THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

NOVEMBER 2018 DIET

PROFESSIONAL LEVEL EXAMINATIONS

Question Papers

Suggested Solutions

Marking Guides

Plus

Examiner's Reports

FOREWARD

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

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

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

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

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

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

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

<u>NOTES</u>

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

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION - NOVEMBER 2018

CORPORATE REPORTING

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Adegaga Laboratories Plc ("AdeLabs") is one of the largest companies in Nigeria engaged in cosmetic development and manufacturing. Its largest customer base is in the healthcare sector for post-surgery patients and the Nigeria movie industry (aka Nollywood). In the prior financial period, AdeLabs' expansion strategy has been largely focused on growth by acquisition and joint ventures.

Additional Information:

(i) As part of this, AdeLabs acquired 80% of the equity share capital of Bodegas limited ("Bodegas") on January 1, 2015 when the retained earnings of Bodegas was ₦93.75 million. Following the share acquisition, AdeLabs had control over Bodegas – no shares have been issued by Bodegas following the acquisition on January 1, 2015. The non-controlling interest in Bodegas was measured at its fair value of ₦20 million at the date of acquisition.

(ii) On January 1, 2016, AdeLabs acquired 50% of the equity share capital of ChidePlastics limited ("ChidePlast") when the retained earnings of ChidePlast was ₦41.25 million. This acquisition was classified as a joint venture in accordance with IFRS 11 Joint Arrangements. ChidePlast has not issued any shares since the acquisition date.

(iii) The balance on "other reserves" relates to movements in the values of investments in Bodegas and ChidePlast in the books of AdeLabs. ₦18.75 million relates to Bodegas and the remainder to ChidePlast.

(iv) AdeLabs' non-current liabilities relate to a borrowing (long-term) taken out on January 1, 2017. This borrowing has an agreed coupon rate of 4% p.a and the interest expense due in respect of 2017 has been paid and accounted for in profit for the year. The effective interest rate estimated with this financial liability is 8% p.a.

(v) As part of its annual impairment review, AdeLabs concluded that the goodwill on the acquisition of Bodegas was impaired by 20% at December 31, 2017. No other impairments of goodwill have arisen.

(vi) AdeLabs sold goods to ChidePlast with a value of ₦75 million and a selling margin of 40% in November 2017. As at year end December 31, 2017, 75% of these items are unsold.

Accounts for all companies are made up to December 31 annually.

The draft statements of financial position for AdeLabs, Bodegas and ChidePlast as at December 31, 2017 are as follows:

ASSETS	**ADELABS**	**BODEGAS**	**CHIDEPLAST**
	₦'000	**₦'000**	**₦'000**
Non-current assets			
Property, plant and equipment	300,000	262,500	225,000
Investment in Bodegas	262,500	-	
Investment in ChidePlast	150,000	-	
	712,500	262,500	225,000
Current assets	112,500	150,000	75,000
Total assets	**825,000**	**412,500**	**300,000**
EQUITY AND LIABILITIES			
Equity			
Share capital (₦1 ordinary shares)	225,000	150,000	112,500
Share premium	75,000	18,750	18,750
Other reserves	26,250	-	-
Retained earnings	243,750	161,250	93,750
Total equity	570,000	330,000	225,000
Non-current liabilities	187,500		
Current liabilities	67,500	82,500	75,000
Total liabilities	255,000	82,500	75,000
Total equity and liabilities	**825,000**	**412,500**	**300,000**

Required:

Prepare for Adegaga Laboratories Plc:

a. A consolidated statement of financial position as at December 31, 2017.
(20 Marks)

b. On January 1, 2018, AdeLabs acquired an additional 10% of the equity shares of Bodegas. The purchase consideration for this additional acquisition was ₦52,500,000.

Required:

i. Briefly explain how this additional acquisition will impact on the preparation of AdeLabs consolidated financial statements for the year ended December 31, 2017. (4 Marks)

ii. Calculate the adjustment that will be required to be made to AdeLabs' statement of financial position as a result of this acquisition. (6 Marks)

(Total 30 Marks)

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

QUESTION 2

(1) KutuKutu Plc. has a policy in place to pay its employees a performance bonus. This bonus is to be paid in cash and is unrelated to the movement in its share price. KutuKutu Plc. has the choice of settling the bonus in cash or in equity shares to the value of the cash bonus. Based on bonuses paid in prior years, KutuKutu Plc. has always settled the bonuses of qualified employees in shares.

(2) KutuKutu Plc. grants one share option to each of its 50 employees on January 1, 2016. The share options will vest at the end of 2 years provided that:

The employees remain in KutuKutu Plc.'s employment at that date; and the Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA) of KutuKutu Plc. for the second year achieves a specified target.

At the grant date, each recipient is required to make a non-refundable cash payment of ₦2,000 to KutuKutu Plc. This payment is based on the estimated fair value (FV) of the share option which reflects the probability that the target EBITDA will be achieved in the second year. FV of each option would be ₦250 (excluding the effect of the EBITDA condition).

If KutuKutu Plc. does not achieve the target EBITDA or if an employee leaves the employment of KutuKutu Plc., no shares will be issued and the employee will not be entitled to a repayment. Accordingly, both service and non-market vesting conditions are deemed to be substantive.

Required:

a. Do the transactions entered into in (1) above meet the definition of equity-settled share based payment transactions within the scope of IFRS 2? (8 Marks)

b. How should the transaction in (2) above be accounted for? (12 Marks)

(Total 20 Marks)

QUESTION 3

Banny Plc. (Banny) is a diversified company that has achieved its present size through vertical and horizontal acquisition. The directors have identified two potential target entities for acquisition. The first is Abana Limited (Abana) which is into cement business near Offa, Kwara State. The second is Doha Limited (Doha) which is also into cement business near Oturukpo, Benue State. Banny has obtained copies of their audited financial statements. Extracts of these financial statements together with notes providing additional information are given below.

Statement of Profit or loss for the year ended December 31, 2017

	Abana	**Doha**
	₦'m	₦'m
Revenue	136,000	132,000
Cost of sales	(84,000)	(91,900)
Gross profit	52,000	40,100
Other operating expenses	(36,000)	(28,000)
Profit from operations	16,000	12,100
Finance costs	(6,000)	(8,000)
Profit before tax	10,000	4,100
Income tax expense	(3,000)	(2,000)
Net profit for the period	7,000	2,100

Statement of changes in equity for the year ended December 31, 2017

	Abana	**Doha**
	₦'m	**₦'m**
Balance January 1, 2017	44,000	32,000
Surplus on revaluation of property	___	12,000
Net profit for the period	7,000	2,100
Dividend paid	(4,000)	(2,000)
Balance December 31, 2017	47,000	44,100

Statement of financial position as at December 31, 2017

	₦'m	₦'m	₦'m	₦'m
Non-current assets				
Property, plant and equipment		64,000		70,100
Current Assets				
Inventories	12,000		14,000	
Trade receivables	24,000		20,000	
		36,000		34,000
		100,000		**104,100**
Equity				
Issued capital (₦1 ordinary shares)		32,000		24,000
Revaluation reserves		—		10,000
Retained earnings		15,000		10,100
		47,000		44,100
Non-current liabilities				
Long term borrowings		32,000		36,000
Current liabilities				
Trade payables	10,000		10,000	
Income tax	3,000		2,000	
Short term borrowings	8,000	21,000	12,000	24,000
		100,000		**104,100**

Notes:

(1) Doha revalued its non-current assets for the first time following the adoption of IFRS on January 1, 2017. The non-current assets of Abana are very similar in age and type to the non-current assets of Doha. However, Abana has a policy of maintaining all its non-current assets at depreciated historical cost. Both entities charge depreciation of non-current assets to cost of sales. Abana has transferred the excess depreciation on the revalued assets from the revaluation reserve to retained earnings as permitted by IAS 16 - Property, plant and equipment.

Banny uses ratio analysis to appraise potential acquisition target and bases its judgement using four key ratios:

- Return on capital employed;
- Gross profit margin;
- Turnover on capital employed; and
- Leverage.

For the purpose of the ratio analysis, Banny computes capital employed as capital and reserves plus borrowings, long- term plus short- term.

Your assistant has computed the four key ratios for the two entities from the financial statements provided and concluded that Abana is a better target for acquisition than Doha. However, you are not sure, given the information on the revaluation of its non-current assets as stated above.

Required:

a. Compute and explain the adjustments that would be appropriate in respect of Note 1 on revaluation of property, plant and equipment so as to make the financial statements of Abana and Doha comparable for analysis. (14 Marks)

b. Calculate the four ratios used by Banny for both Abana and Doha after making the adjustments you have recommended in your answer to part (a). (4 Marks)

c. In the light of your analysis in (a) and (b) above, advise Banny which of the two companies is a better target for acquisition based on the adjusted ratios. (2 Marks)

(Total 20 Marks)

QUESTION 4

a. Happy is a publicly listed company. Its financial statements for the year ended July 31, 2017 including comparatives are shown below:

Statement of profit or loss and other comprehensive income for the year ended:

		July 31, 2017	July 31, 2016
		₦'m	₦'m
Revenue		62.0	50.0
Cost of sales		(43.6)	(37.2)
Gross profit		18.4	12.8
Distribution costs		(7.2)	(4.8)
Administrative expenses		(4.4)	(3.2)
Finance costs	- loan interest	(0.3)	(0.5)
	- lease interest	(0.5)	(0.2)
Profit before tax		6.0	4.1
Income tax expense		(2.0)	(1.5)
Profit for the year		4.0	2.6
Other comprehensive income (note (i))		2.7	—
		6.7	2.6

Statement of financial position as at 2016	July 31, 2017		July 31,	
	₦'m	₦'m	₦'m	₦'m
Assets				
Non-current assets				
Property, plant and equipment		28.0		21.4
Deferred development expenditure		2.0		
		30.0		21.4
Current assets				
Inventory	6.6		7.6	
Trade receivables	5.9		4.4	
Bank	0.1	12.6	2.6	14.6
Total assets		42.6		36.0
Equity and liabilities				
Equity				
Ordinary shares of ₦1 each		16.0		16.0
Revaluation reserve		2.7		—
Retained earnings		6.4		3.5
		25.1		19.5
Non-current liabilities	₦'m	₦'m	₦'m	₦'m
8% loan notes	2.8		6.25	
Deferred tax	3		1.6	
Finance lease obligations	2.4	8.2	1.8	9.65
Current liabilities				
Finance lease obligations	1.5		1.2	
Trade payables	5.3		4.2	
Current tax payable	2.5	9.3	1.45	6.85
Total equity and liabilities		42.6		36

Notes:

(i) On November 1, 2016, Happy acquired an additional plant under a finance lease that had a fair value of ₦3 million. On this date, it also revalued its property upwards by ₦4 million and transferred ₦1.3 million of the resulting revaluation reserve to deferred tax. There were no disposals of non-current assets during the period.

(ii) Depreciation of property, plant and equipment was ₦1.8 million and amortisation of the deferred development expenditure was ₦400,000 for the year ended July 31, 2017.

Required:

Prepare a statement of cash flows for Happy for the year ended July 31, 2017, in accordance with IAS 7 Statement of Cash Flows, using the indirect method. (10 Marks)

b. Compliance with the fundamental principles as expressed in ICAN's Code of Ethics, may potentially be constrained by a range of circumstances among which can be threats.

Required:

As a Consultant to the management of Gatuso Plc., write a draft report to identify and evaluate the various threats to the fundamental principles that might disrupt its objectivity and give circumstances that can create such threats. (10 Marks)

(Total 20 Marks)

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

QUESTION 5

Atigen Manufacturing Limited bought a new machine for its factory in Otta, Ogun State for ₦140 million on January 1, 2015. At acquisition, the machine was estimated to have a life span of 7 years with no scrap value. The carrying amount at December 31, 2017 is ₦80 million.

The machine generates largely independent cash flows and therefore is tested for impairment as a stand-alone asset. Due to a downturn in the economy and reduction as well as cancellation of major customer orders due to changes in the market place, the directors concluded that the machine may be impaired. You are provided with the following information:

Fair value of the machine: ₦60 million;

Selling costs is 5% of the fair value; and

Value-in-use based on discounted future cash flows is ₦63.5 million.

Required:

a. Determine if the machine is impaired based on the above information. (6 Marks)

b. Calculate (if any) the impairment charge, the directors should take to profit or loss. (9 Marks)

(Total 15 Marks)

QUESTION 6

You have been asked to make a presentation to your team on cryptocurrencies. A snapshot of your draft presentation includes the following:

"Cryptocurrency is a new phenomenon in the financial market. A cryptocurrency is a digital or virtual currency designed to serve as a medium of exchange.

Cryptocurrencies are created through cryptography, often with a maximum possible number of 'coins' that can exist through solutions to a complex algorithm with their value supported only by the laws of supply and demand. Cryptocurrencies are currently not regulated by government or other similar entity.

The following are some of the types of cryptocurrency in the market:

Bitcoin - The first ever cryptocurrency that started the market awareness and "boom";

Ethereum - A programmable currency that lets developers build different distributed apps and technologies that wouldn't work with Bitcoin; and

Ripple - Unlike most cryptocurrencies, it doesn't use a Blockchain in order to reach a network-wide consensus for transactions. An iterative consensus process is implemented, which makes it faster than Bitcoin but also makes it vulnerable to hacker attacks.

There are a lot of merchants - both online and offline - that accept Bitcoin as the form of payment while Ethereum and Ripple, are not widely accepted yet.

Required:

Following your presentation, you are asked how a holding of cryptocurrency should be classified in the financial statements of your clients. (15 Marks)

(Total 15 Marks)

QUESTION 7

a. Agbero plc is a public company rendering services to Lagos State Government especially in the area of public transport. Agbero is listed on the Lagos Stock Exchange. In its annual financial statements for the year ended March 31, 2018, Agbero plc had identified the following operating segments:

Segment 1 local bus operations;

Segment 2 inter-city bus operations, and

Segment 3 road constructions.

The company disclosed two reportable segments. Segments 1 and 2 were aggregated into a single reportable operating segment. Operating segments 1 and 2 have been aggregated on the basis of their similar business characteristics, and the nature of their products and services. In the local bus operations market, it is the Lagos state local transport authority which awards the contract and pays Agbero plc for its services. In the local bus operation market, contracts are awarded following a competitive tender process, and the ticket prices paid by passengers are set by and paid to the Lagos state transport authority. In the inter-city bus operation market, ticket prices are set by Agbero and the passengers pay Agbero for the service provided.

Required:

i. Advise Agbero plc on how the above accounting issues should be dealt with in its financial statements. (6 Marks)

ii. Although the company is happy with IFRS 8-Operating segment, hence its desire to comply with the above, it is not clear about who to designate as its chief operating decision maker in line with the standard. Define Chief operating decision maker in line with IFRS 8 - Operating Segment and identify who this should be in Agbero plc. (2 Marks)

b. Agbero Plc entered into a contract with Lagos State Government on April 1, 2016 to undertake construction of a new light railway line. The total revenue from the contract is ₦5 billion over a three-year period.

The contract states that ₦1 billion will be paid at the commencement of the contract but although invoices will be subsequently sent at the end of each year, the Lagos State Government will only settle the subsequent amounts owing when the contract is completed. The invoices sent by Agbero Plc to date (including ₦1 billion above) were as follows:

Year ended March 31, 2017 ₦2·8 billion

Year ended March 31, 2018 ₦1·2 billion

The balance will be invoiced on March 31, 2019. Agbero Plc has only accounted for the initial payment in the financial statements to March 31, 2017 as no subsequent amounts are to be paid until March 31, 2019. The amounts on the invoices reflect the work undertaken in the period.

Required:
Agbero Plc. wishes to know how to account for the revenue on the contract in the financial statements to date. Advise Agbero Plc.

Market interest rates are currently at 6%. (7 Marks)
(Total 15 Marks)

SOLUTION 1

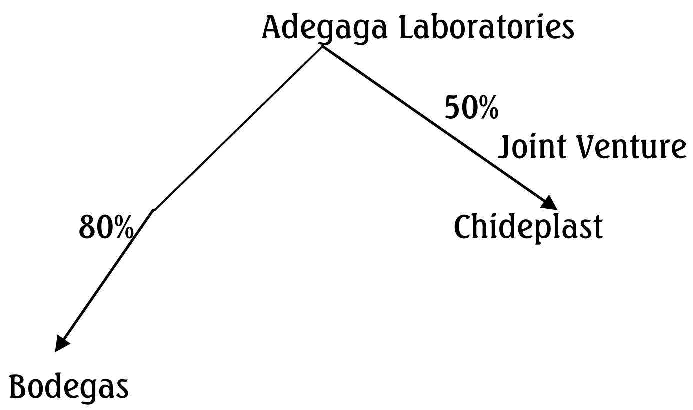
a.

ADEGAGA LABORATORIES GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AS AT DECEMBER 31, 2017

	₦'000
Non-Current Assets	
Property, plant and equipment (300,000 + 262,500)	562,500
Goodwill wk3	1,000
Investment in associate (Chideplast) wk6	157,500
Total non-current assets	**721,000**
Current Assets	
Current assets (112,500+150,000)	262,500
Total assets	**983,500**
Equity & Liabilities	
Equity	
Share capital	225,000
Share premium	75,000

Retained earnings wk5	305,050
Non-controlling interest wk4	33,450
Total equity	**638,500**
Non-current liabilities (187,500+7500) wk9	195,000
Current liabilities (67,500+82,500)	150,000
Total equity & liabilities	**983,500**

Wk 1 Control structure



WK 2 Fair value of net asset of subsidiary Bodegas

	At acquisition Date	At reporting date
	1/1/15	31/12/17
	₦'000	₦'000
Share capital	150,000	150,000
Share premium	18,750	18,750
Other reserves	-	-
Retained earnings	93,750	161,250
Fair value	**262,500**	**330,000**

Post-acquisition profit **₦67,500**

Alternative calculations
Net assets of the subsidiary – Bodegas

	Reporting Date	Acquisition Date	Post Acquisition
	₦'000	₦'000	₦'000
Share capital	150,000	150,000	-
Share premium	18,750	18,750	-
Retained earnings	93,750	161,250	67,500
	262,500	**330,000**	**67,500**

Wk 3 Goodwill

	₦'000
Fair value of investment in Bodegas as at 31/12/17	262,500
Less: increase in FV recognised in other reserves	(18,750)
Purchase consideration as at 1/1/2015	**243,750**
Non-controlling interest 20%	20,000
Total consideration 100%	**263,750**
Fair value of net asset at acquisition wk2	(262,500)
Goodwill at acquisition 1/1/15	1,250
Impairment	(250)
Goodwill at reporting date	1,000

Wk 4 Non-controlling interest	**₦'000**
Fair value of NCI at acquisition	20,000
Share of profits (20% x 67,500) (wk6)	13,500
Share of impairment in subsidiary (20% x 250)	(50)
Fair value at reporting date	33,450

Wk 5 Group retained earnings

Parent	243,750
Interest on borrowings	(7,500)
Share of impairment in subsidiary (80% x 250)	(200)
Share of profits in (Bodegas) (80% x 67,500)	54,000
Share of profits in (Chideplast)(50% x 52,500)	26,250
Unrealized profit on sales to chideplast wk 6	(11,250)
Retained earnings at reporting date	**305,050**

Wk 6 Joint Venture

Cost of investment in Chideplast	150,000
Less Fair value gain recognized in other reserve	(7,500)
Unrealised profit on sales (75,000x75%x40%x50%)	(11,250)
Share of profit in Chideplast	26,250
Joint venture at reporting date	**157,500**

Note: post acquisition profit in Joint Venture

At acquisition date	At reporting date
₦41,250,000	₦93,750,000

₦52,500,000

WK 7 Fair value gain recognized in other reserves

Adelabs cannot carry out fair valuation of investment in Bodegas and Childeplast after gaining control in Bodegas on 1/1/2015; similarly, Chideplast is an equity accounted investment, therefore fair value gain would have to be derecognized as follows:

	₦'000	₦'000
Dr Other reserves	26,250	
Cr Investment in Bodegas		18,750
Cr Investment in Chideplast		7,500

WK 8: Unrealized profit on goods sold to Chideplast needs to be accounted for and deducted from investment in Chideplast to the tune of control. i.e ₦75,000x at 75% unsold x 40% margin x 50% control = ₦11,250,000.

	₦'000	**₦'000**
Dr Retained earnings of parent	11,250	
Cr Investment in Chideplast		11,250

Wk 9: **Financial Investment measured at amortized cost**

Opening balance	Nominal Interest (4%)	Effective Interest 8%	Closing balance
₦'000	₦'000	₦'000	₦'000
187,500	(7,500)	15,000	195,000

Debit ₦7,500,000 to Adelab Group retained earnings and credit financial liability ₦7,500,000.

ALTERNATIVE

		₦'000
Long term borrowings		187,500
(Difference of unpaid Interest	(8% - 4%) x ₦187,500,000	7,500
		195,000

b.(i) **Step acquisition where control already exist**

This is step acquisition where control already exists. IFRS 3 – Business combinations (revised) states that where control already exists, parent needs to account for additional acquisition as mere change in shareholding between shareholders. In relation to Adelabs, Adelabs control Bodegas by 80% on 1/1/15 but stepped up its acquisition by acquiring 10% more on 1/1/2018 after the year end. This will increase holding to 90% while NCI will become 10%

This falls under IAS 10 - event after reporting date as it occurred after reporting date but before the approval of financial statements.

Event after reporting date are event both favourable and unfavourable that occurred after reporting date but before the approval date. It can be an adjusting or non-adjusting event.

In this case, this is non-adjusting event therefore it requires only disclosure to the financials statement as at 31/12/2017.

ii. In 2018 the following adjustments will be required to be made to Adelabs' statement of financial position:

	₦'000	₦'000
Dr. Investment in Bodegas	52,500	
Cr. Bank account		52,500

Being Adelabs additional 10% acquisition of Bodegas on January 1, 2018.

EXAMINER'S REPORT

The question tests candidates' knowledge on the preparation of consolidated statement of financial position and the impact of additional acquisition on the group and parent separate statement of financial position.

Candidates demonstrated poor understanding of the question, as only few of them understand clearly the difference between subsidiary, associate and joint venture relationships.

Commonest pitfall was that candidates were consolidating the figures of chideplast (joint venture) with those of the parent and subsidiary in Part (a) of the question.

Candidates could not demonstrate adequate knowledge of step acquisition and additional acquisition after control has been achieved by the parent.

Candidates are advised to prepare adequately to internalize the principles involved generally in group accounts as this is consistently tested in this syllabus.

Marking Guide		**Marks**	**Marks**
a.	Consolidated statement of financial position		
	- Non-current asset	$2^1/_2$	
	- Current asset	$1^1/_2$	
	- Equity and liabilities	5	
	- Workings	<u>11</u>	20
b.	Step acquisition where control already exists: Increase in holding to 90% applying IFRS 3: Business Combination.	2	
	Identifying event after reporting date - IAS 10	1	
	Treatment of non-adjusting events in the financial statements	<u>1</u>	4
c.	Computation of adjustment required to SOFP as a result of the acquisition	2	
	Journal entries with narration	<u>4</u>	6
	Total		**<u>30</u>**

SOLUTION 2

a. According to IFRS 2 – Share based payments. An entity should recognize the financial effects of all share based payment transactions in its financial statement.

Share based payment transaction is a transaction in which an entity issues shares or share options as consideration for goods or services rendered. It also includes a transaction where an entity acquires goods or services and agrees to pay cash which will be based or influenced by price of the entity's share.

It simply infers that an organization, i.e. Kutukutu Plc uses its shares as a basis of payment for the services rendered by employees or goods purchased. It can be either equity settled or cash settled.

Equity-settled is where organization used their own shares in exchange and will be recognized like this:

Dr Profit or loss over the vesting period
Cr Equity options with total amount

Whereas cash-settled will be recognized thus:

Dr Profit or loss account
Cr Liability

As regards Kutukutu Plc, the bonus is not cash-settled due to the facts that

- Performance bonus is to be paid in cash but the bonus payment is unrelated to the movement in its share price.

At this juncture, it must be mentioned that the transactions entered into in(i) does not meet the definition of equity – settled share based payment transactions within the scope of IFRS 2.

b. IFRS 2 explains that the share based payment transaction should be measured at the fair value of the goods or services received. If fair value of goods and services cannot be measured reliably then the entity should measure the transaction at fair value of the equity instruments granted.

This transaction should be accounted for as equity-settled share based payment arrangement and this falls within the scope of IFRS 2.

The postings in the books of Kutukutu Plc will be as follows:

Year 1

Dr	Expenses (P or L)	₦50,000	
Cr	Equity		₦50,000

Year 2

Dr	Expenses (P or L)	₦100,000	
Cr	Equity		₦100,000

Kutukutu Plc

Statement of profit or loss for the period ended December 31,

	2017	**2016**
Expenses	₦50,000	₦50,000

Kutukutu Plc

Statement of financial position as at December 31,

	2017	**2016**
Equity Components	₦100,000	₦100,000

Workings

Year 1:	50 staff x ₦2,000 x ½	=	₦50,000
Year 2:	50 staff x ₦2,000 x $^2/_2$	=	₦50,000

Assumptions:

No employees left the organization (Kutukutu Plc) during the two years in question.

Fair value (FV) of each option (₦250) is considered constant at the grant date (i.e. date of agreement between employees and Kutukutu Plc)

EXAMINER'S REPORT

The question tests candidates' knowledge of the conditions and the provisions of equity-settled share based payment transactions within the scope of IFRS 2 – Share based payments and how to account for the transactions in the financial statements.

About 36% of the candidates who wrote the paper attempted the question and performance was poor.

The candidates' commonest pitfalls were poor understanding of IFRS 2 and their inability to differentiate between equity-settled share-based payment and cash-settled share- based payment transactions.

Candidates are advised to study in-depth all the applicable IFRS/IAS for better performance in future examinations.

Marking Guide

		Marks	**Marks**
a.	Features of equity-settled share-based under IFRS 2	2	
	Features of cash-settled share-based under IFRS 2	2	
	Journal entries for equity and cash-settled share-based		

payments	2	
Relating the features to Kutukutu Plc	2	8

b.	Accounting treatment for equity-settled share based payment for:		
	Year 1	3	
	Year 2	3	
	Showing the expenses in the statement of profit or loss of Kutukutu Plc	2	
	Showing the equity components in the statement of financial position of Kutukutu Plc	2	
	Correct assumptions stated	2	12
	Total		20

SOLUTION 3

a. For comparison to be thorough, the basis of accounting of the two companies Doha and Abana should be the same, hence Abana using historical cost and Doha using IFRS as first adopter should be harmonised.

(i) Reduce non-current assets by ₦10 billion
(ii) Reduce the revaluation reserves to NIL
(iii) Reduce the cost of sales by ₦2 billion for the excess depreciation as a result of the revaluation.
(iv) Increase gross profit by ₦2 billion

Based on the foregoing, the new figures for Doha are as follows:

Item	**Old figures** ₦'m	**Adjustments** ₦'m	**New figures** ₦'m
Non-current assets	70,100	(10,000)	60,100
Revaluation reserve	10,000	(10,000)	——
Cost of sales	91,900	(2,000)	89,900
Gross profit	40,100	2,000	42,100
Profit before operations	12,100	2,000	14,100
Equity	44,100	10,000	34,100

b.	**Ratios**		**Formula**	**Doha new figures**	**Abana**
	i.	ROCE	$\frac{PBIT}{\text{Capital employed}}$	$\frac{14,000}{82,100} \times \frac{100}{1}$	$\frac{16,000}{87,000} \times \frac{100}{1}$
				= 17.17%	= 18.39%
				= 17.2%	= 18.4%
	ii.	Gross profit margin	$\frac{\text{Gross profit}}{\text{Sales}} \times \frac{100}{1}$	$\frac{42,100}{132,000} \times \frac{100}{1}$	$\frac{52,000}{136,000} \times \frac{100}{1}$
				= 31.89%	= 38.24%
				= 32%	= 38%
	iii.	Turnover on Capital employed	$\frac{\text{Turnover}}{\text{Capital employed}}$	$\frac{132,000}{82,000}$	$\frac{136,000}{87,000}$
				= 1.608 times	= 1.563 times
				= 1.6 times	= 1.6 times
iv.	Leverage		$\frac{\text{Total debt}}{\text{Equity}}$	$\frac{48,000}{82,100} \times \frac{100}{1}$	$\frac{40,000}{87,000} \times \frac{100}{1}$

$\frac{\text{Long + Short term borrowings}}{\text{Equity}}$ 58.5% = 45.98%

59% = 46%

or

	Doha	Abana
$\frac{\text{Long term borrowings}}{\text{Equity + long term borrowings}}$	$\frac{32,000}{79,000}$	$\frac{36,000}{80,000}$
	= 40.5%	= 45%

c. Abana is better off in terms of leverage, ROCE and gross profit margin compared with Doha, consequently, Abana would be a better investment for acquisition purposes.

The adjustment of revaluation which was carried out to make the financial statements of the two companies comparable makes it a bit more difficult to decide which entity Banny plc. should target. After this adjustment, the asset turnover ratio of both companies appears to be the same at 1.6 times, meaning none is more efficient than the other in the use of the assets to generate income.

Abana has a higher gross profit and return on capital employed when compared to Doha. The main reason may be that Doha has a higher other operating expenses than Abana. This is because the turnover figures of both companies are nearly identical.

Where Abana has an advantage over Doha is in the leverage ratio. Leverage of both entities has increased but more so in the case of Doha. The question is whether the directors will attach more importance to leverage in their investment decision. Consideration as to whether this influences the directors' decision depends on whether they intend to change the financial structure of the company.

Overall, it would appear that Abana would be a better investment on account of profitability. However, it will not make much difference a decision as to choose between the two entities given the close nature of their financial figures. However, this exercise shows the importance of adjusting financial statements to achieve uniform accounting policies when making investment decisions. It is notable that Doha's revaluation is permissible but can impact on ratios if not adjusted.

EXAMINER'S REPORT

The question tests candidates' knowledge on revaluation of non-current assets for the first time following the adoption IFRS and the computation of ratios after making adjustment on the revaluation.

About 71% of the candidates attempted the question. The candidates did not have clear understanding of the question and therefore the performance was generally below average.

The commonest pitfall was the inability of the candidates to compute adjustments to the financial statements before computing the ratios.

Candidates should ensure full coverage of the syllabus to have in-depth knowledge for better performance in future examination.

Marking Guide		**Marks**	**Marks**
a.	Computation of adjustment necessary to make financial statement of Abana and Doha comparable:		
	- State all the adjustments	4	
	- Computation of new figures	10	
			14
B	Ratio computation for Doha and Abana		
	ROCE	1	
	Gross profit	1	
	Turnover of capital employed	1	
	Leverage	1	
			4
C	Advice and conclusion		2
	Total		20

SOLUTION 4

Happy Plc Statement of Cash Flow for the year ended July 31, 2017

Operating activities	₦'m
Profit before tax	6.0
Interest on finance cost	0.8
Depreciation	1.8
Amotisation	0.4
Cash flow before working capital	9.0
Movement in working capital:	
Inventory	1.0
Trade receivable	1.5
Trade payable	1.1
Cash flow before interest and tax	9.6
Finance cost paid	(0.3)
Cash flow from operating activities before tax	9.30
Tax paid (W5)	(0.85)
Net cash flow from operating activities	8.45
Investing Activities	
Development expenditure (W1)	(2.4)
Property, plant & equipment (W2)	(1.4)
Net cash flow from investing activities	(3.8)
Financing Activities	
Finance cost on lease	(0.5)
Dividend paid (W3)	(1.1)
Loan notes redeemed	(3.45)
Lease rental paid (W4)	(2.1)
Net Cash flow from financing activities	(7.15)
Net cash flow for the year	(2.5)
Cash and cash equivalent at the beginning	2.6
Cash and cash equivalent at year end	0.1

WORKINGS

1. **Development Expenditure**

	₦'m
Opening balance	—
Depreciation	(0.4)
Cash paid **	2.4
Closing balance	2.0

2. **Property, plant and equipment**

	₦'m	**₦'m**
Opening balance		21.4
Acquisition		3.0
Revaluation		4.0

	Depreciation	(1.8)
		26.6
	Paid**	1.4
	Closing balance	28.0
3.	**Dividend paid**	
	Retained profit before	3.5
	PAT	4.0
	Dividend paid	(1.1)
		6.4
4.	**Lease rental paid**	
	Opening: finance non-current	1.8
	Opening: finance current	1.2
	Property, plant and equipment	3.0
		6.0
	Closing: finance non-current	2.4
	Closing: finance current	1.5
		(3.9)
	Lease paid	2.1
5.	Tax paid	
	Opening balance	3.05
	Tax provision	2.0
	New PPE (Deferred tax)	1.3
	Closing balance	(5.5)
	Tax paid	0.85

b. Date

To: The management of Gatuso Plc

From: The consultant

Subject: DRAFT REPORT TO IDENTIFY AND EVALUATE THREATS TO FUNDAMENTAL PRINCIPLE

Below are the possible threats to the fundamental principles that might disrupt its objectivity and the circumstances that can create such threats.

Evaluation of threats to the fundamental principle

1. Self interest threat
   - Financial interest

- Incentives compensation
- Inappropriate use of corporate assets
- Concern over employment security
- Commercial pressure from outside

2. Self review threat
   - Members not willing to fault themselves on records prepared by them
   - Business decision data being subject to review by same accountant.
3. Advocacy threat
   - The professional accountant needs to promote the organisation position.
   - Need to window dress accounts
4. Familiarity threat
   - Long association with business contacts
   - Immediate close family members who benefit from the influence of the professional accountants.
5. Intimidation threat
   - Professional accountants conduct is influenced by fear
   - Threat of dismissal or replacement
   - Presence of dormant personality influencing decisions.

If you desire further explanation in any submission above, kindly contact us.

Thanks

The Consultant

EXAMINER'S REPORT

The question tests candidates' knowledge on the preparation of statement of cash flows using the indirect method in accordance with IAS 7 – Statement of Cash Flows. Part (b) of the question tests the identification and evaluation of the various threats to the fundamental principles that might disrupt its objectivity.

About 96% of the candidates attempted the question. Those who attempted part (a) of the question demonstrated a fairly good understanding of the requirement. In Part (b), they mixed up the threats with the fundamental principles of accounting.

Candidates' commonest pitfall was their inability to correctly derive the cash flows. Also, some were not able to identify and evaluate the various threats to the fundamental principles in ICAN Code of Ethics.

Candidates are advised to prepare very well for future examinations using the Institute's study texts and pathfinder.

Marking Guide		**Marks**	**Marks**
a.	Derivation of cash flow items and preparation of cash flow statement:		
	- Operating activities	3	
	- Investing activities	3	
	- Financing activities	3	
	- Cash and cash equivalent	1	**10**
b.	Identification of threats	5	
	Circumstances creating threats	5	**10**
	Total		**20**

SOLUTION 5

Atigen Manufacturing Limited year ending December 31, 2017

a. Determination of impairment of the machine:

-	Carrying amount:		**₦'000**
	Cost		140,000
	Less: Accumulated depreciation (₦140÷7)x3		60,000
			₦80,000
-	Fair value (less costs to sell):		
	Fair value of machine		60,000
	Less: Costs to sell (5% of ₦60,000,000)		3,000
			₦57,000
-	Value–in-use:		
-	The present value of the future Cash flows	=	₦63,500
-	Recoverable amount – higher of fair value less costs to sell, and value in use	=	₦63,500

- The machine is impaired because the carrying amount is greater than its recoverable amount.

b. Determination of impairment charge to take to profit or loss.

	₦'000
Carrying amount	80,000
Recoverable amount	63,500
	16,500

- Thus an impairment write-down of ₦16.5m (80m - 63.5m) is required.

- The accounting entries are as follows:

Dr. Profit or Loss (Admin expenses)	₦16.5m	
Cr. Property, plant and equipment		₦16.5m
Being impairment charge on the machine at December 31, 2017		

EXAMINER'S REPORT

The question tests the candidates' knowledge of impairment of a machine as a stand-alone asset and the computation of impairment charge to be taken to statement of profit or loss.

About 97% of the candidates attempted the question. The candidates understand the requirements of the question and their performance was above average.

However, major pitfalls were inability to apply the principles and theories in IAS 36 –impairment of assets and making correct presentation of the figures.

Candidates are advised to be well acquainted with the requirements of the accounting standards and its application to the real corporate world situation for better performance in future examinations.

Marking Guide		**Marks**	**Marks**
a.	Calculation to determine whether the machine is impaired or not		
	-Determination of carrying amount	2	
	-Determination of fair value	2	
	-Determination of value –in-use	2	**6**
b.	Determination of Impairment charges	6	
	Accounting entries	3	**9**
	Total		**15**

SOLUTION 6

A cryptocurrency is a digital or virtual currency that uses cryptography for security. A cryptocurrency is difficult to counterfeit because of this security feature. Many cryptocurrencies are decentralized systems based on blockchain technology, a distributed ledger enforced by a completely different network of computers.

In classifying cryptocurrencies in the financial statements, holders of such currencies will need to determine how to classify them based on whether they are:

Financial instruments	-	IAS	32
Intangible assets	-	IAS	38
Inventory	-	IAS	2

a. Financial Instruments – IAS 32 defines a financial asset as any asset that is cash or equity instrument of another entity (e.g. shares of another entity). It can equally be described as a contractual right to receive cash or another financial asset from another entity; or to exchange financial instruments with another entity under conditions that are potentially unfavorable to the entity.

Cryptocurrencies do not meet this definition because they do not give any contractual rights to the holder.

In view of this, cryptocurrencies cannot be disclosed or classified as financial instrument in the financial statements.

b. Intangible assets – IAS 38 defines an intangible asset as an "identifiable non-monetary asset without physical substance". An asset is a resource that is controlled by the entity as a result of past events and from which future economic benefits are expected.

The three critical attributes of an intangible asset are:

Identifiability

Control (power to obtain benefits from the asset)
Future economic benefits (such as revenues or reduced future costs).

Cryptocurrency meets the definition of an intangible asset because it has no physical substance and is non-monetary.

In view of this, cryptocurrency can be classified as intangible asset in the financial statements either at cost or, if there is an active market and the entity chooses to apply the revaluation model, at fair value with changes in value recognized in other comprehensive income (if above cost) or profit or loss (if below cost) as required by IAS 38.

c. Inventory – IAS 2 provides that inventories include assets held for sale in the ordinary course of business (finished goods), assets in the production process for sale in the ordinary course of business (work in progress), and materials and supplies that are consumed in production (raw materials).

Cryptocurrency falls in the scope of IAS 2 and can be classified as inventory in the financial statements.

EXAMINER'S REPORT

The question tests candidates' understanding of the treatment and presentation of cryptocurrencies as a new phenomenon in financial market and its classification in the financial statements.

About 22% of the candidates attempted the question. The candidates displayed a poor understanding of cryptocurrency as a contemporary current issue in financial engineering that is still being subject to future debates.

Candidates' commonest pitfall borders on the inability to link the concept to relevant International Financial Reporting Standards (IFRS) like IAS 38 – Intangible assets, IAS 2 – Inventory and IAS 32 – financial instruments.

Candidates' should endeavour to familiarize themselves with contemporary issues in the financial world by reading relevant journals and articles.

Marking Guide	**Marks**	**Marks**
Definition of cryptocurrency and general introduction	3	
Different classification of cryptocurrency as:		
- Financial Instruments – IFRS 9	4	
- Intangible Assets – IAS 32	4	
- Inventory - IAS 2	4	
Total		**15**

SOLUTION 7

a.i. IFRS 8 – defines an operating segments as a component of an entity that engages in revenue earning business activities, whose operating results are regularly reviewed by the chief operating decision maker.
The standard permits or allow for one or more operating segments to be aggregated into a single reportable segment provided certain conditions are met. These conditions are:

Principally, operating segments should have similar economic characteristics.

- They are expected to have the same future outcome with their similar characteristics.

Areas of similar characteristics to satisfy are as follows:

- Nature of the products and services;
- Nature of the production process;
- Type or class of customers for their products and services;
- Methods used to distribute their products or provide their services; and
- The nature of regulatory environment.

Treatment of accounting issues in Agbero Plc
Information given reveals the following:
Segment 1 - Local bus operation – Serves passenger within the town
Segment 2: Inter -city bus operation – Serves passenger across the state.
This shows the 2 Segments have different classes or type of customers.

Regulatory environment:
Local bus operation:

- The Lagos State Local Transport Authority is vested with the power to award or withdraw local bus operation contract to Agbero Plc, which is not a function of passengers availability.

Intercity bus operation market:

- Decision to withdraw from a route in intercity operation rests with Agbero Plc, based on availability of passengers and viability of the route.

Pricing: Based on their operating environments.

- Local Bus Operation: Ticket prices paid by passenger are set by the Lagos Transport Authority, where Agbero Plc only collects commission. No economic risk.
  Inter-city bus operation: Agbero sets the ticket price paid by passengers. revenue risk exposure is here.

The 2 segments do not have similar characteristics for aggregation; as such they should be reported separately.

ii. According to IFRS 8:

- Chief operating decision maker is often the Chief Executive Officer (CEO) or Chief Operating Officer (COO). It is a function and not necessarily a person.

- The person identified as chief operating decision maker is the person(s)
  responsible for making strategic decision about the entity's segments (title or no title)

- In line with the above, the 2 operations managers at segment 1 and 2 and the General Manager overseeing their operations are qualified to be chief operating decision makers.

b. **AGBERO PLC** **Accounting for the revenue on the contract in the financial statement**

- Revenue should be measured at the fair value of the consideration received or receivable.
- Fair value of the consideration, of deferred inflow of cash or cash equivalent received is less than the nominal value, hence need to discount.
- Though Agbero Plc is providing interest free credit to buyer, interest must still be imputed at the market rate of 6% given, based on revenue recognition, as defined in the IASB Framework.
- The criteria for incorporating an item that meet definition of revenue in the statements of profit or loss are as follows:

  i. It is probable that any future economic benefit associated with the item of revenue will flow to the entity;
  ii. The amount of revenue can be measured with reliability;
  iii. Must recognize revenue as work is performed throughout the contract life; and
  iv. Revenue should be discounted to reflect delay. Agbero Plc should correct the prior period errors retrospectively in the financial statements for the year ended March 31, 2018 - by re-

stating the comparative amounts for the prior period presented in which error occurred.

The calculation of revenue's fair value is as follows:

i. Year ended March 31, 2017

Expected revenue to be recorded by Agbero Plc
Already recognized – ₦1 billion
Balance as per issued invoice = ₦1.8 billion/1.06/1.06 = ₦1.6 billion
Total = ₦1 billion + ₦1.6 billion = ₦2.6 billon

ii. Year ended March 31, 2018

Issued invoice	=	₦1.2 billion
₦1.2 billion/1.06	=	₦1.13 billion
Additionally year	=	Interest income on ₦1.6 billion of
		2017
= ₦1.6 billion and 6%	=	0.096 billion
Total for 2018	=	1.13 billion + 0.096 billion
	=	1.226 billion

EXAMINER'S REPORT

The question tests candidates' knowledge on the presentation and operations of provisions of IFRS-8 - Operating segment and the treatment of accounting issues in the financial statements. The question further test the recognition and how to account for the revenue contract in the financial statements.

About 72% of the candidates attempted the question. Generally, candidates displayed poor understanding of the question and their performance was poor.

Commonest pitfall was the inability of majority of the candidates to properly apply the provisions of the accounting standards IFRS 8 and IFRS 15 to the situation depicted in the scenario.

Candidates should have adequate knowledge of accounting standards and be able to apply it to practical scenarios. They should also use ICAN study texts for better performance in future examinations.

Marking Guide

		Marks	Marks
a.i	Treatment of accounting Issues in the financial statement:		
	-Conditions to meet for aggregation of total reportable segments	3	
	- Treatment of accounting issues for:		
	Regulatory environment	$1^1/_2$	
	Pricing	$\underline{1^1/_2}$	6
ii	Definition of Chief operating decision maker (CODM)	1	
	Identification of CODM	$\underline{1}$	2
b.	Treatment of Revenue on contract in the financial statement		
	- Criteria of meet definition of revenue	4	
	Computation of revenue fair value for Year:		
	2017	$1^1/_2$	
	2018	$\underline{1^1/_2}$	$\underline{7}$
	Total		$\underline{\underline{\mathbf{15}}}$

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION - NOVEMBER 2018

ADVANCED TAXATION

Time Allowed: 3¼ hours (including 15 minutes reading time)

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

XYZ Nigeria Limited is a manufacturing company that produces ice cream. It was incorporated on January 7, 2009 with an authorised share capital of ₦12,000,000 made-up of 12,000,000 ordinary shares of ₦1.00 each. All the shares were fully allotted and paid for.

It commenced business on January 2, 2012. The detailed statement of profit or loss for the year ended December 31, 2017 is shown below.

	₦	₦
Revenue		112,500,000
Gross profit		48,199,800
Expenses:		
Directors' emoluments	7,200,000	
Staff salaries	11,800,000	
Motor vehicle expenses	960,000	
Insurance	725,000	
Repairs and maintenance	2,485,000	
Business promotion and entertainment	1,300,000	
Printing and stationery	310,500	
Transport and travelling	2,750,000	
Provision for bad debts	328,000	
Postage and communication expenses	1,300,000	
Advertising	1,000,000	
Utilities – electricity, gas, water etc	1,820,000	
Security charges	1,200,000	
Miscellaneous expenses	485,000	
Secretarial fees and expenses	120,000	
Legal fee	340,000	
Audit fee	500,000	
Interest on loan	725,000	

Bank charges and commissions	1,250,600	
Depreciation	2,000,700	(38,599,800)
Net profit for the year		**9,600,000**

You are provided with the following information:

		₦
(i)	Net assets as at December 31, 2017	21,500,000
(ii)	Property, plant and equipment-	60,900,000

The breakdown is as follows:

Description	**Date of construction/purchase**	**Amount**
		₦
Industrial building	December 27, 2011	18,000,000
Non-Industrial building	December 27, 2011	10,200,000
Plant and machinery	December 19, 2011	22,500,000
Office furniture and equipment	November 30, 2011	3,700,000
Motor vehicles	December 17, 2011	6,500,000

(iii) All capital allowances in the past were fully utilised.

(iv)	Unrelieved loss as at December 31, 2016 -	870,000
(v)	The breakdown of repairs and maintenance is as follows:	₦
	Repairs of office furniture	155,000
	Servicing of office equipment	330,000
	Construction of new gate house	2,000,000
		2,485,000
(vi)	Allowance for bad debts consist of:	₦
	General provision	253,000
	Specific debts adjudged bad	75,000
		328,000
(vii)	Advertising, consists of:	₦
	Advertisement of the company's product on radio stations	825,000
	Advertisement on neon sign posts	70,000
	Advertisement on sign boards	105,000
		1,000,000
(viii)	Legal charges comprise the following:	₦
	Retainership	200,000
	Legal services rendered to the wife of the managing director	25,000
	Cost of income tax appeal	65,000
	Cost of debt collection	50,000
		340,000

The auditors submitted the audited financial statements to the tax office on June 29, 2018. This was evidenced by the stamped copy of the covering letter in the auditors' file. The tax inspector raised a Best of Judgement (BOJ) assessment of ₦10,000,000 and late returns penalty of ₦75,000 on September 7, 2018.

The managing director was concerned that despite efforts by the management to comply with tax regulations, the tax office still raised the B.O.J assessment and the late returns penalty. During discussions at the management meeting of the company, the blame was attributed to the auditors.

You are required to:

a. Compute the tax liabilities of XYZ Nigeria Limited for the relevant assessment years. Show all workings. (25 Marks)

b. Based on the result in (a) above, advise the managing director of XYZ Nigeria Limited on the **validity** or **otherwise** of the best of judgement assessment and the penalty raised by the tax office. (5 Marks)

(Total 30 Marks)

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

QUESTION 2

Olu oil limited has been in the oil prospecting business in one of the major oil fields in the Niger Delta region of Nigeria since 2009. The company has provided the following operational results for the year ended December 31, 2015.

(i) Type of crude oil and sales statistics
Bonny light: 35,000 barrels exported at 39° API
Bonny medium: 25,200 barrels exported at 35° API
Forcados: 16,300 barrels exported at 32° API
Price per barrel
Bonny light: $52.03 at 35° API
Bonny medium: $49.04 at 35° API
Forcados: $48.29 at 35° API

Actual realised price was arrived at after adjusting for the variance in API. Thus, for every API, $0.03 was the variance in price at 35° API.

(ii) Local sales of crude oil: 32,750 barrels of crude oil was produced and sold in the domestic market at the rate of ₦345 per barrel.

(iii) The natural gas sold was from two contracts:

Contract	Value (₦)	Load factor
Obi Limited	42,285,000	62^0
Oba Limited	27,775,000	74^0

(iv) Miscellaneous income: ₦125,800,300

(v) Expenses included:

	₦
Intangible drilling cost	225,000,000
Rent	27,000,000
Royalty on export sales	7,116,400
Royalty on local sales	1,150,000
Interest paid	15,350,000
Transportation cost	13,730,000
Non-productive rent	6,725,000
Depreciation	23,000,000
Operating cost	318,250,000
Donations	5,500,000
Pension contribution	6,939,750
Custom duty	4,000,000
Harbour dues	2,500,000
Repairs of equipment	10,463,000
Bad debts written-off	13,510,000
Stamp duty on share capital	1,750,000
Management and administrative expenses	150,600,000

(vi) Miscellaneous income included ₦105,500,000, from the sale of refined petroleum products. An equivalent attributable expenses of ₦88,240,000 was included in management and administrative expenses.

(vii) Interest paid included ₦5,350,000, which was paid to Prince Limited, an associated company.

(viii) Donations included:

Body/Institution	Amount (₦)
Nigerian political party	2,000,000
Boko Haram victims rehabilitation fund	2,500,000
Society for the blind	1,000,000

(ix) The pension scheme was approved by the Joint Tax Board.

(x) Exchange loss on remittance amounting to ₦3,200,000 was included in management and administrative expenses.

(xi) The schedule of qualifying capital expenditure includes:

Asset type	Date of acquisition	Location	Amount (₦)
Building	February 10, 2013	Onshore	83,000,000
Pipeline & storage tank	May 1, 2014	Continental shelf of 170 metres of water depth	65,000,000
Plant & machinery	October 23, 2015	Territorial waters of 60 metres of water depth	52,000,000

(xii) Capital allowances brought forward was ₦12,700,000.

(xiii) The rate of exchange was ₦360 to a US Dollar.

(xiv) NNPC provides the relevant schedule as follows:

Load Factor	G-Factor per cent
50^0	16.9
60^0	15.5
70^0	14.3
80^0	13.6

Required:

Evaluate the transactions and advise the management on:

(a.) Assessable profit (14 Marks)
(b.) Chargeable profit (2 Marks)
(c.) Chargeable tax (2 Marks)
(d.) Total tax liability payable (2 Marks)
(Total 20 Marks)

QUESTION 3

(a) Sadiq Corporation was incorporated in Sweden as a limited liability company and has a subsidiary, Omologede Ventures Nigeria Limited located in Akure, Nigeria.

Peniel Nigeria Plc awarded a contract to Sadiq Corporation to renovate a rice milling factory in Gboko, Benue State and another in Abakaliki, Ebonyi State. The contract value for the Gboko factory is \$11,064,150 and \$7,337,616 for the Abakaliki factory. Sadiq Corporation later sub-contracted the two jobs to its subsidiary in Nigeria. The renovation is expected to be completed within six months.

The following information was submitted to the Federal Inland Revenue Service by Omologede Ventures Nigeria Limited for the year ended December 31, 2017;

	₦
Direct materials	962,100,000
Scaffolding	183,538,320
Administrative expenses on hired professionals	33,352,800
Rentals on equipment	18,708,248
Maintenance of equipment	7,431,688
Personnel card (domestic)	28,803,029
Personnel cost (foreign)	14,738,250
Fees to engineers	11,298,689
Other operational costs	6,512,070

The following additional information is provided:

(i) Capital allowance agreed by Omologede Ventures Nigeria Limited with the Federal Inland Revenue Service for the year was ₦104,418,744.

(ii) 60% of the total contract sum was made available to Omologede Ventures Nigeria Limited.

(iii) Depreciation is ₦69,902,092.

(iv) 70% of the total contract sum was paid at the beginning of the job, while the balance was paid in September of the same year.

(v) Exchange rate at the time of signing the contract was ₦180 to $1. The rate changed in August of the same year to ₦195 to $1

Withholding tax provisions were fully complied with by the two companies and the tax remitted to the relevant tax authority as and when due.

Required:

As the local consultancy firm in Nigeria, provide advice to the management of the two companies on the tax implications of the contracts for the relevant year of assessment, clearly showing their tax liabilities (if any). (15 Marks)

(b) Double taxation agreements exist among Nigeria and some foreign countries.

Required:

Explain the term "Permanent Establishment" as contained in the double taxation agreement between Nigeria and the United Kingdom. (5 Marks)

(Total 20 Marks)

QUESTION 4

(a) Write a short note on Foreign Direct Investment (FDI) and incentives available to foreign investors in Nigeria. (7 Marks)

(b) Fidelis Agom recently decided to relocate to Sweden as a result of a new appointment offered to him by a multinational company. His wife, Chioma decided to sell all her jewelries which she acquired for a sum of ₦6.3 million.

The buyer, Chief Mrs Ngozi Danladi was unable to pay immediately the sum of ₦8.4 million. She therefore decided to enter into a sale agreement with Chioma Agom to pay in four instalments within an interval of three months as follows:

₦3.5 million
₦2.1 million
₦2.1 million
₦0.7 million

The first instalment was paid on November 10, 2013 which was the day of sale.

You are required to:

Compute the capital gains tax for the relevant years of assessment. (5 Marks)

(c) You are the tax controller of Abbey Limited, the holding company of a group of companies involved in various businesses including: trading, manufacturing, distribution and packaging.

The companies from time to time supply goods and services to each other at pre-determined prices.

You are required to:

Advise the board of Abbey Limited on the factors to be considered when the entities transact business amongst themselves to ensure that the arm's length principle is upheld. (8 Marks)

(Total 20 Marks)

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

QUESTION 5

As a senior official in a firm of tax consultants, your tax manager has just discussed with you issues relating to one of your clients.

The summary of the discussion is as follows:

Mr. Eket - a native of Oron who resides in Uyo in Akwa Ibom State, owned two properties, one in Kano and the other in Benin. The property in Kano was built at a cost of ₦23 million, while that in Benin was acquired at a cost of ₦19.5 million. In year 2012, the property in Kano was sold by Mr Eket, for ₦32 million and disposal expenses amounted to ₦2.80 million.

In year 2014, Mr Eket died and the property in Benin was transferred to his wife (Emem) by the executor of his Will. The market value of the properties in Kano and Benin were ₦28 million and ₦23 million respectively.

In October 2016, the property in Benin was acquired by the Edo State Government to give way to a highway construction. A compensation of ₦27 million was paid to Emem.

Required:

(a.) Determine the capital gains tax payable (if any) (5 Marks)
(b.) Determine the relevant tax authority to which the liability is due. (5 Marks)
(c.) Give reasons for the treatment in (a) and (b) (5 Marks)

(Total 15 Marks)

QUESTION 6

a. In the interpretation of "Taxing Statutes", there are principles on which the interpretation of a particular statute is based by the courts. Legal practitioners are expected to have the knowledge in order to understand the statutes and their implications. These fundamental principles, guide judges in interpreting the laws in order to arrive at their decisions.

   Required:

   Evaluate **three** of the rules of literal interpretation in taxation. (9 Marks)

b. A large proportion of the total foreign exchange earnings generated by the Federal Government of Nigeria is from petroleum related activities.

   In the oil and gas industry, some regulatory agencies, such as Nigerian National Petroleum Corporation (NNPC), National Petroleum Investment Management Services (NAPIMS), Department of Petroleum Resources (DPR), Central Bank of Nigeria (CBN), Federal Inland Revenue Service (FIRS), etc. have been established to ensure sanity and accountability in the upstream, midstream, downstream, gas utilisation and oil service sectors.

You are required to:

Explain **two** roles **each,** of the following players in the oil and gas industry in Nigeria:

DPR
NNPC
CBN (6 Marks)
(Total 15 Marks)

QUESTION 7

The Petroleum Industry Governance (PIG) Bill which was recently passed into law by both chambers of the Nigerian National Assembly, has again rekindled the interest of local and foreign investors in the Nigerian oil and gas industry.

A Chinese billionaire-investor, Mr. Wu Chen, while browsing the internet, came across the PIG Bill and the Petroleum Profits Tax Act (PPTA) Cap P.13 LFN 2004 (as amended); downloaded and studied them carefully. He, however, could not understand a particular section of the Act that relates to classification of costs in the upstream sector of the industry.

Mr. Chen thereafter contacted one of his close associates in Nigeria, Mr Li Yen, to help seek for a reputable tax consultancy outfit that can provide professional advice on the issue at stake. The report is to be submitted to Mr. Chen's subsidiary company in Nigeria, Wu Integrated Limited, Victoria Island, Lagos.

Required:

As the newly appointed tax consultant to Mr. Chen, you are to write a report on-classification of costs in the upstream sector of the oil and gas industry in Nigeria. Specifically, your report should explain the following:

(a.) Mineral rights acquisition costs (5 Marks)
(b.) Development costs (5 Marks)
(c.) Production costs (5 Marks)
(Total 15 Marks)

Nigerian tax rates

1. Capital allowances

	Initial %	Annual %
Building expenditure	15	10
Industrial building expenditure	15	10
Mining expenditure	95	Nil
Plant expenditure (excluding furniture and fittings	50	25
Manufacturing industrial plant expenditure	50	Nil
Construction plant expenditure (excluding furniture and fittings)	50	Nil
Public transportation motor vehicle	95	Nil
Ranching and plantation/expenditure	30	50
Plantation equipment expenditure	95	Nil
Research and development expenditure	95	Nil
Housing estate expenditure	50	25
Motor vehicle expenditure	50	25
Agricultural plant expenditure	95	Nil
Furniture and fittings expenditure	25	20

2. Investment allowance 10%

3. Rates of personal income tax

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

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

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

4. Companies income tax rate 30%

5. Tertiary education tax (2% of assessable profit)

6. Capital gains tax 10%

7. Value added tax 5%

Solution 1a

XYZ Nigeria Limited
Computation of companies income tax for 2018 year of assessment

	₦	₦
Profit for the year		9,600,000
Add disallowed expenses:		
Repairs & maintenance – construction of new gate	2,000,000	
Allowance for bad debt – general provision	253,000	
Legal fee – wife of the managing director	25,000	
Legal fee – cost of income tax appeal	65,000	
Depreciation	2,000,700	4,343,700
Adjusted/assessable profit		13,943,700
Unrelieved loss brought forward	870,000	
Relieved	(870,000)	(870,000)
		13,073,700
Capital allowance for the year absorbed		(2,867,000)
Total profit		10,206,700
Income tax @ 30% of total profit		3,062,010
Tertiary education tax @ 2% of assessable profit		278,874

Minimum tax computation

(i) 0.5% of gross profit: 0.5% x ₦48,199,800 = ₦240,999

(ii) 0.5% of net assets: 0.5% x ₦21,500,000 = ₦107,500

(iii) 0.25% of paid-up capital: 0.25% x ₦12,000,000 = ₦30,000

(iv) 0.25% of revenue ₦500,000 1,250 =

0.125% of in excess of ₦500,000 = ₦112,000,000 ₦140,000
112,500,000

Plus
The highest of (i) – (iii) above ₦ 240,999 = ₦380,999

The minimum tax liability is ₦380,999. Given that the companies income tax liability is greater under normal assessment than the minimum tax liability, minimum tax provisions do not apply.

Workings

Computations of capital allowances								
	Assets class	Industrial building	Non-industrial building	Plant & machi Nery	Office furniture & fittings	Motor vehicles	Total	
	Rate% (Initial/annual)	15:10	15:10	50:25	25:20	50:25		
	Year of purchase	2012	2012	2012	2012	2012		
		₦	₦	₦	₦	₦	₦	
2012 Year of assessment	Cost	18,000,000	10,200,000	22,500,000	3,700,000	6,500,000	600,000,000	
	Initial allowance	2,700,000	1,530,000	11,250,000	925,000	3,250,000	19,655,000	
	Annual allowance	1,530,000	867,000	2,812,500	555,000	812,500	6,577.000	
	Investment allowance	-	-	2,250,000	-		2,250,000	
	Tax written down value	13,770,000	7,803,000	8,437,500	2,220,000	2,437,500	34,668,000	
2013 Year of assessment	Annual allowance	1,530,000	867,000	2,812,500	555,000	812,500.	6,577,000	
	Tax written down value	12,240,000	6,936,000	5,625,000	1,665,000	1,625,000	28,091,000	
2014 Year of assessment	Annual allowance	1,530,000	867,000	2,812,500	555,000	812,500	6,577,000	
	Tax written down value	10,710,000	6,069,000	2,812,500	1,110,000	812,500	21,614,000	
2015 Year of assessment	Annual allowance	1,530,000	867,000	2,812,490	555,000	812,490	6,576,980	
	Tax written down value	9,180,000	5,202,000	10	555,000	10	14,937,020	
2016 Year of assessment	Annual allowance	1,530,000	867,000	2,812,490	554,990	-	2,951,990	
	Tax written down value	7,650,000	4,335,000	10	10	10	11,985,030	
2017 Year of assessment	Annual allowance	1,530,000	867,000	-	-	-	2,397,000	
	Tax written down value	6,120,000	3,468,000	10	10	10	9,588,030	
2018 Year of assessment	Annual allowance	1,530,000	867,000	-	-	-	2,397,000	
	Tax written down value	4,590,000	2,601,000	10	10	10	7,191,030	
2018 Year of assessment		-	2,000,000				2,000,000	
Initial allowance		-	(300,000)				(300,000)	
Annual allowance		-	(170,000)				(170,000)	2,867,000
Old		1,530,000	867,000	0	0	0	(2,397,000)	
		3,060,000	3,264,000	10	10	10	6,324,030	

(b) James Okpobo
(Chartered Accountants)
256, Ikorodu Road, Obanikoro, Lagos.

The Managing Director
XYZ Nigeria Limited
247, Oke Aro Road
Ibadan, Oyo State

Dear Sir,

RE: Best of judgement assessment of ₦10,000,000 and late returns penalty of ₦75,000

We refer to the discussion held with your good self in respect of the above subject.

We advise as follows:

(a) **Tax liabilities of the company**

Based on the tax liabilities computed for the year ended December 31, 2017 (Assessment Year 2018), your company is expected to pay ₦3,062,010 and ₦278,874 for companies income tax and tertiary education tax respectively.

We have objected to the best of judgement assessment of ₦10,000,000 because the audited financial statements of your company were filed within six months after the accounting year-end. The arbitrary assessment levied on your company by the FIRS is not in agreement with our tax computations already submitted to the tax office and this cannot be sustained.

(b) **Late returns penalty of ₦75,000**

In our letter of objection to the FIRS, we have stated that the audited financial statements were submitted on June 29, 2018, before the deadline of June 30, 2018, hence, the returns were not submitted late and your company was not liable for any late returns penalty.

Whilst thanking you for your patronage to date, it is hoped that our explanations are detailed enough.

Yours faithfully,
For: James Okpobo & Co

Jimoh Mohammed
For: Managing Partner

EXAMINER'S REPORT

The question tests candidates' knowledge and understanding of computations of tax liability and timing of submission of returns of financial statements and penalty for late submission.

Majority of the candidates performed above average.

The major pitfall of a few candidates was the inability to tabulate capital allowances and write a letter of advice as a consultant.

Candidates are advised to study ICAN Study Texts and other relevant text books when preparing for future examinations.

MARKING GUIDE

(a)	Marks	Marks
Heading		½
Net profit per accounts		½
Disallowed expenses (½ mark for each)	3 ½	
Assessable profit	½	
Unrelieved loss brought forward	½	
Total of capital allowances	½	
Total profit	½	5 ½
Companies income tax		½
Tertiary education tax		½
Minimum tax computation		
❖ Gross profit	½	
❖ Net assets	½	
❖ Paid – up capital	½	
❖ Revenue (3 points at ½ mark per point)	1 ½	
Statement on relevance of minimum tax computation	½	3 ½
Capital allowances computation		
<u>Assessment year 2012</u>		
Cost (½ mark for each asset)	2 ½	
Initial allowance (½ mark for each allowance)	2 ½	
Annual allowance (½ mark for each allowance)	2 ½	
Investment allowance	½	
<u>Assessment year 2013</u>		
Total annual allowance	½	
<u>Assessment year 2014</u>		
Total annual allowance	½	

Assessment year 2015		
Total annual allowance	½	
Assessment year 2016		
Total annual allowance	½	
W.D.V c/f for p & m and m/vehicles at ½ mark each)	1	
Assessment year 2017		
Total annual allowance	½	
W.D.V c/f for office furniture	½	
Assessment year 2016		
Cost of gate house	½	
Initial allowance	½	
Total annual allowance		
- Old assets	½	
- New assets	½	14
		25

(b)	Heading	1
	Opening paragraph	½
	Comment on tax liabilities	1
	Comment on late returns penalty	1
	Comment on objection	1
	Closing paragraph	½
		5

(TOTAL 30 MARKS)

SOLUTION 2

The managing director Date:
Olu Oil Limited
250 Oil Road
Port Harcourt
Rivers State, Nigeria

Dear Sir,

Re: Tax matters

We hereby state as follows:

(a) We have evaluated the operational results of the company for the year ended December 31, 2015 and the income derived from the following sources:

i. Crude oil sale exported;
ii. Crude oil sale in the domestic market;
iii. Natural gas sold from two contracts of Obi Limited and Oba Limited;
iv. Other miscellaneous income.

(b) We also considered the expenses and other relevant information relating to both income and expenditure, capital allowances and the prevailing exchange rate during the period and advise as follows:

Appendix I shows the detailed computations of the petroleum profits tax for the assessment year 2015 from which we arrived at the following result:

(i) Assessable profit ₦748,908,465
(ii) Chargeable profit ₦691,008,465
(iii) Chargeable tax ₦587,357,195
(iv) Total tax payable ₦607,858,561

We are also enclosing detailed workings of the following:

(i) Export sales Wk (i)
(ii) Local sales Wk (ii)
(iii) Total chargeable natural gas Wk (iii)
(iv) Companies income tax @ 30% and tertiary education tax @ 2% of refined product sales

We would be most obliged to give further information on request.

Yours faithfully,
For:…………………

Olu Oil Limited
Petroleum profits tax
For 2015 assessment year

	₦	₦
Export sales (Wi)		1,384,818,480
Local sales (Wii)		11,298,750
Natural sales (Wiii)		59,713,254
Miscellaneous income (₦ 125,800,300 – ₦ 105,500,000)		20,300,300
		1,476,130,784
Less: allowable expenses (Section 10)		
Intangible drilling	225,000,000	
Rent	27,000,000	
Royalty on export sales	7,116,400	
Royalty on local sales	1,150,000	
Interest paid (₦15,350,000 – ₦5,350,000)	10,000,000	
Transport	13,730,000	
Non-productive rent	6,725,000	
Operation cost	318,250,000	
Donations (₦5,500,000 – ₦2,000,000)	3,500,000	
Pension contribution	6,939,750	

Custom duty	4,000,000	
Harbour dues	2,500,000	
Repairs and maintenance of equipment	10,463,000	
Bad debts written off	13,510,000	
Management and administration		
(₦150,600,000 – ₦88,240,000)	62,360,000	712,244,150
		763,886,634
Loss brought forward		-
		763,886,634
Tertiary education tax (2/102 x ₦763,886,634)		(14,978,169)
(a) **Assessable profit**		748,908,465
Less: Capital allowances:		
Lower of:		
85% of assessable profit	636,572,195	
Less: 170% of PIA (1.7 x ₦5,200,000)	8,840,000	
	627,732,195	
And		
Capital allowance for the year (Wiv)	40,000,000	
PIA (Wv)	5,200,000	
	45,200,000	
		45,200,000
(b) **Chargeable profit**		703,708,465
Assessable tax @ 85%		598,152,195
(c) **Chargeable tax @**		598,152,195
Tertiary education tax		14,978,169
Companies income tax (Wvi)		5,178,000
Tertiary education tax		345,200
(d) **Total tax payable**		618,653,564

Workings:

(i)	Export sales						
		Bonny light		Bonny medium		Forcados	
		API	$	API	$	API	$
	Standard	35º	52.03	35º	49.04	35º	48.29
	Actual	39º		35º		32º	
	Difference	4º x 0.03	0.12	0º x 0.03	0	(3)º x 0.03	(0.09)
			52.15		49.04		48.20
	Exchange rate	₦360		₦360		₦360	

		₦18,774	₦17,654.40	₦17,352
	Quantity sold	35,000	25,200	₦16,300
	Revenue	₦57,090,000	₦444,890,880	₦282,837,600
	Total export sales = ₦1,384,818,480			
(ii)	Local sales			
	32,750 barrels x ₦345 = 11,298,750			
(iii)	Natural gas			
	<u>Obi Limited</u>			
	$\frac{60-62}{60-70} = \frac{15.5-x}{15.5-14.3}$			
	$\frac{-2}{-10} = \frac{15.5-x}{1.2}$			
	X = 15.26%			

Discount = 15.26% of ₦42,285,000=₦6,452,691
Chargeable natural gas = ₦42,285,000 – ₦6,452,691 = ₦35,832,309

Oba Limited

$$\frac{70-74}{70-80} = \frac{15.5-x}{14.3-13.6}$$

$$\frac{-4}{-10} = \frac{14.3-x}{0.7}$$

X = 14.02% of ₦27,775,000 = ₦3,894,055
Discount X = 14.02% of ₦27,775,000=₦3,894,055
Chargeable natural gas = ₦27,775,000 – ₦3,894,055 = ₦23,880,945
Total chargeable natural gas = ₦59,713,254

(iv) Annual allowance

QCE	Year acquired	Cost (₦)	Rate	Capital allowances (₦)
Building & pipeline	2013	83,000,000	20%	16,600,000
Storage tank	2014	65,000,000	20%	13,000,000
Plant & equip	2015	52,000,000	20%	10,400,000
				40,000,000

(v) Investment Tax Credit (ITC) or PIA
Plant and equipment (cost) = ₦52,000,000
Rate applicable = 10%
ITC = 10% of N52,000,000 = ₦5,200,000

(vi) Companies income tax

	₦
Income from sales of refined products	105,500,000
Less: Related cost	88,240,000
Total profit	17,260,000

Companies income tax @ 30% of total profit	₦5,178,000
Tertiary education tax @ 2% of assessable profit	₦345,200

EXAMINER'S REPORT

The question tests candidates' knowledge of petroleum profits tax especially the evaluation of assessable profit, chargeable profits and other parameters to compute the total tax liability payable.

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

The major pitfall was the inability of the candidates to evaluate correctly the various parameters necessary for management decision.

Candidates are advised to be more proactive in their studies and use necessary study texts for future examinations.

Marking guide	**Marks**	**Marks**
Determination of assessable profit		
1 mark for each correct point on		
Export sales	1	
Local sales	1	
Natural sales	1	
Miscellaneous income	1	
Section 10 allowable expenses		
½ mark for each point	7½	
Calculation of tertiary education tax	1	
Assessable profit	1½	14
Determination of chargeable profit		
Capital allowances calculation		
$^1/_8$ mark for each correct point	¾	
Unutilised C/A b/f	¼	
Chargeable profit	1	2
Chargeable tax		2
Determination of total tax payable		
Chargeable tax		

Tertiary education tax	½	
Companies income tax	½	
Tertiary education tax	½	
(½ mark for each correct point)	½	2
		20

SOLUTION 3

(a) The managing director
Sadiq Corporation Limited
Sweden

Thro'

The managing director
Omologede Ventures Nigeria Limited
Nigeria

Dear Sir,

Omologede Ventures Nigeria Limited
Re: Tax implications of contract for renovation of rice milling factory in Benue State and Ebonyi State Nigeria

As requested, we wish to advise as follows:

(i) The project awarded by Peniel Nigeria Plc to Sadiq Corporation is a turnkey project. A turnkey project is a single or one-off project, involving survey deliveries, installation or construction;

(ii) The turnkey nature is liable to tax in Nigeria and such a project is not deemed to be split between the Nigeria source and the offshore source, hence taxed wholly in Nigeria.

(iii) The contract was awarded to Sadiq Corporation (a non-resident company) and sub-contracted to Omolegede Ventures Limited (a subsidiary of Sadiq Corporation).

The whole profit on the contracts in Benue and Ebonyi State is taxable as a Nigerian profit while expenses on sub-contracting to Omologede are allowable by the tax authority in Nigeria. These expenses are limited to cost to Sadiq Corporation.

(iv) From Appendix I, the sub-contract on the project is limited to the actual cost incurred by Omologede Ventures (₦1,266,463,094), therefore, the sub-contract value of ₦2,037,075,496 will be disallowed by the tax authority.

(v) From the same Appendix I, the total profit amounted to ₦2,024,223,989, while the companies income tax amounted to ₦607,267,196.70.

The withholding tax on the contract amounted to ₦271,610.066 and tertiary education tax amounted to ₦42,572,855.

(vi). The explanation on the withholding tax is as follows:
Peniel Nigeria Plc had deducted 5% on the total contract to Sadiq Corporation which will in turn withholds 5% from the sub-contract to Omolegede Ventures Limited. Please see the details of the working in Wk 2

We use this opportunity to thank you for giving us the opportunity to serve you. Should there be need for any further clarification, we would be most obliged to respond promptly.

Yours faithfully,
For: XY Associates Limited

....
Managing Partner

Appendix I

	Sadiq Corporation		
	Summary of tax liabilities for 2018 year assessment		
		₦	₦
	Income tax (Wk 1)		607,267,197
	Withholding tax on contract value (Wk 2)		(271,610,066
(i)	Income tax payable		335,657,131
(ii)	Tertiary education tax		42,572,855
(iii)	WHT on engineering fees @ 5% (₦11,298,689 x 5%)		564,934,45
	Workings:		
(Wk 1)	Sadiq Corporation		
	Computation of income tax liability for 2018 Year of assessment		
	Taxable income (Wk 3)		3,395,125,827
	Allowable expenses = the lower of:		
	(i) Sub-contract value to Omologede Ventures (Wk 2) **OR**	2,037,075,496	
	(ii) Actual cost incurred by Omologede Ventures:		
	Direct materials	962,100,000	
	Scaffolding	183,538,320	
	Admin expenses on hired professionals	33,352,800	
	Rentals on equipment	18,708,248	
	Maintenance of equipment	7,431,688	
	Domestic personnel cost	28,803,029	
	Foreign personnel cost	14,738,250	
	Fees to engineers	11,298,689	
	Other operational costs	6,512,070	
	(ii) Actual cost incurred by Omologede Ventures	1,266,483,094	
	Allowable expenses = the lower = (ii)		(1,266,483,094)
	Adjusted/assessable profit		2,128,642,733
	Capital allowance		
	Capital allowance claimed		(104,418,744)
	Total profit		2,024,223,989
	CIT @ 30% x ₦2,024,223,989		607,267,197
(Wk 2)	WHT (Wk2) (₦101,853,775 + ₦169,756,291)		(271,610,066)
	Companies income tax payable (net)		335,657,131
	Tertiary education tax @ 2% x ₦2,128,642,733		42,572,855

		Contract Value	WHT @ 5%
(Wk 2)	Taxable income - Omologede Ventures	₦	₦
	Gboko project - ($11,064,150 x 60% x 70%) x ₦180/$)	836,449,740	41,822,487
	- ($11,064,150 x 60% x 30%) x ₦195/$)	388,351,665	19,417,583
	Abakaliki project - ($7,337,616 x 60% x 70%) x ₦180/$)	554,723,770	27,736,189
	- ($7,337,616 x 60% x 30%) x ₦195/$	257,550,322	12,877,516
		2,037,075,497	101,853,775
	Taxation income - Sadiq Corporation:		
	Gboko project - ($11,064,150 x 40% x 70%) x ₦180/$)	557,633,160	-
	- ($11,064,150 x 40% x 30%) x ₦195/$)	258,901,110	-
	Abakaliki project -($7,337,616 x 40% x 70%) x ₦180/$)	369,815,846	-
	($7,337,616 x 40% x 30%) x ₦195/$)	171,700,214	-
		1,358,050,330	-
	Total value/WHT to Sadiq Corporation	3,395,125,827	169,756,291
			271,610,066

Since a withholding tax of 5% would have been deducted on the total contract value by Peniel Nigeria Plc, the same total withholding tax credit will be utilized by Sadiq Corporation. Also, Sadiq Corporation is obliged to deduct withholding tax from the sub-contract to Omologede Ventures because it was an entirely fresh contract to Omologede Ventures and only the tax withheld on the contract fee to Omologede Ventures shall be utilized by Omologede Ventures.

Therefore, the withholding tax to be utilized against the total income tax on the contract is the aggregate of tax withheld by Peniel Nigeria Plc and Sadiq Corporation as shown above.

(b) Permanent establishment means a fixed place of business where the business of an enterprise is wholly or partly carried on. These include:

(i) a place of management, a branch, an office, a factory, workshop and a mine, oil and gas well, a quarry or any other place of extraction of natural resources;

(ii) a building site or construction or installation project if it lasts more than twelve months; and

(iii) a dependent agent acting on behalf of an enterprises and habitually exercises in a contrasting state an authority to conclude contracts in the name of the enterprise.

Permanent establishment is central to the jurisdiction of a source country to tax the profits from foreign trade carried on by a non-resident company within its jurisdiction.

As contained in Article 7 of double taxation agreement between Nigeria and the United Kingdom, business profits not arising from a permanent establishment are to be taxed only in the country of the taxpayer's residence. Profits attributed to a permanent establishment will be taxed in the country in which the permanent establishment is situated.

EXAMINER'S REPORT

The question tests candidates' knowledge of the tax implications of the operations of a foreign company having a subsidiary in Nigeria.

A high proportion of the candidates attempted the question and performance was poor.

The major pitfall was the inability of the candidates to explain the concepts of double taxation and permanent establishment.

Candidates are advised to be more thorough in their efforts to comprehend and correctly identify the requirements of any question before proffering any solution.

Marking guide	**Marks**	**Marks**
Heading and conclusion of the letter to management	2	
Definition of turnkey project	2	
Explanation of Nigerian profits	½	
Explanation of actual cost incurred by Omologede	½	
Explanation of withholding tax	½	
Workings:		
Total profit	2	
Companies income tax	2	
Withholding tax	2	
Tertiary education tax	2	
Assessable profit		15

Explanation of permanent establishment	1	
• Three alternatives of permanent establishment	3	
• Jurisdiction of source country to tax	½	
• Explanation of article 7	½	
		5
		20

SOLUTION 4

(a) **Foreign Direct Investment (FDI)**

A foreign direct investment is an investment in the form of a controlling ownership in a business in one country by an entity based in another country. This is different from Foreign Portfolio Investment (FPI) which is investing in financial assets such as stock or bonds in a foreign country.

Measures are usually put in place to promote economic growth and development in Nigeria through incentives to foreign investors. These include tax and other fiscal incentives to Multi National Enterprises (MNE) in order to influence their investment decisions in favour of Nigeria and these are made to be competitive with other nations. Some of these incentives are meant to attract Foreign Direct Investment (FDI) to key sectors of the Nigerian economy especially oil and gas.

Foreign investment inflow is, however, critically hinged on factors like security, political stability and provision of infrastructures, the negative effect of which, may serve as disincentives to foreign inflow of investments.

Incentives

The incentives available to foreign investors in Nigeria include the following:

(i) In accordance with Nigeria Enterprises Act, they are entitled to 100% foreign ownership in any new venture in Nigeria except those in banking, oil and gas, insurance and mining;

(ii) A foreign investor in an enterprise shall be guaranteed unconditional transferability of funds through an authorized dealer in freely convertible currency of dividend or profit;

(iii) In 1992, the Nigeria Free Trade Zone Act was passed establishing Nigerian Expert Processing Zone Authority (NEPZA) and the Free Trade Zones (FTZ) with their attendant benefits to foreign investors;

(iv) They are allowed to repatriate proceeds (net of taxes) and other obligations in case of sale or liquidation of the enterprise or any interest attributable to the investment;

(v) They are protected against nationalization and expropriation. Where an acquisition is made in national interest or for public purpose and the investor shall be entitled to:

- Payment of fair and adequate compensation;
- Payment of compensation without undue delay and authorization; and for its repatriation in convertible currency;

(vi) Generally interest earned by non-resident lender to a Nigerian company is exempted from tax fully or partly depending on the repayment and grace periods as follows;

From January 1 1990,

Repayment period	**Grace period**	**Rate of exemption**
Above 7 years	Not less than 2 years	100%
5 – 7 years	Not less than 18 months	70%
2 – 5 years	Not less than 12 months	40%
Below 2 years	Nil	Nil

This incentive is to encourage foreigners to lend to Nigerian companies on long repayment period basis;

(vii) From January 1, 1990, a non-resident company which makes a deposit in Nigeria wholly with foreign currencies transferred to Nigeria will have interest earned exempted from tax. This is a direct invitation to foreigners to transfer foreign currencies to Nigeria and open a deposit account with such funds. The incentive is a full exemption from tax of interest earned on such deposits;

(viii) A foreign company going into the mining of solid minerals shall be exempted from tax for the first three years of its operation. In addition, initial allowance is granted at the rate of 95% of its qualifying mining expenditure with retention of 5% in its books until disposal. Also, a company that engages in mining of solid minerals and earn annual income of less than N1m is assessable to tax at the lower rate of 20%;

(ix) All new industrial undertakings including foreign companies and individuals operating in an export processing zone (EPZ) are allowed full tax holidays for three consecutive years;

(x) Companies with at least 25% imported equity capital is exempted from the application of minimum tax provision;

(xi) Companies operating in the agricultural sector enjoy number of incentives such as pioneer status, small business rate, exemption from minimum tax, no restriction on capital allowance claimable in any tax year, etc; and

(xii) Generally, the provision of the Industrial Development (Income Tax Relief) Act 1971 grants a tax free holiday to companies operating in industries which are designated as pioneer industries or producing products.

(b) **Chioma Agom**
Computation of Capital Gains Tax (CGT) for 2013 year of assessment

Year of assessment	Date of payment	Amount paid ₦	Chargeable gain @ 10% ₦	CGT payable @ 100% ₦
2013	10-11-2013	3,500,000	875,000	87,500
2014	10-02-2014	2,100,000	525,000	52,500
2014	10-05-2014	2,100,000	525,000	52,500
2014	10-08-2013	700,000	175,000	17,500
	Total	8,400,000	2,100,000	210,000

NB
Since the payment period for the instalment does not exceed 18 months, the total chargeable gain of ₦2,100,000 will be deemed to have accrued in 2013 year of assessment and the CGT of ₦210,000 due will be paid in 2013 year of assessment.

(c) To: Board of directors of Abbey Limited

From: The tax controller

Factors to be considered when entities transact business among themselves to ensure that the Arm's Length principles are upheld

We are all aware that our companies from time to time supply goods and services to one another at pre-determined prices.

Arm's length transaction is defined as basis of determining fair market value on dealings amongst independent, unrelated and well informed parties looking out for their individual interests.

To qualify as an arm's length transaction, neither of the involved parties may have any interest in the transactions. To ensure that conflict of interest does not happen, there are factors to be considered to ensure that the arm's length principle is upheld.

These principles include:

(a) The similarity or identical nature of the transaction to that entered into by an unconnected taxable person;
(b) The facts and circumstances of the transactions per economic relevance;
(c) The characteristics of the goods, property or service transferred or supplied;
(d) The functions undertaken by the person entering into the transaction per resources expended and the risks assured;
(e) The contractual terms of the transaction;
(f) The economic circumstances in which the transactions take place and
(g) The business strategies pursued by the connected taxable persons to the controlled transaction.

If these principles are adhered to, we will be complying with the provisions of the tax laws.

Kind regards

Olowolaye Afisiri
Tax controller

EXAMINER'S REPORT

The question tests candidates' understanding of the concept/incidence of foreign direct investment and related incentives available to foreign investors in Nigeria. Part (a) of the question is a direct capital investment in Nigeria while part (b) question is a direct capital gains tax computation requirement, whilst part (c) question is designed to test candidates' understanding of the tax implications of a holding company transaction business on a regular basis with its subsidiaries. Many candidates attempted the question and demonstrated above-average

understanding of both parts (a) and (b) of the question. The major pitfall was the candidates' inability to understand the question on transfer pricing requirements.

Candidates are advised to read the Institute's Study Texts to ensure adequate coverage of the various topics in the syllabus.

Marking Guide		**Marks**	**Marks**
(a.)	- Description of foreign direct investment		2
	- Incentives available to direct foreign investors in Nigeria		5
(b.)	Year of assessment – Name of CGT payer	½	
	Year 2013	½	1
	Date of payments (¼ mark for each correct date)		1
	Instalments paid (¼ mark for each correct instalment)		1
(c.)	Chargeable gains ¼ mark for each correct computation		1
(d.)	CGT payable ¼ mark for each correct point		1
(e.)	Memo to board/factors for arm's length transactions		8
			20

SOLUTION 5

(a) **Mr Eket**
Computation of capital gains tax for 2012 year of assessment
Disposal of Kano property

	₦	₦
Sales proceeds		32,000,000
Deduct:		
Acquisition cost	23,000,000	
Disposal expenses	2,800,000	(25,800,000)
Chargeable gains		6,200,000
Capital gains tax @ 10%		620,000

Mr. Eket
Computation of capital gains tax for 2014 year of assessment
Disposal of Benin property to Emem

	₦
Sales proceeds	19,500,000
Deduct:	
Acquisition cost	(19,500,000)
Chargeable gains	Nil
Capital gains tax @ 10%	Nil

Mr. Eket
Computation of capital gains tax for 2014 year of assessment
Disposal of Benin property (Acquisition by the Edo State Government)

	₦
Sales proceeds	27,000,000
Deduct:	
Acquisition cost	(23,000,000)
Chargeable gains	4,000,000
Capital gains tax @ 10%	Nil

(b) The relevant tax authority to which the Capital Gains Tax (CGT) is payable for the property in Kano is Akwa Ibom State Internal Revenue Service, while that of Benin is also the same Revenue Service.

Solution to Question 5c

Reasons for the solutions in 5a & 5b

(i) Basis for determining the capital gains tax in (a) above:

The disposal of property in Kano by Eket is liable to capital gains tax at 10% of the chargeable gain because it is not established that the Kano property is a private residence of Mr. Eket. Therefore, the property is a chargeable asset liable to CGT in 2012 year of assessment on actual year basis.

The disposal of Benin property to Emem is by way of gift, therefore the consideration must be such amount that is sufficient to secure the disposal. Therefore, neither gain nor a loss shall accrue to the executors for Eket's Will in 2014 year of assessment.

However, the disposal of Benin property to Edo State Government was through forced acquisition. Assets disposed due to compulsory or forceful acquisition are specifically exempted from capital gains tax, provided the owner has not taken any prior step to dispose such asset. The chargeable gain of ₦4 million on disposal of Benin property in 2016 YOA shall be exempted from CGT.

(ii) The relevant tax authority to which the capital gains tax is due is Akwa-Ibom State Internal Revenue Service. The reason is that Mr. Eket and Emem (Mrs Eket) are native of Akwa-Ibom State and reside in Oron, Akwa-Ibom State.

EXAMINER'S REPORT

The question tests candidates' knowledge of the computation of capital gains tax.

Many candidates attempted the question and performance was above average. The major pitfall was the display of lack of knowledge by the candidates on the relevance of the locations of an asset (property) sold and that of the owner of the asset (property), in ascertaining the relevant tax authority.

Candidates are advised to ensure that they understand the requirements of a question before attempting same.

Marking Guide		Marks	Marks
(a)	Disposal of Kano property by Mr. Eket		
	Cost of acquisition	½	
	Chargeable gain	½	
	Capital gains tax	1	
	Transfer of Benin property to Emem		
	Chargeable cain	½	
	Capital gains tax	½	
	Disposal of Benin property (To Edo Govt)		
	Acquisition cost	½	
	Chargeable gain	½	
	Capital gains tax	1	5
(b)	Relevant tax authority for remittance of capital gains tax:		
	Capital gains tax		
	Kano property	2½	
	Benin property	2½	5

(c)	Explanation of (a) & (b)		
	i. Disposal of Kano property by Eket	1	
	ii. Transfer of property to Emem No chargeable gain	1	
	iii. Take-over of property by Edo State Govt	1	
	iv. Explanation of relevant tax authority Kano property – residence	1	
	Benin property – residence	1	5
			15

SOLUTION 6

a) One of the cardinal rules for the interpretation of taxing statutes is the "Rule of literal interpretation".

Taxing statutes are interpreted as follows:

(i) If the language of the statute is clear and unambiguous, courts must give words their ordinary meaning. Courts have no authority to place a different construction on it, even if it leads to an injustice, it must apply it according to its terms;

(ii) No tax can be imposed on the subject without words in the Act clearly showing an intention to lay a burden upon him. In other words, the subject cannot be taxed unless he comes within the letters of the law;

(iii) Where the language of an Act is plain and unequivocal, judicial construction is not only unnecessary but is forbidden;

(iv) In a Taxing Act, one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing to be implied. One can only look at the language used.

Thus, when the language of a taxing statute is clear, if an assessee falls within the four corners of the statute, he/she is to be taxed; if not, no tax is to be levied; and

(v) There is no scope for importing into the statute, words which are not there. Such importation would be, not to construe, but to amend the statute. Even if there be a *casus omissus*, the defect can be remedied only by legislation and not by judicial interpretation.

(b) **Role of DPR**

DPR has the statutory responsibility of ensuring compliance to petroleum laws, regulations and guidelines in the oil and gas industry. The discharge of these responsibilities involves monitoring of operations at drilling sites, producing wells, production platforms and flowstations, crude oil export terminals, refineries, storage depots, pump stations, retail outlets, any other locations where petroleum is either stored or sold, and all pipelines carrying crude oil, natural gas and petroleum products, while carrying out the following functions, among others:

i. Supervising all petroleum industry operations being carried out under licences and leases in the country;

ii. Monitoring the petroleum industry operations to ensure that they are in line with national goals and aspirations including those relating to flare down and domestic gas supply obligations;

iii. Ensuring that health safety and environment regulations conform With national and international best oil field practices;

iv. Maintaining records on petroleum industry operations, particularly on matters relating to petroleum reserves, production/exports, licences and leases;

v. Advising government and relevant government agencies on technical matters and public policies that may have impact on the administration of petroleum activities;

vii. Processing industry applications for leases, licences and permits;

viii. Ensure timely and accurate payments of rents, royalties and other revenues due to the government; and

ix. Maintain and administer the National Data Repository (NDR).

NNPC is saddled with responsibility to:

i. Control and supervise joint venture contract (JVC), production sharing contract (PSC) and service contract (SC) operations in oil and gas industry;

ii. Regulate oil and pump prices for petroleum products;
iii. Regulate and supervise the oil and gas industry on behalf of government;
iv. Bridge the gap between the upstream and the downstream sectors, through operation in the midstream sector of the industry;
v. Engage the oil and gas operations on behalf of the FGN and regulate the operations of the industry; and
vi. Carry out research in connection with petroleum or anything derived from it and promote activities for the purpose of utilizing the results of such research in the oil and gas industry.

The CBN is saddled with responsibility to:

i. Ensure close monitoring of exposure of banks to the oil and gas sector in Nigeria and taking appropriate measures to curtail system risks in the industry;
ii. Supervise the exposure of banks to the foreign exchange market in their lending to the oil and gas industry;
iii. Notify the Federal Inland Revenue Service, through a payment advice of oil revenue receipts from FG designated banks abroad, when such revenue is transferred to the federation account with CBN;
iv. Act as a member of the board of the Federal Inland Revenue Service, which administers, assesses and collects income taxes for corporate bodies operating in the oil and non-oil sectors of the economy; and
v. Establish the foreign exchange rate for transactions in the petroleum industry.

EXAMINER'S REPORT

The question tests candidates' knowledge of the evaluation of the rules of literal interpretation in taxing statutes, roles played by the Department of Petroleum Resources (DPR), the Nigerian National Petroleum Corporation (NNPC), and the Central Bank of Nigeria (CBN).

Candidates' performance was very poor. The major pitfall was lack of understanding of the rules of literal interpretation of taxing statutes and the roles played by the Department of Petroleum Resources (DPR), the Nigerian National Petroleum Corporation (NNPC) and the Central Bank of Nigeria (CBN).

Candidates are advised to read the Institute's Study Texts and be abreast of developments in the oil and gas sectors of the economy when preparing for future examinations.

MARKING GUIDE

			Marks
(a)	3 marks each for any 3 correct points		9
(b)	i.	Role of DPR 1 mark each for any two correct points	2
	ii.	Role of NNPC 1 mark each for any two correct points	2
	iii.	Role of CBN 1 mark each for any two correct points	2
			15

SOLUTION 7

Wu Integrated Limited
Victoria Island
Lagos

Dear Sir,

Report on classification of costs in the upstream sector of the Nigerian oil & gas industry

Your recent letter and the subsequent discussions with the undersigned on the above subject-matter refer.

In line with the Petroleum Profits Tax Act 2004 (as amended), please find below a detailed information on the classification of costs in the upstream sector of the Nigerian oil & gas industry.

(a) **Mineral rights acquisition costs:** These are costs incurred in acquiring concession rights in 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 capitalized when incurred. They include the cost of:

(i) Oil prospecting licence (OPL); (to search for oil)

(ii) Oil exploration licence (OEL) (to explore for petroleum)

(iii) Oil mining lease (OML); (to win, work, carry away and dispose of petroleum)

(iv) Bonuses and options to purchase or lease properties;

(v) Minerals, when land including mineral rights purchased; and

(vi) Recording fees, legal and other costs incurred in acquiring Properties;

(vii) Pre-licence 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 on the acquisition of speculative seismic data and expenditure on the subsequent geological and geophysical analysis of the data.

(b) **Development costs:** These are costs incurred to obtain access to proved reserves and provide facilities for extracting, gathering, treating, and storing the oil and gas. These costs are incurred after a decision has been taken to develop a field or reservoir, and include the following:

(i) Drilling, equipping and testing development and production wells;

(ii) Production platforms, down hole and wellhead equipment, pipelines production and initial treatment and storage facilities as well as utility and waste disposal systems;

(iii) Improved recovery systems and equipment;

(iv) Development costs are usually capitalized as part of the costs of a company's wells and related equipment and facilities. Thus, all cost incurred to drill and equip development wells and service wells are development costs and are capitalized whether the well is successful or unsuccessful; and

(v) Costs of drilling those wells and costs of constructing equipment and facilities are usually included in the company's uncompleted wells, equipment and facilities until drilling or construction is completed.

(c) **Production costs:** These are the recurrent costs incurred in oil and gas production activities. Production involves lifting the oil and gas to the surface, gathering, treating, field processing and storage. Production costs are usually determined to be all costs incurred from the maintenance of the wells and well heads to the storage facilities when the oil and gas are ready for export or delivery to a refinery.

Production costs are those incurred to operate and maintain a company's well and related equipment and facilities, including depreciation, depletion and applicable operating costs of support equipment and facilities. Examples of production costs are:

(i) Gathering, treating, field process & storage;

(ii) Costs of personnel engaged in the operation of wells and related equipment and facilities;
(iii) Repairs and maintenance of production facilities;
(i) Materials, supplies, fuel consumed and services utilized in such operations;
(v) Royalties payment
(vi) Lifting/convening to the surface

I hope these provisions of the Act that guide the operation of oil and gas industry in Nigeria satisfy your enquiries. However, if you still need any further clarification on this, please feel free to contact me.

Yours faithfully,
For: XYZ Tax Consultants

J. O Kleek
Tax Manager

EXAMINER'S REPORT

The question tests candidates' knowledge of the classification of costs in the upstream sector of oil and gas industry in Nigeria with specific reference to the mineral rights acquisition costs, the development costs and the production costs.

Few candidates attempted this question and performance was poor. The major pitfall was the inability of the candidates to explain the concepts and nature of costs in the oil and gas sector of the economy.

Candidates are advised to make use of the Institute's Study Texts and Pathfinder when preparing for future examinations.

Marking Guide

		Marks
(a.)	Material rights acquisition costs	
	Introduction/definition	1
	Classification of costs/licence	
	(any 4 points)	4
(b.)	Development cost	
	Introduction/definition	1
	Classification of costs	
	(Any 4 points)	4

(c.)	Production costs Introduction/definition Classification of costs (Any 4 points)	<u>4</u>
		<u>15</u>

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2018

STRATEGIC FINANCIAL MANAGEMENT

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Eko Plc. (Eko) is a listed company in food retailing sector and has large stores in all major cities in the country. Eko's board is considering diversifying by opening holiday travel shops in all of its stores.

At a recent board meeting, the directors discussed how the holiday travel shops project (the project) should be appraised. The sales director insisted that Eko's current weighted average cost of capital (WACC) should be used to evaluate the project as majority of its operations will still be in food retailing. The finance director disagreed because the existing cost of equity does not take into account the systematic risk of new projects. He said that the company's overall WACC, which reflects all of the company's activities, would change as a result of the project's acceptance. The board was also concerned about the market's reaction to its diversification plans. Another board meeting was scheduled at which Eko's advisors would be asked to make a presentation on the project.

You work for Eko's advisors and have been asked to prepare information for the presentation. You have established the following:

Eko intends to raise the capital required for the project in such a way as to leave its existing debt to equity ratio (by market value) unchanged following the diversification. Extracts from Eko's most recent management accounts are shown below:

Statement of financial position as at May 31, 2017

	₦'M
Ordinary share capital (10 kobo shares)	233
Retained earnings	5,030
	5,263
6% Redeemable debentures at nominal value (redeemable 2021)	1,900
Long term bank loans (interest rate 4%)	635
	7,798

On May 31, 2017, Eko's ordinary shares had a market value of 276 kobo (ex-div) and an equity beta of 0.60. For the year ended May 31, 2017, the dividend yield was 4.2% and the earnings per share was 25 kobo. The return on the market is expected to be 8% p.a and the risk free rate is 2% p.a.

Eko's debentures had a market value of ₦108 (ex-interest) per ₦100 nominal value on May 31, 2017 and they are redeemable at par on May 31, 2021.

Companies operating solely in the holiday travel industry have an average equity beta of 1.40 and an average debt to equity ratio (by market value) of 3:5. It is estimated that if the project goes ahead, the overall equity beta of Eko will be made up of 90% food retailing and 10% holiday travel shops.

Assume that the income tax rate will be 20% p.a for the foreseeable future.

Required:

a. Ignoring the project, calculate the current WACC of Eko using:

   i. The Capital Asset Pricing Model (CAPM) (8 Marks)

   ii. The Gordon's Growth Model (6 Marks)

b. Use the CAPM to calculate the cost of equity that should be included in a WACC suitable for appraising the project and explain your reason. (5 Marks)

c. By calculating an overall equity beta and using the CAPM, estimate the overall WACC of Eko assuming that the project goes ahead and comment on the implications of a permanent change in the overall WACC. (5 Marks)

d. Advise whether Eko should diversify its operations and how the stock market might react to the proposed project. (3 Marks)

e. Identify the appropriate project appraisal methodology that should be used when a project's financing results in a major increase in a company's market gearing ratio and using the data relating to Eko, calculate the project discount rate that should be used in this circumstance. (3 Marks)

(Total 30 Marks)

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

QUESTION 2

Tamilore Limited (TL) is an agro-based firm, specialising in yam and rice production in Benue State of Nigeria. One of the harvesters is due to be replaced on November 30, 2018, the last day of TL's current financial year. An investment appraisal exercise has recently been completed which confirmed that it is financially beneficial to replace the machine at this point. TL is now considering how best to finance the acquisition of the harvester to be replaced. TL is already highly geared.

A government development agency has offered the following two alternative methods of financing the machine:

Alternative 1

A loan of ₦49,200,000 at 6% interest rate to buy the machine on November 30, 2018. If this option is selected, the machine will be depreciated on a straight-line basis over its estimated useful life of 5 years.

Alternative 2

Enter into a finance lease. This will involve payment of annual rental of ₦12 million with first payment due on November 30, 2019. The lease payments will be for the entire estimated useful life of the machine which is 5 years when the ownership will pass to TL without further payment.

Other information

(i) Whether leased or purchased outrightly, maintenance would remain the responsibility of TL and would be ₦450,000 payable annually in advance.

(ii) TL is liable to tax at a rate of 25%, payable annually at the end of the year in which the tax charge or tax saving arises.

(iii) TL is able to claim capital allowances on the full capital cost of the machine in equal installments over the first four years of the machine.

(iv) Assume that TL has sufficient taxable profits to benefit from any savings arising therefrom.

(v) All workings in ₦'000.

Required:

a. Show that the implied interest rate in the lease agreement is 7%. (3 Marks)

b. Advise, using present value method, whether Tamilore Limited should borrow to buy the machine or lease it. (12 Marks)

c. Instead of lease financing, one director has suggested an equivalent Islamic finance.

i. Explain briefly the principles of Islamic finance. (2 Marks)

ii. Explain **three** main advantages of Islamic finance. (3 Marks)

(Total 20 Marks)

QUESTION 3

Lagelu Plc. (LP) is a very successful entity. The company has consistently followed a business strategy of aggressive acquisitions, looking to buy companies that it believes were poorly managed and hence undervalued. LP can be described as a modern day conglomerate with business interests stretching far and wide.

Its board of directors has chosen the takeover targets with care. LP has maintained its price earnings (P/E) ratio on the stock market at 12.2.

LP's figures show a profit after tax of ₦4,430 million, and it has 375 million shares.

Lam Technical (LT) is a well-established owner-managed business. It has had its ups and downs, in financial terms, corresponding directly with the state of the global economy. Since 2001, its profits have fallen each year with the 2017 results as stated below:

	₦'Million
Revenue	7,500
Operating profit	2,400
Interest	(685)
Profit before tax	1,715
Taxation @ 25%	(429)
Profit after tax	1,286
Number of shares in issue	150 million
Earnings Per Share(EPS)	₦8.57

With economists predicting an upturn in the global economy, LT's management team feels that revenue will increase by 6% per annum up to and including year 2021. The company's operating profit margin is not expected to change in the foreseeable future.

Operating profits are shown after deducting non-cash expenses (including tax allowable depreciation) of ₦650m. This is expected to increase in line with sales. However, the company has recently spent ₦1,050m on purchase of non-current assets. LT's management believes this value will have to increase by 10% per annum until year 2021 to enable the company remain competitive.

LT is currently financed by debt and equity. It has maintained a constant debt to total asset ratio of 40% and there is no intention to change this financing mix in the nearest future.

The company has a cost of equity of 17% and weighted average cost of capital of 12%.

Assume tax rate of 25% in all cases.

Some of LT's major shareholders are not so confident about the future and would like to sell the business as a going concern. The minimum price they would consider would be the fair value of the shares, plus 10% premium. LT's Chief Financial Officer believes the best way to find the fair value of the shares is to discount the forecast Free Cash Flows to the firm, assuming that beyond year 2021 these will grow at a rate of 3% per annum indefinitely.

Required:

a. Prepare a schedule of forecast Free Cash Flows to the firm for each of the years from December 31, 2018 to 2021. (5 Marks)

b. Estimate the fair value of LT's equity on per share basis. (6 Marks)

c. LP intends to make an offer to LT based on a share for share swap. LP will exchange one of its shares for every two LT shares. Assuming that LP can maintain its price earnings (P/E) ratio of 12.2, calculate the percentage gain in equity value that will be earned by both groups of shareholders. (6 Marks)

d. What factors should the LT shareholders consider before deciding whether to accept or reject the offer made by LP? (3 Marks)

(Total 20 Marks)

QUESTION 4

Yemi John Plc. (YJ) is planning to raise ₦30 million new finance for a major expansion of existing business and is considering a rights issue, a placing or an issue of bonds. The corporate objectives of YJ, as stated in its annual report, are to maximise the wealth of its shareholders and to achieve continuous growth in earnings per share. Recent financial information on YJ is as follows:

	2017	**2016**	**2015**	**2014**
Turnover (₦m)	28.0	24.0	19.1	16.8
Earnings before interest and tax (EBIT) (₦m)	9.8	8.5	7.5	6.8
Profit after tax (PAT) (₦m)	5.5	4.7	4.1	3.6
Dividends (₦m)	2.2	1.9	1.6	1.6
Ordinary shares (₦m)	5.5	5.5	5.5	5.5

Reserves (₦m)	13.7	10.4	7.6	5.1
8% Bonds, redeemable 2024 (₦m)	20	20	20	20
Share price (₦)	8.64	5.74	3.35	2.67

The par value of the shares of YJ is ₦1.00 per share. The general level of inflation has averaged 4% per year in the period under consideration. The bonds of YJ are currently trading at their par value of ₦100. The values for the business sector of YJ are as follows:

Average return on capital employed *	25%
Average return on shareholders' fund	20%
Average interest coverage	20 times
Average debt/equity ratio (market value basis)	50%
Return predicted by the capital asset pricing model	14%

* EBIT/closing total capital employed

Required:

a. Evaluate the financial performance of YJ, analyse and discuss the extent to which the company has achieved its stated objectives of:

   i. maximising the wealth of its shareholders; and

   ii. achieving continuous growth in earnings per share (13 Marks)

   Note: Up to 8 marks are available for financial analysis.

b. Analyse and discuss the relative merits of a rights issue, a placing and an issue of bonds as ways of raising finance for the expansion. (7 Marks)

(Total 20 Marks)

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

QUESTION 5

Kuku Plc. had a need for a machine. After four years of purchase, the machine will no more be capable of efficient working at the level of use by the company. Meanwhile, it has been the company's practice to replace machines every four years. The production manager has pointed out that in the fourth year, the machine will need additional maintenance to keep it working at normal efficiency. The question has therefore arisen as to whether the machine should be replaced after three years instead of four years, in line with the company's practice.

Relevant information is as follows:

(i) A new machine will cost ₦240,000. If the machine is retained for four years, it will have a zero scrap value at the end of the period. If it is retained for three years, it will have an estimated disposal value of ₦30,000. The machine will attract capital allowance of 20% (reducing balance tax allowance) in the years of being owned by the company except the last year. In the last year, the difference between the machine's written-down value for tax purposes and its disposal proceeds will be allowed to the company as an additional tax relief if the disposal proceeds are less than the tax written-down value.

It is assumed that the machine will be bought and disposed of on the last day of the company's accounting year.

(ii) The company tax rate is 30% and tax is payable on the last day of the accounting year concerned.

(iii) During the first year of ownership, the supplier takes responsibility for any necessary maintenance work. In the second and third years, maintenance costs average ₦30,000 a year. During the fourth year, these will rise to ₦60,000. Maintenance charges are payable on the first day of the company's accounting year and are allowable for tax.

(iv) The company's cost of capital is estimated at 15%.

Required:

a. Prepare calculations to show whether it would be economically beneficial to replace the machine after three years or four years. (12 Marks)

b. Discuss **two** other issues that could influence the company's replacement decision. This should include any weakness. (3 Marks)

(Total 15 Marks)

QUESTION 6

Alpha Plc. is a Nigerian manufacturer of plastic containers, which it sells in many West African and other African countries. In three months' time, Alpha Plc. is due to receive 70 million Kudi from a country in Central Africa whose currency is Kudi. At a board meeting slated for today, the directors will be discussing whether or not there is a need to hedge the foreign exchange exposure associated with this transaction and if so, how best this might be achieved. At the board meeting, three possible alternatives will be considered:

(i) Not to hedge this transaction;

(ii) Use a forward contract. Exchange rates quoted by Alpha Plc.'s bank today are:
Spot 1.1548 - 1.1608 Kudi/₦; and
3 months forward 1.1438 - 1.1508 Kudi/₦; and

(iii) Use an over-the-counter currency option on Kudi which is available through Alpha Plc.'s bank. Current premiums at an exercise price of 1.1650 Kudi /₦ are ₦1.10 per 100 Kudi for a call option and ₦1.25 per 100 Kudi for a put option.

Required:

a. State **four** reasons why a firm might reasonably choose not to hedge its exposure to exchange rate risk. (4 Marks)

b. Show the effect of each of the three alternatives being considered, assuming that the spot-exchange rate in three months' time is:

   i. 1.1850 – 1.1880 Kudi/₦

   ii. 1.1295 – 1.1320 Kudi/₦ (7 Marks)

c. State **four** methods available to firms to reduce their exposure to foreign exchange risks which do not involve the use of financial contracts.
(4 Marks)
(Total 15 Marks)

QUESTION 7

Agency theory was developed by Jenson & Meckling (1976) who defined the agency relationship as a form of contract between a company's owners and its managers, that is, where the owners appoint agents (managers) to manage the company on their behalf. As part of this arrangement, the owners must delegate decision-making authority to the management.

In this respect, the owners expect the agents to act in their best interest.

Required:

a. Agency conflicts may arise in various ways. Discuss **four** of these conflicts.
(9 Marks)

b. State **four** methods by which problems arising from the conflicts could be reduced. (6 Marks)
(Total 15 Marks)

Formulae

Modigliani and Miller Proposition 2 (with tax)

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

Asset Beta

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

Equity Beta

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

Growing Annuity

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

Modified Internal Rate of Return

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

The Black-Scholes Option Pricing Model

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

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

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

The Put Call Parity

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

Binomial Option Pricing

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

$$d = 1/u$$

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

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

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

The Miller-Orr Model

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

Annuity Table

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

Where r = discount rate

n = number of periods

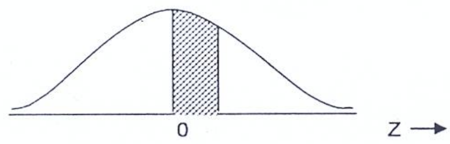
Discount rate (r)

Periods

(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	
1	0·990	0·980	0·971	0·962	0·952	0·943	0·935	0·926	0·917	0·909	1
2	1·970	1·942	1·913	1·886	1·859	1·833	1·808	1·783	1·759	1·736	2
3	2·941	2·884	2·829	2·775	2·723	2·673	2·624	2·577	2·531	2.487	3
4	3·902	3·808	3.717	3·630	3.546	3.465	3·387	3·312	3·240	3·170	4
5	4·853	4·713	4·580	4·452	4·329	4·212	4·100	3·993	3.890	3·791	5
6	5·795	5·601	5·417	5·242	5·076	4·917	4·767	4·623	4.486	4·355	6
7	6·728	6.472	6·230	6·002	5·786	5·582	5·389	5·206	5·033	4·868	7
8	7·652	7·325	7·020	6·733	6·463	6·210	5·971	5·747	5·535	5·335	8
9	8·566	8·162	7·786	7.435	7·108	6·802	6·515	6·247	5·995	5·759	9
10	9·471	8·983	8·530	8·111	7·722	7·360	7·024	6·710	6.418	6·145	10
11	10·368	9·787	9·253	8·760	8·306	7·887	7.499	7·139	6·805	6.495	11
12	11·255	10·575	9·954	9·385	8·863	8·384	7·943	7·536	7'161	6·814	12
13	12·134	11·348	10·635	9·986	9·394	8·853	8·358	7·904	7·487	7·103	13
14	13·004	12·106	11·296	10·563	9·899	9·295	8·745	8·244	7·786	7·367	14
15	13·865	12·849	11·938	11·118	10·380	9·712	9·108	8·559	8·061	7·606	15
(n)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%	
1	0·901	0·893	0·885	0·877	0·870	0·862	0·855	0·847	0·840	0·833	1
2	1·713	1·690	1·668	1·647	1·626	1·605	1·585	1·566	1·547	1·528	2
3	2.444	2.402	2·361	2·322	2·283	2·246	2·210	2·174	2·140	2·106	3
4	3·102	3·037	2·974	2·914	2·855	2·798	2·743	2.690	2·639	2.589	4
5	3·696	3·605	3·517	3·433	3·352	3·274	3·199	3·127	3·058	2·991	5
6	4·231	4·111	3·998	3·889	3·784	3·685	3·589	3.498	3.410	3·326	6
7	4·712	4·564	4.423	4·288	4·160	4·039	3·922	3·812	3·706	3·605	7
8	5·146	4·968	4.799	4·639	4.487	4·344	4·207	4·078	3·954	3·837	8
9	5·537	5·328	5·132	4·946	4·772	4·607	4.451	4·303	4·163	4·031	9
10	5·889	5·650	5.426	5·216	5·019	4·833	4·659	4.494	4·339	4·192	10
11	6·207	5·938	5·687	5.453	5·234	5·029	4·836	4·656	4.486	4·327	11
12	6·492	6·194	5·918	5·660	5·421	5·197	4·988	4·793	4·611	4.439	12
13	6·750	6.424	6·122	5·842	5·583	5·342	5·118	4·910	4·715	4·533	13
14	6·982	6·628	6·302	6·002	5·724	5.468	5·229	5·008	4·802	4·611	14
15	7·191	6·811	6.462	6·142	5·847	5·575	5·324	5·092	4·876	4·675	15

NORMAL DISTRIBUTION

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



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

SOLUTION ONE

a) i) **Using CAPM to compute cost of equity (K_E)**

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

  $= 2 + 0.60(8 - 2) = 5.6\%$

- Cost of redeemable debt

  We need the IRR of:

Year 0	Current market value	= (108)
Years 1 – 4	Interest, net of tax = 6 (1 – 0.2)	= 4.8
Year 4	Redemption value	= 100

  Try 2%: NPV = -108 + 4.8(3.808) + 100(0.924) = 2.678

  Try 3%: NPV = -108 + 4.8(3.717) + 100(0.889) = -1.258

$$\text{IRR} = \text{K}_D = 2 + \frac{2.678}{2.678 + 1.258} \times (3 - 2) = 2.68\%$$

- Cost of bank loan = 4(1 – 0.20) = 3.20%
- Market values

	₦m
Equity: 2,330 shares × ₦2.76	= 6,430.80
Debentures: ₦1,900m × 108/100	= 2,052.00
Loans	= 635.00
	9,117.80

$$\text{WACC} = \left(\frac{₦6{,}430.80}{₦9117.80} \times 5.6\right) + \left(\frac{₦2{,}052}{₦9{,}117.80} \times 2.68\right) + \left(\frac{₦635}{₦9{,}117.80} \times 3.20\right) = 4.8\%$$

ii) **Using Gordon growth model to compute K_E**

g = (r)(b)

Return on Capital Employed (r)

Retention rate (b)

Dividend	= share price × dividend yield	
	=₦2.76 × 4.2%	= 11.6kobo
Retention	= 25kobo – 11.6kobo	= 13.4kobo
∴ b	= 13.4k/25k	= 53.60%

$$\text{Return (r)} = \frac{PAT}{Opening\ \ share\,holders'\,fund}$$ (PAT = Profit after Tax)

$$= \left[\frac{(₦0.25 \times 2{,}330)}{₦5{,}263 - ₦(2{,}330 \times 0.134)}\right] = 11.77\%$$

(Note: In the above calculation, opening shareholders' fund has been used as the preferred method. If average shareholders fund is used, it will be fully rewarded but for future examinations, the former is preferred)

Growth rate (g) = 0.1177 × 0.5360 = 6.3%

$$\therefore \quad K_E = \frac{D_O(1+g)}{V_E} + g$$

$$= \frac{11.6(1.063)k}{276k} + 0.063 = 0.1077 = 10.77\%$$

Cost of debt and market values are as in (a)(i) above.

$$\therefore \text{WACC} = \left(\frac{₦6,430.80}{₦9117.80} \times 10.77\%\right) + \left(\frac{₦2,052}{₦9,117.80} \times 2.68\%\right) + \left(\frac{₦635}{₦9,117.80} \times 3.20\%\right) = 8.42\%$$

b) The cost of equity should be adjusted to reflect the systematic risk of the new project. The equity beta for the holiday travel industry should be adjusted for gearing. It is assumed that debt is risk free, since we are not given beta of debt.

- $\therefore$ Asset beta (β_A) of the holiday travel industry will be:

$$\beta_A = \frac{1.40 \times 5}{5+3(1-0.2)} = 0.95 \text{ while}$$

- Equity beta for the project is

$$\beta_E = 0.95 + \left[(0.95 - 0)\left(\frac{₦2,687}{₦6,431}\right)(1 - 0.20)\right] = 1.27, \text{ hence}$$

- K_E = 2+ 1.27(8 - 2) = 0.0962 = 9.62%

The WACC to be used for the project should reflect the **business risk** of the project and the **financial risk** of the company.

c) If the diversification goes ahead, cost of equity will reflect the **systematic risk** of both divisions.

- Weighted average beta of the enlarged group

  = (1.27× 0.10) + (0.6 × 0.90) = 0.667
- K_E = 2 + 0.667(8 - 2) = 0.06 = 6%

- WACC of the enlarged group

  = [(6% × ₦6,431) + (2.68% × ₦2,052) + (3.20% ×₦635)]/9,118 = 5.06%

The implications of a permanent change in the company's WACC from 4.8% to 5.06% are less clear. An increase in the WACC is usually associated with reductions in value. On the other hand, if the new project has a positive NPV, it could result in an increase in the market capitalisation.

d) The diversification plans may not be welcomed by the market. From portfolio theory, we know that rational shareholders would hold a well-diversified portfolio and that they might not welcome the company diversifying. Conglomerate companies often trade at a discount.

e) If the gearing changes dramatically, then, it is not suitable to use WACC/NPV to appraise the project. Instead, adjusted present value (APV) should be used.

The discount rate will be that of an all equity company using the β_A of 0.95 to reflect the systematic risk. Therefore, the discount rate will be:
$2 + 0.95(8 - 2) = 0.077$ or 7.7%.
This will be used to calculate the base case NPV. The NPV will then be adjusted for the financing side effects.

EXAMINER'S REPORT

This question tests candidates' understanding of various aspects of cost of capital, which include cost of equity (using CAPM and Gordon model), cost of redeemable debt and cost of bank loan. It also tests candidates' knowledge of adjustment for financial gearing in calculating cost of equity.

About 95% of the candidates attempted the question. Candidates were expected to calculate weighted average cost of capital (WACC) under varying scenarios and to comment on the results. Generally, the performance of the candidates was poor.

Major pitfalls of candidates include the following:

- **Inability to calculate the Gordon growth model;**
- **Inability to adjust beta factor for financial risk and business risk;**
- **Failure to identify the appropriate cost of capital to use when there is a significant change in gearing; and**
- **Inability to identify the appropriate investment appraisal methodology to use when there is a significant change in gearing.**

It is recommended that success at this level of the examination demands that candidates should cover comprehensively the Institute's syllabus and make use of the Study Texts and the Pathfinders.

MARKING GUIDE

			Mark	Mark
(a)	i.	Computation of :		
		- cost of equity using CAPM	1	
		- cost of redeemable debt using IRR	3	
		- cost of bank loan	½	
		Summary of the market values of equity & debt	1½	
		Calculation of WACC using CAPM	2	8
	ii.	Calculation of:		
		- dividend paid	½	
		- retained earnings	½	
		- retention rate	½	
		- Return on capital employed (ROCE)	1	
		- growth rate	½	
		- cost of equity using growth rate	1	
		- WACC using gordon's growth model	2	6
(b)		Calculation of:		
		- asset beta of the holiday travel industry	1½	
		- equity beta for the project	1½	
		- cost of equity using CAPM	1	
		Recommendation on the WACC to be used for the project	1	5
(c)		Computation of:		
		- weighted average beta of the group	1½	
		- cost of equity (K_E)	1	
		- WACC of the enlarged group	1½	
		Comment on the change in the company's WACC	1	5
Z(d)		Discussion on diversification plans		3
(e)		Identification of the appropriate appraisal method to be used - APV as against WACC/NPV	1	
		Calculation of the project's discount rate and recommendation for adjustment to take care of the financing side effects	2	3
				30

SECTION B

SOLUTION TWO

a) **Implied interest rate in the lease**

Cost of machine/annual lease rental = ₦49,200/₦12,000 = 4.100

From the annuity table under '5 years', this gives an implied rate of 7%.

Candidates can also use IRR to determine the implicit interest rate using the following figures.

Year 0	(49,200)
1-5	12,000

However, the method is longer.

b) **Notes**

In the following evaluation of the financing options, the following items are ignored because they are **common** to the two alternatives:

i) tax savings on capital allowances; and
ii) maintenance charges and related tax savings.

Alternative 1 – Outright purchase

The net relevant cost is the purchase cost of ₦49,200,000.

Alternative 2 – Lease finance

- After tax cost of borrowing = 6% x (1 – 0.25) = 4.5%

- **Interest component of lease rental (₦'000)**

	(a)	(b)	(c)	(b + c)	(a + b) – (b + c)
Year	**Opening balance ₦'000**	**Interest at 7% ₦'000**	**Principal repayment ₦'000**	**Rental payment ₦'000**	**Closing balance ₦'000**
1	49,200	3,444	8,556	12,000	40,644
2	40,644	2,845	9,155	12,000	31,489
3	31,489	2,204	9,796	12,000	21,693
4	21,693	1,519	10,481	12,000	11,212
5	11,212	785*	10,427	12,000*	0

(* rounded up)

NPV of lease option in (₦'000)

Year	1	2	3	4	5
Lease rental	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)
Tax relief on interest	861	711	551	380	197
NCF	(11,139)	(11,289)	(11,449)	(11,620)	(11,803)
PVF at 4.5%	0.957	0.916	0.876	0.839	0.803
PV	(10,660)	(10,341)	(10,029)	(9,749)	(9,478)

Total = (50,257) or (₦50,257,000)

Recommendation

An outright purchase of the machine at a cost of ₦49,200,000 is relatively cheaper and therefore recommended.

c (i) The main principles of Islamic finance include:

- ✓ Wealth must be generated from legitimate trade and asset-based investment (the use of money for the purposes of making money is expressly forbidden);
- ✓ Investment should have a social and an ethical benefit to the wider society beyond pure return;
- ✓ Risk should be shared; and
- ✓ Harmful activities (haram) should be avoided.

The intention is to avoid injustice, asymmetric risk and moral hazard and unfair enrichment at the expense of another party.

ii) The key advantages of Islamic Finance include:

- Gharar (uncertainty, risk of speculation) is not allowed, reducing the risk of losses;
- Excessive profiteering is also not allowed, only reasonable mark-ups are allowed;
- Banks cannot use excessive leverage and are therefore less likely to collapse;
- The rules encourage all parties to take a longer-term view and focus on creating a successful outcome for the venture, which should contribute to a more stable financial environment; and
- The emphasis of Islamic finance is on mutual interest and co-operation, with a partnership based on profit creation through ethical and fair activity benefiting the community as a whole.

EXAMINER'S REPORT

Parts 'a' and 'b' of the question test candidates' understanding of the analysis of lease or buy decision, while part 'c' tests candidates' knowledge of the basic principles of Islamic finance.

About 80% of the candidates attempted the question. Candidates are expected to calculate implicit interest rate on a lease and assess the desirability of lease or buy. Despite the fact that a similar question was tested in a recent examination, the level of performance was below average.

Major pitfalls include:

- Inclusion of common cost in their analysis, thereby wasting valuable examination time;
- Failure to include tax savings on interest; and
- Apparent lack of knowledge of basic principles of Islamic finance.

Candidates are advised to make effective use of the Institute's Study Text and the Pathfinder.

MARKING GUIDE

			Mark	Mark
(a)		Confirmation of the 7% implied interest rate with relevant computation		3
(b)		Identifying the relevant cost	1	
		Determining the after tax cost of borrowing	1	
		Calculation of interest component of lease rental using amortisation table	4½	
		Calculation of the NPV of lease option	4½	
		Recommendation	1	12
(c)	i.	1 mark per relevant point, max 2 points	2	
	ii.	1 mark per relevant point, max 3 points	3	5
				20

SOLUTION THREE

a)

	2018	2019	2020	2021
	₦m	₦m	₦m	₦m
Revenue	7,950	8,427	8,933	9,469
Operating profits (32% of revenue)	2,544	2,697	2,859	3,030
Tax at 25%	(636)	(674)	(715)	(758)
Non cash expenses	689	730	774	821
Capital expenditures	(1,155)	(1,271)	(1,398)	(1,538)
Free cash flow to the firm	1,442	1,482	1,520	1,555

Note: It is also possible to calculate forecast free cash flow to the firm (FCFF) starting from profit after tax. In this question however, it is faster starting from operating profit (EBIT).

Note: Operating profit (as % of revenue)

=2,400/7,500 = 32%

b) Calculation of total value of the company.

This is given as the present value of the future FCFF.

			₦m
2018	$1{,}442\ (1.12)^{-1}$	=	1,288
2019	$1{,}482\ (1.12)^{-2}$	=	1,181
2020	$1{,}520\ (1.12)^{-3}$	=	1,082
2021	$1{,}555\ (1.12)^{-4}$	=	988
			4,539

2021 – Infinity:

$$\frac{1{,}555 \times 1.03}{0.12 - 0.03} \times (1.12)^{-4} = 11{,}310$$

Total value of the company		15,849
Value of debt (40%)		(6,339)
Total value of equity (60%)		9,510
Number of shares		150m
Value per share (9,510/150)	=	₦63.40
P/E ratio (₦63.40/8.57)	=	7.40

c) Total current value of LP = (total profit after tax) × P/E

= 4,430m × 12.2	= ₦54,046m
Number of shares	375m
Current value per share (₦54,046 ÷ 375)	= ₦144.12

LP expects to maintain its P/E ratio after acquiring LT. Therefore, the post-acquisition value of the two entities combined can be ascertained by applying LP's P/E ratio to the sum of the latest earnings of each company (as the P/E ratio of LP (12.2), exceeds that of LT, (7.4), this is known as "bootstrapping").

Current profit after tax for:	₦m
LP	4,430
LT	1,286
	5,716
P/E ratio-LP	12.20

Post-acquisition total value of the combined companies = ₦5,716m × 12.20 = ₦69,735.20m

Total post-acquisition number of shares:

Currently in LP	375
Issued to shareholders in LT (150m/2)	75
Revised number of shares	450

Revised value per share (VPS) in LP (₦69,735.20m / 450)	=	₦154.97
Revised market value per existing share in LT: ₦154.97 × ½	=	₦ 77.49

Percentage gain by:

Shareholders in LP

$$= \frac{154.97 - 144.12}{144.12} \times 100 = 7.53\%$$

Shareholders in LT

$$= \frac{77.49 - 63.39}{63.39} \times 100 = 22.24\%$$

d) Factors to consider by shareholders of LT include:

i. LT shareholders wanted a gain of 10% on the fair value of their shares. Based on the above calculations, they are getting about 22%, which is likely to encourage them to accept the offer;
ii. LT may decide to reject the offer believing that LP will make a more lucrative offer in the future;
iii. The fair value of the LT shares has been based on forecasts and estimates. Some sensitivity analysis needs to be carried out to ensure the value is robust;
iv. There is no guarantee that LP can maintain its P/E ratio at 12.2. Hence, the post-acquisition value is then uncertain;
v. LT shareholders may feel that as the economic conditions are improving, their business prospects and value will get better. They may reject the offer and stay independent; and
vi. Not all shareholders of LT want to sell the company. The constitution of the company may allow the takeover to be blocked unless a certain percentage majority of the shareholders agree.

EXAMINER'S REPORT

The question tests candidates' knowledge of valuation of equity using free cash flow to the firm. It also tests candidates' understanding of various discounting techniques (growing annuity, delayed growth etc).

About 40% of the candidates attempted the question. Candidates were expected to calculate free cash flow to the firm, market value of equity and analysis of gain of the various stakeholders. However, candidates' failure to understand the basic requirements of the question led to their poor performance.

Major pitfalls of candidates include:

- **Failure to adjust for depreciation and tax; and**
- **Poor understanding of simple discounting principles.**

Candidates are advised to use the Institute's Study Text, the Pathfinder and cover the syllabus comprehensively when preparing for the Institute's examinations in future.

MARKING GUIDE

		Mark	Mark
(a)	Calculations of:		
	- Revenue	1	
	- Operating profit	1	
	- Tax	1	
	Non cash expenses	1	
	Capital expenditure	1	5

(b)	Computations of:		
	- total value of the company	4¼	
	- value of debt	¼	
	- total value of equity	½	
	- value per share	1	6
(c)	Calculations of:		
	- total current value of LP	½	
	- LP's current value per share	½	
	- post-acquisition value of the combined companies	1	
	- post-acquisition number of shares	1	
	- post-acquisition value per share in LP	½	
	- post-acquisition value per existing shares in LT	½	
	- percentage gain by LP shareholders	1	
	- percentage gain by LT shareholders	1	6
(d)	1 mark per correct point explained, max 3 points		3
			20

SOLUTION FOUR

a) Financial Analysis

	2017	2016	2015	2014
Turnover growth	17%	26%	14%	-
Geometric average growth: 19%				
EBIT growth	15%	18%	10%	-
Geometric average growth 13%				
EPS (kobo)	100	85	75	66
EPS growth	18%	13%	14%	-
Geometric average growth 15%				
Dividend per share (kobo)	40	35	29	29
DPS growth	14%	21%	-	-
Geometric average growth 11%				
Shareholders' Fund (ordinary shares + reserves (₦m)	19.2	15.9	13.1	10.6
8% bonds (₦m)	20.0	20.0	20.0	20.0
Capital employed (₦m)	39.2	35.9	33.1	30.6
Return on capital employed	25%	24%	23%	22%
Return on Shareholders' Funds	29%	30%	31%	34%
Debt/Equity ratio (market value)	42%	63%	109%	136%
Total Shareholders' return	58%	82%	36%	-

[(Capital gain + dividend) / opening share price] for 2017:

[(864 – 574) + 40]/574 = 58%

Achievement of Corporate Objectives

YJ has shareholder wealth maximisation as an objective. The wealth of shareholders is increased by dividends received and capital gains on shares owned. Total shareholder return compares the sum of dividend received and the capital gain with the opening share price. The shareholders of YJ had a return of 58% in 2017, compared with a return predicted by CAPM of 14%. The lowest return which shareholders have received was 36% and the highest return was 82%. On this basis, the shareholders of the company have experienced a significant increase in wealth. It is debatable whether this has been as a result of actions of the company. Share prices may increase irrespective of the actions and decisions of managers. In fact, looking at the dividend per share history of the company, there were two years (2014 & 2015) when dividends were constant, though earnings per share increased.

Another objective of the company was to achieve a continuous increase in EPS. Analysis shows that EPS increased every year by an average of 14.9%. This objective appears to have been achieved.

Comments on Financial performance

- Return on capital employed (ROCE) has been growing towards the sector average of 25% on a year-by-year basis from 22% in 2014. This steady growth in the primary accounting ratio can be contrasted with irregular growth in turnover, the reasons for which are unknown.

- Return on Shareholders' Funds has been consistently higher than the average for the sector. This may be due more to the capital structure of the company than to good performance. In every previous year except 2017, the gearing of the company was higher than the sector average.

The current debt/equity ratio of the company is 42% (20/47.5). Although, this is less than the sector average value of 50%, it is more useful from a financial risk perspective to look at the extent to which interest payments are covered by profits.

	2017	2016	2015	2014
EBIT (₦m)	9.8	8.5	7.5	6.8
Bond interest (₦m)	1.6	1.6	1.6	1.6
Interest coverage ratio (times)	6.1	5.3	4.7	4.3

The interest coverage ratio is not only below the sector average, it is also low enough to be a cause for concern. While the ratio shows an upward trend over the period under consideration, it still indicates that an issue of further debt would be unwise.

A placing, or any issue of new equity shares such as rights issue or a public offer, would decrease gearing. If the expansion of business results in an increase in profit before interest and tax, the interest coverage ratio will increase and financial risk will fall. Given the current financial position of the company, a decrease in financial risk is certainly preferable to an increase.

(b) A placing will dilute ownership and control, provided a new equity issue is taken up by new institutional investors, while a rights issue will not dilute ownership and control, provided existing shareholders take up their rights. A bond issue does not have ownership and control implications, although restrictive or negative covenants in bond issue document can limit the actions of a company and its managers.

All the three financing choices are long-term sources of finance and so are appropriate for a long-term investment such as the proposed expansion of existing business.

Equity issues such as a placing and a rights issue do not require security. No information is provided on the non-current assets of the company, but it is likely that the existing bond issue is secured. If a new bond issue was being considered, the company would need to consider whether it has sufficient non-current assets to offer as security, although it is likely that new non-current assets would be bought as part of the business expansion.

EXAMINER'S REPORT

The question tests candidates' knowledge of key accounting ratios and their use in performance evaluation. It also tests candidates' understanding of the relative merits of placing, rights and bonds issues.

About 85% of the candidates attempted the question and performance was poor. Candidates were expected to calculate and interprete, from the given data, some key accounting ratios. They were also expected to discuss relative merits of placing, rights and bonds issues.

Candidates' commonest pitfalls were their inability to make use of the calculated accounting ratios to assess the performance of the given company and their failure to understand the concept of placing as they wrote completely irrelevant things.

Candidates are advised to practise more examination questions on financial analysis and capital market operations.

Marking Guide

		Mark	Mark
(a)	Computation of growth rates and accounting ratios e.g.:		
	- Turnover growth rate	1	
	- EBIT growth rate	1	
	- EPS growth rate	1	
	- DPS growth rate	1	
	- Return on capital employed (ROCE)	1	
	- Return on shareholders' funds	1	
	- Debt/Equity ratio (gearing ratio) market value	1	
	- Total shareholders' return	1	
	Discussions on the achievement of corporate objective - Shareholders wealth maximisation	3	
	Comments on financial performance	2	13
(b)	Analysis and discussion of the relative merits of:		
	- rights issue	3	
	- Placing	2	
	- bonds issue	2	7
			20

SECTION C

SOLUTION FIVE

(a)

3-Year Life

Year	0	1	2	3
	₦	₦	₦	₦
Outlay	(240,000)			
Tax savings on capital allowances	14,400	11,520	9,216	27,864
Maintenance cost		(30,000)	(30,000)	
Tax savings on Maintenance cost			9,000	9,000
Scrap value				30,000
Net Cash Flows	(225,600)	(18,480)	(11,784)	66,864
DCF @15%	1	0.897	0.756	0.658
PV	(225,600)	(16,577)	(8,909)	43,997

NPV = (₦207,089)

4-Year Life

Year	0	1	2	3	4
	₦	₦	₦	₦	₦
Outlay	(240,000)				
Tax savings on capital allow.	14,400	11,520	9,216	7,373	29,491
Maintenance cost		(30,000)	(30,000)	(60,000)	-
Tax savings on Maintenance cost			9,000	9,000	18,000
Net Cash Flows	(225,600)	(18,480)	(11,784)	(43,627)	47,491
DCF @15%	1	0.897	0.756	0.658	0.572
PV	(225,600)	(16,577)	(8,909)	(28,707)	27,165

NPV = (₦252,623)

Summary:

	3 year (Option)	4 year (Option)
	₦	₦
NPV as above	(207,089)	(252,623)
Annuity factor @ 15%	2.283	2.855
Equivalent Annual cost (EAC)	(90,709)	(88,484)

Recommendation: A four year life is marginally more economical and should therefore be adopted.

WORKINGS

Time/ Year

			Tax @ 30%
		₦	₦
0	Cost	240,000	
	Capital allowance (20%)	(48,000)	14,400
1	Tax written down value	192,000	
	Capital allowance (20%)	(38,400)	11,520
2	Tax written down value	153,600	
	Capital allowance (20%)	(30,720)	9,216
	Tax written down value	122,880*	
	Proceeds	(30,000)	
	Balancing allowance if sold in year 3	92,880	27,864
3	Tax written down value	122,880*	
	Capital allowance (20%)	(24,576)	7,373
	Balancing allowance if sold in year 4	98,304	29,491

*Represents tax written down value if machine is not sold at the end of the 3rd year.

(b) Relevant issues include the following:

(i) The analysis in (a) ignores price changes of all descriptions as a change in the price of a new machine, for example, could easily alter the conclusion. Same will be true for all of the input factors;

(ii) The approach taken assumes that replacement will take place with an identical machine. The machine may be technologically superseded. The company may conclude that it no longer has a need for such a machine. In practice, it seems unlikely that many such assets are replaced with identical models on a continuing basis; and

(iii) The timing of the cash outflows on new machines could be an issue in practice, i.e making payments every fourth year may cause less of a cash flow problem than every third year.

EXAMINER'S REPORT

This question tests candidates' ability to analyse and explain capital asset replacement.

About 85% of the candidates attempted the question and performance was very poor.

Candidates' commonest pitfalls were their inability to accurately calculate the appropriate capital allowances, the related tax savings and their failure to correctly identify the relevant cash flows together with their timings.

Candidates are advised to practise past examination questions using the Pathfinders, the students' Study Text and other relevant materials.

MARKING GUIDE

		Mark	Mark
(a)	Computation and recognition of capital allowances and tax saving thereon for the two years (3 & 4 years respectively) 2 marks for each year	4	
	Recognition of maintenance cost and the tax savings thereon for the two years – 1 mark for each year	2	
	Recognition of the scrap value for the third year	$^1/_4$	
	Computation of the NPV for the 3rd & 4th years	1¾	
	Calculations of equivalent annual cost (EAC) for the 3rd & 4th years	2	
	Recommendation	2	12
(b)	1½ marks per correct points discussed, max 2 points		3
			15

SOLUTION SIX

(a) Reasons why a firm might reasonably choose not to hedge its exposure to exchange rate risk include:

(i) Costs (direct and implicit);
(ii) Materiality of the exposure;
(iii) Attitude to risk may lead the firm to decide to leave the upside potential open;
(iv) Portfolio effect; and
(v) If shareholdings are fully diversified, the shareholders' exposure to systematic risk will not be affected. So, there will be no benefits for them from hedging.

(b) **Alternative 1 – Do not hedge**

If the company does not hedge, the receivables will be converted at the appropriate spot rates in 3 months' time.

Note that the company is **selling** Kudi and the bank is **buying**. The relevant buying rate should be used, i.e 1.1880 and 1.1320.

If the spot rate is	1.1880	1.1320
Value of receivables is	70,000,000 Kudi/1.1880 Kudi/₦ = ₦58,922,559	70,000,000 Kudi/1.1320 Kudi/₦ = ₦61,837,456

Alternative 2 – Forward contract

With this alternative, the receivables will be converted at the agreed rate of 1.1508, irrespective of the spot rate in 3 months' time.
Amount due is 70,000,000 Kudi/1.1508 Kudi/ ₦ = ₦60,827,251.

Alternative 3 – Currency option

As the company is hedging a foreign asset, a put option (the right to sell) is needed. A premium of ₦1.25 per 100 Kudi will be paid, i.e
(70,000,000 Kudi/100) x ₦1.25 = ₦875,000.

Evaluation			
Sport rate in 3 months' time is	1.1880	or	1.1320
Exercise rate	1.1650		1.1650
Exercise?	Yes		No
Applicable rate	1.1650 Kudi/₦		1.1320 Kudi/₦
Gross amount due 70m Kudi/1.1650 Kudi/₦ =	₦60,085,837	70m Kudi/1.1320 Kudi/₦ =	₦61,837,456
Premium payable	(875,000)		(875,000)
Net amount receivable	₦59,210,837		₦60,962,456

(c) Methods available to firms to reduce their exposure to foreign exchange risk which do not involve the use of financial contracts include:
   - (i) Appropriate choice of invoice currency;
   - (ii) Matching payments and receipts (e.g creating payables and receivables in same currency);
   - (iii) Matching assets and liabilities (e.g creating overdraft borrowing in respect of a receivable);
   - (iv) Leading and lagging payments; and
   - (v) Maintaining currency accounts.

EXAMINER'S REPORT

The question tests candidates' ability to analyse various foreign currency hedging techniques. In particular, they are to analyse the use of forward contract and over the counter (OTC) option.

Candidates are expected to use certain financial derivative instruments to hedge foreign exchange risk. However, candidates' lack of understanding of the basic requirements of the question led to their poor performance. About 50% of the candidates attempted the question.

Candidates' commonest pitfalls were their inability to identify the appropriate exchange rate to use and their inability to identify which financial option to use.

Candidates are advised to familiarise themselves with foreign exchange transactions to be able to perform well in this topic in future.

MARKING GUIDE

		Mark	Mark
(a)	1 mark per identified correct point, max 4 points	-	4
(b)	Alternative 1 – do not hedge:		
	- Identifying the correct spot rates	1	
	- Calculation of the value of the receivables	1	
	Alternative 2 – forward contract		
	- Identifying the correct rate to use	1	
	- Calculation of the amount due	1	
	Alternative 3 – current option		
	- Calculations of the premium payable and the net amount receivable	3	7
(c)	1 mark per reasonable method stated, max 4 points		4
			15

SOLUTION SEVEN

(a) Agency conflicts are differences in the interests of a company's owners and the managers.

These conflicts arise in several ways which include:

i) **Moral hazard:** A manager has an interest in receiving benefits from his or her position as a manager. These include all the benefits that come from status, such as a company car, use of company's airplane, accommodation, lunches and so on;

ii) **Effort level:** Managers may work less than they would if they were the owners of the company. The effect of this lack of effort could be lower profit and a lower share price. The problem may exist in a large company at middle levels of management as well as at senior level management. However, the interests of middle level managers and the interest of senior level managers might well be different, especially if senior level management staff are given pay incentives to achieve higher profits while the middle level management staff are not;

iii) **Earnings retention:** The remuneration of directors and senior managers is often related to the size of the company rather than its profits. This gives managers an incentive to grow the company and increase its sales turnover and assets, rather than to increase the returns to the company's shareholders. Management is more likely to want to re-invest profits in order to make the company bigger, rather than pay-out the profits as dividends;

iv) **Risk aversion:** Executive directors and senior managers usually earn most of their income from the company they work for. They are therefore interested in the stability of the company because this will protect their job and their future income. This means that management might be risk averse, and reluctant to invest in higher-risk projects. In contrast, shareholders might want a company to take bigger risks, if the expected returns are sufficiently high; and

v) **Time horizon:** Shareholders are concerned about the long-term financial prospects of their company because the value of their shares depends on expectations for the long-term future. In contrast, managers might only be interested in the short term. This is partly because they might receive annual bonuses based on short-term performance and partly because they might not expect to be with the company for more than a few years. Managers might therefore have an incentive to increase accounting returns on capital employed (or return on investment) whereas shareholders have a greater interest in long-term share value.

(b) Several methods of reducing the agency problems have been suggested. These include:

i. **Assessing the relative importance of stakeholders' interests**. Apart from the problem of taking different stakeholders' interests into account, an organisation also faces the problem of weighing stakeholders' interests when considering future strategy;

ii. **Agency theory resolution strategy**. This relates to analysing the problem that can arise when ownership and control are separated and how they might be mitigated by negotiating contracts that allow the principal to control the agent in such a way that the agent will operate in the interests of the principal;

iii. **Firm induced strategies**. Agency theory sees employers of businesses, including managers, as individuals, each with his or her own objectives. Also, within a department of a business, there are departmental objectives. If achieving these various objectives also leads to the achievement of the objective of the organisation as a whole, there is said to be goal congruence. Examples are: profit-related/economic value added pay, share awards, share options and so on;

iv. **Separation of roles**. Too much power should not accrue to a single individual within an organisation. For example the role of the Chairman and the Chief Executive should be separated;

v. **Accounting standards**. Adequate information should be given in the financial statements of a company;

vi. **Corporate governance.** This is the system by which companies are directed and controlled. It deals with governance problems that result from the separation of ownership and management of a company, such as the rights of shareholders, the role of stakeholders, disclosure and transparency, responsibilities of the board and so on;

vii. **Threat of Dismissal.** This may not be effective as ownership in many big companies (where ownership and control are highly separated) is widely dispersed and shareholders often find it difficult to speak with one voice. Few shareholders attend the annual general meetings and in any case, directors usually ensure they get enough proxies to support them at meetings. It should be noted however, that the presence of institutional investors could weaken the directors' strength; and

viii. **Exposure to take-over bid**: This could deter managers from taking actions that will be at variance with share price maximisation. If the company's earnings potentials are being knowingly or unknowingly suppressed through bad policies and the share is consequently undervalued in relation to its true value, it may be exposed to hostile take-over bid. The result is that some top managers might lose their job.

EXAMINER'S REPORT

The question tests candidates' understanding of various agency conflicts in finance.

About 95% of the candidates attempted the question. The performance was generally satisfactory with some candidates producing excellent solutions.
Candidates are expected to discuss the various possible conflicts of interest between managers and shareholders. They are also required to identify mitigating factors.

Candidates' commonest pitfalls were their inability to explain correctly the major conflict areas identified by them and their lack of knowledge of the mitigating factors.

Candidates are advised to study the Institute's Study Text, Pathfinders and other materials relating to agency conflicts and costs to be able to perform better in future examinations.

MARKING GUIDE

		Mark	Mark
(a)	2¼ marks per correct point mentioned and discussed, max 4 points		9
(b)	1½ marks per correct method stated, max 4 points		6
			15

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION - NOVEMBER 2018

ADVANCED AUDIT AND ASSURANCE

Time Allowed: 3¼ hours (including 15 minutes reading time)

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

SECTION A: COMPULSORY (30 MARKS)

QUESTION 1

You are the audit partner of Rolami Adiatu & Company, a firm of Chartered Accountants. In the process of planning an audit, you have identified the need to train audit personnel involved in the audit of clients engaged in on-line businesses.

You have concluded arrangements with your human resources department to organise training for the firm's audit team which includes trainees, supervisors and managers. You are preparing notes which will assist you to train the team and make them appreciate the problems that may arise in the audit of on-line businesses and how they could be minimised.

Required:

a. Prepare briefing notes which explain on-line systems and the operational advantages they offer to entities that use them. (6 Marks)

b. Identify the general and application controls which need to be put in place to tackle the audit problems created by on-line systems. (9 Marks)

c. i. Discuss Electronic Data Interchange (EDI).
   ii. Explain **four** possible problems EDI may create for the auditor.
   iii. Explain **four** relevant controls to be put in place to minimise the audit risk inherent in EDI systems. (15 Marks)

(Total 30 Marks)

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

QUESTION 2

Yusuf Olatunji & Co., (Chartered Accountants) have been auditors to XBC Bank Limited. There has been some regulatory and compliance issues for which the bank was sanctioned and paid penalties to both the Central Bank of Nigeria and the

Financial Reporting Council of Nigeria. At the board of directors meeting to consider the last annual report audited by the firm, some of the problems caused by the auditors were raised. Following the reoccurrence of such issues, it was proposed that another audit firm be engaged in addition to the present firm. To achieve their objective, a bigger firm that has international affiliation was considered to take a leading position in a joint audit arrangement and to ensure appropriate compliance.

Your firm has been approached for the appointment. A meeting was scheduled between your firm, Yusuf Olatunji & Co. and the executive management of the bank. In preparation for the meeting, you are informed that you will address the meeting on the advantages and disadvantages of joint audit, being an area some members of the management team have expressed concerns.

After the meeting, your firm was subsequently appointed and the necessary formalities were properly followed. Your partner has directed that you liaise with Yusuf Olatunji & Co. to obtain the necessary materials for the preparation of the audit and that you review your firm's audit manual with respect to the concerns of management on joint audit.

Your assessment of the documents obtained from the other auditor revealed the following amongst others:

i. Part of the penalty was on improper disclosure relating to a material property, plant and equipment (PPE) acquired during the previous year and a substantial loan above the limit authorised for a sector of the economy;

ii. The classification of unresolved transactions as debit balances in the statement of financial position resulting in an increase in operating profit and the payment of higher taxes than projected;

iii. The IT operations of the bank had weak controls such that it was possible for some staff to over-ride some of them;

iv. The net current assets have continued to fall and in the preceding year have fallen below industry average despite increase in gross earnings.

Required:

a. Evaluate the advantages and disadvantages of joint audit. (8 Marks)

b. Prepare an agenda for the scheduled meeting between the two audit firms. (4 Marks)

c. Develop the appropriate audit approach to address each of the issues identified from the review of the documents obtained from Yusuf Olatunji & Co. (8 Marks)

(Total 20 Marks)

QUESTION 3

You are the auditor in charge of the audit of Big Bank Plc. Two new associates who recently joined the firm have been assigned to your team and you need to provide them on-the-job training on audit process. The training should focus on audit evidence and testing procedures for gathering audit evidence.

Required:

a. Explain **six** procedures for gathering audit evidence. (6 Marks)

b. Explain to members of your team the terms "sufficient" and "appropriate" audit evidence. (2 Marks)

c. Explain **four** principles that an auditor uses in assessing the reliability of audit evidence in line with ISA 500. (4 Marks)

d. You have allocated the following audit areas to the two new associates on your team:

   i. Bank and cash balances; and
   ii. Payroll.

   Identify the audit procedures that you will discuss with your team members for substantive testing of audit areas mentioned above. (8 Marks)

(Total 20 Marks)

QUESTION 4

You are an audit senior in a firm of Chartered Accountants. You are about to commence work on the audit of B & Z Pharmaceuticals Limited, a family owned and managed limited liability company. You have been informed by a business contact that the company has not been trading very successfully and is having difficulties with its bankers. However, you are not aware of any specific details.

The Engagement Manager on the audit is also aware of this information and is concerned about the ability of B & Z Pharmaceuticals Limited to continue in business for the foreseeable future. He has asked you to visit the company in order to ascertain the current state of affairs.

Required:

a. Prepare a list of questions that you would wish to ask and details of any information that you would wish to obtain from the Finance Director of B & Z Pharmaceuticals Limited, so as to enable you identify indicators and assess ability of the company to continue as a going concern. (16 Marks)

b. Explain briefly the audit opinion that you would give assuming you concluded, after carrying out appropriate audit procedures, that there was a material uncertainty regarding the ability of the company to continue in business and management has included appropriate disclosures in the financial statements.

(You are not required to draft the audit report). (4 Marks)

(Total 20 Marks)

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

QUESTION 5

As a result of recent global financial crises, audit inspection reports in various jurisdictions have noted areas requiring professional judgment. Such areas include fair value, related party transactions and going concern assessments, where regulators and oversight bodies believe that auditors should clearly demonstrate professional scepticism.

Required:

a. Explain the term "Professional Scepticism" (3 Marks)

b. Identify the stages in the audit process where professional scepticism is necessary (3 Marks)

c. Discuss **three** ways in which the application of professional scepticism can be demonstrated by the auditor. (9 Marks)

(Total 15 Marks)

QUESTION 6

You are the Group Engagement Partner on the audit of the consolidated financial statements of GoodLife Investment Plc for the year ended 31 December 2017. GoodLife Investment Plc is a group of companies with subsidiaries in various countries across Africa.

Based on the relative size of the components in terms of revenue, profit before tax, total assets, total liabilities and net assets, you have identified some of the subsidiaries as significant components.

Component materiality has been determined as ₦22 million. In addition, from your preliminary risk assessment, you have identified some components that are likely to contain significant risk of material misstatements of the group financial statements.

You plan to request component auditors to perform work on the financial information of the following components as at 31 December 2017.

Component ID	Component Name	Component Auditor	Country	Classification of Component	Component is likely to include the following significant risks of material misstatement in the group financial statements
GIP	Goodlife Investment Plc	JPM & Co. (Chartered Accountants), Lagos, Nigeria	Nigeria	Significant component	• Fraudulent recognition of revenue • Credit risk - allowance for loan impairment and impairment of other financial assets • Valuation of financial instruments
GISAL	Goodlife Investments South Africa Limited	QSS Audit (Chartered Accountants), Guateng, South Africa	South Africa	Significant component	
GIL	Goodlife Insurance Limited	JPM & Co. (Chartered Accountants), Lagos, Nigeria	Nigeria	Insignificant component	Valuation of insurance liabilities
GPRS	Goodlife Properties & Real Estate Services	Adibe & Co. (Chartered Accountants), Lagos, Nigeria	Nigeria	Significant component	
GSL	Goodlife Stores Limited	Kwesi & Co. (Chartered Accountants), Accra, Ghana	Ghana	Insignificant component	

Required:

a. Identify **four** factors that need to be considered by the group auditor in determining the use of component auditors to work on the financial information of these components. (4 Marks)

b. Discuss **three** principles to be applied when determining the type of work to be performed on each of the components above. (Link specific consideration to relevant components as shown above). (9 Marks)

c. List **four** contents of a Group Audit Instruction to a component auditor (2 Marks)

(Total 15 Marks)

QUESTION 7

You are the partner responsible for the audit of JJ Industries Limited for the year ended 31 December 2017. The final audit has been completed and you are aware that there is a guidance for auditors relating to audit reports - *ISA 706-Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report.*

Required:

ai. Explain "Emphasis of Matter paragraph" and provide **three** examples and the potential situations in which such a paragraph may be used.

(6 Marks)

ii. Define "Other Matter paragraph" and give **two** examples of the use of such a paragraph. (4 Marks)

Note: You are not required to produce draft paragraphs

b. *ISA 705-Modifications to the Opinion in the Independent Auditor's Report* require the auditor to modify his opinion in the audit report.

Discuss the two situations under which the auditor must issue a modified opinion in line with ISA 705. (5 Marks)

(Total 15 Marks)

SECTION A

SOLUTION 1

a. On-line systems are network computer systems that allow users direct access to centrally-held data and programs. Access to the central files is through remote terminals.

On-line systems offer a number of operational advantages to entities that use them. These include:

i. They permit the immediate entry of transactions from many different locations, instead of having to submit transactions to a central computer for processing. For example, if a retailing company operates an on-line system for sales, sales transactions data can be inputted immediately for centralized processing through terminals in each retail store;

ii. In the same way, centralized master files, such as master files for inventory, are updated immediately. This means that subsequent users of the system can use the up-to-date versions of master files;

iii. On-line system allows users to make inquiries and obtain immediate responses, by having access to master files or reference files. For example, users are able to give immediate answers to customers about prices of product or the current status of their order; and

(iv) Reduction in operational costs

b. On-line systems are usually efficient and effective for the user, however, they create additional problems for the auditor who needs to access the effectiveness of the system controls. There should be sufficient general controls and application controls to minimise the risks that arise from using on-line systems, as specified below:

i. General controls in an on-line system could include the following:
There must be effective controls over access to the system and its files. This is because in on-line systems, transactions are processed as soon as they are inputted.

- There should be controls written into the system software to prevent or detect unauthorised changes to programs.

- Transactions logs should be used to create an "audit trail". An audit trail refers to the ability of the auditor to trace a transaction through all its processing stages. An audit trail may not exist in paper form in computer systems. The computer programs should therefore be written in such a way as to generate the trail for any transactions on request.

- Firewalls should be used for systems that have access to the internet. Firewalls are hardware or software devices that prevent unauthorised access to a system from an internet user; and

- Back up mechanism for transactions.

ii. Application controls in an on-line system could include the following:

- Pre-processing authorisation, such as logging on to the system, and the use of user names and passwords.

- Data validation checks in the software, to check the completeness and accuracy of processing such as checking that a product code has been entered with the correct number of digits; and

- Balancing, that is checking control totals of data submitted from remote terminals before and after processing.

C.i. Electronic Data Interchange (EDI) systems are systems that allow the electronic transmission of business documents, such as invoices or payroll information between different computer systems. The EDI system provides a form of translation service so that the data transmitted from one computer system is changed into a form that can be read by the other computer, without any need for human intervention.

Electronic Data Interchange may operate within the organisation for example, the sales department may use EDI to transfer copies of customer orders electronically to a separate computer system of the accounting department.

EDI may also operate externally, for example, a company may use EDI to submit payroll data for processing to the computer system of a payroll agency, or may submit purchase orders for inventory electronically to the computer system of a supplier.

ii. EDI systems can improve the operational efficiency of an entity, but may also generate the following problems for the auditor who has to assess the efficiency of the system controls.

- The lack of a paper audit trail
- An increased level of dependence on the computer systems of the organisation and possibly the computer systems of other entities. Any failure or control weakness in one computer system may have an impact on the computer system that is being audited.
- There may be a risk of loss or corruption of data in the process of transmission; and
- There will be security risks in the transmission of data.

iii. Auditors should expect to find effective controls in place to minimise the risks inherent in EDI systems. Typically, controls will cover such matters as:

- Controls over transmission of data, such as the encryption of data before transmission, acknowledgement systems, and the use of authentication codes for senders of data;
- Monitoring and checking of output;
- Virus protection systems; and
- Contingency plans and back-up arrangements.

EXAMINER'S REPORT

The question tests candidates' understanding of information and communication technology (ICT).

Being a compulsory question, about 99% of the candidates attempted the question, but performance was poor.

The commonest pitfall of the candidates was inability to differentiate between on-line systems and electronic data interchange.

Candidates are enjoined to read the Institute's Study Text properly before enrolling for future examinations.

Marking Guide		Marks	Marks
a.	Definition of on-line system	2	
	Operational advantages to users (2 marks each for any 2 points)	4	6
b.	General controls (2 marks each for any 3 points)	6	
	Application controls (1 mark each for any 3 points)	3	9
c.	Explanation of EDI	2	
	Areas of operation of EDI (2 marks each for 2 points)	4	
	Problems that may be generated for the auditor (1 mark each for any 4 points)	4	
	Controls to be put in place to minimise risks ($1\frac{1}{4}$ mark each for any 4 points)	5	15
	Total		**30**

SOLUTION 2

SECTION B

ai. Advantages of joint audits include:

- A large company may, because of its size benefit from the services of more than one firm of auditors in order to sufficiently cover its operations;
- After the acquisition of a large subsidiary, using joint auditors may help the transition process while the group auditors become familiar with the new subsidiary. The 'old' auditors should be familiar with the business of the subsidiary and should pass their knowledge over to the parent company auditors.

For the parent company auditors, this should accelerate the process of getting to know the business of the new subsidiary;

ii. Joint auditors may provide a higher level of technical expertise than either audit firm could provide individually;

iii. Improved geographical coverage may be obtained for the audit, where each of the joint auditors on its own does not have offices that cover all the geographical locations of the component companies in the group;

- Improve quality of work done by the auditors;
- Reduces time spent on audit;
- Sharing of experience between firms; and
- It has been suggested that two medium-sized accountancy firms might join forces and tender for the audit of a company for which the auditors would normally be one of the 'Big 4' accountancy firms. This is possibly a way in which medium-sized firms might try to 'break the monopoly' of the Big 4 on large company audits.

iv. **Disadvantages of joint audits**

Possible disadvantages of joint audits include the following:

- The extra cost to the client. It is likely to cost more to use two accountancy firms than one;
- The possible difficulty the two firms may have in agreeing the division of work and coverage of branches;
- Difficulty in sharing the audit fees between the firms; and
- There is joint liability for claims against the firms.

b. Areas of focus at the planning meeting between the two audit firms are:

i. Introduction of the audit firms and their participating staff

ii. Planning meetings and sessions to ensure the effective delivery of the assignment;

iii. Communication channels for the joint auditors and the management of the company being audited;

iv. Documents to be prepared by each firm and the review of working papers of the component auditors;

v. Risk assessment of the client, based on the previous issues raised;

vi. Evaluation of the audit procedures to be performed to address the risk identified in the evaluation of the client's systems;

vii. Materiality basis for the various accounts and account balances; and

viii. Agreement of fees between the parties.

c) The audit approach to address each of the issues include:

i. **Property plant and equipment (PPE) acquired during the previous year and substantial loan above the limit authorized for a sector of the economy**

- Confirm the cost of acquisition of the PPE by checking the official receipt obtained when they were acquired.
- Review the minutes of the board of directors' meeting which gave rise to the acquisition of the PPE.
- Confirm the calculation of the depreciation for the year using company accounting policy.
- Confirm the authorisation of the loan obtained during the period.
- Ascertain the existence of the loan by comparing the interest charged on it.
- Review the company's policy on loans vis-a-vis the amount obtained during the period.

ii. **Debit Balances**

This will require a thorough review of the items classified as debit balances on the statement of financial position.

The effect of the debit balance is a misstatement of both actual profit/performance and the financial position of the entity. Hence a detailed evaluation and proper classification will be necessary.

Excess tax paid:

The tax laws allow the over or under provision to be adjusted in the subsequent year. This allows for proper adjustments to be made on the tax issue. An evaluation needs to be made to determine whether this issue would result in a re-statement of the prior year statements of financial position.

iii. **IT operation**

- The IT operations require to be evaluated properly. There should also be a specified administrator. This will give authority to assign levels of control as functions overriding control could lead to fraud. There should also be sufficient audit trail of IT system, a situation activities report (systems log) to avoid where no particular person would be held accountable.

iv. **Decline in net current assets**

This could be made possible by a number of factors, such as:

- Growing current liabilities as a result of borrowings, or improper classifications of either assets or liabilities,

- Each of these options portends a negative signal and requires a proper review of the assets and liabilities balances to ensure that the appropriate amounts are recorded;

- Treatment and classification issues would be evaluated to ensure proper presentation in the financial statements and determination of a true position for the entity; and

- It would be important to also discuss with the appropriate level of management regarding the business operations and outlook of the entity.

EXAMINER'S REPORT

The question tests candidates' understanding of joint audit.

About 85% of the candidates attempted the question and performance was poor.

The commonest pitfall of the candidates was their inability to prepare agenda for the maiden meeting of the joint auditors and identification of key audit issues.

Candidates are advised to read the Institute Study Text properly and interpret questions correctly before attempting them.

Marking Guide		**Marks**
a.	1 mark each for any four advantages and four disadvantages	8
b.	1 mark each for any four points	4
c.	Identification of each of the four problems- 1 mark each	4
	Proposal of method of resolution - 1 marks each	4
	of each of the four problems	8
	Total	**20**

SOLUTION 3

a) **Procedures for gathering audit evidence**

i. **Inspection:** This involves looking at an item - support documents e.g. invoices, entries in accounting records of intangible assets.

ii. **Observation:** This involves watching a procedure e.g. physical inventory counts, distribution of wages, opening of mail. This procedure is limited to the point in time when the observation takes place. It should also be noted that the person performing the procedure may act differently when being observed.

iii. **Inquiry:** This involves seeking information from knowledgeable persons inside or outside the entity, evaluating responses to those inquiries, and corroborating those responses with other audit evidence. As such, inquiry alone does not provide sufficient audit evidence when performing controls or substantive testing. Other audit procedures are performed in conjunction with inquiry.

iv. **External confirmation:** A specific type of inquiry – seeking confirmation from a third party e.g. a bank or trade receivable.

v. **Recalculation:** This involves checking the mathematical accuracy of documents or records e.g. adding up the list of year-end trade receivables.

vi. **Re-performance**: This involves independently carrying out procedures or controls, which were originally performed by the client e.g. re-performing the aging of year-end trade receivables.

vii. **Analytical procedures:** This involves evaluating and comparing financial and/or nonfinancial data for plausible relationships and investigating unexpected fluctuations. For example, using period-to-period changes in the employee count and increase in payroll to develop an expectation for payroll expenses for current period and investigating unexpected differences/fluctuations.

b) **"Sufficient"** relates to the quantity of evidence. There must be enough audit evidence to support the auditor's conclusion or opinion.

"Appropriate" relates to the quality, relevance and reliability, of the evidence.

c) Principles that an auditor uses in assessing the reliability of audit evidence.

There are a number of general principles set out in ISA 500 to assist the auditor in assessing the reliability of audit evidence. These can be summarized as follows:

i. Audit evidence is more reliable when it is obtained from independent sources outside the entity under audit. However, internally generated audit evidence is more reliable when the related controls are effective;

ii. Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference. For example, observation of the operation of a control by the auditor is more reliable than inquiry about the operation of that control;

iii. Audit evidence is more reliable when it exists in documentary form. This could be paper, electronic or other medium. For example, a written record of a meeting taken at the time is more reliable than a subsequent oral representation of the matters discussed; and

iv. Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies, or documents that have been filmed, or otherwise transformed into electronic form. This is because the reliability of those other forms may depend on the controls over their preparation and maintenance.

di. Audit Procedures for Bank and Cash balances

Bank Balances

- Request and obtain confirmation of balances from banks
- Review bank reconciliation statements and test the validity of reconciling items on a sample basis
- Review large or round-sum amounts just before and immediately after the reporting period.
- Agree balances in the bank confirmation to the bank reconciliation statements.
- Assess audit significance of other information in the confirmation obtained from the bank.
- Perform analytical procedures

Cash Balances

i. Carry out cash counts and agree amounts in the ledger to cash count certificates.

ii. Check that postings are made correctly to ledger accounts.

dii. **Audit Procedures for Payroll**

- Check the arithmetical accuracy of the calculations in payroll and payroll records.
- Check postings to ledger accounts.
- Check that correct pay rates are used.
- Check that correct, authorised rates are used for statutory deductions, such as tax and voluntary deductions.
- Check that overtime, bonuses and similar payments have been properly authorised.
- Check that inclusion of new employees are properly authorised
- Check that inclusion of new employees have not been paid for periods before they join or after they leave.
- Check the pay for hours worked or output produced against the authorised documentation.
- Check that payments of deductions have been made to the appropriate authorities
- Check the signed receipts for wages paid in cash.
- Check that the correct entries have been made in the wages control account.
- Verify the existence of a sample of employees on the payroll.
- When wages are paid in cash, observe the distribution of pay packets.
- Carry out analytical procedures, such as trend analysis and average pay per employee.

EXAMINER'S REPORT

The question tests candidates' understanding of audit evidence.

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

Marking Guide		**Marks**	**Marks**
a.	1 mark each for any six (6) procedures listed	6	
b.	1 mark each for explanation of Sufficient and Appropriate	2	
c.	1 mark each for the four (4) principles listed	4	
d.i)	1 mark each for any four (4) points	4	
ii)	½ mark each for any eight (8) points	4	20
	Total		**20**

SOLUTION 4

a) The determination of the viability of B & Z Pharmaceuticals Ltd. is to ascertain that the company is still a going concern. Viability implies continued existence and survival. Such continued survival and existence implies that the entity is a going concern.

Usually, entity's financial statements is prepared on the assumption that the entity will continue in operational existence in the foreseeable future. However, the financial, operational and other indicators will continue to show the appropriate signals.

ISA 570-Going Concern requires that the auditor of a company must perform risk assessment procedures to consider whether there are events or indications that may cast significant doubt on the entity's, ability to continue as a going concern.

Such assessment is usually in three areas of analysis as follows:

- Financial indicators;
- Operational indicators; and
- Other indicators

The questions to be asked will be on the indicators of assessing going concern in the three areas.

Questions on financial indicators

- **Maturing outstanding borrowings:** How much of outstanding borrowing have become due and are yet unsettled; what is responsible for their being unsettled?

- **Withdrawal of financial support:** What are the reasons for the withdrawal of financial support by the external financial suppliers?

- **Change of credit to cash from suppliers:** How many of the suppliers have cancelled credit sales to the company and have reverted to cash-on-delivery sales?

- **Inability to obtain financing for essential new development or other essential investment:** Has any approaches to any financing agency for funds for investment been rejected and to what extent?

Questions on operating indicators

- **Management intentions to liquidate the entity or cease operations:** Is there any consideration or intentions to liquidate the company or cease operations?

- **Loss of key management staff without replacement:** How many key management staff have resigned in the last twelve to twenty four months without replacement?

- **Loss of major market, key customer(s), franchise, license, or principal supplier(s):** Have there been losses of any key component of the business such as market share, specific big customer?
- **Labour difficulties e.g. riot, strike or conflict:** Has there been labour related issues and the nature of the specific issues in contention?

- **Shortage of important suppliers**: Has there been shortage of important suppliers to the company?

- **Emergence of highly successful competitor**: Has the business been threatened by the emergence of highly successful competitor? Any idea about the estimated share of the market under threat of being captured by the competitor?

Other indicators

- **Pending legal or legal regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy:** Are there any pending legal proceedings and what is the amount of the impending liability?

- **Change in law or regulation or government policy expected to adversely affect the entity**: Are there new laws or regulations that are expected to affect the company's business and how is this being handled?

- **Uninsured or underinsured catastrophes when they occur**: What are the expected value of the uninsured or underinsured catastrophes and what is the likelihood of occurrence?

b) If it is concluded that there is material uncertainty regarding the company's ability to continue as a going concern, an unmodified audit opinion will be issued on the financial statements since management has made sufficient disclosures in those financial statements.

However, the audit report will include an Emphasis of Matter which would be used to draw attention of users to the issue which is fundamental to the users' understanding of the financial statements.

EXAMINER'S REPORT

The question tests candidates' understanding of going concern.

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

The commonest pitfall of the candidates was lack of understanding of the question thereby giving same solution for parts 'a' and 'b'.

Candidates are advised to read and interpret questions correctly before attempting them.

Marking Guide		**Marks**
a.	2 marks each for any 8 points	16
b.	Decision on Emphasis of matter	2
	Decision on unmodified audit opinion and inclusion of reason	2
	Total	**20**

SECTION C

SOLUTION 5

a. Professional scepticism as defined by ISA is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. It requires the auditor to plan and perform an audit recognizing that circumstances may exist that cause the financial statements to be materially misstated. i.e. an inquisitive mind.

The need for professional scepticism in an audit cannot be overemphasized. Professional scepticism is an essential attitude that enhances the auditor's ability to identify and respond to conditions that may indicate possible misstatements. It includes a critical assessment of audit evidence. It also means being alert for audit evidence that contradicts other audit evidence or that brings into question the reliability of information obtained from management and those charged with governance (TCWG). This critical assessment is necessary in order for the auditor to draw appropriate conclusions.

b. Professional skepticism is relevant and necessary throughout the audit even though reference to it is not repeated within each ISA, including:

- engagement acceptance: integrity of owner and management;

- identifying and assessing risks of material misstatements;
- designing nature, timing and extent of further audit procedures that are responsive to assessed risks of material misstatements; and evaluating audit evidence; and
- forming audit opinion

c. The auditor can demonstrate the application of professional scepticism in the following ways:

   i. Communication: Professional scepticism is often demonstrated in the various communications and inquiries with management and those charged with governance (TCWG) held by the auditor during the course of an audit. For example, the auditor's communication with TCWG includes, where applicable, why the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework not to be most appropriate to the particular circumstances of the entity;
   ii. Documentation: Documentation remains critical. The ISAs require auditors to document discussions of significant matters with management, TCWG, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. Such documentation helps the auditor_demonstrate how significant judgments and key audit issues were addressed and how the auditor has evaluated whether sufficient and appropriate audit evidence has been obtained.

      Examples of circumstances where it is particularly important to prepare documentation include:

      - Significant decisions from engagement team discussions regarding fraud;
      - Identified or suspected non-compliance with laws and regulations;
      - Basis of auditor's conclusions about estimates;
      - Identifying information that is inconsistent with the auditor's final conclusions on a significant matter;
      - Reasonableness of areas of subjective judgments;

   iii. Use of persons with specialist skills to work on specific areas of the audit that relate to the specialist's skills-set; and

   iv. Consultation with more senior personnel of the audit or consultation with a technical unit set aside by the firm. Consultation with a regulator on a contentious issue is also one of the ways the auditor can demonstrate professional skepticism.

EXAMINER'S REPORT

The question tests candidates' understanding of professional skepticism.

About 85% of the candidates attempted the question but performance was poor.

The commonest pitfall was candidates' inability to interpret the questions properly thereby confusing part 'b' with 'c'.

Candidates are enjoined to read the Study Text in details and interpret questions correctly before attempting them.

Marking Guide		**Marks**
a.	1 mark each for 3 points	3
b.	1 mark each for any 3 points	3
c.	3 marks each for any 3 points	9
	Total	**15**

SOLUTION 6

a. When the group auditor plans to request a component auditor to perform work on the financial information of a component, he must assess the following issues:

   i. Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit. In particular that he is independent;
   ii. The component auditor's professional competence;
   iii. Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence; and
   iv. Whether the component auditor operates in a regulatory environment that actively oversees auditors.

   The group auditor cannot simply rely on the work performed by the component auditor without assessing the likely quality of that work. If the component auditor is not independent or there are serious concerns about any of the other matters above, the group auditor will need to obtain evidence.

b. The three principles when determining the type of work to be performed on each of the components are as follows:

   i. Where a component is of individual financial significance to the group, the group auditor or a component auditor must perform an audit using component materiality;

ii. Where a component is significant because of likely significant risk of material misstatement, the group auditor or a component auditor must perform one or more of the following:

- An audit using component materiality;
- An audit of one or more account balances, classes of transactions or disclosures, depending on where the risk of material misstatement lies; and
- Specified audit procedures to address the risk of material misstatement; and

iii. For non-significant components the group auditor should perform analytical procedures at a group level. If the group auditor does not consider that sufficient appropriate audit evidence will be obtained from all of the above work, then additional work should be performed on non-significant components, similar to that for significant components. The selection of such components should be varied from year to year.

However, linking specific considerations to relevant components in the group, the following principles will be adopted by the auditor:

Goodlife Investment Plc (GIP)

- This is a component that is of individual significance to the group and also acts as a parent company:

- The group auditor in the name of Messrs. JPM & Co. should perform its audit using the following principles:

i. Its component materiality
ii. An audit of one or more account balances, classes of transactions such as valuation of financial instruments
iii. Specific audit procedures to address the risk of material misstatements e.g. ascertain whether revenue recognition has been treated in line with relevant IFRS.

Goodlife Investments South Africa Limited (GISAL) and Goodlife Properties and Real Estate Services (GPRS)

These are also significant components and the same principle mentioned above apply.

Goodlife Insurance Limited (GIL) and Goodlife Stores Limited (GSL)

The two companies above are insignificant components and as such the component auditor should perform analytical procedures to obtain relevant audit evidence in carrying out their audit.

In addition, GIL audit emphasis should be placed on appropriate valuation of insurance liabilities as this constitute significant risk of material misstatements.

c. **Contents of group auditor's instruction to the component auditor**

The group auditor's instructions to the component auditor should set out the following:

- the work required;
- the use to be made of that work;
- the form and content of the component auditor's communication with the group engagement team;
- a request for co-operation;
- ethical requirements;
- component materiality; and
- identified significant risks.

EXAMINER'S REPORT

The question is on group audit.

About 30% of the candidates attempted the question but performance was poor.

The commonest pitfall of the candidates was that rather than giving comments on each event, they gave a summary comment.

Candidates are advised to read and interpret the question correctly before attempting it.

They should also read the Study Text properly while preparing for future examinations.

Marking Guide		**Marks**
a	1 mark each for any 4 points	4
b	1 mark each for any 9 points	9
c	½ mark each for any 4 points	2
	Total	15

SOLUTION 7

a(i) An Emphasis of Matter (EOM) paragraph is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed within the financial statements, that, in the auditor's judgement is of such importance that it is fundamental to the users' understanding of the financial statements. ISA 706 states that the paragraph must only be used provided the auditor has sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph should refer only to information presented or disclosed in the financial statements.

The paragraph is therefore used to highlight a fundamental issue to the users of the financial statements. It does not relate to a disagreement or a limitation in scope, and therefore is not in any way a qualification of the audit opinion. An EOM paragraph should clearly state that the auditor's opinion is not modified in respect of the matter emphasized.

An EOM paragraph should include a clear reference to the matter being emphasized, and to where relevant disclosures that fully describe the matter can be found in the financial statements.

Examples are provided in ISA 706 of the potential situations in which an EOM paragraph may be used:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action;
- Early application, where permitted, of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date;
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position; and
- Significant going concern issues.

(ii) Other Matter paragraph deals with a matter which is not included in the financial statements but which is relevant to an understanding of the audit, the auditor's responsibilities, or the auditor's report.

ISA 706 gives the following examples of circumstances in which an 'other matter' paragraph may be necessary:

- Where the auditor is unable to resign from the engagement even though the possible effect of a limitation of scope imposed by management is pervasive (relevant to users' understanding of the audits). This should be rare in practice;

- Where local law or custom allows the auditor to elaborate on his responsibilities in his report, (relevant to users' understanding of the auditors responsibilities or audit report); and

- If revision of other information issued with audited financial statements e.g the director's report is considered necessary by the auditor but management refuses to make the revision.

b. **When the auditor must issue a modified opinion**

ISA 705-Modifications to the Opinion in the Independent Auditor's Report requires the auditor to modify his opinion in the audit report in two situations:

Material misstatement: This occurs when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are 'not free from material misstatement'. In other words, the auditor considers that there is a material misstatement in the financial statements; and

Limitation on scope: This occurs when the auditor is unable to obtain sufficient appropriate evidence to conclude that the financial statements as a whole are free from material misstatement. In other words, the auditor has been unable to obtain sufficient appropriate audit evidence to reach an opinion that the financial statements give a true and fair view. Therefore the financial statements may contain a material misstatement.

ISA 705 suggests that a limitation on scope may occur as a result of:

- circumstances beyond the control of the entity, such as when the entity's accounting records have been destroyed;

- circumstances relating to the nature or timing of the auditors work: an example is when the auditor is appointed too late to enable him attend the physical inventory count;

- limitations imposed by management. Management of the client entity may prevent the auditor from obtaining the audit evidence required, for example by:
    - preventing the auditor from observing the physical inventory count;

- preventing the auditor from asking for confirmation of specific account balances, for example, receivables circularization; and

- Non-receipt of written representations requested by the auditor from management/those charged with governance.

EXAMINER'S REPORT

The question tests candidates' understanding of some international standards on auditing, particularly ISA 705 and ISA 706.

About 95% of the candidates attempted the question but performance was poor.

The commonest pitfall of the candidates was their inability to restrict themselves to the specific requirements of the question.

Candidates are enjoined to read the Study Text properly and interpret the question correctly before attempting it.

Marking Guide		**Marks**	**Marks**
a.(i)	3 marks for the explanation of EOM	3	
	1 mark each for any three (3) points	3	
(ii)	2 marks for the explanation of OM	2	
	1 mark for any two (2) points	2	10
b.	$2^1/_2$ marks each for the two (2) situations		5
	Total		**15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2018

CASE STUDY

Time Allowed: 4 hours (including reading time)

INSTRUCTION: YOU ARE TO USE THE CASE STUDY ANSWER BOOKLET FOR THIS PAPER

DOVE INVESTMENTS LIMITED

You are Daniel Opara, a financial consultant in the firm of Global Business and Financial Consulting Services, specializing in business advisory and financial engineering services.

You received an email from your Managing Partner, Yusuf Sanni (exhibit 1), asking you to work on an assignment recently giving to your firm by Dove Investments Limited (DIL), one of your clients.

DIL has requested your firm to advise whether or not to increase its investment in Creative Homes Mortgage Bank Limited, a primary mortgage bank.
The following time allocation is suggested:

Reading	1hour
Planning and calculation	1hour
Drafting report	2hours
	4hours

LIST OF EXHIBITS

EXHIBIT DESCRIPTION

1. Email from Yusuf Sanni to you Daniel Opara, a financial consultant.

2. Letter from Tobi Adeola, the Managing Director/CEO of Dove Investments Limited.

3. 4-year statement of profit or loss and other comprehensive income of Creative Homes Mortgage Bank Limited.

4. 4-year summary of statement of financial position of Creative Homes Mortgage Bank Limited.

5. Highlights of strategic plan of Creative Homes Mortgage Bank Limited.

6. Organogram of Creative Homes Mortgage Bank Limited.

7. Primary mortgage banks industry.

Exhibit 1

GLOBAL BUSINESS AND FINANCIAL CONSULTING SERVICES

Email

To: Daniel Opara

From: Yusuf Sanni

Re: Dove Investments Limited

Date: October 10, 2017

Refer to our meeting in my office this morning in respect of our above client. I will like you to carry out a thorough analysis of the summarized 4 year financial statements together with the relevant notes (exhibits 3 to 4) to evaluate the financial health of Creative Homes Mortgage Bank Limited (CHMBL). Note that the result of your analysis will form the basis of our advice to Dove Investments Limited (DIL) whether or not to go ahead with the planned increase of its investment in CHMBL.

You are also required to appraise CHMBL's current 4 year Strategic plan, as contained in exhibit 5. To assist you on this, our research department has carried out an industry analysis of the primary mortgage banks in the country, a copy of the report is attached herewith as exhibit 7.

Your report should include:

1. An evaluation of the performance together with the financial health of CHMBL in the past four years, taking into consideration the returns to date on DIL's current investment in CHMBL, the bank's future prospect and advise whether DIL should go ahead with the planned increase in its investment or not; and

2. An analysis and evaluation of CHMBL's 5 year strategic plan, 2016 – 2020, and state the possibility, giving the current financial health of the bank, of achieving the bank's strategic objectives within the plan period. Your report should include advice to the board of DIL on what step to take to strengthen the strategic position of the bank for better future performance and guaranty the security of DIL's investment in CHMBL.

I am aware that you currently have other assignments you are working on, however, I will like you to give this assignment a top priority as I have promised the Chief Executive Officer (CEO) of DIL that we will turn in our report within seven (7) working days. I would be grateful therefore if I can receive your draft report for my consideration within five (5) working days from today.

Yusuf Sanni

Exhibit 2

DOVE INVESTMENTS LIMITED
5, Olive Avenue, Old GRA, Ikeja, Lagos.

The Managing Partner,
Global Business and Financial Consulting Services,
3 Glover Street,
Ikoyi,
Lagos.

12 October, 2017

Attn. Yusuf Sanni, FCA

Dear Sir,

INVESTMENT IN CREATIVE HOMES MORTGAGE BANK LIMITED

This is a follow up to my telephone conversation with you earlier this morning. Our board is asking for your firm's advice on our intention to increase our investment in the above bank.

As I discussed with you during our discussion, the bank is looking for additional funding to shore up its share capital base and to fund its current strategic plan. The board of the bank has invited us, being their major shareholder, to increase our holdings in the bank.

Our board will, therefore, like you to carry out an analysis of the bank's financial health, with emphasis on the bank's performance, security and safety of shareholders' fund and future potentials. To assist you on this assignment, I enclosed herewith the banks' four years summarized financial statements, together with relevant notes.

Also enclosed is the highlights of the bank's current five years strategic plan, 2016 – 2020, to enable you appraise the company's business with a view of reporting on the possibility of the bank's achieving its strategic objective of transiting into a deposit money bank during the bank's next strategic plan period, 2021 – 2025 as contained in the bank's current strategic plan. The bank's current organization structure is attached to the highlights of the strategic plan to assist you to do a thorough analysis and comment on the ability of the bank's current management set up to drive the strategic plan.

This is an urgent assignment and I will be looking forward to seeing your report in the next one week. I trust, as usual, you will deliver.

Thanks for your usual assistance.

Yours faithfully,
For: **Dove Investments Limited**

Tobi Adeola
Managing Director/CEO

Exhibit 3

CREATIVE HOMES MORTGAGE BANK LIMITED
Financial statements summary
Statement of profit or loss and other comprehensive income

	2013	2014	2015	2016
	₦'m	₦'m	₦'m	₦'m
Interest income	1,177.8	1,616.6	1,803.8	2,093.2
Interest expenses	661.8	585.3	1,014.0	1,048.5
	516.0	1,031.3	789.8	1,044.7
Income from sale of properties	1,031.0	586.8	932.8	631.0
Other income	87.8	369.8	79.6	180.1
Operating income	**1,634.8**	**1,987.9**	**1,802.2**	**1,855.8**
Operating expenses:				
Impairment charges	192.3	366.3	227.0	257.9
Depreciation and amortization	137.4	168.6	170.2	176.2
Personnel costs	759.3	1,192.2	989.7	992.0
Administration and marketing	234.8	260.3	242.3	253.4
Bank charges	51.3	45.3	52.5	39.3
	1,375.1	**2,032.7**	**1.681.7**	**1,718.8**
Profit or (loss) before tax	259.7	(44.8)	120.5	137.0
Tax expenses/income	18.4	20.8	(102.8)	(28.1)
Profit or(loss) after tax	278.1	(24.0)	17.7	108.9
Fair value profit or (loss) on investments	144.6	(23.6)	(13.2)	(1.0)
Total comprehensive income for the year	**422.7**	**(47.6)**	**4.5**	**107.9**

Exhibit 4

CREATIVE HOMES MORTGAGE BANK LIMITED
Financial statements summary
Statement of financial position

	2013 ₦'m	2014 ₦'m	2015 ₦'m	2016 ₦'m
Cash and balances with banks in Nigeria	1,880.3	1,515.5	1,320.7	3,388.8
Investments in treasury bills	-	-	-	150.0
Mortgage loans	7,998.2	8,997.9	9,318.1	10,200.0
Investments	86.4	376.8	288.0	281.4
Properties held for sale	6,516.9	9,098.2	-	-
Receivables and prepayments	583.3	443.2	8,294.4	8,180.7
Intangible assets	161.7	103.1	62.1	48.3
Deferred tax assets	-	153.6	52.5	52.5
Property, plant and equipment	584.2	666.5	708.3	582.7
	17,811.0	**21,354.8**	**20,044.1**	**22,884.4**
Liabilities:				
Customers' deposits	5,228.5	7,755.6	7,000.3	9,432.8
Obligations to NHF	2,463.3	3,103.7	2,398.0	2,427.3
Tax payable	97.2	208.0	169.7	43.1
Staff gratuity obligations	386.4	349.8	238.6	125.6
Accrued expenses and other liabilities	555.2	538.6	606.9	859.2
	8,730.6	11,955.7	10,413.5	12,888.0
Net Assets	**9,080.4**	**9,399.1**	**9,630.6**	**9,996.4**
Equity:				
Share capital	5,000.0	5,000.0	5,000.0	5,000.0
Share premium	3,245.0	3,245.0	3,245.0	3,245.0
Retained earnings	(237.2)	(284.8)	(280.3)	(172.4)
Statutory reserves	626.8	626.8	626.8	626.8
Prudential regulatory reserves	445.8	812.1	1,039,.1	1,297.0
	9,080.4	**9,399.1**	**9,630.6**	**9,996.4**

NOTES

1. The properties held for sale were disposed off in 2015 in compliance with the Central bank of Nigeria's regulations that primary mortgage banks should divest from direct property trading. Receivables in 2015 and 2016 include amounts outstanding for collection from the sale.

2. The provision for risk assets impairment is in accordance with the Central Bank of Nigeria's prudential guidelines.

3. The fair value of the bank's ordinary share has been estimated to be ₦1.00 per share.

Exhibit 5

HIGHLIGHTS OF STRATEGIC PLAN: 2016 - 2020

Market & Growth Strategies

- Strengthen our leadership focus by maintaining strategic investment and partnership with businesses that are complementary to our core services.
- Focus on the provision of affordable mortgages.
- Strengthen business acquisition that is focused along specific segment/ market.
- To be one of the top 5 mortgage banks in Nigeria with demonstrative strong market dominance and leadership across key financial indicators.
- Be the market leader in service delivery in our chosen markets and target customer segment.
- Strengthen CHMBL's brand through brand repositioning and thought leadership engagements that will set CHMBL as the leading mortgage bank brand in Nigeria.
- Adoption of a highly integrated Bank-wide marketing strategy where every member of staff is a marketer. An achievable target will be set for each category of staff with incentive package attached to motivate performance.
- Branch expansion shall be vigorously pursued to increase service channels and growth of the customer and deposit base of the bank.
- CHMBL will introduce new savings account products that encourage depositors to "save to own" their own homes – one of such products is the newly introduced Creative Home Savings Account (CHSA).
- Lack of affordable housing stock is one of the challenges PMBs face in Nigeria. CHMBL will establish a strategic alliance with reputable estate developers and in-turn will offer mortgages to the developers' off-takers. This will give CHMBL an instant pool of mortgage customers.
- Management shall maximize interest income, expand non-interest income base and adopt stringent cost management approach to grow the bank's profitability during the plan period.
- CHMBL shall strive to build on the brand name by being visible to and remaining in the minds of people in Nigeria. Therefore, CHMBL shall strive to develop products that meet the needs of identified target market as the need arises. We shall always ensure that our products are current, competitive and are sustainable.
- CHMBL shall position itself as one of the market marker and leaders in the industry.
- CHMBL shall create customers' service desks across branch network.
- CHMBL shall streamline the distribution of staff to reduce the high ratio of non-customer facing staff to customer facing staff.
- CHMBL shall introduce performance based account allocation.
- CHMBL shall carry out regular training of customer service officers on client service management and product knowledge.
- CHMBL shall, during the plan period create a Business Development directorate to drive retail and deposit mobilization.

- CHMBL shall carry out a revision and simplification of existing mortgage products
- CHMBL shall strive to grow its loan portfolio and deposit base.
- CHMBL shall grow fee-based income by undertaking more investment banking activity.

Information technology

- CHMBL intends to upgrade its ICT offering with the introduction of more e-banking products, such as on-line banking, debit cards etc.
- CHMBL shall collaborate with a commercial bank for the provision of convenient banking services (debit card and prepaid card).
- CHMBL shall introduce automation of credit origination and implementation of straight through operations system to reduce error rates and manual processing.
- Set up a structured archiving system.

People and culture

- CHMBL shall constantly carry out aggressive training programs for all level of staff.
- CHMBL shall introduce Corporate and Employee Performance Management Systems (PMS).
- CHMBL shall review and establish a robust Management succession plan.
- CHMBL shall entrench a culture of reward and sanction system.

Risk Management

- CHMBL shall ensure that every transaction must cover all associated costs including percentages return to stakeholders, reasonable profit and affordable price. This strategy would also guide the risk management and investment decision in line with the guidelines provided by CBN, NDIC and FMBN from time to time.
- CHMBL shall institutionalize Enterprise Risk Management Framework (ERM).
- CHMBL shall establish bank wide risk acculturation programs.
- CHMBL shall establish a strong corporate governance framework.
- CHMBL shall carry out extensive training of all levels of staff on risk policies and processes.
- CHMBL shall introduce framework for Key Risk Indicators (KRI) and Risk Control Self-Assessment (RCSA).

Injection of new capital

To finance the strategic plan, CHMBL aims to attract new investment in equity and debt to enable it serves its customers better. CHMBL is currently looking for equity investor (s) to acquire a minimum of 20 % stake in its operations, the ideal equity investor would be one that can add value to CHMBL through capacity development and access to long term loanable funds.

Long term strategic focus

The focus is to eventually transit to a commercial bank in Nigeria in the next strategic plan period, 2021 – 2025.

Strategic Targets

Financial indicators:

		Conservative ₦	Preferred ₦
Loans:	2016	10.5b	12.5b
	2017	11.5b	13.8b
	2018	12.7b	15.2b
	2019	14.0b	16.7b
	2020	15.4b	18.4b
Deposits:	2016	12.5b	15.0b
	2017	13.8b	16.5b
	2018	15.2b	18.2b
	2019	16.7b	20.0b
	2020	18.4b	22.0b
PBT:	2016	305.0m	465.0m
	2017	335.5m	511.5m
	2018	369.1m	562.6m
	2019	405.9m	618.9m
	2020	446.5m	680.8m

Exhibit 6

ORGANOGRAM

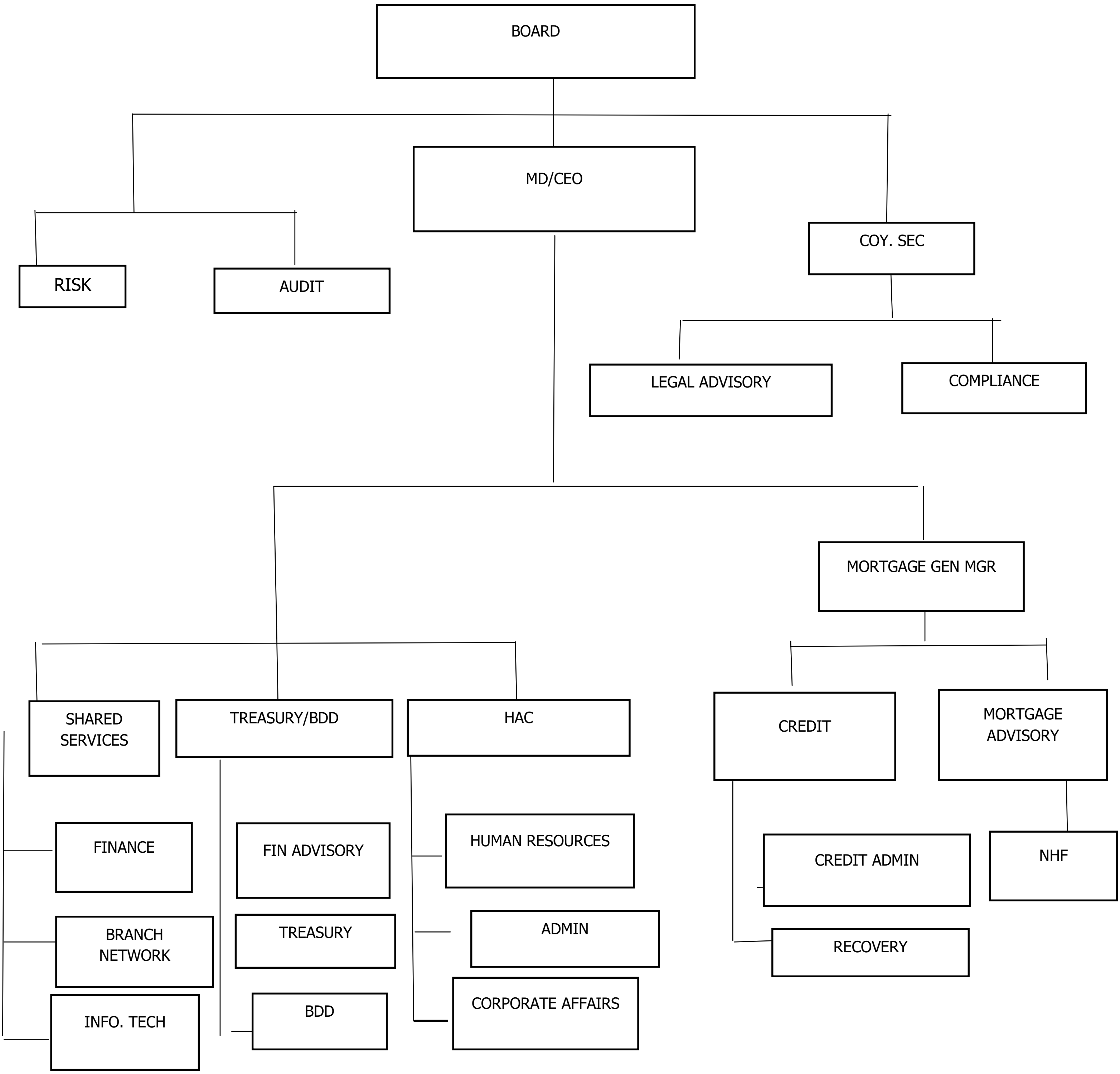


Exhibit 7

THE NIGERIAN PRIMARY MORTGAGE INDUSTRY

The Mortgage Industry in Nigeria and its Outlook

The Nigerian Primary Mortgage Industry falls under the category of "Other Financial Institutions" as defined by the Central Bank of Nigeria and operates under the guidelines contained in the amended Banks and Other Financial Institutions Act of 1991 (BOFIA).The Central bank of Nigeria (CBN) has the primary oversight function of regulating non-bank financial institutions with responsibility for monitoring Microfinance Banks, PMIs, FMBN and other local development finance institutions.

Competitive rivalry in the industry is ranked low. This is because the awareness of obtaining mortgage loans is low and time consuming, with costly process of title documentation by the authorities. The non-existence of laws instituting mortgage securitisation as well as mortgage friendly laws backing the execution of non-judicial foreclosure mechanisms and the high cost of funds may discourage potential investors. Mortgage companies are continuously seeking ways to attract customers by developing products that offer lower rates of interest and longer repayment periods, all aimed at increasing customer base and ensuring customer loyalty.

The Mortgage Sector in Nigeria has 100 licensed Primary Mortgage Institutions. 15% (15) of which have State coverage while about 85% have National coverage. The South West has the highest number of PMIs, which accounts for over 60% of the total number of PMIs in Nigeria. Some of these PMIs in the South West are Commercial Banks and Financial Institutions related, few are owned by State Governments while the remaining are owned by private individuals and other non-bank organisations.

Lagos State has the highest number of PMIs in Nigeria with more than 50% of the PMIs, followed by Abuja with about 10% of the PMIs.

The mortgage industry is expected to experience a major boost in activity as a result of the reforms of the Federal Government in mortgage delivery services and monetisation of major personnel costs.

The major risks confronting the industry are:

Business Risk- repayment default: The risk of borrowers being unable to repay their obligations to the Company, which could erode its capital.

Sectorial Risk: The potential reoccurrence of banking crisis may result in systemic risk considering the level of inter-bank activity within the industry. However, the banking and mortgage sector reforms, and the recent increase in regulatory activities by the Central Bank of Nigeria is expected to improve service excellence and surveillance in the Banking industry.

Political risk: Adverse changes in banking legislation, CBN policies, or the general instability and uncertainty that characterise the Nigerian political climate could impact the Bank's business. The political risks profile has been adversely affected by the Boko Haram situation. However, the resolve of the Federal Government to address the Boko Haram issue will restore confidence and promote business.

OPPORTUNITY FOR GROWTH

There is a huge potential for growth in the industry. This is because the real estate sector of the nation's economy remains highly untapped. With an estimated population going to 200 million, Nigeria housing deficit is glaring, particularly in the urban centers. The Federal Ministry of Works and Housing in year 2013, estimated the housing deficit at 17 million units. These would require over N68 trillion to finance at an average of ₦4 million per unit. This means, Nigeria need to produce about 850,000 housing units annually for the next 20 years, in other to close the gap. The Federal Housing Authority (FHA) revealed that it has only been able to produce 8,000 units of housing units between 2010 and 2013. The situation has not changed significantly in 2016 as a result of the current economic problem the country is grappling with. It is therefore obvious, that there is a critical housing condition in Nigeria. Put in proper prospective, it shows that there is a huge market for real estate housing development and immense opportunities for Mortgage finance in Nigeria.

ICAN CASE STUDY 2018

First Marking

DATE		CANDIDATE NO.	

TIME		MARKER NUMBER	

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

SUPERVISOR SIGNATURE		CHECKER SIGNATURE	

Change made? ☐

REQUIREMENT 1 – CHMBL's Financial Analysis

USES DATA AND INFORMATION APPROPRIATELY

- Uses information provided in Exhibit 1
- Uses information provided in Exhibit 2
- Uses information provided in Exhibit 3 – Income statement
- Uses information in exhibit 4 – statement of financial position
- Uses information in exhibit 5 – strategic plan

V	NC	BC	CA	SA

IDENTIFIES ISSUES AND OPTIONS

- Identifies that CHMBL has not paid dividend since 2013
- Identifies that CHMBL's performance from 2013 to 2016 was not impressive
- Identifies that CHMBL's growth from 2013 to 2016 was minimal
- Need to consider how to integrate BBNL's staff into the culture of TDNL.

V	NC	BC	CA	SA

USES PROFESSIONAL TOOLS AND KNOWLEDGE

- Calculates profitability ratios
- Calculates activity ratios
- Calculates leverage ratios.
- Prepare CHMBL's trend analysis.
- Prepares common size analysis to show trends in the components of the financial statements

-

V	NC	BC	CA	SA

APPLYING PROFESSIONAL SCEPTICISM AND ETHICS

- Recognises that we are not told whether the summarised financial statements have been audited
- Recognises that we do not have industries averages of the ratios with which to benchmark CMBL's performance.
- Recognises that since CHMBL has sold its properties held for sale, income will no longer flow from this source from 2017 and it is one of the major area of revenue to the bank.

V	NC	BC	CA	SA

USESG ANALYTICAL SKILLS (material points)

Written report

- Determines the rate of growth in CHMBL's operating performance.
- Determines that despite increase in interest income, the bottom line was not impacted because interest cost was very high. An indication that the company's deposit mobilisation was from costly sources, e.g. term deposit.
- Determines that CHMBL did no meet its financial targets in 2016 as contained in the bank's strategic plan.
- Determine that CHMBL's operating cost was very high, especially its personal costs.

V	NC	BC	CA	SA

EVALUATIVE SKILLS AND JUDGEMENT

- Evaluates the performance of CHMBL and explain its volatility.
- Evaluates why CHMBL has not paid dividends from 2013 to 2016.
- Evaluates the effect of income from prosperities on the performance of CHMBL and what this means to the future profitability of CHMBL.
- Evaluates the fact that CHMBL's liabilities have been growing and has grown more than the bank's equity fund from 2013 to 2016.

V	NC	BC	CA	SA

CONCLUSIONS
(Draws distinct conclusions under a heading)

 Concludes that the returns of DIL's investment in CHMBL since 2013 has been minimal and only in terms of growth.

 Concludes that CHMBL has not paid any dividends to DL since the time it acquired the bank's share.

 Concludes that CHMBL has not achieved any noticeable growth since 2013.

 Concludes that the gearing of CHMBL is growing rapidly and this may mean a threat on DIL's investment in the bank.

 Concludes that increasing DIL's investment in CHMBL as at now may be riskly.

V	NC	BC	CA	SA

RECOMMENDATIONS (commercial / relevant)

 Recommends that DIL should not consider increasing its investment in CHMBL for now.

 Recommends that DIL should appoint an independent auditor to carry out a due diligence audit of CHMBL to discover the reason for present low performance.

 Recommends that DIL should get involved in the management of CHMBL by appointing at least one executive director to join the board to protect DIL's investment.

V	NC	BC	CA	SA

SA	
CA	
BC	
NC	
V	
Total	

REQUIREMENT 2 – Evaluation of CHMBL's Strategic Plan

USES DATA AND INFORMATION APPROPRIATELY	**IDENTIFIES ISSUES AND OPTIONS**
☐ Uses information on Exhibit 5 ☐ Uses information in Exhibit 6 ☐ Uses information in Exhibit 7 ☐ Uses information in exhibit 2	☐ Identifies that mortgage industry has not grown as it ought to ☐ Identifies that current economic recession is having a negative impact on mortgage business.
	☐ Identifies that the declining disposable income will further hinder ability of mortgage banks to perform well.
	☐ Identifies that the current management structure of CHMBL is very weak and may not be able to drive its strategic plan. ☐ Identifies that the company has no specific strength in the industry upon which it could build competitive advantage.
V NC BC CA SA	**V** NC BC CA SA
USES PROFESSIONAL TOOLS AND KNOWLEDGE	**APPLYING PROFESSIONAL SCEPTICISM AND ETHICS**
(written into report) ☐ Recognises PESTEL as the strategic tools to use to analyses CHMBL's business environment. ☐ Recognises SWOT analysis as the tool of analysis to determine CHMBL's position in the industry. ☐ Recognises the various elements of SWOT ☐ Recognises the purpose of strategic plan.	☐ Considers whether the summarised financial statement is from the audited accounts of CHMBL. ☐ Considers that the current management structure in CHMBL may not be able to drive its strategic plan. ☐ Considers the impact of the current economic environment on the achievement of CHMBL's strategic plan.= ☐ Consider the effects of declining disposable income in the country on the future performance of CHMBL:.
V NC BC CA SA	**V** NC BC CA SA
USESG ANALYTICAL SKILLS (material points)	**EVALUATIVE SKILLS AND JUDGEMENT**
☐ Evaluates the current management structure of CHMBL ☐ Evaluates the company's 2016's performances as compared with its strategic plan. ☐ Evaluates the organisation structure and note that ir does not show a clear succession plan. ☐ Evaluates the performance of CHMBL in line with the four pillars identified in the strategic plan	(Uses analytical headings) ☐ Evaluates each elements of PESTEL model and their effect on CHMBL. ☐ Evaluates CHMBL's strengths. ☐ Evaluates CHMBL's weaknesses. ☐ Evaluates opportunities in the business environment. ☐ Evaluates potential threats in the environment. ☐ Evaluates whether CHMBL has a competitive advantage over its competitors.
V NC BC CA SA	**V** NC BC CA SA

CONCLUSIONS
(Draws distinct conclusions under a heading)

- Concludes that CHMBL should us its current strategic plan to carve out a niche for itself in the industry.
- Concludes that CHMBL should endeavour to develop a competitive advantage by looking for a gap in the industry and build on it.
- Concludes that DIL should get involved in the management of CHMBL by appointing an experienced banker as an executive director.
- Concludes that CHMBL should set in motion specific actions to put in effect its strategic plan of market growth as contained in the strategic plan.
- Concludes that CHMBL, as it is currently, may not be able to meet its long term strategic plan of transiting into a deposit money bank.

V	NC	BC	CA	SA

RECOMMENDATIONS (commercial / relevant)

- Recommends that DIL should appoints an experienced banker to join the management team of CHMBL as an executive director.
- Recommends that DIL should impress it on the management of CHMBL to pursue aggressive expansion by opening up new branches in strategic locations in the country to drive deposit and growth.
- Recommends that DIL may need to carry out a due diligence on the bank so as to appraise itself of all issues at stake.
- Recommends that DIL needs to pay close attention to the operations of CHMBL by constantly monitoring its performance.
- Recommends that DIL should restructure the bank to position it for better performance.

V	NC	BC	CA	SA

Appendices	Main Report

Appendices

Appendices R1: Content and style

- Shows CHMBL financial ratios.
- Shows the CHMBL's trend analysis
- Shows CHMBL's common size financial statements.
- Shows comparison of CHMBL's 2016 performance with the strategic plan's financial targets

V	NC BC CA SA

Appendices R2: Content and

- Shows CHMBL's PESTEL analysis.
- Shows CHMBL's strengths.
- Shows CHMBL's weaknesses.
- Shows opportunities in the environment
- Shows threats in the environment.

V	NC BC CA SA

Main Report

Report: Structure

- Sufficient appropriate headings
- Appropriate use of paragraphs / sentences
- Legible
- Correctly numbered pages

V	NC BC CA SA

Report: Style and language

- Relevant disclaimer (external report)
- Suitable language for the board
- Tactful / ethical comments
- Acceptable spelling and punctuation

V	NC BC CA SA

CC	
SC	
IC	
ID	
NA	
Total	

REQUIREMENT 1

APPENDICE 1

Creative Homes Mortgage Bank Limited

Trend analysis - 2013 – 2016

Income statement

YEARS	2013	2014	CHANGE		2015	CHANGE		2016	CHANGE	
	N'm	N'm	N'm	%	N'm	N'm	%	N'm	N'm	%
Interest Income	1,177.8	1,616.6	-438.8	-37.3	1803.8	187.2	11.6	2093.2	289.4	16.0
Interest expenses	661.8	585.3	76.5	11.6	1,014.0	428.7	73.2	1048.5	34.5	3.4
	516.0	1,031.3	-515.3	-99.9	789.8	(241.5)	-23.4	1,044.7	254.9	32.3
Income from sale of properties	1,031.0	586.8	444.2	43.1	932.8	346.0	59.0	631.0	-301.8	-32.4
Other income	87.8	369.8	-282	-321.2	79.6	(290.20)	-78.5	180.1	100.5	126.3
Operating income	1,634.8	1,987.9	-353.1	-21.6	1,802.2	(185.7)	-9.3	1,855.8	53.6	3.0
Operating expenses:										
Impairment charges	192.3	366.3	-174	-90.5	227.0	(139.3)	-38.0	257.9	30.9	13.6
Depreciation and amortisation	137.4	168.6	-31.2	-22.7	170.2	1.6	0.9	176.2	6.0	3.5
Personnel costs	759.3	1,192.2	-432.9	-57.0	989.7	(202.5)	-17.0	992.0	2.3	0.2
Administrative and marketing costs	234.8	260.3	-25.5	-10.9	242.3	(18.0)	-6.9	253.4	11.1	4.6
Bank charges	51.3	45.3	6	11.7	52.5	7.2	15.9	39.3	-13.2	-25.1
	1,375.1	2,032.7	-657.6	-169.4	1,681.7	-351.0	-45.1	1,718.8	37.1	- 3.2

	2013	2014	CHANGE		2015	CHANGE		2016	CHANGE	
Profit or(loss) before tax	259.7	-44.8	**304.5**	**-349.3**	**120.5**	165.3	(139.2)	137.0	16.5	(148.8)
Tax expense	18.4	20.8	**-2.4**	**-13.0**	-102.8	(123.6)	-594.2	-28.1	74.7	-72.7
Profit or(loss) after tax	278.10	(24.00)	302.1	**108.6**	17.7	41.70	(733.43)	108.90	91.20	(221.47)
Fair value profit or (loss) on investments	144.6	-23.6	**168.2**	**116.3**	-13.2	10.4	-44.1	-1	12.2	-92.4
Total comprehensive income for the year	422.7	(47.6)	**470.3**	**111.3**	4.5	52.1	-109.5	107.9	103.4	2297.8

Statement of financial position

	2013	2014	CHANGE		2015	CHANGE		2016	CHANGE	
	N'm	N'm	N'm	%	N'm	N'm	%	N'm	N'm	%
Assets:										
Cash and balances with banks in Nigeria	1,880.3	1,515.5	364.8	19.4	1,320.7	-194.8	-12.9	3,388.8	2,068.1	156.6
Investments in treasury bills	-	-			-			150.0		
Mortgage loans	7,998.2	8,997.9	-999.7	-12.5	9,318.1	320.2	3.6	10,200.0	881.9	9.5
Investments	86.4	376.8	-290.4	-336.1	288.0	-88.8	-23.6	281.4	-6.6	-2.3
Properties held for sale	6,516.9	9,098.2	-2581.3	-39.6	-		-	-		
Receivables and prepayments	583.3	443.2	140.1	24.0	8,284.4	7,841.2	1,769.2	8,180.7	- 103.7	-1.3
Intangible assets	161.7	103.1	58.6	36.2	62.1	-41.0	-39.8	48.3	- 13.8	-22.2
Deferred tax asset	-	153.6	153.6		52.5	-101.1	-65.8	52.5	-	-
Properties, plant and equipment	584.2	666.5	-82.3	-14.1	708.3	41.8	6.3	582.7	- 125.6	-17.7
Total assets	**17,811.0**	**21,354.8**	**-3543.8**	**-19.9**	**20,034.1**	**-1,320.7**	**-6.2**	**22,884.4**	**2,850.3**	**14.2**
			0			-			0	
Liabilities:			0			-			0	
Customers' deposit	5,228.5	7,755.6	-2527.1	-48.3	7,000.3	-755.3	29.9	10,432.8	3,432.5	49.0

						-	-			
Obligations to NHF	2,463.3	3,103.7	640.4	26.0	2,398.0	705.7	22.7	2,699.3	301.3	12.6
				-		-				-
Tax payable	97.2	208.0	-110.8	114.0	169.7	38.3	34.6	43.1	- 126.6	74.6
						-	-			-
Staff gratuity obligations	386.4	349.8	36.6	9.5	238.6	111.2	303.8	125.6	- 113.0	47.4
Accrued expenses and other liabilities	555.2	538.6	16.6	3.0	606.9	68.3	411.4	859.2	252.3	41.6
				-		-				
	8,730.6	**11,955.7**	**-3225.1**	**36.9**	**10,413.5**	**1,542.2**	**12.9**	**12,888.0**	**2,474.5**	**23.8**
Net assets	**9,080.4**	**9,399.1**	**-318.7**	**3.5**	**9,630.6**	**231.5**	**2.3**	**9,996.4**	**365.8**	**3.8**
Equity:										
Share capital	5000	5000	0	-	5000	-	-	5000	0	-
Share premium	3245	3245	0	-	3245	-	-	3245	0	-
				-		-				
Retained earnings	-237.2	-284.8	47.6	20.1	-280.3	4.5	1.6	-172.4	107.9	- 38.5
Statutory reserves	626.8	626.8	0	-	626.8	-	-	626.8	0	-
				-						
Prudential regulatory reserves	445.8	812.1	-366.3	82.2	1,039.10	227	28.0	1,297.00	257.9	24.8
				-						
	9080.4	9399.1	-318.7	3.5	9630.6	231.5	2.5	9996.4	365.8	3.8

APPENDICE 2

Creative Homes Mortgage Bank Limited

Common size analysis 2013 – 2016

Income statement

YEARS	**2013**	**2014**	**2015**	**2016**
	%	**%**	**%**	**%**
Interest income	100.0	100.0	100	100.0
Interest expenses	56.2	36.2	56.2	50.1
	43.8	63.8	43.8	49.9
Income from sale of properties	87.5	36.3	51.7	30.1
Other income	7.5	22.9	4.41	8.6
Operating income	138.8	123.0	99.9	88.7
Operating expenses:				
Impairment charges	16.3	22.7	12.6	12.3
Depreciation and amortisation	11.7	10.4	9.43	8.4
Personnel costs	64.5	73.7	54.9	47.4
Administrative and marketing costs	19.9	16.1	13.43	12.1
Bank charges	4.4	2.8	2.91	1.9
	116.8	125.7	93.2	82.1
Profit or(loss) before tax	22.0	-2.8	6.7	6.5
Tax expense	1.6	1.3	6.0	-1.3
Profit or(loss) after tax	23.6	-1.5	1.0	5.2
Fair value profit or (loss) on investments	12.3	-1.5	-0.7	-0.0
Total comprehensive income for the year	35.9	-2.9	0.2	5.2

Creative Homes Mortgage Bank Limited

Common size analysis 2013 – 2016

Statement of financial position

YEARS	**2013**	**2014**	**2015**	**2016**
	N'm	**N'm**	**N'm**	**N'm**
Assets:				
Cash and balances with banks in Nigeria	21.7	17.6	15.3	38.8
Investments in treasury bills				1.7
Mortgage loans	92.4	104.5	108.3	116.9
Investments	1.0	4.4	3.3	3.2
Properties held for sale	75.3	105.6		
Receivables and prepayments	**6.7**	**5.1**	96.3	**93.8**
Intangible assets	1.9	1.2	0.7	0.6
Deferred tax asset		1.8	0.6	0.6
Properties, plant and equipment	6.7	7.7	8.2	6.7
Total assets	205.7	248.0	232.8	262.3
Liabilities:		-	0	
Customers' deposit	**60.4**	**90.1**	81.3	**119.6**
Obligations to NHF	33.3	45.2	39.6	30.9
Tax payable	1.1	2.4	2.0	0.5
Staff gratuity obligations	4.5	4.1	2.8	1.4
Accrued expenses and other liabilities	6.4	6.3	7.1	9.8
	105.7	148.0	132.8	162.3
Net assets	100.0	100.0	100	100.0

Equity:				
Share capital	57.7	58.1	58.0	57.3
Share premium	37.5	37.7	37.7	37.2
Retained earnings	- 2.7	- 8.9	-13.3	- 19.6
Statutory reserves	7.2	7.3	7.3	7.2
Prudential regulatory reserves	0.3	5.8	10.2	17.9
	100.0	100.0	100	100.0

APPENDICE 3

	2013	2014	2015	2016
RATIOS ANALYSIS				
PROFITABILITY				
Gross profit margin	516/1177.8%	1031.3/1616.6%	610.4/1803.8%	1044.7/2093.2%
	43.80%	63.79%	0.3384	49.91%
Net profit margin	259.7/1177.8	(44.8)/1616.6	120.5/1803.8	137./2093.2%
	22.04%	-2.77%	0.0668	6.55%
Returns on total assets				
Returns on capital employed (ROCE)	422.7/17811.0%	(47.6)/21354.8%	4.5/20044.1%	107.9/22884.4%
	2.37%	-0.22%	0.0002	0.47%
Returns on equity	422.7/8659.6%	(47.6)/8612.0%	4.5/8616.5%	107.9/8724.4%
	4.88%	-0.55%	0.0005	1.24%

LIQUIDITY

Liquid ratio:

Cash and balances with other banks	1880.3	1515.5	1320.7	3388.8
Treasury bills	0	0	0	150
	1880.3	1515.5	1320.7	3538.8
Customers' deposit	5228.5	7755.6	7000.3	9,432.80
	1880.3/5228.5	1515.5/7755.6	1320.7/7000.3	3538.8/9,432.8
	0.36	0.2	0.19	0.38
CBN's recommendation	0.20	0.20	0.2	0.20

LOANS AND ADVANCES TO SHAREHOLDERS

FUND RATIO:

Total loans and advances	7,998.2	8,997.9	9318.1	10,200.0
Shareholder's fund	8,659.6	8,612.0	8616.5	8,724.4
	7998.2/8659.6	8997.9/8612.	9318.1/8616.5	10200/8724.4
	0.92	1.04	1.08	1.17
CBN's recommendation	1.20	1.20	1.2	1.20

SOLVENCY

Debts/equity + debts	8,730.6/17811.	11,955.7/21354.8%	10,413.5/20044.1%	12,888.0/22884.4%
	49.02%	55.99%	51.95%	56.32%

APPENDICE 4
COMPARISON OF 2016 PERFORMANCE WITH STRATEGIC PLAN

	ACTUAL	**PLANNED**	**DIFF**	**%**
	Nm	**Nm**	**Nm**	
LOAN				
Conservative	10,200	10,500	-300	3
Preferred	10,200	12,500	-2300	-18
DEPOSITS				
Conservative	9,433	12,500	-3,067	-25
Preferred	9,433	15,000	-5,567	-37
PBT				
Conservative	137	305	-168	-55
Preferred	137	465	-328	-71

Creative Homes Mortgage Bank Limited

Horizontal analysis - 2013 - 2016

YEARS	**2013**		**2014**		**2015**		**2016**	
	N'm		**N'm**		**N'm**		**N'm**	
Interest income	1,177.8	100.0	**1,616.6**	100.0	1,803.8	100.0	2,093.2	100.0
Interest expenses	661.8	56.2	585.3	36.2	1,014.0	56.2	1,048.5	50.1
	516.0	43.8	**1,031.3**	63.8	**789.8**	43.8	**1,044.7**	49.9
Income from sale of properties	1,031.0	87.5	586.8	36.3	932.8	51.7	631.0	30.1
Other income	87.8	7.5	369.8	22.9	79.6	4.4	180.1	8.6
Operating income	1,634.8	138.8	1,987.9	123.0	1,802.2	99.9	1,855.8	88.7
Operating expenses:		-		-		-		-
Impairment charges	192.3	16.3	**366.3**	22.7	227.0	12.6	257.9	12.3
Depreciation and amortisation	137.4	11.7	**168.6**	10.4	170.2	9.4	176.2	8.4
Personnel costs	759.3	64.5	1,192.2	73.7	989.7	54.9	992.0	47.4
Administrative and marketing costs	234.8	19.9	260.3	16.1	242.3	13.4	253.4	12.1
Bank charges	51.3	4.4	45.3	2.8	52.5	2.9	39.3	1.9
	1,375.1	116.8	2,032.7	125.7	1,681.7	93.2	1,718.8	82.1
Profit or (loss) before tax	259.7	22.0	- 44.8	- 2.8	**120.5**	6.7	137.0	6.5
Tax expense	18.4	1.6	20.8	1.3	- 102.8	- 5.7	- 28.1	- 1.3
Profit or (loss) after tax	278.1	23.6	- 24.0	- 1.5	17.7	1.0	108.9	5.2
Fair value profit or (loss) on investments	144.6	12.3	- 23.6	- 1.5	- 13.2	- 0.7	- 1.0	- 0.0
Total comprehensive income for the year	422.7	35.9	- 47.6	- 2.9	4.5	0.2	107.9	5.2

Statement of financial position

	2013		2014		2015		2016	
	N'm		N'm		N'm		N'm	
Assets:								
Cash and balances with banks in Nigeria	1,880.3	21.71	1,515.5	17.60	1,320.7	15.35	3,388.8	38.84
Investments in treasury bills	-		-		-		150.0	1.72
Mortgage loans	7,998.2	92.36	8,997.9	104.48	9,318.1	108.27	10,200.0	116.91
Investments	86.4	1.00	376.8	4.38	288.0	3.35	281.4	3.23
Properties held for sale	6,516.9	75.26	9,098.2	105.65	-		-	
Receivables and prepayments	583.3	6.74	443.2	5.15	8,284.4	96.26	8,180.7	93.77
Intangible assets	161.7	1.87	103.1	1.20	62.1	0.72	48.3	0.55
Deferred tax asset	-		153.6	1.78	52.5	0.61	52.5	0.60
Properties, plant and equipment	584.2	6.75	666.5	7.74	708.3	8.23	582.7	6.68
Total assets	**17,811.0**	205.68	**21,354.8**	247.97	**20,034.1**	232.78	**22,884.4**	262.30
				-		-		-
Liabilities:				-		-		-
Customers' deposit	5,228.5	60.38	7,755.6	90.06	7,000.3	81.34	10,432.8	119.58
Obligations to NHF	2,884.1	33.31	3,890.8	45.18	3,412.1	39.65	2,699.3	30.94
Tax payable	97.2	1.12	208.0	2.42	169.7	1.97	43.1	0.49
Staff gratuity obligations	386.4	4.46	349.8	4.06	238.6	2.77	125.6	1.44
Accrued expenses and other liabilities	555.2	6.41	538.6	6.25	606.9	7.05	859.2	9.85
	9,151.4	105.68	**12,742.8**	147.97	**11,427.6**	132.78	**14,160.0**	162.30
Net assets	**8,659.6**	100.00	**8,612.0**	100.00	**8,606.5**	100.00	**8,724.4**	100.00

Equity:								
Share capital	5,000.0	57.7	5,000.0	58.1	5,000.0	58.0	5,000.0	57.3
Share premium	3,245.0	37.5	3,245.0	37.7	3,245.0	37.7	3,245.0	37.2
Retained earnings	- 237.2	- 2.7	- 762.4	- 8.9	- 1,142.6	- 13.3	- 1,710.6	- 19.6
Statutory reserves	626.8	7.2	626.8	7.3	632.1	7.3	632.1	7.2
Prudential regulatory reserves	25.0	0.3	502.6	5.8	882.0	10.2	1,557.9	17.9
	8,659.6	100.0	8,612.0	100.0	8,616.5	100.0	8,724.4	100.0

EXAMINER'S REPORT

The case tests the candidates' ability in evaluating the performance and financial health of a mortgage bank. The case further requires an analysis of the strategic plan of the bank.

The candidates understanding of the ratios and models required to perform the analysis was poor, hence performance was below average. Candidates' commonest pitfalls are:

(i) Inability to compute correctly relevant ratios applicable for financial analysis of a mortgage bank;

(ii) Using inappropriate model, such as balanced scorecard for the analysis;

(iii) Inability of most candidates to advise the board on the strategic steps to be taken to strengthen the strategic position of the bank;

(iv) Inability to properly identify the bank's strengths and weaknesses and, opportunities and threats in the environment;

(v) Inability to carry out proper interpretation of the ratios computed; and

(vi) Inability to write an appropriate and acceptable report.

Case Study requires analytical skill, so candidates are advised to put to bear the knowledge and skills gained in the other subjects of the Institutes examination to ensure success in Case Study examination in the future.