THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

NOVEMBER 2013 PROFESSIONAL EXAMINATION II

Question Papers

Suggested Solutions

Plus

Examiners' Reports

FOREWORD

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

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

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

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

(iv) The profession; in improving pre-examinations and screening processes, and so 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 altered slightly so that some principles or application of them may be more clearly demonstrated.

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

NOTES

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

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL EXAMINATION II – NOVEMBER 2013

FINANCIAL REPORTING & ETHICS

Time Allowed: 3 hours

SECTION A: PART I MULTIPLE-CHOICE QUESTIONS (20 Marks)

ATTEMPT ALL QUESTIONS IN THIS SECTION

Write ONLY the alphabet (A, B, C, D or E) that corresponds to the correct option in each of the following questions/statements:

1. Which of the following is **TRUE** of the distinctions between religion and ethics?

   A. Ethics appeals to authority; religion to reason
   B. Religion deals with questions about how we ought to live; ethics does not
   C. Ethics appeals to reason; religion to authority
   D. Ethics applies not to everyone whereas everyone is religious
   E. Ethics deals with questions about how we ought to live; religion relates to the questions about eternity

2. The ethical doctrine which holds that an action is morally right if the consequences of that action are more favourable than unfavourable only to the agent performing that action is:

   A. Ethical altruism
   B. Normative ethics
   C. Ethical egoism
   D. Ethical objectivism
   E. Ethical relativism

3. Kantianism is also known as:
   A. Ethics of duty
   B. Emotivism
   C. Virtue ethics
   D. Universal law
   E. Objectivism

4. A corporation enters contractual obligations through people who are:

A. Intelligent
B. Socially responsible
C. Its employees
D. By law or strong traditions, its agents or accredited representatives
E. Its shareholders

5. Which of the following statements best describes the term "financial position"?

A. The net income and expenses of an entity
B. The net of financial assets less liabilities of an entity
C. The total of equity less minority interest of an entity
D. The potential to contribute to the flow of cash and cash equivalents of an entity
E. The assets, liabilities and equity of an entity

6. The process of rendering stewardship, carrying correlative burden of performance and shouldering responsibilities can be labelled as:

A. Auditing
B. Accountability
C. Insider dealing
D. Confidentiality
E. Contractual obligation

7. Which of the following is **NOT** a dimension of Corporate Social Responsibility?

A. Human dimension
B. Philanthropic dimension
C. Legal dimension
D. Ethical dimension
E. Economic dimension

8. The motivation to be of correct behaviour by those who are highly trained and disciplined is called:

A. Conduct
B. Responsibility
C. Professionalism
D. Behaviourism
E. Independence

9. According to the Code of Best Practices (2003), the three key players in the implementation of regulatory framework for corporate governance are:

   A. Boards of directors, shareholders and audit committees
   B. Boards of directors, stakeholders and audit committees
   C. Boards of directors, employees and ethics committees
   D. Boards of directors, chief executive officers and shareholders
   E. Boards of directors, stakeholders and chief executive officers

10. The concept which refers to the reduction of rate of consumption of resources, energy utilization and waste production per unit of a product or service is:

   A. Action-enabling recommendation
   B. Eco-accounting
   C. Environmental audit
   D. Environmental cost accounting
   E. Eco-efficiency

11. Moon Plc, a publicly quoted company invested a substantial amount of resources in promoting its brand names over the last five years. These amounts were capitalised as intangible assets in the year in which the expenditure were incurred. At 31 December 2011, expenditure totalling ₦30 million was included in Moon Plc's Statement of Financial Position. A further ₦5million was invested in Moon's brands during 2012. The company depreciates its assets at 10% straight line.

   According to IAS 38 (Intangible assets), which of the following values of the asset created would be disclosed in the Statement of Financial Position as at 31 December 2012?

   A. ₦35million
   B. ₦30million
   C. ₦28.5 million
   D. ₦5million
   E. Nil

12. Which of the following is **NOT** a correct requirement for inclusion in an entity's first IFRS financial statements?

   A. Two Statements of Financial Position
   B. Two Statements of Comprehensive Income

C. Two separate Income Statements (if presented)
D. Two Statements of Cash Flows
E. Two Statements of Changes in Equity

13. In terminating the appointment of a key management staff, the following disclosures are required in the financial statements under the related party transactions **EXCEPT**:

A. All employees' benefits to which share-based payment applies
B. Other short-term employees' benefits
C. Terminal benefits
D. Post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care
E. All forms of consideration paid, payable or provided by the company or on behalf of the company, in exchange for services rendered to the company

14. According to IAS 11 (Construction Contracts), the Statement of Financial Position and notes should include the following **EXCEPT**:

A. Amount of advances received
B. Amount of retention monies
C. Contingent assets and contingent liabilities
D. Amount due from customers net of taxes
E. Contracts in progress (cost-to-date plus profit or cost-to-date-less losses)

15. According to IAS 38 (Intangible Asset), amortisation of an intangible asset with a finite life period should commence when:

A. It is first recognised as an asset
B. It is probable that it will generate future economic benefits
C. The costs can be identified with reasonable certainty
D. It is available for use
E. It is recognised in profit or loss

16. Which of the following is **NOT** a criterion that is essential for business success?

A. Satisfactory profit margin
B. High level of asset turnover
C. Adequate level of liquidity
D. Favourable changes in equity
E. Appropriate level of gearing

17. On 1 January 2012, Tree-trunk Plc acquired 30% of the voting shares of Tree-branch Limited when the retained earnings of Tree-branch Limited was ₦2.8million. The purchase consideration was ₦6million. At 31 December 2012, the retained earnings of Tree-branch Limited was ₦5million. Determine the carrying amount of the investment in Tree-branch Limited in Tree-trunk Plc's financial statements at 31 December 2012:

A. ₦8.34million
B. ₦7.50million
C. ₦6.84million
D. ₦6.66million
E. ₦5.33million

18. When an investor ceases to have significant influence, the investment should be accounted for:

A. Using the equity method
B. In accordance with the requirements of IAS 39
C. Using straight line consolidation
D. At cost
E. In accordance with income approach

19. Double Plc sold finished goods to Triple Plc, its associate with 40% interest. The goods cost Double Plc ₦18million and were sold to Triple Plc for ₦22million. As at year end, none of the inventory had been sold by Triple Plc.
Determine the unrealised profit to be eliminated from Double Plc's books.

A. ₦4million
B. ₦2.8million
C. ₦2.4million
D. ₦1.6million
E. ₦0.5million

20. Shares issued in exchange for the settlement of a liability are included in the Earnings Per Share (EPS) calculation from:

A. The date the services were contracted
B. The completion of the services
C. The settlement date
D. The date that the new shares are allotted
E. The date that the new shares are registered

SECTION A: PART II SHORT-ANSWER QUESTIONS (20 Marks)

ATTEMPT ALL QUESTIONS IN THIS SECTION

Write the correct answer that best completes each of the following questions/statements:

1. The concept in the code of ethics which imposes an obligation on professional accountants to adhere to all relevant laws, rules and regulations is.....................................

2. The Code of Ethics for Professional Accountants was issued by an international organization called.....................................

3. The threat caused by a financial relationship between a member of a professional body and a client is called...............................

4. Financial statements are required to give a...................and.................view of the state of affairs of the company.

5. Researchers and disseminators whose duties are to collect data, analyse them, make comparison between companies within and outside the same industry and make such information available to the public are called ....

6. The best internal control system will fail if top management................the controls.

7. The process by which a firm undermines the rules of ethical competition by spreading damaging information is known as..........................

8. When a chartered accountant makes unsolicited contact with a non-client through visit or phone call with a view to establishing a professional relationship is ....

9. A person who possesses the legal capacity to employ someone to perform an act which the person is competent to do is called the....................

10. One of the critical roles of the audit committee is that it serves as a communication link between the board of a company and the.................

11. Under the proportionate consolidation method of accounting, the Statement of Comprehensive Income of the venturer includes its share of.............or .... of the joint venture.

12. An entity sold goods worth ₦12million to its associate (30%). The goods cost ₦8million and none has been sold by the associate. Calculate profit to be recognised on the transaction.

13. Which Act makes provisions for mergers, take-overs and acquisitions?

14. If an investor's share of losses of an associate equals or exceeds its interest in the associate, the investor should........................its share of further losses.

15. International Financial Reporting Standards (IFRS) are issued as accounting standards subsequent to an.........................being issued for public comments.

16. According to IAS 1 (Presentation of Financial Statements), an entity shall prepare its financial statements using the accrual basis of accounting except for..

17. According to IAS 1 (Presentation of Financial Statements), the presentation and classification of items should be consistent from one period to another unless a change would result in a more appropriate presentation. Under what other circumstance can a change be allowed?

18. According to IAS 11 (Construction Contracts), if a contract covers more than one asset, the construction of each asset should be treated as a separate construction contract. However, a group of contracts can as well be treated as a single construction contract. State any **TWO** conditions under which contracts can be so treated.

19. Business combinations should be accounted for using the.................method.

20. Friend Limited has 45% interest in a joint venture with Foe Limited. Friend Limited granted loans of ₦5million to the joint venture. The amount to be shown in Friend Limited's Statement of Financial Position at its reporting date for the loan due from the joint venture is................................

SECTION B: ATTEMPT QUESTION 1 AND ANY OTHER THREE QUESTIONS (60 Marks)

QUESTION 1

CASE STUDY

Obi Madubuchi, MBA, ACA is a financial consultant to Golden Bank Plc, a publicly listed bank. He is currently involved in the International Financial Reporting Standards (IFRS) conversion process for the bank's most recent statutory financial reports. Ikenna Nwokobia, MSc, ACA, is the Head, Financial Control (FINCON) Department and Obi's best friend. They both attended the same secondary school and university and were in the same class all through, studying Accounting.

Before Obi offered his services to the bank, he was a fast rising star in a major international audit firm and rose to the rank of Manager. He was suddenly asked to resign when the firm decided to take a new path which he did not fit into. A few years later, Obi couldn't find a job and his friend, Ikenna even helped with his bills and children's (who Ikenna also regarded as his kids) school fees. Zainab, Ikenna's wife, was a very close friend of Obi since their university days and was also his wife's best friend. Their families have become very close because of Obi and Ikenna's friendship with all their children attending the same school. Obi decided to set up a small consultancy firm but wasn't getting much by way of clients until Ikenna was awarded the IFRS consultancy contract with the bank, for which Obi felt heavily indebted to Ikenna.

During his review of the bank's loan assets, Obi discovered that the bank's loans had been seriously impaired and this has not been taken into account by the bank in prior years' audited financial statements and even in the current year's. Further review showed that certain material loans running into billions of Naira had been granted to a company used as a front by Ikenna and a director of the bank. The whole idea was to receive loans from the bank; never to pay back and disclose them as "non-performing loans", arm-twisting and even threatening their auditors and other financial consultants.

Obi decided to have a 'showdown' meeting with Ikenna to discuss his findings. He insisted that these loans should be written down to their 'recoverable amounts' and the loans should be disclosed as impaired and 'non-performing' as well as the inclusion of the related party disclosure notes in compliance with IFRS, other provisions and the Central Bank of Nigeria's Prudential Guidelines.

Ikenna barked at Obi, "how dare you, after everything we went through and all I have done for you? How dare you?" In the weeks that followed Ikenna did everything possible to make Obi change his mind including getting their wives involved. In view of the friction between both parties, Obi found it difficult to explain to his children why they couldn't spend the night or even go visiting Ikenna's family house like they used to. Obi kept on thinking about Ikenna's comments, "this is not an external audit, it is consultancy, hence, there is no risk". Obi was confused and deeply concerned about his professional and moral position.

You are required to:

(a)

(i) Discuss the moral issues arising from the above case study (2 Marks)

(ii) How does the issue of professionalism arise in the above case? (2 Marks)

(b) Given the situation in this case, what would you advise Obi to do? Your answer should be based on the principles of professional ethics as presented in ICAN's professional code of conduct. (3 Marks)

(c) In accordance with IAS 24 (Related Party Disclosures), define a related party and list any **TWO** disclosures required under IAS 24. (2 Marks)

(d) Below are some extracted information from the books of Golden Bank Plc's as at 31 December 2012:

Description	**₦'million**	**%**	**Date**
Loan granted	5,500		
Loan interest rate		10	
Current market interest rate		12	
Original effective interest rate		10	
Date granted			1 January 2010
Maturity date			1 January 2015

At the end of 2012, it was estimated that the future remaining cash flows from the loan would be only ₦2.85billion.

You are required to:

(i) Determine the amount of impairment loss that should be recognised on the above loan facility and the amount at which the loan should be carried in Golden Bank Plc's books. (4 Marks)

(ii) Prepare the journal entries to be passed in respect of the impaired loan assets of Golden Bank Plc in accordance with IFRS 1 (First-time adopter of IFRS). (2 Marks)

(Total 15 Marks)

QUESTION 2

(a) Recording the substance of transactions, rather than their legal form, is an important principle in financial reporting. The use of off-statement of financial position financing arrangement enables companies to obtain financing without showing debts on their books.

You are required to:

Describe how the use of off-statement of financial position financing can mislead users of financial statements, making specific reference to **THREE** user groups and giving examples where recording the legal form of transactions may mislead them. (6 Marks)

(b) WAASIMI entered into the following transactions during the year ended 31 March 2012:

In March 2012, WAASIMI factored some of its trade receivables to ASEJERE, a finance house. Based on selected account balances, ASEJERE paid WAASIMI 80% of its book value. The agreement was that ASEJERE would administer the collection of the receivables and remit a residual amount to WAASIMI depending upon how quickly individual customers paid. Any balance not collected by ASEJERE after six months will be refunded to ASEJERE by WAASIMI.

On 1 April 2011, WAASIMI's freehold building had a carrying amount of ₦15million and an estimated remaining useful life of 20 years. On this date, WAASIMI sold the building to GBAJUMOSE for a price of ₦24million and entered into an agreement with GBAJUMOSE to lease back the building for an annual rental of ₦2.6million for a period of five years. The auditors of WAASIMI have commented that in their opinion the building had a market value of ₦20million at the date of its sale and to rent an equivalent building under similar terms to the agreement between WAASIMI and GBAJUMOSE would cost ₦1,600,000 per annum. Assume finance cost of 10% per annum.

You are required to:

(i) Briefly explain the major accounting issues involved in the above transactions using the principles of substance over form.

(ii) State the relevant accounting treatments of the various elements identified.

(iii) State the classes of charges to be incurred and their appropriate accounting treatment. (9 Marks)

(Total 15 Marks)

QUESTION 3

(a) IAS 23 (Borrowing Costs), states that an entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.

You are required to explain the following:

(i) Borrowing costs eligible for capitalisation
(ii) Commencement date of capitalisation
(iii) Expenditure on a qualifying asset
(iv) Suspension of capitalisation
(v) Cessation of capitalisation (10 Marks)

(b) Swagger Ltd has a number of loan arrangements taken to finance various stages of its expansion several years ago. The existing loan portfolio is as follows:

Loan 1 - ₦30.5million, interest paid at 18%
Loan 2 - ₦48million, interest paid at 18.5%
Loan 3 - ₦28million, interest paid at 17.5%
Loan 4 - N50million, interest paid at 16%

The company commissioned a warehouse construction which will be put up for rental on completion. The expected cost of construction to completion of the warehouse is estimated at ₦73million, which is expected to be funded from its existing borrowings.

You are required to:

Calculate borrowing costs to be capitalised. (5 Marks)

(Total 15 Marks)

QUESTION 4

(a) "Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities".

You are required to:

Discuss the concept of control as outlined in IAS 27 (Consolidated and Separate Financial Statements) (5 Marks)

(b) On 2 January, 2011 Paddy Plc acquired 80% of the voting shares in Giddy Limited for ₦48million. The following information is relevant:

	Paddy Plc	Giddy Ltd
	₦' million	₦' million
Non-Current Assets	192	54
Current Assets	108	36
Investment in Giddy Ltd	48	-
Total Assets	**348**	**90**
Non-Current Liabilities	102	42
Current Liabilities	72	18
Ordinary Share Capital	120	18
Retained Earnings	54	12
Total Equity & Liabilities	**348**	**90**

Fair value of Giddy Limited's net identifiable assets was equal to its book value. The non-controlling interest is measured at its proportionate share of Giddy Limited's net assets. Paddy Plc accounts for its investment in Giddy Limited at cost in its separate financial statements.

You are required to:

(i) Prepare Paddy's Consolidated Statement of Financial Position as at 31 December 2011. (6 Marks)

(ii) Prepare the necessary journal entries in each of the two scenarios below assuming that:

- On 31 December 2012, Paddy Plc acquired an additional 10% of shares of Giddy Limited for ₦6million.

- On 31 December 2012, Paddy Plc sold 10% of the shares of Giddy Limited for ₦10million. (4 Marks)

(Total 15 Marks)

QUESTION 5

Kaka Giwa and Ike Gideon are chartered accountants living in Lagos. They have agreed to set up a firm and proposed the names "Giwa and Gideon Accounting Firm International" or "Men Only Accounting Firm International". They also proposed to start with two offices in Lagos.
While Ike Gideon was reading the newspaper one day, he saw an advert of "Giwa and Gideon Accountants", a firm based in Ibadan. In spite of this information, they were still determined to go ahead with the registration of the firm as "Giwa and Gideon Accounting Firm International". They also decided to print a letterhead to this effect.

You are required to:

(a) Advise Giwa and Gideon whether or not to go ahead with the name "Giwa and Gideon Accounting Firm International"? (2 Marks)

(b) Discuss the moral issue at stake if Giwa and Gideon had named the company "Men Only Accounting Firm International"? (4 Marks)

(c) State the information to be disclosed in an accounting firm's letterhead? (3 Marks)

(d) List the documents Giwa and Gideon are required to present to the Corporate Affairs Commission for the purpose of registration of their firm? (6 Marks)

(Total 15 Marks)

QUESTION 6

Only few stakeholders can directly influence the professional behaviour of a chartered accountant.

You are required to:

(a) List any **SIX** stakeholders that could influence the professional behaviour of a Chartered Accountant. (3 Marks)

(b) Using any **THREE** stakeholders listed in (a) above, discuss how they can directly influence the professional behaviour of chartered accountants. (6 Marks)

(c) Discuss any **THREE** areas of interest for stakeholders of the accounting profession. (6 Marks)

(Total 15 Marks)

SOLUTIONS TO SECTION A

PART I MULTIPLE CHOICE QUESTIONS

1. C
2. C
3. A
4. D
5. E
6. B
7. A
8. C
9. A
10. E
11. E
12. A
13. E
14. C

15. D

16. D

17. D

18. D

19. D

20. D

TUTORIALS

11. Under IAS 38, Expenditure on intangible assets are expensed in the year it is incurred, thus, NIL value will be disclosed in the Statement of Financial Position as at 31 December, 2012.

17.

Cost of Investment		₦6.00 million
Share of post acquisition reserves		
30% of (₦5million – ₦2.8 million)		₦0.66 million
		6.66 million

19. The computation of unrealiseed profit to be eliminated:
40% of (₦22 million – ₦18 million) = ₦1.6 million

EXAMINERS' REPORT

The questions cover the syllabus.

All the candidates attempted the questions and performance was above average. However, most of the candidates did not answer question 10 correctly.

Candidates should ensure adequate coverage of the syllabus for better performance in future examinations.

PART II SHORT ANSWER QUESTIONS

1. Professional Behaviour
2. International Federation of Accountants (IFAC)
3. Self Interest
4. True and Fair
5. Financial Analyst/Financial Journalist/Rating Agency

6. Overrides/Violates

7. Disparaging/Demarketing

8. Cold Calling

9. Principal

10. External Auditors/Management/Shareholders

11. Profit or Loss

12. ₦2.8 million

13. Investment & Securities

14. Discontinue recognition of/Not recognise

15. Exposure Draft

16. Statement of Cashflow

17. Where a change is required by IFRS

18. Any two of:

    i. The group of contracts is negotiated as a single package

    ii. The contracts are performed concurrently or in a continuous sequence

    iii. The constraints are so inter-related that they are in effect part of a single project

19. Acquisition

20. ₦2.75 million

TUTORIALS

12. The intergroup profit is (₦12m – ₦8m) = ₦4million
    The profit to be recognised is 70% x ₦4m
    = ₦2.8million

20. The loan to Foe Ltd (the Joint Venture) should be eliminated to the extent of Friend Ltd's interest.

    The amount to be shown in Friend Ltd's Statement of Financial Position would be:

    55% x ₦5m
    = ₦2.75million

EXAMINERS' REPORT

The questions cut across the entire syllabus and all the candidates attempted them.

Performance was average. Candidates are advised to pay more attention to the basic concepts, principles and standards of Financial Reporting and Ethics.

SOLUTIONS TO SECTION B

QUESTION 1

(a)(i) The moral issues arising from the above case are:

- Conflict of interest arising from Obi's loyalty to Ikenna for his favour during his trying times and his obligation to the bank.
- The issue of whether or not Obi should disclose the loan as impaired and non-performing and covering it up as requested by Ikenna.
- The issue of whether Obi should be silent on the issue or blow the whistle.
- There is the issue of intimidation of auditors, other financial consultants and Obi.
- Professional accountants have obligation to various stakeholders. There is therefore the issue of Obi's obligation to other stakeholders.

(ii) The issue of professionalism arises in this case because what Ikenna wanted Obi to do would violate the principle of professional behaviour which stipulates that a professional accountant should always comply with the rules and regulations of the profession and avoid doing anything that would put the profession in disrepute.

In the light of this, Obi should act professionally and disclose the true status of the loans, notwithstanding Ikenna's intimidation.

(b) Obi is advised to go ahead and disclose the true nature of the loans in line with the following principles of professional ethics:

- **Integrity**: As a professional accountant, Obi is expected to be honest, fair and straightforward in all professional and business dealings. Therefore, Obi should write down the loans to their "recoverable amounts" and also disclose them as impaired and non-performing.

- **Objectivity**: Obi should not negotiate his business or professional judgement on account of bias, conflict of interest or undue influence by Ikenna. If he cannot approach the issue objectively, he may consider resigning.

- **Professional competence and due care**: Obi is obliged to demonstrate and maintain professional skills and knowledge in order to deliver competent services. He should, therefore, not allow Ikenna's requests to jeopardise his professional competence.

(c) IAS 24, (Related Party Disclosures) defines a related party as a person or entity that is related to the reporting entity.

DISCLOSURES REQUIRED UNDER IAS 24

(i) **The relationships between parents and subsidiaries**: Regardless of whether there have been transactions between a parent and a subsidiary, an entity must disclose the name of its parent and, if different, the ultimate controlling party. If neither the entity's parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so must also be disclosed (IAS 24.16).

(ii) **Management Compensation**: Disclose key management personnel compensation in total and for each of the following categories (IAS 24.17):

- Short-term employee benefits
- Post-employment benefits
- Other long-term benefits
- Termination benefits
- Share-based payment benefits

(iii) **Related party transactions**: If there have been transactions between related parties, disclose the nature of the related party relationship as well as information about the transactions and

outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements.
These disclosures would be made separately for each category of related parties and would include (IAS 24. 18 - 19):

- The amount of the transactions
- The amount of outstanding balances, including, terms and conditions and guarantees
- Provisions for doubtful debts related to the amount of outstanding balances
- Expense recognised during the period in respect of bad or doubtful debts due from related parties

(d) (i) The loan interest rate (coupon rate) and the effective interest are the same, hence, the carrying amount of the principal will remain the same throughout the life of the loan until it is redeemed at maturity. (See tutorial note).

On 31 December, 2013, the carrying amount of the loan is ₦5.5billion and it is estimated that only ₦2.8billion is to be recovered. The carrying amount of the loan should be restated to the present value of the estimated future cash flows of ₦2.85billion discounted at the original effective interest rate of 10% for two years.

₦2.85billion $(1.1)^{-2}$ = ₦2.355billion
This results in an impairment loss of:
₦5.5billion – ₦2.355billion = ₦3.145billion

The loan asset will be written down to ₦2.355billion and an impairment loss of ₦3.145billion recognised. The loan asset will continue to be accounted for using amortised cost, based on the new carrying amount of ₦2.355billion.

TUTORIAL

DATE	OPENING BALANCE	INTEREST INCOME (10%)	PAYMENT	CLOSING BALANCE
	₦'M	₦'M	₦'M	₦'M
1 Jan 2010	5,500	550	(550)	5,500
2011	5,500	550	(550)	5,500

2012	5,500	550	(550)	5,500
2013	5,500	550	(550)	5,500
2014	5,500	550	(550)	5,500
2015	5,500	550	(6,050)	-

(ii) IFRS 1 (First-time Adoption of IFRS) requires entities (First-time adopters of IFRS) to make necessary entries to adjust the Statement of Financial Position (SFP) from the entity's previous GAAP to IFRS as at the date of the opening SFP (transition date). These adjustments which relate to recognition or measurement of items are recognised directly in retained earnings or, if appropriate, another category of equity.

The journal entry required is, therefore:

	DR	CR
	₦'b	**₦'b**
Retained Earnings	3.145	
Financial Assets (Loan)		3.145
Being impairment loss on financial assets		

EXAMINERS' REPORT

The question is structured to examine candidates' ability to identify some of the moral issues that can arise for a professional accountant in practice, their understanding of the disclosure requirements of IAS 24 as well as their ability to compute impaired amount of loan and pass journal to effect the impairment.

Being a compulsory question, all the candidates attempted it, but their performance was poor. Their major pitfalls were their inability to identify the principles of professional ethics that are relevant to the case study, lack of knowledge of the provisions of relevant accounting standards and failure to provide narration to the journal entry.

Candidates are advised to develop appropriate understanding of the principles of professional ethics and their applications to practical situations as well as improve upon their technical accounting skill.

QUESTION 2

(a) **Substance over form:**

Most forms of off-Statement of Financial Position financing indicate the effect of what is in substance, for example, debt finance either not appearing on the Statement of Financial Position at all or being netted off against related assets such that it is not classified as debt.
The main problem of off-Statement of Financial Position finance is that it results in financial statements that do not faithfully represent the transactions and events that have taken place. This implies that such financial statements cannot be relied upon and as a result, any decision made on the basis of the information contained in the financial statements will be incorrect and misleading.

Major user groups are:

- Lenders of capital
- Suppliers
- Investors (existing and potential)

How the major user groups can be misled:

- Lenders of capital are especially concerned about the entity's gearing position. When the borrowing is high, it increases risk.
- Suppliers are concerned with liquidity position of the entity. The existence of consignment inventories may be relevant to trade suppliers. Sometimes, consignment inventories and their related current liabilities are not recorded on the Statement of Financial Position as the wording of the purchase agreement may be such that legal ownership of the goods remains with the supplier until specific event(s) occur.
- Investors are concerned with the entity's profitability performance. Where borrowing is low, it becomes inexpensive and tax efficient with promising returns to the shareholders.

(b) (i) Accounting Issues Involved

- **Factoring**

This is a common method of entities releasing the liquidity of their trade receivables. The issue involved here is whether the trade receivables have been sold, or the income from the finance house for their 'sale' should be treated as a short-term loan. The main substance issue with this type of transaction is to identify which party bears the risk relating to the asset. If the risk lies with the finance house (Asejere), the trade receivables should be removed from the Statement of Financial Position. In this case, it is clear that Waasimi still bears the risk relating to slow and non-payment of trade receivables. The residual payment by Asejere depends on how quickly the receivables are collected, the longer it takes, the less the residual payment. Any balance uncollected by Asejere after six months will be refunded by Waasimi, which reflects the non-payment risk.

❖ **Sale of Freehold property**

This is an example of sales and lease back of a property. If an asset is sold at an amount that is different from its fair value, there is likely to be an underlying reason for that. In this case it appears that Gbajumose has paid Waasimi ₦4million more than the worth of the building. No unrelated company would do this knowingly without there being some form of compensating transaction. This sale is linked to five years rental agreement.

The question indicates that the rent is not at fair value, being ₦1,000,000 per annum (₦2,600,000 – ₦1,600,000) above what a commercial rent for a similar building would be.

It is now clear that the excess purchase consideration of ₦4million is "in substance" a loan rather than sales proceeds (legal form) which is being repaid through the excess (₦1million per annum) of the rentals. Although, this is a sale and leaseback transaction as the property is a freehold and has an estimated remaining useful life of 20 years, which is longer than the five years leaseback period. The lease is not a finance lease, hence, the property should be treated as sold and derecognised.

(b)(ii) Relevant Accounting Treatment:

❖ **Factoring**

- Cash received from Asejere (80% of the selected receivables) should be treated as a current liability (a short-term loan).
- The difference between the gross trade receivables and the amount received from Asejere (plus any amount directly from the credit customers) should be recognised in Statement of Profit or Loss.

- **Sale of freehold property**
  - Sale of the property should be recorded at its fair value (₦20million).
  - Profit on disposal would be ₦5million (₦20million – ₦15million).
  - The excess of ₦4million (₦24million – ₦20million) should be treated as a loan (Non-current liability).

iv. Classes of charges to be incurred:

- **Factoring**
  - Administrative expenses (for Asejere collecting receivables).
  - Finance cost (reflecting the time taken to collect the receivables).
  - Impairment of trade receivables (bad debts).
- **Sale of freehold property**
  - The total rental payment of ₦2.6 million should be split into three elements as:

▪ Property rental cost	₦1.6m
▪ Finance cost (10% of ₦4m)	₦0.4m
▪ Capital repayment of the loan	₦0.6m
	₦2.6m

EXAMINERS' REPORT

The question examines the accounting principle of "substance over form" and its application to specific transactions covering some provisions of IAS 16 (Property, Plant & Equipment), IAS 17 (Leases), IAS 36 (Impairment of Assets), and IFRS 5 (Non-current Assets Held for Sale and Discontinued Operations).

Most candidates did not attempt the question and performance was below average. Candidates displayed very poor understanding of the provisions of the relevant accounting standards.

Candidates are advised to pay more attention to the provisions of International Financial Reporting Standards for better performance in future examinations.

QUESTION 3

(a)(i) **Borrowing costs eligible for capitalization**

These are borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. Other borrowing costs are recognised as expenses.

Borrowing costs eligible for capitalization are:

- Those directly attributable to the acquisition, construction or production of a qualifying asset that would have been avoided if the expenditure on the qualifying asset had not been made.
- The borrowing cost that directly relates to that qualifying asset, when an entity borrows funds specially for the purpose of obtaining a particular qualifying asset.
- The entity shall determine the amount of borrowing costs eligible for capitalization as the actual borrowing costs incurred on that borrowing during the period, less any investment income on the temporary investment of the borrowing.
- The entity shall determine the amount of borrowing costs eligible for capitalization by applying capitalization rate to the expenditure on the asset.

(ii) **Commencement date of capitalization:** This is the date when the entity first meets all of the following conditions:

- It incurs expenditure for the assets;
- It incurs borrowing costs; and
- It undertakes activities that are necessary to prepare the asset for its intended use or sale.

(iii) **Expenditure on a qualifying asset**: These include only those expenditure that have resulted in:

- Cash payments;
- Transfers of other assets; or

- The assumption of interest bearing liabilities

Expenditure is reduced by any progress payments received and grants received in connection with the assets.

(iv) **Suspension of capitalization**

An entity shall suspend capitalization of borrowing costs during extended periods in which active development is interrupted. During this period, borrowing costs are recognized as an expense.

(v) **Cessation of capitalization**

An entity shall cease capitalizing borrowing costs when:

- Substantially all the activities necessary to prepare the qualifying assets for its intended use or sales are complete.
- When an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts.
- The entity shall cease to capitalise borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale.

(b) **SWAGGER LIMITED**

The borrowing cost to be capitalised will be the weighted average cost of the existing loan portfolio over the period of the construction.

Calculation of borrowing costs to be capitalised:

Loan Type	Amount ₦'Million	Capitalization Rate (%)	Cost ₦' Million
Loan 1	30.50	18.0	5.49
Loan 2	48.00	18.5	8.88
Loan 3	28.00	17.5	4.90
Loan 4	50.00	16.0	8.00
	156.50		27.27

Weighted Average Rate

$$\frac{₦27.27m}{156.50} \times \frac{100\%}{1} = 17.42\%$$

Borrowing costs to be capitalized

17.42% x ₦73,000,000

= ₦12,716,600

= <u>₦12.7m</u>

<u>Comment</u>

No particular financial year is given for the computation of borrowing cost to be capitalised. One financial year is assumed for the computation.

EXAMINERS' REPORT

The question requires the definition and explanation of some concepts in IAS 23 (Borrowing Costs), as well as the computation of borrowing costs eligible for capitalisation.

Majority of the candidates attempted the question but performance was poor. Candidates generally displayed very poor knowledge of the concepts and provisions of the standard.

Candidates are advised to study the provisions of International Financial Reporting Standards very well in their preparation for future examinations.

QUESTION 4

(a) Control is presumed when the parent acquires more than half of the voting rights of the entity.

Even when more than one half of the voting rights are not required, control may be evidenced by power:

(i) Over more than one half of the voting rights by virtue of an agreement with other investors.

(ii) To govern the financial and operating policies of the entity under a statute or an agreement.

(iii) To appoint or remove the majority of the members of the board of directors, or

(iv) To cast the majority of votes at a meeting of the board of directors.

(b) (i)

Paddy Plc and its subsidiary
Consolidated Statement of Financial Position as at 31 December 2011

	₦ 'M	₦ 'M
Non-current assets		246
Goodwill (see working)		24
Current asset	144	
Current liabilities	(90)	
		54
		324
Non-current liabilities		(144)
		180

Financed by:

	₦ M	₦ M
Ordinary share capital		120
Consolidated retained earnings		54
Shareholders' fund		174
Non-controlling interest		6
		180

Computation of goodwill

Purchase consideration		48
Non-controlling interest at acquisition		6
		54
Net assets at acquisition date:		
Ordinary share capital	18	
Retained earnings	12	
		(30)
Goodwill on consolidation		24

Non-controlling interest:
Non-controlling interest at acquisition date
= 20% of ₦30million = 6

Assumption: The question has no information on pre and post acquisition reserves. Therefore, it was assumed that there was no change in the net asset since acquisition date.

The reserve in the Statement of Financial Position of Giddy Ltd was also assumed to be entirely pre-acquisition reserves.

(ii) **Journal Entries**

		₦'M	₦'M
(1)	Non-controlling interest	3	
	Equity	3	
	Cash Book	__	6
	Being additional 10% of shares of Giddy Ltd acquired by Paddy Plc for ₦6million	6	6
(2)	Cash Book	10	
	Non-controlling interest		3
	Equity	__	7
	Being the sales proceed of 10% of the shares of Giddy Ltd disposed by Paddy Plc for ₦10million	10	10

EXAMINERS' REPORT

The question tests candidates' understanding of the concept of control and ability to prepare post-acquisition Consolidated Statement of Financial Position in accordance with the provisions of IAS 27 (Consolidated and Separate Financial Position).

More than half of the candidates attempted the question, but performance was below average. Most of the candidates displayed poor knowledge of the provisions, terminologies and requirements of the standard and were unable to prepare Consolidated Statement of Financial Position.

Candidates should endeavour to have adequate understanding of the provisions of International Financial Reporting Standards for better performance in future.

QUESTION 5

(a) Giwa and Gideon are advised not to register the name Giwa and Gideon Accounting Firm International" because:

(i) They do not have offices outside the country. They proposed to start with two offices in Lagos. So they are not truly international and it would be misleading to be described as such.

(ii) The proposed registration name may be confusing with the one in Ibadan.

(b) The moral issues at stake if Giwa and Gideon had named the company "Men Only Accounting Firm International" are:

i. The name of the practice appears frivolous, misleading, offensive and rude because the name suggests that the firm attends only to male gender as clients.

ii. A practice name should be consistent with the dignity of the accounting profession. It should not suggest bias, prejudice, or discrimination against any race, gender or culture. Doing this, will not project an image consistent with the accounting profession bound by high ethical and technical standards. This borders on the dignity of the profession.

(c) Information to be disclosed in an accounting firm's letterhead include the following:

(i) The name of the firm

(ii) Details of the firm:
(a) Address
(b) Telephone number
(c) E-mail address
(d) Fax number
(e) Name(s) of Partner(s)

(iii) An identification of any specialist service that the firm provides or services rendered as long as they can demonstrate the requisite expertise.

(iv) A letterhead should not have the designatory letters, description or title in the name of a person to which he or she is not entitled, e.g. Ph.D, MAAT, Principal Partner, Senior Partner.

(v) A letterhead should not list any services the firm cannot provide.

(vi) The letterhead should be clear and consistent with the dignity of the profession.

(d) Documents to be presented at the Corporate Affairs Commission for the purpose of registration of the firm include:

i. Availability of Name form

ii. Application for registration of firm's name (CAC/BN/I)

iii. Two passport photographs of partners

iv. Evidence of professional competence (i.e. License to practice issued by the Institute to the partners)

EXAMINERS' REPORT

The question tests candidates' understanding of the ethical issues to be considered when setting up an accounting firm and the requirements to be satisfied when processing its registration with the Corporate Affairs Commission.

Many of the candidates attempted the question and their performance was average. They displayed a fair understanding of the moral issues involved and the requirements for setting up and registering an accounting firm.

The commonest pitfall of the candidates was their inability to itemise the moral issues to attend to in the process of starting and registering an accounting firm.
Candidates are advised to improve on the presentation of answers in a precise manner.

QUESTION 6

(a)(i)

Stakeholders that can influence the professional behaviour of Chartered Accountants

(a) Investors/Shareholders
(b) The Government
(c) The Accounting Professional Bodies/Institutes
(d) The Employees
(e) The International Community
(f) The Management/The Board of Directors
(g) Regulatory Authorities – CBN, NDIC, SEC, NSE, etc
(h) Multilateral Institutions – World Bank, IFC, IMF, etc
(i) The General Public
(j) Donor Agencies
(k) Creditors

(l) Debtors

(b) **The professional behaviour of Chartered Accountants can be influenced by the following stakeholders:**

(i) **Management/Board of Directors** has the interlocking functions of creating corporate policy and organising, planning, controlling and directing an organisations' resources in order to achieve stated objectives. The management is a group of top executives saddled with these functions. They include the CEO, MDs, Top Managers and the Directors.
The management, as the direct employer of the accountant, influences the professional behaviour of the accountant. Management gives instructions and directives to the accountant which are intended to aid the achievement of the objectives of the corporate policy. Thus, the accountant is obliged to comply, even when there is a clash of interest between the management and the expected professional attitude of the accountant to the directives of management.

(ii) **Major shareholders** are core investors that hold substantial shares to be able to influence management decisions. These shareholders who in some organisations may be part of management and board of directors are mainly concerned with the management of their investments to maximize share value. Thus, they can be a major source of pressure on the professional accountant.

(iii) **Professional accounting bodies and Institutes** such as ICAN, ANAN and ACCA, regulate the professional environment in which members operate. They develop codes of conduct, enforce compliance by members and also ensure continuous professional education of members to enhance performance.

(iv) **Employee**
An employee is a person who is hired to provide services to a company on a regular basis in exchange for compensation. Such services are not provided as part of an independent business.

In any organisation, the accountant is directly influenced by employees in the finance and accounts department, which may include the cashiers, the storekeeper, account officer, etc. The records provided by these employees form the major inputs that are used in preparation of the financial statements.

A good understanding of the expected roles of various employees aid the production of financial reports which show the true and fair view of the financial position of the organisation.

(v) **Government**

Government regulates the business environment in which professional accountants operate. Pronouncements, regulations and legislations impact directly on the professional behaviour of Chartered Accountants.

(vi) **Creditors**

In preparing the financial statements of an organisation, for instance, accountants need to take into consideration the expectations of its existing and prospective creditors. It is for this reason that accountants may resort to creative accounting.

(vii) **Debtors**

To provide a true and fair view of the financial position of an organisation, accountants must at every point present an accurate account of the debt owed it under the current assets.

(viii) **Donor Agencies**

The expectations of both existing and prospective donor agencies often determine how the accounts of relevant organisations are presented. Hence, accountants may want to present the accounts of an organisation in a way that would show that past donations have been properly utilised in order to attract additional grants.

(ix) **Regulatory Authorities**

Such regulatory authorities are CBN, SEC, NSE, NDIC and FRC, FIRS, etc which formulate policies, rules and regulations that condition the business environment in which a professional accountant operates. For instance, these authorities require financial reports to monitor compliance of an organisation with their various policies, rules and regulations and accountants are expected to prepare financial statements in conformity with these guidelines.

(c) The areas of interest for stakeholders of the accountancy profession include the following:

(i) **Government:** The government requires and uses accounting information as a score sheet for stewardship, decision making and performance control.

(ii) **Employees:** Employees would like to know the profitability, solvency and liquidity positions of their establishments to confirm stability of tenure, promotion prospects and the possibility of continued supply of recreational facilities.

(iii) **Employers**: Employers are interested in accounting information to ascertain the profits made, compare yearly figures and take decisions on the scale of operations.

(iv) **Existing Investors**: Existing investors/shareholders are anxious to know whether funds placed in a business will continue to earn reasonable return.

New Investors: Prospective investors are interested in putting their money in viable, profitable and liquid ventures.

(v) **Banks, Creditors and Lenders**: These financial agents would not grant credit to entities whose performances are poor and those whose performance indices point to inability to repay loans, service charges etc.

(vi) **Companies Within the Same Industry**: These are interested in comparing the performance of firms so as to draw comparison using ratio as benchmark.

(vii) **The general public**: They should at all times be given a true and fair picture of the financial position of the organisation.

(viii) **The Institute**: It expects its members to adhere strictly to the Code of Conduct guiding the profession to ensure standard and professionalism.

(ix) **Regulatory authorities**, like the professional bodies, expect strict adherence to policies, rules and regulations guiding the business environment in which accountants operates.

EXAMINERS' REPORT

The question tests candidates' knowledge of the broad spectrum of the stakeholders of the accounting profession and the various forms of relationship existing between professional accountants and their stakeholders.

Most of the candidates attempted the question and performance was above average. Candidates' commonest pitfalls were the lack of clarity of expression and inability to articulate how Stakeholders can influence the professional behaviour of chartered accountants.

Candidates are advised to improve their communication skills and pay adequate attention to the relationship between professional accountants and their diverse stakeholders.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL EXAMINATION II – NOVEMBER 2013

STRATEGIC FINANCIAL MANAGEMENT

Time Allowed: 3 hours

SECTION A: PART I MULTIPLE-CHOICE QUESTIONS (20 Marks)

ATTEMPT ALL QUESTIONS IN THIS SECTION

Write ONLY the alphabet (A, B, C, D or E) that corresponds to the correct option in each of the following questions/statements:

1. Which of the following stakeholders bears the greatest risk?

   A. Preference shareholders
   B. Ordinary shareholders
   C. Debenture holders
   D. Loan stock holders
   E. Bond holders

2. **ONE** of the financial objectives of a firm is to

   A. Seek growth
   B. Be a market leader
   C. Survive autonomy
   D. Seek diversification
   E. Maximise shareholders wealth

3. Which of the following is a self-regulatory institution within the Nigerian financial system?

   A. National Insurance Commission (NAICOM)
   B. Nigerian Stock Exchange (NSE)
   C. Central Bank of Nigeria (CBN)
   D. Securities and Exchange Commission (SEC)
   E. National Pension Commission (NPC)

4. The most potentially effective instrument of good corporate governance of a company is

   A. Shareholders
   B. Top executive officers
   C. Employees
   D. Board of directors
   E. Executive Directors

5. Iyaloja Limited has an investment with initial cash outflow of ₦100,000 and a cash inflow of ₦50,000 each year for years 1, 2, 3, and 4. What is the Profitability Index (PI) of the investment if the cost of capital is 10%?

   A. 1.0797
   B. 1.5850
   C. 2.0000
   D. 2.1584
   E. 2.7097

6. The major advantage of Internal Rate of Return (IRR) over Accounting Rate of Return (ARR) is that it

   A. Incorporates the entire stream of income in calculating the profitability of a project.
   B. Is simple to understand and use
   C. Is easy to calculate
   D. Considers the total profit of a project
   E. Considers time value of money

7. Gordon's model of "dividend relevance" is based on all the following assumptions **EXCEPT** that there are/is

   A. No taxes
   B. Constant cost of capital
   C. Constant returns
   D. Variation in growth rate
   E. Perpetual earnings

8. Olubi Nig. Plc. does not plough back any earnings and is expected to pay a steady dividend of ₦5 per share. If the current stock price is ₦40, what is the market capitalisation rate?

A. 12.5%
B. 12.9%
C. 14.29%
D. 15.0%
E. 15.5%

9. Which of the following is **NOT** a method of making new issues in the primary market?

A. Offer for sale
B. Bonus offer
C. Rights offer
D. Private placement
E. Offer by tender

10. In a rights issue, the following pieces of information are normally conveyed to the shareholders through the issuance of a rights circular **EXCEPT** the

A. Number of additional shares needed to be subscribed
B. Subscription price
C. Expiry date
D. Options available to a shareholder to exercise
E. Amount to be paid

11. The form(s) of efficient capital market is/are

I. The weak form
II. The semi-strong form
III. The strong form

A. I only
B. II only
C. III only
D. I, II, and III
E. I and III only

12. Which of the following is **NOT** the duty of the Governing Council of the Nigerian

Stock Exchange?

A. Policy making
B. Selling shares on the floor of the exchange
C. Giving approval to quotations and listing of securities
D. Protecting the interest of the investing public
E. Making rules and regulations for dealing members

13. Payable Deferred Period is measured by

A. $\frac{\text{Payables}}{\text{Purchases}} \times \frac{365}{1}$ days

B. $\frac{\text{Payables}}{\text{Credit Purchases}} \times \frac{365}{1}$ days

C. $\frac{\text{Receivables}}{\text{Purchases}} \times \frac{365}{1}$ days

D. $\frac{\text{Purchases}}{\text{Receivables}} \times \frac{365}{1}$ days

E. $\frac{\text{Payables}}{\text{Receivables}} \times \frac{365}{1}$ days

14. Which of the following is **NOT** a piece of information an investing company will require for the purpose of acquiring a target company?

A. Conglomerate records
B. Financial records
C. Corporate records
D. Regulatory (Statutory) records
E. Employees records

15. The market price of A Limited is ₦90 and that of B Limited is ₦60. If A Limited offers 3 of its shares in exchange for 4 of B Limited's shares, what would be the ratio of exchange?

A. 0.667
B. 1.000
C. 1.067
D. 1.105
E. 1.125

16. Which of the following financial intermediaries was established to take care of the interest of Small and Medium Enterprises?

A. Small and Medium Enterprises Development Agency of Nigeria
B. Small and Medium Industries Equity Investment Scheme
C. Microfinance Banks
D. African Development Bank
E. Bank of Industry

17. Which of the following is **TRUE** of Nigerian Export-Import Bank (NEXIM)?

A. It was established before 1991 but commenced operation in 1991
B. It was established in 1991 but commenced operation in 1992
C. It was established and commenced operation in 1992
D. It was established and commenced operation in 1990
E. It was established and commenced operation in 1993

18. The act of converting the foreign currency equivalent of foreign denominated assets into a more stable currency is known as

A. Hot money
B. Conditioning
C. Hedging
D. Speculation
E. Lags

Use the following information to answer questions 19 and 20:

The following information refers to an investment in projects A and B:

Economic Condition	Probability	Return %	
		Project A	Project B
Good	0.5	50	0
Bad	0.5	0	50

19. Assuming an equal amount is invested in each project, what is the expected rate of return of project A?

A. 0%
B. 1%
C. 20%
D. 25%
E. 50%

20. What is the standard deviation of project B?

A. 0%
B. 1%
C. 20%
D. 25%
E. 50%

SECTION A: PART II SHORT-ANSWER QUESTIONS (20 Marks)

ATTEMPT ALL QUESTIONS IN THIS SECTION

Write the correct answer that best completes each of the following questions/statements:

1. State **TWO** major strategic decisions which the finance manager of a company is expected to make for the development of the company's business.

2. The level of strategy which is concerned with the overall purpose and scope of an organisation and how value will be added to the different parts of the business units is known as ....

3. A medium which uses computer and electronic technology as a substitute for the use of cheques and other paper transactions is known as ....

Use the following information to answer questions 4 and 5:

Gaskiya Nigeria Limited is investing in a project with the following cash flows: Year 0 (₦150,000), Year 1 ₦100,000, Year 2 ₦100,000, Depreciation on the company's assets is ₦50,000 while its cost of capital is 10%.

4. Calculate the project's Net Present Value.

5. Determine the company's Internal Rate of Return.

Use the following information to answer questions 6 and 7:

Regina Plc. has, in issue, one million ordinary shares of ₦0.50 each with a market value of ₦1.80 per share. It also has, in issue, ₦600,000 20% debenture with a market value of ₦125. Interest has just been paid. The company paid a dividend of ₦600,000.

6. Calculate Regina Plc.'s cost of equity.

7. Determine the company's cost of debt.

8. State the type of dividend which the Board of Directors of a company has the power to declare and pay.

9. Another name for a rights issue is ....

10. A method of raising capital through special direct invitation to selected prospective investors is known as ....

11. A market where prices of securities fully reflect the information about the company, the industry and the economy as a whole is known as ....

12. The major regulatory body in the Nigerian Capital Market is ....

13. A banker buys dollars at ₦160.128 and sells at ₦160.198 per dollar. How many basis points is the spread per dollar?

14. A merger offer made by one company to buy the shares of a target company for a much higher price per share is called.........................

15. A very detailed and extensive evaluation of a proposed merger and acquisition is referred to as ....

16. Sweettrade Plc.'s share is currently selling for ₦50. An investor who is interested in the shares anticipates a dividend of ₦3 at the end of the year and also expects that the price of the share would have appreciated to ₦60 by the end of the current year. What is the expected return from the investment?

17. One of the main sources of funds available to a foreign subsidiary is ....

18. What is the formula for calculating dividend yield?

19. The combination of securities in a basket or pool in such a way as to reduce total risk without losing returns therefrom is known as ....

20. A company is financed by 40% risk free debt. The Treasury Bill rate is 10%, the expected market return is 18% while the stock beta is 0.5. What is the company's cost of capital?

SECTION B: ATTEMPT QUESTION ONE AND ANY OTHER THREE QUESTIONS (60 MARKS)

QUESTION 1

CASE STUDY

Bamisoro Nigeria Limited is a fast growing profitable company. The company is based in Lagos and has just won a contract to supply gas to the State's Electricity Board. In this regard, the company planned to commission a 35-kilometre pipeline at a cost of ₦260m to enable it execute the contract. The pipeline, when installed, will carry the gas to an agreed location under the control of the State Electricity Board.
With all these arrangements in place, it is expected that the sales of the company will increase from the present ₦360m to about ₦1,100m.

The anticipated revenue from sales to the State's Electricity Board is expected to be ₦120m per annum.

Apart from this contract, the pipeline could also be used to transport Liquefied Natural Gas (LNG) to other willing customers in the suburb. The sales from this source are put at ₦80m per annum.

The management of Bamisoro Nigeria Limited considers the useful life of the pipeline to be 20 years. The financial manager estimates a profit to sales ratio of 20% per annum for the first 12 years and 17% per annum for the remaining life of the project.
The project is not likely to have any salvage value.
Bamisoro Nigeria Limited is located in a remote area hence would enjoy exemption from tax.

The company's cost of capital is 15%.

(a) You are required to distinguish between mutually exclusive investment and independent investment. (2 Marks)

(b) Why is investment decision important to organizations and what techniques can be used to ensure that optimal investments are undertaken by firms? (3 Marks)

(c) What is the project's payback period? (2 Marks)

(d) Advise Bamisoro Nigeria Limited giving reasons as to the acceptability of the project based on the payback criterion. (2 Marks)

(e) Compute the project's NPV and IRR. (6 Marks)

(Total 15 Marks)

QUESTION 2

Bendeh Plc., an ungeared company has, in issue, 12 million ordinary shares of ₦1 each. Its net operating income is ₦1.2 million and cost of capital is 10%. It has a similar capital structure to that of Abadah Plc, a geared company with 8.4million ordinary shares of ₦1 each and ₦3.6 million 6% debenture stock and a net operating income of ₦1.2 million.

Chief Bobameto owns 10% of the shares in Abadah Plc. He is wondering whether he could increase his wealth without incurring additional risk by selling his shares in Abadah Plc and buying some of the ordinary shares of Bendeh Plc.

You are required to

(a) Advise Chief Bobameto on how he might improve his position if

(i) He invests only in the levered company. (5 Marks)

(ii) He undertakes a policy of switching his interest to the ungeared company. (5 Marks)

(b) State clearly **FIVE** reservations you might have about the scheme. (5 Marks)

(Total 15 Marks)

QUESTION 3

Alawada Limited is considering a five-year project whose initial cost would be ₦3million. The contribution consists of annual sales of ₦2.8million and variable costs of ₦2million for 1,000,000 units of sales per annum. These are the expected money values in year 1.

All sales would be made through a single distributor who has asked for a fixed selling price of ₦2.80 per unit for three years after which prices could be increased by 20% for year 4 and held constant at this new price for years 4 and 5. The variable cost is ₦2.00 per unit and it consists of material cost of ₦0.80 which is expected to increase by 5% per annum and the balance represents labour cost which is expected to increase by 10% per annum for each year. The company's cost of capital is assumed to be 10%.

You are required to

(a) Calculate the Net Present Value of the project and advise on its viability. (9 Marks)

(b) State **TWO** features of capital budgeting decision. (2 Marks)

(c) Give **FOUR** reasons why capital budgeting decision is important. (4 Marks)
(Total 15 Marks)

QUESTION 4

Chief Alagbala has the following portfolio of shares in five listed companies in Nigeria:

Companies	**Black**	**Blue**	**Yellow**	**Purple**	**White**
Shares held (units)	15,000	18,000	10,000	12,000	20,000
Price per unit	₦0.50	₦0.60	₦0.40	₦0.25	₦0.35

The following data are given in relation to the shares:

Companies	**Black**	**Blue**	**Yellow**	**Purple**	**White**
Market value per share	₦2.50	₦2.20	₦1.90	₦1.50	₦0.60
Current dividend yield	2.2%	4.0%	5.2%	2.6%	1.8%
Beta Factor	1.32	1.20	0.80	1.05	0.80

At present the risk-free rate of return is 8% while the market return is 14%.

You are required to

(a) Calculate
  (i) the Beta Factor
  (ii) the required return on the portfolio. (10 Marks)

(b) Explain the relevance of Portfolio Theory to Chief Alagbala (5 Marks)
(Total 15 Marks)

QUESTION 5

(a) It is argued that shareholders are indifferent between dividends and capital gains and that the value of a company is determined solely by the earnings power of its assets and investments.

You are required to write short notes on the following:

  (i) Cash dividend
  (ii) Stock dividend

(iii) Scrip issue (6 Marks)

(b) Mainland Plc. has just made earnings of ₦2,250,000. Its Directors are trying to decide on a dividend policy. If they retain 20% of earnings, they believe they can achieve an annual growth rate of 5% in earnings and dividend. If they retain only 10% of earnings, the growth rate would be 2% and shareholders would expect a return of 14%.

You are required to determine which retention policy would maximise the value of the company's shares. (6 Marks)

(c) State **THREE** advantages of retained earnings to a company. (3 Marks)

(Total 15 Marks)

QUESTION 6

(a) A number of analytical models are available to assist the lessor in determining what lease payments to charge. Other models are available to assist the lessee in determining which is the less expensive source of financing assets acquisition between leasing and borrowing.

You are required to

(i) Define an operating lease. (2 Marks)

(ii) State **ONE** advantage and **TWO** disadvantages of using debt finance. (3 Marks)

(iii) State **FIVE** limiting factors in debt financing. (5 Marks)

(iv) Explain the term "concealed gearing". (2 Marks)

(b) Halelluyah Limited currently has a sales volume of 125,000 units with a total fixed cost of ₦900,000. Selling price per unit is ₦20 while the variable cost per unit is ₦12.

You are required to calculate the degree of operating leverage at 125,000 units.

(3 Marks)
(Total 15 Marks)

SECTION A

PART I - MULTIPLE-CHOICE QUESTIONS

1. B
2. E
3. B
4. D
5. B
6. E
7. D
8. A
9. B
10. E
11. D
12. B
13. B
14. A
15. E
16. C
17. A
18. C
19. D
20. D

<u>Tutorials</u>

Q5.

Yr	CF	DF @		PV
	₦	10%	₦	

0	(100,000)	1.0000	(100,000)
1 – 4	50,000	3.1698	158,490
		NPV	58,490

$$P\,I = \frac{\text{Initial Investment + Net Present Value}}{\text{Initial Investments}}$$

$$= \frac{₦158,490}{₦100,000} = 1.5850$$

Q.8

$$K_e = \frac{d}{MVe} \times 100\%$$

$$\frac{₦5}{₦40} \times \frac{100}{1} = 12.5\%$$

Q. 15

$$\frac{₦90 \times 3}{₦60 \times 4} = \frac{270}{240} \qquad \text{i.e. } 1.125$$

Q. 19

$E(R_A)$ = (0.5 x 50) + (0.5 x 0) = 25%

Q.20

$E(R_B)$= (0.5 x 50) + (0.5 x 0) = 25%

Variance = $\sigma^2{}_B$ = $0.5(25)^2 + 0.5\,(50 - 25)^2 = 625$

Std Deviation = σ_B = $\sqrt{625}$ = 25%

EXAMINERS' REPORT

The questions cover a reasonable part of the syllabus.
Candidates' performance was fair. Some of them showed good understanding of the questions while others had problems in providing appropriate solutions.

Candidates are advised to ensure adequate coverage of all sections of the syllabus for better performance in future.

PART II – SHORT-ANSWER QUESTIONS

1. Long term investment decision, long term financing decision, dividend decision

and liquidity decision (any two)

2. Corporate strategy/strategic planning
3. e-banking
4. ₦23,550
5. 21.83%
6. 33.33%
7. 16%
8. Interim dividend
9. Pre-emptive rights or privileged subscription or subscription right issue
10. Private placement
11. Efficient capital market/efficient financial market
12. Securities and Exchange Commission (SEC)
13. 7 basis points
14. Bear hug offer
15. Due diligence
16. 26%
17. - Funds generated by the subsidiary
    - Funds transferred within the group
    - Subsidiary's retention (Retained Earnings)
    - Funds through borrowings/loan

18. $\frac{\text{Dividend Per Share}}{\text{Market Value Per Share}} \times 100$

19. Portfolio Management
20. 12.4%

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Questions 4 and 5

YR	C/F	D/F@ 10%	PV	D/F@ 24%	PV
	₦		₦		₦
0	(150,000)	1.0000	(150,000)	1.0000	(150,000)
1 - 2	100,000	1.7355	173,550	1.4569	145,690
		NPV	23,550		(4310)

$$IRR = 10\% \left(+\frac{23,550}{23,550 + 4310}\left(x\ \frac{24\% - 10\%}{1}\right)\right)$$

$$= 10\% + 11.83 = 21.83\%$$

Question 6 and 7

Q6 $K_e = \frac{d}{MV_e} \times 100\% = \frac{600,000}{1,800,000} = \underline{\underline{33.33}}\%$

Q7 $K_d = \frac{Interest}{MV_d} \times 100\% = \frac{20}{125} = \underline{\underline{16\%}}$

Q13

	₦
Selling Rate	160.198
Buying Rate	160.128
	000.070 x 100

∴ Basis points = 0.070 x 100 = 7

Q16 $E_r = \frac{Div + (P_1 - P_0)}{P_0} \times 100\% = \frac{3 + (60 - 50)}{50} \times \frac{100\%}{1} = \underline{\underline{26\%}}$

OR

$$E_r = \left(\frac{Expected\ \ Div + Expected\ \ following\ \ year\ \ price}{Initial\ \ Investment} - 1\right) \times 100\%$$

$$= \left(\frac{3.00 + 60.00}{50} - 1\right) \times 100\% = 1.26 - 1 \times 100\% = \underline{\underline{26\%}}$$

Q20

Company Beta = (0 x 0.4) + (0.5 x 0.6) = 0.3

Cost of Capital = $R_f + \beta\ (R_m - R_f)$

= 10 + 0.3(18-10)

= 12.4%

EXAMINERS' REPORT

The questions test candidates' understanding of the various aspects of the syllabus. Candidates' performance was average. Some of them did not have a good understanding of some of the questions hence they gave wrong answers or failed to answer them.

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

SECTION B

QUESTION 1 - CASE STUDY

(a) The difference between mutually exclusive investments and independent investments is that for mutually exclusive investments, once one project is selected another must be forgone because the projects are in competition, whereas for independent investments/projects, the selection of one project does not foreclose the selection of others.

(b)(i) Investment decision is important to organisations as it involves the identification of viable projects. It deals with the appraisal of projects using various techniques to determine those that are viable.

(ii) Techniques that can be used to ensure optimal investments include Net Present Value (NPV) Internal Rate of Return (IRR), Pay Back Period and Accounting Rate of Return (ARR).

(c) Using Pay Back Period:

Year	Cashflows
	₦'000
0	(260,000)
1-12	480,000 i.e. 40m x 12
13 - 20	272,000 i.e. 34m x 8

Pay Back Period = $\frac{\text{₦260,000,000}}{\text{₦40,000,000}}$ years

= 6.5 years

(d) The project should be accepted because its Pay Back Period (PBP) is less than the projects' life. The PBB is about one-third of the project's economic life.

Year	Cash flow	DF(15%)	Present Value
	₦'000		₦'000
0	(260,000)	1.0000	(260,000)
1 – 12	40,000	5.4206	216,824
13 – 20	34,000	0.8387	28,516
	Net Present Value		(14,660)

Using Internal Rate of Return (IRR)
Try 12% Discount Factor

Year	**Cashflow**	**DF(12%)**	**Present Value**
	₦'000		**₦'000**
0	(260,000)	1.0000	(260,000)
1 – 12	40,000	6.1944	247,776
13 – 20	34,000	1.2750	43,350
Net Present Value			31,126

$$IRR = DF_p + \left(\frac{NPV_p}{NPV_p + NPV_n}\left(DF_n - DF_p\right)\right)$$

$$= 12\% + \left(\frac{31,126}{31126 - (14660)} x\ (15 - 12)\right)$$

$$= 12\% + 2.039\%$$

$$= 14.039\%$$

EXAMINERS' REPORT

The question tests candidates' knowledge of capital investment decision with special reference to evaluation of capital projects and the various techniques available for investment appraisal.

Over 90% of the candidates attempted the question and performance was below

average. The only identified pitfall was candidates' lack of understanding of parts (c), (d) and (e) of the question.

Candidates are advised to always cover the syllabus adequately, work on past questions and make use of the Institute's Study Packs and Pathfinders in their preparations for the Institute's examinations for better result in future.

QUESTION 2

(a)(i) Bobameto's position if he invests only in levered company is as follows:

Investment = ₦12,000,000 - ₦3,600,000
= ₦8,400,000

Cost of equity = $\frac{₦1,200,000 - (₦3,600,000 \times 0.06)}{₦8,400,000}$
= 11.71%
≈ 12%

WACC = $0.06 \left(\frac{₦3,600,000}{₦12,000,000}\right) + 0.12 \left(\frac{₦8,400,000}{₦12,000,000}\right)$
= 0.3 + 0.7 = 0.10
or 10%

Where WACC = Weighted Average Cost of Capital

∴ Value of the company (Abadah Plc) = $\frac{\text{Net Income}}{\text{WACC}}$
= $\frac{₦1,200,000}{0.10}$
= ₦12,000,000

∴ Chief Bobameto's Investment = 0.10 (₦8,400,000)
= ₦840,000

Returns on Investment = Net Income - Debenture Interest
= ₦1,200,000 - ₦216,000
= ₦984,000 x 10%
= ₦98,400

(a)(ii) Bobameto's position if he switches to the ungeared company's shares will be as follows:

Sells shares in geared company	₦840,000
Substituting his personal for corporate gearing at debt equity ratio of $\frac{₦3,600,000}{₦12,000,000}$ (i.e. 30/70) @ 6% to attain 10% holding in Bendeh Plc. (0.10 x ₦3,600,000)	360,000
	₦1,200,000
∴ Return on Investment = 0.10 (₦1,200,000)	= ₦120,000
Less: Cost of personal borrowing (6% x ₦360,000)	21,600
	₦98,400

Decision:

Chief Bobameto's net income remains unaffected by switching from geared company to an ungeared one. He is, therefore, advised to remain in the ungeared company for his rest of mind.

(b) The reservations about the scheme include the following:

(i) Transaction cost was ignored.
(ii) Taxation was ignored.
(iii) Perfect information is assumed.
(iv) The assumption of the same risk associated with personal and corporate borrowing is unrealistic.
(v) The efficiency of the stock markets in terms of forced equality of two similar securities.
(vi) The overall cost of capital of a geared firm decreases in line with the net earnings approach if the cost of debt remains unchanged.
(vii) The reduced overall cost of capital may cause the value of the geared firm to increase than that of the ungeared firm.

EXAMINERS' REPORT

The question tests candidates' ability to evaluate and determine optimal capital mix via the concept of arbitrage under the capital structure aspect of the syllabus.

The level of attempt was low as the number of candidates that attempted the question was less than 40%. It, therefore, appears that most of the candidates that sat for the examination did not understand the import of the question. The few that attempted it only had just a fair knowledge of it, hence performance was poor.

Candidates' commonest pitfalls were their inability to compute the expected returns

for the two options and their inadequate knowledge of Modigliani and Miller (M&M) theory on capital structure.

Candidates are advised to always cover the syllabus adequately and endeavour to remember key formulae for better result in future examinations.

SOLUTION 3

Alawada Limited

(a) Calculation of Net Present Value (NPV)

Year	CF	DF @ 10%	PV
	₦		₦
1	800,000	0.9091	727,280
2	640,000	0.8264	528,896
3	466,000	0.7513	350,106
4	836,700	0.6830	571,466
5	630,675	0.6209	391,586
			2,569,334
Less: Initial Outlay			(3,000,000)
Net Present Value			(430,666)

The project is not viable since the NPV shows a negative figure of ₦430,666.

Workings

Year	1	2	3	4	5
Sales (₦)	2,800,000	2,800,000	2,800,000	3,360,000	3,360,000
Less:					
Materials	(800,000)	(840,000)	(882,000)	(926,100)	(927,405)
Labour	(1,200,000)	(1,320,000)	(1,452,000)	(1,597,200)	(1,756,920)
Net MCF	800,000	640,000	466,000	836,700	630,675

(b) Features of capital budgeting decisions include the following:

i. They involve large outlay.

ii. The benefits will accrue over a long period of time, usually well over one year and often much longer, so that the benefits cannot all be set off against costs in the current year's Income Statement.

iii. They are very risky.

iv. They involve irreversible decision.

(c) i. The continued existence of any company is not predicated on its investment on short-term basis but rather on its long-term investment strategies.

ii. Investment decisions facilitate the identification of viable projects in order to maximise the wealth of the shareholders.

iii. Companies need to undertake long-term investments which are the pre-requisite to the concept of "on-going concern" basis.

iv. Capital budgeting ensures that the management team does not mortgage the future of the company for their personal individual financial gains through short-term investments.

v. It assists the streamlining of the projects being executed by the organisation.

EXAMINERS' REPORT

The question tests candidates' knowledge of evaluation of capital projects and their understanding of the features and importance of capital budgeting decision.

Over 90% of the candidates attempted the question and performance was fair. Despite the fact that the cost of capital (the discount rate) was not given in the part 'a' of the question, candidates correctly assumed a discount rate which goes to show a high level of understanding of this part of the question by the candidates.

However, parts (b) and (c) of the question were not fully understood by the candidates hence the mix up in their solutions and this impacted on their overall performance in the question.

Candidates' commonest pitfall was their inability to differentiate between features of capital budgeting and the reasons for capital budgeting.

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

SOLUTION 4

(a)(i) The Beta Factor for the portfolio can be calculated by means of a weighted average of the Beta values of the individual shares. Market values should be used in the weightings.

	Number of Shares	Market Price	Market Value (MV)	Beta Factor (B)	MV_x
		₦	₦		₦
Black Plc.	15,000	2.50	37,500	1.32	49,500
Blue Plc.	18,000	2.20	39,600	1.20	47,520
Yellow Plc.	10,000	1.90	19,000	0.80	15,200
Purple Plc.	12,000	1.50	18,000	1.05	18,900
White Plc.	20,000	0.60	12,000	0.80	9,600
Total			126,100		140,720

∴ The portfolio Beta = $(MV x \beta)/MV$

= 140,720/126,100

β = 1.11594

(ii) The required return on the portfolio can be calculated by establishing the required rate of return for each share, and then applying this to the market value of the holding.

The formula used is: $R_s = R_f + \beta (R_m - R_f)$

where R_s = Return on the individual share

β = Beta factor

R_m = Market rate of return

R_f = Risk free rate of return

A quicker way to calculate this is to calculate 'R_s' for the portfolio as a whole using the Beta factor previously derived, and then to apply this rate of return to the market value of the portofolio:

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

R_s = 8% + 1.11594 (14% - 8%)

R_s = 14.6956%

∴ Selected return = ₦126,100 x 14.6956%

= ₦18,531

Alternatively, we can calculate the 'R_s' for each security and have an aggregate value for the portfolio as demonstrated below:

			Market Value	

	Beta Factor	R_s (%)	(MV)	R_s x MV
			₦	
Black Plc.	1.32	15.92	37,500	5,970
Blue Plc.	1.20	15.20	39,600	6,019
Yellow Plc.	0.80	12.80	19,000	2,432
Purple Plc.	1.05	14.30	18,000	2,574
White Plc.	0.80	12.80	12,000	1,536
Total				18,531

(b) Portfolio Theory will assist Chief Alagbala with a formal means of evaluating the systematic risk profile of his portfolio. He can decide the level of risk that he is happy to accept and express this in terms of a target Beta factor for his portfolio as a whole. He can then select securities which will provide him with this risk/return profile. As has been demonstrated above, he can also use the theory to indicate whether an individual security is correctly priced in the market, as this will influence his buying and selling decisions.

At the same time, however, the portfolio manager must be aware of the theoretical shortcomings of this form of analysis as stated below:

(i) The theory assumes that transactions costs can be ignored. In practice, the costs of buying and selling shares, particularly in relatively small quantities may become significant.

(ii) It further assumes that investors hold a well diversified portfolio and they are, therefore, protected against unsystematic risk and need only be concerned with systematic risk.

(iii) The theory is based upon a single period time horizon. This is unrealistic in terms of the way business decisions within firms are made.

In practice, the portfolio manager must also take other factors as well as the risk/return profile into account. The factors include the following:

- Liquidity

The manager must ensure that liquid funds are available to meet current commitments. This may mean that the portfolio at any one time contains a higher than predicted element of risk-free securities which are being held in anticipation of a known payment.

- Purpose

  The purpose for which the portfolio is being held will influence its make-up. For instance, if the overall fund is small and transaction costs are significant, and the fund is being invested with the intention of providing a regular income, then the manager will select high income securities in preference to growth stocks. This may mean that the optimum portfolio from the point of view of the theory may not be the one which should be selected in practice.

- Investment Criteria

  The owners of the fund may lay down investment criteria such as the ethical status of the companies in which to invest. This may restrict the choice available to the portfolio manager. Again, this may mean that the "optimum portfolio" is not chosen.
  Thus, it can be seen that the theory does have relevance to a portfolio manager in his selection of securities, but it does not provide the complete answer to the structuring of a portfolio.

EXAMINERS' REPORT

The question tests candidates' understanding of the various techniques available in analysing and selecting a portfolio of securities under the risk management aspect of the syllabus.

The level of attempt of the question was very low as less than 20% of the candidates attempted it. The few of them that attempted the question did not have a clear understanding of the question, hence their performance was poor.

Candidates' commonest pitfalls were their inability to remember the formulae for computing the portfolio risk (Beta) and expected return of the listed portfolio as well as their inadequate knowledge of the concept of portfolio theory.

Candidates are advised to always give considerations to all sections of the syllabus in their preparations for the Institute's examination. They should also endeavour to improve their knowledge on 'portfolio management' aspect of the syllabus for better result in future.

SOLUTION 5

(a) i Cash Dividend

This is the payment of cash via an instrument that is known as dividend warrant to equity holders. Most companies pay dividends in cash. Cash dividend is a product of cash availability and cash planning. The cash account and the reserves account of a company will be reduced when the cash dividend is paid. Thus both the total assets and the net worth of the company are reduced when cash dividend is distributed. The market price of the share drops in most cases as a result of the dividend distributed.

ii. Stock dividend/Scrip dividend

A stock/scrip dividend involves the payment of a dividend in the form of extra shares rather than cash.

As an alternative to paying out cash dividends during a year, a company may choose to pay a stock dividend (scrip dividend). This is essentially a transfer to the shareholders of a number of additional equity shares without the payment of cash as dividend to the shareholder i.e. preservation of company's liquidity.
It is subject to withholding tax and it also gives an option to the shareholder to collect cash.

iii. Scrip issue/Bonus issue/Capitalisation issue

This is the capitalisation of the reserves of a company by the issue of additional shares to existing share-holders in proportion to their holdings, usually at no cost.

A scrip issue is also called bonus issue or capitalisation issue.
The declaration of bonus shares will increase the paid up share capital and reduce the reserves and surplus of the company. The total net worth is not affected by the bonus issue.

(b)(i) Determination of market value of the firm based on retention of 20% of earnings.

Dividend payable = 80% of ₦2,250,000
= ₦1,800,000

$$\therefore MV = \frac{D_0(1+g)}{K_e - g}$$

MV = ₦1,800,000 (1.05)

$$0.14 - 0.05$$

$$= \underline{\underline{₦21,000,000}}$$

Where MV is Market Value, D_0 is Initial Dividend, g is dividend growth rate, K_e is cost of capital

(ii) Retain 10%

Dividend payable = 90% of ₦2,250,000

$= \underline{\underline{₦2,025,000}}$

$$\therefore MV = \frac{₦2,025,000\,(1.02)}{0.14 - 0.02}$$

$$= \underline{\underline{₦17,212,500}}$$

Advice:

The retention policy that favours the company is that of the retention of 20% as it will make the market value of the company higher than when 10% is retained.

(c) The advantages of retained earnings include the following:

i. There is no cost associated with the use of retained earnings as it does not lead to a cost involving the payment of cash.

ii. The use of retained earnings as opposed to new shares or debenture avoids issue costs.

iii. It avoids the possibility of dilution of control resulting from an issue of shares.

iv. Retained earnings are an attractive source of finance as investment projects can be undertaken without involving the shareholders or any outsiders.

EXAMINERS' REPORT

The question tests candidates' knowledge of dividend policy decision with emphasis on the different types of dividends and the significance of the relevance and irrelevance theories of dividend policy on the value of the firm.

Over 90% of the candidates attempted the question and performance was above average.

Candidates' commonest pitfalls were their failure to apply appropriate formulae in computing the market values of Mainland Plc.'s shares for the two options and their

inability to differentiate between stock dividend and scrip issue.

Candidates are advised to prepare adequately by reading wide and working on past questions making use of the Institute's Pathfinders and Study Packs when preparing for the Institute's examinations.

SOLUTION 6

a(i) **Operating Lease**

This is a rental agreement between a lessor and a lessee whereby the lessor is responsible for the upkeep, maintenance, servicing and insurance of the leased asset i.e. all risks and rewards incident to ownership remain with the lessor.

It is also known as full service lease or wet-lease in the airline industry.

This type of lease agreement does not cover the useful, economic, working life of the leased asset, so that at the end of an agreement, the lessor can lease the same asset to someone else (or to the same lessee) and obtain a good rental for it.

Since all risks and rewards incidental to ownership remain with the lessor, he relies on subsequent leasing or eventual sale of the asset to recover his capital outlay.

The lease can sometimes be cancelled at a short notice.

(ii) **Advantages of using Debt Finance**

- Provided that profit can be earned, Earnings Per Share (EPS) will be boosted; this should increase the share price and will help the company to raise new share capital when required.
- It indicates the available debt capacity of the business.
- Loan capital is cheap because interest payments are treated for tax purposes as business expenses.

Disadvantages of using debt finance

- Default in the repayments of the debt may lead to the filing of winding up/liquidation order on the company by the creditors in a law court.
- As gearing increases, the cost of equity also increases due to financial

risk.

- High gearing may negatively affect the firms' credit rating and its ability to raise more fund.
- Debenture holders have prior claim on the earnings of the company as they must be paid their interest whether the company makes profit or not.
- There is an inherent dilution of control in that the interest payments effected would have reduced the level of distributable profits.

(iii) Limiting factors in debt financing include the following:

- Legal limits imposed by a firm's article of association.
- Limitation imposed by existing lenders in the form of covenant restricting the issue of further debts.
- Annuity and volatility of cash flows available to service debts; generally the more volatile the firm's earning streams, the lower will be the limit on prudent borrowing.
- Level of interest charges.
- Perception by investors and management of an optimum level or gearing.
- The amount and type of assets which can be used as security for borrowing.
- Previous levels of gearing.
- The impact of borrowing on the volatility of return on equity shareholders.

(iv) Concealed Gearing

This is otherwise called Off Statement of Financial Position gearing (off Balance Sheet gearing).

It describes a method of financing which does not appear in the Statement of Financial Position (balance sheet). The most common example of this is with leasing (operating leases). If a company finances the acquisition of a fixed asset by a lease, only the lease payments will appear in the Statement of Comprehensive Income (profit and loss account) and no asset or liability appears in the Statement of Financial Position (balance sheet).

Another example of concealed gearing is the practice of borrowing through an associate. Since only the net assets of the associate are revealed in the investors' accounts, this form of financing will not be shown. It may be possible to deduce that such borrowings exist by the fact that the contingent liabilities note may refer to the guarantee given against the borrowing of the associate.

(b) The Degree of Operating Leverage (DOL) at a given quantity level is calculated as follows:

$$\text{Degree of operating leverage at sales level } Q = \frac{\text{Contribution}}{\text{EBIT}}$$

$$= \frac{₦1{,}000{,}000}{₦100{,}000}$$

DOL= 10 times

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Contribution = Total Sales – Variable Cost
EBIT = Total Sales – (Variable Cost + Fixed Cost)

	₦
Total Sales	2,500,000
Less Variable Cost	1,500,000
Contribution	1,000,000
Less fixed Cost	900,000
EBIT	100,000

where EBIT = Earnings Before Interest and Tax

ALTERNATIVE SOLUTION

$$\text{DOL} = \frac{Q(SP - VC)}{Q(SP - VC) - FC}$$

where: Q = Quantity
SP = Selling Price
VC = Variable Cost
FC = Fixed Cost

$$= \frac{125{,}000 \times (20 - 12)}{125{,}000\ (20 - 12) - 900{,}000}$$

$$= \frac{125{,}000 \times 8}{}$$

$$(125{,}000 \times 8) - 900{,}000$$

$$= \frac{1{,}000{,}000}{1{,}000{,}000 - 900{,}000}$$

$$= \frac{1{,}000{,}000}{100{,}000}$$

$$= 10 \text{ times}$$

EXAMINERS' REPORT

Part 'a' of the question tests candidates' understanding of leasing and debt financing under the financial decision aspect of the syllabus while part (b) tests their knowledge of evaluation of a company's performance under corporate strategy and financial management part of the syllabus.

Over 80% of the candidates attempted the question but performance was poor. This is an indication that candidates' understanding of the question was low.

Candidates' commonest pitfalls were their

i. failure to define operating lease and 'concealed gearing' correctly,
ii. inability to differentiate between the disadvantages of debt finance and limiting factors in debt financing.
iii. failure to remember the formulae for computing the degree of operating leverage.

Candidates are advised to take time to read, understand and interprete questions appropriately before attempting them. They should also endeavour to remember key formulae.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL EXAMINATION II – NOVEMBER 2013

ADVANCED TAXATION

Time Allowed: 3 hours

SECTION A: PART I MULTIPLE-CHOICE QUESTIONS (20 Marks)

ATTEMPT ALL QUESTIONS IN THIS SECTION

Write ONLY the alphabet (A, B, C, D or E) that corresponds to the correct option in each of the following questions/statements.

1. Which of the following is **NOT** a member of the Federal Inland Revenue Service Board (FIRSB)?

   A. A representative of the Attorney-General of the Federation
   B. Executive Chairman appointed by the President and subject to confirmation of the Senate
   C. A representative of the Minister of Finance not below the rank of a Director
   D. The President of Chartered Institute of Taxation of Nigeria
   E. The Registrar-General of the Corporate Affairs Commission or his representative not below the rank of a Director.

2. Tertiary Education Tax is chargeable on:

   A. Chargeable profit
   B. Realisable profit
   C. Total profit
   D. Assessable profit
   E. Accounting profit

3. Where a Taxpayer is aggrieved with the decision of the Tax Appeal Tribunal, he/she can appeal against the Tribunal's decision to the:

   A. Supreme Court
   B. Joint Tax Board
   C. Federal High Court
   D. Court of Appeal
   E. Magistrate Court

4. In filing Income Tax Returns, a Corporate Tax Payer shall submit the following **EXCEPT:**

   A. Capital allowances computation
   B. Income tax computation
   C. Signed audited financial statements together with a covering letter from the tax consultant
   D. A declaration of voluntary compliance
   E. Self Assessment Forms for Income and Tertiary Education Tax

5. In cases of Tax Evasion/Audit, prior years' assessments could be reopened:

A. For exactly 3 years
B. Beyond the statutory limit of 6 years
C. Beyond the statutory limit of 7 years
D. Beyond 10 years
E. For 21 years

6. Which of the following is **NOT** a Taxable Income in the hands of an individual partner in a Partnership?

A. Partner's share of the profits
B. Partner's capital
C. Passage costs charged to the accounts
D. Partner's costs charged to the accounts
E. Partner's salary

7. The person who has a right to the Capital of a Settlement when the Life Interest terminates is the:

A. Annuitant
B. Remainderman
C. Settlor
D. Beneficiary
E. Legatee

8. The following are allowable deductions under the Capital Gains Tax Act CAP C1 LFN 2004 **EXCEPT:**

A. Insurance premiums on the asset
B. Incidental costs of disposal
C. Cost of acquisition or purchase price, including all costs incidental to the purchase
D. Improvement costs wholly, exclusively and necessarily incurred
E. Costs wholly, exclusively and necessarily incurred in establishing, preserving or defending the owner's title to or right over the asset

9. A year of assessment in relation to Capital Gains Tax means:

A. Any date to 31 March
B. A year beginning 1 April and ending on 31 March of the year
C. A year beginning 1 January and ending 31 December in the same calendar year with effect from 1969
D. A year beginning 1 October and ending 30 September of the next year
E. Any date to 31 December

10. The following are exempted from tax, even if they are derived from trade or business being carried on by the Bodies concerned, **EXCEPT:**

A. The profits of any Company being a Body Corporate established by or under any Local Government law or edict in force in any State in Nigeria
B. Dividend distributed by a Unit Trust
C. Dividend received from Investments in non export-oriented businesses
D. The profits of any Company formed for the purpose of promoting sporting activities where such profits are wholly expendable for such purpose, subject to such conditions as the Revenue Service may prescribe.
E. The profits of any Nigerian Company in respect of goods exported from Nigeria, provided that the proceeds from such exports are repatriated to Nigeria and are used exclusively for the purchase of raw materials, equipment and spare parts

11. Which of the following is **NOT** an allowable deduction? Donation to

A. Boys Scouts of Nigeria
B. the Nigerian Youth Trust
C. the Islamic Education Trust
D. Youth Club of Nigeria
E. the Cocoa Research Institute of Nigeria

12. The tax relief period for a Company holding a Pioneer Certificate is usually for a period of:

A. Five years in the first instance
B. Four years in the first instance

C. Three years in the first instance
D. Two years in the first instance
E. One year in the first instance

13. Which of the following is **NOT** applicable in a Double Taxation Agreement?

A. The tax payable on the worldwide income will be reduced by the credit admissible under the terms of agreement
B. Credit is allowable only for a Nigerian company
C. Any claim for an allowance by way of credit shall be made not later than five years after the end of the assessment year
D. In the event of any dispute as to the amount allowable, the claim shall be subject to objection and appeal in like manner as an assessment
E. A company can elect not to take the benefit of the credit available under the arrangement in respect of the foreign profit earned by it for the assessment year

14. Production costs under the Petroleum Profits Tax Act include the following **EXCEPT:**

A. Royalties
B. Repairs and maintenance of production facilities
C. Cost of personnel engaged in the operation of wells and related equipment and facilities
D. Cost of excavation of soil
E. Materials, supplies, fuel consumed and services utilised in such operations

15. The Profits of a Company engaged in Petroleum Operations and taxed under the Petroleum Profits Tax Act for an accounting period is computed as the aggregate of the following **EXCEPT:**

A. The value of chargeable oil disposed of
B. The proceeds of sale of all chargeable oil
C. The value of all chargeable natural gas
D. The value of all chargeable oil and liquid gas
E. All income incidental to and arising from one or more of its petroleum operations

16. Under the Petroleum Profits Tax Act, the following are disallowable expenditure **EXCEPT:**

A. Any capital withdrawn or any sum employed or intended to be employed as capital
B. Any capital employed in improvements as distinct from repairs
C. Sums recoverable under an insurance or contract of indemnity
D. Amounts incurred as income tax, profits tax or other similar tax, whether charged within Nigeria or elsewhere
E. All sums incurred by way of interest on any inter-company loans obtained under terms prevailing in the open market

17. The powers and duties specified in the First Schedule of the Petroleum Profits Tax Act CAP P13 LFN 2004 that cannot be delegated by the Federal Inland Revenue Service include all the following **EXCEPT:**

A. Powers and duties of the Federal Inland Revenue Service Act 2007
B. The Revenue Service powers under the artificial transaction provisions
C. The Revenue Service power to grant relief for error or mistake
D. Reconciliation of manifest on tax payments into various banks
E. The Revenue Service's power to levy penalty for rendering incorrect accounts

18. Petroleum Profits Tax for Companies engaged in Petroleum Operations are assessed on:

A. Change of accounting year basis
B. Penultimate year basis
C. Accounting period basis
D. Preceding year basis
E. Cessation of business basis

19. Which of the following does **NOT** attract ad-valorem duties?

A. Mortgages
B. Bills of exchange
C. Promisory notes
D. Lease documents
E. Policy of life insurance

20. Which of the following according to the Stamp Duties Act CAP S8 LFN 2004 is **NOT EXEMPTED** from Stamp Duties?

A. Receipts issued for the payment of any government taxes, duties or levies
B. Instruments providing for penal rent or increased rent in the nature of a penal rent
C. Treaties/Agreements entered into between the Federal Government and any other foreign Governments or foreign private corporations/ international organisations
D. Marketable securities
E. Liquidation sales/transactions

SECTION A: PART II SHORT-ANSWER QUESTIONS (20 Marks)

ATTEMPT ALL QUESTIONS IN THIS SECTION

Write the correct answer that best completes each of the following questions/statements:

1. The Tax Audit exercise that covers Companies within a specific Industry is known as ……………………

2. Customs and Excise Duty is an example of ………………………………

3. Incomes derived from sources other than the exercise of physical or mental efforts either in the past or present are known as ……………………

4. For a new Company, the due date for filing of Income Tax Returns under the Companies Income Tax Act CAP C21 LFN 2004 is ………………. from the accounting year end or ……………. from the date of incorporation, whichever is earlier.

5. A means by which enjoyment of an Estate or part of it is transferred to another person, either through a disposition, trust, covenant, agreement, arrangement or transfer of assets by reference to a Trust deed, for the benefit of such persons, is known as……………………

6. An advance payment of income tax that cannot be used later as credit for any other tax such as Tertiary Education Tax or Value Added Tax is known as ………………….

7. Any aggrieved taxpayer objecting to an assessment in respect of Capital Gains Tax shall, in accordance with the Companies Income Tax Act, take the case to the ……………………

8. Where there is a change of accounting date, the Revenue Service has the power to compute as it deems fit, the assessable profits for ………………………… and ………………………

9. Under Pioneer legislation, the estimated cost of Qualifying Capital Expenditure to be incurred by a Company on or before Production Day shall not be less than ₦150,000 in the case of any other Company or ₦……………………… in the case of an …………………… Company.

10. Under the Double Taxation Agreement, a claim for Commonwealth Relief has to be made not later than ……………………… after the end of the Year of Assessment affected.

11. The differences between Taxable Income and Accounting Income for a period that does not reverse in subsequent periods is known as.........................

12. A Non-resident Company is taxable in Nigeria only on the profit deemed to be derived from Nigeria while a Resident Company is taxable in Nigeria on................................

13. A Company that is yet to commence business after six months of incorporation and seeks to obtain Tax Clearance Certificate must pay.............

14. Any liquid hydrocarbons obtained in Nigeria from natural gas by separation or by any chemical or physical process but before the same has been refined or otherwise treated is referred to as..........................

15. The amount of any rent for which there is provision for its deduction from the amount of any royalties under an Oil Prospecting Licence or Oil Mining Lease, to the extent that such rent is not so deducted is known as..................

16. In Petroleum Operations,..................are incurred to obtain access to proved reserves and provide facilities for extracting, gathering, treating, and storing the oil and gas.

17. When Petroleum producing Companies enter into agreements with NNPC for the production of crude oil in particular oil fields, such agreements are called.......................

18. In relation to any crude oil exported from Nigeria by a company, the F. O. B. price at the Nigerian Port of Export for Crude Oil, of the gravity and quality in question which is from time to time established by the company is known as ....

19. The Duty that varies with the values of the consideration on the Documents that are to be stamped is called.......................................

20. Under the Stamp Duties Act CAP S8 LFN 2004, Stamp Duty is managed by the................

SECTION B: ATTEMPT QUESTION 1 AND ANY OTHER THREE QUESTIONS (60 Marks)

QUESTION 1

CASE STUDY

In response to the Federal Government's appeal to Nigerians in the diaspora to come and invest in Nigeria, Chief Aide Kampe took up the challenge to return to the country and establish in his home State, large-scale farms and factories for the processing of agricultural products for export to the United Kingdom.

Chief Kampe strongly believes that a potential market for agro-products exists abroad having lived in the United Kingdom for several years. To this end, a preliminary study commissioned by Chief Kampe revealed that most of the plant and machinery for the farm projects will be imported while some others will be sourced locally in Nigeria. Since the farmlands are situated in the remote areas of his home State, additional expenditure will be incurred to provide necessary infrastructure such as Bore-holes and Power generators.

Chief Kampe's in-law, who is the Commissioner of Works in his State, has promised to assist with the provision of access road to the factory. The Chief is wondering whether additional assistance could come from the Federal Government and has therefore approached you to advise him on the Tax Incentives available to Companies engaged in Farming and Processing of Agricultural Products as well as Export-oriented businesses in Nigeria.

He believes he will enjoy some incentives which he puts at ₦2,500,000, ₦10,000,000, ₦6,000,000 and ₦7,000,000 for Boreholes, Roads, Power generators and Agricultural business respectively.

You are required to:

Prepare a report for Chief Kampe which will address his concerns. Include in your report, the conditions that need to be met to qualify for such Incentives. **(15 Marks)**

QUESTION 2

(a) State the **Composition and Functions** of the Joint State Revenue Committee. (8 Marks)

(b) When is a tax assessment considered final and conclusive? (2 Marks)

(c) State the information required in a valid Notice of Appeal to the Tax Appeal Tribunal. (5 Marks)

(Total 15 Marks)

QUESTION 3

Mr. Okuko is a staff of one of the Federal Government Agencies in Nigeria. His emoluments for 2012 and other incomes are as follows:

	₦
Basic salary	16,000,000
Housing Allowance	10,000,000
Transport Allowance	4,800,000
Utility Allowance	1,200,000
Entertainment Allowance	400,000

The following additional information is made available:

i. Interest income earned on bonds/securities issued by the Federal Government ₦1,733,333

ii. Net rent received as landlord ₦1,800,000

iii. He was registered with BMW Pension Fund Managers. His office paid 15% to the BMW Pension Fund Managers (employee and employers contribution).

iv. He contributed monthly to the National Housing Fund (NHF).

v. He obtained a salary advance of ₦800,000 in November 2011, repayable in the 2nd quarter of the following year.

vi. He received a dividend warrant of ₦266,667.

vii. He has a Life Insurance Policy and paid ₦40,000 per month as Life Premium.

You are required to:

Compute the following for Mr. Okuko for 2012 Assessment Year:

(a) Gross Income (6 Marks)
(b) Total reliefs (3 Marks)
(c) Chargeable income (2 Marks)
(d) Annual tax payable (2 Marks)
(e) Monthly tax payable (2 Marks)

(Total 15 Marks)

QUESTION 4

Emene Tiles Limited was granted a Pioneer Certificate with its Production Day as 1

July, 2007.

The following information has been obtained from its records:

		₦
i.	Accumulated profit as at 30 June, 2010	4,950,000
ii.	Capital expenditure incurred during the Pioneer period as certified by the FIRS:	
	Building	2,400,000
	Plant and Machinery	2,250,000
	Motor Vehicles	1,500,000
	Furniture and Fittings	750,000

iii. After the end of the Pioneer period, the company adopted 31 December as its year end and the adjusted profits from the new trade were:

	₦
6 months to 31 December, 2010	1,800,000
Year to 31 December, 2011	2,700,000

You are required to:

Compute the Tax Liabilities of the Company for the relevant Years of Assessment **(15 Marks)**

QUESTION 5

Nkwoagu Limited sold a Plant to Ozo Nchi on 31 December 2007 for ₦5,200,000 which cost ₦3,250,000 to acquire on 1 March 2005.

The sales agreement provided for payment of an initial deposit of ₦2,080,000 on the day of sale and the balance of ₦3,120,000 payable in three equal instalments on 31 December, 2008, 2009 and 2010.

Ozo Nchi made actual payments as detailed below:

Date	₦
31/12/2007	2,080,000
31/12/2008	1,040,000
31/12/2009	1,040,000
31/12/2010	260,000

Ozo Nchi died and the balance of ₦780,000 could not be recovered by Nkwoagu Limited as at 31 December, 2012. Consequently, the balance was written off as Bad Debt, with the consent of the FIRS.

You are required to:

Compute the Capital Gains Tax payable. **(15 Marks)**

QUESTION 6

Chigold Petroleum Limited's records show the following as at 31 December 2011:

	₦
Sale of crude oil export	278,300,000
Sale of natural gas	15,125,000
Other incidental income	1,512,500
The expenses incurred during the period are as follows:	
Production	72,600,000
Administration	96,800,000
Intangible drilling cost	15,125,000
Non-productive rentals	6,050,000
Royalties on export	1,512,500
Royalties on local sales	605,000
Custom duties on plant & machinery	9,075,000
Provision for restoration of wells	45,375,000

The following additional information was made available:

(i) Existence of a Memorandum of Understanding (MOU) credit of ₦6,050,000.

(ii) Petroleum Investment Allowance has been agreed at ₦4,537,500.

(iii) Depreciation included in Production expenses amounted to ₦12,100,000.

(iv) Capital Allowances agreed with FIRS is ₦18,150,000.

You are required to:

Compute the Chargeable Tax for the relevant accounting period. **(15 Marks)**

NIGERIAN TAX RATES

1. **CAPITAL ALLOWANCES**

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

2. **INVESTMENT ALLOWANCE** 10%

3. **RATES OF PERSONAL INCOME TAX**

Graduated tax rates with consolidated relief allowance of ₦200,000 or 1% of the Gross Income, whichever is higher, plus 20% of the 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 has been granted, the balance of Income shall be taxed as specified in the tax table above.

4. **COMPANIES INCOME TAX RATE** 30%

5. **TERTIARY EDUCATION TAX** (2% of Assessable Profit)

6. **CAPITAL GAINS TAX** 10%

7. **VALUE ADDED TAX** 5%

SOLUTIONS TO SECTION A

PART I MULTIPLE-CHOICE QUESTIONS

1. D
2. D
3. C
4. D
5. B
6. B
7. B
8. A
9. C
10. C
11. D
12. C
13. C
14. D
15. D
16. E
17. D
18. C
19. A
20. D

EXAMINERS' REPORT

The questions adequately cover the entire syllabus. A large number of the candidates attempted all the questions, whilst a few avoided answering some of the questions.

Majority of the candidates scored over 50% of the marks obtainable.

PART II SHORT-ANSWER SOLUTIONS

1. Routine Sector Audits

2. Indirect Tax
3. Unearned Income
4. (a) Six months (b) Eighteen months
5. Settlement
6. Withholding Tax
7. Tax Appeal Tribunal
8. (i) The year of Assessment in which the change occurs
   (ii) The two years of Assessment following
9. ₦50,000; indigenously controlled Company
10. 6 years
11. Permanent Timing Differences
12. Its worldwide income
13. Pre-Operational levy
14. Casing-head Petroleum Spirit
15. Non-productive rents
16. Development costs
17. Production Sharing Contracts
18. Posted price
19. Ad Valorem Duty
20. Commissioner of Stamp Duties

EXAMINERS' REPORT

The questions fairly covered the syllabus. Over 95% of the candidates attempted all the questions and performance was above average. Candidates need to regularly update their knowledge of appropriate terminologies or concepts used to summarise sections of the various Tax Acts.

SOLUTIONS TO SECTION B

SOLUTION 1

20 November, 2013

The Manager Director,
Kampe Agriculture Ltd,
Chief Avenue,
Lagos

Attention: Chief Aide Kampe

Dear Sir,

RE: TAX INCENTIVES AVAILABLE TO COMPANIES ENGAGED IN FARMING AND PROCESSING OF AGRO-PRODUCTS AND EXPORT-ORIENTED BUSINESS IN NIGERIA

We refer to your enquiry on the tax incentives available to companies engaged in agricultural business, processing of agricultural products and export oriented business, in Nigeria and would like to respond as follows:

Appendix 1: Rural Investment Allowance

Appendix II: Incentives for Agricultural purposes

Appendix III: Incentives for Manufacturing businesses and processing of Agricultural products

Appendix iv: Incentives for Exports

Based on the various Investment Allowances and Incentives stated in the various appendices, your Company can make the necessary claims on the amount incurred on the Qualifying Capital Expenditure at the specified percentages and Capital Allowances.

We hope you will find all the above very useful. Kindly revert if you require further clarifications.

Thank you

Yours faithfully
AJANAKU & CO
Chartered Accountants

(a) **APPENDIX I**

Rural Investment allowance is granted to Companies that open up for business in the rural areas by investing in such process. The allowance is granted to

Companies that incur capital expenditure on the provision of facilities like electricity, water or tarred roads. The business or trade must be located at least 20km away from such facilities.

In addition to the normal Initial Allowance, the following rates of allowances are granted.

(i)	Where there are no facilities at all,	-	100%
(ii)	No Electricity	-	50%
(iii)	No water	-	30%
(iv)	No Road	-	15%

The Rural Investment allowance is granted as a deduction from the assessable profits of the year in which the facility was completed. Where there is no Assessable Profit in the year of completion, or the Assessable Profit is less than the Rural Investment Allowance, the unrelieved allowance lapses.

(b) **APPENDIX II**

Incentives for Agricultural Purposes

(i) No restriction on Capital Allowances claimable

(ii) Agricultural plants, equipment and plantation equipment are granted 95% Initial Allowance in the first year of being put into use and the balance of 5% is retained in the books until disposal Ranching and plantation equipment enjoy 30% Initial Allowance and 50% Annual Allowance.

(iii) No payment of Minimum Tax where the Company makes small profit, or no profit.

(iv) Lower rate of tax of 20% of Total Profits for the first 5 years of commencement of business as is applicable to small Companies in other sectors of the economy.

(v) Investment Allowance of 10% for qualifying expenditure incurred on Plant and Equipment other than in marketing and processing. However, this cannot be granted simultaneously with the Rural Investment allowance.

(vi) Interest on Bank loan to a company engaged in Agricultural business is tax exempt, provided the moratorium is not less than 18 months, and the rate of interest on the loan is not more than the base lending rate at the time the loan was granted.

(vii) Some Agro—allied Companies are granted Pioneer Status.

- Exempted from Income Tax for at least three years or maximum of 5 years
- Dividend from the exempted profits do not suffer tax in the hands of the Shareholder.

(c) **APPENDIX III**

Incentives to Companies engaged in Manufacturing

(i) Dividends received from Small Companies in the sector are tax-exempt in the hands of the Shareholders

(ii) Incentives (i), (iv), (v), (vi) and (vii) as in Agricultural production, are also granted for manufacturing.

(d) **APPENDIX IV'**

Incentives for Export

Some of the incentives available to the Investors in Agricultural and Manufacturing concerns are also available to Exporters.
Additions to the above are:

(i) Profits of any Nigerian Company in respect of goods exported from Nigeria is tax exempt provided that the proceeds from such exports are repatriated to Nigeria.

(ii) Goods exported are exempted from VAT and are used exclusively for the purchase of Raw Materials, Equipment and Spare parts

(iii) The profits of a Company whose supplies are exclusively inputs for the manufacturing of products for export are exempted from tax, provided the exporter gives a Certificate of Purchase of the inputs of the exportable goods to the seller of the supplies.

(iv) The profits of an undertaking which is export-oriented, established within and outside Export-Free zone, shall be exempted from tax for the first 3 consecutive years of assessment, provided:

- The Company is 100% export-oriented
- The undertaking must not have been brought about or formed as a result of split-up, merger or reconstruction of an already existing business.
- The enterprise is not formed by transfer of Machinery or Plant previously used for any purpose to the new enterprise and where this is done, the machinery or plant transferred must not exceed 25% of the total value of the machine or enterprise.

- It manufactures, produces, and exports articles during the relevant year and the export proceeds form at least 75% of the Enterprise's Turnover.
- The Equipment and operating assets of the Company must not be utilised for any other purpose than the production of exportable goods.
- At least 75% of the undertaking's export –earnings are repatriated to Nigeria and deposited in a Domiciliary account in a recognised Bank in Nigeria.

Capital item	Amount	%	Incentives
	₦		₦
Borehole	2,500,000	30	750,000
Road	10,000,000	15	1,500,000
Power Generators	6,000,000	50	3,000,000

Note: These incentives are targeted at some preferred sectors of the Economy such as Manufacturing, Agriculture, Export, Solid Minerals, etc

EXAMINERS' REPORT

This is a compulsory and comprehensive Case Study question designed to examine candidates' knowledge and understanding of the current Tax Reliefs/Incentives available to Investors in the Agricultural Manufacturing and Export-oriented sectors of the Nigerian Industrial Sector. Over 98% of the Candidates attempted the question, but performance was generally poor, as less than 10% of them scored up to half of the marks allocated. Understanding of the question was very poor, as displayed in the answers proffered.

Many candidates demonstrated very poor knowledge and understanding of the available/applicable Reliefs and Incentives, whilst some mistakenly provided as answer, Reliefs applicable to Pioneer companies. Another major pitfall, was the inability of majority of the candidates to present their answers in a proper Report format.

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

SOLUTION 2

(a) (i) **Composition of the Joint State Revenue Committee**

- Chairman of the State Internal Revenue Service as the Chairman
- Chairman of the Local Government Revenue Committee
- A representative of the Bureau of Local Government Affairs not below the rank of a Director
- A representative of the Revenue Mobilisation Allocation and Fiscal Commission as an observer
- State Sector Commander of the Federal Road Safety Commission as an observer
- The legal adviser of the State Internal Revenue Service
- The Secretary of the Committee who shall be a staff of the State Internal Revenue Service.

(ii) Functions

- Implement decisions of the Joint Tax Board
- Advise the Joint Tax Board and the State and Local Governments on Revenue matters
- Harmonise tax administration in the State
- Enlighten members of the public generally on State and Local Government Revenue matters
- Carry out such other functions as may be assigned to it by the Joint Tax Board.

(b) An assessment is said to be final and conclusive where,

(i) No valid objection or appeal has been lodged within the time limit for the appeal to be made to the Board, the Appeal Commissioners and to the Federal High Court, against an assessment as regards the amount of the total profits assessed.

(ii) The amount of the Total profits has been agreed to, after the Board must have amended the assessment and notice of tax payable served on the company.

(iii) The amount of the total profit has been determined after objection and revision of the amended assessment and notice of tax payable served on the Company.

(iv) An appeal, the assessment as made, agreed to, revised or determined on appeal by Appeal Commission/ High court and notice of tax payable has been served on a Company.

(c) Information required in a Valid Notice of Appeal to the Tax appeal Tribunal

The 5th Schedule of the Federal Inland Revenue Service (Establishment) Act 2007 states in Section 13(2) of the schedule that:

(i) The appeal shall be filed within a period of 30 days from the date on which a copy of the order or decision which is being appealed against is made or deemed to have been made by the service.

(ii) It shall be in such form and be accompanied by such fees as may be prescribed provided that the tribunal may entertain an appeal after the expiry of the 30 days, if it is satisfied that there was sufficient cause for the delay.

EXAMINERS' REPORT

This is a straightforward three-part question designed to test candidates' knowledge and understanding of an organ of the Tax Authority and its related functions as well as some provisions of the Tax Laws with regards to Assessments and Appeals. About 70% of the Candidates attempted the question, and performance was average.

Candidates performed well in Parts (a) and (b) of the question, but displayed poor understanding of Part (c). Candidates need to appreciate the distinction between the various levels of Tax Authorities with respect to their powers and functions. Candidates should update their knowledge with current Tax Amendments.

SOLUTION 3

(a)

COMPUTATION OF GROSS INCOME

	₦	₦
Basic salary		16,000,000
Housing allowance		10,000,000
Transport allowance		4,800,000
Utility allowance		1,200,000
Entertainment allowance		400,000
GROSS EMOLUMENT		32,400,000
Interest on FGN Bond	1,733,333	
Dividend Income	266,667	
Gross rent received	2,000,000	4,000,000

GROSS INCOME		36,400,000
Less: Tax-Exempt Income		
Interest on FGN Bond	1,733,333	
Dividend Income	266,667	2,000,000
TAXABLE INCOME		34,400,000
Less: Reliefs		
Consolidated Relief Allowance	7,644,000	
N H F (2.5% of Basic)	400,000	
Pensions (7.5% of B,H,T)	2,310,000	
Life Premium	480,000	
TOTAL RELIEFS		10,834,000
CHARGEABLE INCOME		23,566,000

(b)

COMPUTATION OF ANNUAL TAX PAYABLE

	₦
1ST ₦300,000 @ 7%	21,000
NEXT ₦300,000 @ 11%	33,000
NEXT ₦500,000 @ 15%	75,000
NEXT ₦500,000 @ 19%	95,000
NEXT ₦1,600,000 @ 21%	336,000
BALANCE ₦20,366,000 @ 24%	4,887,840
ANNUAL TAX PAYABLE	5,447,840

(c) COMPUTATION OF MONTHLY TAX PAYABLE

$\frac{\text{ANNUAL TAX PAYABLE}}{12} = \frac{₦\,5,447,840}{12}$

= ₦453,986.67

WORKING 1:

CONSOLIDATED RELIEF ALLOWANCE

HIGHER OF ₦200,000 or 1% of the Gross Income, plus 20% of the Gross Income .

₦364,000 + ₦ 7,280,000 = ₦7,644,000

WORKING 2: NATIONAL HOUSING FUND

2.5% of BASIC SALARY
2.5% x ₦16,000,000
= ₦400,000

WORKING 3: PENSIONS CONTRIBUTION

7.5% OF TOTAL BASIC SALARY, HOUSING AND TRANSPORT.
7.5% x ₦30,800,000
= ₦2,310,000

Note: Monthly emoluments means a total of Basic Salary, Housing Allowance and Transport Allowance.

EXAMINERS' REPORT

The question was designed to test Candidates' knowledge and understanding of the Basic Rules and Principles applicable to the computation of Personal Income Tax under the revised Personal Income Tax (Amendment) Act 2011.
Candidates' understanding of the question was poor, as less than 15% of the Candidates scored up to 50% of the marks allocated.

Candidates' commonest pitfall was their very poor understanding of the provisions of the Act regarding the computation of the relevant Reliefs such as Personal Allowances, National Housing Fund (NHF) Pension and Life Insurance Premium contributions.
Candidates are advised to spare some extra study time to understand the provisions of the relevant Acts.

SOLUTION 4

EMENE TILES LIMITED
TAX COMPUTATIONS FOR THE ASSESSMENT YEARS 2010-2012

	₦	₦
2010 Assessment year (Actual)		
1/7/2010 – 31/12/2010		

Assessable Profit		1,800,000
Less: Capital Allowances (w1)		(3,040,125)
Unutilised C/A C/F		1,240,125
Total Profit		NIL
Income Tax Liabilities		NIL
Tertiary Education Tax (2% of ₦1,800,000)		36,000
		36,000

2011 Assessment year (1st Twelve months)		
(1/7/2010 – 30/6/2011)		
1/7/2010 -31/12/2010	1,800,000	
1/1/2011 – 30/6/2011 (6/12 x 2,000,000)	1,350,000	
		3,150,000
Less Capital Allowances		
b/f	1,240,125	
For the year (w2)	888,771	
		(2,128,896)
Total Profit		1,021,104
Income Tax @ 30%		306,331
Tertiary Education Tax 2% of ₦3,150,000		63,000
Total payable		369,331

2012 Assessment year (preceding year Basis)	
1/1/2011-31/12/2011	
Assessable profit	2,700,000
Less: Capital Allowance for the year (W3)	(888,771)
Total Profit	1,811,229
Income Tax 30%	543,369
Tertiary Education Tax @ 2% of ₦2,700,000	54,000
Tax Payable	597,369

Notes:

(i) Emene Tiles Ltd being a manufacturing concern, enjoys 100% Capital allowances

(ii) The Pioneer period of three years were:

1/7/07 – 30/6/08

1/7/08 – 30/6/09

1/7/09 - 30/6/2010

(iii) The accumulated profit for the 3 years to 30th June 2010 was tax exempt

(iv) At the end of the Pioneer period, Commencement Rules apply thus:

2010 – Actual year Assessment 1/7/2010 – 31/12/2010

2011 – 1st Twelve months 1/7/2010 – 30/6/2011

2012 – preceding year Basis 1/1/2011 – 31/12/2011

(v) The Investment allowance of 10% is a one-off allowance and it applies only to Plant and Machinery. It does not come into the computation of the Tax-Written-Down value.

Workings to solution 4

	Initial Allowance (%)	Annual Allowance %	Investment Allowance %
Building	10	10	-
Plant & Machinery	50	25	10
Motor Vehicle	50	25	-
Furniture & Fittings	25	20	-

	Building	Plant & Machinery	Motor Vehicle	F/Fittings	Total
	₦	₦	₦	₦	₦
2010 Ass year (1-7-2010-31/12/2010)					
Qualifying Exp	2,400,000	2,250,000	1,500,000	750,000	
Investment Allowance		(225,000)			(225,000)
Initial allowance	(360,000)	(1,125,000)	(750,000)	(187,500)	(2,422,500)
Annual allowance	(102,000)	(140,625)	(93,750)	(56,250)	(392,625)
					(w1) 3,040,125
WDV c/f	1,938,000	984,375	656,250	506,250	
2011 Assessment year (1/7/2010-30/6/2011)					
Annual allowance	(215,333)	(328,125)	(218,750)	(126,563)	(w2) (888,771)
TWDV c/f	1,722,667	656,250	437,500	379,687	
2012 Ass. year (1/1/2011-31/12/2011)					
Annual allowance	(215,333)	(328,125)	(218,750)	(126,563)	(w3) (888,771)
TWDV. c/f	1,507,334	328,125	281,750	253,124	

EXAMINERS' REPORT

This question tests Candidates' knowledge and understanding of the provisions of the Tax Act with regard to Reliefs granted to Organizations with Pioneer status both during and Post-Pioneer status periods. (Commencement rules). Only about 60% of the candidates attempted this question. Majority of them displayed poor understanding of the requirements of the question as they could not compute correctly the applicable Capital Allowances as well as the Tertiary Education Tax.

Candidates are advised to be more thorough in their preparations for future examinations. They should always anticipate/envisage unusual scenarios in questions.

SOLUTION 5

NKWAOGU LIMITED
COMPUTATION OF CAPTIAL GAINS TAX
ASSESSMENT YEAR 2007-2010

	₦
Sale proceeds	5,200,000
Cost of Acquisition	(3,250,000)
Chargeable gain	1,950,000

The assessment of the Chargeable gain of ₦1,950,000 is as follows:

Year of Assessment	Computation of chargeable gain	Amount	CGT
	₦	₦	₦
2007	$\frac{2,080,000\ x\ 1,950,000}{5,200,000}$	780,000	78,000
2008	$\frac{1,040,000\ x\ 1,950,000}{5,200,000}$	390,000	39,000
2009	$\frac{1,040,000\ x\ 1,950,000}{5,200,000}$	390,000	39,000
2010	$\frac{1,040,000\ x\ 1,950,000}{5,200,000}$	390,000	39,000
		1,950,000	195,000

NOTE:

Since OZO Nchi died and the balance of ₦780,000 could not be recovered by Nkwoagu and the balance was written off as bad debt with the consent of the FIRS, the computation for Assessment year 2010, will be done on the full payment outstanding i.e (₦ 260,000 + 780,000) = ₦1,040,000 and FIRS will give a tax refund or Tax Credit for the CGT on the unpaid balance.

Computation of Tax Credit

Chargeable Gain = $\frac{₦780,000\ x\ ₦1,950,000}{₦5,200,000}$ **= ₦292,500**

Tax Credit 10% of ₦292,500 = ₦29,250

EXAMINERS' REPORT

The question tests Candidates' knowledge and understanding of some usual scenarios in the computation of Capital Gains Tax, such as Instalmental payments, the incidence of Bad Debt, and the treatment of the 10% Tax Credit. Less than a quarter of the candidates attempted this question, and of this number, less than 10% scored up to 50% of the marks allocated. Candidates are advised to prepare better for future examinations by using current Study Materials and working through several editions of the Institute's Pathfinder and other such publications.

SOLUTION 6

CHIGOLD PETROLEUM LIMITED
CHARGEABLE TAX FOR THE YEAR 2011

	₦	₦	₦
Sale of Crude Oil			278,000,000
Sale of Natural Gas			15,125,000
Other Income			1,512,500

			294,937,500
Less:			
Section 10 expenses			
Production cost (72,600,000-12,100,00)		60,500,000	
Admin expenses		96,800,000	
Intangible Drilling Cost		15,125,000	
Non-productive Rentals		6,050,000	
Royalties on Export		1,512,500	
Royalties on local sales		605,000	
Custom Duty on plant & machinery		9,075,000	
Tertiary Education Tax @ $^{2}/_{102}$ (294,937,500 -189,667,500) = $^{2}/_{102}$ x 105,270,000		2,064,118	
			191,731,618
Assessable Profit			103,205,882
Deduct Lower of			
Capital Allowance Agreed	18,150,000		
Petroleum Investment Allowance	4,537,500		
	22,687,500		
OR			
85% of Assessable profit (103,205,882) =	87,725,000		
Less 170% of PIA ₦ 4,537,500	(7,713,750)		
	80,011,250		
Capital allowance claimed			(22,687,500)
Chargeable Profit			80,518,320
Assessable Tax ₦80,518,320 @ 85%			68,440,625
Less: MOU credit			(6,050,000)
PPT payable			62,390,625

EXAMINERS' REPORT

This is a question examining Candidates' knowledge and understanding of some of the major guiding principles applicable in the computation of Chargeable Tax under the Petroleum Profits Tax Act CAP P13 LFN 2004.

Over 90% of the candidates attempted the question, and performance was above average as over 70% of those that attempted the question scored over 60% of the allocated marks.

Whilst some candidates didn't get the appropriate year of Assessment right, others didn't get the treatment of Depreciation and Capital Allowances as well as the computation of Tertiary Education Tax under the Act correctly.

Candidates are advised to be more thorough in the coverage of major sections of the syllabus, including the Petroleum Profits Tax Act CAP P13 LFN 2004.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL EXAMINATION II – NOVEMBER 2013

PUBLIC SECTOR ACCOUNTING & FINANCE

Time Allowed: 3 hours

SECTION A: PART I MULTIPLE-CHOICE QUESTIONS (20 Marks)

ATTEMPT ALL QUESTIONS IN THIS SECTION

Write ONLY the alphabet (A, B, C, D or E) that corresponds to the correct option in each of the following questions/statements.

1. The Act of National Assembly that provides for the prudent management of the nation's resources, encouraging and ensuring accountability and transparency in the handling of the nation's resources is the :

   A. Pension Reform Act, 2007
   B. Economic and Financial Crime Commission Act, 2007
   C. Procurement Act, 2007
   D. Fiscal Responsibility Act, 2007
   E. Finance(Control and Management) Act, 1958

2. The accounting basis that records anticipated expenditure that has been authorised by management in the vote book is called:

   A. Accrual Basis
   B. Cash Basis
   C. Modified Accruals Basis
   D. Modified Cash Basis
   E. Commitment Basis

3. The opening of bank accounts by Federal Parastatals and Agencies of government as required by Financial Regulations should be authorised by:

   A. Chairman Federal Inland Revenue Service
   B. Central Bank of Nigeria Governor
   C. Permanent Secretary Ministry of Finance
   D. Accountant-General of the Federation
   E. Auditor-General for the Federation

4. Which of the following is **NOT** an external user of Government Accounting?

   A. The public
   B. The investors
   C. The suppliers
   D. The employees
   E. Government other than the reporting government

5. Which of the following is **NOT** a member of the Federation Account Allocation Committee?

   A. The Minister of Finance
   B. The Minister of Industry, Trade and Investment
   C. All States' Commissioners of Finance
   D. All States' Accountants-General
   E. The Permanent Secretary of the Federal Ministry of Finance

6. The following are the duties of Economic and Financial Crimes Commission (EFCC) **EXCEPT** the:

   A. Determination of the extent of financial loss by government, individual or organisation
   B. Enforcement and due administration of the provisions of the EFCC Act
   C. Enforcement of all economic and financial crimes
   D. Investigations of all financial crimes
   E. Education of the public on and against bribery, corruption and related offences

7. Which of the following is a budgetary system that focuses on results or output achieved?

   A. Performance budgeting
   B. Perspective budgeting
   C. Flexible budgeting
   D. Periodic budgeting
   E. Capital budgeting

8. Virement of funds from one sub-head to the other may be granted under the following conditions **EXCEPT:**

   A. It is not used to create a new sub-head
   B. It shall not be used to re-introduce items disallowed by the Estimate Committee
   C. Amount to be vired from any sub-head should not exceed any limit prescribed by the National Assembly.
   D. It does not apply to queries raised by the Auditor-General
   E. It is issued after the final approval of the President

9. Which of the following is **NOT** a function of the Fiscal Responsibility Commission?

A. Monitoring and enforcing the provisions of the Fiscal Responsibility Act
B. Undertaking fiscal and financial studies
C. Disseminating national and international standard practices which will result in greater efficiency
D. Making rules for carrying out its functions
E. Sanctioning economic saboteurs

10. Which of the following is **NOT** necessarily a way in which Medium-Term-Expenditure Framework improves budget processes?

A. Clarity of policy objectives and improved predictability of budget allocations
B. Comprehensive coverage over public services
C. Improved use of Information and Communications Technology (ICT).
D. Improved transparency in the use of resources
E. Considering alternative options and new ideas

11. A surplus budget may be used to:

A. Reflate the economy
B. Tackle economic recession
C. Tackle the problem of inflation
D. Encourage consumption of foreign goods
E. Promote expansion of employment opportunities

12. Which of the following is **NOT** an instrument for procuring domestic public debt?

A. Commercial Papers
B. Treasury Bills
C. Treasury Bonds
D. Treasury Certificates
E. Government Development Stock

13. Intervention of Government in the economy may be justified on the following grounds **EXCEPT:**

A. Provision of merit goods
B. Provision of private goods
C. The need to stabilise the economy
D. Inequality in income distribution
E. Externalities associated with economic activities

14. The argument that revenue allocation to each State should at least be sufficient to maintain existing facilities is hinged on the principle of:

A. Derivation
B. Even development
C. National interest
D. Independent revenue
E. Need

15. Which of the following statements is **NOT TRUE** of Net Present Value approach of project appraisal in the Public Sector. It

A. Takes the risk involved in each project into consideration
B. Relies heavily on the estimation of the cost of capital.
C. Does not provide a measure of a project actual rate of return
D. Uses all cash flows occurring over the entire life of the project
E. Recognises the time value of money

16. The following are examples of financing activities **EXCEPT**

A. Payments of the owners to acquire the enterprise's shares
B. Proceeds from issuing shares and other equity investments
C. Payments to acquire property, plant and equipment, intangible and other long-term assets
D. Repayments of amount borrowed
E. Payments by a lessee for the reduction of the outstanding liability relating to a finance lease

17. When public enterprises become inefficient and a huge drain pipe for scarce financial resources invested on them, the Federal Government embarks on:

A. Indigenisation
B. Nationalisation
C. Privatisation

D. Globalisation
E. Deregulation

18. An audit which checks the relevance and adequacy of documents that support a transaction is called:

A. Verification Audit
B. Management Audit
C. Final Audit
D. Vouching Audit
E. Interim Audit

19. The following are problems associated with the use of cost-benefit analysis in the appraisal of public sector projects **EXCEPT:**

A. Valuation of implicit costs
B. Valuation of intangible benefits
C. Choosing the appropriate discount rate
D. Obtaining information on all costs and benefits identifiable with a project
E. Lack of a decision criterion for project selection.

20. Financial assistance that comes from one government to another government at either international or local level is described as a:

A. Loan
B. Grant
C. Subvention
D. Reimbursement
E. Statutory allocation

SECTION A: PART II SHORT-ANSWER QUESTIONS (20 Marks)

ATTEMPT ALL QUESTIONS IN THIS SECTION

Write the correct answer that best completes each of the following questions/statements:

1. A transaction, not involving cash movement but having substantial effect on an enterprise's cash flow is known as ....

2. The budgeting technique that ensures that all activities are re-evaluated each time the annual budget is to be formulated is called ....

3. The officer who is entrusted with an official receipt (Treasury Book 6A), licence, custody and disbursement of public money and is required to keep one of the recognised cash books is known as ....

4. The e-payment authorised by Ministries, Departments and Agencies must be supported by .... from each paying Ministry to the bank.

5. Section 162 of the 1999 Constitution provides for the establishment of a pool account called ....

6. The final recommendation of the Accountant-General of the Federation in cases of loss of Federal funds involving State officers shall be made through .... to the State Civil Service Commission of the State officer concerned.

7. The project that is appraised using Accounting Rate of Return (ARR) and yields a value, that is “equal to or greater than” that set by the Management should be ....

8. A civil servant is expected to contribute ....percentage of his salary to the Pension Retirement Savings Account.

9. The Accountant-General of the Federation must render statement of distribution from the Federation Account to both Houses of National Assembly not later than .... days following the end of each year.

10. The authority by which an officer controlling expenditure allows another officer to spend from his vote in another Ministry is called ....

11. The costs or benefits to the third parties which may arise from the operations of a project are called ....

12. An analytical tool in decision making which enables a systematic comparison between the estimated cost and estimated value of undertaking a project is...

13. The salaries and allowances of statutory officers are charged directly to the ....

14. What is the name of the expenditure framework that covers a period of three years?

15. A situation where the original repayment terms of a debt is extended by

introducing a grace period is referred to as ....

16. State any **TWO** items of current liability in the Statement of Financial Position of parastatals.

17. The sharing of revenue among the same level of government either state level, or local level with the source of revenue from the Federal level is..........

18. The principle of revenue allocation which provides that the State where the bulk of the revenue is obtained should have extra share over and above what other states receive is the principle of ....

19. Government spending on social security, retirement benefits, pensions and students' bursary are categorised as ....

20. A development plan which spans between twenty to twenty five years is termed ....

SECTION B: ATTEMPT QUESTION 1 AND ANY OTHER THREE QUESTIONS
(60 Marks)

QUESTION 1

FINANCING IPP IN SONGHAI

"Distinguished Senators of the Federal Republic of Songhai that is the letter from the President", the Senate President concluded. "He is seeking your kind approval for a \$2b foreign loan to finance the planned Independent Power Project (IPP). The attraction of the loan includes its softness, twenty years moratorium and the injection of scarce foreign exchange into the scheme. Distinguished ladies and gentlemen, the ball is in your court".
"Mr. President'', a Senator stood up. ''Yes, the Senator from Jiga State, you are recognised", the President replied. "Thank you, Mr President. This hallowed chamber should not be seen as a rubber stamp authority. This letter should be thoroughly debated. And if I may open the debate, why don't we consider raising an equivalent amount from internal sources like treasury bills and treasury certificates. We succeeded in settling all our foreign debts not long ago. Do we want to plunge the country into another debt trap so soon?" the Senator asked rhetorically.

"Mr. President sir". "Yes, distinguished Senator from Rano State, I recognise you", the Senate President said. "Thank you, Mr President", the Senator began. "It is true that a foreign loan will enable the country acquire foreign exchange. The President perhaps forgot to add that foreign experts would work on the projects and the World Bank would supervise them. True talk. But we seem to be oblivious of the fact that when we want to service the loan, it must be in foreign exchange. To repay the loan also, it must be in foreign exchange. We seem also to have forgotten that the creditors will insist that we procure certain equipments from them. And, are we ready for another structural adjustment of our economy? Remember, restructuring will involve further reduction in government expenditure and throwing more people out of work. Have we forgotten that there are other charges too, like administrative charges that must be paid in foreign exchange? I however do not agree with the Senator from Jiga State on how to raise domestic loan. I'll rather suggest bonds and development loan stock. The other sources are short term instruments for meeting short term shortfalls in revenue'', the Senator concluded.

A Senator shouted: "Point of order"! "Yes, the Senator from Kobo State, you can raise your point of order". "Thank you Mr. President", the Senator said. "It is time to bring the legislative session to a close". "Okay, Senator, your point of order is sustained", the Senate President said, "We shall continue the debate on the next legislative date".

You are required to:

(a) Explain the concepts of "soft" and "moratorium" as they relate to foreign loan in the above case study. (3 Marks)

(b) Identify **TWO** instruments of short term and **TWO** of long term internal sources of debt. (4 Marks)

(c) Identify **FOUR** advantages of external loan. (4 Marks)

(d) Identify **FOUR** disadvantages of external loan. (4 Marks)

(Total 15 Marks)

QUESTION 2

(a) Briefly describe Statement of Value Added. (1 Mark)

(b) State **THREE** advantages and **TWO** disadvantages of Statement of Value Added. (5 Marks)

(c) Electricity Corporation of TOBO State has the underlisted information of its operation during the year ended 31 December 2012:

	₦'million
Sales of electricity	25,000
Purchase of electricity	8,000

Salaries and wages	2,000
Purchase of Stationery	450
Repairs and maintenance	900
Communication expenses	1,200
Distribution expenses	700
Depreciation	650
Interest on Loan	1,500

You are required to:

Prepare the Statement of Value Added of the Corporation for the year ended 31 December 2012. (9 Marks)

(Total 15 Marks)

QUESTION 3

(a) International Public Sector Accounting Standard 4 (IPSAS 4) deals with the effects of changes in foreign exchange rates.

You are required to:

(i) Explain what you understand by "Functional Currency" as contained in the Standard. (3 Marks)

(ii) Explain the requirements for the initial recognition of a transaction in the functional currency under the Standard. (3 Marks)

(b) A Government entity purchased equipment from a foreign supplier for €600,000 on 31 March 2012, when the exchange rate was €1= ₦200. The entity also sold goods to a foreign customer for €350,000 on 30 April 2012, when the exchange rate was €1= ₦200. As at the entity's year end on 31 May 2012, these amounts were still outstanding. The closing exchange rate was €1= ₦220. The entity's functional currency is in Naira.

You are required to:

Calculate the exchange difference that would be recorded in the Statement of Financial Performance for the period ending 31 May, 2012. (9 Marks)

(Total 15 Marks)

QUESTION 4

(a) Effective cash management is one of the challenges of Treasuries all over the world.

You are required to:

State **THREE** objectives of cash planning and management. (3 Marks)

(b) The following information relates to the WAWA Local Government Council's newly established Division in charge of Poultry Farms. The Local Government advanced a sum of ₦420,000 repayable in three equal monthly instalments from December 2013.

The following information was provided by the Division:

		Nov 13	Dec 13	Jan 14	Feb 14	Mar 14	April 14
		₦,000	₦,000	₦,000	₦,000	₦,000	₦,000
i.	Budgeted sales: Growers, Layers & Eggs	-	2,200	2,000	1,900	2,100	1,950
ii.	Purchases: Feeds & others	-	280	320	250	260	300
	Layers	-	445	500	350	390	510
	Growers	-	725	780	600	650	890

iii. Receivables Policy

10% advance payment (e. g. 10% of December is paid in November).

70% paid in the month of Sales.

10% paid in the month after sales

10% paid 2 months after sales.

iv. Payables Policy

Growers: 80% immediate payment
20% the following month
Layers: 50% immediate payment
50% paid the following month
Feeds and others: Payments made immediately

v. The Veterinary Officer is paid ₦150,000 monthly

vi. Farm workers are paid ₦250,000 every other month from December 2013.

You are required to:

Prepare three months cash budget for January - March 2014. (12 Marks)

(Total 15 Marks)

QUESTION 5

Inspite of several Revenue Allocation Commissions set up over the years and the consequent amendments introduced into the allocation formulas, revenue allocation issue in Nigeria remains controversial.

You are required to:

(a) Discuss any **THREE** grounds of criticism of revenue allocation system in Nigeria. (9 Marks)

(b) Explain the principles of derivation and population in revenue allocation. (6 Marks)

(Total 15 Marks)

QUESTION 6

An important tool available to the Government for economic management is fiscal policy.

You are required to:

(a) Explain what fiscal policy is, highlighting the instruments of the policy. (5 Marks)

(b) Discuss the economic objectives that fiscal policy can be used to achieve. (10 Marks)

(Total 15 Marks)

SECTION A: PART 1 - MULTIPLE CHOICE QUESTIONS

1. D

2. E

3. D

4. D

5. B

6. C

7. A

8. E

9. E

10. C

11. C

12. A

13. B

14. E

15. A

16. A

17. C

18. D

19. E

20. B

EXAMINERS' REPORT

The Multiple Choice Questions (MCQ) test candidates' understanding of concepts, principles and theories on topics in the syllabus. Candidates' performance was above average.

PART II SHORT-ANSWER QUESTIONS

1. Non-Cash flow transaction
2. Zero-based budgeting
3. Sub-Accounting Officer

4. A Mandate
5. Federation Account
6. Federal Civil Service Commission
7. Accepted/Undertaken
8. 7½%
9. 90 days
10. Authority to Incur Expenditure (A.I.E.)/Departmental Warrant
11. Externalities
12. Cost Benefit Analysis
13. Consolidated Revenue Fund
14. Medium-Term-Expenditure Framework (MTEF)
15. Debt Rescheduling
16. Creditors, Accrued Expenses, Deposits, Bank Overdraft
17. Horizontal Revenue Allocation
18. Derivation
19. Transfer payment
20. Perspective/Long term planning

EXAMINERS' REPORT

The Short-Answer Questions (SAQs) test candidates' knowledge of theories, concepts and principles on topics covering the entire syllabus. Candidates' performance was above average.

SOLUTIONS TO SECTION B

QUESTION 1

(a) (i) Soft Loan: This is a loan with liberal repayment conditions like low rate of interest and long period of repayment.

(ii) Moratorium: It is a period when the payment of interest or principal or both of a loan is/are legally suspended.

(b) Two instruments of short term internal loan are Treasury Bills and Treasury Certificates. Two instruments of long term loan are Development Loan Stock and Bonds.

(c) Advantages of external loan are:

(i) It creates avenue for foreign investment in the economy.

(ii) Injecting of scarce foreign exchange into the economy is made possible.

(iii) The loan has a long period of moratorium.

(iv) It is a soft loan – it has liberal repayment conditions.

(v) It facilitates the importation of much needed foreign expertise.

(vi) It enhances faster growth and development.

(vii) It will be supervised by the World Bank.

(d) Disadvantages of foreign loan:

(i) The use of foreign currency to service a loan may further worsen the exchange rate of a country.

(ii) Where proper structure is not put in place, un-employment will set in.

(iii) It will reduce the sovereignty of a country since specific instructions will be coming from the external creditors.

(iv) Failure to deploy debt management techniques may pose a serious threat to the repayment plan thereby making it more expensive to service.

(v) Other charges like administrative charges must also be paid in foreign exchange.

EXAMINERS' REPORT

The case study on the practical issue of public project financing by means of foreign loan. Candidates are required to distinguish between "soft" and "moratorium" in the context of foreign loan. They are also to identify the instruments of internal sources of

debt, advantages and disadvantages of external loan.

Being a compulsory question, all the candidates attempted the question. Majority of them showed good understanding of the case study and provided quality answers.

However, some of them could not differentiate between the concepts of "soft" and "moratorium" as they pertain to foreign loan.

Candidates are advised to keep up the standard and be much more reflective on the subject matter of case studies with a view to improving their future performance.

QUESTION 2

(a) Statement of Value added shows what value the entity has created and its distribution among stakeholders, that is, employees, government, proprietors and the business entity.

(b) (i) Advantages of Statement of Value Added

- It is simple to prepare and understand.
- It serves as a basis of assessing social performance of a business.
- It can be used to predict managerial efficiency.
- It serves as an indication of a company's wage paying ability.
- It is a means of evaluating reward to the providers of capital.

(ii) Disadvantages of Statement of Value Added

- Information from the statement can cause the employees to ask for higher wages if they consider the wealth as not favourably distributed.
- Value added can be misinterpreted to mean profit, whereas not all expenses were taken into account before arriving at value added.
- It does not provide a detailed analysis of the income and out of pocket expenses.
- It only shows wealth distributed and not the effectiveness of the

distribution.

(c) **Electricity Corporation of Toto State**
Statement of Value Added for the year ended 31 December 2012

	₦'million		%	
Sales of Electricity	25,000			
Bought in Goods and Services (note 1)	<u>11,250</u>			
Value Added	<u>13,750</u>			100
Distributed as follows:				
To employees				
- Salaries and wages	2,000			14.55
To provider of capital				
- Interest on loan		1,500		10.90
Retain in the business				
- Depreciation	650		4.73	
- Surplus for the year	<u>9,600</u>			<u>69.82</u>
	<u>13,750</u>			<u>100</u>

Tutorials
Note 1

Bought in Goods and Services

	₦'million
Purchase of electricity	8,000
Distribution Expenses	700
Purchase of Stationery	450
Repairs and maintenance	900
Communication expenses	<u>1,200</u>
	<u>11,250</u>

	₦'million	₦'million
Sales of Electricity		25,000
Cost incurred:		
Purchase of Electricity	8,000	
Distribution Expenses	700	
Salaries and Wages	2,000	
Depreciation	650	
Purchase of Stationery	450	
Interest on Loan	1,500	
Repairs and Maintenance	900	
Comm*unication Expenses	<u>1,250</u>	<u>15,400</u>

Surplus for the year **9,600**

EXAMINERS' REPORT

The question tests candidates' knowledge of Statement of Value Added. Many of the candidates attempted the question but some were unable to define and state the advantages and disadvantages of the Statement.

Some candidates did not understand the format of the Statement. The performance was average.

Candidates are advised to study the content of the syllabus, pathfinders and literature review on the topic.

QUESTION 3

(a) According to Paragraph 11 of IPSAS 4 on Effects of Changes in Foreign Exchange rates, Functional currency is the currency of the primary economic environment in which the entity, being reported upon, operates.

It is the currency:

(i) That revenue is raised from, such as taxes, grants and fines.
(ii) That mainly influences sales prices for goods and services.
(iii) Of the country whose competitive forces and regulations mainly determines the sales prices of its goods and services.
(iii) The currency that mainly influences labour, material and other costs of providing goods and services. This will often be the currency in which such costs are denominated and settled.

(b) Paragraph 23 of IPSAS 4 on Effects of Changes in Foreign Exchange rates defines initial recognition as:

A functional currency transaction is one that is denominated or requires settlement in a foreign currency, including transactions arising when an entity:

(i) Buys or sells goods or services whose price is denominated in a foreign currency.

(ii) Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency;

(iii) Otherwise acquires or disposes assets, or incurs or settles liabilities, denominated in a foreign currency.

(c) (i) Equipment at 31 March 2012 = €600,000
Functionary Currency – Naira
Exchange rate (open) €1 = 200
Therefore, equipment value at functional currency
= 600,000 x ₦200 = <u>₦120 million</u>

Equipment at 31 May 2012 = €600,000
Exchange Rate (Closing) = €1 = ₦220
Therefore, equipment value of functional currency
= €600,000 x ₦220 = ₦132 million
Exchange loss at 31 May 2012
= ₦(132 – 120) million = <u>₦12 million</u>

Trade Receivable at 30 April 2012 = <u>€350,000</u>
Exchange rate €1 = ₦200
Therefore, Trade Receivable at functional currency
= €350,000 x ₦220 = <u>₦70 million</u>

Trade Receivable at 31 May 2012 = €350,000
Exchange rate (closing) €1 = ₦220
Therefore, Trade receivable at Functional currency
= €350,000 x ₦220 = ₦77 million.

Exchange gain = ₦(77 – 70) million
₦7 million

EXAMINERS' REPORT

The question tests the candidates' knowledge of International Public Sector Accounting Standard (IPSA 4) which deals with changes in foreign exchange rates.

The question was not well attempted by the candidates. However, the performance of those who attempted was fair.

The inability of the candidates to attempt the question could be ascribed to the fact that they were not familiar with the provisions of the Standard.

Candidates are advised to pay more attention to all International Public Sector Accounting Standards.

QUESTION 4

(a) Objectives of cash planning and management:

(i) To facilitate the knowledge of amount of liquid cash available to execute projects.

(ii) It shows the organisation/establishment the likely period of cash shortage, so that loans or overdrafts can be raised or some marketable securities sold.

(iii) Shows period of surplus cash which can be invested to earn some returns.

(iv) Cash management ensures that optimum cash level is maintained in the ordinary course of business of day-to-day operations.

(v) Unutilized surplus cash can also result in decreased profitability as it can only be invested at short term interest rates.

(vi) Knowledge of cash availability to pay debts as they fall due.

(vii) To ensure that future contingencies can be easily met.

(b) **WAWA LOCAL GOVERNMENT**

POULTRY FARM

CASH BUDGET FOR THE PERIOD JANUARY – MARCH 2014

	JANUARY	FEBRUARY	MARCH
	₦'000	₦'000	₦'000
RECEIPTS			
Sales of layers, growers and egg (W.2)	1,810	1,960	2,055
Total – A	1,810	1,960	2,055
PAYMENTS			
Purchases of layers and growers (W.2)	1,241.50	1,060	1,010

Purchases – Feeds and others	320	250	260
Repayment of Loan	140	140	-
Farm Workers	-	250	-
Ventinary Officer	150	150	150
TOTAL B	1,851.50	1,851	1,420
Bal b/f (W1)	757.50	716	825
Receipts – payments	(41.50)	109	635
Bal. c/f	716	825	1,460

Tutorial (1)

(1) November - Amount borrowed - 420,000
- Advance sales - 220,000
640,000

Receipts for December (W.2) 1,740,000

- Payments for December

- Purchases (W.2)	802,500		
Loan repayment	140,000		
Feeds and others	280,000		
Vet Officer	150,000		
Farm workers	250,000	1,622,500	117,500
Balance carried forward to January			757,500

Tutorial (2)

	Nov. 2013	Dec. 2013	Jan. 2013	Feb. 2013	Mar. 2013
	₦'000	₦'000	₦'000	₦'000	₦'000
Receipts					
Advance (Amount Borrowed)	420				
Sales: Layer & Eggs					
Dec. 2013	220	1,540	220	220	-
Jan. 2014	-	200	1,400	200	200
Feb. 2014	-	-	190	1,330	190
March 2014	-	-	-	210	1,470
April – 2014	-	-	-	-	195
Total	640	1,740	1,810	1,960	2,055
PURCHASES					
Growers - Dec. 2013		580	145	-	-

- Jan. 2014	-	-	624	156	-
- Feb. 2014	-	-	-	480	120
- March 2014	-	-	-	-	520
Layers - Dec.	-	222.50	222.50	-	-
- Jan.	-	-	250	250	-
- Feb.	-	-	-	175	175
- March	-	-	-	-	195
Total	00	802.50	1,241.50	1,061	1,010

EXAMINERS' REPORT

The question tests candidates' understanding of Cash Management techniques. The first part of the question, which is the theoretical aspect, was not well understood and the performance was poor.

The second part, which is the computation of cash budget, was fairly understood and the performance was average.

The commonest pitfall was that the candidates were unable to determine the Opening Cash Balance as at 1 January 2014.

Candidates should be familiar with all aspects of the ICAN syllabus. They should also be conversant with the Pathfinder and other relevant literature.

QUESTION 5

(a) The revenue allocation system in Nigeria has been criticised on the following grounds.

(i) High concentration of revenue in the coffers of the Federal Government. Actual receipts by the Federal Government had been far in excess of its statutory share as a result of stabilization fund, dedicated projects, Petroleum Trust Fund (PTF). etc

(ii) Reliance on population figures projected from controversial census figures (1963, 2006). The use of population principle has adverse effect on the prospects of generating accurate census figures in the future.

(iii) Non application of equity in the allocation formula as it applies to some specific items e.g. CIT, VAT etc.

(iv) The use of landmass is also criticised as biased in favour of states with large landmass but thin population while states with small landmass and large population suffer.

(b) (i) Derivations: The principle asserts that the State from which the bulk of revenue is obtained should receive an extra share above what other states receive. The principle was mainly applied to the proceeds of exports and taxes or agricultural products. It is hinged on the need to be just.

(ii) Population: The principle asserts that since Government is about people, development is about people and that the purpose of government is the welfare of the people. Therefore, States with larger population should receive extra share over and above others with smaller population.

EXAMINERS' REPORT

The question tests candidates' understanding of the revenue allocation system with particular reference to the underlying principles and the basic criticisms against the system.

Many of the candidates attempted the question, but only few of them showed good understanding of the question. Thus performance was generally below average. The commonest pitfall was candidates' inability to articulate topical the criticism against the revenue allocation system.

As this is a topical issue in contemporary Nigeria, candidates are advised to be more familiar with the principles, problems and challenges of the revenue allocation system in Nigeria. They should consult relevant materials on this topic in textbooks on Public Finance and the pathfinder of the Institute as well as various social-economic journals in Nigeria.

QUESTION 6

(a) (i) Fiscal policy is the use of the rate, size and timing of taxation and Government expenditure to achieve some macroeconomic objectives in the economy.

(ii) The instruments include:

- Taxation - Changing the tax rates on the rules about liability to tax;

- Government Expenditure - Changing the size and timing of government expenditure on goods and services; and
- Transfer payments – payment made by the Government to individuals without any goods or service in exchange.

(b) Economic objectives that fiscal policy could be used to achieve include:

(i) Price stability: This refers to the situation where the general level of prices of goods and services changes very little or not change at all.

Hence, a no-inflation situation is achieved. Governments attempt to control the rate of price increases because inflation distorts the economy. Government can reduce expenditure or increase the tax rate to control inflation.

(ii) Full employment: Full employment is desirable because idle resources constitute a loss to the economy. Full employment does not however imply employment for every single person in the economy. There can be voluntary unemployment, residual unemployment and those unemployed because they are changing jobs. Increasing government expenditure and transfer payments and reducing taxation may help to increase employment.

(iii) Economic Growth: This refers to increases in the national output year in year out. The output of goods and services must grow at a faster rate than population growth, if the country's standard of living is to be sustained. Government expenditure and transfer payments may be increased and taxation reduced to increase economic growth.

(iv) Balance of payments equilibrium: Balance of payments is a record of a country's transaction with the rest of the world over a period. If the total of debit items exceeds credit items, a balance of payments deficit occurs. The country can then increase its import duty rates to discourage importation. This will correct the deficit.

(v) Reducing income inequality: This involves the process of adjustment to conform with the principle of social justice and equity. Income distribution may be skewed in favour of the rich. A progressive tax structure will help to reduce the inequality.

EXAMINERS' REPORT

The question requires an explanation of what fiscal policy is and its instruments. It also requires a discussion of the macroeconomic objectives the policy can be used to achieve.

The question was popular; over 80% of the candidates attempted it while their performance was above average. However, many of the candidates found it difficult to correctly define fiscal policy and some of them confused monetary policy instruments with fiscal policy instruments.

Candidates need to be more exposed to this aspect of the syllabus and not depend on residual knowledge. They should consult relevant text books on Public Finance as well as the Pathfinder of the Institute.