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## Capital Structure And Cost Of Capital



**My ICAN Membership Made A Total Impact On My Career**

— Akinyinka Akinremi FCA

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Tel: 7642294, 7642295,

Fax: 2610304

E-mail: [info.ican@ican.org.ng](mailto:info.ican@ican.org.ng)

[corporateaffairs@ican.org.ng](mailto:corporateaffairs@ican.org.ng);

ICAN Website: [www.ican-ngr.org](http://www.ican-ngr.org)

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Correspondence should be addressed to:

The Corporate Communication and Marketing Directorate, ICAN  
P.O. Box 1580, Lagos.

## Editor's Note

Capital Structure and Cost of Capital are indispensable entities in doing business across the globe. Capital Structure is the way in which a company is financed through a combination of long term capital which include ordinary shares and reserves, preference shares, loan stock and debenture; and short term liabilities such as bank overdraft, trade creditors and other debt obligations.

The author of our lead article in this edition: **"Capital Structure and Cost of Capital"** Dr. Ben Ukaegbu tries to demonstrate how to calculate a company's cost of capital to the Weighted Average Cost of Capital (WACC) He paid more attention to the dividend valuation model in the article.

Mr. Akinyinka Akinremi is a role model to young and would-be Chartered Accountants. As an accomplished and highly experienced professional, he knew his onions early in life and pursued it vigorously. Apart from his diverse experience in many sectors of the economy.

During an interview he granted the ICAN Students' Journal team, he bared his mind on many issues ranging from the nation's economy, accounting profession, early education and career etc.

Our regular column - The Examiner - is also published to guide our students on how to write and pass their examinations without much ado.

Your comments and contributions are welcome. Please write to [corporateaffairs@ican.org.ng](mailto:corporateaffairs@ican.org.ng) or [aoolwolabi@ican.org.ng](mailto:aoolwolabi@ican.org.ng)

## Royal Fathers Extol ICAN Virtues



**L-R:** Lagos State Head of Service, Mrs. Olabowale Ademola; ICAN President, Otunba Olufemi Deru and Ogun State Deputy Governor, Chief (Mrs) Yetunde Onanuga at the Western Zonal Districts' Conference of ICAN held at Ijebu Ode

**T**he Erinjugbo II of Remoland, His Royal Majesty, Sir Michael Adeniyi Sonariwo and the Ajalorun of Ijebu Ife, Oba Adesesan Oguntayo, who are Fellows of the Institute of Chartered Accountants of Nigeria (ICAN) respectively have extolled the virtues of the Institute for bringing them into limelight as Chartered accountants before becoming traditional rulers.

Oba Sonariwo, who spoke at his palace in Ijebu Ode, Ogun State when he played host to the 51st President of the Institute, Otunba Olufemi Deru who paid him a courtesy visit as part of activities for the 10th Western Zonal Districts' Conference held from February 15 to 18, 2016 in Ijebu Ode, said he was grateful and proud of the profession.

He noted that the values and culture of the profession were actually inculcated into him by the Institute thus equipping him to become successful in all his life's

endeavours, particularly now as a royal father.

He said the virtues of the Institute which include accuracy, integrity and accountability

are the models that had guided the accountancy profession in the past 50 years.

He noted that whereas the Institute had a very humble beginning with few members in 1965 when the Charter was handed down, it has grown into thousands of disciplined professionals who are contributing immensely to the growth and development of the nation in various spheres.

He thanked the ICAN President for the visit, adding that he was proud of his service to the Institute. He also assured the President and Council that he would continue to support the Institute in every possible way he could while on the throne.

Similarly, Oba Oguntayo, the Ajalorun of Ijebu Ife attributed his success as an entrepreneur and now in royalty to the Institute, while describing accountancy as the best profession.

He said he was proud and privileged to be among the 250 members who founded the Institute and witnessed the signing of the Charter in 1965.



**L-R:** Ajalorun of Ijebu Ife, Oba Adesesan Oguntayo; Oba of Ilaro, Oba Kehinde Olugbenle; Head of Service, Lagos State, Mrs Olabowale Ademola; ICAN President, Otunba Olufemi Deru; Deputy Governor of Ogun State, Chief Yetunde Onanuga; Vice President of ICAN, Deacon Titus Soetan and Registrar/Chief Executive of ICAN, Mr. Rotimi Omotoso at the Conference.

## ICAN Donates 350-Sitting Capacity Lecture Theatre To The Polytechnic, Ibadan



ICAN Lecture Theatre at The Polytechnic Ibadan

In its resolve to enhance accounting education in the country, the Institute has donated a 350 sitting capacity lecture theatre to The Polytechnic Ibadan, Oyo state.

Speaking at the commissioning and official handing over of the building to the Institution's authority, the 51st ICAN President, Otunba Samuel Olufemi Deru, said the commissioning of this magnificent building complex is one of the testimonies to show that the Institute is not only making a difference but living up to its expectations as a leading global professional body.

"As a driver of positive change and partners in progress with key players in the public and private sectors, the Institute has continued to impact positively on the process of value and wealth creation in the world of commerce and governance".

"ICAN expects creativity and innovations

that will provide endless chances for new ideas to emerge and add value to our individual and collective lives from this building," he expatiated.

He therefore called on the Polytechnic's authority to ensure good maintenance and judicious use of the structure.

In his response, the Rector of the Polytechnic, Professor Olatunde Fawole recalled that the foundation of the building was laid a few months ago, adding that ICAN has fulfilled its promise of commissioning it in due date.

Expressing the appreciation of the governing board, management, staff and students of the Polytechnic for the unparalleled donation, the Rector assured the ICAN President of good use and proper maintenance of the building.

He disclosed that ICAN was the first professional body that would make a

donation of that magnitude to the Institution in almost five decades of its existence.

He promised that the long standing relationship between the Institute and the Polytechnic, which formed the basis of choosing it for the project, would be jealously guarded and maintained.

Also, the representative of the Permanent Secretary in the state's Ministry of Education, Mr Kolawole Oyekanmi, described ICAN gesture as unprecedented. He said it was a giant stride taken to contribute to the growth of education in Oyo state and Nigeria as a whole.

"This kind gesture is indicative that the task of taking education to a greater height, is a collective responsibility of all and sundry. It is onerous task which must not be left in the hands of government alone," he concluded.

## My ICAN Membership Made A Total Impact On My Career

**M**r. Akinyinka Ayodeji Akinremi is the Head, Internal Control & Compliance at International Energy Services Limited, a regional oil and gas engineering servicing company with presence in seven African countries and chairs the Company's Project Committee overseeing projects portfolio worth \$70m. A multi-skilled professional, a willing leader, an avid operations risk management & business process improvement practitioner and a key driver of big ticket projects. Mr. Akinremi is armed with strong training, team spirit and doggedness garnered from over 15 year's industry experience mainly in financial services, regulatory supervision, business strategy, research, risk control, compliance and assurance functions.

He is a Fellow of the Institute of Chartered Accountants of Nigeria (FCA), Fellow of the Chartered Institute of Bankers of Nigeria (FCIB); Certified Information System Auditor (CISA) and Certified in Risk & Information Systems Control (CRISC). He has participated in and led statutory audit engagements of organisations in different sectors of the economy such as energy, finance, telecoms, health, manufacturing, & hospitality. Akinremi's professional competence has also taken him to some of the top class organisations in Nigeria including the Central Bank of Nigeria where he led IT audit & credit risk team engagements as a Bank Examiner for 4 years; Standard Chartered Bank of Nigeria Ltd where he led audit & control assignments across branches; Babcock University, Ilishan, Ogun State where he taught Accounting, Banking,

Finance and Business courses as well as Intercontinental Bank Plc where he handled various Risk Management, Strategic development & business growth assignments for 32 branches of the Bank. In this interview Mr. Akinremi bares his mind on a variety of issues bothering on accounting practice, his career and ICAN. Excerpts.

### Q: Let's meet you

**A:** I am Akinyinka Akinremi. I started my accounting career in 1998 as the youngest chartered accountant in Nigeria. The following year I became a chartered banker, also qualifying as one of the youngest then. Along the line, I had a string of other qualifications that set me up for a fulfilling career in accounting. So far it has been a fruitful and rewarding career. I had my first degree in Banking & Finance from Ogun State University, (now Olabisi Onabanjo University), Ago-Iwoye and my MBA in Obafemi Awolowo University, Ife also as one of the youngest Executive MBA graduates in 2001. I had my CISA in 2002, with a passing score of 86%; which was one of the highest global score at the time. I am currently the Head of Internal Control and Compliance at the International Energy Services Limited, a top class oil and gas services company with presence in seven countries.

### Q: What's your philosophy in life?

**A:** My philosophy in life is built around hard work, excellence and being an inspiration or role model. I believe that if you have anything to do, you should do it the best way possible, the first time, all the time. Along the line where I have worked, I have always been a source of inspiration for people around me, by the grace of God. In the class, people want to move or associate with me, believing that I can motivate them to pass. Today some of such people who saw ICAN exams as insurmountable are now Fellows. People feel that if I could qualify at a young age, they too could do it. This has enabled me to have an open mind and not reject anyone that comes to me. This played out during the period of my articleship as audit senior in the firm of HLB Z.O. Ososanya.



Akinyinka Akinremi: Accounting is a noble profession

Same could be said of my stint in the CBN, where my experience in IT audit was brought to bear on the job where I partnered with other colleagues to upscale the quality of IT bank examination in the Banking Examination & Supervision departments.

**Q: Some time ago you were in the university as a lecturer; do you think this added any value to your career?**

**A:** Yes. It made it easier for me to pass the various examination and interview stages of the CBN recruitment exercise and also sharpened my natural leadership abilities. As a university lecturer, project supervisor and course adviser, I had the unique privilege of mentoring young minds who drew enormous inspiration from my modest achievements. **Recall that at 25, I already had 5-different academic and professional qualifications (B.Sc, MBA, ACA, ACIB, and CISA). Hence, the students were naturally inspired by this.** When I moved to Babcock University as a lecturer in 2002, I pioneered the teaching of key Accounting and related courses such as Investment Analysis, Corporate & Business Finance, Operations Research, Practice of Banking, Financial Economics and International Trade & Finance at the undergraduate level and also instituted academic prizes for the best student in each course taught and these were awarded during the annual convocation (2002-2008).

Being the only lecturer with both accounting and banking professional certifications made it easier for me to multi-task and teach diverse courses. It also enabled the university to attain hitch free professional certifications of the Accounting and Banking & Finance programmes from ICAN and CIBN, in record time. In all, I taught over a thousand students between 2002 and 2008 when I left, who today are doing well in the various sectors of the Nigerian economy. It was a great symbiotic relationship. For the school, it was a source of great value to have someone that not only added value but also acted as motivation to the faculty and young brilliant minds. For me, it provided an opportunity to mentor a lot of people, while living out my passion of motivating people to be the best they could be. The academic lecturing platform would



It was the ICAN qualification that gave me the edge

not have been possible but for the support of Oyebola Oyedepo a bosom professional colleague (who brought the academic opening to my attention) and Professor Sunday Owolabi (the then Head of Accounting Department) who had enormous faith in my academic abilities.

**Q: What are the key motivations and expectations that made you seek a career in accounting?**

**A:** My first awareness of Accounting or ICAN was in the late 80s when an older sister in my extended family (Oreoluwa Ajayi) finished from University of Ife, (now OAU) and passed her ICAN qualifying exams in record time. Being an above average science pupil in the secondary school (Abadina College, University of Ibadan) and growing

up in a university environment, the natural thought was that I would study medicine and surgery in the university, as only the best was good enough for that. A handful of events however changed this.

Firstly, I had my GCE before I finished my secondary school with good grades to seek admission into the university. However, during the Abacha days when there were forced school closures and university admission backlogs (as it took more than two years before the schools could open normally), I came across a tuition house, Achievers Professional Training Institute in Ibadan where I was made to understand I could enroll into ICAN professional exam stage straight, without it affecting my undergraduate studies. I learnt it was difficult and I told myself that if the exam was difficult I would want to do it, if not for anything else, to satisfy my curiosity. I thought I should do it before school resumed and thereafter I would seek admission into my desired course at the time. So I started and passed the Foundation exams in November 1996 and passed the qualifying exams in November 1998. When the ASUU strike was getting prolonged and universities were not opened for us to process admission I decided to add the CIBN professional exams to it to keep me more occupied. By the time universities were resuming I was already at an advanced stage. Up till after my secondary school education, I never thought I would be an accountant and in fact, I knew next to nothing about the profession aside the fact that if you study Accounting in the university, you must do ICAN in order to be professionally successful.

**Q: Can you recount the first experiences, especially when you were writing the ICAN examinations?**

**A:** From day one, we heard that ICAN was difficult to pass and therefore required serious hard work. That even with hard work only few people passed the exams. So I put in 20 hours a day, slept for three to four hours only. It was a highly regimented life, you could wake up at 12 midnight to study and continue till day break. But I was ready for it. Of course, the exams weren't that difficult

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**Recall that at 25, I already had 5-different academic and professional qualifications (B.Sc, MBA, ACA, ACIB, and CISA). Hence, the students were naturally inspired by this.**

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because we had mock exams that prepared us for the real thing. In all the papers, I had the best scores in the mock, so I knew that in a way I was prepared.

On getting to the exam proper, there was this large crowd of people who gathered for it. It was a fascinating sight. In those days you answer all, and so proper planning and allocation of time to all the questions were important. For me it was not bad, but I was prepared and God also helped me to take the right decisions.

**Q: What exactly is accounting; how do you describe accounting to a ten year old?**

**A:** In a simple term, accounting is about rendering stewardship of how resources are used. In another way it is the process of rendering account of how resources of time, money, men, materials, etc, have been used or an assignment has been undertaken. Professionally however, it is the body of the profession that deals with how resources and activities are recorded and organised in figures. Those who do these are accountants. The beauty of accounting certification (unlike other professional bodies) is that it offers you opportunity for paid employment as well as the chance to set yourself up as consultant or practitioner instead of just seeking to be an employee.

**Q: Can you say that your membership of ICAN has made an appreciable impact on your career so far?**

**A:** I would say the membership of ICAN has made a total impact on my career (not only an appreciable one!). Casting my mind back, when I was doing my NYSC in the firm of HLB Z.O. Ososanya & co, there were people who had graduated from university before I concluded my school certificate who automatically became my juniors because I had ICAN qualification. Right there in the field of engagements and every other place I have worked, people could easily see the value I was adding, without necessarily knowing about my academic back-ground. The qualification and disciplined approach to life gave me a platform which wasn't there. For instance, I was in CBN as an assistant manager when I was barely 25 years old, yet there were people who had the same first



***The beauty of accounting certification (unlike other professional bodies) is that it offers you opportunity for paid employment as well as the chance to set yourself up as consultant or practitioner instead of just seeking to be an employee.***



degree as I had who were two to three steps below me.

To me, it was the ICAN qualification that gave me the edge to have a big career head start at a very young age. Same in the academic environment, where I taught for a while; people who had first degrees were started out as graduate assistants but I was already at the middle level of leadership in the academia by virtue of my ICAN certification. I give a lot of credit to ICAN for its enormous impact on my career and how far I have come. The value addition has not only been on my career, it has also set me up to live a more disciplined life style.

**Q: Do you think accountants have a key role to play in government's anti-corruption drive?**

**A:** The role of an accountant cannot be downplayed. It is very crucial. The professional body regulating it also need to ensure that we don't have quacks getting into the field at will and creating problems for practitioners. The code of ethics we are asked to abide by helps to keep everyone in check. This is why accountants are invaluable to anti-corruption, whether it is the one championed by government or the one in the private sector. Accountants are needed to create, keep and analyse records. Various

specialisations in the profession such as Auditing & Investigation, Forensic Accounting and even Insolvency provide the skills needed to drive anti-corruption. Don't forget that accountants are the ones who create the records and are in the best position to know when they have been tampered with.

**Q: What can you say are the key challenges of accounting profession in Nigeria today?**

**A:** For me the major challenge is that accounting is very pervasive – tax, audit, finance, credit, risk, etc, and this gives rise to the proliferation of bodies and institutes. This means that due to the interlocking nature with various professions; other bodies are also regulating accounting or aspects of it. This dichotomy over the years has diluted accounting practice thereby creating quality problems. But the quality that ICAN members bring to the table in doing their jobs distinguishes them from the rest. One other thing is the pace at which we churn out accountants which is not in tandem with the state of our economy and the pace of our economic growth. This has created a situation where a lot of chartered accountants are increasingly finding it difficult to find professional jobs and are therefore doing other things. You see them veering into trading, transportation, import/export, etc.

**Q: Has there been any time you wished you took to another profession because of the challenges in accounting?**

**A:** May be the only thing I would have thought of doing was being a medical doctor because the practice is somehow less subjective to diverse interpretations and your suggestions or recommendations alone in acting out your role as a professional accountant might not be sufficient to effect desired change. On the other hand, if you are dealing with a patient; you don't need so much opinions, thoughts or votes; all you need to do is find solution to the ailment, using established procedures. With medical practice; you can immediately see the results of your efforts in treatment of your patients.

**Q: Take a holistic look at the accounting space in Nigeria and you'll notice that there are now many accounting bodies. How do you compare this situation to**

**when the profession was controlled by only ICAN?**

**A:** When ICAN was doing it alone, it appeared there were limitations that affected the number of people that were admitted into the profession per time and people saw the Institute as a cult. It couldn't spread the gospel of accounting to all the nooks and crannies well at a time because of these limitations. People were saying things like "you know when you start ICAN but you don't know when you'll finish." However, the truth was that people weren't really passing much due to poor preparation by candidates and inadequacy of materials to prepare with. But the advent of other accounting bodies has given ICAN a good competition to open the entry gate a little more, without necessarily crashing the standard.

Now more people pass unlike before because of improved information flow, better preparation, more tuition centres and availability of a variety of study materials. Even study centres are everywhere these days unlike when they were only in a few towns. Before, there wasn't much ICAN involvement even in schools, universities, etc. But now they have brought accounting education to the grassroots - there are centres in all the states unlike before. Every now and then they go to secondary schools to provide career guidance under a programme called "catch them young". They are donating materials and infrastructure to aid accounting education such as lecture theatres, endowment of professorial chairs, PhD scholarships, tuition centres,

books, accounting packages, etc.

Generally, ICAN now devotes much of its resources to enhance accounting development. The competition from other accounting bodies has made ICAN to be more open and sensitive to the needs of the society. This is a kind of flexibility that one would never have thought would exist in the field. Despite this competition, ICAN will hold its own because of the quality of training students' undergo, the institutional experience in running one of the foremost professional bodies, unique value addition of members in their various spheres, and inroads the Institute has made before now.

**Q: Look at the adoption of global standards in accounting such as IPSAS and IFRS; what difference do they make to the way accounting is practiced in Nigeria?**

**A:** The advanced countries think far ahead of us. Before anyone thought about it, they had already considered their excess capacity and seen that this needed to be sent abroad and this was how they came about globalisation. Globalisation of the profession has opened new job functions for our members as new skill areas emerge. IPSAS and IFRS have set standards for reporting all over the world. That is good, but each country should not be too quick to jump into every proposed change without adequate preparation and relevance to the local context. You have to look at your own uniqueness and allow enough time for cut over. I can say that the time given in Nigeria to migrate was not enough.

To start with, only few companies even submit their annual accounts to the Corporate Affairs Commission, so why push all registered companies to adopt IFRS/IPSAS in a very short time? **I think we need more incentives and more awareness on IPSAS and IFRS adoption than sanctions.** There should be enough time for awareness. There may even be need to introduce award to those who migrate as encouragement. For instance you may give award to the best IFRS compliant companies in various sectors as a motivation for them to embrace it.

**Q: what do you think will be the profile of the future accountant?**

**A:** An accountant of the future will be one that will be an all-rounder. One that is versatile; has a global perspective on business issues; is analytical; one that can

add value and is strategy-driven. Above all he/she must be open-minded, be a life-time student and be technology-driven. He must be a leader, manager and problem solver combined.

**Q: Accounting is largely a time consuming job requiring full concentration all the time. How do you ensure work life balance?**

**A:** It is a bit tricky. To me, I would say, "I was born to work". I was born on the first working day of the week during business rush hour! So everything about me has always centred on asking myself "what do I want to do today?" Until I finish what I want to do I probably won't rest or eat. This has really affected my way of life as I feel satisfied and fulfilled working.

Nevertheless I have come to realize that life is not about work alone and accounting profession has inculcated discipline, planning and strategy into me; these I use to great advantage in my private life. I don't carry work home because the "domestic stakeholders" will not allow me to be in the "office at home".

Experience has taught me that no matter how I may love work I must give my family their time when I am at home, but when I am at work, I concentrate on the work. Because the nature of my job is round the clock, it will encroach into my time if I am not careful.

**Q: Do you have any advice for young people desiring to become chartered accountants?**

**A:** Yes. Accounting is a noble profession but to succeed you must love problem solving and must be entrepreneurial in nature. You must have the spirit of hard work and be committed to life-long learning. This will help you learn several things to attain versatility.

**Q: What do you do when you are not officially working?**

**A:** I mentor people. I play tennis, take the kids for swimming. I am also engaged in religious activities and hang out with friends. Above all I can't do without reading. I also check up on family and friends.

**Q: Thank you very much for your time**

**A:** It's my pleasure.



The role of an accountant cannot be downplayed

# Capital Structure And Cost Of Capital

By Ben Ukaegbu

## Introduction

Capital structure refers to the way in which a company is financed, by a combination of long term capital (ordinary shares and reserves, preference shares, loan stock and debentures) and short term liabilities such as bank overdraft, trade creditors and other debt obligations. The purpose of this paper is to demonstrate how to calculate a company's cost of capital, ranging from the individual component of capital to the weighted average cost of capital (WACC). In this edition, more attention will be paid to the dividend valuation model and a later edition focus will be given to the capital asset pricing model (CAPM).

## The Cost of Capital:

The cost of capital (or discount, hurdle rate) reflects investors' requirements or expectations of the returns on their investment. For this reason, the *cost of capital* may be regarded as the amount of returns required by the providers of capital, and the discount rate for investment decisions should be based on a firm's cost of capital.

## Cost of Capital as an opportunity cost of finance:

The cost of capital, however it is measured, is an opportunity cost of finance, because it is the minimum return that investors require. If they do not receive this return, they will transfer some or all of their investment to somewhere else.

## Cost of Capital and Risk:

It can be said that cost of capital consists of three elements of risk:

- **'risk-free rate of return':** The return which would be required from an investment if it were completely free from risk. Typically, a risk-free yield would be the yield on government securities, (assuming at the moment that government securities are riskless);
- **'premium for business risk':** An increase in the required rate of return due to the existence of uncertainty about the future and a firm's business prospects. There is a possibility that the actual returns from an investment in the future may not be as high as they are currently expected to be. 'Things may go wrong;' therefore an additional return is required to pay the investor for this element of risk in his investment. Business risk will be higher with some firms than others, and some types of project undertaken by any firm may be more risky than other types of project that it undertakes;
- **'premium for financial risk':** Financial risk relates to the danger of high debt and gearing levels, or even insolvency. For ordinary shareholders, financial risk is evident in the

variability of earnings after deducting payments to holders of debt capital securities. The higher the gearing of a company's capital structure, the greater will be the financial risk to ordinary shareholders, and this should be reflected in a higher risk premium and therefore a higher cost of capital.

Different companies are likely to be in varying types of business (differing business risk) and also likely to have different capital structures (varying financial risk). Consequently, the cost of capital of one company may differ radically from the cost of capital of another.

## Cost of different types of funds

Where a company uses a mix of equity and debt capital, its overall cost of capital may be defined as the weighted average of the cost of each type of capital (WACC). WACC is therefore an average of the cost of all the company's (long term) capital sources, weighted to allow for the differing proportions of each type of capital in the company's capital structure.

## The cost of Ordinary share capital

New funds from equity shareholders are obtained in one of two ways: a new issue of shares and retained earnings. Both of these sources of funds have a cost. The use of share capital has no accounting cost. The use of equity by a firm does not involve any outlays which an accountant would normally call costs. However, equity-holders expect either *dividends* or *capital gains* from their investments and such expectations give rise to an opportunity cost of capital. The cost of these sources of funds are derived from, firstly, shareholders will not be prepared to provide funds for a new issue of shares unless the return to their investment is sufficiently attractive. Secondly, retained earnings also have a cost. This is an opportunity cost, the dividend forgone by shareholders.

## Calculating the cost of equity

There is no 'correct' method for calculating the cost of equity, however, the most widely accepted methods are:

- The capital asset pricing model (CAPM)
- The dividend valuation model
- The earnings yield approach

## Capital asset pricing model

A company's cost of equity can be determined using CAPM. Cost of equity = risk free rate + beta (market return - risk free rate)

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

In order to determine the variables in the CAPM equation, we have to estimate the risk free rate with the yield on long-term government bonds. (*Detailed worked examples of this method will be published in the next edition of the Journal.*)

### Earnings Yield

This is calculated as earnings available to shareholders divided by the market value of equity. It is the inverse or the reciprocal of the price-earnings ratio. The application of this method will be explored further in the next edition of the Journal.

### The Dividend Valuation Model

This is simply an expression of the fundamental theory of share values, that the price of a share is the expected future dividend receipts from the share, discounted at the shareholders (marginal) cost of capital.

$$R = \frac{D}{MV}$$

where R = the shareholders' cost of capital; D = the annual dividend per share, starting from the end of year 1 and then continuing annually in perpetuity.

### The cost of ordinary share capital: the Dividend growth Model (Gordon's Model (1958))

Shareholders will normally expect dividends to increase year by year and not to remain constant in perpetuity. The fundamental theory of share values states that the market price of a share is the discounted future cash flows of revenues from the share, so the market value given an expected growth in dividends would be:

$$MV (\text{ex div}) = \frac{do(1+g)}{(1+g)(1+r)} + \frac{do(1+g)^2}{(1+g)^2(1+r)^2} + \text{etc...}$$

Some Textbooks give an alternative formula:

$$r = \frac{do(1+g)}{MV} + g$$

Where MV: (ex div) is the current market price.

do: is the current net dividend.

r: is the shareholders' marginal rate of time preference.

g: is the expected annual growth in dividend payments.

and both r and g are expressed as proportions.

### Example: Dividend Growth Model:

A share has a current market value of 96k, and the last dividend was 12k. If the expected growth rate of dividends is 4% per annum, calculate the cost of equity capital.

### Solution:

$$\begin{aligned} \text{Cost of capital} &= \frac{12(1+0.04)}{96} + 0.04 \\ &= 0.13 + 0.04 \\ &= 0.17 \text{ or } 17\%. \end{aligned}$$

A serious objection to the 'growth model' method of calculating the cost of equity capital is that there must be great practical

difficulties for shareholders in deciding what the rate of growth will be.

### Cost of debt capital and preference shares:

To estimate the cost of fixed interest or fixed dividend capital is much easier than the estimation of the cost of ordinary capital because the interest received by the holder of the security is fixed by contract and will not fluctuate in amount.

The cost of debt capital already issued is the rate of interest (interest rate of return) which equates the current market price with the discounted future cash receipts of the security.

In the case of *irredeemable debt (or preference shares)* the future cash flows may be considered as the interest (or dividend) payments in perpetuity so that:

$$wo = \frac{k}{I} \quad \text{and} \quad I = \frac{k}{wo}$$

Where wo = the current market price of debt capital after payment of the current interest (dividend);

k = the interest (dividend) received

I = the cost of debt (preference share) capital.

If the debt is REDEEMABLE then in the year of redemption the interest payment will be received by the holder as well as the amount payable on redemption. In this case, the internal rate of return (IRR) technique is adopted.

### Example:

#### Cost of Irredeemable and Redeemable Debt Capital:

Tokunbo Smith plc has in issue 10% debentures of a nominal value of N100. The market price is N90 ex interest. Calculate the cost of this capital if the debenture is:

Irredeemable;

Redeemable at par after 10 years.

Ignore taxation.

### Solution:

#### Cost of Irredeemable debt capital:

$$\frac{k}{wo} = \frac{N10}{N90} \times 100\% = 11.1\%.$$

**Cost of Redeemable debt capital:** The capital profit that will be made from now to the date of completion = N10 (N100 - N90). This profit will be made over a period of 10 years which gives an annualised profit of N1 which is about 1% of current market value. The best trial and error figure is to try first is, therefore, 12%.

Year	Cashflow	Try 12%		Try 11%	
		df	PV	df	PV
0	market value	(90)	1.000	(90.0)	1.00 (90.00)
1-10	Interest	10	5.650	56.5	5.89 58.90
10	Cap. Repmt.	100	0.32	32.0	0.35 35.00
			-1.5		+3.9

The cost of debt capital is, therefore  

$$\frac{(11 + 3.9 \times 1)}{3.9 + 1.5} = 11.72\%$$

### Debt capital and taxation

The interest on debt capital is an allowable deduction for purposes of taxation and so the cost of debt capital and the cost of share capital are not properly comparable costs. This tax relief on interest ought to be recognised in Discounted Cash Flow (DCF) computations. One way of doing this would be to include tax savings due to interest payments in the cash flows of every project. A simpler method, and one that is normally used, is to allow for the tax relief in computing the cost of debt capital, to arrive at an 'after-tax' cost of debt.

The after tax cost of irredeemable debt capital is:

$$I = \frac{k}{w_0} (1 - t)$$

Where: I = the cost of debt capital  
 k = is the annual interest payment;  
 w<sub>0</sub> = the current market price of the debt capital ex-interest (ie after payment of the current interest)  
 t = is the rate of corporation tax.

### The Weighted Average Cost of Capital

#### Procedure

1. Calculate the after tax cost of each of the components of the firm's financial structure.

These should be costs that would be incurred if the firm raises new funds and not the historical cost of financing.

2. Calculate the weight of each type of finance in the financial structure. Use market value weights for equity, debt, convertibles etc.
3. The weights should reflect the firm's long-run capital structure i.e. optimal capital structure.
4. Calculate the weighted average cost of capital as

$$WACC = k_d(1-t) \frac{D}{D+E} + k_e \frac{E}{D+E}$$

#### Uses of the WACC

For the evaluation of scale enhancing projects, expansion projects that have the same business and financial risk as current projects. In this context it is also assumed that the scale-enhancing project will be financed in the same way as previous projects.

If new projects are contemplated, then the cost of equity must reflect the business risk of the new project as well as any financial risk, if the project will change the company's capital structure.

The correct cost of capital to use in investment appraisal is the marginal cost of the funds raised to finance the investment. The WACC might be considered the most reliable guide to the marginal cost of capital, but only on the assumption that the company continues to invest in the future, in projects of a standard level of business risk, by raising funds in the same proportions as its existing capital structure.

#### Summary

In most examination questions, candidates are required to determine the cost of capital for the company given an extract from the company's financial statement. It is advised that candidates should calculate the cost of capital of each element of the capital structure (equity; preference shares and debenture stock) in order to determine the weighted average cost of capital (WACC). Candidates are at liberty to apply any method in determining the cost of equity subject to the information given. For instance, it will be impossible to adopt CAPM approach where there is no information on the 'risk-free rate', market rate or beta component. In relation to fixed interest debt, debenture stock, candidates should be mindful whether the debt is redeemable or irredeemable. Where the debt is redeemable, the IRR technique is safely applicable.

**Below is an examination standard question to demonstrate how Examiners usually test candidates' knowledge in the area of cost of capital and WACC.**

**Below is an extract from the Financial Statement of Dasuku plc at 31 December 2015:**

	N'000	N'000
Fixed Assets		22,350
Current Assets	16,900	
Creditors falling due within 1 year	(4,000)	
Net Current Assets		12,900
8% Debentures		(8,000)
		27,250

Ordinary share capital (50k shares)	10,000
6% Preference Shares (N1.00 shares)	5,000
Share Premium Account	4,000
Retained Earnings	8,250
	27,250

The company's ordinary shares are currently trading at 240k ex-dividend. The dividend of 20k is payable during the next few days. The expected rate of growth of the dividend is 7% per year. The current price of the preference shares is 80k and the dividend has recently been paid. The debenture interest has also been paid and the debentures are currently trading at N110 per N100 nominal. Corporation tax is at the rate of 28% per year.

#### Requirements:

- Calculate the gearing ratio for Dasuku plc using:
  - Book Values;
  - Market Values.
- Estimate the company's weighted average cost of capital (WACC), that is, the return required by the providers of the three types of capital, using the respective market values as weighting factors.
- Assume that Dasuku plc issued the debentures one year ago to finance a new investment.  
  
Discuss the reasons why the company may have issued debentures rather than preference shares to raise the required finance.
- Explain how the Capital Asset Pricing Model (CAPM), would be used as an alternative method of estimating the cost of equity, indicating what information would be required and how it would be obtained.

#### Suggested Solutions

- The gearing ratio:  $\text{Gearing} = \frac{\text{Prior charge capital}}{\text{prior charge capital} + \text{equity}}$

#### (i) Book Values

8% Debenture Stock	8,000
6% Preference shares	5,000
	<b>13,000</b>

#### Equity

Ordinary share capital	10,000
Share premium	4,000
Retained earnings	8,250
	22,250

#### Gearing Ratio: 13,000

$$\frac{13,000}{13,000 + 22,250} = 36.9\%$$

#### (ii) Market Values

8% debentures @ N110 x 8000	8,800
6% Preference shares at 80k	4,000
	<b>12,800</b>

#### Equity

$$\text{Ordinary shares } (10,000 \times 2) \text{ at N2.40} = \text{N48,000}$$

$$\text{Gearing} = \frac{12,800}{12,800 + 48,000} = 21.1\%$$

- |                           |   |              |
|---------------------------|---|--------------|
| Cost of equity            | = | 15.9% or 16% |
| Cost of Preference shares |   | 7.5%         |
| Cost of debt              |   | 5.2%         |

$$\frac{48000 \times 15.9}{60800} + \frac{4000 \times 7.5}{60800} + \frac{8800 \times 5.2}{60800}$$

$$\text{WACC} = 13.79\% \text{ or } 14\%$$

#### c) Reasons for using Debenture Stock

- Cheaper form of finance than preference shares because debenture interest is tax deductible, unlike preference dividends.
- Debentures are more attractive to investors because they can be secured against the company's assets;
- They rank before preference shareholders in the event of a winding-up (liquidation).
- Issue costs should be lower for debentures than for preference shares.

- CAPM** would estimate the cost of equity using the equation;

$$K_e = R_f + B(R_m - R_f)$$

$R_f$  is the risk free rate of return. This could be estimated as the current return offered by irredeemable gilts or government bonds. Beta(B) is the volatility of the company's share price to the market. This can either be calculated from recent periods' data or can be read off from pre-calculated figures published by professional organisations. Either method has problems. In calculating beta oneself, the value of Beta will be different depending on the number of recent periods used in the analysis.

$R_m$  is the return currently available from the equity market. Indices are published to replicate returns over recent periods of time. Again, the choice of period will affect the observed return.



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## Audit and Assurance (SKILLS LEVEL EXAMINATION - 2014)

### Question 1

Your firm has recently been appointed auditor of Snowden Company ('Snowden'), a limited liability company whose shares are not traded publicly. The company operates a chain of 25 Nigeria-based retail stores. Snowden is a gentlemen's outfitter specialising in dinner suits. One warehouse supplies all 25 stores with inventory. This is based in the West of Nigeria. Snowden's suppliers are principally based in Spain. The majority of inventory items are the previous year's designs, which the wholesalers supply to Snowden at discounted prices. All orders are bought to ensure inventory is present for the fashion seasons of March, June and December. Cheque, credit card or cash is the usual method of payment for sales.

To ensure competition with other retailers is maintained, the company offers a returns policy to its customers, which allows goods to be returned to the store for any reason with a full refund offered. Goods returned under this policy are then sold on in bulk through the trade, sometimes at less than their original cost to Snowden. The company's employees include monthly paid head office staff and store managers and a weekly paid core number of other store staff.

In addition, the company employs a number of casual staff in peak periods. Permanent staff are paid weekly/monthly by direct bank transfer and casual staff in cash. Snowden's managing director, aged 58, is also the company's main shareholder. He is a particularly dominant managing director and is involved in all major decisions and rarely delegates. He seeks each year to grow the business and improve upon the previous year's profitability. This is also to fund his own expensive lifestyle. The company has recently acquired new offices near to its central warehouse. The purchase was financed by large bank borrowings under term loans, which call for annual capital repayments.

Required:

- State and briefly describe the five principles of professional ethics for chartered accountants per ICAN's Code of Conduct. (5 marks)
- Describe the different elements of audit risk and explain why the auditor needs to consider risk when conducting an audit. (5 marks)
- Identify possible factors that will increase the level of inherent risk of an audit client. (8 marks)

- Identify, from the circumstances outlined above, the factors which indicate high audit risk in respect of the audit of Snowden. (12 marks) **(Total: 30 marks)**

### Question 2

ISA 530 Audit Sampling and other Means of Testing defines audit sampling as: 'The application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population.'

Required:

- Define sampling risk. (1 mark)
- List five methods of sample selection and explain how they function. (10 marks)
- Which of the above sample selection methods in part (b) would you use if you wanted to maximise the opportunity of having high-value items in your sample? Explain why. (3 marks)
- Define 'tolerable error.' (1 mark)
- List five situations where sampling may not be appropriate. (5 marks) **(Total: 20 marks)**

### Question 3

The basic principle of independence states that a member's objectivity must be beyond question if they are to be an auditor. That objectivity can only be assured if the member is, and is seen to be, independent. IFAC's code of ethics states that there is a presumed dependency on fees and hence self-interest threat to independence where total fees from a public interest entity and its related entities represent 15% or more of the income of the audit practice for two consecutive years.

Required:

- What safeguards could be applied to reduce this threat to an acceptable level? (4 marks).

A further rule on independence covers goods and services. Goods and services should not be accepted by a practice or

by anyone closely connected with it unless the benefit is clearly insignificant.

Required :

(b) How would you view the following with respect to goods and services in terms of acceptability, and why?

(i) The client offers the auditor a drink after the audit

(ii) The client offers to take the auditor on holiday after the audit. (4 marks)

(c) The client offers the auditor discounted goods. What factors need to be considered in determining whether it is acceptable to purchase discounted goods? If the auditor was unsure whether the goods and services were acceptable, who might he consider contacting, outside his own firm? (5 marks)

(d) Johnson is the audit manager of a team engaged on the audit of a listed company. During his initial discussion with the chief executive officer (CEO) of the company, he was informed that depressed economic conditions have badly affected the company and its liquidity. Due to uncertainty about the future of the company, certain key employees have left including several staff members of accounting and finance department. Consequently, the accounting records are in a bad shape and the management is making efforts to complete the draft accounts quickly. He therefore requested Johnson to carry out necessary accounting work and to help prepare the annual financial statements at a fee to be agreed mutually.

Required:

Briefly describe the guidelines contained in ICAN's Code of Conduct and the extent of support that can be offered by the auditors, in the above situation? (7 marks) (Total: 20 marks)

## Corporate Reporting

(PROFESSIONAL LEVEL EXAMINATION - Nov., 2014)

### Question 4

Critics of traditional corporate financial reporting under Generally Acceptable Accounting Practice (GAAP) argue that financial statements alone are not considered sufficient without a narrative that provides a context within which to interpret the financial position, financial performance and cash flows of an entity.

A financial expert within the board of Abcon Kombe Plc, aware of the above criticism has proposed that Abcon Kombe Plc should include in its financial statements, management commentary to satisfy the numerous analysts that use its annual reports.

Required:

(a) Advise the Board on FIVE elements of information which IFRS Practice Statement expects to be included in management commentaries in order to meet its objectives. (5 Marks)

(b) Relate the FIVE elements of information above to the needs of the various primary users. (7 Marks)

(c) Justify why management commentaries should be made compulsory in Nigeria's financial reporting environment. (3 Marks) (Total 15 Marks)

### Question 5

(a) An entity is normally viewed as a going concern. It is assumed that the entity has neither the intention nor the desire of liquidation or of curtailing materially the scale of its operations.

However, if the going concern is threatened, the financial statements would be prepared on a different basis.

Required:

State the factors that indicate an organisation may no longer be a going concern under the following categories.

i. Financial

ii. Operations

iii. Legal or regulatory (6 Marks)

(b) Luck & Co. has been making losses over the last few years. Its statement of financial position at 31 December, 2013 showed the following:

Luck & Co. Statement of financial position as at 31 December, 2013

	N	N
<b>Non-current assets:</b>		
Property, plant and equipment		80,000
<b>Current assets:</b>		
Inventory	20,000	
Receivables	40,000	60,000
		140,000
<b>Equity and Liabilities:</b>		
Ordinary capital		100,000
Retained earnings		(140,000)
Secured loan stock		100,000
Payables		80,000
		140,000

On liquidation, the assets would realise the following:

	N	N
Property, plant and equipment		30,000
Inventory		12,000
Receivables		36,000
		78,000

If the company continues to trade for the next four years, profit after charging N20,000 per annum as depreciation on the property, plant and equipment would be as follows:

	N
2014	4,000
2015	20,000
2016	26,000
2017	28,000
	78,000

Assume that there would be no surplus cash to settle the payables and loan-stock holders until after four years when inventory and receivables could be realised at their book values.

Required:

Evaluate the financials and advise the management of Luck and Co on the options available to them and redraft the statement of financial position of Luck and Co after the exercise. (9 Marks) **(Total 15 Marks)**

## Audit and Assurance

(SKILLS LEVEL EXAMINATION - 2014)

### Suggested Solution To Question 1

(a) **Integrity:** A chartered accountant should be straightforward and honest in all professional and business relationships.

**Objectivity:** A chartered accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

**Professional competence and due care:** A chartered accountant has a continuing duty to maintain the required professional knowledge and skill to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A chartered Accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services.

**Confidentiality:** Confidential information acquired as a result of professional and business relationships should not be disclosed to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for personal advantage of the chartered accountant or third parties.

**Professional Behaviour:** A chartered accountant should comply with relevant laws and regulations and should avoid

any action that discredits the profession.

(b) Different elements of audit risk.

#### Inherent risk

- risk of material error arising from the entity and its environment.

#### Control risk

- risk that internal controls fail to prevent or detect a material error.

#### Detection risk

- risk that auditor's substantive procedures will fail to detect a material error.

The auditor needs to consider risk so he can:

- Plan effectively
- Ensure audit attention is devoted to appropriate areas

(c) Factors include:

- Losses or low profits
- High levels of gearing
- Cash flow problems (or going concern issues)
- Dominant chief executive
- New company
- Few customers
- Few product lines
- Previous year's audit report qualified
- Previous year's management letter recommendations not implemented
- New directors
- Industry in which the company operates ?
- Integrity of the directors
- High staff turnover
- Overtrading
- Seasonality of the business
- Complex transactions
- Sensitivity to external factors (e.g. interest rates, exchange rates)
- Levels of approximation or contentious accounting issues

(d) Factors contributing to high audit risk:

- New audit to your firm
- No reason for change of auditor
- Fashion is a volatile/seasonal business especially 'out-of-fashion' inventory
- Large chain of stores
- Company sells luxury goods
- Small number of suppliers
- Large number of cash transactions (sales/wages)
- Dominant/majority shareholder MD
- MD poor at delegation
- MD's extravagant lifestyle
- MD is 58, soon to retire?
- Company's customer returns policy
- Large bank borrowings
- Moving into new offices

- Casual staff employed
- Risk of obsolete inventory as company may be stuck with last year's trend (difficult to determine inventory values)
- Inventory control issue with respect to number of stores/ inventory lost in transit or double counted –
- Luxury items first to go in event of economic downturn – this puts company at risk
- Risk of stock-outs/loss of supplier/large borrowings causing going concern problems
- Risk of incomplete recording of sales
- Risk of misappropriated cash
- MD desire for profit may lead to manipulation of results
- Casual staff resulting in misstated tax liabilities/fines/interest/ misstated payroll figure
- Exposure to foreign exchange risk resulting in misstated inventory/purchases
- Customer returns could give rise to misstated balances in accounts/inventory at NRV or may be obsolete

## Suggested Solution To Question 2

- (a) Sampling risk is the risk that the conclusion auditors draw will be different from that which they would have drawn had they examined the entire population.

- (b) Five methods of sample selection include:

**Simple random selection:** This is a method of selection in which every item in a population has the same statistical probability of being selected as every other item. The sample will therefore be representative of the population as a whole. This involves selecting from a source of random numbers, either by use of computer programs which generate random numbers or of random number tables.

**Value weighted selection:** This involves using the currency unit value rather than the items as the sampling population. Each individual currency unit (say, a dollar) in the population is given an equal chance of selection. For example, one dollar is selected out of the first two thousand and thereafter each two thousandth dollar is selected. Since an individual currency unit cannot be examined, the item which includes that dollar is selected for examination, usually an invoice, payment or balance.

**Systematic selection:** The auditor calculates a uniform sampling interval by dividing the population size by the sample size. Having determined a starting point at random, every item that corresponds to the sampling interval is selected.

**Block sampling:** This is not generally an appropriate method of selection because populations might be expected to be structured in such a way that items in a sequence have similar characteristics to each other but different characteristics to items elsewhere in the population.

**Haphazard selection (or judgement sampling):** A selection process in which the auditor attempts to give all items in a population a chance of being selected by choosing items haphazardly. The auditor should avoid conscious bias and predictability in selecting items. For example, a tendency to

favour items that appear to be 'easy' i.e. items that appear to be simple and without complication.

- (c) Value-weighted selection.

High-value items have a greater chance of selection. Since we are sampling every, say, two thousandth dollar, it is more likely that this will be part of a material balance and this trend will follow our sample as a whole. Random and systematic sampling are both genuinely random so there is a greater chance of their sample containing high-value items.

Block sampling may be totally unrepresentative of a sample as it concentrates on a certain attribute. Haphazard sampling includes human judgment and thus, bias. So this should be excluded.

- (d) Tolerable error is the maximum error in the population that the auditor would be willing to accept and still conclude that the result from the sample has achieved the audit objective.

- (e) Sampling may not always be appropriate:

- Where the auditor is 'on enquiry' and is performing further audit procedures as a result of earlier testing.
- Populations are too small to justify a sampling approach.
- All transactions/balances are material.
- 'Sensitive' items, such as directors' emoluments which require precise disclosure.
- Population is non-homogeneous i.e. dissimilar Note - credit will be given for other valid suggestions.

## Suggested Solution To Question 3

- (a) Safeguards include:

- discussing the extent and nature of fees with the audit committee or other appropriate persons at the client -
- taking steps to reduce dependency on that client (for example, by refusing lucrative non-audit services or taking those on and resigning as auditor)
- having external quality control reviews
- consulting a third party, such as ICAN or another professional accountant.
- For clients who are public interest entities, disclose to those charged with governance that the total of fees represents more than 15%. The firm shall also consider other safeguards such as performing a post-issuance review (and/or a pre-issuance review if fees significantly exceed 15%).

- (b)(i) Acceptable. The goods and services of a drink being offered would normally be perceived as being insignificant by a reasonably informed independent third party.

- (ii) Unacceptable. The value of a holiday would normally be considered significant by a reasonably informed independent third party. As such it would be almost impossible to remain perceived of being independent, and hence the gift should be declined.

- (c) The auditor may need to consider the following:

- The amount of the discount. For example anything above 10% may no longer be considered to be insignificant.
- Whether the client staff are offered a similar discount.

- The timing of when the goods are offered could impact on the inventory count itself (particularly cut-off).
- If the goods were of a fashionable nature (or in any other way appealing to the audit staff) might it cause accusations of favouritism within the audit department?
- If there proves to be errors relating to inventory at the end of the audit, might the client accuse the auditor of a lack of professionalism?
- If the auditor is uncertain, contact ICAN.

- (d) Preparing accounting records and financial statements and then auditing them creates a significant self-review threat. This may also apply where an assurance engagement involves reviewing subject matter (such as forecasts) prepared by the firm itself.

In providing such assistance, firms must not make management decisions such as:

- deciding on or changing journal entries without the client's approval
- authorising or approving transactions-
- preparing source documents or originating data (including decisions on valuation assumptions). The provision of advice on accounting principles and presentation in the financial statements given during the course of an audit will not generally threaten the firm's independence. Such advice is considered to be part of the normal audit process.

The Code specifies that for listed or other public interest clients the audit firm may not provide accounting or book-keeping services, including payroll services and the preparation of financial statements, except:

- in an emergency, or
- if the work is of a routine or mechanical nature. Where such services are provided, all of the following safeguards should be applied:
- the client must accept responsibility for the results of the work
- the firm must not assume any management role
- the team providing the services must be different to the audit team. In the case of Johnson the auditor is precluded from providing the requested services because the client is a listed company. In the absence of experienced client staff it is difficult to argue that the work would be of a routine or mechanical nature and there would be a high risk of the auditor taking management decisions. Also it would be difficult to argue that this is an emergency (as opposed to bad management), hence to provide the requested accounting services would fail both ethical tests per the code.

## Corporate Reporting

(PROFESSIONAL LEVEL EXAMINATION - Nov., 2014)

### Suggested Solution To Question 4

- (a) Five elements of information which IASB practice state-

ment expects to be included in management commentaries are:

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

- (b) (i) **Nature of business**

The knowledge of the business in which a company / entity engages in and the external environment a business operates will enable the users to have further information about an entity and how it works.

- (ii) **Objectives & strategies**

It provides readers of commentaries in financial statements opportunity to assess the strategies adopted by the entity and the likelihood that those strategies will be successful in meeting management's stated objectives.

- (iii) **Resources, risks & relationships**

This is a basis for determining the resources available to the entity as well as obligations to transfer resources to others. The ability of the entity to generate long term sustainable net inflow of resources and the risks to which those resources generating activities are exposed, both in the near and in the long-term will be of benefit to the users.

- (iv) **Results and prospect**

Users of financial statements would also need to understand whether an entity has delivered in line with expectations and, implicitly, how well management has understood the entity's market, executed its strategy and managed the entity's resources, risks and relationships.

- (v) **Performance & measures**

Users should be able to focus on critical performance measures and indicators that management uses in assessing and managing the entity's performance against stated objectives & strategies.

- (c) **Reasons for Management commentaries**

- (i) Promoting an entity and attraction of investors, lenders, customers and other Stakeholders.
- (ii) Enables management to communicate its plans and outlook to the users.
- (iii) Enhanced understanding of financial statements for better decision making.
- (iv) It makes the report more explanatory, transparent and acceptable.
- (v) Without mandatory management commentaries, directors may take a minimalist approach to disclosure which will make financial reports inadequate and less informative.

**Examiners' Report**

This question tests candidates' knowledge of the provisions, requirements and rationale of IFRS Practice Statement relating to Management Commentaries in Financial Statements.

Most of the candidates attempted the question but performance was very poor.

Candidates generally displayed poor knowledge of the provisions of the IFRS Practice Statements.

Emphasis should be placed on all aspects of IFRS provisions and requirements for improved performance in this paper. performance was good.

**Suggested Solution To Question 5**

- (a) The Financial factors that indicate an organization may no longer be a going
- (i) Financial concern are:
- Default on loan or similar agreements
  - Arrears as to payment of dividend
  - Denial of usual trade credits from suppliers
  - Restructuring of debt
  - Recurring operating losses
  - Negative workings capital
  - Negative cash flow from operating activities
  - Adverse key financial ratios
  - Non-compliance with statutory capital requirements
  - Need to dispose off substantial assets.
- (ii) Operations
- Labour difficulties i.e strike, high labour turnover etc.
  - Emergence of a highly successful competitor
  - Loss of key customers
  - Decrease in market share
  - Withdrawal of Operating licence where applicable
  - Loss of principal suppliers
- (iii) Legal or regulatory factors
- Changes in law or regulations that adversely affect the entity
  - Pending legal or regulatory proceedings against the entity
  - Uninsured or underinsured insurable risks
  - Natural disaster such as drought, catastrophe, earthquake or flood.
  - Withdrawal of operating licence
- (b) Options available to the management of Luck & Co:
- Option 1
- If liquidation takes place now, the amount that will be available to the loan stock holders is N78,000, leaving them with a deficiency of N22,000. In this case, there would be nothing for the creditors and shareholders.
- Option 2
- If trading continues for the next four years and the estimated results are achieved, the available cash would be as follows:

	N
Profit	78,000
Depreciation	80,000
Inventory	20,000
Receivables	40,000
	218,000

With this option, loan stockholders and creditors would be paid in full N100,000 and N80,000 respectively, leaving N38,000 available for the shareholders.

However, the loan stockholders probably have the right to appoint a receiver and would insist on some compensation for not enforcing their right.

In addition, the creditors might also expect compensation for having to wait for four years before receiving payment.

**Option 3**

The loan stockholders and creditors may be persuaded to waive the amounts owed to them in exchange for ordinary shares to enable them have full participation in the future profit of the company. Terms of such an exchange might be as follows:

- (i) 75,000 units of N1 ordinary shares to the loan stockholders (3 of N1 ordinary shares for every N4 of loan stock)
- (ii) 40,000 units of N1 ordinary shares to the creditors (1 of N1 ordinary shares for every N2 due)
- (iii) 25,000 units of N1 ordinary shareholdings (1 of N1 ordinary shares for every 4 of the existing N1 ordinary share).

**LUCK & CO**

Redrafted Statement of Financial position after the exercise.

	N
<b>Assets:</b>	
Property, Plant and Equipment	80,000
Inventory	20,000
Receivables	40,000
	140,000
Equity	140,000

**Examiners' Report**

This question examines candidates understanding of the financial, operational and legal/regulatory indicators of going concern challenges in an entity and available options in tackling them.

Most of the candidates attempted the question but performance was poor.

Candidates were unable to differentiate between financial, operational and legal/regulatory indicators.

Candidates need to read standard texts on all aspects of the syllabus.

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