through a mixed offer of one of its shares for two BO Plc shares plus a cash payment, such that a 30% premium is paid for the acquisition. Shareholders of BO Plc feel that a 50% premium would be more acceptable. EP Plc has sufficient cash reserves if the premium is 30%, but not, if it is 50%.

You are required to:

- Estimate the additional equity value created by combining EP Plc and BO Plc based on the free cash flow to firm method. Comment on the results obtained and discuss briefly the assumptions made; (11 Marks)
- Estimate the impact of EP Plc's equity holders if premium paid is increased to 50% from 30% (5 Marks)

- c. Estimate the additional funds required if a premium of 50% is paid instead of 30% and discuss how this premium could be financed. (4 Marks)
(Total 20 Marks)

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

QUESTION 5

BADEJO Limited, a small company, is currently considering a major capital investment project for which additional finance will be required. It is not currently feasible to raise additional equity finance, consequently debt finance is being considered. The decision has not yet been finalized whether this debt finance will be short or long term and it is to be a fixed or variable rates. The financial controller has asked you, as the company's Accountant to prepare a report for the forthcoming meeting of the board of directors.

Required:

Prepare a draft report to the board of directors which identifies and briefly explains:

- a. The main factors to be considered when deciding on the appropriate mix of short, medium or long term finance for BADEJO Limited. (8 Marks)
- b. The practical considerations which could be factors in restricting the amount of the debt which BADEJO Limited could raise. (7 Marks)
(Total 15 Marks)

QUESTION 6

- a. You work in the corporate finance department of a major bank. The bank has invested in 20,000.000 shares of Ode Oil Plc. You are concerned about the recent volatility in Ode Oil Plc's share price due to the recent instability in the global oil market. You plan to protect the bank's investment from a possible fall in Ode Oil Plc's share price for the next three months and you do not plan to sell the shares at present.

You have the following additional information:

Ode Oil Plc's current share price	₦10
Call option's current share price	₦11
Option expiry	3 months
Interest rate (annul)	8%
Ode Oil Plc's share annual standard deviation	64%

Required:

How many call options do you need to buy or sell in order to delta-hedge the bank's position. Please be specific.

Note: Delta may be estimated using $N(d_1)$ (7 Marks)

- b. The expected return on the market portfolio (estimated from past data) is 12% p.a. with a standard deviation of 15% and the risk-free rate of 4%p.a. The actual prices, last year dividends and the covariances from three securities (A, B, C) with the market are given in the table below:

Security	Actual Price (₦)	Last Year Dividend (₦)	Covariance with Market
A	107	1.30	0.025650
B	618	18.00	0.018675
C	1,350	22.00	0.029025

Required:

- Calculate the betas and the required rates of return of securities A, B and C. (3 Marks)
- In the table below you have market consensus forecast of 12-month price targets, ex-div, and the expected divided growth rate of the securities.

Security	12-month price target (N)	Dividend growth rate (%)
A	122.50	12
B	740.00	10
C	1,500.00	11

Assuming the dividends are paid in 12 months exactly, compute the required stock price for the 3 stocks and state your conclusion.

(4 Marks)

- iii. Considering the results in (ii) above, explain briefly what will be your strategy?

(1 Mark)

(Total 15 Marks)

QUESTION 7

MK Plc is considering the best way to finance the replacement for a particular high specification piece of equipment that has become too costly to main. The replacement equipment is estimated to have a useful life of 4 years with no residual value after that time.

Two alternative financing schemes being evaluated are:

- Scheme A: Buy the equipment outright funded by a bank loan
- Scheme B: Enter into a four year finance lease

Scheme A: Buy outright, funded by a bank loan

MK Plc could purchase the equipment outright at a cost of ₦200 million on July 1, 2016. MK Plc can normally borrow at an annual interest rate of 13% a year.

Scheme B: Four year finance lease

The equipment would be delivered on July 1, 2016 and MK Plc would pay a fixed amount of ₦58,790.000 each year in advance commencing July 1, 2016, for four years. At the end of four years, ownership of the equipment will pass to MK Plc without further payment.

Other information

- MK Plc has cost of equity of 20% and WACC of 16%
- MK Plc is liable to company tax at a marginal rate of 30% which is settled at the end of the year in which it arises

- Tax depreciation allowances on the full capital cost are available in equal instalments over the first four years of operation.

You are required to:

- a. Calculate which payment method is expected to be cheaper for MK Plc and recommend which should be chosen solely on the present value of the two alternatives as at July 1, 2016. (13 Marks)
 - b. Discuss the appropriateness of the discount rate used in (a). (2 Marks)
- (Total 15 Marks)**

Formulae

Modigliani and Miller Proposition 2 (with tax)

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

Asset Beta

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

Equity Beta

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

Growing Annuity

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

Modified Internal Rate of Return

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

The Black-Scholes Option Pricing Model

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

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

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

The Put Call Parity

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

Binomial Option Pricing

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

$$d = 1/u$$

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

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

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

The Miller – Orr Model

$$Spread = 3 \times \left(\frac{\frac{3}{4} \times Transaction\ Cost \times Variance\ of\ Cash\ flows}{Interest\ rate\ (as\ a\ proportion)} \right)^{\frac{1}{3}}$$

Annuity Table

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

Where r = discount

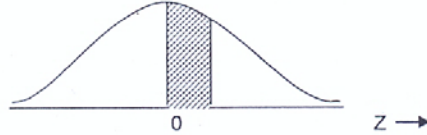
n = number of periods

Discount rate (r)

<i>Periods</i>										
(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
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606
(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
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	6.492	6.194	5.918	5.660	5.421	5.197	4.988	4.793	4.611	4.439
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675

NORMAL DISTRIBUTION

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



$Z = \frac{(x - \mu)}{\sigma}$	0.00	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.08	0.09
0.0	.0000	.0040	.0080	.0120	.0159	.0199	.0239	.0279	.0319	.0359
0.1	.0398	.0438	.0478	.0517	.0557	.0596	.0636	.0675	.0714	.0753
0.2	.0793	.0832	.0871	.0910	.0948	.0987	.1026	.1064	.1103	.1141
0.3	.1179	.1217	.1255	.1293	.1331	.1368	.1406	.1443	.1480	.1517
0.4	.1554	.1591	.1628	.1664	.1700	.1736	.1772	.1808	.1844	.1879
0.5	.1915	.1950	.1985	.2019	.2054	.2088	.2123	.2157	.2190	.2224
0.6	.2257	.2291	.2324	.2357	.2389	.2422	.2454	.2486	.2518	.2549
0.7	.2580	.2611	.2642	.2673	.2704	.2734	.2764	.2794	.2823	.2852
0.8	.2881	.2910	.2939	.2967	.2995	.3023	.3051	.3078	.3106	.3133
0.9	.3159	.3186	.3212	.3238	.3264	.3289	.3315	.3340	.3365	.3389
1.0	.3413	.3438	.3461	.3485	.3508	.3531	.3554	.3577	.3599	.3621
1.1	.3643	.3665	.3686	.3708	.3729	.3749	.3770	.3790	.3810	.3830
1.2	.3849	.3869	.3888	.3907	.3925	.3944	.3962	.3980	.3997	.4015
1.3	.4032	.4049	.4066	.4082	.4099	.4115	.4131	.4147	.4162	.4177
1.4	.4192	.4207	.4222	.4236	.4251	.4265	.4279	.4292	.4306	.4319
1.5	.4332	.4345	.4357	.4370	.4382	.4394	.4406	.4418	.4430	.4441
1.6	.4452	.4463	.4474	.4485	.4495	.4505	.4515	.4525	.4535	.4545
1.7	.4554	.4564	.4573	.4582	.4591	.4599	.4608	.4616	.4625	.4633
1.8	.4641	.4649	.4656	.4664	.4671	.4678	.4686	.4693	.4699	.4706
1.9	.4713	.4719	.4726	.4732	.4738	.4744	.4750	.4756	.4762	.4767
2.0	.4772	.4778	.4783	.4788	.4793	.4798	.4803	.4808	.4812	.4817
2.1	.4821	.4826	.4830	.4834	.4838	.4842	.4846	.4850	.4854	.4857
2.2	.4861	.4865	.4868	.4871	.4875	.4878	.4881	.4884	.4887	.4890
2.3	.4893	.4896	.4898	.4901	.4904	.4906	.4909	.4911	.4913	.4916
2.4	.4918	.4920	.4922	.4925	.4927	.4929	.4931	.4932	.4934	.4936
2.5	.4938	.4940	.4941	.4943	.4945	.4946	.4948	.4949	.4951	.4952
2.6	.4953	.4955	.4956	.4957	.4959	.4960	.4961	.4962	.4963	.4964
2.7	.4965	.4966	.4967	.4968	.4969	.4970	.4971	.4972	.4973	.4974
2.8	.4974	.4975	.4976	.4977	.4977	.4978	.4979	.4980	.4980	.4981
2.9	.4981	.4982	.4983	.4983	.4984	.4984	.4985	.4985	.4986	.4986
3.0	.49865	.4987	.4987	.4988	.4988	.4989	.4989	.4989	.4990	.4990
3.1	.49903	.4991	.4991	.4991	.4992	.4992	.4992	.4992	.4993	.4993
3.2	.49931	.4993	.4994	.4994	.4994	.4994	.4994	.4995	.4995	.4995
3.3	.49952	.4995	.4995	.4996	.4996	.4996	.4996	.4996	.4996	.4997
3.4	.49966	.4997	.4997	.4997	.4997	.4997	.4997	.4997	.4997	.4998
3.5	.49977									

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

SOLUTION 1

a)

i) **Ung geared cost of Equity (K_{EU})**

The base-case NPV is computed using ungeared cost of equity. We need to estimate this from the information about the proxy company. A number of methods can be used:

*** Using MM cost of Equity Formula**

$$K_{EG} = K_{EU} + (K_{EU} - K_D) \left(\frac{V_D}{V_E} \right) (1 - t), \text{ where}$$

K_{EG} = cost of equity of the proxy company = 18.1%

K_{EU} = the ungeared cost of equity, i.e. the cost of equity that reflects only the business risk of the new project = x

$$\left(\frac{V_D}{V_E} \right) = \text{debt/equity ratio of the proxy company} = 20/80 = 0.25$$

K_D = cost of debt, before tax, of the proxy company = 4%, since we are told it is risk-free.

Substituting figures in the formula, the position will be:

$$18.1 = x + (x - 4) (0.25) (1 - 0.30)$$

$$18.1 = x + (0.25x - 1) 0.70$$

$$18.1 = x + 0.175x - 0.70$$

$$18.1 + 0.70 = 1.175 x$$

$$1.175 x = 18.8$$

$$x = \frac{18.8}{1.175} = 16$$

i.e. 16%

*** Using MM WACC Formula**

- Current WACC of the proxy company:

$$\frac{V_E}{V_E + V_D} \cdot K_E + \frac{V_D}{V_E + V_D} \cdot K_D \cdot (1 - t)$$
$$(0.8)(18.1) + (0.2)(4)(1 - 0.3)$$

$$\text{i.e. } 14.48 + 0.56 = 15.04\%$$

$$WACC_g = WACC_u \left[1 - \left(\frac{V_D}{V_E + V_D} \right) (t) \right]$$

Substituting 15.04% for $WACC_g$ in the above formula, the position will be:

$$15.04 = x[1 - (0.20)(0.30)]$$

$$15.04 = x(1 - 0.06)$$

$$15.04 = 0.94x$$

$$x = 16\%$$

ii) **Base – Case NPV**

Given the life of the project of 15 years and differential growth (inflation) rates, it is faster to compute the PV of each item separately. Note that the given WACC of 14% and cost of equity of 17.5% of Katam Plc. are irrelevant.

* Contribution, net of tax		(N/m)
Contribution at year 0 prices:		
(N 522.50/1.045) x 0.40	=	200
Less tax at 30%		<u>(60)</u>
Net of tax		<u>140</u>
Real cost of capital = (1.16/1.045) – 1	=	0.110048 or say 11%
Annuity factor for 15 years at 11%	=	7.191
PV of contribution = N 140 x 7.19087	=	N 1,006.74
* Incremental fixed cost, net of tax		
Fixed cost at year 0 prices:		
(N 84.32/1.054) x (1 – 0.3)	=	N 56m
Applicable real cost of capital:		
(1.16/1.054) – 1 = 0.10569 or 10%		
Annuity factor for 15 years at 10%	=	7.606
PV = N 56 x 7.606	=	N 425.94

ALTERNATIVE METHOD

Growing annuity can be used to calculate the present value of each of the items involving growth (inflation). As given in the formula sheet, the present value of growing annuity is given by:

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

*** Contribution**

Contribution, net of tax, in Year 1 is

$$\text{N}(522.50 \times 0.4) \times (1 - 0.30) = \text{N}146.30\text{m}$$

$$\text{PV} = \frac{\text{N}146.30}{0.16 - 0.045} \left(1 - \left(\frac{1.045}{1.16} \right)^{15} \right) = \text{N}1,006.46$$

* **Incremental fixed costs**

Amount in year 1, net of tax:

$$\text{N}84.32\text{m} \times (1 - 0.3) = \text{N}59.024\text{m}$$

$$\text{N} \frac{59.024}{0.16 - 0.054} \left(1 - \left(\frac{1.054}{1.16} \right)^{15} \right) = \text{N}424.53\text{m}$$

* **Tax savings on tax depreciation**

$$\text{Annual tax savings} = \text{N}750 \times 0.2 \times 0.30 = \text{N}45\text{m}$$

These are **money** cash flows and must be discounted using money cost of capital of 16%

$$\text{Annuity factor (years 1 - 5) @ 16\%} = 3.274$$

$$\text{PV} = \text{N}45 \times 3.274 = \text{N}147.33\text{m}$$

Summary

	Nm
PV of contribution	1,006.74
PV of fixed costs	(425.94)
PV of tax savings on depreciation	147.33
Outlay	(750.00)
Base-case NPV	<u>(21.87)</u>

Financing side Effects

The project is financed as follows:

		Nm
Development Bank Loan	40% of N750m	300
Commercial loan:	60% x 50% x N750m	225
Equity	60% x 50% x N750m	225
Net amount needed		<u>750</u>

Issue costs

	Commercial loan Nm	Equity Nm
Net amount needed	225.00	225.00
Issue costs $\left(\frac{1}{99} \times 225 \right)$	2.27	$\left(\frac{3}{97} \times 225 \right)$ 6.96
Gross amount	<u>227.27</u>	<u>231.96</u>

$$\text{Tax savings on issue cost, due in year 1} = 2.27 \times 0.30 = \text{N}0.68\text{m}$$

Tax savings on interest

		₦m
Development Bank loan: $\text{₦}300 \times 0.03 \times 0.30$	=	2.70
Commercial loan: $\text{₦}227.27 \times 0.05 \times 0.30$	=	3.41
Total annual tax savings (year 1 -10)		<u>6.11</u>

After tax interest savings on Development Bank's loan

	₦m
Gross savings $300 \times (0.05 - 0.03)$	6.00
Tax on savings at 30%	<u>(1.80)</u>
Net interest savings (years 1 – 10)	<u>4.20</u>

Present value of the financing side effects

The present values of the financing side effects are calculated at the company's normal cost of borrowing of 5%, gross of tax.

Items	Year	NCF ₦m	PVF @5%	PV ₦m
Issue costs – Equity	0	(6.96)	1.000	(6.96)
- Com. loan	0	(2.27)	1.000	(2.27)
Tax savings on issue cost	1	0.68	0.952	0.65
Tax savings on interest	1 – 10	6.11	7.722	47.18
Interest savings on Development Bank's loan	1 – 10	4.20	7.722	32.43
Total PV of financing side effects				<u>71.03</u>

Note: In calculating the present values of the financing cash flows, the discount factor used is 5% to reflect the normal borrowing/default risk of the company.

Alternatively, the risk-free rate of 4% could be used depending on the assumption made. Credit will be given where these are used to estimate the discount factor.

Calculation of APV

	₦m
Base – case NPV	(21.88)
Financing side – effect	<u>71.03</u>
APV	<u>49.15</u>

Recommendation

Although the project has a negative NPV if financed purely by equity, it is worthwhile accepting it because of its proposed financing method. Accepting the project is expected to increase shareholders' wealth by ₦49.15 million.

b)

- i) The APV method is most appropriate in the following circumstances:
 - When it permanently changes the level of gearing of a company.
 - When the project involves unusual financing costs such as a subsidised loan.
 - It significantly changes the company's debt capacity.
 - If a number of project-specific financing options are to be considered.
- ii) The main benefits of this method are that
 - It should provide a more accurate assessment of the real worth of the project to the company.
 - It can deal more transparently with the side effects of financing.
 - The base case NPV stays the same even if assumptions about capital structure change, therefore fewer recalculations are required.

Limitations of APV

- The equation for asset betas in a taxed world assumes that cash flows are perpetuities. The cash flows for this investment are not perpetuities.
- APV requires the identification of all financing side effects and their discount at a rate reflecting their risk. In a complex investment situation, especially an overseas investment, it might be difficult to identify relevant financing side effects, and their appropriate discount rates.
- Since the regearing process is based on M&M Model, it ignores bankruptcy costs, tax exhaustion and agency costs.

MARKING GUIDE

	Marks	Marks
a.		
Calculation of ungeared cost of equity	3	
Calculation of base-case NPV	7	
Calculation of financing side effect	9	
Calculation of APV	1	
Recommendation	1	
	<hr/>	21
b.		
Circumstances for use, 1 mark per point, max. 3 points	3	
Advantages, ½ mark per point, max 2 points	3	

Limitations, $\frac{1}{2}$ mark per point, max 2 points

3	
	9
	30

EXAMINER'S REPORT

The question tests candidates understanding of the application of capital project appraisal techniques using Adjusted Present Value (APV) method.

Over 90 percent of the candidates attempted the question. They are expected to compute the ungeared cost of equity, the base-case NPV, using growing annuity formula provided in the paper, and the various issue costs. Virtually all the candidates did not show good understanding of the requirements of the question as they demonstrated lack of proper understanding of adjusted present value, hence, their failure to provide correct solution to the problem resulting in their poor performance.

Candidates commonest pitfalls were their

- i. Inability to calculate the required cost of capital;
- ii. Use of money cash flows rather than real cash flows to save time
- iii. Lack of proper understanding of APV;
- iv. Failure to include net interest savings on subsidised finance;
- v. Lack of understanding of application of annuity factor in solving problems with constant cash flows; and
- vi. Inability to make use of growing annuity formula in dealing with the question in order to save time.

Candidates are advised to cover the syllabus adequately, make use of the Institute's Study Text and Pathfinders and improve their knowledge on the application of appraisal techniques section of the syllabus, paying particular attention to the appropriateness of adjusted present value (APV), in arriving at investment decisions. Candidates' are strongly advised to practice several comprehensive examination questions when preparing for the Institute's examinations

SOLUTION 2

a) Rights issue price = $\text{₦}4 \times 0.85 = \text{₦}3.40$

		₦
5 existing shares @ ₦ 4	=	20.00
<u>1 new share @ ₦3.40</u>	=	<u>3.40</u>
<u>6</u>		<u>23.40</u>

i) Theoretical ex-rights price = $\text{₦}23.40 \div 6 = \text{₦}3.90$

ii) Value of rights in total = $\text{₦}3.90 - \text{₦}3.40 = \text{₦}0.50$

Value of rights per existing share = $\text{₦}0.50 \div 5 = \text{₦}0.10$

b) Calculation of EPS

i) Existing EPS

Current VPS	=	₦ 4.00
P/E ratio	=	15.24
$\therefore \text{EPS} = \frac{\text{₦}4}{15.24} \times \frac{100}{1} \text{ kobo}$	=	26.25k

Number of shares = $2\text{m}/0.5 = 4\text{m shares}$

Total earnings = $4\text{m} \times \text{₦}0.2625 = \text{₦}1.05\text{m}$

ii) Post rights EPS

Additional number of shares = $4\text{m} \div 5$	=	800,000
Existing number of shares	=	<u>4,000,000</u>
Post-rights number of shares		<u>4,800,000</u>
Gross funds raised = $800,000 \times \text{₦}4 \times 0.85$	=	₦ 2,720,000
Issue costs		<u>(₦220,000)</u>
Net funds raised		<u>₦2,500,000</u>
Debenture interest saved, net of tax		
= $\text{₦}2,500,000 \times 0.12 \times (1 - 0.30)$	=	₦ 210,000
Revised earnings, after tax		
= $\text{₦}1,050,000 + \text{₦}210,000$	=	<u>₦1,260,000</u>
Revised EPS = $\text{₦}1,260,000 \div 4,800,000$	=	26.25 kobo

- c) As the price/earnings ratio is constant, the share price expected after redeeming part of the debentures will remain unchanged at $\text{₦}4$ per share ($\text{₦}0.2625 \times 15.24$). Since this is greater than the theoretical ex-rights share price of $\text{₦}3.90$, using the funds raised by the rights issue to redeem part of the debentures results in a capital gain of

10k per share. The proposal to use the rights issue funds to redeem part of the debentures therefore results in an increase in shareholders' wealth.

d) **Notes:** In the analysis below, alternative assumptions are used. Full credit is given for any of the assumptions used by the candidates.

i) **Gearing Ratio**

The calculation is based on book value

- **Current Position**

Case 1 - Excluding bank overdraft

	₦'000
Debt	4,500
Equity	3,500
∴ D/E ratio	$= \frac{4,500}{3,500} \times 100 = 129\%$

Case2- Including bank overdraft

	₦'000
Debt = ₦4,500 + ₦1,250	5750
Equity	3500
∴ D/E ratio	$= \frac{5,750}{3,500} \times 100 = 164\%$

Comments: Both values are above the sector average of 100%. Issuing new equity will therefore be attractive in this situation.

* **Expected Position - After rights issue**

	Excluding Overdraft	Including Overdraft
	₦'000	₦'000
Debt: ₦4,500 – ₦2,500 =	2000	
(₦4,500 – ₦2,500) + ₦1,250 =		3250

Equity	₦3,500 + ₦2,500	=	6000	6000
∴ D/E ratio			33%	54%

If the rights issue is not used to redeem the debenture issue, the decrease in gearing, is less dramatic.

- Excluding overdraft:

$$\frac{4,500}{6,000} \times 100 = 75\%$$

Including overdraft:

$$\frac{5,750}{6,000} \times 100 = 96\%$$

Comments: In both cases, the debt/equity ratio falls to less than the sector average, signaling a decrease in financial risk. The debt/equity ratio would fall further if increased retained profits were included in the calculation, but the absence of information on the company's dividend policy makes retained profits uncertain.

ii) Interest Cover

First, we need to establish the level of EBIT (Earning Before Interest and Tax)

Existing earnings, after tax	=	₦1,050,000
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Tax Rate		30%
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Earning before tax:

$$\frac{1,050,000}{1-0.30} \times 100 = \text{₦1,500,000}$$

Add existing interest:

- Debentures	₦4.50m x 0.12	=	₦540,000
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- Overdraft	₦1,250,000 x 0.07	=	<u>₦87,500</u>
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EBIT ₦2,127,500

The EBIT is not affected by any financing decision.

Existing total interest = ~~₦540,000~~ + ~~₦87,500~~ = ~~₦627,500~~

Revised interest payment:

~~₦627,500~~ – (0.12 x ~~₦2,500,000~~) = ~~₦327,500~~

Interest cover:

Existing ~~₦2,127,500~~ / ~~₦627,500~~ = 3.4times

Revised ~~₦2,127,500~~ / ~~₦327,500~~ = 6.5times

Comments: There will be an improvement in interest cover from 3.4 times (which is below the sector average of 6 times) to 6.5 times (which is marginally better than the sector average)

A rights issue will also be attractive to BeeJay Plc. since it will make it more likely that the company can raise further debt finance in the future, possibly at a lower interest rate due to its lower financial risk.

It should be noted that a decrease in gearing is likely to increase the average cost of the finance used by BeeJay Plc., since a greater proportion of relatively more expensive equity finance will be used compared to relatively cheaper debt. This will increase the discount rate used by the company and decrease the net present value of any expected future cash flows.

MARKING GUIDE

		Marks	Marks
a.	Ex-right price and value of right		3
b.	Existing earnings	1	
	Revised EPS	3	
		<hr/>	4

c.	Analysis of wealth		2
d.	Gearing and comments	4	
	Interest cover and comment	7	
		<hr/>	11
	Total		<hr/> 20 <hr/>

EXAMINER'S REPORT

The question tests candidates' knowledge of the various computations associated with rights issue and its effects on leverage and interest cover.

Over 80 percent of the candidates attempted the question but most of them showed inadequate knowledge of its requirements. However, Part a (i and ii) of the question were well attempted by many of the candidates while the other parts of the question were poorly attempted by almost all the candidates that attempted it, hence the overall performance was poor.

Candidates' commonest pitfalls were their failure to evaluate and interpret data correctly and lack of in-depth knowledge of the requirements of the question particularly in the Part (d) where they failed to make relevant computations that were expected to assist them in correctly evaluating the effect of the rights issue on leverage and interest cover.

Candidates' are advised to cover the syllabus adequately, read, understand and interpret questions appropriately before attempting them for better result. They should also endeavor to make use of the Institute's Study Text when preparing for the Institute's examinations.

SOLUTION 3

a)

i) Issue Price

The spot yield curve should be used to calculate a likely issue price. The government bond yield curve needs to be adjusted by the credit spread for an AA rated company.

	1 year	2 years	3 years	4
year				
Govt's bond spot-yield curve	3.30	3.80	4.50	
5.30				
Add AA spread	<u>0.27</u>	<u>0.40</u>	<u>0.51</u>	<u>0.60</u>
	<u>3.57</u>	<u>4.20</u>	<u>5.01</u>	<u>5.90</u>

To price the bond, the cash flows associated with it are discounted using the above spot rates.

$$\text{Price} = \frac{5}{1.0357} + \frac{5}{(1.042)^2} + \frac{5}{(1.0501)^3} + \frac{105}{(1.059)^4} = \text{N}97.24$$

ii) Yield to Maturity (YTM)

The YTM is computed by trial and error as follows:

$$\text{Try 6\%: NPV} = -\text{N}97.24 + 5(3.465^*) + 100(0.792) = -\text{N}0.71$$

(* annuity factors at 6% for 4 years)

$$\text{Try 5\%: NPV} = -\text{N}97.24 + 5(3.546) + 100(0.823) = \text{N}2.79$$

$$\text{YTM} = 5 + \left[\left(\frac{\text{N}2.79}{\text{N}2.79 + 0.71} \right) \times (6 - 5) \right] = 5.80\%$$

iii) Duration

Year (n)	CF N'000m	DFat 5.80%	PV N'000m	PV x n N'000m
1	5	0.945	4.725	4.725
2	5	0.893	4.465	8.930
3	5	0.844	4.220	12.660
4	105	0.798	<u>83.790</u>	<u>335.160</u>
			<u>97.200</u>	<u>361.475</u>

$$\text{Duration} = \frac{\text{N}361.475}{\text{N}97.2} = 3.72 \text{ years}$$

b)

- i) **Different attitudes to risk and return** - Shareholders may want the company to undertake risky projects with correspondingly high expected levels of returns. Bondholders will want the company to undertake projects that guarantee sufficient returns to pay their interest each year, and ultimately to repay their loans.
- ii) **Dividends** - Large dividends may be preferred by shareholders, but may concern bondholders, because the payments leave low cash balances in the company and hence put at risk the company's ability to meet its commitments to the bondholders.
- iii) **Priority in insolvency** - Bondholders may wish to take the company into liquidation if there are problems paying their interest, to guarantee their investment. Shareholders however may wish the company to continue trading if they expect to receive nothing should the company go into liquidation.
- iv) **Attitudes to further finance** - Shareholders may prefer the company to raise additional finance by means of loans, in order to avoid having to participate in a rights issue, or the risk of dilution of their shareholding and control if an open stock market issue is made. Bondholders may not wish the company to take on the burden of additional debt finance, of payment of interest and repayment to avoid additional financial risk.
- v) **Restriction imposed by bondholders** - Restriction imposed by bondholders to protect their loans, such as charges preventing the company from selling assets or covenants, may limit the company's ability to maximize returns for shareholders.
- vi) **Bankruptcy costs** - If the costs of bankruptcy, such as receivers and lawyers' fee, are likely to be significant, bondholders may be much less willing than shareholders for the company to bear any risk. Significant bankruptcy costs may mean that there is insufficient money left to repay loans.

MARKING GUIDE

	Marks	Marks
a.i. Computing spot rates	3	
Calculation of bond price	3	
	<hr/>	6
ii. Computing YTM		3
iii. Computation of duration		6
b. Discussion of agency problems, 1 mark per point, subject to max of 5 points		5
		<hr/>
		20
		<hr/>

EXAMINER'S REPORT

The question tests candidates' knowledge of the application and evaluation of bonds based on business scenarios and their understanding of yield, yields to maturity duration and bond pricing using government yield curves. It also tests agency problems in finance.

About 90% of the candidates attempted the question and performance was generally poor. The Part (a) of the question which carried 75% of the mark was not well understood while Part (b) was fairly attempted.

Candidates commonest pitfalls were their:

- i. Inability to use the government's yield curve to generate the spot rate while those who were able to do so could not successfully use them; and
- ii. Lack of sufficient details on conflict of interest between shareholders and bondholders.

Candidates are advised to take time to read, understand and interpret questions appropriately and note their specific requirements before attempting them. They should also endeavor to cover the syllabus in their preparation for the Institute's examinations and make use of the Institute's Study Text and other relevant materials.

SOLUTION 4

a) • Current market value

		₦
EP Plc.	$210 \times \text{₦}29$	6,090
BO Plc.	$200 \times \text{₦}12$	<u>2,400</u>
		<u>8,490</u>

• Asset beta

$$\left(\frac{6,090}{8,490} \times 0.9\right) + \left(\frac{2,400}{8,490} \times 1.2\right) = 0.985$$

• Equity beta

$$\begin{aligned}\beta_E &= \beta_A + (\beta_A - \beta_D) \left(\frac{V_D}{V_E}\right) (1 - t) \\ &= 0.985 + (0.985 - 0) \left(\frac{40}{60}\right) (1 - 0.20) = 1.51\end{aligned}$$

• Cost of equity

$$\begin{aligned}K_E &= R_F + \beta_E (R_M - R_F) \\ &= 2 + 1.51(7) = 12.57\%\end{aligned}$$

• WACC

$$\text{WACC} = (0.6 \times 12.57) + (0.4 \times 4.55)(1 - 0.2) = 9\%$$

• Additional Equity created

Present value of free cash flow:

			₦million
Yr 1	$\frac{1,080 \times 1.05}{1.09}$	=	1,040.37
2	$\frac{1,080 \times 1.05^2}{1.09^2}$	=	1,002.19
3	$\frac{1,080 \times 1.05^3}{1.09^3}$	=	965.41
4	$\frac{1,080 \times 1.05^4}{1.09^4}$	=	<u>929.98</u>
PV of FCFF years 1 – 4*			3,937.95

PV of FCFF years 5 – infinity:

$$\frac{1,080 \times 1.05^4 \times 1.0225}{(0.09 - 0.0225) \times 1.09^4} = \underline{14,087.52}$$

Total PV of FCFF 18,025.47

Add PV of synergy:

$$100 \times 3.40^{**} \quad 340.00$$

Total value of the combined company

18,365.47

Less value of debt (40%) (7,346.18)

Combined value of

equity (60%) 11,019.29

Existing total value of equity (8,490.00)

Additional equity created 2,529.29

* The PV of FCFF for the first 4 years can be calculated using the growing annuity formula provided in the formula sheet:

$$PV = \frac{FCFF_1}{r-g} \left[1 - \left(\frac{1+g}{1+r} \right)^n \right]$$

$$= \frac{1,080 \times 1.05}{0.09 - 0.05} \left[1 - \left(\frac{1.05}{1.09} \right)^4 \right] = 3,937.95$$

** Annuity factor at 9% for 4 years.

Comments

Although the equity beta and the risk of the combined company is more than that of EP Plc. on its own, probably due to BO Plc's higher business risk (reflected by the higher asset beta), overall the benefits from growth in excess of the risk free rate and additional synergies have led to an increase in the value of the combined company.

However, a number of restrictive assumptions have been made in obtaining the valuation, for example:

- the assumption of growth of cash flows in perpetuity may be unrealistic;
- whether the calculation of the combined company's asset when based on the weighted average of the market values is based on good evidence or not; and
- the given figures such as growth rates, tax rates, free cash flows, market risk premium, etc. are realistic or not.

In all, it may be necessary to undertake sensitivity analysis to determine how changes in the variables would impact on the value of the combined company.

b) Purchase consideration of BO Plc.:

			£million
30% premium	$= 1.30 \times \text{£}2,400\text{m}$	$=$	3,120
50% premium	$= 1.50 \times \text{£}2,400\text{m}$	$=$	3,600
New number of shares:			
210m + ($\frac{1}{2} \times 200\text{m}$)		$=$	310m

Loss in value per share of combined company, if 50% of premium is paid instead of 30%.

$$(\text{£}3,600 - \text{£}3,120)/310 \text{ shares} = \text{£}1.55/\text{share}$$

This represents a drop in value of approx 5.3% on original value of EP Plc. share (1.55/29)

c) The amount of additional cash is about ~~£~~480 million, if EP Plc. agrees to the demand made by BO Plc.'s shareholders and pays the 50% premium. EP Plc. has a number of options to raise the ~~£~~480 million:

- i) The company could take on additional loan. But this will increase financial leverage and the WACC, which in turn will reduce the value of the company.
- ii) EP Plc. could raise the amount by issuing additional equity capital, but the existing shareholders may not see this as a positive development.
- iii) EP Plc. could offer a higher proportion of its shares in the share-for-share exchange instead of paying cash for the additional premium – but this will lead to further dilution of the equity holding of the existing shareholders of EP Plc.

It is however necessary to consider whether the shareholders of BO Plc. would consider, more of cash or more of equity shares?

MARKING GUIDE

	Marks	Marks
a. Existing value of equity	1	
Asset beta	1	
Equity beta	1	

	Cost of equity	$\frac{1}{2}$	
	WACC	$\frac{1}{2}$	
	Total value of the company	3	
	Extra equity	2	
	Comments	2	
		<hr/>	11
b.	Premium	2	
	New number of shares	1	
	Loss of value	2	
		<hr/>	5
c.	Additional cash required	2	
	Comments, (1 mark per valid comment – max 2 points)	2	4
	Total		<hr/> 20 <hr/>

EXAMINER'S REPORT

The question tests candidates' knowledge of modern business valuation techniques under mergers and acquisition with emphasis on candidates understanding of the analysis of merger and acquisition premium.

The level of attempt was low as only about 20 percent of the candidates attempted the question and performance was poor.

Candidates' commonest pitfalls were their inability to correctly compute the value of the company using free cash flow to the firm (FCFF), failure to analyse the synergies and failure to compute the acquisition premium as demanded in the question.

Candidates are advised to always cover the syllabus adequately and make use of the Institute's Study Text when preparing for the Institute's examination for better result. They should also pay attention to learning some key formulae and their applications.

SOLUTION 5

To: The Board of Directors - Badejo Limited

From: Accountant

Date: May 18, 2016

SUBJECT:

- (a) The factors to be considered in deciding the appropriate mix of short, medium or long term finance for the company.
- (b) Factors to be considered in restricting the amount of debt which a company could raise

a. The factors to be considered in deciding the appropriate mix of short, medium or long term finance for the company include:

- i. **The term of finance** - The term should be appropriate to the asset being acquired. As a general rule, long term finance should be financed from long-term sources. Cheaper short-term funds should be used to finance short-term funds requirements such as fluctuations in the level of working capital.
- ii. **Flexibility** - Short-term debt is a more flexible source of finance. It is better than long term debt which sometimes may require payment of penalties when paid before maturity. Long-term debt also has the disadvantage of being locked in the interest rate payment when there is a fall in interest rate.
- iii. **Repayment terms** - The company must have sufficient funds to be able to meet repayment schedules contained in the loan agreement. Since short-term funds are usually repayable on demand or at short notice, it is therefore risky to finance long-term capital investments with short-term funds.
- iv. **Availability** - In case of a negative change in the company's position or a change in economic conditions, it may be difficult to renew short-term finance.
- v. **Cost** - Interest on short-term debt is in most cases usually less than on long-term debt. However, if short-term debt has to be renewed frequently, issue expenses may raise its cost.

- vi. **Effect on gearing** - Certain types of short-term debt (bank overdraft, increased credit from suppliers) will not be usually included in gearing calculation. If a company is seen as too highly geared, lenders may be unwilling to lend it money or decide that the high risk of default must be compensated by higher interest rate or restrictive covenants.
- b. Factors to be considered in restricting the amount of debt which the company could raise include:
 - i. **Restrictions in the memorandum and articles of association of the company** - There will be a need for the company to examine the legal documents carefully to see if there is any restriction placed on the amount the company could borrow and for what purpose
 - ii. **Previous records of the company** - If the company or its directors or shareholders has a low credit rating, investors may be unwilling to subscribe for the debentures that may be issued by the company
 - iii. **Restriction on current borrowing** - If the terms of any current loan to the company contain restriction on borrowing rights, it may be difficult for the company to obtain further loan.
 - iv. **Uncertainty over project** - The project is a significant one, and presumably the interest and ultimate repayment that lenders obtain may be very dependent on the success of the project. If the result are uncertain, lenders may not be willing to take the risk.
 - v. **Security-** Inability of the company to provide the security that lenders require particularly when it is faced with restriction on its assets.

Signed

ACCOUNTANT

MARKING GUIDE

	Marks	Marks
Format		1½
a. 1½ marks per point, max 5 points		7½
b. 1½ marks per point, max 4 points		7
Total		<u>15</u>

EXAMINER'S REPORT

The question tests candidates' knowledge of the evaluation and application of financing options for a business and emphasizes short, medium and long term alternative financing.

Over 90 percent of the candidates attempted the question and performance was poor. Most of the candidates could not differentiate between sources of finance and factors to be considered in capital mix hence, performance was poor.

Candidates' commonest pitfalls were their inability to differentiate between sources of finance and the factors that determine the capital mix. In addition, they could not identify the limiting factors to debt financing.

Candidates are advised to adequately cover the syllabus and make use of the Study Text in their preparation for the Institute's examinations. They should also ensure to read, understand and interpret questions appropriately and note their specific requirements before making an attempt.

SOLUTION 6

a) The Black – Scholes Option Pricing Model formula given as

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

- First, we need to determine d_1

$$d_1 = \frac{\ln\left(\frac{10}{11}\right) + 0.08 + (0.5 \times 0.64) \times 0.25}{0.64\sqrt{0.25}} = -0.0753$$

- $N(d_1) = N(-0.0753)$
 $= 1 - N(0.0753)$
 $= 1 - [0.5 + (0.0279 + 0.53(0.0319 - 0.0279))]$
 $= 0.470$

- Let x = number of call options needed for delta-hedging

Security	Qty	Delta/unit	Total delta
Shares	20,000,000	1.00	20,000,000
Call	x	0.47	$0.47x$
Total			<u>$20,000,000 + 0.47x$</u>

For delta-hedging, this total should be equal to 0. That is:

$$20,000,000 + 0.47x = 0$$

$$\text{i.e. } 0.47x = -20,000,000$$

$$x = -42,553,191 \text{ calls}$$

Thus, the bank needs to **sell** 42,553,191 calls for delta-hedging.

b)

$$\text{i) Beta} = \frac{\text{covariance with market}}{\text{variance with market}}$$

$$\beta_A = 0.025650 / 0.15^2 = 1.14$$

$$\beta_B = 0.018675 / 0.15^2 = 0.83$$

$$\beta_C = 0.029025 / 0.15^2 = 1.29$$

The required return is given by:

$$R_i = R_F + \beta_i(R_M - R_F)$$

$$R_A = 4 + 1.14(12 - 4) = 13.12\%$$

$$R_B = 4 + 0.83(12 - 4) = 10.64\%$$

$$R_c = 4 + 1.29 (12 - 4) = 14.32\%$$

ii)

- Expected dividends in 1 year:

$$A \quad 1.3 \times 1.12 = \text{₦}1.456$$

$$B \quad 18.0 \times 1.10 = \text{₦}19.80$$

$$C \quad 22.0 \times 1.11 = \text{₦}24.42$$

- Expected stock price (cum-div) in 1 year

$$A \quad (107 \times 1.312) + 1.456 = \text{₦}122.4944$$

$$B \quad (618 \times 1.1064) + 19.80 = \text{₦}703.5552$$

$$C \quad (1,350 \times 1.1432) + 24.32 = \text{₦}1,567.64$$

Summary

Stock	Forecast price (₦)	Required price (₦)	Conclusion
A	122.50	122.4944	Properly valued
B	740.00	703.5552	Over valued
C	1,500.00	1,567.640	Under valued

iii) If you believe that the market consensus forecast is correct, sell stock B (over-valued) and buy stock C (under-valued)

MARKING GUIDE

	Marks	Marks
a.		
Calculation of d_1	2½	
Calculation of d_2	2	
Calculation of number of calls	1½	
Correct interpretation (i.e. sell)	1	
		7
b.		
Calculation of covariances	1½	
Calculation of required return	1½	
Calculation of expected dividends	1½	
Calculation of expected price	1½	
Summary	1	
Conclusion	1	
	<hr/>	8

EXAMINER'S REPORT

Part (a) of the question tests candidates' knowledge of delta hedging using Black-Scholes option pricing model while Part (b) tests candidates' application of Capital Asset Pricing Model (CAPM).

The level of attempt was very low as not more than 20 percent of the candidates attempted the questions and performance was very poor. Candidates are expected to compute d_1 and $N(d_1)$ and apply the result in their recommendations. They are also expected to analyse the securities stated in the question using capital assets pricing model.

Candidates' commonest pitfalls were their inability to apply the Black Scholes formula for d_1 and make use of the normal distribution table.

Candidates are advised not to be selective in their choice of study for the examination of the Institute. They should ensure that they cover the syllabus and not leave out any part in their preparations.

Candidates are expected to be guided by the Study Text and should not limit themselves to the Study Text alone but should take advantage of other textbooks for more details.

SOLUTION 7

a) Financial evaluation of the two options.

Scheme A. The relevant cost is simply the cost of the equipment i.e. ₦200million

Scheme B. Finance lease – a number of steps are needed here:

i) Implied interest rate

The implied interest rate on the lease is computed as follows:

	₦'000
Cost of equipment	₦200,000
Less advance lease rental	(58,790)
Net cost of rental	<u>141,210</u>

This is repaid by ₦58,790,000 p.a. for 3 years.

Annuity factor = $141,210/58,790 = 2.402$.

From the annuity tables, a 3-year cumulative present value of 2.402 corresponds to approximately 12%. Therefore the implied interest on the lease is 12%.

Alternative method

An alternative method is to compute the IRR of the following cash flows associated with the lease:

	₦000
Year 0	Net cost of the asset
	141,210
1 – 3	lease rentals
	(58,790)

IRR = 12% approx.

ii) Interest component of each rental

Year	Opening balance ₦'000	Interest at 14% ₦'000	Rental ₦'000	Closing balance ₦'000
0	200,000	0	58,790	141,210
1	141,210	16,945	58,790	99,365*

2	99,365	11,924	58,790	52,499
3	52,499	6291**	58,790	0

* $141,210 - (58,790 - 16,945)$

** Rounding error adjusted against interest to ensure closing balance of zero.

iii) **Tax savings on interest**

			₦000
Year 1	$16,945 \times 0.3$	=	5,084
2	$11,924 \times 0.3$	=	3,577
3	$6,291 \times 0.3$	=	1,887

iv) **Discount rate.** The discount rate to use is the cost of borrowing, net of tax
 $= 13 (1 - 0.30) = 9.1\%$

v) **NPV of lease option**

Year	0	1	2	3
	₦000	₦000	₦000	₦000
Lease rentals	(58,790)	(58,790)	(58,790)	(58,790)
Tax relief interest	0	5,084	3,577	1,887
NCF	(58,790)	53,706	(55,213)	(56,903)
PVF at 9.1%	1	0.917	0.840	0.770
PV	(58,790)	(49,248)	(46,379)	(43,815)
Total PV	(₦198,232,000)			

Note: The above calculations are based on differential cash flows. We have therefore ignored tax savings on tax depreciation. Whether the company buys the equipment by borrowing or adopts a finance lease, it is entitled to tax depreciation on the equipment. If the relevant tax savings are incorporated into the analysis, the result will be as follows:

Annual tax depreciation:	₦'000
$₦200m \times \frac{1}{4} \times 0.30$ (year 1 – 4)	15,000
Annuity factor at 9.1% (4 years)	3.233
$PV = 15,000 \times 3.233$	= ₦48,495

	Buy	Lease
	₦000	₦000
NPV as previously calculated	(200,000)	(198,232)
Tax savings on depreciation	48,495	48,495
Net cost	<u>(151,505)</u>	<u>(149,737)</u>

It is clear that the **relative position** of the two alternatives remains the same.

Conclusion: The leasing option offers a cost savings of ₦1,768,000 relative to the purchase option and it is therefore the preferred option.

b) The two main possible discount rates are:

The decision to invest in the equipment being financed will have already been evaluated taking project specific risk into account. The evaluation in (a) is being used to support the financing decision rather than the investment decision. Cash flows should be discounted at either WACC or project specific discount rate when evaluating the investment decision since the project is financed using the company's debt and equity resources. However, the financing decision is a separate decision and the discount rate should be tailored appropriately.

In financing decision, we can use debt as the 'base line' and compare other forms of finance to the cost of debt by using the cost of debt as the discount rate. The post-tax cost of debt is the opportunity cost of leasing and can be used to discount the incremental cash flows arising from leasing as compared to buying outright using the discount rate. Note that it would have been equally acceptable to use leasing as the 'base' instead of debt and hence discount cash flows at the post tax implied cost of leasing. However, it is generally simpler to discount at the post tax cost of debt.

MARKING GUIDE

	Marks	Marks
a. Scheme A	1	
Scheme B:		
• Implied interest rate	2	
• Interest calculations	4	
• Tax savings on interest	1	
• Discount rate to use	$\frac{1}{2}$	
• NPV of lease option	$4\frac{1}{2}$	
	<hr/>	13
b. Discussion		2
		<hr/>
Total		15

EXAMINER'S REPORT

The question tests candidates understanding of the analysis of finance lease.

More than 80 percent of the candidates attempted the question and performance was very poor. Candidates are expected to compute implied interest rate in the lease and also analyse the tax saving on interest but they showed very limited understanding of the question.

Candidates' commonest pitfalls were their:

- i. Inability to identify the correct discount rate to use;
- ii. Improper treatment of the advanced lease rental; and
- iii. Inability to calculate implied interest rate and cost.

Candidates' are advised to prepare adequately for the Institute's examinations and make use of the Study Text and Pathfinders in their preparations.

GENERAL OBSERVATIONS

This particular examination has demonstrated a number of disturbing trends in the attitude of the candidates towards the examination. Some of these include:

- i. **Limited coverage of the syllabus** – It would appear that candidates have declared some parts of the syllabus as unexaminable! How wrong they are!!

In this paper, topics like free cash flow model, bond valuation using spot rates, delta hedging, etc. were tested at the surface. In future examinations, and based on recent developments in the Nigerian economy (for example, the decision of the CBN to introduce currency forwards and futures), candidates should expect these topics to be tested in greater depth. Candidates should also note that there is “no-go-area” in the entire syllabus.

- ii. **Key Financial Management Formulae** – There are evidences that candidates do not learn the use and the application of the formulae annexed to the question paper. In this examination, only very few candidates made use of growing annuity formula in solving question number one. Candidates wasted time (and hence marks!) in compounding and discounting over a period of 15 years when the desired result could have been achieved with one or two lines, using growing annuity.

Future examination questions will continue to test the use and the applications of these formulae.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION - MAY 2016

ADVANCED AUDIT AND ASSURANCE

Time Allowed: 3 hours

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

SECTION A:

COMPULSORY

(30 Marks)

QUESTION 1

Your firm was recently appointed the statutory auditors of Foodys, a limited liability company in Nigeria, for the year ended December 31, 2015. The previous auditors, from whom your firm has received professional clearance, did not wish to be re-appointed as auditors.

The principal activities of the company are the distribution and retail of fine Spanish food products. All products are imported from suppliers based in Spain and delivered to Foodys's central warehouse in the south west of Nigeria. The company has its own retail outlets but also supplies national supermarket chains and small independent retailers in Nigeria. Sales through Foodys's retail outlets are on cash basis and sales to supermarkets and independent retailers are on credit basis.

The company maintains computerised records for inventories held at the distribution centre and retail outlets. The inventory records are supported by continuous counting procedures and as a result the company does not undertake a physical count at the year end.

Foodys's retail outlets are equipped with computerised tills. As each sale is recorded, the computer updates the quantity sold and the inventory balance. The manager at each outlet is responsible for banking the takings on a daily basis.

During the year, the company engaged consultants to design and implement the company's new website with online ordering facilities. Under the terms of the contract, the website was scheduled to be operational by the end of September 2015 in order to take advantage of the high seasonal demand at this time of the year. Due to technical problems, the website was not launched until the end of November 2015. The consultants have been paid in full for their work. However, the company has commenced legal proceedings for breach of contract.

Despite failing to meet its sales targets in respect of online sales, the management accounts for the 11 months to November 30, 2015 indicate an increase in sales revenue

of 12% compared with the same period in 2014. Inventory and receivables balances are significantly higher than the previous year as a result of the increased level of activity.

Management is planning to expand the retail activities of the business by opening additional retail outlets. It is hoping to fund the expansion with a bank loan and has approached the company's bankers to provide the funding. The bankers require the audited financial statements before making a decision. Management is keen to have the funding in place to progress with the expansion and would like to have the audit completed by February 28, 2016.

Required:

- a. Identify the key business risks from the circumstances described above.
- b. List the factors which have led you to identify that risk;
- c. Outline the audit work you would perform to address the risk

(Total 30 Marks)

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

QUESTION 2

- a. Comment on the need for ethical guidance for accountants on money laundering.
(5 Marks)
- b. You are senior manager in Nnamdi & Co, a firm of Chartered Accountants in Nigeria. Recently, you have been assigned specific responsibility for undertaking annual reviews of existing clients. The following situations have arisen in connection with three clients:
 - i. Nnamdi & Co was appointed auditor and tax advisor to Unicorn Co last year and has recently issued an unmodified opinion on the financial statements for the year ended March 31, 2016. To your surprise, the tax authority has just launched an investigation into the affairs of Unicorn on suspicion of under-declaring income.
(7 Marks)
 - ii. The chief executive of Hassan Co., an exporter of specialist equipment, has asked for advice on the accounting treatment and disclosure of payments being made for security consultancy services. The payments, which aim to ensure that consignments are not impounded in the destination country of a major customer, may be material to the financial statements for the year

ending December 31, 2015. Hassan does not treat these payments as tax deductible. (4 Marks)

- iii. Your firm has provided financial advice to the Adetunji family for many years and this has sometimes involved your firm in carrying out transactions on their behalf. The eldest son, Verni, is to take up a position as a senior government official to a foreign country next month. (4 Marks)

Required:

Identify and comment on the ethical and other professional issues raised by each of these matters and state what action, if any, Nnamdi & Co should now take. (Total 20 Marks)

QUESTION 3

The Kuramo Art Gallery and Museum (KAGM) is in the centre of a city that is popular with tourists. About 65% of its income comes from admission fees and annual memberships, and about 30% of its income comes from sponsorship of special exhibitions by companies. Most of the remaining income comes from a small cafe and gift shop in the art gallery and museum.

Admission fees come from sales of tickets to daily visitors and from annual membership subscriptions from 'Friends of KAGM' who are entitled to free entry to the art gallery and museum at any time.

Day tickets can be purchased by credit card in advance, by a telephone 'hotline' or at KAGM's website on the Internet. Alternatively, day tickets can be bought with cash or credit card at the 'door' on the day of the visit. Reduced prices are available for children, students and individuals aged over 65, and there are also special reduced-price 'family tickets' for two adults and two children.

Sponsorship arrangements are agreed up to 18 months in advance. Some corporate sponsors, particularly transport companies (bus companies and railway companies) sell advertising to KAGM.

The management of KAGM have identified the following applicable risks that need careful attention. They believe that these risks should be managed actively.

- (i) There is a failure to attract more visitors because of the poor condition of

many of the paintings in the art gallery and of the items in the museum. Paintings must be restored regularly because their condition deteriorates. KAGM has just one specialist restorer, who is unable to keep up with the required volume of work. The management of KAGM recognise that investment in new items and the restoration of existing items is inadequate, but blame the lack of income for the problem.

- (ii) Some corporate sponsorship agreements may not be invoiced due to poor communication between the sponsors, KAGM's sponsorship managers and the accounts department of KAGM.
- (iii) Some sponsorship agreements are not invoiced at their correct amount. This happens often when a sponsor is also a company that provides advertising for KAGM. Normal practice is for these sponsors to deduct their advertising charges from the amount they pay to KAGM in sponsorship. However, the accounts department in KAGM is not given the details of these set-off arrangements.
- (iv) Some of the cash received from day visitors at the door may be stolen (or lost, or used by management for business expenses) and does not reach KAGM's cashier.
- (v) The on-line booking system for buying tickets in advance on the KAGM website is not always available because the website is 'down'.

Required

- a. Describe appropriate internal controls to manage each of the applicable risks described above. (15 Marks)
 - b. Explain the financial statements risks that arise from each of these applicable risks. (5 Marks)
- (Total 20 Marks)

QUESTION 4

You are the manager responsible for four audit clients of Globe & Co, a firm of Chartered Accountants. The year end in each case is June 30, 2015.

You are currently reviewing the audit working paper files and the audit seniors' recommendations for the auditors' reports. Details are as follows:

- a. Red Co. limited is a subsidiary of Yellow Holdings Plc. Serious going concern problems have been noted during this year's audit. Red will be unable to trade for the foreseeable future unless it continues to receive financial support from the parent company. Red has received a letter of support ('comfort letter') from Yellow Holdings Plc.

The audit senior has suggested that due to the seriousness of the situation, the audit opinion must at least be qualified 'except for'. (5 Marks)

- b. Edo Co Plc 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 given in the financial statements. The carrying amount of goodwill in the statement of financial position as at June 30, 2015 is the same as at June 30, 2014 as management's impairment test shows 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 emphasis of matter paragraph. (6 Marks)

- c. The directors' report of Prompt Co 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 16% 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 directors' report. (4 Marks)

- d. Audit work on the after-date bank transactions of Twinkle Co Limited has identified a transfer of cash from Star Co. Limited. The audit senior assigned to the audit of Twinkle has documented that Twinkle's finance director explained that Star commenced trading on July 20, 2015 after being set up as a wholly-owned foreign subsidiary of Twinkle.

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 year's financial statements. (5 Marks)

Required:

For each situation, comment on the suitability or otherwise of the audit senior's proposals for the auditors' reports. Where you disagree, indicate what audit report modification (if any) should be given instead.

(Total 20 Marks)

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

QUESTION 5

Badagry Yachting and Marina (BYM) have a marina on the West Coast of Nigeria and a large sales operation dealing in yachts and speedboats. You are responsible for the audit of BYM and have found some potential causes of concern that could indicate fraudulent activity or financial misconduct within the company. In particular:

- (i) 30% of the yachts on sale by BYM are supplied through one of the major international boating companies with a special finance arrangement deal. However, BYM have also obtained separate finance on these yachts, which are therefore in effect being 'double financed'.
- (ii) Ten yachts shown as assets by BYM cannot be located, with no explanation other than that they have not been sold. These yachts are worth approximately N50million.
- (iii) Long delays have occurred in performing reconciliations with the last four months of reconciliations still not completed. At the time of the last reconciliation, material differences had been identified upon which no action appears to have been undertaken.
- (iv) Sales have been overstated by N100million in the current financial statements.

The finance director has been off sick with stress for the last five months and therefore has not been available to discuss any of the issues identified.

Required

- a. Explain the difference between fraud and error and how the issues shown here could be categorised as fraud or error. **(6 Marks)**

- b. Discuss the role of management and the role of the auditor in the prevention and detection of fraud and error. (3 Marks)
- c. Describe what steps you would take to further investigate and then report on the matters referred to above. (6 Marks)

{Total 15 Marks}

QUESTION 6

Bob Removals Limited is a removals company. In the year ended December 31, 2015 the company made a trading profit of N800,000. You are the manager in charge of the audit.

The following issues have arisen:

- (i) A customer is suing the company for N1m for damage caused to antique furniture. The company is defending the claim and believes that the furniture was a reproduction as opposed to antique and therefore worth only N100, 000.
- (ii) A balance due from Safe Storage in respect of sub-contract work, of N300, 000, has been outstanding for over six months. Your firm has been asked by Bob Removals' accountant not to write to Safe Storage for direct confirmation of this amount as the latter company objects to such letters. You have been assured by the accountant that the relationship between the two companies is good and that the outstanding balance will be paid.
- (iii) Bob Removals has recently invested in four new removal vans and is currently carrying out extensive refurbishment of its premises. As a result of this expenditure the company has reached its overdraft limit of N500,000.

Required

For each of the above issues:

- a. State, with reasons, the audit work that you would expect to find when undertaking your review of the audit working papers for the year ended December 31, 2015
- b. Draft the relevant sections dealing with these issues of the written representation letter you would wish the directors to sign.

(Total 15 Marks)

QUESTION 7

You are one of three audit managers working for a medium-sized firm of accountants which has just taken on the audit of Mastay Designs limited. Mastay Designs retails designer clothes through its two shops located in busy towns 30 kilometres apart.

The clothes sold are very exclusive. They are designed by the company's owner, Mrs. Smith, who is also the managing director. 50% of the company's clothes are made to order with the remainder being produced as inventory for the two shops. Each hand made piece can take up to three months from commencement of design to finishing and can sell for up to N100,000.

Mrs Smith splits her time equally between the two shops. She employs two shop managers, two assistants, and other staff who make up her designs in workrooms above each shop. There are two other directors: Mr. Smith, her husband, the finance director, and Ms Craft, her sister, who is the marketing director.

The following is an extract from the financial statements:

	Year ended September 30, 2015 (draft)	Year ended September 30, 2014 (actual)
	N	N
Non-current assets		
Intangible (goodwill)	675,000	750,000
Property, plant and equipment	400,000	450,000
Current assets		
Inventories		
Finished goods	1,500,000	2,100,000
Work in progress	450,000	750,000
Note to the draft accounts		

There is a legal claim pending. However, the directors consider that it is so unlikely to succeed that no provision has been made for it in the financial statements.

The goodwill figure arose when Mastay Designs Limited, originally a partnership was incorporated to become a limited company in July 2011.

Required:

- a. State the evidence you would require from Mastay Designs limited in order to verify the year end inventory figures and justify your answer. (4 Marks)
- b. Briefly describe what audit work you would perform to verify the figure for goodwill in the financial statements. (3 Marks)
- c. Explain what is meant by an 'accounting estimate' and describe what work you would perform to verify whether or not the figure for the legal claim pending should be included in the financial statements. (4 Marks)
- d. Mastay Designs limited has approached its bank to discuss raising finance for a new exciting 12 month partnership venture with a major clothes designer. The bank has asked for a five year forecast to be examined and reported on by an accountant. Briefly describe what work you would carry out in connection with the forecast, including the contents of your firm's report. (4 Marks)

(Total 15 marks)

SOLUTION TO QUESTION 1

- 1a. Business risks according to ISA 315 relate to identifying and assessing the risk of material misstatements through understanding the entity and its environment and can be defined as risks resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

Based on the scenario in the question, the following are the business risks that are embedded in the operations of **Foody's Ltd**:

- i) The imported food is perishable and might spoil before getting to Nigeria.
- ii) Foreign exchange fluctuations may lead to large losses and may not be treated in line with IAS 21.
- iii) The risk that the food might have expired before being sold to customers causing reputational risk. Some of the expired goods might be carried in inventory without value adjustment in line with IAS 2.
- iv) Credit risk arising from payment default by national supermarket chains and independent retailers and inadequacy of provisions, thus overstating the receivables.
- v) High maintenance cost of website and likely technical problems with the website ordering facilities, leading to increased operational cost and errors in recorded inventory/revenue
- vi) Cash sales in company's outlets increase the risk of pilferage
- vii) Mismatch of computerised inventory records and the physical existence of inventory leading to errors in inventory value.
- viii) Current year's Financial Statement is required for the primary purpose of obtaining bank funds for the expansion project. This increases the inherent risk of management bias in the preparation of the Financial Statements.
- ix) Bank loan may require compliance with strict covenants, pledging of the company's assets, high interest costs, which may not be properly treated in line with IFRS. It will also increase the company's financial leverage.
- x) Coordination, supervision, and monitoring issues relating to having multiple distribution outlets. A business model involving multiple locations is difficult to control, increasing the likelihood of inefficiencies, system deficiencies, and theft of inventory or cash.

- xi) Political risk with Spain may stall or frustrate the only source of supply of goods, e.g., imposition of increased import duties on or outright ban of imported food products and political strife between the two countries.
- xii) Legal proceedings against the consultant for breach of contract may increase reputational risk. The strained relationship may prevent access to the consultant in future when the need for their services arises.

(b) The factors that aid risk identification, and

(c) audit work to address each risk:- These are discussed in a tabular form as follows:

i) The imported food might spoil before getting to Nigeria.

b) Factors aiding risk identification	c) Audit work to address the risk
<ul style="list-style-type: none"> ▪ The nature of the business. ▪ The nature of the inventories. ▪ The mode of operation of the business. 	<ul style="list-style-type: none"> ▪ Inspect the terms of contract governing the importation of inventory from Spain ▪ Examine whether adequate mitigation is in place covering the physical security and insurance of the inventory while in transit to Nigeria.

ii) Foreign exchange fluctuations may lead to large losses and may not be treated in line with IAS 21.

b) Factors aiding risk identification	c) Audit work to address the risk
<ul style="list-style-type: none"> ▪ Foreign currency fluctuation in Nigeria is enormous and highly unpredictable ▪ Foreign exchange (FX) is highly regulated. ▪ Requirements of IFRS 	<ul style="list-style-type: none"> ▪ Inquire from management how FX risk exposure is being managed. ▪ Review the company's cash flow forecast and examine the assumptions relating to FX rate fluctuations. Ensure that management assumptions are reasonable. ▪ Inspect the accounting records to ascertain if FX transactions and differences were treated in line with IAS 21.

- iii) The risk that the food might have expired before being sold to customers causing reputational risk and some of the expired inventory might be carried at year end without value adjustment in line with IAS 2.

b) Factors aiding risk identification	c) Audit work to address the risk
<ul style="list-style-type: none"> ▪ The nature of the business. ▪ The nature of the inventories ▪ Inventory valuation is subject to IFRS regulation ▪ The company's reputation 	<ul style="list-style-type: none"> ▪ Inquire of management the process in place for identifying slow moving items and how such items are valued. ▪ Review internal audit plan, work, and report on inventory. ▪ Perform detailed cost and NRV testing of inventory to ensure valuation at lower of cost and NRV in line with IAS 2.

- iv) Credit risk arising from default by national supermarket chains and independent retailers and inadequacy of provisions, thus overstating the receivables.

b) Factors aiding risk identification	c) Audit work to address the risk
<ul style="list-style-type: none"> ▪ The nature of the business. ▪ Competitive practices ▪ Degree of judgment by management ▪ Degree of oversight by those charged with governance on accounting practices. 	<ul style="list-style-type: none"> ▪ Inquire from management the credit control measures in place, such as credit references, credit limits, credit monitoring. ▪ Test such controls as stated above to ensure that they are effective. ▪ Perform age analysis of receivables and ensure adequate provision has been made by management. ▪ Circularize the receivables

- v) High maintenance cost of website and likely technical problems with the website ordering facilities, leading to increased operational cost and errors in recorded inventory/revenue.

b) Factors aiding risk identification	c) Audit work to address the risk
<ul style="list-style-type: none"> ▪ Significance of volume of online sales. ▪ Susceptibility of websites to technical hitches and attack 	<ul style="list-style-type: none"> ▪ Inquire from management to understand the nature of the problem with the website. ▪ Test application controls over the

through virus and malicious acts of hackers	<p>website sales with the aid of CAATs.</p> <ul style="list-style-type: none"> Obtain evidence that antivirus is regularly updated, firewall is in place and working effectively, and patches are being run regularly.
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vi) Cash sales in company's outlets increase the risk of pilferage

b) Factors aiding risk identification	c) Audit work to address the risk
<ul style="list-style-type: none"> Cash is susceptible to outright theft and teeming and lading Nature of the company's business segment Customers convenience Practice by competitors 	<ul style="list-style-type: none"> For a sample of daily sales, ensure they are recorded, and they are banked completely on a daily basis. Review the controls around the cash operations such as segregation of duties and ascertain if they are effective. Observe operations and perform surprise till counts with reconciliation to the records.

vii) Mismatch of computerised inventory records and the physical existence of inventory leading to errors in inventory value.

b) Factors aiding risk identification	c) Audit work to address the risk
<ul style="list-style-type: none"> The perpetual inventory system adopted by the company which does not require year-end inventory count Susceptibility of inventory to theft being imported food products The mode of operation of the business. 	<ul style="list-style-type: none"> For a sample of items in the inventory records, verify the physical existence of the items to identify overstatement of records. For a sample of physical items of inventory, check that the records are accurate to identify possible omission or understatement of records. Do a detailed cost/NRV testing for a sample of items Select a sample of items sold after year-end and compare their sales value with the valuation made for them in the year-end inventory. Carry out cut-off procedure to ensure the correctness of the inventory value in the financial statements.

- viii) Current year's Financial Statements is required for the primary purpose of obtaining bank funds for the expansion project. This increases the inherent risk of management bias in the preparation of the Financial Statements.

b) Factors aiding risk identification	c) Audit work to address the risk
<ul style="list-style-type: none"> ▪ The company's present state of finance. ▪ Management pressure to obtain the funds. ▪ Tendency for management to change accounting policies and estimates ▪ IAS 8 requirements for change of accounting policies and accounting estimates. 	<ul style="list-style-type: none"> ▪ Emphasize professional skepticism to the engagement team. ▪ Audit approach should emphasize substantive procedures ▪ Analytical review is required to identify significant changes in trends for more detailed testing. ▪ Inquire from management of changes in accounting policies and evaluate their appropriateness in line with IAS 8 ▪ Accounting estimates and all other areas of subject judgment should be extensively reviewed for reasonableness.

- ix) Bank loan may require compliance with strict covenants, pledging of the company's assets, high interest costs, which may not be properly treated in line with IFRS. It will also increase the company's financial leverage.

b) Factors aiding risk identification	c) Audit work to address the risk
<ul style="list-style-type: none"> ▪ Level of the company's financial risk. ▪ The general banking rule in Nigeria ▪ The requirements of IFRS on the treatment of bank loan as financially liability. 	<ul style="list-style-type: none"> ▪ Review the proforma loan contract terms to understand the nature of the loan, the interest costs, and the implications of the covenants. ▪ Discuss with the management how they intend to meet the loan requirements. ▪ Evaluate the company's current financial gearing to assess if it is overtrading and needs to inject more permanent capital into the business

- x) Coordination, supervision, and monitoring issues relating to having multiple distribution outlets. A business model based on multiple locations is difficult to control, increasing the likelihood of inefficiencies, system deficiencies, and theft of inventory or cash.

b) Factors aiding risk identification	c) Audit work to address the risk
<ul style="list-style-type: none"> ▪ The nature of the business. ▪ The mode of operation of the business. ▪ The complexity of the structure of the business. ▪ Present control structure including internal audit 	<ul style="list-style-type: none"> ▪ Review internal audit reports on operations in remote locations and test if issues are resolved. ▪ Inquire of management of the process in place for monitoring the activities in remote locations. ▪ Review the schedule of inventory and ensure that it includes the inventory in the remote locations

- xi) Political risk with Spain or EU countries may stall or frustrate the only source of supply of inventory, e.g., imposition of increased import duties or outright ban of imported food products.

b) Factors aiding risk identification	c) Audit work to address the risk
<ul style="list-style-type: none"> ▪ Political factors relating to government policies of Nigeria and Spain. ▪ Potential changes in government policies ▪ State of the economy of the country in which the company trades. 	<ul style="list-style-type: none"> ▪ Discuss with management if there are plans to diversify the supply sources. ▪ Review political reports on the relationship and the level of trade between the two countries

- xii) Legal proceedings against the consultant for breach of contract

b) Factors aiding risk identification	c) Audit work to address the risk
<ul style="list-style-type: none"> ▪ Relationship between the company and the consultant ▪ The nature and terms of contract ▪ The potential future need for the services of the consultant ▪ Likelihood of success of the 	<ul style="list-style-type: none"> ▪ Discuss with management the implications of the legal action against the consultant on the company's reputation. ▪ Ascertain whether an alternative specialist can be engaged to maintain the website now and in future. ▪ Discuss with the company's lawyers on

litigation ▪ The company's reputation	the likelihood of the success of the litigation
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Marking Guide - Question 1

- a. Identifying business risks in the scenario
1 mark each for any ten risks 10 marks
- b. Identifying factors leading to or aiding risk
½ mark each for any twenty factors 10 marks
- c. Stating audit work to be performed to address each risk identified
½ mark each for any twenty steps 10 marks
- 30 marks

Examiner's Report

The question tests candidates' knowledge in respect of business risks and work to be carried out in respect of the risks identified.

Being a compulsory question, almost all the candidates attempted the question. Performance in part (a) of the question was fair, but poor in parts (b) and (c).

The commonest pitfall of the candidates was their inability to link parts (b) and (c) to part (a).

Candidates are enjoined to cover the syllabus more appropriately before registering for examination.

SOLUTION TO QUESTION 2

(a) Need for ethical guidance

- Accountants working in a country that criminalises money laundering are required to comply with anti-money laundering legislation and failure to do so can lead to severe penalties. Guidance is needed because:
 - legal requirements are onerous;
 - money laundering is widely defined;
 - accountants may otherwise be used, unwittingly, to launder criminal funds;
 - Money laundering can damage personal reputation.

- Accountants need ethical guidance on matters where there is conflict between legal responsibilities and professional responsibilities. In particular, professional accountants are bound by a duty of confidentiality to their clients. Guidance is needed to explain:
 - how statutory provisions give protection against criminal action for members in respect of their confidentiality requirements;
 - when client confidentiality overriding provisions are available.
- Further guidance is needed to explain the interaction between accountants responsibilities to report money laundering offences and other reporting responsibilities, for example:
 - reporting to regulators;
 - auditor's reports on financial statements (ISA 700);
 - reports to those charged with governance (ISA 260);
 - reporting misconduct by members of the same body.
- Ethical guidance is needed to make accountants working in countries that do not criminalise money laundering aware of how anti-money laundering legislation may nevertheless affect them. Such accountants may commit an offence if, for example, they conduct limited assignments or have meetings in a country having anti-money laundering legislation (e.g. Nigeria, UK, Ireland, Singapore, Australia and the United States).

(b) Annual reviews of existing clients

(i) Tax investigation – Unicorn Co.

- Unicorn is a relatively new client. Before accepting the assignment, the auditors should have carried out customer due diligence (CDD). They should therefore have sufficient knowledge and understanding of Unicorn to be aware of any suspicions that the tax authority might have.
- As the investigation has come as a surprise it is possible that, for example:
 - the tax authorities suspicions are unfounded;
 - the auditors failed to recognise suspicious circumstances.
- The auditor should review any communication from the predecessor auditor obtained in response to its 'professional inquiry' (for any professional reasons why the appointment should not be accepted).
- A quality control for new audits is that the audit opinion should be subject to a second partner review before it is issued. It should be considered now whether or not such a review took place. If it did, then it should be sufficiently well documented to evidence that the review was thorough and not a mere formality.
- Criminal property includes the proceeds of tax evasion. If Unicorn is found to be guilty of under-declaring income that is a money laundering offence.

- The auditors' reputational risk will be increased if implicated because it knew (or ought to have known) about Unicorn's activities. They may also be liable if found to have been negligent in failing to detect any material misstatement arising in the financial statements.
- Unicorn's audit working paper files and tax returns should be reviewed for any suspicion of fraud being committed by Unicorn or error overlooked by the auditors. Tax advisory work should have been undertaken and/or reviewed by a manager/partner not involved in the audit work and/or appropriate safeguards for self-review threat applied.
- As tax advisor, the auditors could soon be making disclosures of misstatements to the tax authorities on behalf of Unicorn. They should encourage Unicorn to make necessary disclosure voluntarily.
- If the auditors find reasonable grounds to know or suspect that potential disclosures to the tax authorities relate to criminal conduct, then a suspicious transaction report (STR) should be made to the relevant authorities.

(ii) Advice on payments

There is no obvious tax issue, therefore:

- Hassan is not overstating expenditure for tax purposes.
- The auditor should consider his knowledge of import duties, etc in the destination country before recommending a course of action to Hassan.
- The payments being made for security consultancy services may amount to bribery and corruption.

If this is a bribe:

- Hassan clearly benefits from the payments as it receives income from the contract with the major customer. This is criminal property and possession of it is a money laundering offence
- The auditors should consider the seriousness of the disclosure made by the chief executive in the context of domestic law.
- The auditors may be guilty of a money laundering offence if the matter is not reported. If a report to the relevant authorities is considered necessary the auditors should encourage Hassan to make voluntary disclosure. If Hassan does not, the auditors will not be in breach of client confidentiality for reporting knowledge of a suspicious transaction.

(iii) Financial advisor - Adetunji Family

- Customer due diligence (CDD) and record-keeping measures apply to designated non-financial businesses and professions who prepare for or carry out certain transactions on behalf of their clients.

- Yemi is a 'politically exposed person' ('PEP' i.e. an individual who is to be entrusted with prominent public functions in a foreign country).
- The auditors' business relationships with the family therefore involve reputational risks similar to those with Yemi. In addition to performing normal due diligence measures the auditors should:
 - have risk management systems to have determined that Yemi is a PEP;
 - obtain senior partner approval for maintaining business relationships with such customers;
 - take reasonable measures to establish the source of wealth and source of funds;
 - conduct enhanced ongoing monitoring of the business relationship.
- The auditor can choose to decline to act for the family and/or Yemi (if asked).
- If the business relationship is to be continued, senior partners approval should be obtained for any transactions carried out on the family's behalf in future.

Marking Guide - Question 2

- | | | |
|-------|---|-----------------|
| a. | Stating of money laundering as a crime; need for guidance; the use of accountants unwittingly; how statutory provisions give protection; reporting to regulators; reporting to those charged with governance, etc
(1 mark each for any 5 points) | 5 marks |
| bi. | Stating of quality control for new audit; tax evasion as criminal property; failure to recognise suspicious circumstances; reputation risk to auditors; review of audit working papers, etc.
(1 mark each for any seven points) | 7 marks |
| bii. | Stating of knowledge of client's business; not overstating expenditure for tax; could be guilty; voluntary disclosure by auditor; etc
(1 mark each for any four points) | 4 marks |
| biii. | Highlighting the –
Need for customer due diligence; politically exposed person; the need for risk management; senior partner approval for new business etc
(1 mark each for any four points) | 4 marks |
| | | <u>20 marks</u> |

Examiners' Report - Question 2

The question tests candidates understanding of ethical issues.

Most candidates attempted the question, but performance was poor.

The commonest pitfalls of the candidates were their lack of knowledge in this area, and inability to apply their theoretical knowledge to practical issues.

Candidates are enjoined to cover the syllabus more approximately before registering for examinations. They should also learn to apply their theoretical knowledge to practical issues since this will be among their duties as Chartered Accountants.

SOLUTION TO QUESTION 3

(3a) The applicable risks and audit work to be carried out include:

- i) Poor conditions of paintings leading to failure to attract visitors.
 - Determine the standard of performance for a specialist restorer, which should help to determine the number of restorers that are needed.
 - Based on this, budget should be prepared to assess the level of funding needed.
 - Restorers' performance should be measured and monitored regularly.
 - Restorers' remuneration should be tied to performance.
 - Incentive scheme should also be set for them to encourage good performance above expectation.
- ii) Corporate sponsorship agreements not invoiced because of poor communication among the parties.
 - Sponsorship agreement once executed with the sponsor should be sent to the Accounts Department.
 - Accounts Department should issue invoice on each agreement the same day and send to the sponsor.
 - Accounting entries should be passed in the sales journal and ledgers the same day invoice is issued.
 - Invoice and sponsorship agreements should be serially numbered and sequentially used.
 - Invoices and agreements should be matched for posting purposes,
 - The serial numbers of the two documents should be regularly accounted for,
 - Regularly, agreements should be reconciled with invoices and the entries in the books to identify agreements that were not invoiced.

iii) Invoicing wrong amounts due to unrecorded set-off.

- Sponsors' invoicing for advertising should be sent directly to the KAGM's Account Manager.
- Sponsorship agreements should include a column reflecting if advertising will also be rendered by the sponsor. The sponsor should indicate on the agreement if set-off is to be applied.
- Agreements should indicate the payment period.
- Accounts department should issue statement of accounts to the sponsors periodically.
- Accounts department should follow-up on the sponsors for settlement.

iv) Improper accounting for cash from day visitors

- Day visitors should be issued a token, and they should present the token to the cashier who collects cash from them and activate the token.
- Different tokens should be for different pricing categories - individual, family, etc to ensure that correct amount is charged and collected.
- Cashier should bank all cash takings daily.
- An imprest system should be maintained for that purpose. The imprest should be regularly replenished and expenses retired.
- Internal audit staff should do surprise cash count regularly.
- Cash book should be reconciled with bank statements regularly and the reconciliation statements should be reviewed independently by someone of sufficient authority.
- Reconciling items should be investigated, monitored, and cleared timely.
- CCTV should be installed, with camera fixed at the sensitive points including over the entrance door and the cashier's stand.

v) Defective website

- Income from admission and membership fees, part of which are paid online through website, constitute 65%. This is a major part of KAGM's income, and therefore a high risk.
- Website should be regularly maintained and monitored
- The program controls should also be tested regularly.
- Security measures should be reinforced.
- Antivirus should be deployed and updated regularly
- Website transactions should be monitored

- Service maintenance agreement should be in place with a contractor, with service level agreement on the maximum time of restoration with penalty clauses.

(3b) Financial statements risks are those risks that arise from business activity which have impact on the items in the financial statements. The following are the financial statements risks for each identified business risk.

Risk	Financial Statements Risk
The poor condition of paintings in the gallery.	Reduction in the number of visitors to the place will definitely reduce the overall revenue of the company which will also lead to a fall in profit, and possible manipulation of turnover figure.
Incomplete invoicing to corporate sponsors	This will lead to inaccurate record of income and even loss of revenue to the company which also leads to reduction in revenue.
Invoicing wrong amounts due to unrecorded set-off.	This will affect the figure to be included in the financial statements.
Improper accounting for cash from day visitors	This will reduce the profit of the company thereby affecting the financial statements.
Defective website	This may lead to loss of revenue and also the website equipment may be subjected to depreciation in the financial statements.

Marking Guide – Question 3

- a) Identification of risks, which include
- i. Poor conditions of painting leading to failure to attract visitors.
 - ii. Corporate sponsorship agreement not invoiced because of poor communication among the parties.
 - iii. Invoicing wrong amounts due to unrecorded set-off
 - iv. Improper accounting for cash from day visitors
 - v. Defective website
- (1 mark for each risk mentioned) 5 marks
- (2 marks for any two Internal Control Points raised under each risk stated above) 10 marks
- b) Listing risks and stating how they affect financial statements

(½ mark each for five risks and effects on financial statements 5 marks respectively)

Examiners' Report – Question 3

The question tests candidates understanding of internal control on risks and how risks affect financial statements

About 60% of the candidates attempted the question and performance was poor.

The commonest pitfall of the candidates was that they were writing on general internal control issues rather than those directed towards specific risks.

Candidates need to read and digest the study text before embarking on examinations, and also interpret questions properly before attempting them.

SOLUTION TO QUESTION 4

(a) **Red Co. Limited**

Since **Yellow Holdings Plc** has confirmed its continuing support for **Red Co. Limited** and this is evidenced in the letter of support, provided that this and any other audit evidence (such as written representations from management) are considered sufficient and appropriate, and this has been disclosed appropriately in the financial statements, a modified opinion would not be required.

A modified opinion would be suitable if a letter of support from the parent company had not been received. If the letter of support were considered insufficient then the matter would be highlighted in the auditor's report in an "emphasis of matter" paragraph.

(b) **Edo Co Plc**

The company has changed its accounting policy for goodwill during the year and failed to disclose this in the financial statements. In accordance with IAS 8: *Accounting policies, changes in accounting estimates and errors*, the change in policy should be disclosed in the financial statements.

An unmodified opinion on the financial statements with the inclusion of an emphasis of matter paragraph is therefore not suitable as the opinion should be modified on the grounds of a misstatement regarding disclosure - depending on the materiality of the issue, the modification would either be qualified ('except for') (if material) or adverse (if pervasive).

(c) **Prompt Co Limited**

Although the auditors are not required to provide an opinion on other information in documents containing financial statements, they are required to

read the other information and consider its consistency with the accounts in accordance with ISA 720: *The auditor's responsibility in relation to other information in documents containing audited financial statements*.

As there is a material inconsistency between what has been reported in the financial statements and what is stated in the directors' report, if the directors refuse to make any amendments to the directors' report so that it is consistent with the accounts, then although an unmodified opinion on the financial statements can be issued, an emphasis of matter paragraph should also be included to highlight this inconsistency.

(d) **Twinkle Co Limited**

A wholly-owned subsidiary of **Twinkle Co Limited** has commenced trading on 20 July 2015, subsequent to **Twinkle Co Limited** year end. It is not clear whether the company was incorporated prior to 30 June 2015.

The auditors should obtain more information about **Star Co. Limited**. It should be possible to obtain details about its registration from the Company or Companies' Registry. If this information is unavailable, this would represent an inability to obtain sufficient appropriate audit evidence in respect of which the auditors would have to qualify their auditor's opinion in respect of it.

If the company was incorporated after 30 June 2015, it requires disclosure in the financial statements as a non-adjusting event after the end of the reporting period. If these disclosures are not made, the auditors would have to qualify the auditor's opinion for 2015 due to a misstatement regarding the disclosure. However, assuming the subsidiary was accounted for correctly in the 2016 financial statements, the 2016 auditor's report would be unaffected.

If the company was incorporated before 30 June 2015 then the subsidiary needs to be consolidated in **Twinkle Co Limited** financial statements and the relevant disclosures have to be made. If this is not the case, then the auditor's opinion for 2015 would have to be qualified over a misstatement in respect of the accounting treatment of the subsidiary **Star Co. Limited**. This would also result in the 2016 auditor's opinion having to be qualified over the same issue if it was not corrected, as the problem would affect the comparative financial information in the following year, however a disclaimer opinion would be more appropriate position to take.

Marking Guide - Question 4

a) Detailed discussion of topic	3 marks	
Stating of modified opinion	<u>2 marks</u>	5 marks
b) Detailed discussion of topic	4 marks	
Stating of unmodified opinion	<u>2 marks</u>	6 marks
c) Detailed discussion of issue	2 marks	

“Emphasis of matter” paragraph	<u>2 marks</u>	4 marks
d) Detailed discussion of issue	3 marks	
Disclaimer opinion	<u>2 marks</u>	<u>5 marks</u>
		<u>20 marks</u>

Examiners’ Report – Question 4

The question tests candidates understanding of the different types of audit opinion and when appropriate to apply them.

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

The commonest pitfall of the candidates is the mix-up of opinions in each scenario.

The need for candidates’ adequate preparation for examinations cannot be over-emphasised.

SOLUTION TO QUESTION 5

- (a) Fraud can be defined as intentional misrepresentation of financial information in order to gain personal advantage. Fraud involves deception on the financial information in order to have an unjust and illegal advantage. Examples of fraud include falsification of records or documents and misappropriation of assets.

Error on the other hand can be defined as unintentional misrepresentation of financial information not necessarily to gain personal advantage. Examples of error include unintentional mistake, misapplication of accounting policies, genuine oversight and clerical mistakes.

The key distinction between fraud and error is therefore whether the effect on the financial statements is deliberate (fraud) or unintentional (error). Other difference between fraud and error may arise in relation to any legal or regulatory reporting requirement. There may be requirement to report a suspicion of fraud but not error.

- (i) The issue of double financing on a particular transaction calls for concern as this may be related to fraudulent act.
- (ii) Financial statements must have been materially misstated where existence of assets that are worth ₦50m cannot be physically located and there is no convincing explanation to back up their non existence. This obviously is a fraudulent act.
- (iii) Not performing reconciliation as at when due is an act that can put the auditor on an enquiry coupled with detection of material differences upon which no action had been taken. All these indications tend towards fraudulent act and needs to be investigated.

(iv) The overstated sales could either be error or fraud. However, the overstated amount of ₦100m could cause material misstatement of the financial statements and this should be thoroughly investigated.

(b) **MANAGEMENT RESPONSIBILITY**

The primary responsibility for the prevention and detection of fraud and error rest with management. The responsibility may be partly discharged by putting in place adequate and effective accounting and internal control system. However, such control can only minimize fraud and error but it cannot completely eliminate them.

AUDITORS RESPONSIBILITY

It is not the primary responsibility of the auditor to prevent or detect fraud or error, although the audit may act as a deterrent to fraud. **However, the auditor should plan his work very well in order to detect material misstatements that could distort the financial statements.**

According to ISA 240, an auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatements, whether caused by fraud or error.

(c) **The audit procedures where fraud or error is suspected**

The auditor should take the following steps when fraud or error is suspected:

- Identify the extent and possible impact on the financial statements of the fraud or error. Document the facts fully in the audit files. Additional testing may be required to establish the likely extent of any misstatements.
- Consider the possible impact on other areas of the audit and on the overall assessment of audit risk. This may result in a revision to the original audit plan.
- The findings should be discussed with management, regardless of the extent of the problem, and management should be kept informed of developments.
- The auditor should determine the action that management should take. This should include the possibility of seeking legal advice if fraud is suspected.
- The auditor should normally communicate on a formal basis to management at an appropriate level. In the case of a company, the auditor communicates formally with the board of directors or the audit committee. However, if management themselves are involved in a suspected fraud, the auditor should consider taking legal advice to decide the best course of action. In extreme cases, the auditor may feel it is appropriate to resign.
- The auditor should consider the impact on his audit report to the members, in terms of any impact on the true and fair view presented by the financial statements.
- Further enquiry on the long absence of the finance director.

Marking Guide – Question 5

- | | | |
|----|--|-----------------|
| a) | Clear distinction between fraud and error | 2 marks |
| | Correct indication of fraud or error, backed by justifications
(1 mark each for the four instances) | <u>4 marks</u> |
| | | 6 marks |
| b) | Description of management responsibility on fraud and error (1½ marks) | |
| | Description of auditors responsibility on fraud and error (1½ marks) | 3 marks |
| c) | Stating of any four procedures where fraud or error is suspected
(1½ marks each for any four) | <u>6 marks</u> |
| | | <u>15 marks</u> |

Examiners' Report – Question 5

The question tests candidates understanding in respect of fraud and error.

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

SOLUTION TO QUESTION 6

BOB REMOVAL LIMITED

- (a)i. - Response from the enquiries made of the management of the company. The reason for this enquiry is to get actual direct response on the allegation.
- Response from the enquiry made from solicitor of the company. The reason for this is to confirm the legal case and position of the company in paying for the damage.
 - Checking whether the legal suit of ₦1m has been recognised in the account of the company as contingent liabilities.
- (ii) - Copy of the document used to request for the balance from Safe Storage. This is to serve as evidence that a request was made to get detailed address of the customer.
- Evidence of the request made to top management of the company on the need to write confirmation letter to their customers.
 - A written representation from top management staff of the company to accept the assertion of the Accountant. This will serve as evidence to back up the figure in the financial statements.
 - Copy of the company's credit policy in the working papers file. This is to confirm whether the receivables that is far over six months is within the company policy and also to know whether to recommend the receivables of ₦300,000 as bad and recognised as such in the accounts.

- (iii) - check the payment voucher used to purchase the van or the minutes of meeting where decision was taken for the purchase of the van. This is to confirm the authority to purchase the van, and their values.
- Check the minutes of the Board of Directors meeting to confirm the authority for the renovation of the company's premises.
- Review the documentation of the discussion with the top management staff of the company to confirm whether the company's overdraft limit has been extended.
- Review correspondence with bank as further confirmation of overdraft.

b)

Bob Removals Limited
14, Criminal Avenue,
Panti, Yaba,
Lagos.

19th May, 2016

The Managing Partner
Ilabe & Co.,
Chartered Accountants,
Ikeja,
Lagos.

Dear Sir,

LETTER OF REPRESENTATION

As part of our responsibilities to prepare the financial statements and also to provide you with all the necessary information and explanations needed for the purpose of your audit, we are giving you additional confirmation in respect of the balances in the account as listed below.

RECEIVABLES

The amount of ₦300,000 which is overdue for receipt from our customer is hopeful of recovery. The length of overdue period is within our credit policy period and as a result there is no need for any receivables confirmation.

CONTINGENT LIABILITY

The legal claim by our customer on the antique furniture has been settled out of court by a payment of ₦250,000; no further amount is expected to be paid and no claims have been received.

We hope that this information meets your requirements. Should you require further confirmation, please do not hesitate to contact us.

Yours faithfully,
BOB REMOVAL LIMITED
Managing Director

Marking Guide - Question 6

- a) Listing of audit work expected to be found in working paper file, with reasons for each
(1 mark each for any nine points) 9 marks
- b) Proper drafting with relevant headings e.g
- * Client letter headed paper/address
 - * Audit firm's name/address
 - * Heading
 - * Body content
 - Receivable/overdue debt
 - Contingent liability
 - * Closing remarks
- (1 mark each, maximum of 6 points) 6 marks
15 marks

Examiners' Report – Question 6

The question tests candidates understanding of relevant sections of audit working paper file.

Majority of the candidates attempted the question and performance was good.

SOLUTION TO QUESTION 7

- (a) The evidence you would require involve:
- i. Carrying out physical inspection of where the inventories are located; this is to confirm the existence of those inventories.
 - ii. Obtaining the final inventory sheets that were prepared by the Master Design Staff and work back any additions or deductions from the inventories to confirm the final figure in the year end account.
 - iii. Checking a sample of cost price to purchase invoice; this is to ensure correctness of the inventory price.
 - iv. Reviewing the requirements of IAS 2 to ensure that the inventory figure has been approximately treated in the accounts.
 - v. Assessing the condition of the inventory at their location; this is to identify obsolete and out of fashion inventory.
 - vi. Ensuring that inventories are valued at the lower of cost and net realisable value.

- vii. Vouching raw materials and labour costs to invoices and time sheets/labour rates.
- (b) Audit procedures to verify goodwill in the financial statements include the following:
- Ascertain the total components of the purchase consideration.
 - Confirm the total value of the purchase consideration
 - Ascertain the net assets of the partnership business before incorporation into limited company.
 - Check the arithmetical accuracy of the calculated goodwill
 - Confirm the treatment of the goodwill in the accounts to ascertain whether it is in line with IFRS 3: Business combinations.
- (c) Accounting estimates is an approximation of the amount of an item in the absence of a precise measurement. Estimates are made for the financial statements by the management of the entity, using their judgement.

The audit work that would be performed in order to verify whether or not the figure for the legal claim pending should be included in the financial statements include

- Confirm the existence of the legal claim from the management of **Mastay Design Ltd.**
 - Review the minutes of the board of directors meetings for information relating to legal suit
 - Review the financial statements for any contingent liability relating to the legal suit.
 - Confirm in writing from the company's solicitor the condition of the suit and the likely provision to be made in the accounts.
 - Confirm whether the legal claim has been properly treated in the accounts in line with relevant **IFRS**.
- (d) Procedures relating to a profit forecast that **Mastay Designs Limited** will use in support of a bank loan application might be as follows:
- Understand the basis of the forecast (by asking the person who prepared it). Then test the calculation of the forecast according to its method (for example, if it has been extrapolated from previous results, re-perform the arithmetic of the extrapolation).
 - Consider whether the assumptions in the forecast are consistent with each other (for example, will sales grow at that rate without additional marketing costs?)
 - Consider whether the forecast is reasonable in the light of known facts such as:
 - Current economic circumstances
 - Past trading history
 - Discuss the key variables and sensitivities with management. Often, key assumptions will be estimates of sales demand and sales price, and the

gross profit ratio. The auditor should establish the basis on which these estimates have been made.

- Review internal consistency of forecast (for example, has the same interest rate been used throughout the forecast, has the same growth rate been applied to sales and purchases?)
- Compare assumptions and bases for forecasting with information used internally (for example, by the marketing department)
- Compare figures with other forecasts to ensure consistency (for-example, depreciation should appear in both profit forecast and capital expenditure forecast)
- Compare figures with any available evidence - for example, costs may be compared to quotations for work to be done. Assess costs for reasonableness. For example if the profit forecast includes estimates of advertising and marketing costs, do these seem reasonable in comparison with the value of sales turnover and other operating costs?
- Consider whether all items of cost have been included. For example if the profit forecast involves the launch of a new product, have all the initial running costs been included, such as initial marketing costs and set-up costs for operations.
- Consider whether the forecast of the amount of finance required allows for working capital.
- Check that the forecast of profit and cash flows includes the cost of borrowed finance.
- Check that forecasts of costs and revenues allow for estimated inflation.
- It would also be appropriate to carry out some sensitivity analysis of the forecasts of revenues, costs and profits, to establish the extent to which estimates in the forecast would need to differ before the forecast profit turns into a forecast of loss.

Reporting on Profit forecast

A report from the audit/accountancy firm on Profit forecast should contain the following elements:

- Title
- Addressee
- Identification of the Profit forecast (for example by page references to pages in same document as the report, where the Profit forecast can be found).
- A statement that management is responsible for the Profit forecast, including the assumptions on which it is based.
- A reference to the purpose of the Profit forecast and/or the restricted distribution of the report (and the Profit forecast) to a limited number of users.
- A statement of negative assurance as to whether the assumptions that management have made provide a reasonable basis for the Profit forecast
- An opinion as to whether the Profit forecast is properly prepared on the basis of these assumptions, and whether the Profit forecast is presented in accordance with the relevant financial reporting framework.

- The report should also contain warnings (caveats) that the Profit forecast is a forecast or projection, and the results indicated by the Profit forecast might not be achieved
- Date, address and signature of the accountant/auditor.

Marking Guide – Question 7

a	Describing the evidence required to verify and justify inventory figures (1 mark each for any four points)	4 marks
b	Describing audit work to be performed to justify figure of goodwill in financial statements (1 mark each for any three points)	3 marks
c	Defining accounting estimate Describing audit work to be performed to verify whether the figure for pending legal claim or contingent liability is acceptable	1 mark 3 marks
d	Describing of audit work in respect of profit forecast (½ mark each for any four points) Listing items in profit forecast report (½ mark each for any four points)	2 marks <u>2 marks</u> <u>15 marks</u>

Examiners' Report – Question 7

The question tests candidates understanding in respect of accounting estimates, goodwill valuation, stock valuation and profit forecast.

Almost all the candidates attempted the question but performance was poor.

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

Candidates are advised to study in-depth all the areas of the syllabus.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION - MAY 2016

CASE STUDY

Time Allowed: 4 hours (including reading time)

INSTRUCTION: ENSURE YOU USE THE CASE STUDY ANSWER BOOKLET FOR THIS PAPER

Requirement

You are Mario Lorraine, a partly qualified Chartered Accountant sitting the Professional (Final) Level Examinations of the Institute of Chartered Accountants of Nigeria (ICAN). You are currently employed in the firm of Hadley, Deolu and Co.(Chartered Accountants)- a firm of Chartered Accountants.

You are to prepare a draft report to Enam Binchang, MBA. FCA, the Chief Finance Officer (CFO) of Wonder Bank Limited, a client company, as set out in the email (Exhibit 1) from Tinuke Abubakar. Director Business Advisory unit of the firm.

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 Tinuke Abubakar, Director, Hadley, Deolu & Co
2	Email from Enam Binchang, CFO of Wonder Bank Limited to Tinuke Abubakar.
3	2 - year summarized income statement of Wonder Bank Limited to December 31. 2015
4	2- year summarized statement of financial position of Wonder Bank Limited to December 31, 2015
5	Commentary on the financial statements of Wonder Bank Limited

Hadley, Deolu & Co.(Chartered Accountants)
EMAIL

From: Tinuke Abubakar
To: Mario Lorraine
Re: Wonder Bank Limited
Date: March 27, 2016

As discussed in our weekly update meeting this morning. I will like you to take on the responsibility for this particular client's project.

As a background to the project, Wonder Bank Limited as you know is one of the biggest banks in the West African region and we do quite a lot of work for the bank.

The bank currently operates as the biggest bank in Nigeria, Ghana and the Republic of Benin. The current project is very "confidential" and I implore you to treat it strictly as such. The project has been tagged 'Sky-high' as it is aimed at reducing the bank's costs and transforming its operations, using the most up-to-date technology while also saving costs and impacting positively on its bottom line by an estimated ~~N~~20 billion over the next three (3) years.

"Project Sky-high " is to be achieved by three initiatives:

1. Migration;
2. Robotics; and
3. Contracted Services.

Please read through the forwarded email (Exhibit 2) which I received from the CFO of Wonder Bank. The email gives further details about each initiative and let us have a meeting later today to discuss any question you might have.

As you familiarize yourself with the initiatives, you will notice that all the three initiatives will particularly affect many of the bank's staff, with some "long-serving employees" being forced to leave the bank. This is because their roles may no longer

be necessary with the latest technology the bank intends to operate by the end of “Project Sky High” in 2019.

The CFO made it clear during our conference call yesterday when he said, “ we will only retain the minimum number of people to get the job done and I don’t give a damn what anyone thinks about how we achieve this. We have a target to meet and any staff, full-time or contract, who thinks they will be getting huge pay-outs in the form of severance packages are in for the shocker of their lives. We are running a bank and not charitable enterprise. Besides, I also have my bonus to think about and getting the numbers right for this project and improving the overall performance of the bank is most important to me at this time”.

I will also like you to take a look at the just released financial information of Wonder Bank’s Nigerian operations (Exhibits 3 & 4) and perform a detailed analysis as requested by the CFO using the analysis tools the client has suggested. Wonder Bank has also provided explanatory notes to the financial information (Exhibit 5).

We have to get this report out to the client in 24 hours so I will like to see a draft by the close of business today. We will discuss your report prior to sending out the final version to the client in our meeting at 8:00 am tomorrow.

Kind regards.

Tinuke Abubakar, FCA

Director, Hadley, Deolu & co (Chartered Accountants)

Required

Using the attached information to draft a report to Enam Binchang, Chief Finance Officer, Wonder Bank Limited.

Your report should comprise:

1. A SWOT analysis of “Project Sky-High”, taking into consideration all the three initiatives and their individual merits and demerits. Your report should also consider alternative business options open to Wonder Bank Limited as well as the possible risks of each initiative and how such risks may be addressed.
 - a. A determination of whether it will be cheaper for Wonder Bank Limited to lease or to buy the Robots for the Robotics initiative.
 - b. A brief discussion on the financial reporting implication of leasing option in (a) above as well as its implications on gearing and financial risk of Wonder Bank Limited.

Note: For calculation of gearing ratio, comparison should be made between the pre-lease and post-lease scenarios, assuming the lease arrangement commenced at the start of 2016.

WONDER BANK LIMITED

March 26, 2016

The Managing Partners
Hadley, Deolu & Co (Chartered Accountants)
1, City Street, Lagos
Nigeria

Attention: Tinuke Abubakar, FCA

Dear Tinuke,

Thank you for taking the time to discuss with me during our conference call of yesterday. Further to the discussion, please see below further information about "Project Sky- High".

As you know, we are currently rated number one in West Africa, in terms of customer service and customer satisfaction and we are also the largest bank in the country by number of branches and total assets. At the end of this project we will have left all our competitors. "down- under" as we truly intend to go 'sky high' by the year 2019. The Board is very committed to this project and we are doing everything to ensure that the bank achieves this target.

The project is split into three (3) initiatives, Migration, Robotics and Contracted Services

Migration

The migration initiative has to do with moving roles from Nigeria to Ghana and the Republic of Benin (Benin). Certain roles will be identified and demised in Nigeria and similar roles will be created in Ghana and Benin. The rationale for this is wage saving in the two countries as wages in Nigeria are considered to be at almost 40% more than what is obtainable in Ghana and Benin.

An estimated 2,300 roles have been identified to be demised in Nigeria and 1,350 roles to be created in Ghana while 756 roles are to be created in Benin. There will be a maximum parallel running period of two (2) months for each role created. However, this is dependent on the level of

complexity of the role being demised, for example, an Information Technology (IT) role will take longer than a non-technical role. All roles that may require a parallel running period longer than two months will have to seek approval from the Project Director. I do not expect that such approvals will be granted as we are all very conscious about costs and especially costs that will be attributed to “Project Sky-High”. The costs incurred as a result of this project will be the costs of hiring for the new roles, severance costs and other benefits paid to employees for outgoing roles. The benefits will be the cost saved from demising the roles in Nigeria. The workers union in Ghana is very active and has recently began organizing small protests but we are more worried about how we are going to get around the labour laws which are quite strict. Our Business Heads in Ghana, as a result, do not seem to be cooperating at this time. They have taken the position that we are putting the organization at risk of law suits amidst potential regulatory breaches as well as unlawful dismissals. My view is that they are not ambitious and we really do not want unambitious people who cannot see the big picture, as Business Heads, I do believe the estimated role demises being thrown around are not at the level we should be, as this target can easily be increased by another 60-70%. I believe this will save the bank much more money.

Robotics

The Robotics initiative relates to the service centres and ATM centres for transactions, cash deposits and cash withdrawals. The bank intends to have a zero human hire at such centres. These will be a state of the art centres manned by robots that are able to have limited but useful communication with our customers to carry out routine as well as limited non-routine transactions.

These robots will be manufactured in China and then shipped and installed in Nigeria. The security and programming for such robots and their operations will be done and managed by X-Botics Limited, a firm based in France. Currently we have 459 staff working in service centres across West Africa and such roles will be demised except the security staff.

The Project Director has obtained approval from the regulatory authorities to proceed with the project and Wonder Bank Limited has conducted an investment appraisal. The lease term will be for the entire duration of “Project Sky-High”. However, the first option is to acquire the Robots from a Chinese Company for ₦5.80 billion. This price includes

security and programming costs which will be paid in one lump sum. The market price for such similar assets is estimated to be ₦6.0 billion. The Robots will have to be replaced at the end of a 4 years cycle and will have a near nil value at the end of each cycle.

The other option is that the asset could be leased for ₦1.70 billion per year. This amount is payable in arrears. The interest rate implicit in the lease is estimated to be 6.68%. Wonder Bank will be required to maintain and insure the Robots during the lease term. The ownership title to the Robots will not pass to Wonder Bank at the end of the lease term of four years. But in any case, at that time, the Robots will have a near nil value.

Wonder Bank can borrow at an interest rate of 12.85. Capital allowances are granted on similar business assets on a reducing balance basis at 40% per annum.

We are very keen to get this initiative off the ground as quickly as possible as our market research shows that this will be the norm in the banking industry in the next few years. We like to put our best foot forward while ensuring that we are the first to give this type of services to our customer not just in West Africa, but in the whole of Africa. This is in line with our strategic objective of always being at the forefront of cutting edge technology.

Contracted Services

This initiative relates to services that are provided by third parties to the bank. These include services supplied to the bank such as paperwork, advertising and branding and other contracted services. Our costs for these initiatives will mainly be travel costs, contract negotiation costs, legal and other professional advisory fees.

The main benefit from these initiatives will be from contract negotiation as we have put together a team of experienced negotiators who will ensure that we get the best deals available on the market. Other benefits will be from our reduction in paper use and printing as the bank intends to go paperless within the next year. This ties into our recent promotion of a green environment and the cutting down of less trees as we have recently been promoting on our website and very much highlighted in our annual reports

Kindly consider all the above and let us have your thoughts as soon as possible and as always, get in touch if you have any question.

Looking forward to the draft report to enable us discuss the key issues ahead of the meeting with the Board's investment committee.

Yours sincerely,

Enam Binchang
Chief Finance Officer, Wonder Bank Limited

Wonder Bank Limited
(Extracts from company accounts)
Income Statement
Year ended December 31

		2015	2014
	Commentary	₦'million	₦'million
Interest income	2	9,876	10,072
Interest expense		<u>3,296</u>	<u>4,029</u>
Net interest income		6,580	6,043
Other income		<u>350</u>	<u>114</u>
Total income		6,930	6,157
Impairment charges and other credit			
Provisions		<u>3,218</u>	<u>2,866</u>
Net Income		3,712	3,291
Administration and general expenses		680	768
Depreciation of property, Plant and equipment	3	594	403
Amortisation of intangible assets		<u>400</u>	<u>450</u>
Operating expenses		<u>1,674</u>	<u>1,621</u>
Profit before tax		2,038	1,670
Tax	8	<u>632</u>	<u>523</u>
Profit after tax		<u>1,406</u>	<u>1,147</u>

EXHIBIT 4

Wonder Bank Limited

(Extracts from company accounts)

Statement of financial position

as at December 31

		2015	2014
Assets	Commentary	N'million	N'million
Cash and balances at Central Banks	7	39,818	22,113
Items in the course of collection from other banks		1,898	1,743
Trading portfolio assets		42,195	48,905
Derivative financial instruments		10,410	9,455
Loans and advances to other banks		18,046	19,145
Loans and advances to customers		226,673	205,110
Other assets		4,893	3,755
Property, plant and equipment	3	8,210	8,532
Deferred tax assets		<u>396</u>	<u>412</u>
Total assets		<u>352,539</u>	<u>319,170</u>
Liabilities:			
Deposits from other banks		70,104	68,720
Items in the course of collection due to			

other banks		1,977	1,236
Customer accounts		211,357	198,004
Trading portfolio liabilities		3,456	3,991
Derivative financial instruments		5,844	4,705
Debt securities in issue		29,956	26,005
Other liabilities		1,349	1,096
Deferred tax liabilities		2,640	1,352
Provisions	9	9,893	893
Retirement benefit liabilities		<u>2,689</u>	<u>1,865</u>
Total liabilities		<u>339,265</u>	<u>307,867</u>
Shareholders' equity:			
Called up share capital	5	1,198	1,098
Share premium account		4,222	4,322
Other reserves		1,455	890
Retained earnings		<u>6,399</u>	<u>4,993</u>
Total shareholders' equity		<u>13,274</u>	<u>11,303</u>
Total liabilities and shareholders' equity		<u>352,539</u>	<u>319,170</u>

EXHIBIT 5

Commentary on the financial statements of Wonder Bank Limited

1. Reporting entity

These financial statements are prepared for Wonder Bank Limited. The Bank is a major financial services provider engaged in retail and commercial banking, credit cards, investment banking, wealth management and investment management services

Wonder Bank Limited is a private limited company, incorporated in Nigeria and having its registered office in Nigeria and foreign branches in Ghana and the republic of Benin.

2. Interest

Interest is recognized as interest income and interest expense in the income statement for all interest bearing financial instruments classified as held to maturity, available for sale or other loans and receivables using the effective interest method.

The effective interest method is a method of calculating the amortised cost of a financial asset or liability (or group of assets and liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts the expected future cash payments or receipts through the expected life of the financial instrument or when appropriate, a shorter period, to the net carrying amount of the instrument. The application of the method has the effect of recognizing income (and expense) receivable (or payable) on the instrument evenly in proportion to the amount outstanding over the period to maturity or repayment.

3. Property, plant and equipment

Property, plant and equipment is stated at cost less accumulated depreciation and provisions for impairment, if any. Additions and subsequent expenditures are capitalized only to the extent that they enhance the future economic benefits expected to be derived from the assets.

Depreciation is provided on the depreciable amount of items of property, plant and equipment on a straight-line basis over their estimated useful economic lives. The depreciable amount is the gross carrying amount, less the estimated residual value at the end of its useful economic life.

Freehold buildings and long-leased property (more than 50 years to run) 2-3.3%

Leasehold property (less than 50 years to run) Over the remaining life of the lease

Computers and similar equipment 20.33%

Fixtures and fittings and other equipment 10-20%

4. Computer Software

Computer software is stated at cost, less amortization and provisions for impairment, if any.

The identifiable and directly associated external and internal costs of acquiring and developing software are capitalized where the software is controlled by the Bank, and where it is probable that future economic benefits that exceed its cost will flow from its use over more than one year.

Costs associated with maintaining software are recognized as an expense when incurred

Capitalised computer software is amortised over three to five years.

5. Ordinary shares

The authorized ordinary share capital of the Bank as at December 31, 2015 was 2,396 million ordinary shares of ₦0.5 each (2014: 2,196 million).

During the year, the Bank issued 200 million ordinary shares, for cash consideration of ₦100m.

6. Dividends on ordinary shares

Dividends on ordinary shares are recognized in equity in the periods in which they are paid or, if earlier, approved by the Wonder Bank Limited's (the Bank's) shareholders

7. Cash and Cash equivalents

For the purposes of the cash flow statement, cash comprises cash on hand and demand deposits and cash equivalents comprise highly liquid investments that are convertible into cash with an insignificant risk of changes in value with original maturities of less than three months.

8. Tax

Tax charged is based on the Nigerian company income tax rate of 30% (2014: 30%) and tertiary education tax rate of 2% (2014: 2%)

9. Provisions

Provisions are made with respect to commission clawbacks, warranties and litigation claims. On November 25, 2015, a claim for ₦9 million was brought against the bank. The bank's legal counsel are of the view, taking account of all available evidence, that it is more likely than not that there will be an outflow of economic resources. Accordingly, a provision for this amount has been recognized in the financial statement.

REQUIREMENT 1 –SWOT Analysis

USES DATA AND INFORMATION APPROPRIATELY

- * Uses information provided in Exhibit 1
- * Uses information provided in Exhibit 2
- * Uses information in financial statements and commentary
- * Recognises the importance of this project in cash/profit terms - within the next 3 year
- * Recognises the importance of this project strategically
- * Recognises other issues (size of project, project governance, etc

V	NC	BC	CA	SA
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USES PROFESSIONAL TOOLS AND KNOWLEDGE

- * Recognises the appropriate model
- * Considers the accuracy of the information provided
- * Considers wider issues

V	NC	BC	CA	SA
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USES ANALYTICAL SKILLS (materials points) written Report

- * Identifies strengths of Sky high project (internal)
- * Identifies weaknesses of Sky high project (internal)
- * Identifies opportunities of Sky high project (external)
- * Identifies threats of Sky high project (external)

V	NC	BC	CA	SA
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IDENTIFIES ISSUES AND OPTIONS

- * Identifies that a project may have a slower start
- * Identifies that a new project needs to build momentum
- * Identifies the relevant staff union issues
- * Identifies the relevant security issues with outsourcing of robots' management
- * Identifies issues with other outsourcing arrangements
- * Identifies that projects will generate negative press if affected staff go public

V	NC	BC	CA	SA
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APPLIES PROFESSIONAL SCEPTICISM AND ETHICS

- * Evaluates the quality of project governance and management
- * Recognises that all targets may not be achievable within the set time frame
- * Evaluates suggested approach to delivering the project and ethical issues
- * Considers issue of releasing confidential information and details to third party
- * Considers the possibility of breaking regulatory rules
- * Considers the ethical implications of wrong attitude to staff welfare
- * Considers undue consideration to accruable personnel benefits by the directors

V	NC	BC	CA	SA
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EVALUATIVE SKILLS AND JUDGEMENT

- * Recognises that new project will increase cash flow/profit
- * Recognises that additional costs of the project may be understated
- * Recognises that there may be continuing costs (updates/maintenance)
- * Recognises that there will be ongoing needs to invest/update robots/IT equipment in the future

CONCLUSIONS

(Draws distinct conclusions under a heading)

- * Concludes on overall project design and objectives
- * Concludes on best/worst outcomes as suggested
- * Concludes on project risk concerning cash flow/profit generation
- * Concludes on non-financial issues surrounding the project

V	NC	BC	CA	SA
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RECOMMENDATIONS (commercial / relevant)

- * WBL should hire experienced project managers
- * Negotiates best terms for staff/WBL
- * Negotiates best terms based on excellent historic record
- * Considers alternative courses of action/achieving goal with workforce shake-up
- * WBL should create detail cash flow forecast and monitor it

V	NC	BC	CA	SA
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REQUIREMENT 2 - Analysis of Project and Ratio Analysis

USES DATA AND INFORMATION APPROPRIATELY

- * Uses WBL Financial Statements
 - Income Statement
 - Statement of financial position
- * Uses commentary on WBL's financial statement (Exhibit 5)
- * Uses information in email provided in Exhibit 1
- * Uses information in email provided in Exhibit 2
- * Identifies wider issues

V	NC	BC	CA	SA
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USES PROFESSIONAL TOOLS AND KNOWLEDGE(written into Report

- * Performs appropriate calculation on lease and purchase options
- * Performs appropriate gearing calculations
- * Considers (but does not perform) other calculations
- * Considers the accuracy of estimates made
- * Identifies whether WBL have sufficient cash for an outright purchase

V	NC	BC	CA	SA
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USES ANALYTICAL SKILLS (material points)

- * Calculates post tax cost of debt
- * Determines appropriate discount factors
- * Determines NPVs for lease and purchase options
- * Calculates gearing ratio accurately

V	NC	BC	CA	SA
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IDENTIFIES ISSUES AND OPTIONS

- * All figures should be discussed in the context of each option
- * Needs to justify stable gearing ratio
- * Needs to explain factors affecting lease option
- * Needs to explain factors affecting purchase option
- * Needs to consider non-financial factors

V	NC	BC	CA	SA
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APPLIES PROFESSIONAL SCEPTICISM AND ETHICS

- * Considers the leasing option and quality
- * Considers control over costs and timing of cash flows
- * Considers tax implications (capital allowance)
- * Ensures that other analyses & evaluations are considered
- * Considers ethical issues
- * Considers whether the financial statement has been audited or not

V	NC	BC	CA	SA
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EVALUATIVE SKILLS AND JUDGEMENT (Uses analytical headings)

- * Considers all costs as these may be understated-especially for the purchase option
- * Considers use of other appraisal methods
- * Questions use of interest rate-could be higher? Lower? How was it derived?
- * Considers other issues and how these may affect the market value per share

V	NC	BC	CA	SA
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CONCLUSIONS

(Draws distinct conclusions under a heading)

- * Concludes on better option (lease vs purchase)
- * Concludes on gearing ratios
- * Concludes on other financial factors not considered
- * Concludes on other non-financial factors
- * Concludes on strengths/weakness of analysis tools used

V	NC	BC	CA	SA
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RECOMMENDATIONS (commercial / relevant)

- * WBL must understand and consider methods of analyses used
- * WBL should consider the information, its accuracy
- * WBL should consider other factors in planning and delivering the project
- * WBL should consider the possibility of maintaining the Robots to keep them working on 24 hours basis

V	NC	BC	CA	SA
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Appendices	Main Report																								
<p>Appendices R1: Content and style</p> <ul style="list-style-type: none">Shows the SWOT Analysis tableShows the company’s strengthsShows the company’s weaknessesShows the opportunities available to the companyShows the threats the company may race <p>Appendices R2: Content and style</p> <ul style="list-style-type: none">Logical approach and numbers clearly derivedWell presented analysis of NPV on outright purchase and lease optionDetermines the cash flows of outright and lease options <p>Calculate the NPV of outright purchase and lease option as well as gearing ratio of Wonder Bank Limited for 2015</p> <ul style="list-style-type: none">States whether the lease us a finance or operating lease with reasons <table><tr><td>V</td><td>BC</td><td>CA</td><td>SA</td></tr></table>	V	BC	CA	SA	<p>Report: Structure</p> <ul style="list-style-type: none">Sufficient appropriate headingsAppropriate use of paragraphs/sentencesLegibilityCorrectly numbered pages <table><tr><td>V</td><td>BC</td><td>CA</td><td>SA</td></tr></table> <p>Report: Style and language</p> <p>Relevant disclaimer (external report)</p> <ul style="list-style-type: none">Suitable language for the boardFactual/ethical commentsAcceptable spellings and punctuations <table><tr><td>V</td><td>BC</td><td>CA</td><td>SA</td></tr></table> <table><tr><td>CC</td><td></td></tr><tr><td>SC</td><td></td></tr><tr><td>IC</td><td></td></tr><tr><td>ID</td><td></td></tr><tr><td>NA</td><td></td></tr><tr><td>Total</td><td></td></tr></table>	V	BC	CA	SA	V	BC	CA	SA	CC		SC		IC		ID		NA		Total	
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Marking Key- Appendice - Requirement 1

SWOT Analysis

Strengths

- Increased cash flow
- Improved profits over the next few years
- Improved services in the offshore operations (Ghana and Benin)
- Board commitment and support for the project
- Targets have been set high
- Professional advice has been sought
- Project seems to fit into the organisations strategic plan e.g. promotion of a green environment promoted on website and annual reports

Weaknesses

- Staff lay-off
- Unionised workforce could cause problems
- Targets seem too optimistic
- No clear project plan/governance outlined
- Over-aggressive/ambitious approach to project delivery
- Possible vested interests

Opportunities

- Improved brand image in the offshore countries
- Market leader in advances in new technology
- Potential expansion of operations to other offshore centres
- Knowledge spreads from onshore to offshore centres
- Cutting wastage/inefficiencies to improve service delivery
- Opportunity to contribute to cleaner/greener environment

Threats

- Protests could cause further problems
- Threats to sensitive data
- Staff may move over to competitors
- Reputational risk (Negative publicity if made public)
- Legal risk due to current/potential lawsuits
- Regulatory risk due to possible breach of rules

APPENDICE FOR REQUIREMENT 2

Suggested Solution:

Robotics Project

Post tax cost of debt:

Post tax cost = 12.8% x (1 – 0.3) = 8.96% 8.96%

Project Sky high has a duration of 4 years (January 2016 - December 2020), therefore a period of 4 years has been used in our calculations

NPV of cost to buy:

W1 - Tax savings on tax depreciation allowances
N’billions

	40% TWDV N’b	30% Tax saving at 30% N’b
Initial cost	5,800.0	
Year 1: 40% - End of year	<u>2,320.0</u>	696.0
	3,480.0	
Year 2: 40% - End of year	<u>1,392.0</u>	417.6
	2,088.0	
Year 3: 40% - End of year	<u>835.2</u>	250.6
	1,252.8	
Year 4: balancing allowance - End of year	<u>1,252.8</u>	<u>375.8</u>
Residual value	<u>-</u>	<u>-</u>

W2 – Cash flow for purchase of Robots
N’billions

	Start N’ b	End of year 1 N’ b	End of year 2 N’ b	End of year3 N’ b	End of year 4 N’ b
Initial Outlay	5,800.0				
Tax savings		696.0	417.6	250.6	375.8
Net cash flows	5,800.0	696.0	417.6	250.6	375.8
8.96% discount factors	1.0000	0.9178	0.8423	0.7730	0.7095
Present values	5,800.0		351.7		

	638.8	193.7	266.6
Net present value			<u><u>4,349.2</u></u>

NPV of Leasing Option:

W3 – NPV

This rate of 6.681% is then used to calculate the interest element for each year.

	Opening balance N'billions	6.681% Interest at 6.681% N'billions	Repayment N'billions	Closing balance N'billions
Year 1	5,800.0	387.5	1,700.0	4,487.5
Year 2	4,487.5	299.8	1,700.0	3,087.3
Year 3	3,087.3	206.3	1,700.0	1,593.6
Year 4	1,593.6	106.5	1,700.0	0.0

Candidates should not be penalized for rounding-up differences and marks should be award for non-zero closing balances at the end of year 4 that are due to rounding differences

Tax relief calculation

(N'billions)	Year 1	Year 2	Year 3	Year 4
Allowable interest	387.5	299.8	206.3	106.5
Accounting depreciation (5800/4years)	1,450.0	1,450.0	1,450.0	1,450.0
Total tax allowable costs	1,837.5	1,749.8	1,656.3	1,556.5
Tax savings at 30%	551.2	524.9	496.9	466.9
Receivable at end of year	1	2	3	4

NPV of cost calculation

(N'billions)	Start	End of year 1	End of year 2	End of year 3	End of year 4
Lease charge		1,700.0	1,700.0	1,700.0	1,700.0

Tax savings b/f		551.2	524.9	496.9	466.9
Net cash flows		1,148.8	1,175.1	1,203.1	1,233.1
Discount Factors @ (8.96%)	1.0000	0.9178	0.8423	0.7730	0.7095
Present values		1,054.3	989.7	930.1	<u>874.8</u>
NPV					<u>3,848.9</u>

Conclusion: From the calculations above, it can be seen that the leasing option is the cheaper of the two

Determination if the lease arrangement constitutes a finance lease:

Classification of leases

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership from the lessor to the lessee

All other leases are classified as operating leases.

Classification is made at the inception of the lease. [IAS 17, Paragraph 4]

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form.

Situations that would normally lead to a lease being classified as a finance lease include the following: [IAS 17, Paragraph 10]

- a) the lease transfers ownership of the asset to the lessee by the end of the lease term
- b) the lessee has the option to purchase the asset at a price which is expected to be significantly lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised
- c) the lease term is for the major part of the economic life of the asset, even if title is not transferred
- d) at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset
- e) the lease assets are of a specialised nature such that only the lessee can use them without major modifications being made

Comments: Points c and d are particularly applicable as the lease term is for 4 years as well as the economic useful life. The PV of minimum lease payments is 5.512 billion (see working below) while the FV of the lease assets is 6.0 billion. This is approximately 92% of the FV of the leased asset

Determination of Lease as a Finance or Operating Lease

a

Fair Value of the Lease

N'million

6,000,000

b Present Value of Minimum Lease Payments

**NPV calculation
N'billions**

	Start	End of year 1	End of year 2	End of year 3	End of year 4
Annual Lease Rentals	-	1,700.00	1,700.00	1,700.0	1,700.00
Discount Factors @ 8.96%	1,00,000	0.9178	0.8423	0.7730	0.7095
Present values	-	1,560.2	1,431.90	1,314.2	1,206.10
NPV					<u><u>5,512.40</u></u>

According to IAS 17, the lease should be recognised at the lower of:

A	FV of the leased asset	6,000,000
b	PV of Minimum lease payments	5,512.40
	Therefore it should be recognized at	5,512.40

Calculation of Gearing Ratio

Current Gearing

Debt (Interest bearing liabilities)	313,394.00
Debt + Equity	326,668.00
Gearing Ratio = Debt / (Debt+Equity)	0.959

Gearing (Including Lease Obligation)

Debt	317,700.27	This excludes the interest charge of ₦493.9m from retained earnings as would have been charged to the income statement
Equity	330,480.36	
Gearing Ratio = Debt / (Debt+Equity)	0.961	

Lease obligation at end of one year	₦' m
At beginning	5,512.4
Interest charge @ 8.96%	493.9
Lease payment	1,700.0
At year end	4,306.27

Lease asset at the end of the year

At beginning	5,512.36
Depreciation (over the lease term of 4 years)	1,378.09
At year end	4,134.27

Conclusion: The lease option insignificantly increases the gearing ratio/financial risk of the bank. The overall risk profile of the bank does not change as a result of the lease arrangement

Wonder Bank Plc

Income Statement Extract

		2015	2014
	Commentary	N'million	N'million
Interest income	1	9,876	10,072
Interest expense		<u>3,296</u>	<u>4,029</u>
Net interest income		6,580	6,043
Other income		<u>350</u>	<u>114</u>
Total income		6,930	6,157
Impairment charges and other credit provisions		3,218	2,866
Net income		3,712	3,291
Administration and general expenses		680	768
Depreciation of property, plant and equipment	2	594	403
Amortisation of intangible assets		400	450
Operating expenses		1,674	1,621
Profit before tax		2,038	1,670
Tax	3	<u>632</u>	<u>523</u>
Profit after tax		<u>1,406</u>	<u>1,147</u>

Wonder Bank Plc
Statement of Financial Position Extract

		2015	2014
Assets	Commentary	N'million	N'million
Cash and balances at central banks	7	39,818	22,113
Items in the course of collection from other banks		1,898	1,743
Trading portfolio assets		42,195	48,905
Derivative financial instruments		10,410	9,455
Loans and advances to banks		18,046	19,145
Loans and advances to customers		226,673	205,110
Other assets		4,893	3,755
Property, plant and equipment	3	8,210	8,532
Deferred tax assets		396	412
Total assets		352,539	319,170
Liabilities			
Deposits from banks		70,104	68,720
Items in the course of collection due to other banks		1,977	1,236
Customer accounts		211,357	198,004
Trading portfolio liabilities		3,456	3,991
Derivative financial instruments		5,844	4,705
Debt securities in issue		29,956	26,005
Other liabilities		1,349	1,096
Deferred tax liabilities		2,640	1352
Provisions	9	9,893	893
Retirement benefit liabilities		2,689	1,865
Total liabilities		339,265	307,867
Shareholders' equity			
Called up share capital	5	1,198	1,098
Share premium account		4,222	4,322
Other reserves		1,455	890
Retained earnings		6,399	4,993
Total shareholders' equity		13,274	

		<u>11,303</u>
Total liabilities and shareholders' equity	<u>352,539</u>	<u>319,170</u>

Examiner's report

The case is on a bank with two foreign branches. The bank is proposing a strategic move that involves three initiatives to improve its strategic performance. Candidates are required to:

- Evaluate the proposal by carrying out a SWOT analysis of the project and suggest possible problems or risks inherent in the initiatives while suggesting alternative options open to the bank; and
- Determine whether to lease or buy the Robots required for one of the initiatives.

Most candidates demonstrated a little understanding of the requirements of the case and those who seem to understand did not list the SWOT as required but only mentioned them in their report.

As a result, candidates' performance was very poor as only about 5% of the candidates scored 50% or above.

The commonest pitfall of the candidates are:

- i. Lack of technical ability in report writing
- ii. Lack of understanding of IFRS requirements on determination of whether a lease is finance lease or operating lease;
- iii. Failure to calculate the net present value (NPV) of the two options; and
- iv. Inability to determine the strengths, weaknesses, opportunities and threats (SWOT) of the proposed initiatives.

For future examination, candidates are advised to:

- i. Learn and master report writing skill;
- ii. Practise with previous case study examinations to familiarize themselves with the requirements of case study examination ; and
- iii. Always remember that the knowledge and skills they have acquired in previous subjects of the examination will be required to do well in case study examinations.