THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

MAY 2019 DIET
PROFESSIONAL LEVEL EXAMINATIONS

Question Papers

Suggested Solutions

Examiner's Reports

Plus

Marking Guides

FOREWARD

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

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

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

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

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

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

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

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.

TABLE OF CONTENTS

	PAGE
FOREWARD	4
CORPORATE REPORTING	3 – 34
ADVANCED TAXATION	35 – 77
STRATEGIC FINANCIAL MANAGEMENT	78 – 113
ADVANCED AUDIT AND ASSURANCE	114 – 137
CASE STUDY	138 - 164

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2019

CORPORATE REPORTING

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

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

SECTION A: **COMPULSORY QUESTION** **(30 MARKS)**

QUESTION 1

Oyin Plc. a Nigerian company acquired 960 million equity share capital of Kemy Plc., a foreign subsidiary based in Brazil, on 1 October, 2015 for 1.08 billion Brazilian real (BRL). The functional and presentation currency of Kemy Plc. is the BRL. Since acquisition, Kemy Plc., has operated autonomously of Oyin group.

The statements of financial position of Oyin Plc. and Kemy Plc. as at 30 September, 2017 are as follows:

	Oyin Plc.		Kemy Plc.	
	₦'000	₦'000	BRL'000	BRL'000
Assets:				
Non-current assets:				
Property, plants & equipment		945,000		1,200,000
Investments in Kemy Plc.		180,000		-
		1,125,000		1,200,000
Current Assets:				
Inventories	375,000		450,000	
Trade receivables	300,000		420,000	
Cash	90,000		75,000	
		765,000		945,000
Total Assets		1,890,000		2,145,000

Equity and Liabilities:				
Equity:				
Ordinary share capital: ₦0.50/0.50BRL				
		450,000		600,000
Revaluation reserves		-		90,000
Retained earnings		525,000		510,000
		975,000		1,200,000
Non-current liabilities:				
10% loan notes	300,000		375,000	
8% redeemable preference shares	90,000		150,000	
		390,000		525,000
Current liabilities:				
Trade payables	375,000		300,000	
Taxation	105,000		120,000	
Bank overdraft	45,000		-	
		525,000		420,000
Total equity and liabilities		1,890,000		2,145,000

Additional Information:

(i) It is the policy of Oyin Plc. group to recognise non-controlling interest at acquisition at the proportionate share of the net assets. The retained earnings of Kemy Plc., at the date of acquisition were 390 million BRL.

(ii) Kemy Plc. sells goods to Oyin Plc. at cost plus a mark-up of 33 $\frac{1}{3}$%. At 30 September, 2017, Oyin Plc., held ₦15 million of the goods. The goods were purchased at an exchange rate of ₦1 to 5BRL. On 28 September, 2017, Oyin Plc. sent Kemy Plc., a payment for ₦15 million to clear the intra-group payables. Kemy received and recorded the cash on 2 October, 2017.

(iii) On 1 October, 2016, Kemy Plc. purchased a leasehold building for 375 million BRL, taking out a loan note payable after five years to finance the purchase. The estimated useful life of the building on 1 October, 2016 was 25 years with no estimated residual value. The building is to be depreciated on straight line basis. The building was professionally revalued at 450 million BRL on 30 September, 2017 and the directors have included the revalued amount in the statement of financial position.

Both companies adopt a policy of revaluation for their properties. There was no difference between the carrying amount and fair value of the property of Oyin Plc. at 30 September, 2017.

(iv) Exchange rates are as follows:

Date	BRL to ₦1
1 October, 2015	6.0
30 September, 2015	5.5
30 September, 2017	5.0
Average for the year to 30 September, 2016	5.2

Required:

Prepare the consolidated statement of financial position of Oyin group at 30 September, 2017. **(30 Marks)**

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

QUESTION 2

Below is the draft financial statement of Lanwani Plc. a manufacturer of fast moving consumer goods.

Statement of financial position as at

	2017	2016
Non-Current Assets	₦'000	₦'000
Property, plant and equipment	195,230	191,181
Intangible assets	148,277	99,477
Other non-current assets	1,226	1,927
	344,733	292,585
Current Assets		
Inventories	42,728	31,244
Trade receivables	20,384	19,974
Cash and bank	15,866	12,156
	78,978	63,374
Total assets	423,711	355,959
Equities and liabilities:		
Equities		
Share capital (₦1 each)	3,998	3,964
Share premium	73,770	64,950
Revaluation reserve	45,320	-
Retained earnings	99,692	96,343
	222,780	165,257

Non-Current liabilities:		
Loans and borrowings	5,000	17,000
Employee benefits	13,209	10,101
	18,209	**27,101**
Current liabilities:		
Bank overdraft	8,028	12,676
Current tax liabilities	19,606	19,024
Trade payables	155,088	131,901
	182,722	163,601
Total equity and liabilities	**423,711**	**355,959**

Statement of profit or loss

	2017	2016
	₦'000	₦'000
Revenue	344,562	313,743
Cost of sales	(201,103)	(178,218)
Gross profit	143,459	135,525
Distribution expenses	(66,898)	(61,357)
Administrative expenses	(21,747)	(21,924)
Finance cost	(10,419)	(13,228)
Profit before tax	44,395	39,016
Income tax expense	(13,581)	(11,257)
Profit for the year	**30,814**	**27,759**

The following additional information are relevant:

(i) The Company changed its accounting policy from the cost model to the revaluation model for its property. The amount in revaluation reserve represents the revaluation surplus recognised in 2017. No adjustment was made in respect of 2016.

(ii) Development cost of ₦45 billion was capitalised during 2017. The related asset is not expected to generate any economic benefit until 2020.

Required:

a. Assess the accounting treatment of the change in accounting policy and state the impact on the return on capital employed (ROCE). (3 Marks)

b. Analyse the profitability, liquidity and efficiency of Lanwani Plc. (15 Marks)

c. Briefly discuss **TWO** limitations of the analysis done in (b) above. (2 Marks)

QUESTION 3

Ariba Bank Plc. (the Bank) is a Tier 1 Bank in Nigeria with branch network across all the six geo-political zones of the country. Its credit portfolio is spread among many industries with a special focus on the oil and gas industry and real estate. One of its major customers with a very good credit standing is Dunga Property Development Company (DPDC).

The management of DPDC recently approved a plan to build four shopping malls in major cities across the country. A special purpose entity was registered as a limited liability company, Dunga Malls Limited (DML), dedicated to the development and management of the malls. The project will be solely financed by a loan to be obtained from Ariba Bank. There will be no equity contribution from DPDC other than the minimum required by law to establish a company.

Ariba Bank has approved a loan of ₦80 billion at a fixed interest rate of 15% per annum payable annually in arrears. The loan has a maturity of 10 years with a moratorium of 3 years. There was no transaction cost and therefore the contractual rate is the same as the effective rate. The loan was granted directly to DML on 1 January, 2018.

The Financial Controller of Ariba Bank Plc. is concerned about the accounting treatment of the loan as IFRS 9 Financial Instrument was adopted by the bank during the year. He noted that majority of the bank loans are classified at amortised cost in the statement of financial position but the loans must pass certain tests before such classification.

The Chief Risk Officer noted in his memo that the arrangement is substantially the same as the other borrowing arrangements of the bank except that a borrowing entity would normally have equity or other assets that could be called upon by the bank in a case of default other than the asset being financed.

Required:

a. Discuss how financial assets are classified in accordance with the requirements of IFRS 9. (8 Marks)

b. Advise the Bank on how the loan granted to DML should be classified in the statement of financial position. (6 Marks)

c. Discuss, with supporting calculations, how the loan will be accounted for in the financial statement of the bank for the year ended 31 December, 2018 (6 Marks)

(Total 20 Marks)

QUESTION 4

The Central Bank of Kangora (CBK) operates a post-employment benefit plan whereby employees are entitled to an amount upon completion of employment. Each employee is paid an amount equal to 150% of the annual pay at the time of retirement multiplied by the number of years in service. The plan is not funded.

CBK uses a professional actuary to determine its liability under the plan at the end of every reporting period. The report of the actuary shows that the plan obligation was ₦620 million and ₦906 million as at 1 January, 2018 and 31 December, 2018 respectively. The current and past service cost for the year was ₦108 million. The discount rates were 8% and 12% as at 1 January, 2018 and 31 December, 2018 respectively.

CBK paid a total benefit of ₦48 million during the year.

The financial controller is struggling to complete the reconciliation and accounting entries for the plan. He is particularly confused about the concept of re-measurement and its accounting treatment.

Required:

a. Differentiate between a defined contribution plan and a defined benefit plan and advise CBK on how its post-employment plan should be classified. (5 Marks)

b. Complete the reconciliation and show the journal entries required to record the transactions for the year ended 31 December, 2018. (10 Marks)

c. Discuss the components of re-measurement gain or loss and state the accounting treatment of a re-measurement gain or loss arising on a defined benefit plan. (5 Marks)

(Total 20 Marks)

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

QUESTION 5

a. LPG Plc. is a publicly traded entity on the Nigerian Stock Exchange involved in the production of and trading in natural gas in Nigeria. LPG Plc. jointly owns a gas storage facility with another entity, Tan Oil Nigeria Limited. Both parties extract gas from onshore gas fields in the Niger Delta, which they own and operate independently from each other. LPG owns 55% of the gas storage facility and Tan Oil Nigeria owns 45%. Services and costs are shared between them according to their percentage holding, however, decisions

regarding the storage facility require unanimous agreement of the parties. The gas storage facility is pressurised so that the gas is pushed out when extracted. When the gas pressure is reduced to a certain level, the remaining gas is irrecoverable and remains in the gas storage facility until it is decommissioned. The Nigeria law requires the decommissioning of the storage facility at the end of its useful life. LPG Plc. wishes to know how to treat the agreement with Tan Oil Nigeria Limited including any obligation or possible obligation arising on the gas storage facility.

NB Ignore accounting for the irrecoverable gas.

b. LPG purchased a major gas plant on 1 January, 2018 and the Directors estimated that a major overhaul is required every two years. The costs of the overhaul are approximately ₦25 million which comprises ₦15 million for parts and equipment and ₦10 million for labour. The Directors proposed to accrue the cost of the overhaul over the two years of operations up to that date and create a provision for the expenditure.

Required:

Discuss, with reference to International Financial Reporting Standards (IFRS), how LPG Plc should account for the agreement in (a) above (11 marks) and the transactions in (b) for its year ended 31 August, 2018.

(4 marks)

(Total 15 Marks)

QUESTION 6

Dangogo Plc. has adopted IFRS in the preparation and presentation of its financial statements in line with Financial Reporting Council of Nigeria requirements. During deliberations on their financial statements for the year ended 31 March, 2019 the directors of Dangogo Plc. found the distinction between profit or loss and other comprehensive income confusing. This is the case with many other preparers or users of financial statements in Nigeria who seem to be unclear about the relationship between profit or loss and other comprehensive income (OCI). They blame the conceptual framework for Financial Reporting and IAS 1 regarding the confusing nature of re-classification. The emergence of integrated reporting holds promises for better reporting, but preparers are equally uncertain about whether the International Integrated Reporting Councils (IIRC) or Integrated Reporting (IR) Framework constitutes suitable criteria for report preparation.

Required:

a. Discuss the nature of a re-classification adjustment and the arguments for and against allowing re-classification of items to profit or loss. (6 Marks)

bi. Discuss the objectives of integrated reporting and key components (content elements) of integrated report. (6 Marks)

ii. Comment on any concerns which could limit the Framework's suitability for assessing the performance and prospects of an entity. (3 Marks)

(Total 15 Marks)

QUESTION 7

a. Agbinye Farms operates many plantations across Nigeria. The Company recently acquired a freehold land in Benue for a total of ₦12 million. The trees were planted with the company incurring an operating cost of ₦4 million up to 31 March, 2018 which is the company's year end.

The fair value of the plantation (excluding the land) was determined to be ₦16.4 million as at 31 March, 2018. Based on management assessment, the company is expected to get produce from the plantation for a period of 20 years. The first harvest was done during the year ended 31 March, 2018 and the fair value of the produce was estimated as ₦2.5 million. The Company incurred a total cost of ₦600,000 to complete the harvest.

The company uses the cost model when possible.

Required:

a. Discuss the accounting treatment of the above transactions showing clearly the amount to be recognised in the statement of profit or loss and statement of financial position as at 31 March, 2018. (10 Marks)

b. Megida Plc. has ranches across the North where its cattle are reared. The company is quoted on the Nigerian Stock Exchange under Agricultural Sector. The Financial Controller is not clear as to how to measure its cattle in the financial statement according to IAS 41.

Required:

Advise the Financial Controller on how to measure the cattle in the financial statement of Megida Plc. (5 Marks)

(Total 15 Marks)

SOLUTION 1

OYIN GROUP PLC

Consolidated Statement of Financial Position as at 30 September, 2017

	₦'000	₦'000
Assets:		
Non-current assets:		
Property, plant & equipment (945 + 240)		1,185,000
Goodwill on consolidation (w4)		57,600
Total Non-current assets		1,242,600
Current Assets		
Inventories (375 + 90 – 3.75)	461,250	
Trade receivables (w8)	369,000	
Cash (w9)	120,000	950,250
Total Assets		2,192,850
Equity and liabilities		
Equity		
Ordinary share capital of ₦0.50 each		450,000
Retained Earnings (w5)		577,200
Revaluation reserves		18,000
		1,045,200
Non-controlling interests (w7)		43,650
Non-current liabilities		
10% loan notes (300+75)	375,000	
8% redeemable preference shares (90+30)	120,000	495,000
Current liabilities		
Trade payables (375+60)	435,000	
Taxation (105+24)	129,000	
Bank overdraft (45+0)	45,000	
		609,000
		2,192,850

Workings

W1 Group structure

Oyin acquired 960m of $\frac{600mBRL}{0.5BRL}$ = 1,200 Shares

$$= \frac{960}{1{,}200} \times \frac{100\%}{1} = 80\%$$

Non- controlling interest = 20%

Total = 100%

W2 Adjustment for revaluation of PPE		**BRL'000**
PPE 1 October, 2016		375,000
Depreciation $1/25$		(15,000)
Carrying amount		360,000
Revalued amount		450,000
Revaluation reserves		90,000
Dr. PPE	90,000	
Cr. Revaluation reserves		90,000

W3 Translation of statement of financial position of Kemy Plc.	**BRL'000**	**Rate**	**₦'000**
Property, plant & equipment	1,200,000	5	240,000
Inventories	450,000	5	90,000
Trade receivables	420,000	5	84,000
Cash	75,000	5	15,000
Total Assets	**2,145,000**		**429,000**
Ordinary share capital	600,000	6	100,000
Revaluation reserves	90,000	5	18,000
Retained earnings:			
Pre-acquisition	390,000	6	65,000
Post-acquisition	1,120,000	Bal	57,000
10% loan notes	375,000	5	75,000
8% redeemable preference shares	150,000	5	30,000
Trade payables	300,000	5	60,000
Taxation	120,000	5	24,000
Total equity and liabilities	**2,145,000**		**429,000**

W4 Goodwill on acquisition	BRL'000	Rate	₦'000
Investment at cost ₦180m x 6	1,080,000	6	180,000
Non-controlling 20% interest	198,000	6	33,000
	1,278,000		213,000
Ordinary share capital	600,000	6	100,000
Retained earnings	390,000	6	65,000
	990,000		
Goodwill at acquisition	88,000		165,000
Translation of goodwill			
30 September, 2017	288,000	5	57,600
At acquisition	288,000	6	48,000
Translation gain on goodwill			9,600

W5 Retained earnings

Oyin Plc.	525,000
Kemy Plc. share of post acquisition (57,000 x 80%)	45,600
Translation gain on goodwill (W4)	9,600
Unrealised profit (W6)	(3,000)
	577,200

W6 Unrealised profits on intra-group trading

Unrealized profit

$$\frac{33\frac{1}{3}}{133\frac{1}{3}} \times \frac{N15{,}000{,}000}{} = 3{,}750{,}000$$

	Dr. ₦'000	Cr. ₦'000
Dr. Group retained earnings		
₦3,750,000 x 80%	3,000	
Dr. NCI	750	
Cr. Inventory		3,750

W7 Non-controlling interests

NCI at acquisition W4	33,000
Share of post acquisition profits	
57,000 x 20%	11,400
Unrealised profit (W6)	(750)
	43,650

W8 Receivables

Parent	300,000
Subsidiary	84,000
Less cash in transit	(15,000)
	369,000

W9 Cash

Parent	90,000
Subsidiary	15,000
Add cash in transit	15,000
	120,000

EXAMINER'S REPOR

The question tests candidates' understanding of the preparation of consolidated statement of financial position of foreign entities.

All the candidates attempted the question and the performance was below average.

The commonest pitfall was the inability of candidates to properly translate the line items of statement of financial position and goodwill using appropriate rates.

The examiners have been consistent in examining this aspect of the syllabus hence, candidates are advised to concentrate on all aspects of the consolidated financial statements for better performance in future examinations.

Marking Guide

Question 1	**Marks**	**Marks**
Statement of financial position		
Any 20 ticks @ ½ marks each		10
Working notes on:		
Revaluation of PPE	2½	
- Translation of statement of financial position		4¾
- Group structure		1
- Computation of goodwill		2½
- Retained earnings		1½
- Unrealised profit		1½
- Non-controlling interest		1¼
- Receivables		1
- Cash		1
- Workings on the face of statement of financial position		
		3½
		20
		30

Solution 2

(a)

Accounting policies are rules, principles, convention that underpin the preparation of financial statement.

Any accounting policy chosen by an entity must be consistently applied. A change can only be made if it is required by IFRS or if the change will bring about a more relevant and reliable information.

- If a change in accounting policy is as a requirement of an IFRS, the policy should be applied in the light of the IFRS.
- Retrospective application is not applied to change in cost model to revaluation model.

However, when there is a change in accounting policy, such a change must be applied retrospectively, that is, going backward to re-instate the comparative figures except where it is impracticable to do so. It is considered impracticable only when reasonable effort has been made.

Considering the financial statements of Lanwani Plc, if a retrospective application is not applied, such inconsistency will impact on the financial statement analysis e,g on the Return on capital employed (ROCE). The revaluation surplus and the development cost capitalized will inflate the capital employed for the year 2017 and consequently lead to a deterioration of the ROCE in 2017 compared with the prior year.

b) **LANWANI PLC**

COMPUTATION OF FINANCIAL RATIOS FOR THE YEAR ENDED 2017

RATIOS	FORMULA	WORKING	2017	WORKINGS	2016
PROFITABILTY RATIOS					
ROCE (%)	PBIT/C.E X100	44,395+10419		39018+18228	
		222,780+5,000	24.1%	165,257+17,000	28.7%
GPM (%)	GP X 100	143,459 X100		135,525 X100	
	REVENUE	344,562	41.6%	313,743	43.2%
NPM (%)	PAT-NCI-PREF. DIV X 100	30,814 X 100		27,759 X100	
	REVENUE	344,562	8.9%	313,743	8.8%
ROE (%)	PAT-NCI-PREF. DIV X 100	30,814 X 100		27,759 X 100	
	EQUITY	222,780	13.8%	165257	16.8%
EFFICIENCY RATIOS					
ASSET TURNOVER(TIMES)	REVENUE X 100	344,562 X 100		313,743 X 100	
	C.E	227,780	1.5 TIMES	182,257	1.7 TIMES

INVENTORY TURNOVER (TIMES)	COST OF SALES	201,103		178,218	
	AV. INVENTORY	42,728	4.7 TIMES	31,244	5.7 TIMES
TRADE RECEIVABLE TURNOVER (DAYS)	AV, RECEIVABLE X 100	20,384		19,974 X 100	
	CREDIT REVENUE	344,562	22DAYS	313,743	34DAYS
TRADE PAYABLE PAYMENT PERIOD (DAYS)	A. PAYABLE	155088 X 100		131,901	
	CREIDT PURCHASE(OR C.O.S	201103	281DAYS	178,218	270DAYS
LIQUIDITY RATIOS					
CURRENT RATIO (RATIO)	CURRENT ASSET(CA)	78,978		63,374	
	CURRENT LIABILITIES CL)	182,722	0.43:1	163,601	0.39:1
QUICK RATIO (RATIO)	CA-INVENTORY	78,978-42,728		63,374-31,244	
	CL	182,722	0.198:1	163,601	0.196:1
CASH RATIO (RATIO)	Cash &Cash Equivalent	15,866		12,156	
	CL	182,722	0.087:1	163,601	0.074:1

BRIEF COMMENTS ON LANWANI PLC

FINANCIAL STATEMENT ANALYSIS FOR THE YEAR ENDED 2017

This analysis is based on the financial statements of Lanwani Plc, a manufacturer of fast moving consumer goods, on the profitability, liquidity and efficiency of the company.

PROFITABILITY

These ratios measure how well the entity is performing in the area of returns. The higher the ratios the better. The primary ratio here is ROCE; that measures the overall profitability and efficiency of an entity.

The ROCE has significantly declined from 28.7% in 2016 to 24.1% in 2017. This reduction may not be unconnected with the revaluation surplus and development cost capitalised for the year that inflated the capital employed. This slump could also be traceable to the falling profit margins.

Management is advised to look inward especially into the production area and the policy on overhead with a view to cutting down unnecessary wastages.

EFFICIENCY

The ability of an entity to use it assets to generate revenue is measured by the efficiency ratios. The higher the times the better. The principal ratio here is the asset turnover.

The asset turnover has slightly diminished from 1.7 times in 2016 to 1.5 times in 2017. In the same vein, the inventory turnover nosedived from 5.7 times to 4.7 times. However, in 2017 Lanwani Plc has come to be more efficient in the collection of receivables from the customers while the trade payables are gradually on the increase, the payment period is unreasonably long.

Management is advised to dispose off or possibly replace the non-performing non-current assets. The use of Just-in-time (JIT) system of inventory control could be contemplated to improve on the inventory holding period.

LIQUIDITY

These ratios measure the ability of an entity to settle its short-term obligations as they fall due. The higher the ratios the better. The key ratios here are the current, quick and cash ratios.

The liquidity position of Lanwani Plc is really worrisome as evidenced in the key ratios aforementioned, although these ratios marginally increased from 2016 to 2017 but they are far below the generally acceptable industry average. The two year ratios are very poor but the current year is better when compared with the previous year.

Management is advised to consider disposing non-performing assets to cushion the liquidity position.

In conclusion, the financial performance, efficiency and liquidity position of Lanwani Plc is poor. However, if the recommendation aforesaid are implemented and a team of professionals are injected to manage the affairs of the company, the fortune can be turn around.

(c)

The two limitations of ratios

(i) The use of different accounting policies:
Using ratio analysis to compare entities on year by year basis will be misleading where the preparation of the financial statement are based on different accounting policies.

(ii) Entities in different locations:
Where entities are not in the same location, drawing conclusions from the ratios computed could be misleading because they are not in the same terrain.

(iii) The use of different accounting dates

(iv) Effect of inflation

(v) Manipulation of accounts

EXAMINER'S REPORT

The question tests accounting treatment of the changes in accounting policy and its impact on the profitability, liquidity and efficiency of an entity.

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

The commonest pitfall was inability of the candidates to classify ratios appropriately into profitability, efficiency and liquidity and give recommendations based on the ratios calculated.

Candidates are advised to pay particular attention to ratio analysis, interpretation and limitation of ratios for better performance in their examination.

Marking Guide

	Question 2		
a.	Definition of accounting policy	1	
	Reasons for change of accounting policy	1	
	Implications on Lanwani Plc ROCE	1	3
b.	Computation of three profitability ratios and comments	5	
	Computation of Efficiency ratios and comments	5	
	Computation of liquidity ratios and comments	5	15
c.	Any two limitations of ratios		2
			20

Solution 3

Ariba Bank

(a) According to IFRS 9, on initial recognition, the classification of a financial asset depends on whether it is a debt instrument or an equity instrument. A debt instrument will normally be classified at amortised cost, fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVTPL). An equity instrument cannot be classified at amortised cost.

Classification of a debt instrument will depend on whether the debt instrument passes the cash flow test (normally referred to as the solely payment of principal and interest (SPPI) test) and the business model test.

A debt instrument is generally measured at amortised cost if both of the following conditions are met:

(i) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows (business model test)
(ii) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding (contractual cash flows characteristics test)

A debt instrument is normally measured at FVOCI if both of the following conditions are met:

(i) The asset is held within a business model in which assets are managed to achieve a particular objective by both collecting contractual cash flows and selling financial assets
(ii) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding (contractual cash flows characteristics test)

The requirements above are applied to an entire financial asset, even if it contains an embedded derivative.

A debt instrument that is not measured at amortised cost or at FVOCI must be measured at FVTPL.

(b) The objective of a bank would normally be to collect contractual cash flow, therefore it could be assumed that the business model objective for amortised cost has been met. However, it is important to consider whether the contractual terms give rise to cash flows that are SPPI.

SPPI implies that the Bank will be compensated for time value of money and the credit risk it is exposed to. Compensation for liquidity risk could also be considered for the purpose of SPPI but not the exposure to the risk of the underlying asset.

In the lending to DML, it could be argued that Ariba Bank is exposed to the risk of the underlying asset and facing a risk similar to that of an equity owner since the projects undertaken by DML are solely financed by the loan and there is no equity.

However, Ariba Bank could gain comfort on the basis that the loan was guaranteed by DPDC with a very good credit standing.

Based on the above, the loan will pass the business model test and SPPI test for classification as a debt instrument at amortised and should be classified as such.

(c) Debt instruments classified at amortised cost are initially measured at fair value including transaction cost. In this case, the fair value of the loan granted will be the total face value of ₦80 Billion less the transaction of ₦2 Billion deducted at source I.e. ₦78 Billion. It should be noted that the ₦2 Billion is not recognised immediately in profit or loss, rather it is recognised over the life of the loan as part of the effective interest.

Subsequently, it is measured at amortised cost. The amortised cost of a financial instrument is defined as the amount at which it was measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the 'effective interest method' of any difference between that initial amount and the maturity amount, and minus any write-down.

The carrying amount of the loan at year end will be as follows:

	₦'million
Fair value at 1 January 2018 (80,000 – 2,000)	78,000
Finance income @ EIR of 16% (78,000 x 16%)	12,480
Interest received (80,000 x 15%)	(12,000)
Amortised cost at 31 December 2018	78,480

Finance income of ₦12.48 Billion will be recognised as revenue while the carrying amount at year end in the statement of financial position will be N78.48 Billion. It should be noted that an impairment loss based on expected credit loss will be recognised on the asset.

EXAMINER'S REPORT

The question tests classification of financial assets in accordance with the requirements of IFRS 9 and the required tests before such classification.

About 70% of the candidates attempted the question and the performance was below average.

The commonest pitfall was the inability of the candidates to differentiate classification under IFRS 39 from the classification under IFRS 9.

Candidates are advised to review and learn new international financial reporting standards (IFRSs), their implications and challenges for better performance in future examinations.

Marking Guide

Question 3

a.	Three classification and explanation of financial assets in accordance to IFRS 9	8	
b.	Classification of the loan granted to DML	6	14
c.	Accounting for loan in DML statement of financial position		6
			20

Solution 4

(a) Differences between Defined Contribution Plan and Defined Benefit Plan

Defined Contribution Plan

This is a benefit plan where the entity (employer) and employee both pay a fixed contribution into a separate Entity and the employer has no legal or constructive obligation to pay further contribution if the fund does not hold sufficient assets to pay all employee benefits relating to their service. The risk and rewards have been transferred to the employee

Defined Benefit Plan

This is a plan where an entity (employer) guarantees a particular level of pension benefit to its employees upon retirement, employees will receive annual payment from the fund based on their number of year of service and their final salary.

The entity has obligation to pay extra funds into the pension plan to meet this promised level of pension. The risk is with the employer.

Based on the foregoing, CBK post-employment plan might appear to be a defined benefit plan and should be classified as such. This is evident because CBK's employees are said to be entitled to "an amount equal to 150% of the annual pay at the time of their retirement multiplied by the numbers of years in service".

(b) Reconciliation

Present Value of Pension Obligation

	₦'million
Opening Balance @ 1/1/2018	620
Interest cost @ 8% (620 X0.08)	49.6
Current & Past Service Cost	108
Benefit Paid	(48)
Re-measurement loss	176.4 Balancing figure
Closing balance @ 31/12/2018	**906**

Journal entries:

(i) Interest cost

Dr. Profit or loss	₦49.6
Cr. Plan obligation	₦49.6

To recognise the interest cost on defined benefit plan obligation

(ii) Current and past service cost

Dr. Profit or loss	₦108
Cr. Plan obligation	₦108

To recognise the service cost on defined benefit plan obligation

(iii) Benefits paid

Dr. Plan obligation	₦48
Cr. Bank	₦48

To recognise the amount of benefit paid to past employees

(iv) Re-measurement

Dr. Other comprehensive income	₦176.4
Cr. Plan obligation	₦176.4

To recognise the loss arising from the re-measurement of plan obligation

Charged to Profit or Loss	₦'million
Interest Cost	49.6
Current & Past Service Cost	108
	157.6

Other Comprehensive Income

	₦'million
Re-measurement loss	176.4

Statement of Financial Position

	₦'million
Increase in Liabilities	
Liability at beginning	620
Liability at end	(906)
	286

(c) Re-measurement gain or loss and the accounting treatment.

Re-measurements gain or loss occurs under defined benefit Plan

It is the difference between the amount calculated by the actuary as at the current year end and the components that feature in the computation of pension obligation as stated below:

- The net interest component
- The service cost component
- Any gain or loss on settlement

- Contributions into the plan
- Benefits paid

After the components above are computed, the net pension deficit could differ from the amount calculated by the actuary as at the current year end. This is for several reasons that include the following:

- The actuary's calculation of the value of the plan obligation and assets is based on assumptions, such as life expectancy and final salaries, inflation, implicit rate of interest. All these would have changed year-on-year basis.

- An adjustment, known as the "re-measurement component" must therefore be posted. This is charged or credited to other comprehensive income for the year and identified as an item that will not be reclassified to profit or loss in future periods.

EXAMINER'S REPORT

The question tests the classification of post – employment plan under defined contribution plan and defined benefit plan. It also tests accounting treatment of re-measurement gain or loss and how the components are classified.

More than 80% of the candidates attempted the question and the performance was above average.

The commonest pitfall was that some of the candidates that attempted the question displayed lack of clear understanding of the difference between defined contribution plan and defined benefit plan as stated in the accounting standards.

Candidates are advised to have deep knowledge of the different aspect of the syllabus in order to perform better.

Marking Guide

a.	Definition of defined contribution plan	2	
	Definition of defined benefit plan	2	
	Classification of post employment plan of CBK	1	5
b.	Reconciliation of plan obligation		
	7 ticks @ ½ mark each	3½	
	- Journal entries for 4 items of interest cost current and past services, benefit paid and re-measurement	4	
	- Extract in Statement of financial position and P or L	2½	10
		3	

c.	Discussion of re-measurement gain or loss Accounting treatment of a re-measurement gain or loss arising on defined benefit plan	2	5
			20

Solution 5

(a) The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement (IFRS 11 *Joint Arrangements*).

- A joint arrangement occurs where two or more parties have joint control.

- The parties to the joint arrangement contractually agree that sharing of control exists only when decisions about the relevant activities require the unanimous consent of the parties sharing the control.

- The structure and form of the arrangement determines the nature of the relationship.

- Irrespective of the purpose, structure or form of the arrangement, the classification of joint arrangements under IFRS 11 – Joint Arrangements depends upon the parties' rights and obligations arising from the arrangement.

- A joint arrangement which is not structured through a separate vehicle is a joint operation. In such cases, the contractual arrangement establishes the parties' rights and obligations.

- A joint operator accounts for the assets, liabilities, revenues and expenses relating to its involvement in a joint operation in accordance with the relevant IFRSs.

- Based on the above, the arrangement between LPG Plc and Tan Oil Nigeria Ltd qualifies as a joint operation because:

  - there is no separate vehicle involved;
  - they have agreed to share services and costs;
  - decisions regarding the platform required unanimous agreement of the parties.

- The joint venture here relates to ownership of storage facility that would be used for more than one accounting year.
- IAS 16 states that property, plant and equipment are tangible items which:

- are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- are expected to be used for more than one accounting period.

Consequently, LPG Plc should recognise its share of the asset as property, plant and equipment.

Under IAS 16 property, plant and equipment (PPE), the cost of an item of property, plant and equipment includes the initial estimate of the costs of dismantling, removal of the item and restoration of the site on which it is located.

IAS 37 Provisions, Contingent Liabilities and Contingent Assets contains requirements on how to measure decommissioning, restoration and similar liabilities.

Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation.

The costs incurred by an entity in respect of obligations for dismantling, removing and restoring the site on which an item of property, plant and equipment is located are recognised and measured in accordance with IAS 16 and IAS 37. LPG Plc should recognise 55% of the cost of decommissioning the underground storage facility.

However, because LPG Plc. is a joint operator, there is also a contingent liability for 45% of the decommissioning costs.

The possible obligation for the remainder of the costs of decommissioning depends on the occurrence of some uncertain future event, such as if Tan Oil Nig Ltd goes into liquidation and cannot fund the decommissioning costs.

Therefore, LPG Plc should also disclose a contingent liability relating to the Tan Oil Nigeria Ltd's share of the obligation to the extent that it is contingently liable for Tan Oil Nigeria Ltd's share.

(b) It is not acceptable to accrue the costs of the overhaul.

IAS 37 requires a provision to be recognised if the following conditions are met

- Contractual or legal obligations exist as a result of past event
- If it is probable that there will be an outflow of economic benefits
- If it can be measured reliably

The entity does not have a constructive obligation to undertake the overhaul. Under IFRS, The major overhaul component of ₦15m will then be depreciated on a straight-line basis over its useful life (i.e. over the period to the next overhaul) and any remaining carrying amount will be derecognised when the next overhaul is performed.

Costs of the day-to-day servicing of the asset (i.e. routine maintenance labour cost of ₦10m) are expensed as incurred.

Therefore, the cost of the overhaul should have been identified as a separate component of the gas storage at initial recognition and depreciated over a period of two years. This will result in the same amount of expense being recognised in profit or loss over the same period as the proposal to create a provision in the financials of LPG.

EXAMINER'S REPORT

The question tests application of international financial reporting standards (IFRSs) on joint arrangements; property, plant and equipment and provisions, contingent liabilities and contingent assets to given scenarios.

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

The commonest pitfall was lack of deep knowledge and application of the applicable IFRSs to practical situations.

Candidates are advised to understand the provisions of IFRSs and their applications to issues in real life situations at this level of the Institute examination for better performance.

Marking Guide

Question 5

a.	Accounting for the agreement with reference to IFRS on:		
	- Qualification of LPG Plc and Tan Oil Nig. Ltd. Under IFRS 11	5	
	- Joint venture agreement with reference to ownership of store facility under IAS 16 on PPE	3	
	- Measurement of decommissioning restoration and similar liabilities under IAS 37	3	11
b.	Conditions for recognizing provisions under IAS 37	2	
	Accounting for the cost of overhaul	2	4
			15

Solution 6

(a) Re-classifications adjustments are items that have been recognised in other comprehensive income (OCI) in the current or previous periods now converted or recycled to profit or loss in the current period

An example of items recognised in OCI which may be reclassified to profit or loss include realised gains or losses on cash flow hedges and foreign currency gains on the disposal of a foreign operation.

Certain items recognised in OCI may not be reclassified to profit or loss.

Examples of items which may not be reclassified are changes in a revaluation surplus under IAS 16 Property, plant and equipment, and actuarial gains and losses on a defined benefit plan under IAS 19 Employee Benefits.

The directors of Dangogo Plc may find distinction between profit or loss and other comprehensive income challenging because, there is a general lack of agreement about which items should be presented in profit or loss and in OCI.

The interaction between profit or loss and OCI is unclear, especially the notion of reclassification and when or which OCI items should be reclassified.

A common misunderstanding is that the distinction is based upon realised versus unrealised gains.

Arguments in favour of reclassification include

- If reclassification ceases, there would be no need to define profit or loss, or any other total or subtotal in profit or loss, and any presentation decisions can be left to specific IFRS.
- It is argued that re-classification protects the integrity of profit or loss and provides users with relevant information about a transaction which occurred in the period.
- Additionally, it can improve comparability where IFRS permits similar items to be recognised in either profit or loss or OCI.

Those against re-classification argue that:

- The recycled amounts add to the complexity of financial reporting;
- Re-classification may lead to earnings management;
- The re-classification adjustments may not meet the definitions of income or expense in the period as the change in the asset or liability may have occurred in a previous period.
- The lack of a consistent basis for determining how items should be presented has led to an inconsistent use of OCI in IFRS.

Opinions vary but there is a feeling that OCI has become a home for anything controversial because of a lack of clear definition of what should be included

in the statement. Many users are taught to ignore OCI, as the changes reported are not caused by the operating flows used for predictive purposes.

(b) **Objectives of integrated reporting**

The objectives of integrated reporting include:

- To improve the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital

- Provide a more cohesive and efficient approach to corporate reporting that draws on different reporting strands and communicates the full range of factors that materially affect the ability of an organisation to create value overtime

- Enhance accountability and stewardship for the broad base of capitals (financial, manufactured, intellectual, human, social relationship) and promote understanding of their interdependencies

- Support integrated thinking, decision-making and actions that focus on the creation of value over the short, medium and long term.

- To integrate both qualitative and quantitative report for effective decision making

Content elements of Integrated Reporting Framework

- Organisational overview and external environment – What does the organisation do and what are the circumstances under which it operates?

- Governance – How does an organisation's governance structure support its ability to create value in the short, medium and long term?

- Business model – What is the organisation's business model?

- Risks and opportunities – What are the specific risk and opportunities that affect the organization's ability to create value over the short, medium and long term, and how is the organisation dealing with them?

- Strategy and resource allocation – Where does the organisation want to go and how does it intend to get there?

- Performance Measurement – To what extent has the organisation achieved its strategic objectives for the period and what are its outcomes in terms of effects on the capitals?

- Future Outlook – What challenges and uncertainties is the organisation likely to encounter in pursuing its strategy, and what are the potential implications for its business model and future performance?

- Basis of preparation and presentation - How does the organisation determine what matters to include in the integrated report and how such matters are quantified or evaluated.

(b) ii.

Comment on any concerns which limit the framework's suitability for assessing the performance and prospects of an entity

- With the development of the IIRC Framework, defining the "providers of financial capital" as the primary target audience of the integrated report was an informed decision. A key point here is that disclosing other information on the performance and direction of an enterprise is still relevant in the annual report.

- The firm sustainability reporting still targets various types of stakeholder groups who are not the primary audience of the integrated report. The integrated report is of special value to those user groups who want to see a connection made between sustainability performance and financial performance. This means it's of special value to the various providers of financial capital. Institutional investors and those committed to responsible investment have a special interest in integrated reports.

- To the providers of capital it's critical that reporting is more strategic and forward looking as opposed to annual reporting which has been backward looking and only focused on narrow corporate financial performance of the previous year. Describing the logic of how the enterprise generates income and wealth, where its growth is heading in the longer term, how it uses different types of capital and manages the risks involved is especially relevant to responsible investors in their decision-making.

EXAMINER'S REPORT

The question tests the nature of re-classification adjustment of items into profit or loss; the objectives and key components of integrated reporting and the frameworks suitable for assessing the performance and prospects of an entity.

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

Most of the candidates that attempted the question displayed poor understanding of re-classification adjustments of items into profit or loss.

Candidates are advised to have good knowledge of the area of the syllabus and beyond financial reporting for better performance.

Marking Guide

	Question 6		
a.	Re-classification adjustment nature	2	
	Arguments in favour re-classification of items to P or L (any two @ 1 mark)	2	
	Arguments against re-classification of items to P or L (any two @ 1 mark)	2	6
b (i)	Objectives of integrated reporting (any three @ 1mark each)	3	
	Content elements (any six @ ½ mark each)	3	6
(ii)	Comments on framework suitability for assessing performance and prospects of an entity (any two @ 1½ mark each)		3
			15

Solution 7

(a) Accounting Treatment of Agbinye Farms.

The relevant standards for consideration here are:

- IAS 41- Agriculture
- IAS 2 – Inventory
- IAS 16 Property, plant and equipment

IAS 41 Agriculture outlined assets that are outside of its scope. This includes

- Bearer plants

Bearer plants are used to produce agricultural produce for more than one period. Examples include grape vines or tea bushes. Bearer plants are accounted for in accordance with IAS 16 Property, Plant and Equipment. However, any harvested produce growing on a bearer plant, such as grapes on a grape vine, is a biological asset and so it is accounted for in accordance with IAS 41.

- Land related to agricultural activity.

Land is not a biological asset. It is treated as a tangible non-current asset and accounted for under IAS 16-Property, Plant and Equipment. When valuing a forest, for example, the trees must be accounted for separately from the land that they grow on.

As explained above Agbinye farms operates a plantation, this should be accounted for in accordance with property plant and equipments.

Accounting Treatment

Initial Measurement of Land

The initial cost of land is N12m

- Subsequent Measurement of Land

  For land it remains the same at N12m in the statement of financial position as at 31 March, 2018 since land cannot be depreciated.

- Initial Measurement of Trees (Plantation)

  The N4m operating cost of planting the trees should be taken as the initial cost of PPE i.e the Plantation.

- Subsequent Measurement of Trees (Plantation) using cost model

		₦
Cost (Initial)		4,000,000
Depreciation	(4,000,000) / 20	(200,000)
		3,800,000

Carrying amount at 31/3/2018

DR: Profit or loss depreciation 200,000
CR: Property Plant & Equipment 200,000
Being depreciation for the year

Subsequent measurement of trees using revaluation model.

		₦
Cost (Initial)		4,000,000
Depreciation	(4,000,000) / 20	(200,000)
		3,800,000
Revaluation Surplus		12,600,000
Revaluation		16,400,000

DR: Profit or loss 200,000
CR: PPE 200,000
Being depreciation for the year

DR: PPE 12,600,000
CR: Revaluation Reserve (OCI) 12,600,000
Being Revaluation gain of plantation at 31/3/2018

Extract of Statement of profit or loss	**₦'m**
Fair value gain	2.5
Operating cost	(0.6)
Depreciation	(0.2)
Extract of Statement of financial position	
Non-current asset	**₦'m**
Land	12
Bearer plants (4,000,000 – 200,000)	3.8
Current asset	
Agricultural produce	2.5

Agricultural Produce

The produce growing from the trees in the plantation are biological assets. They should initially be recognised at fair value less costs to sell. Any gain or loss on initial recognition is reported in Statement of profit or loss and be revalued at the year end to fair value less costs to sell with any gain or loss reported in profit or loss

Therefore, in Agbinye farms, the harvested produce are agricultural produce and should be accounted for in line with provisions of IAS 41.

Initially recognised at ₦1.9m (2.5m – 0.6m), with a gain of ₦1.9m reported in profit or loss, the harvested grapes are now accounted for under IAS 2 Inventories and will have a deemed cost of N1.9m.

b. **Megida Plc.**

Living animals are biological assets that are within the scope of IAS-41 Agriculture. An entity applies this standard so far it is engaged in agricultural activities which involve the management of biological transformation of biological assets.

If it's assumed that Megida cattle are majorly diary cattle.

Megida should apply the following standards in line with IASB recommendations

Diary cattle – Recognised as property plant and equipment and depreciated over the useful life of the cattle, if the cattle were used to produced milk

Milk – This should be recognised as agricultural produce in line with IAS 41 as explained above

Cheese –They should apply IAS 2 because these are products that are the result of processing after harvest.

Alternatively,

At initial recognition, they will be accounted for at fair value less cost to sell, except where the fair value cannot be determined reliably hence, it is initially measure at cost. This is unlikely to be the case for Agbinye especially because of its target market.

Subsequently, it will be re-measured at the end of every reporting period at fair value less cost to sell. Change in the fair value less cost to sell will be recognised directly in profit or loss.

It will be presented as biological asset in the statement of financial position which will be a separate class of asset.

EXAMINER'S REPORT

The question tests accounting treatment of

- **plantation and land related to agricultural activities; and**
- **ranches for agricultural company quoted on the Nigerian Stock Exchange.**

About 70% of the candidates attempted the question and the performance was poor.

The commonest pitfall was lack of understanding of the treatment of plantation and ranches, linking them to the relevant international accounting standards like IAS 41, Agriculture; IAS 2 – inventory and IAS 16 – property, plant and equipment. The candidates' displayed poor understanding of the differences between cost model and revaluation model.

Candidates are advised to understand all aspect of the syllabus for better performance.

Marking Guide

a.	Identification of the relevant International Accounting Standards		3
	- Accounting treatment for cost model	2	
	- Accounting treatment for revaluation model	2	4
	- Amount to be recognised in the statement of P or L	1½	
	- Amount to be recognised in the statement of financial position	1½	3
b.	Introduction of cattle as biological assets	2	
	- Treatment as Diary cattle	1	
	- Treatment as Milk	1	
	- Treatment as Cheese	1	5
			15

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2019

ADVANCED TAXATION

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

a. In line with provisions of Petroleum Profits Tax Act Cap P13 LFN 2004 (as amended), **explain** "accounting period" of a petroleum exploration company. (2 Marks)

b. Priceless Oil Limited commenced crude oil production in Nigeria in 2006. The company has provided the following financial report in respect of its operations for the accounting year ended December 31, 2018.

	₦'000
Sale of crude oil- export (190,000 barrels)	2,850,000
- local	653,700
Other income	128,100
Expenditure incurred are as follows:	
Production costs	749,980
Operation costs	930,720
Intangible drilling costs	255,600
Non-productive rent	92,070
Royalties on export sales	43,790
Royalties on local sales	10,800
Custom duty on plant	39,100
Cost of drilling four appraisal wells	104,400
Transportation and travelling	28,300
Salaries and wages	395,200
Management and administrative expenses	105,900
Harbour dues	25,480
Donations	25,000
Pension fund contribution	52,500
Bad debts written off	89,500
Miscellaneous expenses	57,560
Interest paid	35,000
Income tax provision	166,100

Additional information:

(i) Posted price for crude oil exported averaged $52 per barrel (at an exchange rate of ₦306 to $1).
(ii) Included in other income was ₦38,000,000 derived from transportation of crude oil to the refinery. Related expenses which amounted to ₦16,250,000 was included in operation costs.
(iii) The company entered into natural gas contract with Tommy Limited. The value of the contract was ₦655,000,000 and the load factor of the gas was 54^0.
(iv) Depreciation of assets which amounted to ₦120,250,000 was included in production costs.
(v) The schedule of qualifying capital expenditure acquired during the year is as follows:

Type	Date of acquisition	Location	Amount ₦
Storage tank	March 12, 2018	On-shore	23,500,000
Plant and equipment	November 15, 2018	Continental shelf of 130 metres of water depth	75,000,000

(vi) The unutilised portion of capital allowances brought forward from last year was agreed to be ₦33,700,000; while the agreed capital allowance for the year was ₦88,500,000.
(vii) Included in management and administrative expenses was ₦3,500,000 paid on stamp duties for debenture issued and obtained by the company.
(viii) Specific bad debts written off amounted to ₦39,500,000.
(ix) The amount on donation was expended wholly, exclusively and necessarily for the company's petroleum operations.
(x) A sum of ₦12,250,000 paid to another company to retrieve information relating to existence of petroleum in the Nigerian middle belt region, was included in miscellaneous expenses.
(xi) Interest paid included ₦20,500,000, and this was paid to an associate company. The loan was obtained at market rate.

As a result of the need to meet up with the return deadline on payment of petroleum profits tax, the 13th installment has become very urgent.

The management of the company has engaged your firm of Chartered Accountants as tax consultants to the company.

Required:

As the desk officer in charge of petroleum profit tax matters in the accounting firm, the principal partner has directed you to work on the file of Priceless Oil Limited. Specifically, you are to prepare and submit a report on the following computations:

i. Assessable profit (12 Marks)
ii. Chargeable profit (6 Marks)
iii. Chargeable tax (6 Marks)
iv. Total tax payable (6 Marks)
(Total 30 Marks)

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

QUESTION 2

You have been approached by the managing director of a manufacturing company, Ojieaga Integrated Limited, for professional advice on tax evasion and tax avoidance and their challenges to an equitable tax system in Nigeria. Your report is expected to guide the operation of the business, having been subjected in the last three years to various forms of fines and penalties by the Federal Inland Revenue Service on confirmed cases of sharp business practices with their attendant loss of tax revenue to the government.

Required:
Having accepted the terms of engagement, you are to write a report to management for consideration at its next meeting, dealing with the following areas of concern:

a. Distinction between tax evasion and tax avoidance, highlighting **THREE** examples of each case. (6 Marks)
b. Seven solutions to the problem of tax evasion and tax avoidance. (7 Marks)
c. Comment on anti-avoidance legislations in Nigeria. (7 Marks)
(Total 20 Marks)

QUESTION 3

Pardo Nigeria Limited is a manufacturer of polythene bags. It was incorporated on January 1, 2013 but commenced business operation on March 1, 2013. The following is the summary of its adjusted profits for the respective years:

	₦'000
Period ended December 31, 2013	7,200
Year ended December 31, 2014	10,700
Year ended December 31, 2015	12,650
Year ended December 31, 2016	15,220
Year ended December 31, 2017	19,850

The company acquired the following assets:

Date	Asset type	Amount
		₦'000
April 5, 2013	Factory building	5,400
January 17, 2014	Office furniture	2,750
December 1, 2014	Motor vehicle	4,500
January 3, 2015	Production plant	1,820

The company sold some of its assets on December 31, 2017 as follows:

Asset type	Cost	Proceeds
	₦'000	₦'000
Office furniture	250,000	35
Production plant	650,000	60

As the newly appointed tax consultant to the company, the managing director sought your advice on both capital allowance available to the company and the tax liabilities resulting thereof for the relevant years. He, however, informed you during the time of finalising the engagement that the factory building was purchased second-hand from a company that had ceased operation six months earlier.

Required:

Prepare a report addressed to the managing director of the company showing for all the relevant years, the:

a. Capital allowance computations (9 Marks)

b. Tax liabilities payable (11 Marks)

(Total 20 Marks)

QUESTION 4

a. With respect to the Capital Gains Tax Act Cap C1 LFN 2004 (as amended), when is acquisition or disposal effective? (2 Marks)

b. Smaposu Nigeria Limited is based in Ibadan, Oyo State and is into manufacturing of computer accessories. The company undertook the following transactions during the year ended December 31, 2018:

(i) Plant and machinery: Part of plant and machinery was purchased in year 2014 at an all-inclusive price of ₦12,500,000. A machinery was sold for ₦8,100,000 and the value of the undisposed part was ₦5,740,000. Selling expenses incurred amounted to ₦150,000.

(ii) A motor vehicle which was acquired in 2016 for ₦3,000,000 for purpose of the business, was sold to the company's general manager for ₦2,900,000. The market value of the car as at the point of disposal was ₦3,500,000. The company re-acquired similar car for ₦3,500,000.

(iii) As a result of unfavourable business climate in Ibadan, the company relocated to Ikeja, Lagos State. The land and buildings acquired in Ibadan in 2009 for ₦30,000,000 were sold for ₦65,500,000. Cost of valuation and professional fee incurred on disposal was ₦2,000,000. A re-investment was made in Ikeja through acquisition of another landed property valued at ₦50,000,000.

Smaposu Nigeria Limited has just appointed your firm as the company's tax consultant.

You are required to advise the management on:

i. "Deemed" disposal of an asset. (5 Marks)

ii. The capital gains (if any)arising from these transactions. (6 Marks)

iii. The roll-over relief (if any) on re-investment made on acquisition of new assets by the company. (4 Marks)

iv. Capital gains tax payable. (3 Marks)

(Total 20 Marks)

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

QUESTION 5

a. State **four** of the specific provisions of the law as provided in Sections 34 and 35 of the Companies Income Tax Act CAP C2 LFN 2004 (as amended) regarding where there is double taxation agreement between one country and Nigeria. (2 Marks)

b. With respect to double taxation arrangement, state precisely the provisions on the following:

i. Business profits not arising through a permanent establishment. (2 Marks)

ii. Dividend derived by one company resident in one country from another company resident in another country. (2 Marks)

iii. Directors' fees and other similar payments derived by a resident of a country in his capacity as a director of a company which is a resident of another country. (2 Marks)

c. SOKGlobal Limited is a wholly owned Nigerian company that deals with stationery items. It has a functional business unit in Cape Town, South Africa. The company's operating results for the year ended December 31, 2017 are as follows:

	₦'000
Income from Nigeria	60,300
Income from South Africa	38,800
Total income	99,100
Less: Overheads	48,660
Net profit	50,440

	Included in the overheads were:	₦'000
(i)	Depreciation- Nigeria	6,427
	- South Africa	1,088
(ii)	Cost of tax appeal- Nigeria	510
(iii)	Donations- Nigeria business:	
	Social club	100
	Nigerian Museum	250
(iv)	Preliminary expenses –Nigeria	1,900
(v)	Foreign tax suffered	6,120

Profit attributable to South Africa business was ₦8,740

Capital allowances agreed with tax officials for Nigeria and South Africa businesses were ₦5,500,000 and ₦2,210,000 respectively.

Required:

Advise the company on the double taxation relief applicable to the company showing the necessary computations. (7 Marks)

(Total 15 Marks)

QUESTION 6

The need for monitoring and controlling the operations of multi-national enterprises (MNEs) and their local subsidiaries or associate companies around the world has necessitated special interest in various governments putting in place mechanisms for treatment of transfer pricing.

Although, transfer pricing is not new in Nigeria, the law regulating it, the Income Tax (Transfer Pricing) Regulation Act was enacted in August 2012. It specifies that "every taxpayer" is expected to develop a transfer pricing policy in regard to transfer pricing and control transaction, as well as treatment of transactions of permanent establishment (PE) and dispute resolutions"

You have been invited by the Nigerian Association of Chambers of Commerce, Industry, Mines and Agriculture (NACCIMA) to present a paper at a workshop on transfer pricing regulations in Nigeria. The primary objective of the workshop is to provide the participants, both local and foreign stakeholders in the Nigerian business environment, necessary information on transfer pricing issues in Nigeria.

You are required to outline relevant points to address the following issues:

a. Objectives of application of transfer pricing regulation in Nigeria. (3 Marks)

b. The concepts of:

   i. Connected taxable persons (3 Marks)

   ii. Arm's length principle (3 Marks)

c. Description of **three** transfer pricing methods. (6 Marks)

(Total 15 Marks)

QUESTION 7

a. The Federal Government of Nigeria in the third quarter of 2018, announced the discovery of huge hydro-carbon deposit in the Chad basin area of Borno State. This information has attracted interest from local and foreign investors in the Nigerian oil and gas sector. One of such foreign investors is a Japanese billionaire, Mr. Sun Nagasaki, who has investments in some oil and gas operations in Middle East and Latin America.

   Mr. Nagasaki is however not familiar with the regulations guiding the operations, and the incentives available to investors in the oil and gas sub-sector in Nigeria.

   You have been appointed as a tax consultant by Mr. Nagasaki's representative in Nigeria.

Required:

a. Draft a report addressed to Mr. Nagasaki explaining the following issues of interest:

i. Fiscal incentives available in the gas production phase. (2 Marks)

ii. **Six** incentives for the encouragement of exploitation and utilization of associated gas for commercial purpose (downstream operations). (4 Marks)

iii. **Six** incentives and fiscal measures that favour and encourage large investment in oil and gas free trade zone. (4 Marks)

b. For the assessment year 2018, below are the extracts from the tax computations of Alaba Trading Limited:

	₦
Assessable profit	8,200,000
Capital allowances	5,400,000
Dividend payable	6,000,000

Required:

Determine the total tax liabilities of Alaba Limited for the assessment year.

(5 Marks)

(Total 15 Marks)

NIGERIAN TAX RATES

1. **CAPITAL ALLOWANCES**

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

2. INVESTMENT ALLOWANCE 10%

3. RATES OF PERSONAL INCOME TAX

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

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

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

4. COMPANIES INCOME TAX RATE 30%

5. TERTIARY EDUCATION TAX (2% of assessable profit)

6. CAPITAL GAINS TAX 10%

7. VALUE ADDED TAX 5%

SOLUTION 1

(a) The accounting period of a petroleum exploration company covers:

(i) A period of one year commencing on January 1 and ending on December 31 of the same year; or

(ii) Any shorter period commencing on the day the company first makes a sale or bulk disposal of chargeable oil under a programme of continuous production and sales, domestic, export or both, and ending on December 31 of the same year; or

(iii) Any period of less than a year being a period commencing on January 1 of any year and ending on the date in the same year, when the company ceases to be engaged in petroleum operations.

(b) **PQR & CO (CHARTERED ACCOUNTANTS)**

INTERNAL MEMO

Date: .....
From: Desk Officer, PPT matters
To: Principal Partner

Re: Report on tax matters on Priceless Oil Limited

With respect to the above subject matter, this is to formally inform you of the conclusion of the assignment. I have considered the financial report in respect of the operations of the company for the accounting year ended December 31, 2018. Please find below the extract from the computations of the tax liability for 2018 year of assessment in line with the provisions of the Petroleum Profits Tax Act Cap P13 LFN 2004 (as amended).

		₦'000
(i)	Assessable profit (Appendix I)	1,498,630
(ii)	Chargeable profit (Appendix II)	1,364,005
(iii)	Chargeable tax (Appendix III)	1,159,404
(iv)	Total tax payable (Appendix IV)	1,196,337

This is for your review and necessary action.

Regards sir.

O.O.O,
Desk officer

APPENDIX I- Assessable profit

Priceless Oil Limited

Computation of assessable profit

For 2018 assessment year

	₦'000	₦'000
Income		
Export sales (190,000 barrels x ₦15,912) w1		3,023,280
Local sales		653,700
Other income (₦128,100 – ₦38,000)		90,100
Sales of natural gas (w2)		547,973
		4,315,053
Deduct: Allowable expenses:		
Production cost (₦749,980 – 120,250)	629,730	
Operation costs (₦930,720 – 16,250)	914,470	
Intangible drilling costs	255,600	
Non-productive rent	92,070	
Royalties (export sales)	43,790	
Royalties (local sales)	10,800	
Custom duty on plant	39,100	
Cost of drilling appraisal wells (w3)	52,200	
Transportation and travelling	28,300	
Salaries and wages	395,200	
Management and administrative expenses (₦105,900 – 3,500)	102,400	
Harbor dues	25,480	
Donations	25,000	
Pension fund contribution	52,500	
Bad debts	39,500	
Miscellaneous expenses (₦57,560 – 12,250)	45,310	
Interest paid	35,000	
Tertiary education tax (2/102 x ₦1,528,603)	29,973	2,816,423
Assessable profit		**1,498,630**

APPENDIX II- Chargeable profit

Priceless Oil Limited

Computation of chargeable profit for 2018 assessment year

	₦'000	₦'000
Assessable profit		1,498,630
Less: Capital allowances		
Lower of:		
Capital allowance for the year	88,500	
Petroleum investment allowance (w4)	12,425	
Unutilised capital allowance b/f	33,700	
Or	134,625	
85% of Assessable profit of 1,498,630	1,273,835	
Less 170% of PIA (1.7 x 12425)	21,123	
	1,252,712	
Restricted to		134,625
chargeable profit		**1,364,005**

APPENDIX III- Chargeable tax

Priceless Oil Limited

Computation of chargeable tax for 2018 assessment year

	₦'000
Chargeable profit	1,364,005
Assessable tax @ 85%	1,159,404
Less: MOU	-
Chargeable tax	**1,159,404**

APPENDIX IV- Total tax payable

Priceless Oil Limited

Computation of total tax payable for 2018 assessment year

	₦'000
Chargeable tax	1,159,404
Tertiary education tax	29,973
Other taxes (w5)	6,960
Total tax payable	**1,196,337**

Workings

(1) Export sales

Posted price = $52 x ₦306 = ₦15,912

Actual price = ₦2, 850,000 = ₦15,000
190,000

The practice of the Revenue is to pick the higher of the two prices. Hence, the posted price of ₦15,912 per barrel will be used in determining the proceeds from export sales.

(2) Natural gas proceeds

$\frac{50 - 54}{50 - 60} = \frac{16.9 - x}{16.9 - 15.5}$

$\frac{-4}{-10} = \frac{16.9 - x}{1.4}$

(-4)(1.4) = -10(16.9 – x)

-5.6 = -169 + 10x

$x = \frac{163.4}{10} = 16.34\%$

G-factor allowance = 16.34% of ₦655,000,000 = **₦107,027,000**

Net sales proceeds = ₦655,000,000 – ₦107,027,000 = **₦547,973,000**

(3) Cost of drilling appraisal well

The Act allows 2 appraisal wells.

Thus, allowable cost of drilling wells = 2/4 x ₦104,400,000 = **₦52,200,000**

(4) Petroleum investment allowance (PIA)

Storage tank: ₦23,500,000 x 5% =	₦1,175,000
Plant & equipment: ₦75,000,000 x 15% =	11,250,000
	12,425,000

(5) Other taxes

	₦'000
Income from transportation of crude oil	38,000
Related expenses	16,250
Total profit	21,750
Companies income tax @ 30%	6,525
Tertiary education tax @2%	435
Total tax payable from transport business	**6,960**

EXAMINER'S REPORT

The question tests candidates' knowledge of petroleum profits tax and internal memo as the process of internal communication in any business concern.

Candidates' performance was below average. The common pitfalls were lack of understanding of allowable expenses in petroleum profits tax and inability to calculate petroleum investment allowance and describe them using internal memo.

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

MARKING GUIDE

		MARKS	TOTAL MARKS
(a)	Identification of accounting period (one mark each for 2 points		2
(b)i.	Internal memo/report	½	
	Title	½	
	Assessable profit – 30 ticks @¼ mark each	7½	
	Solutions to workings 1, 2 and 3 @ ½ mark each	1½	10
(b)ii.	Chargeable profit- 12 ticks @ ½ mark each	6	6
(b)iii.	Correct computation of assessable tax	3	
	Correct computation of chargeable tax	3	
			6
(b)iv.	Correct computation of tertiary education tax	1½	
	Correct computation of other taxes	1½	
	Total tax payable @ 1½ mark	1½	
	Workings	1½	
			6
	Total		**30**

SOLUTION 2

XYZ& CO (CHARTERED ACCOUNTANTS)

Plot 5, New Town Road,

Maryland Town, Lekki

The Managing Director,

Ojieaga Integrated Limited,

Dear Sir,

Re: PROFESSIONAL ADVICE ON TAX EVASION AND TAX AVOIDANCE AND THEIR CHALLENGES TO EQUITABLE TAX SYSTEM IN NIGERIA

We are in receipt of your letter dated January 15, 2019 requesting for our professional advice on the above subject matter.

Our comments are as follows:

(a) Distinction between tax evasion and tax avoidance

Tax Evasion: This is a deliberate and willful practice of not disclosing full taxable income so as to pay less tax. It is a contravention of tax laws whereby a taxable person fails to pay the tax due or reduces tax liability by making fraudulent or untrue claims on the income tax form. Tax evasion is illegal and when caught, the culprit is punishable under the law.

Examples of tax evasion

Tax is evaded through different ways, some of which include the following:

(i) Non-registration with the relevant tax authority;

(ii) Failure to furnish a return, statement or information or keep appropriate financial records;

(iii) Making an incorrect return by omitting or understating any income liable to tax;

(iv) Refusing or neglecting to pay tax;

(v) Overstating expenses so as to reduce taxable profit or income, which will eventually lead to payment of less tax than otherwise would have been paid;

(vi) Making false claims for allowances and reliefs; and

(vii) Entering into artificial transactions.

Tax Avoidance: This is the arrangement of taxpayers' affairs using the tax shelters in the tax laws. The taxpayer is able to take advantage of loopholes in the tax laws to pay less tax.

Examples of tax avoidance

Tax can be avoided in various ways, including the following:

(i) Incorporating the taxpayer's sole proprietor or partnership into a limited liability company;

(ii) Claiming allowances and reliefs that are available in tax laws in order to reduce the amount of income or profit to be charged to tax;

(iii) Minimising the incidence of high taxation by the acquisition of a business concern which has sustained heavy losses so as to set off the losses against future profits;

(iv) Minimising tax liability by investing in capital asset (for instance, through the new form of corporate financing by equipment leasing), thus sheltering some of the taxpayers' income from taxation through capital allowance claims;

(v) Sheltering part of the company's taxable income from income tax by capitalising profit through the issue of bonus shares to the existing members as a deductible expense to the company;

(vi) Converting what would ordinarily accrue to the taxpayer (employee) as income into capital gain (e.g. compensation for loss of office) to the advantage of the employer and the employee;

(vii) Manipulation of charitable organisations whose affairs are controlled and dominated by its founders, thus taking advantage of income tax exemption; and

(viii) Avoiding the consumption of products with indirect taxes incorporated in their prices (e.g. tobacco).

(b) Suggested solutions to the problem of tax evasion and tax avoidance

Considering the large civil population and the inadequacy of tax revenue personnel, a huge amount of revenue from taxes is lost through evasion and avoidance. Governments have therefore put in place the measures below to reduce the problems of tax evasion and avoidance with a view to ensuring high revenue from taxes.

(i) **Tax clearance certificate (TCC)**: Authorities normally request for tax clearance certificate to be submitted to any ministry, department, commercial bank or any agency of government with whom a tax payer has any dealings. This request normally prompts tax payers to ensure that they pay up their taxes in order to obtain their TCC.

(ii) **Stipulated penalties**: There are stipulated penalties in place, to serve as punishment for tax payers who evade tax and a deterrent to others. This will enable all taxpayers to pay their taxes at the appropriate time

(iii) **Withholding tax**: Withholding tax is an advance payment of tax which is deducted at source on certain transactions. Its deduction and remittance is an obligation on companies and individuals. One of the purposes of the withholding tax is to ensure that taxpayer's income tax is captured in advance at transaction stage.

(iv) **Tax audit and investigation**: In order to ascertain the correctness of audited financial statements forwarded to the tax office, the revenue authority, in its wisdom, created a Resident Tax audit unit in each of its Integrated tax Offices (ITO's). The unit carries out tax audit and at times, investigates in cases of fraud and evasion on taxpayers records in order to recover any shortfall in taxes paid or any unpaid taxes to government.

(v) **Tax education:** The government has put in place tax education programme on the negative effects of tax evasion through continuous workshops and seminars for tax payers.

(vi) **Appointment of tax agents:** The government through the tax authorities has put in place enough tax agents to facilitate timely collection of appropriate taxes. Government has ensures that loopholes are blocked to reduce tax evasion.

(vii) **Transfer pricing regulation:** The transfer pricing regulation enables the revenue authority to reduce the taxpayer's attempt to practically shift profits from Nigeria to another tax jurisdiction by enforcing compliance with arm's length principle. Recently, the FIRS mandates all multinationals to be filing country-by-country report to strengthen the transfer pricing regulation.

(viii) **Introduction of financial transparency:** Government has introduced financial transparency requiring public disclosure of the ultimate human beneficiaries of companies, trusts and foundations. This is to prevent the further subversion of the country's tax base whether by high net-worth individuals, businesses, criminals or terrorists. It is also required to restore faith in the rule of law and the democratic process as the current non-disclosure of beneficial ownership maybe fraudulent.

(c) **Anti-avoidance legislations in Nigeria**

Legislation subsequently made to block loopholes in tax laws and reduce the effect of tax avoidance abuse are known as anti-avoidance Legislations.

Types of anti-avoidance legislations

There are two types of Anti-Avoidance Legislations, namely:

(i) Specific Anti-avoidance Legislation, and

(ii) General Anti-Avoidance Legislation

Specific anti-avoidance legislation is passed to block particular loopholes or known tax avoidance devices. Specific legislation is available in virtually all tax laws in form of restriction, limits, etc. examples are:

i. Restriction on capital allowance claimable;

ii. Application of transfer pricing policy to a controlled transaction;

iii. Payment of minimum tax where minimum tax exceeds normal tax;
iv. Payment of CIT on dividend where dividend exceeds total profit;
v. Business loss claimable limited to amount of loss incurred;
vi. Specifically identifying bodies and institutions to which donation shall be made as contained in Schedule V of CITA;
vii. Rent paid by employer for the benefit of employees should not exceed 100% of employee's basic salary, etc.; and
viii. In 2017, Pension Commission (PENCOM) limited withdrawal from voluntary pension contribution to 50% of the savings and such withdrawal can only be done after two years of the savings.

General anti-avoidance legislation vests the tax authority with power to disregard all manners of transaction entered into that could be proved to have been done solely for tax avoidance purpose. For instance:

(a) Fictitious or artificial transactions
(b) Disallowing all manners of provisions, etc.

It is expected that companies need to understand the above concepts on tax evasion and tax avoidance and must do everything possible to avoid the practice of tax evasion and tax avoidance.

Kindly contact us for any further clarification on the subject matter if necessary.

Thank you.

O.B. Takwa
Partner

EXAMINER'S REPORT

The question tests candidates' understanding of the distinction between tax evasion and tax avoidance, solution to the problems emanating from the two terms, and legislation on tax avoidance measures.

Majority of the candidates attempted the question. Performance was relatively above average.

Most of the candidates could not proffer solutions to the problems of tax evasion, tax avoidance and the discussions of the anti-avoidance legislation put in place by the government.

Candidates should make use of ICAN Study Text and other relevant texts on the topic when preparing for future examinations.

MARKING GUIDE

		MARKS	TOTAL MARKS
(a)	Correct explanation of tax evasion	1½	
	Highlighting correctly three (3) examples of tax evasion	1½	
	Correct explanation of tax avoidance	1½	
	Highlighting correctly three (3) examples of tax avoidance	1½	
			6
(b)	Any correct seven (7) suggested solutions to tax evasion and avoidance		7
(c)	Mentioning of specific legislation	½	
	1 advantage and 1 disadvantage of Specific legislation	2½	
	Mentioning of general anti-avoidance legislation	2	
	General anti-avoidance legislation	2	
			7
	Total		**20**

SOLUTION 3

RDT & ASSOCIATES LIMITED
(Tax and Legal Consultants)
Plot C, Block C, Zone E, Unity Avenue, Command, Ikoyi, Lagos.

May 15, 2019

The Managing Director
Pardo Nigeria Limited
25, Ogba Industrial Estate
Ikeja
Lagos

Dear Sir/Madam,

REPORT ON CAPITAL ALLOWANCES AND TAX PAYABLE FOR THE RELEVANT TAX YEARS

We refer to your mail of May 11, 2019 on the above subject. Having reviewed the details of the adjusted profits and the qualifying capital expenditures in the assets acquired and disposed, below is the summary of the information required:

The relevant years of assessment for tax purposes are 2013 – 2018 Years of assessment.

(a.) The capital allowances computed for the relevant years of assessment, as extracted from the attached workings are as shown below:

Relevant years of assessment

	2013	2014	2015	2016	2017	2018
	₦'000	₦'000	₦'000	₦'000	₦'000	₦'000
Capital allowance (Wk 1,3,4&5)	450.00	1,640.00	3,765.00	2,652.50	1,742.50	1,102.49
Investment allowance	-	-	-	182.00	-	-
Balancing allowance (Wk 6)	-	-	-	-	-	105.00

Building acquired on second-hand
The tax implications of the factory building acquired on second-hand from another company are that:

- No initial allowance would be granted in 2013 Tax Year when the building was acquired and
- put to use by Pardo Nigeria Limited; and the cost of the building to your company for capital allowance purpose shall be
  the lower of:

  - The original cost (not provided) to the company that sold the building; and
  - The purchase cost (₦5,400,0000 to Pardo Nigeria Limited).
    Since the original cost to the company that sold the building is not readily available, then the ₦5,400,000 was used in the computation of the annual allowance in 2013 and other years of assessment (see workings 1 and 3 attached)

(ii) **Investment allowance on production plant**

The company will claim additional investment allowance for the production plant acquired in 2016 YOA at 10% on cost. Usually, such investment allowance will not be considered in the computation of tax written down value of the production plant in 2016 tax year.

(iii) **Balancing allowance on disposal of qualifying capital expenditures in December 2017 (2018 year of assessment)**

The tax written down values of both office furniture and production plant disposed, exceeded their proceeds. The difference is known as balancing allowance and shall be claimed in 2018 tax year as part of capital allowance for that year of assessment.

(b.) The company income tax (CIT) payable by the company is computed on a normal basis at 30% of total profit for each year of assessment, while tertiary education tax (TET) are determined at 2% of each year's assessable profits. These tax liabilities are stated below:

YOA	CIT (Wk2)	TET (Wk2)	Tax payable
	₦'000	₦'000	₦'000
2013	2,025.00	144.00	2,169.00
2014	2,203.00	179.67	2,382.67
2015	2,080.50	214.00	2,294.50
2016	2,944.65	253.00	3,197.65
2017	4,043.25	304.40	4,347.65
2018	5,592.75	397.00	5,989.75
Tax Payable	18,889.15	1,492.07	20,381.22

It is important to arrange the payment of these taxes as soon as possible in order to avoid imposition of penalties for late payment and interest. You may wish to contact us for further action on the payment of the taxes.
Thank you.

Atoro Rejoice
Partner

WORKINGS

(Wk1) Pardo Nigeria Limited

Computation of capital allowances for the relevant years of assessment

		Factory building	Office furniture	Motor vehicle	Production plant	Capital allowance
	Initial allowance (IA)	15%	25%	50%	50%	
	Annual allowance (AA)	10%	20%	25%	25%	
	Investment allowance	-	-	-	10%	
YOA		₦'000	₦'000	₦'000	₦'000	₦'000
2013	Cost	5,400.00	-	-	-	
	AA (Wk 3)	(450.00)	-	-	-	450.00
2014	TWDV b/f	4,950.00	-	-	-	
	Addition – Cost	-	2,750.00	-	-	
	IA (₦2,750 x 25%)	-	(687.50)	-	-	687.50
	AA (Wk 3)	(540.00)	(412.50)	-	-	952.50
		-	-	-	-	1,640.00
2015	TWDV b/f	4,410.00	1,650.00	-	-	
	Addition - Cost	-	-	4,500.00	-	
	IA (₦4,500 x 50%)	-	-	(2,250.00)	-	2,250.00
	AA (Wk 3)	(540.00)	(412.50)	(562.50)	-	1,515.00
		-	-	-	-	3,765.00
2016	TWDV b/f	3,870.00	1,237.50	1,687.50	-	
	Addition – Cost	-	-	-	1,820.00	
	IA (N1,820 x 50%)	-	-	-	(910.00)	910.00
	AA (Wk 3)	(540.00)	(412.50)	(562.50)	(227.50)	1,742.50
						2,652.50
		-	-	-		182.00
Investment allowance						
						2,834.50

2017	TWDV b/f	3,330.00	825.00	1,125.00	682.50	
AA (Wk 3)		(540.00)	(412.50)	(562.50)	(227.50)	1,742.50
2018	TWDV b/f	2,790.00	412.50	562.50	455.00	
	Less: TWDV of assets disposed	-	(412.50)	-	(455.00)	
	TWDV after disposal	2,790.00	-	562.50	-	
	AA (Wk 3)	(540.00)	-	(562.49)	-	1,102.50
	TWDV c/f	2,250.00	-		-	

(Wk2) Pardo Nigeria Limited
Computation of tax liabilities for the relevant years of assessment

YOA		₦'000	₦'000
2013	Assessable profit (Wk 4)		7,200.00
	Capital allowance for the year(Wk 1)		(450.00)
	Total profit		**6,750.00**
	CIT @ 30% of total profit (₦6,750 x 30%)		2,025.00
	TET @ 2% of assessable profit (2% x ₦7,200)		144.00
			2,169.00
2014	Assessable Profit (Wk 4)		8,983.33
	Capital allowance for the year(Wk 1)		(1,640.00)
	Total profit		**7,343.33**
	CIT @ 30% of total profit (₦7,343 x 30%)		2,203.00
	TET @2% of assessable profit (2% x ₦8,983)		179.67
			2,382.67
2015	Assessable Profit (Wk 4)		10,700.00
	Capital allowance for the year (Wk 1)		(3,765.00)
	Total profit		**6,935.00**
	CIT @ 30% of total profit (₦6,935 x 30%)		2,080.50
	TET @ 2% of assessable profit (2% x ₦10,700)		214.00
			2,294.50
2016	Assessable profit (Wk 4)		12,650.00
	Capital allowance		
	Capital allowance for the year(Wk 1)		(2,652.50)
	Investment allowance (₦1,820 x 10%)		(182.00)
	Total profit		**9,815.50**
	CIT @ 30% of total profit (₦9,815.5 x 30%)		2,944.65
	TET @ 2% of assessable profit (2% x ₦12,650)		253.00
			3,197.65

2017	Assessable profit (Wk 4)		15,220.00
	Capital allowance for the year (Wk 1)		(1,742.50)
	Total profit		**13,477.50**
	CIT @ 30% of Total profit (₦13,477.5 x 30%)		4,043.25
	TET @ 2% of assessable profit (2% x ₦15,220)		304.40
			4,347.65
2018	Assessable profit (Wk 4)		19,850.00
	Less : Capital allowance		
	Capital allowance for the year(Wk 1)	1,102.5	
	Balancing allowance (Wk 6)	105.0	(1,207.50)
	Total profit		**18,642.50**
	CIT @ 30% of total profit (₦18,642.5 x 30%)		5,592.75
	TET @ 2% of assessable profit (2% x ₦19,850)		397.00
			5,989.75

(Wk3) Computation of annual allowances (AA)

$$AA = Cost - \frac{\text{Initial allowance}}{N}$$

2013 YOA

Factory building = $\frac{₦5,400}{10}$ - 0 = ₦540 p.a (10/12 X 540) = 450

Office furniture = $\frac{₦2,750 - 687.50}{5}$ = ₦412.5 p.a

Motor vehicle = $\frac{₦4,500 - 2,250}{4}$ = ₦562.5 p.a

Production plant = $\frac{₦1,820 - 910}{4}$ = ₦562.5 p.a

(Wk4) Computation of assessable profits for the relevant years of assessment

YOA	Basis periods	WORKINGS			Assessable profits (N'000)
2013	1/3/2013 - 31/12/2013	Given			7,200
2014	1/3/2013 - 28/02/2014	1/3/2013 - 31/12/2013	Given	7,200	
		1/1/2014 - 28/02/2014	(2/12 x 10,700)	1,783	8,983
2015	1/1/2014 - 31/12/2014	Given			10,700
2016	1/1/2015 - 31/12/2015	Given			12,650
2017	1/1/2016 - 31/12/2016	Given			15,220
2018	1/1/2017 - 31/12/2017	Given			19,850

(Wk5) Computation of basis periods for capital allowance (CA)

YOA	Basis periods (profits)	Basis periods (CA)	QCE register - acquisition/ (disposal)
2013	1/3/2013 - 31/12/2013	1/3/2013 - 31/12/2013	Factory building
2014	1/3/2013 - 28/02/2014	1/1/2014 - 28/02/2014	Office furniture
2015	1/1/2014 - 31/12/2014	1/3/2014 - 31/12/2014	Motor vehicles
2016	1/1/2015 - 31/12/2015	1/1/2015 - 31/12/2015	Production plant
2017	1/1/2016 - 31/12/2016	1/1/2016- 31/12/2016	-
2018	1/1/2017 - 31/12/2017	1/1/2017 - 31/12/2017	(Office furniture & production plant)

(Wk6) Computation of balancing adjustment on Sales of QCE for 2018 YOA:

			Office furniture ₦'000		Prod. plant ₦'000	
Sales proceeds		(i)	35		60	
Cost			250		650	
IA	(₦250 X 25%)		(62.5)	(₦650 X 50%)	(325)	
AA	(₦250 - 62.50) X 4 / (5)		(150.0) / -	(₦650 - 325) x 2 / (4)	(162.50)	
TWDV c/f		(ii)	37.5		162.50	
Balancing allowance		(i)-(ii)	2.50		102.5	105

EXAMINER'S REPORT

The question tests candidates' understanding of the computation of capital allowances and the issue of presenting their solution in the form of a report to the managing director as opposed to writing an internal memo.

Most of the candidates attempted the question.

Candidates' performance was average. The major pitfalls were their inability to compute capital allowances and associated tax liabilities payable. Many candidates did not know the difference between writing as an external consultant and writing internal memo.

Candidates are advised to be more discernible in the future examinations with emphasis on clear understanding of writing reports.

MARKING GUIDE

		MARKS	TOTAL MARKS
(a)	Report to Managing director	1	
	Capital allowance computation:		
	2013 Y/A: Correct total annual allowance	½	
	2014 Y/A: 6 ticks @¼ mark each	1½	
	2015 Y/A: 6 ticks @¼ mark each	1½	
	2016 Y/A: 8 ticks @¼ mark each	2	
	2017 Y/A: 5 ticks @¼ mark each	1¼	
	2018 Y/A: 5 ticks @¼ mark each	1¼	
			9
(b)	Computation of total profit and tax liability		
	2013 Y/A: correct computation	1½	
	2014 Y/A: correct computation	1½	
	2015 Y/A: correct computation	1½	
	2016 Y/A: correct computation	1½	
	2017 Y/A: correct computation	1½	
	2018 Y/A: correct computation	1½	
	Workings	2	
			11
	Total		20

SOLUTION 4

a. (i) Generally, the effective date of acquisition or disposal of chargeable assets shall be the contract (or transaction) date:

(ii) The date at which there is enforceable right to acquire the asset or part thereof, or

(iii) The date at which there is a binding duty to dispose the asset or part thereof.

Where the acquisition or disposal at the contract date as described above is conditional, the acquisition or disposal shall take effect when the condition is satisfied.

Also, where consideration of the contract depends on the value of the asset at the time the conditions are met, the effective date shall be the date when the conditions are satisfied otherwise the effective date shall be the contract date as if the contract was never conditional.

In the case of option, the effective date of acquisition or disposal of the asset shall be the date when the option is exercised.

b.

ABC & CO (CHARTERED ACCOUNTANTS)

15, Ojulobun St, Ikeja
P.O.Box 50, Ikeja

Date: .....

The Managing Director,
Smaposu Nigeria Limited,
Ikeja.
Lagos State

Dear Sir,

Re: ADVICE ON CAPITAL GAINS TAX ON VARIOUS ASSETS DISPOSED DURING THE YEAR ENDED DECEMBER 31, 2018

Your letter dated February 15 in respect of the above subject hereby refers.

We considered the details contained in the documents provided by your good self and state as follows:

(i) There is a 'deemed' disposal of an asset whenever there is death of the original owner of the asset (S.8 Capital Gains Tax Act Cap LFN 2004 (as amended).

On the death of an individual, any asset which the deceased was competent to dispose of shall, for the purpose of the Act, be deemed to be disposed of by him at the date of his death and acquired by the personal representatives or any other person to whom the asset devolve for a consideration equal to:

(a) The amount of consideration for which the asset was last disposed of by way of bargain made at arm's length if ascertained, or
(b) In any other case, the market value of the asset at that date (S.8(1)).

Gains accruing on deemed disposal at market value described in (b) shall not be liable to capital gains tax (S.2 CGT Act).

(ii) In respect of machinery (which forms part of plant and machinery) disposed, the chargeable gains is ₦634,249 and capital gains tax payable is ₦63,424.90. There is no roll-over relief to be claimed because re-investment in new plant was not made. The analysis is as shown in Appendix I.

With regard to the company's motor vehicle (Camry 2010 model) sold to the company's general manager for ₦2,900,000 as against the market value of ₦3,500,000, the transaction was not made at arm's length. It was a related (or connected) party transaction. The practice of the tax authority is to use the market value as against the actual sales proceeds. Hence, the company makes a capital gain of ₦500,000 and capital gains tax payable is ₦50,000. Although the company spent ₦3,500,00 to acquire new motor vehicle for the use of the business, the company does not qualify for roll-over relief, because motor vehicle is not among the assets recognised by the Capital Gains Tax Act Cap C1 LFN 2004 (as amended). Appendix II provided the details of our submission.

As for the disposal of the company's land and building in Ibadan and re-acquisition of another one in Ikeja, the company is expected to pay capital gains tax of ₦1,350,000 on the capital gains of ₦13,500,000. The tax liability is derived after taking into consideration partial roll-over relief of ₦20,000,000 resulting from the acquisition of Land and buildings in Ikeja. Appendix III depicts the details of our computation.

(iii) There is no roll-over relief on re-investment made on acquisition of new motor vehicle because it does not belong to the class of chargeable assets (classes i – iv) for which roll-over relief is available. Also by extension, the amount re-invested (₦2,900,000) is less than the cost of the old vehicle (₦3,000,000).

Should you require further clarifications or explanation, we would be most obliged to do so.

Yours faithfully,

For: ABC & Co.
(Chartered Accountants)
O.B.T

APPENDIX 1

		₦	₦
(i)	Sales proceeds		8,100,000
	Less:		
	Cost of acquisition (W1)	7,315,751	
	Selling expenses	150,000	
			(7,465,751)
	Chargeable gains		634,249
	Capital gains Tax @ 10%		**63,424.90**

	APPENDIX II	₦	₦
(ii)	Sales proceeds		3,500,000
	Less: Cost of acquisition		3,000,000
	Chargeable gains		500,000
	Capital gains tax @ 10%		**50,000**

	APPENDIX III	₦	₦
(iii)	Sales proceeds		65,500,000
	Less:		
	Cost of acquisition	30,000,000	
	Valuation and professional fee	2,000,000	
			(32,000,000)
	Capital gains		**33,500,000**
	Determination of roll-over relief		
	Lower of:		
	Sales proceeds on disposal of old asset and		65,500,000
	Amount re-invested in new asset		50,000,000
	Less: Cost of acquisition of old asset		(30,000,000)
	Roll-over relief		**20,000,000**
	Capital gains record		33,500,000
	Less: roll-over relief		20,000,000
	Chargeable gains		13,500,000
	Capital gains tax		**1,350,000**

Workings

1. Cost of partial disposal

$$\text{Cost} = \frac{A}{A + B} \times C$$

where: A = Disposal value
B= Value of un-disposed part
C = Initial purchase price

$$= \frac{₦8,100,000}{₦8,100,000 + ₦5,740,000} \times ₦12,500,000$$

$$= \frac{₦8,100,000}{₦13,840,000} \times ₦12,500,000$$

$$= \underline{₦7,315,751}$$

EXAMINER'S REPORT

The question tests candidates' knowledge of "deemed disposal of an asset" in capital gains tax, roll over relief, capital gains and the capital gains tax liability.

Most candidates attempted the question, however, the performance was below average.

Many candidates performed well in question 4(a), however, in part 4(b), most of the candidates exhibited poor understanding of the requirements of the part of the question.

Candidates are advised to read hard with good understanding of the terminologies used in ICAN Study Text and the Institute's Pathfinder when preparing for future examinations.

MARKING GUIDE

		MARKS	TOTAL MARKS
(a)	Correct description of when acquisition or disposal is effective		2
(b)i.	Explanation of 'deemed' disposal of an asset		5

ii.	Disposal of machinery:		
	Sales proceeds, cost of acquisition, selling expenses	1	
	Correct chargeable gains	1	
	Disposal of motor vehicle:		
	Sales proceeds and cost of acquisition	1	
	Correct chargeable gains	1	
	Disposal of land & building:		
	Capital gains and roll-over relief	1	
	Correct chargeable gains	1	
			6
iii.	Correct sales proceeds on disposal of old asset, amount re-invested in new asset, cost of acquisition of old asset and Roll-over relief		4
	Correct capital gains tax payable- plant & machinery	1	
iv.	Correct capital gains tax payable- motor vehicle	1	
	Correct capital gains tax payable- land & buildings	1	
			3
	Total		**20**

SOLUTION 5

(a) The following are the specific provisions of the law as provided in sections 34 and 35 of the Companies Income Tax Act CAP C21 LFN 2004 (as amended) regarding where there is double taxation agreement between one country and Nigeria:

(i) It is only applicable to a resident (or Nigerian) company;

(ii) Claim for the relief must be made within 2 years after the year of assessment;

(iii) The relief shall be the Nigerian tax payable on the foreign operation if the Nigerian tax payable is less than the foreign tax paid on the same foreign operation and in which case, there will be no refund for the excess of the foreign tax paid over the Nigerian tax payable;

(iv) The relief shall be the foreign tax paid on the foreign operation if the Nigerian tax payable on the foreign operation is higher than the foreign tax paid and additional tax shall be paid in Nigeria for the excess by which Nigerian tax payable exceeds the foreign tax paid. The additional tax will be determined according to the double taxation agreement between the country and Nigeria;

(v) Any dispute on the amount of the relief shall be subject to objection and appeal procedures as if it were an assessment;

(vi) The provisions of Section 33, where there is no double taxation agreement of the Act shall have no effect;

(vii) The tax payable on the worldwide income will be reduced by the credit admissible under the terms of agreement; and

(viii) 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.

(b)

(i) Business profits not arising through a permanent establishment are only to be liable in the taxpayer's own country of residence, while profits attributable to permanent establishment may be taxed in the country in which the permanent establishment is situated (Article 7). Such profits, for instance in Nigeria, is said to be derived from Nigeria.

(ii) Dividend derived by one company resident in one country from another company resident in another country may be liable to tax in the source country where the dividend is derived. However, the tax so charged shall not exceed 12.5% of the gross dividend if the recipient is a company that has, directly or indirectly, 10% controlling interest in the paying company or the tax shall not exceed 15% of the gross dividend in any other case.

(iii) Director's fees and other similar payments derived by a resident of a country in his capacity as a director of a company which is a resident of another country may be taxed in that other country where the fees and other similar payments arised (Article 16).

c. The double taxation relief available to SOKGlobal Limited for 2018 year of assessment was ₦2,368,000 as computed in workings 1 and 2 below. Since there is no double taxation agreement between South Africa and Nigeria, the claim for the relief must be made within 6 years after 2018 year of assessment.

WORKINGS

(Wk1) SOKGlobal Limited

Double taxation relief for 2018 year of assessment

a. There is no double taxation agreement

b. SOKGlobal Limited is a resident company

c. Double taxation relief = Double taxation rate x Foreign total income

d. Double taxation Rate = Lower of:

(i) Commonwealth rate, and

(ii) Half Nigerian Rate

(iii) Commonwealth rate = $\frac{\text{Foreign tax}}{\text{Foreign total profit}}$ x 100%

= (₦6,120/ ₦15,787) x 100%=> 38.77%

(iv) Half Nigerian rate (½ x 30%) 15%

Therefore, double taxation rate => the lower of (a) & (b) => 15%

Double taxation relief = 15% x ₦15,787 => ₦2,368

(Wk2) SOKGlobal Limited

Computation of Companies income tax for 2018 year of assessment

	SOUTH AFRICA	NIGERIA	TOTAL
	₦'000	₦'000	₦'000
Income	38,800	60,300	99,100
Overheads	(30,060)	(18,600)	(48,660)
Net profit:	8,740	41,700	50,440
Add: Disallowable expenses:			
Depreciation	6,427	1,088	7,515
Cost of tax appeal	-	510	510
Donation to Island Club	-	100	100
Preliminary expenses	-	1,900	1,900
Foreign exchange Loss provision	6,120	-	6,120
Adjusted/ assessable profit	21,287	45,298	66,585
Less: Capital allowance	(5,500)	(2,210)	(7,710)
Total profit	15,787	43,088	58,875

CIT @ 30% of Global total profit	17,663
Less : Double taxation relief (Wk 1)	(2,368)
Income tax payable	**15,294**

Alternative solution if profit attributable to South African (N8,740,000) business is assumed to be included in the overheads

(c) The double taxation relief available to SOKGlobal Limited for 2018 Year of Assessment is ₦3,679,050 as computed in workings 3 and 4 below. Since there is no double taxation agreement between South Africa and Nigeria, the claim for the relief must be made within 6 years after 2018 year of assessment.

WORKINGS

(Wk3) SOKGlobal Limited

Double taxation relief for 2018 year of assessment

i. There is no double taxation agreement

ii. SOKGlobal Limited is a resident company

iii. Double taxation relief = Double Taxation Rate x Foreign Total Income

iv. Double taxation Rate = Lower of:

(a) Commonwealth rate, and

(b) Half Nigerian Rate

(a) Commonwealth rate = $\frac{\text{Foreign tax}}{\text{Foreign total profit}}$ x 100%

= (₦6,120/ ₦24,527) x 100%=> 24.95%

b) Half Nigerian rate (½ x 30%) 15%

Therefore, double taxation rate => the lower of (a) & (b) => 15%

Double taxation relief = 15% x ₦24,527=> ₦3,679.05

(Wk4) SOKGlobal Limited

Computation of Companies income tax for 2018 year of assessment

	SOUTH AFRICA	NIGERIA	TOTAL
	₦'000	₦'000	₦'000
Income	38,800	60,300	99,100
Overheads	(30,060)	(18,600)	(48,660)
Net profit:	8,740	41,700	50,440
Add Disallowable expenses:			
Depreciation	6,427	1,088	7,515
Cost of tax appeal	-	510	510
Donation to Island Club	-	100	100
Preliminary expenses	-	1,900	1,900
Foreign exchange Loss provision	6,120	-	6,120
Adjusted/ assessable profit	21,287	45,298	66,585
Less: Capital allowance	(5,500)	(2,210)	(7,710)
Total profit	15,787	43,088	58,875

EXAMINER'S REPORT

The question tests candidates' understanding of the principle of double taxation, dividend derived by a resident company and directors' fees. The question is also designed to tests candidates' knowledge of report writing.

Few candidates attempted this question.

Candidates did not just show any form of understanding of the principle of double taxation.

Candidates are advised to make use of ICAN Advanced Study Text in order to ensure a better performance in future examinations.

MARKING GUIDE

		MARKS	TOTAL MARKS
(a)	Identifying each of four (4) specific provisions of Double taxation agreement (DTA)		3
(b)i.	Correct description of provision of DTA regarding Business profits not arising through a permanent establishment	2	
ii.	Correct description of provision of DTA regarding dividends derived by one company which is resident from a company resident in another country	2	
iii.	Correct description of provision of DTA regarding Directors' fees and other similar payments derived by a resident directors of a company resident in another country	2	
			6
	Computation of total profit (24 ticks of 1/6 mark each)	4	
(c)			
	Commonwealth rate of tax	½	
	Narrative of commonwealth rate of tax greater than	½	
	Nigerian rate of tax	½	
	Correct result of double taxation relief	½	
			6
	Total		**15**

SOLUTION 6

HIGHLIGHTS OF A PAPER ON TRANSFER PRICING IN NIGERIA, DELIVERED AT A SEMINAR ORGANISED BY NACCIMA

(a) The objectives of transfer pricing regulations are to:

(i) Ensure that Nigeria is able to use appropriate taxable basis to earn taxable income corresponding to the economic activities deployed by taxable persons in Nigeria, including their transactions and dealings with associated enterprises;

(ii) Provide the Nigerian authorities with the tools to fight tax evasion through over or under-pricing of controlled transactions between associated enterprises;

(iii) Provide a level playing field between multinational enterprises and independent enterprises doing business within Nigeria; and

(iv) Provide taxable persons with certainty of transfer pricing treatment in Nigeria.

(b) (i) Connected taxable persons: These include persons, individuals, entities, companies, partnerships, joint ventures, trust or associations (collectively referred to as "connected taxable persons"). The following persons will be regarded as connected taxable persons:

- Any entity dealing with a related party (associate, subsidiary, joint venture);
- A member of a local group of companies;
- Members of a conglomerate;
- Multinationals; and
- Permanent establishment.

(ii) Arm's length principle: Every taxpayer is expected to comply with the arm's length principle in dealing with transactions between related entities. These entities are expected to be guided by the following principles:

- Where a connected taxable person has entered into a transaction or a series of transactions to which these regulations apply, the person shall ensure that the taxable profit resulting from the transaction or transactions is in a manner that is consistent with the arm's length principle.
- Where a connected taxable person fails to comply with the provisions of this regulation, the Federal Inland Revenue Service

shall make adjustments where necessary if it considers that the conditions imposed by connected taxable persons in controlled transactions are not in accordance or consistent with the "arm's length principle".

(c) Transfer pricing methods

(i) **Comparable uncontrolled price method (CUPM):** It compares the price charged for transactions between associated enterprises (related parties) with prices charged for similar transactions between independent enterprises (unrelated parties) in comparable circumstances. If there is any difference between the two prices, this might be an indication that the transactions between the associated enterprises are not made at arm's length.

(ii) **Resale price method (RPM):** It begins with the resale price to an independent enterprise of a product purchased from an associated enterprise and a gross margin is then deducted from this resale price.

(iii) **Cost-plus method (CPM):** Under this approach, the costs incurred by the supplier in making the product transferred or services provided to an associated enterprise are ascertained and a mark-up is then added to those costs. An appropriate mark-up that the same supplier earns in comparable transactions with independent enterprises (internal comparable), or by reference to the mark-up earned in comparable transactions by independent enterprises (external comparable).

(iv) **Profit split method (PSM):** In this method, the first step is to determine the combined profit that arises from a business transaction in which the associated enterprises are engaged. This profit is then split between the associated enterprises in a manner that reflects the division of profit that would have been expected between independent enterprises. The combined profit or loss attributed to the transactions in which the associated enterprises participated is allocated to the associated enterprises in proportion to their respective contributions to that combined operating profit or loss.

(v) **Transactional net margin method (TNMM):** Under this method, the net profit margin that an enterprise earns from transactions with an associated enterprise is compared with the net profit margin earned in comparable transactions with an independent enterprise. It operates in a manner similar to the cost plus and resale price methods. However, the transactional net margin examines the net profits in relation to an appropriate base (e.g. costs, sales, assets) and not gross margin on resale or mark-up on costs.

EXAMINER'S REPORT

The question tests candidates' understanding of the provisions provided in the Income Tax (Transfer pricing) Regulation Act 2012 as amended.

Few candidates attempted the question and performance was low as candidates showed complete lack of understanding of the topic.

Candidates are advised to make use of the Institute's Study Text for a better performance in future examinations.

MARKING GUIDE

		TOTAL MARKS
(a)	Objectives of application of transfer pricing regulation (1 mark each for any three points)	3
(b)i.	Connected taxable persons	3
ii.	Correct points on Arm's length principle	3
		3
(c)	Description of any three (3) methods (2 marks each)	
		6
	Total	**15**

SOLUTION 7

(a)

RTD & Co (CHARTERED ACCOUNTANTS)
4TH FLOOR RTD TOWER, ROAD 2, TIWA AVENUE, REJOICE ISLAND, LAGOS.
TEL:

June 17, 2019

Mr. Oximbo
Representative to Nagasaki Inc.
Oil Tower
Ozumba Nbadiwe Road,
Victoria Island
Lagos.

Attention: Mr. Sun Nagasaki

Dear Sir,

REPORT ON INCENTIVES AVAILABLE TO NIGERIA OIL AND GAS SECTOR

I refer to your mail of February 18, 2019 requesting a report on the available incentives in the Nigeria oil and gas industry.

Below are the summary descriptions of the various incentives which may determine your choice of investment in the industry:

(i) Fiscal incentives available in the gas production phase
These include:

- Petroleum profit tax (PPT) rate to be the same as Companies income tax (CIT) rate at 30%;
- Accelerated capital allowance for all classes of qualifying capital expenditure over a period of 5 years – 20years per annum in the first 4 years, 19% in the 5th year and 1% in the books;
- Investment tax credit of 5% on qualifying plants expenditure; and
- Royalty at 7% on-shore and 5% off-shore.

(ii) **Incentives for encouragement of exploitation and utilization of associated gas for commercial purpose in gas utilization (downstream Operations)**

These include:

- An initial tax free period of 3 years which may be renewed for an additional period of 2 years subject to satisfactory performance of the business;
- Accelerated Capital Allowances after the tax period of 90% annual allowance with 10% retention for investment in plants and machinery;
- An additional investment allowance of 15% which shall not reduce the value of the asset; and
- Tax free dividend during the tax free period where:
  - Investment for the business is in foreign currency, and
  - Introduction on plants and machinery during the period was not less than 30% of equity share capital of the company;
  - Interest on loan for gas project is to be deductible provided that prior approval is obtained from the Federal Ministry of Finance before taking the loan; and
  - All fiscal incentives under the gas utilization down-stream operation in 1997 are to be extended to industrial projects that use gas in power plant, gas to liquid plants, fertilizer plants and gas distribution and transmission plants.

(iii) **Incentives and fiscal measures that favour and encourage large investment in oil and gas trade zone**
These include:

- No personal income tax;
- 100% capital and profit repatriation;
- No foreign exchange regulation;
- No pre-shipment inspection for goods exported into the oil and gas free zone;
- No expatriates quota;
- Tax free holiday of 3 to 5 years renewable for another 2 years;
- Dividends distributed during the tax holidays are also exempted from tax; and
- Investment tax allowance of 10%.

Incentives are also available for LNG projects, please contact us if you need the details about them.

Regards,
Richard Obaloluwa
Managing partner, tax and regulatory services

(b) **Alaba Trading Limited**

Computation of total tax liabilities for 2018 tax year

	₦
Assessable profit	8,200,000
Less : Capital allowances	(5,400,000)
Total profit	2,800,000
Dividend payable	6,000,000
CIT = 30% of higher of total profit of ₦2,800,000 and dividend payable of N6,000,000 (see note below)	
CIT = 30% of Dividend	
(30% x ₦6,000,000)	1,800,000
TET = (2% x ₦8,200,000)	164,000
Total tax liabilities	1,964,000

Note

Section 19, Companies Income Tax Act Cap C21 LFN 2004 (as amended) provides that total dividend (proposed or paid) distributed out of profits of any year of assessment shall replace total profit and be taxed at the rate of 30% in that tax year if the dividend deduction resulted in any of the following situations in the same year of assessment under consideration:

- Where there is no total profits, or
- Where the total profit is less than the amount of dividend which is paid.

EXAMINER'S REPORT

The question tests candidates' understanding of fiscal incentives in oil and gas sector of the economy and presentation of appropriate report.

Few candidates attempted the question and performance was poor.

The common pitfall was the lack of understanding of fiscal incentives in oil and gas sector of the economy.

Candidates are advised to make use of ICAN Study Texts for a better performance in future examinations.

MARKING GUIDE

		MARKS	TOTAL MARKS
(ai)	Correct description of any two (2) fiscal incentives available in the gas production phase		2
(ii)	Correct explanation on any six (6) incentives for encouragement of exploitation and utilisation of gas for commercial purpose in gas utilisation (downstream operations)		4
(iii)	Correct explanation on any six (6) incentives and fiscal measures that favour and encourage large investment in oil & gas free zone ($^2/3$ mark each)		4
(b)	Correct computation of total profit	1	
	Dividend payable	1	
	Correct computation of Companies Income Tax	1	
	Tertiary Education Tax	1	
	Explanation of the relevant anti-avoidance legislation	1	5
	Total		**15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2019

STRATEGIC FINANCIAL MANAGEMENT

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Pako Plc. will soon announce a take-over bid for Ronke Tina (RT) Plc., a company in the same industry. The initial bid will be an all-share bid of four Pako shares for every five RT Plc. shares. The most recent annual data relating to the two companies are shown below:

	₦000 Pako	₦000 RT
Sales revenue	13,333	9,400
Operating costs	(8,683)	(5,450)
Tax-allowable depreciation	(1,450)	(1,100)
Earnings before interest and tax	3,200	2,850
Net interest	(715)	(1,660)
Taxable income	2,485	1,190
Taxation (30%)	(746)	(357)
After-tax income	1,739	833
Dividend	870	458
Other information		
Annual replacement capital expenditure (₦000)	1,600	1,240
Expected annual growth rate in sales, operating costs (including depreciation), replacement investment and dividends for the next four years	5%	6.5%
Expected annual growth rate in sales, operating costs (including depreciation), replacement investment and dividends after four years	4%	5%
Gearing (long-term debt/long-term debt plus equity by market value)	30%	55%
Market price per share (kobo)	298	192
Number of issued shares (million)	7	8
Current market cost, before tax, of fixed-interest debt	6%	7.5%
Equity beta	1.18	1.38
Risk-free rate	4%	
Market return	11%	

The take-over is expected to result in cost saving in advertising and distribution, reducing the operating costs (including depreciation) of Pako from 76% of sales to 70% of sales. The growth rate of the combined company is expected to be 6% per year for four years, and 5% per year thereafter. RT's debt obligations will be taken over by Pako. The corporate tax rate is expected to remain at 30%.

Sales and costs relevant to the decision may be assumed to be in cash terms.

Required:

a. Estimate how much synergy is expected to be created from the take-over, using free cash flow to the firm analysis for each individual company and the potential combined company. State clearly any assumptions that you make.

   Note: The weighted average cost of capital of the combined company is assumed to be 9%. (20 Marks)

b. Discuss any **five** limitations of the above estimates. (5 Marks)

c. Explain, generally, **three** advantages and **two** disadvantages of expansion through merger and acquisition rather than through organic growth.

(5 Marks)

(Total 30 Marks)

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

QUESTION 2

The following financial information is available for PH Plc:

	2014	2015	2016	2017
Earnings attributed to ordinary shareholders	₦200m	₦225m	₦205m	₦230m
Number of ordinary shares	2,000m	2,100m	2,100m	1,900m
Price per share (kobo)	220	305	290	260
Dividend per share (kobo)	5	7	8	8

Assume that share prices are as at the last day of each year.

Required:

a. Calculate PH Plc.'s earnings per share, dividend yield, dividend cover and price/earnings ratio. Explain the meaning of each of these terms and state the limitations they may have. (14 Marks)

b. Explain why the changes that occurred in the figures calculated in (a) above over the past four years might have happened. (6 Marks)

(Total 20 Marks)

QUESTION 3

Able bank, on April 24, 2019 received the following statement of financial position prepared for its customers, Pinko Limited (PL):

Statement of financial position as at April 20, 2019

Non-Current Assets	**₦'000**
Freehold property at cost	20,000
Plant (carrying amount)	172,000
	192,000
Current assets	
Inventories	67,000
Receivables	26,000
	93,000
Total assets	285,000
Equity	
Issued share capital (₦1 each)	50,000
Reserves	23,000
	73,000
Non-current liabilities	
10% loan notes (secured on freehold property)	50,000
Current liabilities	
Bank overdraft	45,000
Sundry payables	117,000
	162,000
Total liabilities	285,000

PL is a long established company which traded profitably until a few years ago. Following the expiration of exclusive patent rights on a particularly profitable product line, results declined dramatically. Over the last twelve months, the company's cash flow problems have steadily increased. The overdraft facility at

present stands at ₦45m and carries a second charge on the company's freehold property.

A meeting has been arranged to consider the company's future. The above statement of financial position will be presented at the meeting and the following proposals will be discussed:

(a) **Immediate liquidation of the company**
In these circumstances, it is estimated that the freehold property would realise ₦65,000,000, the plant ₦21,000,000, the inventory ₦40,000,000 and the receivables would pay up in full. Preferential payables, included in the statement of financial position figure for payables, amounted to ₦27,000,000;

(b) **Tayo Limited (TL) has made an offer to take over the entire business activities of PL:** Under the terms of the offer, Able Bank would receive 80% of the balance due, but repayment would not be made until exactly one year from the date of the creditors' meeting. No further interest would be considered to accrue on the balance due to Able Bank (AB) during the twelve month period.

(c) **Reorganisation and capital reconstruction:** The management of PL is planning a reorganisation of the company's activities which will restore profitability to reasonable levels almost immediately. The reorganisation will be linked with a capital reconstruction scheme. Under this scheme, the existing shareholders will be asked to accept two ₦1 shares in exchange for every five shares currently held. The bank will be asked to accept 10,000,000 ₦1 shares as consideration for one half of the present overdraft. If this proposal is acceptable to creditors, the shareholders have indicated their willingness to take up a further 30,000,000 ₦1 shares for cash and the balance remaining outstanding to the bank would be repaid from the proceeds of this issue. The directors are confident that, if this proposal is put into effect, profits of ₦40,500,000 per annum will be earned for the foreseeable future, of which two-thirds will be paid out as dividends and the remainder reinvested.

Notes: Assume that the Bank earns 15% per annum on all its lending and that the amounts in the statement of financial position include interest that accrued to date. Assume, for convenience, that any adopted proposal would be implemented immediately with payments received immediately unless otherwise stated.

Ignore expenses of realisation and liquidation and assume that no changes have occurred between April 20 and April 24, 2019.

Required:

a. Calculate the amounts which Able Bank would receive under each of the three proposals. (10 Marks)

b. Examine the relative financial merits of the proposals from the viewpoint of Able Bank. (10 Marks)

(Total 20 Marks)

QUESTION 4

The managers of a pension fund follow an active portfolio management strategy. They try to purchase shares and bonds that show a positive abnormal return (positive alpha factor in the case of shares). The pension fund is required by law to hold at least 40% of its investments in bonds. ₦100million is currently available for investment.

Three shares and three bonds are being considered for purchase.

The required return on bonds may be measured using a model similar to the capital asset pricing model, where beta is replaced by the relative duration of the individual bond (D_i) and the bond market portfolio (D_m) i.e. D_i/D_m.

Shares	Expected return (%)	Standard deviation of returns	Correlation coefficient of returns with the markets
Equity market	10.5	15	1
A Plc	11.0	25	0.76
B Plc	9.5	18	0.54
C Plc	13.5	35	0.63

Bonds	Duration (years)	Coupons (%)	Redemption yield (%)
Bond market	7.5	-	5.8
Federal Govt.	1.5	8	4.5
D Plc	8.6	6	5.3
E Plc	14.2	9	7.2

Note: Assume risk free rate of 4 per cent per year.

Required:

a. Evaluate whether or not any of the shares or bonds is expected to offer a positive abnormal return. (10 Marks)

b. The pension fund currently has the maximum permitted investment in shares and wishes to continue this strategy. It has a market value of ₦1,000 million and a beta of 0.62.

Required:

Calculate the required return from the pension fund if any shares and bond with positive abnormal returns are purchased.

State clearly any assumptions that you make. (4 Marks)

c. Discuss possible problems with the pension funds investment strategy. (6 Marks)

(Total 20 Marks)

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

QUESTION 5

You are the portfolio manager of an asset management company based in Kano. Your company has in its portfolio 27,750,000 shares of Yaro Plc., a company listed on the Nigerian Stock Exchange. The shares are currently trading at ₦3.60 per share.

Your company plans to sell the shares in six months' time to pay dividend and you plan to hedge the risk of Yaro's shares falling by more than 5% from their current market value. A decision has therefore been taken to buy an over the counter option to protect the shares. A merchant bank has offered to sell an appropriate six month option to your company for ₦1,250,000.

Yaro's share price has annual standard deviation of 13% and the risk-free rate of 4% per year.

Required:

a. Evaluate whether or not the price at which the merchant bank is willing to sell the option is a fair price. (11 Marks)

b. Explain briefly (without any calculations) how a decrease in the value of each of the following variables is likely to change the value of a call option:

i. Volatility of the stock price (2 Marks)

ii. Risk-free rate (2 Marks)

(Total 15 Marks)

QUESTION 6

You are the head of the treasury group of Top Flight Aviation (TFA), a Nigerian company. The company operates chartered international flights for the elites in the country.

It is now December 31 and TFA needs to borrow £60 million from a UK bank to finance a new air jet. The borrowing and the purchase will be in three months' time and the borrowing will be for a period of six months.

You have decided to hedge the relevant interest rate risk using interest rate futures. Your expectation is that interest rates will increase from 13% by 2% over the next three months.

In the month of March, the current price of Sterling 3-month futures is 87.25. The standard contract size is £500,000.

Required:

a. Set out calculations of the effect of using the futures market to hedge against movements in the interest rate if:

(i) Interest rates increase from 13% by 2% and the futures market price moves by 2%;

(ii) Interest rates increase from 13% by 2% and the futures market price moves by 1.75%; and

(iii) Interest rates fall from 13% by 1.5% and the futures market price moves by 1.25%.

In each case, show the hedge efficiency.

The time value of money, taxation and margin requirements should be ignored. (11 Marks)

b. Show, for the situations in (a) above, whether the total cost of the loan after hedging would have been lower with the futures hedge chosen by the treasurer or with an interest rate guarantee which the treasurer could have purchased at 13% for a premium of 0.25% of the size of the loan to be guaranteed.

The time value of money, taxation and margin requirements are to be ignored.

(4 Marks)

(Total 15 Marks)

QUESTION 7

V Plc. manufactures engineering equipment. The company has received an order from a new customer for five machines at ₦5,000,000 each. V Plc.'s terms of sale are 10 percent of the sales value payable with the order. The deposit has been received from the new customer. The balance is payable 12 months after acceptance of the order by V Plc.

V Plc.'s past experience has been that only 60 percent of similar customers pay within 12 months.

Customers who do not pay within 12 months are referred to a debt collection agency to pursue the debt. The agency has in the past, had a 50 percent success rate of obtaining immediate payment once they became involved. When they are unsuccessful, the debt is written off by V Plc. The agency's fee is ₦500,000 per order, payable by V Plc. with the request for service. This fee is not refundable if the debt is not recovered.

As an accountant in V Plc.'s credit control department, and based on the company's past experience and on discussions with the sales and credit managers, you do not expect the pattern of payment and collection to change.

Incremental costs associated with the new customer's order are expected to be ₦3,600,000 per machine, 70 percent of these costs are for materials and are incurred shortly after the order has been accepted. The remaining 30 percent is for all other costs which you can assume are paid shortly before delivery, that is in 12 months' time. The company is not at present operating at full production capacity.
A credit bureau has offered to provide an error-free credit information about the new customer if the price is right.

V Plc.'s opportunity cost of capital is 16 percent. Ignore taxation.

Required:

Write a report to the Credit Control Manager which:

a. Evaluates, from a purely financial point of view, if V Plc. should accept the order from the new customer on the basis of the above information; and (12 Marks)

b. Comments on what other factors should be considered before a decision to grant credit is taken. (3 Marks)

(Total 15 Marks)

Formulae

Modigliani and Miller Proposition 2 (with tax)

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

Asset Beta

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

Equity Beta

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

Growing Annuity

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

Modified Internal Rate of Return

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

The Black-Scholes Option Pricing Model

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

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

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

The Put Call Parity

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

Binomial Option Pricing

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

$$d = 1/u$$

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

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

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

The Miller-Orr Model

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

Annuity Table

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

Where r = discount rate

n = number of periods

Discount rate (r)

Periods

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

Solution 1

a) The amount of expected synergy created may be estimated by comparing the sum of the pre-acquisition values of the individual companies with the expected post- acquisition value of the combined company.

Pako Plc.

Cost of equity using CAPM:

K_e = 4% + 1.18 (11 % - 4%) = 12.26%

Weighted average cost of capital:

$$WACC = \left[\frac{V_e}{V_e + V_d}\right]k_e + \left[\frac{V_d}{V_e + V_d}\right]k_d(1 - T)$$

$$= 12.26\%(0.7) + 6\%(1 - 0.3)(0.3) = 9.84\%$$

Note: Rounded discount rates, for example 10%, are also acceptable in the solution.

Free cash flow to the firm (FCFF)

Year	1	2	3	4
Sales revenue	**₦'000** 14,000	**₦'000** 14,700	**₦'000** 15,435	**₦'000** 16,206
Operating costs	(10,640)	(11,172)	(11,730)	(12,317)
EBIT	3,360	3,528	3,705	3,889
Tax (30%)	(1,008)	(1,058)	(1,112)	(1,167)
Add back depreciation	1,523	1,599	1,679	1,762
Replacement investment	(1,680)	(1,764)	(1,852)	(1,945)
FCFF	2,195	2,305	2,420	2,539
Discount factors (9.84%)	0.910	0.829	0.755	0.687
Present values	1,997	1,911	1,827	1,744

$$Value\ beyond\ Year\ 4\ is\ estimated\ to\ be\ \frac{2{,}539(1.04)}{0.0984 - 0.04} \times 0.687 = 31{,}063$$

The estimated value of Pako is ₦38,542,000 (₦7,479,000 + ₦31,063,000)

Note: Interest is ignored as financing costs and their associated tax effects are included in the company's discount rate.

RT Plc.

Cost of equity using CAPM:

K_e = 4% + 1.38 (11% - 4%) = 13.66%
Weighted average cost of capital:
WACC = 13.66%(0.45) + 7.5%(1 – 0.3)(0.55) = 9.03%

RT

Year	1	2	3	4
Sales revenue	₦'000	₦'000	₦'000	₦'000
	10,011	10,662	11,355	12,093
Operating costs	(6,976)	(7,429)	(7,912)	(8,426)
EBIT	3,035	3,233	3,443	3,667
Tax (30%)	(911)	(970)	(1,033)	(1,100)
Add back depreciation	1,172	1,248	1,329	1,415
Replacement investment	(1,321)	(1,406)	(1,498)	(1,595)
FCFF	1,975	2,105	2,241	2,387
Discount factors (9.3%)	0.917	0.841	0.772	0.708
Present values	1,811	1,770	1,730	1,690

Value beyond year 4 is estimated = $\frac{2{,}387(1.05)}{0.0903-0.05}$ x $0.708 = 44{,}032$

Total estimated value of RT = ₦51,033,000 (₦7,001,000 + ₦44,032,000)

Combined company

Year	1	2	3	4
	₦'000	₦'000	₦'000	₦'000
Sales revenue	24,097	25,543	27,075	28,700
Operating costs (70%)	(16,868)	(17,880)	(18,953)	(20,090)
EBIT	7,229	7,663	8,122	8,610
Tax (30%)	2,169)	(2,299)	(2,437)	(2,583)
Add back depreciation	2,703	2,865	3,037	3,219
Replacement investment	(3,010)	(3,191)	(3,382)	(3,585)
FCFF	4,753	5,038	5,340	5,661
Discount factors (9%)	0.917	0.842	0.772	0.708
Present values	4,359	4,242	4,122	4,008

Value beyond year 4 is estimated to be = $\frac{5.661(1.05)}{0.0900-0.05} \times 0.708 = 105{,}210$

The estimated value of the combined company

= ₦(16,731,000 + 105,210,000) = ₦121, 941,000

The sum of the individual companies
= ₦38,542,000 + ₦51,033,000
= ₦89,575,000

The expected synergy is
₦121,941,000 – ₦89,575,000 = ₦32,366,000

Alternative method

A **faster** method of computing the present value of the FCFF for the first **4** years and for each of the **3** valuations is to use growing annuity.

Pako Plc. ₦'000)

Every component of the FCFF calculations grows by 5%. Therefore, the FCFF **must** grow by the same 5%.

Check:

Year 2 = 2,195 x 1.05

3 = 2,195 x 1.05^2, etc

Calculate the FCFF for Year 1 and then apply the growing annuity formula.

$$\therefore \text{PV of FCFF Years 1 – 4} = \frac{2{,}195}{0.0984-0.05}\left[1-\left(\frac{1.05}{1.0984}\right)^4\right] = 7{,}480$$

Add PV of FCFF years 5-infinity as computed above, i.e.

$$\frac{2{,}643^*}{0.0984-0.04} \text{ x } 0.687 \qquad = \underline{31{,}091}$$

∴ PV of FCFF from year 1-infinity **38,571**

(*FCFF in Year 5 = 2,195 x $(1.05)^3$ x 1.04)

RT Plc. (₦'000)

Year 1 FCFF as computed above	1,975
Growth rate first 4 years	6.5%

$$\text{PV of FCFF years 1 – 4} = \frac{1{,}975}{0.0903-0.065}\left[1-\left(\frac{1.065}{1.0903}\right)^4\right] = 6{,}997$$

$$\text{Years 5 – infinity} = \frac{2{,}505^* \ X \ 0.708}{0.0903-0.05} \qquad = \underline{44{,}008}$$

∴ PV of FCFF from year 1-infinity **51,005**

(* $FCFF_5$ = 1,975 x $(1.065)^3$ x 1.05)

Combined company (₦'000)

Year 1 FCFF	4,753
Growth rate, years 1 – 4	6%

$$\text{PV} = \frac{4{,}753}{0.09-0.06}\left[1-\left(\frac{1.06}{1.09}\right)^4\right] = 16{,}735$$

$$\text{Years 5 – infinity} = \frac{5{,}944^* \ X \ 0.708}{0.09-0.05} \qquad = \underline{105{,}209}$$

121,944

(* $FCFF_5$ = 4,753 x $(1.06)^3$ x 1.05 = 5,944)

The sum of the individual companies = ₦38.571,000 + ₦51,005,000

= ₦89,576,000

Expected synergy = ₦121,944,000 – ₦89,576,000 = ₦32,368,000

b) The estimates are based upon unrealistic assumptions and are subject to considerable margin of error. Possible limitations include:

i) Sales, operating costs, replacement investments, and dividends are unlikely to increase by the same amount;

ii) Forecasts of future growth rates may not be accurate. Pako is unlikely to have access to enough internal information about the activities of RK to make accurate projections;

iii) The expected reduction in operating costs might not be achieved;

iv) The estimates are based upon present values to infinity of expected free cash flows. A shorter time horizon might be more realistic;

v) The cost of capital for the combined company could differ from that estimated, depending on how the market evaluates the risk of the combined entity;

vi) The analysis is based upon the assumption that the initial offer price is accepted;

vii) There is no information about the fees and other costs associated with the proposed acquisition. In many cases, these are substantial, and must be included in the analysis; and

viii) The post-acquisition integration of organisations often involves unforeseen costs that would reduce the benefit of any potential synergy.

c) **Advantages of merger as an expansion strategy**

As an expansion strategy, mergers are thought to provide a quicker way of acquiring productive capacity, intangible assets and accessing overseas markets.

There are four main advantages that have been put forward in the literature and these are summarised below:

i) **Speed**

The acquisition of another company is a quicker way of implementing a business plan, as the company acquires another organisation that is already in operation. An acquisition also allows a company to reach a certain optimal level of production much quicker than through organic growth. Acquisition, as a strategy for expansion, is particularly suitable for management with rather short time horizons.

ii) **Lower cost**

An acquisition may be a cheaper way of acquiring production capacity than through organic growth. An acquisition can take place, for instance through an exchange of shares which does not have an impact on the financial resources of the firm.

iii) **Acquisition of intangible assets**

A firm through an acquisition will acquire not only tangible assets but also intangible assets, such as brand recognition, reputation, customer loyalty and intellectual property, which are more difficult to achieve with organic growth.

iv) **Access to overseas markets**

When a company wants to expand its operations in an overseas market, acquiring a local firm may be the only option of breaking into the overseas market.

Disadvantages of mergers as an expansion strategy

An expansion strategy through acquisition is associated with exposure to a higher level of business and financial risk.

The risks associated with expansion through acquisitions are:

i) **Exposure to business risk**

Acquisitions normally represent large investments by the bidding company and account for a large proportion of its financial resources. If the acquired company does not perform as well as it was envisaged, then the effect on the acquiring firm may be catastrophic.

ii) **Exposure to financial risk**

During the acquisition process, the acquiring firm may have less than complete information on the target company, and there may exist aspects that have been kept hidden from outsiders.

iii) **Acquisition premium**

When a company acquires another company, it normally pays a premium over its present market value. This premium is normally justified by the management of the bidding company as necessary for the benefits that will accrue from the acquisition. However, too large a premium may render the acquisition unprofitable.

iv) **Managerial competence**
When a firm is acquired, which is larger than the acquiring firm, the management of the acquiring firm may not have the experience or ability to deal with operations on the new larger scale, even if the acquired company retains its own management.

v) **Integration problems**
Most acquisitions are beset with problems of integration, as each company has its own culture, history and ways of operation.

EXAMINER'S REPORT

The part 'a' of the question tests candidates' understanding of valuation of business using free cash flow model, while in part 'b', candidates were asked to determine the value of possible synergy expected from a take-over and to also explain its limitation.

In par (c) candidates' were asked to discuss the key advantages and disadvantages of merger and acquisition rather than organic growth.

Being a compulsory question, visually all the candidates attempted it, more than 75% of the candidates did not attempt part (a) of the question and those who did, showed a real lack of understanding of free cash flow model despite the fact that the topic has been tested severally in recent examination, hence performance was poor.

Candidates' commonest pitfalls were their failure to:

- **Adjust the cash flows for growth;**
- **Identify the relevant cash flows;**
- **Determine the appropriate cost of capital; and**
- **Determine the terminal values of the companies at the end of year 4**

Candidates are advised to practise examination type questions using the Institutes' pathfinder.

Marking Guide

Question 1	**Marks**	**Marks**
Calculation of Pako's cost of equity using CAPM – Pako	1	
Calculation of Pako's weighted cost of capital (WACC)	1	
Calculating the changes in Pako's statement of profit or loss:		
- Sales revenue	½	

- Operating costs	½	
- EBIT	¼	
- Tax	½	
- Replacement investment	½	
Adding back depreciation	½	
Calculating free cash flow to the Firm (FCFF)	¼	
Discount factors	¼	
Present values	¼	
Calculation of value beyond year 4	1	
Estimated value of Pako Plc	½	
Calculation of RT Plc's cost of equity using CAPM	1	
Calculation of RT Plc's weighted cost of capital (WACC)	1	
Calculating the changes in RT Plc's statement of profit or loss:		
- Sales revenue	½	
- Operating costs	½	
- EBIT	¼	
- Tax	½	
- Replacement investment	½	
Adding back depreciation	½	
Calculating free cash flow to the firm (FCFF)	¼	
Discount factor	¼	
Present value	¼	
Calculation of value beyond year 4	1	
Estimated value of RT Plc.	½	
Calculating the changes in the combined company's statement of profit or loss:		
- Sales revenue	½	
- Operating costs	½	
- EBIT	¼	
- Tax	½	
- Replacement investment	½	
Adding back depreciation	½	
Calculation of Free cash flow to the firm (FCFF)	¼	
Discount factors	¼	
Present value	¼	
Calculation of value beyond 4 years	1	
Estimated value of the combined company	¼	
Sum of the estimated values of the individual companies	¼	
Expected synergy	1	20
1 mark per point, max. 5 marks		5

1 mark per advantages given, max. 3 marks	3	
1 mark per disadvantages stated, max. 2 marks	2	5
		30

Solution 2

(a)

	Data	2014	2015	2016	2017
1	Equity earnings (₦m)	200	225	205	230
2	Number of shares (m)	2,000	2,100	2,100	1,900
3	Price per share (kobo)	220	305	290	260
4	Dividend per share (kobo)	5	7	8	8
5	Earnings per share (= 1 ÷ 2) (kobo)	10.0	10.7	9.8	12.1
	Dividend yield (= 4 ÷ 3)	2.3%	2.3%	2.8%	3.1%
	Dividend cover (= 5 ÷ 4)	2.0	1.5	1.2	1.5
	Price/earnings ratio (= 3 ÷ 5)	22.0	28.5	29.6	21.5

Earnings per share

Earnings per share (EPS) shows the amount of profit after tax attributable to each ordinary share. Although a high EPS generally indicates success, care must be taken in interpreting the trend in EPS when there have been share issues, especially rights issues at heavily discounted prices or bonus issues, both of which result in a fall in EPS. Similar problems are encountered when warrants or convertible loan notes are issued.

Dividend yield

The dividend yield shows the ordinary dividend as a rate of return on the share value. The figure is of limited use because it shows only part of the return to the equity investor.

Dividend cover

The dividend cover shows how many times EPS is bigger than the dividend per share. A high dividend cover shows that a large proportion of equity earnings is being reinvested for growth.

Price/earnings ratio

The price/earnings ratio (P/E ratio) shows how many times the share price is bigger than the EPS. In general, the bigger the EPS, the more the share is in demand, though care must be taken when making comparisons because whereas EPS is a historical result, the share price is based on future expectations and is affected by both risk and growth factors. Consequently, abnormal results can often arise from a crude use of P/E ratios.

b) **Trends in 2015**

In 2015, share capital was increased by 5%, probably through a rights issue. Equity earnings increased more than proportionately, resulting in a 7% increase in EPS, indicating a successful year. Demand for the company's share rose swiftly, either because of a general stock market rise or because of high expectations of PH Plc.'s future growth, and the share price rose by approximately 40%. This caused a big rise in P/E ratio and allowed a 40% increase in dividend per share without any fall in dividend yield. The dividend cover fell because the dividend increased much more than earnings.

Trends in 2016

The company's earnings and EPS fell in 2016, either because of normal cyclical business risks or possibly because the high 2015 dividend left insufficient cash for reinvestment. However, the company gave a 'bullish' signal to the market by increasing its dividend per share, indicating future prospects of a swift recovery and increased growth. As a result, the dividend yield increased and, although the share price fell in line with earnings, there was no disproportionate drop in demand for the company's shares, as shown by the stability of the P/E ratio.

Trends in 2017

There was 12% earnings growth in 2017. The company used some of its cash to buy back ordinary shares. This is possibly because it offered shareholders the choice between a cash and a scrip dividend. Share capital reduced by about 10%, resulting in a big increase in earnings per share. Although 2017 was a successful year for earnings, demand for the company's shares fell, as shown by the drop in share price and P/E ratio. It is possible that the market has become uncertain of the company's future plans, as a result of the share issue and share buy-back in quick succession.

EXAMINER'S REPORT

The question test candidates' knowledge of some basic stock market financial ratios. Candidates were expected to calculate, interpret and assess the trend in the given ratios over a number of years.

Almost all the candidates attempted the question, but performance was average. Whereas most of the candidates were able to calculate the ratios, large number of them could neither interpret nor assess the given trend.

In interpreting the trend, it is very disappointing that no single candidate made reference to the fact that there were changes to the number of shares in issues.

Once again, we recommend adequate preparation on the part of students.

Marking Guide

Calculation of earnings per share	2	
Calculation of dividend yield	2	
Calculation of dividend cover	2	
Calculation of P/E ratio	2	
Explaining the meaning of earnings per share and	1	
Its limitation	½	
Stating the meaning of dividend yield and	1	
its limitations	½	
Explaining the meaning of dividend cover and	1	
Its limitap[]ions	½	
Explaining the meaning of P/E ratio and	1	
Its limitation	½	14
2 marks each for explaining the reason for the changes over the years 2015 – 2017		6
		20

Solution 3

a) (i) In a liquidation: the assets would realise the following amounts:

	₦'000	₦'000
Freehold property		65,000
Plant	21,000	
Inventory	40,000	
Receivables	26,000	87,000
		152,000

The proceeds from the freehold property would be used to repay the 10% loan notes of ₦50,000,000 (which has a first charge on the property) and the remaining ₦15,000,000 would be used to repay some of the overdraft (which has a second charge). This leaves ₦(45,000,000 – 15,000,000) = ₦30,000,000 of the overdraft as an unsecured creditor.

Liquidation expenses are ignored, as indicated in the note to the question.

Priority for payment	**₦'000**	**₦'000**
Secured creditors:		
10% loan notes	50,000	
Bank overdraft (balance of property value)	15,000	
		65,000
Preferential creditors		27,000
		92,000

Realisable sales value of assets		152,000
Money left over to pay unsecured creditors		60,000
Unsecured creditors:		
Bank overdraft	30,000	
Sundry other creditors (₦117,000,000 minus Preferential creditors of ₦27,000,000)	90,000	
		120,000
Shortfall of money needed to pay unsecured creditors		60,000

Unsecured creditors will receive a payment of 50 kobo in the ₦1 (₦60m/₦120m)

	₦'000
The Able Bank would receive:	
Secured part of overdraft	15,000
Unsecured part of overdraft (50% of ₦30,000,000)	15,000
	30,000

The money would be received at once.

ii. With the offer of Tayo Ltd:
Able Bank would receive 80% of ₦45,000,000 = ₦36,000,000, but only in one year's time.

iii. Reconstruction scheme:
The share in the reconstructed company will be:

	No. of shares ('000)
Receivables by Able Bank	10,000
Receivables by shareholder (two-fifths of 50,000,000)	20,000
	30,000
Issued for cash	30,000
Total shares of ₦1 in issue	60,000

Able Bank will hold one-sixth of the equity. Able Bank's share of the dividend will be

$$\frac{1}{6} \times \frac{2}{3} \times ₦40,500,000 = ₦4,500,000$$

The first dividend will be received after one year but further dividends should be expected in subsequent years.
In addition, Able Bank will be repaid one-half of the debt at once, i.e. 50% of ₦45,000,000 = ₦22,500,000

4. **Summary**

	Proposal (a)	Proposal (b)	Proposal (c)
	₦'000	**₦'000**	**₦'000**
Cash now	30,000	-	22,500
Cash after 1 year	-	36,000	4,500
Cash in later years			Future dividends in perpetuity

b) The return from the three proposals may be compared by calculating their present value using the given interest rate of 15%.

Proposal (a)	**₦'000**
Overdraft due now	30,000
Proposal (b)	**₦'000**
PV of payment from Tayo Ltd: ₦36,000,000/1.15	31,304
Proposal (c)	**₦'000**
Overdraft received now: 50% × ₦45,000,000	22,500
Dividends: ₦4,500,000 from Year 1 to infinity: ₦4,500,000/0.15	30,000
Total present value	52,500

Proposal (c) offers, by far, the highest return, but it is perhaps the most risky option. If the reconstructed company fails to make the expected profits, the bank might receive only ₦22,500,000. On the other hand. If the reconstruction ends in success, the bank will make a 'profit' on its current overdraft investments in Pinko Ltd. (which is only ₦45 million).

Proposal (b) is marginally preferable to proposal (a), although there must be some risk that Tayo Ltd. may default on payment of its debt.

Liquidation (proposal (a) is the least risky option, but it offers the lowest return.

The choice between the three proposals will depend on the judgement of the management of Able Bank, and in particular, on an assessment of the degree of risk with each option.

EXAMINER'S REPORT

The question tests candidates' knowledge of financial reconstruction, etc. Candidates were expected to identify how to distribute available assets in liquidation, among other things.

About 50% of the candidates attempted the question. The overall performance was extremely poor with large number of the candidates scoring less than 5% of the allocated marks.

A great number of the candidates demonstrated lack of knowledge of the priority of asset distribution in liquidation. Besides large number of them could not recognise the need to bring cash flows occurring at different time period to a common base through discounting.

Candidates for future examinations are advised to cover the entire syllabus comprehensively.

Marking Guide

a	Recognising priority payment to secured creditors:		
	- 10% loan notes	½	
	- Bank Overdraft (Able Bank)	½	
	- Payment to preferential creditors	1	
	Calculating balance due to Able bank and other creditors	1	
	Calculation of dividend due to the unsecured creditors	1	
	Calculation of payment due to Able bank as an unsecured creditor	1	
	Calculation of payment due to Able bank under proposal (b)	2	
	Calculation of payment due to Able bank under proposal (c)	3	10
b	Comparative analysis of the relative financial merits of the 3 proposals to Able bank applying the given 15% interest rate:		
	- Proposal (a)	1	
	- Proposal (b)	1	
	- Proposal (c)	2	
	Comments on the result of the comparative figures arrived at under the 3 proposals, 2 marks each	6	10
			20

Solution 4

a) A positive abnormal return will exist if the expected return from a security is higher than the required return. This may be established by using the Capital Asset Pricing Model (CAPM).

The beta of the individual share may be found using:

$$\text{Beta} = \frac{\text{correlation coefficient} \times \text{investment standard deviation}}{\text{market standard deviation}}$$

$$\beta_A = \frac{0.76 \times 25}{15} = 1.27$$

$$\beta_B = \frac{0.54 \times 18}{15} = 0.65$$

$$\beta_C = \frac{0.63 \times 35}{15} = 1.47$$

Using the CAPM, the required return is given by $R_i = R_f + \beta_i(R_m - R_f)$

Company	Expected return $\overline{R}_i$	Required Return R_i	Alpha $\overline{R}_i - R_i$
	%	%	%
A Plc.	11	4 + 1.27(10.5 - 4) = 12.26	-1.26
B Plc.	9.5	4 + 0.65(10.5 - 4) = 8.22	1.28
C Plc.	13.5	4 + 1.47(10.5 – 4) = 13.56	-0.06

For the bonds, the relative durations are:

$$\text{Federal Govt.} = \frac{1.5}{7.5} = 0.20$$

$$\text{D Plc.} = \frac{8.6}{7.5} = 1.15$$

$$\text{E Plc.} = \frac{14.2}{7.5} = 1.89$$

Organisation	Expected Return $\overline{R}_i$ (%)	Required return R_i (%)	Alpha $\overline{R}_i - R_i$ (%)
Fed. Govt.	4.5	4 + 0.20(5.8 - 4) = 4.36	0.14
D Plc.	5.3	4 + 1.15(5.8 - 4) = 6.07	-0.77
E Plc.	7.2	4 + 1.89(5.8 - 4) = 7.40	-0.20

If these data are accurate, the shares of B Plc. and the Federal Government bond offers a positive abnormal return.

b) The beta of the revised portfolio is the weighted average of the betas of the components of the portfolio.

Investment	Market Value ₦	Beta	Hash total ₦
Existing portfolio	1,000	0.62	620
Shares in B Plc	60	0.65	39
FG bond	40	.20	8
	1,100		667

Beta = 667/1,100 = 0.61

Required return = 4 + 0.61(10.5 - 4) = 7.97%

c) The company's strategy relies upon the pension fund managers being able to regularly and correctly identify underpriced securities. The implication is that the securities' markets are not continuously efficient, and that excess returns can be earned by trading in mispriced securities. Markets are certainly not perfectly efficient, but whether or not mispriced securities can be regularly found that will lead to an abnormal return, after any administrative and transactions costs, is debatable.

A policy of selecting only mispriced securities might mean that the portfolio risk and return are not consistent with the objectives of the portfolio or desire of the investment clients.

The strategy is based on using the capital asset pricing model, and presumes that the model presents an accurate measure of the required returns from securities. The CAPM, however, is based on a number of unrealistic assumptions, such as existence of a perfect capital market, borrowing and lending can take place at the risk free rate, investors have the same expectations about risk and return, investors are well diversified, and all investors consider only the same single time period. It also states that systematic risk is the only relevant measure of risk. It is likely that multifactor models such as the arbitrage pricing theory offer better explanations of the relation between risk and return. Accurate data input for elements of the CAPM such as the market return and relevant betas are difficult to estimate, and the CAPM has empirical anomalies, for example, it appears to overstate the required return on high beta securities and understate the required return on low beta securities.

EXAMINER'S REPORT

The question tests candidates' knowledge of capital asset pricing model (CAPM). They were expected to calculate, for each security, beta factor, required return and alpha value (abnormal return).

Surprisingly and despite the regularity of testing these concepts in previous examinations, the performance of the candidates was poor. Meanwhile, many candidates attempted the question.

Candidates commonest pitfalls were:

- **Use of wrong formulae to calculate beta factor;**
- **Inability to identify the appropriate risk-free rate and market return;**
- **Some candidates' use of the same market return for the equity shares and the bonds; and**
- **Wrong interpretation of the calculated alpha value.**

Success in the Institute's examinations can only be earned through diligent study and adequate use of various study support materials provided by the Institute.

Marking Guide

a	Calculations of the beta of the individual share – A, B & C Plc's	1½	
	Calculations of Alpha i.e $\bar{R}_i$ - R_i of A, B & C Plc	3	
	Calculations of the relative durations for the bonds: Federal Govt., D Plc & E Plc	1½	
	Calculations of Alpha i.e $\bar{R}_i$ - R_i for the bonds: Federal Govt., D Plc & E Plc	3	
	Comment on the result of the Alpha ($\bar{R}_i$-R_i) calculations	1	10
b	Calculation of the beta for the revised portfolio	3	
	Calculation of the required return	1	4
c	Discussion on the possible problems with the pension funds – Para. 1 (2 marks), Para. 2 (1 mark) and Para. 3 (3 marks)		6
			20

Solution 5

a) Put options are required to hedge the price of the shares.

Step 1: Determine d_1 and d_2

$$d_1 = \frac{\text{In } S/E + (r + \sigma^2/2)T}{\sigma\sqrt{T}}$$

S = 360

E = 360 × 0.95* = 342

* The exercise price is 5% lower than the market price as that is the protection required.

r= 0.04

σ = 13% = 0.13

T = 6/12 = 0.5

$$d_1 = \frac{\text{In}\left(\frac{360}{342}\right) + (0.04 + 0.13^2/2)(0.5)}{0.13\sqrt{0.5}} = 0.8215$$

$d_2 = d_1 - (\sigma)(\sqrt{T}) = 0.8215 - (0.13)\ 0.5 = 0.7296$

Step 2: Determine $N(d_1)$ and $N(d_2)$

$N(d_1) = N(0.8215) = 0.2939 + 0.15(0.2967 - 0.2939) = 0.2943$

Since d_1 is positive, we add 0.5 to get 0.5 + 0.2943 = 0.7943

$N(d_2) = N(0.7296) = 0.2642 + 0.96(0.2673 - 0.2642) = 0.2672$

We also need to add 0.5 to get 0.7672

Step 3: Determine the value of call

$C = SN(d_1) - Ee^{-rT}N(d_2) = 360(0.7943) - 342e^{-0.04(0.5)}(0.7672) = 28.76$

Step 4: Using Put Call Parity (PCP), determine the value of put option

$2{,}876 + 342e^{-0.04(0.5)} = P + 360$

P = 3.99 kobo

On the assumption that one put option is bought per share:

Total value of Option = 27.75 million × 3.99kobo = ₦1,107,225

Overcharge by bank: ₦1,250,000 - ₦1,107,225 = ₦142,775

b) • **Volatility of the stock price:** A decrease in volatility will mean that a call option becomes less valuable. A decrease in volatility will decrease the chance that the stock price will be above the exercise price when the option expires.

• **Risk free rate of return:** A decrease in the risk free rate will mean that a call option becomes less valuable. The purchase of an option rather than the underlying will mean that the option holder has spare cash available which can be invested at the risk free rate of return. A decrease in that rate will mean that it becomes less worthwhile to have spare cash available, and hence to have an option rather than having to buy the underlying security.

EXAMINER'S REPORT

Part (a) of the question tests candidates' ability to make use of the Black-Scholes option pricing model to price a put option. Candidates were expected to identify the appropriate option required for the hedge and to price the option accordingly. In part (b), candidates were required to discuss some option 'greeks'.

Less than 5% of the candidates attempted the question and performance was very poor. There is a clear evidence that candidates lack knowledge of this important topic in finance.

Candidates commonest pitfalls were their:

- Failure to identify the type of option needed;
- Using the wrong strike price;
- Wrong use of the various formulae; and
- Inability to use the normal distribution table

Granted the poor level of performance, candidates should note that the examiners are motivated to revisit this topic area in future examination. The study test contains good illustrations for students' practice.

Marking Guide

a	Stating the purpose of the put option	1	
	Calculation of:		
	- The exercise price (E)	½	
	- d_i	2	
	- d_2	1	
	- N (d_i)	1	
	- N (d_2)	1	
	Determination of the value of call option	1½	
	Determination of the value of put option	1	
	Calculation of the total value of options	1	
	Overcharge by bank	1	11
b	Comment on the volatility of the stock price	2	
	Comment on the risk free rate of return	2	4
			15

Solution 6

a) ***Note:***

For each of the scenarios of interest rate movements given in the question, we need to identify the appropriate market price of the futures contracts. Generally, the movements in interest rates and futures prices should be in the same direction but not necessarily 'one-on-one'.

Scenario (i)	**Cash Market**	**Future Market**
Current interest rate (%)	13	(100 – 87.25) = 12.75
Expected (%)	15	12.75 + 2 = 14.75*

(*This gives expected future price of 100 – 14.75 = 85.25)

Scenario (ii)	**Cash Market**	**Future Market**
Expected rate (%)	15	(12.75 + 1.75) = 14.5*

(* implied price = 100 – 14.5 = 85.5)

Scenario (iii)	**Cash Market**	**Future Market**
Expected rate (%)	11.50	(12.75 – 1.25) = 11.50*

(* Implied price = 100 - 11.50 = 88.5)

Note: Because borrowing (rather than lending) is involved, we 'sell futures'.

Evaluation of hedge

Cash market	(i)	(ii)	(iii)
Actual interest rate (R)	15%	15%	11.5%
Actual interest cost = £60m × R × 6/12 = (T)	£4,500,000	£4,500,000	£3,450,000
Target interest cost = £60m × 13% × 6/12	£3,900,000	£3,900,000	£3,900,000
Gain/(loss) on target = (Y)	(£600,000)	(£600,000)	£450,000

Future Market	(i)	(ii)	(iii)
Sell futures	87.25	87.25	87.25
Buy futures	85.25	85.50	88.50
Gain/(loss) = (P) =	2%	1.75%	(1.25%)
Monetary gain/(loss) = £60 × 6/12 × P = (N)	£600,000	£525,000	(£375,000)
Net interest cost = (T - N)	(£3,900,000)	(£3,975,000)	(£3,825,000)
Hedge efficiency = Gain/Loss =	100%	87.5%	120%

b) **Interest rate guarantee (IRG)**

Premium for the guarantee is:

£60m × 0.25% = £150,000.

The guarantee would be used in cases (i) and (ii) because the actual rate (15%) is greater than the target rate (13%).

Then, total cost limiting interest rates to 13% is actual interest of £3,900,000 plus premium £150,000, that is, £4,050,000.

This costs more than the futures contracts hedge in cases (i) and (ii). In case (iii), the guarantee is not used because the prevailing interest rate of 11.5% is less than the guarantee rate of 13%.

Interest costs at 11.5% are:

Interest paid at 11.5% =	£3,450,000
Add premium	150,000
	£3,600,000

This costs less than the futures hedge, reflecting the fact that declining to take up the interest rate option in the case of the guarantee, has allowed the company to take advantage of the lower interest rates in the cash market.

EXAMINER'S REPORT

The question tests candidates' understanding of the risk management element of the syllabus.

Less than 10% of the candidates attempted the question and performance was poor.

Candidates' commonest pitfalls were their inability to:

- **determine whether to buy or sell futures;**
- **evaluate the hedge; and**
- **calculate the hedge efficiency, as required by the question.**

Candidates are advised to give a comprehensive coverage to all aspects of the syllabus as future examinations will continue to draw on all elements of the syllabus.

Marking Guide

a	Scenario (i) Calculation of expected future price	1½	
	Scenario (ii) Calculation of expected rate	1½	
	Scenario (iii) Calculation of expected rate	1½	
	Comment on the decision to sell futures	½	
	Evaluation of hedge – Cash market	3	
	Evaluation of hedge – Future market	3	11
b	Interest rate guarantee:		
	Calculation of the premium for the guarantee	1	
	Calculation of total cost limiting interest rate	1	
	Calculation of interest costs at 11.5%	1	
	Comment on the comparative futures hedge and the interest rate guarantee	1	4
			15

Solution 7

a) From: Finance Manager
To: Credit Control Manager, V plc.
Date: 15May 2019
Subject: Order from new customer

As required, I have looked into the above subject matter. There are three possible outcomes. These are:

i) If all things go as expected, we will receive the balance due from the customer (probability 60%);
ii) we have to pay a ₦500,000 collection fee, as a result of which the balance is received (probability 20%); and
iii) we pay the ₦500,000, but the balance is not forthcoming (probability 20%).

These can be evaluated, and a statistically expected figure calculated, as follows:

		Outcome		
		(i)	(ii)	(iii)
		₦000	₦000	₦000
Now	Receive 10% of ₦25m	2,500	2,500	2,500
	(Pay)70% of ₦18m	(12,600)	(12,600)	(12,600)
	Net (K)	(10,100)	(10,100)	(10,100)

Year 1	(Pay) 30% of ₦18m	(5,400)	(5,400)	(5,400)
	(Pay) collection fee	-	(500)	(500)
	Receive balance	22,500	22,500	-
	Net receipt/(payment)	17,100	16,600	(5,900)
	Discount factor 16% p.a	0.862	0.862	0.862
	Present value at 16% p.a (T)	14,740	14,310	(5,086)
	Net present value (K+T)	4,640	4,210	(15,186)
	Probability	60%	20%	20%
	Expected value	2,784	842	(3,037)
				= ₦589,000

The expected value being positive, the order is financially viable

b) Other factors worthy of consideration include the following:

- Although the expected value is positive, there are only three possible outcomes: ₦4,640,000 positive, ₦4,210,000 positive and ₦15,186,000 negative.
  Depending on your aversion to risk, the size of the negative outcome may dissuade you from accepting the order;
- The possibility/cost of insuring against default'
- The possibility of using other forms of payment, e.g. bills of exchange or different terms (discount for early payment);
- The likelihood of getting further orders as a consequence of accepting this (e.g. repeat or recommendation);
- The possibility of recovering some of the balance at a later date (e.g, on the insolvency of the buyer);
- Opportunity cost, e.g. penalties/layoffs if order is not accepted; and
- The question of whether the 16% already includes a component to reflect uncertainty/risk aversion.

Please let me know if you want me to elaborate on any of the above or take any aspect further.

Signed: **Finance Manager**

EXAMINER'S REPORT

The question tests candidates' understanding of the analysis of working capital.

Candidates were expected to identify the possible outcomes of a customer's order, isolate the relevant cash flows (and their timing) and compute the expected present

value of the cash flows. Over 60% of the candidates attempted the question, but the level of performance was below average.

Candidates commonest pitfalls were their:

- Inability to identify the various possible outcomes;
- Inability to identify the appropriate cash flows and their timing;
- Failure to consider the time value of money; and
- Inappropriate use of the given probabilities

Candidates need to prepare adequately for the Institute's examinations and avail themselves of the study materials made available by the Institute.

Marking Guide

a	Report format; From, To, Date and Signature ¼ each, subject matter ½	1½	
	Stating the three possible outcomes	1½	
	Calculating the three outcomes (now) – K	2	
	Calculating the three outcomes (in Year 1) – T	4	
	Calculation of the net present value(K + T)	1	
	Calculation of the expected value	1	
	Comment on the result	1	12
b	1 mark for each reasonable factor stated, max. 3 marks		3
			15

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2019

ADVANCED AUDIT AND ASSURANCE

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

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

SECTION A: COMPULSORY (30 MARKS)

QUESTION 1

Ayeniromo Microfinance Bank Limited has been operating for more than five years in Ekemode Local Government area of a state in Nigeria. The bank opened three cash centres in three locations in the local government area in 2013.

Business activities have been very encouraging in one of the cash centres until a sudden change in activities in 2016. This resulted in the negative performance of the cash centre. The managing director thereafter decided to investigate the causes of the problems in the cash centre.

An interim report of the preliminary investigation on the cash centre identified infractions on cash takings from customers by some staff of the cash centre during the year 2016.

The managing director and the board decided to engage your firm as forensic accountants with the following terms of reference:

(i.) investigate whether fraud has actually occurred and if so, to obtain evidence to support that assertion in a court of law;
(ii.) identify the individual(s) who has/have committed the fraud and obtain evidence that can be used in a court of law to link them with the fraud; and
(iii.) estimate the financial loss that has occurred because of the fraud.

You are required to:

a. Discuss the concept of forensic accounting and explain the nature of forensic investigation and forensic audit. (10 Marks)

b. Analyse and apply the **FIVE** fundamental principles of the IFAC's Code of ethics for professional accountants to forensic investigation. (10 Marks)

c. Explain the procedures to be followed in a forensic investigation engagement for Ayeniromo Microfinance Bank Limited. (10 Marks)

(Total 30 Marks)

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

QUESTION 2

Bolokupalemo Pharmaceuticals Limited is a fast growing company operating with its head office in Onitsha. The management of the company is targeting the takeover of another company located in the south – south zone of Nigeria with the intention of expanding its business frontier. Preliminary discussions reveal that the management of the other company has not shown any effective resistance to the proposed takeover. However, the management of Bolokupalemo wants a clear due diligence work to be performed to determine the viability of the acquisition.

As the auditor of the acquiring company, its management has approached you to carry out a due diligence work on the company that it has proposed to acquire.
The management also requires your firm to carry out the engagement in accordance with the provisions of International Standard on Review Engagements (ISRE 2400).

You are required to:

a. Explain the concept of "due diligence engagement" (2 Marks)
b. Discuss the items to be investigated in a due diligence exercise (5 Marks)
c. Explain the benefits of using an audit firm for due diligence engagement. (5 Marks)
d. Discuss the objectives of "International Standard on Review Engagement" (ISRE 2400) (5 Marks)
e. Explain the principles to be applied in review engagements as set out by ISRE 2400. (3 Marks)

(Total 20 Marks)

QUESTION 3

Jemigboran Commercial Industries has been operating for some years. Its management has sought your input as the auditor of the company on a proposal by the information technology (IT) team of the company to introduce a framework as "control objectives for information and related technologies (COBIT)" for its operations.

Required:

a. Explain COBIT as an IT governance tool, and the purpose it serves in an organisation. (8 Marks)

b. Identify and explain **SIX** specific components of COBIT. (12 Marks)

(Total 20 Marks)

QUESTION 4

Itanforiti Publishers Limited has been in printing and publishing business for many years in Ibadan. The company has been performing well with a competitive advantage over many companies in the industry as a result of the engagement of high profile team of personnel and in-house printing of its published books.

The board of directors comprises of two brothers and their wives. The older brother is the chairman and the younger, the managing director. The fortunes of the company started dwindling in 2013 when conflicts could no more be resolved amicably among the members of the board of directors.

The chairman, being a majority shareholder assumed executive powers by combining the roles hitherto played by the managing director with his own as executive chairman in 2015. Governance of the company became unsettled and key staff of the organisation started resigning in turn.

In 2016, the financial reports of the company revealed its inability to pay creditors and supply of raw materials became irregular. In addition, the level of receivables became too high with high figure of doubtful and irrecoverable debts.

Your firm acts as auditors to the company and you have been presented with the financial statements for the year ended 31st December, 2017 for audit.
The financial statements were prepared on a going concern basis.

Required:

a. Identify and explain the objectives of the auditor in the area of going concern in accordance with International Standards on Auditing (ISA 570). (5 Marks)

b. Explain the going concern assumption and the implications for the financial statements if the entity is not a going concern. (5 Marks)

c. Explain the going concern duties of the directors. (3 Marks)

d. Evaluate the risk assessment procedures to be performed by the auditor on the going concern status of the entity. (ISA 570). (7 Marks)

(Total 20 Marks)

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

QUESTION 5

Insurgency Relief Providers (IRP) is a non-governmental organisation set up by a popular philanthropist from the southwest part of the country. The philanthropist sits as the chairman of the board of trustees and has a manager who is a close relative of the chief executive officer. All the management activities are in the hands of the manager and the board of trustee sits occasionally to formalise major decisions. Initially the sum of ₦50,000,000 was provided by the philanthropist and fund raising was organised to raise additional ₦200,000,000 in cash and pledges by political associates. The activity of IRP has been carried out with these and other donations from friends and well wishers.

Activities of IRP are essentially performed in the north east region of the country. These activities include food and materials supply using chartered vehicles and police/military escorts. The distribution is carried out with the involvement of some staff of the NGO who travel by air and within the safe zones of the region.

Due to the successes recorded and the need to increase these activities, the chairman of the board of trustee has made appeals to some foreign friendly associates to be involved in his organisation's activities by providing financial support. A number of these organisations have shown interest and would want to review the operational activities and financial statements of IRP over the past three years.

For the purpose of the current request from foreign associates and other agencies, a statutory audit of the financial statements is required.

Your firm was appointed and has accepted the engagement.

Required:

a. Assess the inherent risks associated with the audit of the financial statements of IRP. (10 Marks)

b. Identify **FIVE** audit risks to be addressed by the auditor. (5 Marks)

(Total 15 Marks)

QUESTION 6

During the recent audit of Ogundu Commercial Limited, a privately owned trading company, you discovered that the former chief accountant resigned immediately after the conclusion and approval of the previous audited financial statements. The new chief accountant came in during the month of May and was working at familiarizing himself with the systems and financial operations of the company; and also ensuring that the accounting records are ready for board of directors

quarterly meetings and finalising the accounts for the next audit. Due to the pressure of work, the chief accountant lost part of the journals raised by the previous auditors but proceeded to finalise the accounts. This resulted into least expected financial performance for the year. The previous auditor is a sole practitioner and is now deceased.

The directors are concerned because the financial statements would be used to seek facilities from banks. The success or otherwise of the facility will impact on the operations of the company and may lead to a reduction in both operation and staff engagement.

Required:

a. Evaluate the effect of the loss of the audit journals on the financial statements and the factors you would consider, as auditors in drafting your report. (5 Marks)
b. In accordance with ISA 570, evaluate the actions required of the auditors in relation to the observed misstatement. (5 Marks)
c. Discuss the content of the communication expected of the auditors to the client before and after the audit other than the auditors' report. (5 Marks)

(Total 15 Marks)

QUESTION 7

You are an audit manager in a firm of Chartered Accountants. Your firm has been appointed as joint auditors with another firm to carry out the audit of Opeloyeru Automotive Company Limited which has acquired another company in the same industry to expand its business across six states in the south west zone of Nigeria.

You are required to:

a. Explain the concept of joint audit. (5 Marks)
b. Discuss the reasons why joint audit is considered desirable. (5 Marks)
c. Explain possible setbacks for engagement in joint audits (5 Marks)

(Total 15 Marks)

SOLUTION ONE

SECTION A

a. Forensic accounting involves the preparation of financial information for use as evidence by a court of law. Examples include the provision of financial information relating to:
- Loss of earnings;
- Settlement of a legal dispute involving the valuation of a business;
- Losses relating to an insurance claim;
- A divorce settlement; and
- Investigation into fraudulent activities within an entity

There are two aspects of forensic accounting:
- Forensic investigations; and
- Forensic audit

Forensic Investigation

A forensic investigation is an aspect of forensic accounting carried out in response to a suspicion of wrongdoing, usually to prove or disprove certain assumptions.

The objective of a forensic investigation is to obtain evidence that might be used in legal proceedings to resolve a dispute or prove innocence/guilt in a criminal case, such as providing evidence of money laundering.

Forensic investigations are usually reactive, meaning that they seek to prove or disprove suspicions of wrongdoing and provide evidence for legal proceedings. However, investigations can also be proactive or preventative.

Techniques of forensic auditing can be used to identify risks of wrongdoing and then steps can be taken to improve the situation.

Forensic Audit

Forensic audit is an element in forensic accounting. It refers to the methods and procedures used to obtain audit evidence in a forensic investigation.

Forensic auditing may be defined as the process of:
- Gathering, analysing and reporting on data, much of it financial in nature, in the pre-defined context of legal dispute or investigation into suspected irregularities and
- In some cases, giving preventative advice in the area.

(b) Application of ethical principles to forensic investigations

The ethical principles that apply to accountants carrying out forensic work are the same as accountants in every situation. These are:

(i) **Integrity**
In legal disputes and criminal investigations, individuals may be dishonest. However, the forensic accountant must act with integrity and honesty at all times;

(ii) **Objectivity**
The forensic accountant is paid by a client to carry out an investigation, and the client will presumably be hoping for a particular outcome to the investigation. For example, in a fraud investigation, the criminal investigators who use a forensic accountant may be hoping for evidence of guilt. However, the forensic accountant must remain independent (in spite of the advocacy threat) and should seek to obtain evidence to reach a fair opinion;

(iii) **Professional competence and due care**
Forensic accounting is a specialised area of work, and individuals should be sufficiently competent to do the work;

(iv) **Confidentiality**
The normal ethical rule is that accountants should maintain client's confidentiality, and should not disclose information without the client's consent. An exception is that the duty of confidentiality is overridden by the requirement to provide evidence when requested by a court of law. Legal requirements for disclosure override the rules of client confidentiality; and

(v) **Professional behavior:**
Forensic accountants often appear as witnesses in court, and in the public eye they should display professional behavior and act in a way that is not detrimental to the image of the accounting profession.

(c) Procedures to be followed in forensic investigations

The procedures that a forensic accountant will follow will depend on the terms and the objectives of the engagement.

In many cases, procedures will be similar to auditing procedures and will depend on exactly what is being proved or disproved, these are;

(i) Establishing the objectives of the investigation;

(ii) Planning the investigation with a view to achieving the objectives. For example, in an investigation into suspected fraud, the auditor should plan how to establish whether fraud has occurred, how it could have happened and how long has it been going on – as well as who has committed the fraud and how much has been lost;

(iii) The audit work should be planned in a way that will provide sufficient appropriate evidence to achieve the objectives of the audit. The evidence should be strong enough to 'stand up' to scrutiny in court if required: in fraud cases, audit evidence should therefore try to establish a motive for the alleged fraudster, identify the opportunity that the fraudster had to commit the fraud and also any evidence of measures by the fraudster to conceal his crime;

(iv) Audit evidence may be gathered in various ways – similar to the methods used in a normal audit. This includes interviewing individuals (including individuals suspected of fraud).

Evidence could be obtained by using the following methods:

- Assess the overall control environment and controls in particular, segregation of duties;
- Ascertain the staff of the bank that are charged with the responsibilities of cash taking from customers including posting into the system;
- Obtain a print out or master files from the system in respect of cash takings for the periods;
- Review any unauthorised changes to the system and identify the staff involved; and
- Scrutinise any entries into the suspense account and obtain an explanation as to what each entry relates;

(v) The auditor should use the evidence obtained to form an opinion. If the evidence is insufficient, he should try to obtain additional evidence; and

(vi) At the end of the investigation, a report is prepared for the client.

EXAMINER'S REPORT

The question tests candidates understanding in respect of forensic accounting, forensic investigation and forensic audit.

Being a compulsory question, all the candidates attempted the question and performance was good.

Marking guide	Marks	Marks
(i) Discussion of the concept of forensic accounting	1	
(ii) Two aspects of forensic accounting (½ x 2)	1	
(iii) Explanation of forensic investigation (4 x 1)	4	
(iv) Explanation of forensic audit	2	
(v) Definition of forensic auditing	2	10
(b) Application of ethical principle to forensic Investigation	5 × 2	10
(c) Procedures to be followed in forensic Investigation	5 x 2	10
Total marks		**30**

SECTION B

SOLUTION TWO

a) **Concept of due diligence engagements**

(i) One of the most common forms of direct reporting engagement is '**due diligence**' work. This term refers to any engagement where the practitioner is engaged to make inquiries into the accounts, organisation or activities of an entity.

(ii) Due diligence work is most commonly used in the context of mergers and takeovers. The work involves obtaining information about the target company prior to the takeover (or merger). The objective should be to find out everything that may be relevant about the target company's operations, financial performance, financial position and future prospects. In addition, information should also be gathered about the business environment in which the target company operates.

b) The following items are to be investigated in a due diligence exercise:

(i) **Financial performance and financial position**

The practitioner will look at the available historical financial information about the target company, such as its financial statements for the past few years. Ratio analysis will often be used to make an assessment. The practitioner will also look at the target company's management accounts, budgets and profit/cash flow forecasts, and any current business plan;

(ii) **Operational issues**

The practitioner should also look for any operational issues in the target company that may raise questions about its value. For example, the target company might have important contracts with major customers, and the practitioner should try to find out when these contracts reach their termination date and the probability that the contracts will be

renewed. Other operational problems may be discovered, such as a high rate of labour turnover, high costs incurred in meeting warranties or guarantees to customers;

(iii) **Management representations**
Management of the takeover target may have provided representations to the potential buyer. For example, they might have given a written assurance that the target company is not subject to any tax investigation or potential litigation. Due diligence work should seek to establish that these representations appear to be correct;

(iv) **Identification of assets**
A takeover usually results in purchased goodwill in the consolidated financial statement. However, the takeover target may have several intangible assets that do not appear in its statement of financial position (because they were internally – generated assets) but which should be recognised for the purpose of consolidation. Examples are internally – generated patent rights, customer lists, databases and brand names. These should be identified and valued, for inclusion in the consolidated statement of financial position after the acquisition. It is also useful for the management of the potential buyer to be aware of the nature and estimated value of the intangible assets that they would be acquiring; and

(v) **Benefits and costs of a takeover**
Due diligence may also include an attempt to estimate the future benefits of the takeover, such as cost savings from synergies and economies of scale. Any 'one off' expenses such as redundancy costs and reorganisation costs will have to be estimated – by the potential buyer if not by the due diligence process.

c) **Benefits of using an audit firm for due diligence engagement**
Management could do some or all the due diligence works themselves. However, using an accountancy firm to do the work has two potential benefits thus:

(i) Hiring an accountancy firm to do the work saves management time of the potential buyer. In addition, the practitioners assigned to the due diligence work should have suitable experience in this type of work. For large takeover, the amount of time and resources required to carry out proper due diligence can be substantial.

(ii) Using a professional firm to do due diligence may help to reassure shareholders in the potential buyer (or investors who will be asked to provide loan/finance for the takeover) that the acquisition has been properly evaluated.

d) **Objectives of International Standard on Review Engagements –(ISRE 2400)**

ISRE 2400 Engagements to review financial information sets out the objective of a review of financial statements as follows:

(i) "The objective of such a review is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework"

(ii) Note that a review:
- requires less evidence than an audit; and
- has an opinion that is expressed in negative terms (it gives **'negative assurance'**)

(iii) A review engagement provides a lesser form of assurance than an audit, As a result of this, the work for the review will usually be limited to analytical review and other review procedures. Detailed verification work (for example, substantive tests) will not usually be carried out. This will usually mean that fewer but more experienced staff, will be required for a review engagement than for an audit.

e) ISRE 2400 sets out the following general principles that should be applied to a review engagement. The practitioner should:

i) Comply with relevant codes of ethics;

ii) Plan and perform the work with an attitude of **professional skepticism,** recognising that material misstatements may exist in the information that is subject to review; and

iii) Obtain **sufficient and appropriate evidence**, primarily through inquiry and analytical procedures.

The actual terms of a review engagement should be agreed with the client, and set out in an **engagement letter**.

EXAMINER'S REPORT

The question tests candidate's knowledge in respect of due diligent engagement. About 90% of the candidates attempted the question and performance was good.

Marking guide		Marks	Marks
a)	Explanation of due diligence engagements		2
b)	Items to be investigated in due diligence exercise (1 mark each for 5 points)		5
c)	Benefits of using an audit for due diligence (2½ marks each for two points)		5
d)	*Objectives of ISRE 2400:*		
	Explanation of objective of the review	2	
	Detailed review	3	
			5
e)	General principles to be applied in ISRE 2400 Review		3
Total marks			**20**

SOLUTION THREE

a) **Control Objectives For Information And Related Technologies (COBIT)**

(i) COBIT is an IT governance tool that has been of tremendous benefits to IT professional and has contributed immensely to effective control of information systems. Linking information technology and control practices, COBIT consolidates and harmonises standards from prominent global sources into a critical resource for management control professional and auditors. As such, COBIT represents an authoritative, up-to-date control framework, a set of generally accepted control objectives and a contemporary product that enables the easy application of the framework and control objectives, referred to as the audit guidelines.

(ii) COBIT applies to enterprise-wide information systems, including personal computers, mini-computers, mainframes and distributed processing environments. It is based on the philosophy that IT resources need to be managed by a set of naturally grouped processes in order to provide the pertinent and reliable information which an organisation needs to achieve its objectives.

(iii) COBIT has been developed as a generally applicable and accepted standard for good information technology (IT) security and control practices that provides a reference framework for management, users and information system auditors as well as control and security practitioners.

(iv) The purpose of COBIT is to provide management and business process owners with an information technology (IT) governance model that helps in understanding and managing the risks associated with IT. COBIT helps to bridge the gaps between business risks, control needs and technical issues. It is a control model to meet the needs of IT governance and ensure the integrity of information and information system.

b) Specific components of COBIT are:

i) Management guidelines;
ii) Executive summary;
iii) Framework;
iv) Control objectives;
v) Audit guidelines; and
vi) Implementation tool set

i) **Management guidelines**

To ensure a successful enterprise, one has to effectively manage the union between business processes and information systems. The management guidelines are composed of:

- Maturity models, to help determine the stages and expectation levels of control and compare them against industry norms;
- Critical success factors, to identify the most important actions for achieving control over the IT processes;
- Key goal indicators to define target levels of performance; and
- Key performance indicators, to measure whether an IT control process is meeting its objective.

These management guidelines will help answer the questions of immediate concern to all those who have a stake in enterprise success.

(ii) **Executive summary**

Sound business decisions are based on timely, relevant and concise information. Specifically designed for time pressed senior executives and managers, COBIT includes an executive overview which provides thorough awareness and understanding of COBIT's key concepts and principles. Also included is a synopsis of the framework providing a more detailed understanding of the concepts and principles, while identifying COBIT's four domain (planning and organisation, acquisition and implementation, delivery and support, and monitoring) and 34 IT processes.

(iii) **Framework**

A successful organisation is built on a solid framework of data and information.

The framework explains how IT processes deliver the information that the business requires to achieve its objectives. This delivery is controlled through 34 high-level control objectives, one for each IT process, contained in the four domains. The framework identifies which of the seven information criteria (effectiveness, efficiency, confidentiality, integrity, availability, compliance and reliability), as well as which IT resources (people, applications, technology, facilities and data) are important for the IT processes to fully support the business objective.

(iv) **Control objectives**

The key to maintaining profitability in a technologically changing environment is how well control is maintained. COBIT's control objectives provide the critical insight needed to delineate a clear policy and good practice for information technology controls. Included are the statements of desired results or purposes to be achieved by implementing the specific and detailed control objectives throughout the 34 information technology processes.

(v) **Audit guidelines**

To achieve desired goals and objectives one has to constantly and consistently audit one's procedures. Audit guidelines outline and suggest actual activities to be performed corresponding to each of the 34 high level IT control objectives, while substantiating the risk of control objectives not being met. Audit guidelines are an invaluable tool for information system auditors in providing management assurance and/or advice for improvement.

(vi) **Implementation tool set**

Implementation tool set contains:

- Management awareness and IT control diagnostics
- Implementation guide frequently asked questions (FAQ)
- Case studies from organisations currently using COBIT; and
- Slide presentations that can be used to introduce COBIT into organisations.

The tool set is designed to facilitate the implementation of COBIT, relate lessons learned from organisations that quickly and successfully applied COBIT in their work environments, and lead management to ask about each COBIT process: Is this domain important for our business objectives? Is it well performed? Who does it and who is accountable? Are the processes and control formalised?

EXAMINER'S REPORT

The question tests candidate's knowledge on Information Technology.

About 80% of the candidates attempted the question, but performance was poor.

The commonest pitfall of the candidates was that they could not identify and explain the component of Control Objectives for Information and Related Technology (COBIT).

Candidates are enjoined to read the Institute's Study Text properly and understand the requirements of questions before attempting them.

Marking guide		**Marks**	**Marks**
a) Control objectives for information and related technologies (COBIT) (2 marks for any four)			8
b) Specific components of COBIT:			
Listing	6 x ½	3	
Explanation	6 x 1½	9	12
Total marks			**20**

SOLUTION FOUR

a) The objectives of the auditor in this area, according to ISA 570, are to:

i) Obtain sufficient appropriate evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements;

ii) Conclude whether a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern; and

iii) Determine the implications for the audit report.

This is a subjective area where judgment is usually required to assess the uncertainties surrounding the assumptions that were made by management in reaching their conclusion about the going concern status of the entity.

b) The going concern assumption means that the income statement/statement of comprehensive income and statement of financial position are prepared **on the assumption that the entity will continue in operational existence for the foreseeable future.**

If the entity is **not** a going concern, there will be significant implications for the financial statements.

For example:

- The distinction between 'current' and 'non-current' for both assets and liabilities ceases to have any meaning; all assets and liabilities become 'current';

- All assets must be carried in the statement of financial position at their net realisable value; and

- There may be additional liabilities.

The auditor needs to be satisfied that the going concern assumption is appropriate to the financial statements under audit. This will involve an investigation of the financial and operating position of the client before the end of the reporting period. If this review indicates that the going concern assumption may not be appropriate, further investigation will be needed.

c) **Going concern: duties of the directors**

In preparing the financial statements, the directors must satisfy themselves (in accordance with IAS 1) that the going concern basis is appropriate. In some countries, there is a requirement for large companies (listed companies) to disclose the fact that, in the opinion of the directors, the company is a going concern.

It is therefore the responsibility of management to make the going concern assessment.

d) ISA 570 requires that the auditor must perform **risk assessment procedures** to consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

If management has already performed such an assessment, the auditor must:

- Discuss this assessment with management;

- Determine whether the assessment identified any relevant events or conditions, and, if so;

- Determine management's plans to address them.

If management has not yet performed such an assessment, the auditor must:

- Discuss with management the basis for the intended use of the going concern assumption; and

- Inquire of them whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern.

In evaluating management's assessments, the auditor must consider the same time period. If management looked less than 12 months into the future, the auditor should ask management to make a re-assessment looking at least 12 months into the future. The auditor must also inquire if management is aware of any relevant events or conditions beyond this time period.

EXAMINER'S REPORT

The question tests candidates' knowledge in respect of going concern assumption and implication on financial statements.

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

Marking guide	**Marks**	**Marks**
a) Explaining three (3) objectives 1x3 points	3	
Conclusion on the objectives	2	
		5
b) Meaning of going concern	2	
Implication of not being a going concern	1	
Examples of the implications ($^1/_2$x 2 points)	1	
Conclusion on the explanation of going concern	1	
		5
c) Explaining the going concern duties of the directors		3
d) Requirements of ISA 570 on risk assessment	2	
Under "if management **has** performed the test" ($^1/_2$x any 2 points)	1	
"if management **has not** performed the test" (1 x 2)	2	
Conclusion on evaluation of management's assessment	2	
		7
Total marks		**20**

SECTION C

SOLUTION FIVE

a) The inherent risks associated with the audit of the financial statement of IRP include:

i) Operations have not been audited for the past years implies that controls may be very weak;

ii) Funds for political associations will create the risk of political interference in the operations of IRP;

iii) Management by a family member may indicate risks involving accounting controls and misappropriation;

iv) The expenses of the fund-raising organised are not adequately accounted for suggests the risk of financial statements misstatement;

v) The apparent lack of operational structure could lead to poor business and control decisions;

vi) The risk of freighting through chartered vehicles and operational hindrances for the size of the organisation;

vii) The management being handled by a single family member creates room for business risks for both business and financial statements risks;

viii) Lack of the application of a proper structure and set up for management of IRP;

ix) Regulation and frequency of travels which could lead to loss of funds through non-essential travels.

x) Governance of the NGO appear not to be strong because the Board of trustees meet occasionally and therefore risk may not be adequately monitored

(b) Audit risk areas to be addressed by the auditor in the audit of IRP financial statements include:

i) Understatement of revenue (income from donations);
ii) Overstatement of expenses;
iii) Overstatement of liabilities;
iv) Understatement of current assets (cash and bank balances);
v) Overstatement of non-current assets (PPE);
vi) Fraud (misappropriation of assets); and
vii) Financial statements are prepared for a purpose and it is likely to be misstated.

EXAMINER'S REPORT

The question tests candidates understanding of audit risks.

About 75% of the candidates attempted the question, but performance was poor.

The commonest pitfall of the candidates was their inability to identify the inherent risk associated in the scenario.

Candidates are advised to study the Institute's Study Text properly before embarking on future examination.

Marking guide	**Marks**	**Marks**
a) 2 marks each for any Five points	10	
b) 1 mark for each FIVE (5) risks identified	5	
Total		**15**

SOLUTION SIX

a)(i) Two issues concerning the effect of the loss of the audit journals are:

- Loss of document impacting on the entries and completeness of entries.

- Initial audit engagement will be considered in accordance with ISA 510.

- The absence of the audit journal will lead to an incomplete information of the financial statement.

- Going concern problems
  Also, the going concern status of the company will be assessed in accordance with ISA 570;

- ISA 705 on modification of the audit report. The modification will be based on financial statement misstatement and also inability to obtain sufficient appropriate audit evidence.

(ii) Factors to be considered:

- Loss of accounting documents implying incompleteness of accounting records;

- Loss of financial capability to continue business at expected standard;

- Possible decline in operations and staff strength;

- The competence and skill of the chief accountant will impact on the quality of the financial statements' preparation.

b.) ISA 570 Going concern states the duties of both directors and auditors with respect to the going concern.

The objectives of the auditor with regard to this in accordance with ISA 570 are to:

- Obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements;

- Conclude whether a material uncertainty exists that may cast doubt on the entity's ability to continue as a going concern; and

- Determine the implication for the audit report.

ISA 570 requires that the auditor must perform risk assessment procedure to consider whether there are conditions that may cast significant doubts on the entity's ability to continue as a going concern.

The auditor must:

- Discuss with management the basis for an intended use of the going concern assumption;

- Enquire from management whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern;

- The auditor will consider factors in the following areas on the going concern assumptions:
  - Financial;
  - Operational; and
  - Other issues.

- The auditor will perform additional audit procedures.

c.) Communication between the auditor and the client is necessary in an audit engagement.

In accordance with ISA 260 'communication with those charged with governance', the following will be part of the communication:

- Auditors responsibilities in relation to the audit, including the notification that he is responsible for forming and giving an opinion on the financial statements prepared by management;

- The auditor does not relieve management or those charged with governance of their responsibilities;

- An overview of the planned scope and timing of the audit; and

- After the audit, the auditor will communicate any significant findings from the audit which are called management letter points. They are communicated with any deficiencies in internal control as required by ISA 265.

The management letter will normally include:
- auditor's view on the entity's accounting policies, estimates and financial statement disclosures;
- any significant difficulties encountered during the audit;
- any significant matters arising from the audit brought to the attention of management and written representation requested; and
- any other matters arising from the audit that significant to the oversight of the financial reporting process.

EXAMINER'S REPORT

The question tests candidates understanding concerning audit report.

About 90% of the candidates attempted the question, but performance was poor.

The commonest pitfall of the candidates was their inability to evaluate the required actions of an auditor in relation to observed misstatements.

Candidates are advised to study properly, particularly the Institute's Study Text and have understanding of the questions requirement before attempting the question.

Marking guide	Marks	Marks
a) Issues affecting loss of journal	3	
Any two factors at 1 mark each	2	
		5
b) Introduction of ISA 570	1	
Discussion of objectives of ISA 570 1mk x 2 Duties of the auditor under ISA 570 1mk x 2	2	
	2	
		5
c) Necessity for communication	1	
Requirements of ISA 260	2	
Management letter points 1mk x 2	2	
		5
Total		**15**

SOLUTION SEVEN

a) **Concept of Joint Audit**

- A joint audit involves two (or more) audit firms appointed to audit the financial statements of an entity.

- Joint audit may occur in other situations, but they are most commonly found in group audits. In particular, when a group acquires a new subsidiary, it is not unusual to appoint the group's auditors jointly with the subsidiary's existing auditors, at least for a period of time after the acquisition.

- The joint audit provides a joint opinion on the financial statements of the subsidiary.

- The key to a successful joint audit is good communication between the firms, including **joint planning meetings** and **regular discussions** between the firms at all key stages of the audit process. The meetings and discussions should be **fully documented.**

b) **Reasons for the desirability of joint audit**

The reasons why joint auditors might be appointed include the following:

(i) The client company may be so large that it requires the services of more than one firm of auditors;

(ii) After the acquisition of a large subsidiary, using joint auditors may help the transition process while the group auditors become familiar with the new subsidiary. The 'old' auditors should be familiar with the business of the subsidiary and should pass their knowledge over to the parent company's auditors. For the parent company's auditors,

this should accelerate the process of getting to know the business of the new subsidiary;

(iii) Joint auditors may provide a higher level of technical expertise than either audit firm could provide individually;

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

(v) It has been suggested that two medium – sized audit firms might 'join forces' and tender for the audit of a company for which the auditors would normally be one of the 'Big' audit firms. This is possibly a way in which medium – sized firms might try to 'break the monopoly' of the Big 4 on large company audits.

c) **Possible setbacks for engagement in joint audit**

Possible disadvantages of joint audit include the following:

(i) Extra cost to the client: it is likely to cost more to use two audit firms than to use one;
(ii) Possible inconsistencies between the joint auditors in the audit methods that they use. If so, there may be problems in reaching agreement on whose audit method to use;
(iii) The possible difficulty that the two firms may have in agreeing on the division of work;
(iv) Additional problems that will arise in monitoring and controlling the audit work of two different firms;
(v) The two firms may find it difficult to work well together, and each firm may try to become the lead firm in the joint audit; and
(vi) If there is a claim against the auditors for negligence in the conduct of the audit, there may be some difficulty in identifying which of the joint auditors is potentially liable.

EXAMINER'S REPORT

The question tests candidates understanding in respect of joint audit.

About 95% of the candidates attempted the question and performance was good.

Marking guide	Marks	Marks
a) Concept of joint audit (2½ marks for any 2 points)	5	
b) Reasons for desirability of joint audit (1 mark each for 5 points)	5	
c) Possible setbacks for engagement in joint audit (1 mark each for 5 points)	5	
Total		**15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2019

CASE STUDY

Time Allowed: 4 hours (including reading time)

INSTRUCTION: YOU ARE TO USE THE CASE STUDY ANSWER BOOKLET FOR THIS PAPER

Case study

You are Josephine Desmond, writing the Professional level of ICAN examination. You are working in the Lagos office of Adewale, Okechwuku, Gana & Co (chartered accountants) which has its offices in all the state capitals of the country. You are reporting to Alex Gana, the partner in charge of the business advisory unit of the firm.

Your responsibilities include:

- Preparing detailed financial analysis and reports on the performance of your business advisory clients;

- Analysing your clients' financial statements to identify area of weaknesses and proffering likely solutions to correct the anomalies;

- Assessing operational and strategic business proposals submitted by clients for analysis to see how each aligns with the clients' objectives and its impact on its business and financial risks;

- Assessing clients' financial and business forecast together with the assumptions upon which they are based to form judgements and recommendations to your supervising partner; and

- Drafting reports to be submitted to clients on the result of clients' financial, operational and strategic business analyses you have carried out.

Your responsibilities demand that you keep yourself abreast of your clients' industries and external operating environment so as to be able to contribute objectively to the assigned tasks.

Your business advisory partner, Mr. Alex Gana, has just received the management accounts of one of your firm's business advisory clients, Spicey Restaurant Limited, for the year ended 31 December, 2018 together with a business proposal for

evaluation and advice. Your partner has sent you an email (exhibit 1), attaching the documents for you to work on and prepare a report for him, showing your conclusion and recommendations, for submission to the directors of Spicey Restaurant Limited.

The following overall time allocation is suggested:

Reading	1 hour
Planning and calculations	1 hour
Drafting the report	2 hours

LIST OF EXHIBITS

Exhibit	Description
1	Email from Alex Gana to Josephine Desmond
2	Email from Henrietta Jones, the Managing Director of Spicey Restaurant Limited to Alex Gana.
3	Spicey Restaurant Limited's 3-year management accounts, from 2016 – 2018, together with appropriate notes
4	History of catering industry in Nigeria
5	Spicey Restaurant Limited: history, operations, board and management
6	Spicey Restaurant Limited's cost/pricing structure
7	Proposed contract terms received from Lagus Hospitals Limited (LH)
8	Press article on the food industry in Nigeria and the need for quality control

Exhibit 1

MEMO

From: Alex Gana

To: Josephine Desmond

Subject: Spicey Restaurant Limited

Date: 6 March, 2019

As usual, Spicey Restaurant Limited (SR) has just completed another successful year of trading and has asked us to evaluate its performance in the past year and at the same time analyse the financial impact of its new business opportunity. SR has been approached by Lagus Hospitals Limited (LH) to provide catering services for its five hospital units in the Lagos metropolis. I attach herewith exhibits 2 to 8 which include SR's management accounts for the year ended 31 December, 2018, business proposal from LH, together with other write-ups that could assist you in your analyses.

You are to carry out a detailed analysis of the management accounts and prepare a report for SR's board. You are also required to carry out an evaluation and appraisal of the business proposal and recommend appropriate course of actions to be taken by SR.

Please draft for my review, a report addressed to the board of SR. The report should comprise:

1. A review of SR's management accounts for the year ended 31 December, 2018 as presented in Exhibit 3. Your review should include an analysis of the key changes in revenue, costs and overheads across its 2 revenue streams by comparison with the previous two years. You should evaluate the impact of these changes on SR's operating profit. In addition, please comment on the reasons for non-cash balance despite the huge profits made in the years;
2. A financial assessment of the catering contract from LH, as contained in exhibit 7 and a discussion of any broader commercial and ethical considerations as well as the risks that may be associated with accepting this contract.

I look forward to receiving your draft report.

Alex Gana

Exhibit 2

EMAIL

From: Henrietta Jones – Spicey Restaurant Limited

To: Alex Gana – Adewale, Okechukwu, Gana & Co

Subject: Spicey Restaurant Limited

Date: 4 March, 2019

Alex,

As you know, we have completed another successful year of trading and as usual, our board would like you to carry out a review of our performance during the year. Your review should comprise of an analysis of key changes in revenue, costs and expenses, across the two revenue streams and comparison with the two previous years. The board would also like you to explain the reasons for the little or no cash balance at the end of the year despite the huge profit.

We have also received a proposal from Lagus Hospitals Limited (LH), to provide in-house catering services for all the patients and staff of its five hospital units within the Lagos metropolis. It is great to receive this interest from a major new client, more so, as you are also aware, one of our most important existing contracts, with Dove group of schools expires on 30 June, 2019 and we do not know whether Dove would renew this contract or not. However, whichever way it goes, with this new contract coming from LH, we would be fine. Therefore, our board would like you to evaluate this proposed contract and advise on its possible effect on SR's future revenue and to highlight any ethical and business trust you would want our board to consider.

I have provided as much information as I can on LH (proposed contract terms) and you should still have some information on Dove as our client in your file. Our costing and payment terms for Dove is essentially the same with this proposed contract from LH. But you may need to take note of the following regarding the costing of the LH contract proposal:

- The actual costs of table water to SR are 75cl, ₦45 and 1.5 litres, ₦90 per bottle; and
- Management time estimated to be spent on LH contract per month is 400 hours and our management time charge out rate is ₦1,000 per hour.

Thanks for your continued efforts,

Henrietta

Exhibit 3

Spicey Restaurant Limited
Statement of financial position as at 31 December

	Notes	2016	2017	2018
		₦'000	₦'000	₦'000
Non-current assets	1	136,927	134,429	126,696
Current assets	2	4,125	5,516	6,183
Current liabilities	3	(34,657)	(28,615)	(23,957)
Total net assets		106,395	111,330	108,922
Financed by				
Share capital		1,000	1,500	1,500
Revenue reserve		110,145	166,168	212,573
Directors current account		(13,764)	(63,802)	(105,151)
Shareholders fund		97,381	103,886	108,922
Term loan		9,014	7,464	-
		106,395	111,330	108,922

Spicey Restaurant Limited
Income statement as at 31December

		2016	2017	2018
		₦'000	₦'000	₦'000
Revenue	4	254,299	193,739	170,000
Less cost of sales	5	94,667	60,566	49,854
		159,632	133,173	120,146
Other income		688	540	646
Gross profit		160,320	133,713	120,792
Admin expenses		57,048	41,786	44,295
Finance cost		1,185	891	-
Depreciation		6,519	8,649	8,255
Total expenses		64,752	51,326	52,550
Net profit before tax		95,568	82,387	68,242
Tax expense		(30,582)	26,364	21,837
Net Profit after tax		64,986	56,023	46,405

Note 1: Non-current assets

Cost

	Land & building ₦'000	Plant & equipment ₦'000	Motor vehicles ₦'000	Furniture & fittings ₦'000	Total ₦'000
Cost at 1/1/2016	120,000	11,850	5,250	14,183	151,283
Additions	-	-	-	-	-
Cost at 31/12/2016	120,000	11,850	5,250	14,183	151,283
Depreciation					
As at 1/12/2016	-	3,493	-	2,608	6,101
For the year	-	2,930	2,488	2,837	8,255
As at 31/12/2016	-	6,423	2,488	5,445	14,356
Carrying amount 31/12/2016	**120,000**	**5,427**	**2,762**	**8,738**	**136,927**

Cost	Land & building ₦'000	Plant & Equipment ₦'000	Motor vehicles ₦'000	Furniture & fittings ₦'000	Total ₦'000
Cost at 1/1/2017	120,000	11,850	5,250	14,183	151,283
Additions	-	-	6,150	-	6,150
Cost at 31/12/2017	120,000	11,850	11,400	14,183	157,433
Depreciation					
As at 1/12/2017	-	6,423	2,488	5,445	14,356
For the year	-	2,962	2,849	2,837	8,648
As at 31/12/2017	-	9,385	5,337	8,282	23,004
Carrying amount 31/12/2017	**120,000**	**2,465**	**6,063**	**5,901**	**134,429**

Cost	Land & building ₦'000	Plant & equipment ₦'000	Motors vehicle ₦'000	Furniture & fittings ₦'000	Total ₦'000
Cost at 1/1/2018	120,000	11,850	11,400	14,183	157,433
Additions	-	-	-	523	523
Cost at 31/12/2018	120,000	11,850	11,400	14,706	157,956
Depreciation					
As at 1/12/2018	-	9,386	5,337	8,281	23,004

For the year	-	2,464	2,850	2,942	8,256
As at 31/12/2018	-	11,850	8,187	11,223	31,260
Carrying amount					
31 Dec 2018	**120,000**	**-**	**3,213**	**3,483**	**126,696**

Note 2

	2016	2017	2018
	₦'000	₦'000	₦'000
Current assets			
Inventory	4,125	4,775	4,386
Receivables	-	251	-
Bank / cash	-	490	1,797
	4,125	5,516	6,183

Note 3

Current liabilities			
Trade Payables	4,075	1,460	2,120
Accounts Payables	30,582	27,155	21,837
	34,657	28,615	23,957
Share capital			
Issued and fully paid	1,000	1,500	1,500

Note 4

Revenue			
Drinks	82,297	77,980	68,705
Food	172,002	115,759	101,295
	254,299	193,739	170,000

Note 5

Cost of sales:			
Drinks	24,277	20,821	16,720
Food	70,390	39,745	33,134
	94,667	60,566	49,854

Exhibit 4

History of catering industry in Nigeria

The history of catering industry in Nigeria started with the Nigerian Railway Caterers, managed by Mr. Roberts Foth who operated it as a catering service on the Nigerian Railway Corporation cabins and it consists of restaurant and bar. The company was later taken over by the Nigerian Railway Corporation and registered as a limited liability company which was later sold to the Nigeria UAC and G B Olivant. The company's name was changed to Nigerian Hotel Limited in 1946.

In 1962, Mr. Foth took over the management of the hotel and expanded its operations. The hotel, which started as a guest house grew to become Ikoyi Hotels. By 1974, the hotel was managing the following hotels:

i. Ikoyi Hotels, Lagos;

ii. Airport Hotels, Lagos;

iii. Bristol Hotels, Lagos;

iv. Arewa Hotel, Kaduna;

v. Sokoto Hotel, Sokoto;

vi. Lake Chad Hotel, Maiduguri;

vii. Hill Station Hotel, Jos;

viii. Premier Hotel, Ibadan;

ix. Lafia Hotel, Ibadan; and

x. Metropolitan Hotel, Calabar.

The first private hotel in Nigeria was established by Nicholas at No 6, Broad Street, Lagos, known as, Olympic Hotel and the second one was Grand Hotel, Idumota, Lagos.

Since 1960s, Nigeria has had one of the fastest population growth rates in the world. In 2010 almost half of all Nigerians live in cities - a number totaling 73 million. As more people choose to settle in Nigeria's crowded cities, the time to prepare meals has become more demanding. With more women joining the work force, their traditional roles have changed. As a result, many urban people now opt to eat some of their meals outside the home. To meet the demand, many small restaurants known as '*bukkas*' have sprung up all across Nigerian cities to serve the

working population. These restaurants generally serve Nigerian traditional meals either in open-air areas or in low-cost small rudimentary dining buildings. Their meals are relatively cheap and as a result, they have gained a high level of patronage among the Nigerian urban masses.

More recently, modern Nigerian fast food restaurants have also sprung up to cater for a more up-market consumers with western tastes. Modern fast food restaurants place emphasis on cleanliness, hygiene, comfort and well maintained dining environment. These restaurants serve western snacks and fast foods and ice cream together with traditional Nigerian dishes.

Modern fast food restaurants have experienced rapid growth over the past decades recording almost 30% year-on-year to reach a total revenue of approximately $400 million from around 800 outlets in 2009. Expansion in telecommunications, banking, and retailing has meant that many more Nigerians are joining the middle class with increased disposable income.

In addition, modern fast food companies have gained increased access to capital through bank loans, private equity and stock market listings to roll out many more outlets around primary Nigerian cities such as Lagos, Abuja and Port Harcourt. However, the industry faces many obstacles including instability in power supply, security, negative global publicity and the effects of the general issues facing the growth of tourism in Nigeria.

Restaurant chains have emerged as part of the changing face of Nigeria. While Nigeria has always had restaurants of all classes, the new entrant belongs to middle income fast food along the chain. The likes of Mama Cass, Chicken Republic, T.F.C, Tantalisers and Mr. Biggs have taken up the race, building multicity chains of restaurant all over the country. These chains have an average rate from ₦1,500 per plate, depending on the class of the restaurants and the location. They have been highly successful and represent the highest change in the industry.

The low end still exists, known as *"mama put"*, these road side restaurants give the general public access to restaurant dining, their range is incredible and based on the individual setup run by each proprietor. The price per plate can run from as low as ₦100 - ₦1,500.

There exists a rising high end characterised by high rates and located mainly in the major cities like Lagos and Abuja. These "true" restaurants offer high end dining with global palettes from Chinese, Japanese to Italian foods.

Another strong feature in the industry are hotel restaurants, they are a major attraction for any hotel in Nigeria and correspond in quality to the hotels in which

they are situated. They present a reasonable value proposition to travelers who are not always comfortable venturing outside of their hotels for various reasons.

Exhibit 5

Spicey Restaurant Limited: History, operations, board and management

History

Spicey Restaurant Limited (SR) was established by Mrs. Henrietta Jones. Mrs. Jones was a trained nurse and has worked at the General Hospital, Lagos for several years. She is naturally talented with the art of cooking and hospitality and enjoys cooking and catering for family and friends.

In January, 2009, Mrs. Jones decided to pursue her natural bent. She resigned from the General Hospital and with the assistance of her husband, got a land at a very good location in the city where she built Spicey Restaurant. Her husband, Dr. Jones, being a very popular man in the society, ensured that the opening of the restaurant, in September 2009, was attended by who is who in Lagos. This led to high patronage from the middle and high class customers, which the restaurant has been enjoying since then.

Right from the inception, Mrs. Jones left no one in doubt that Spicey Restaurant is out to cater only for the highbrow of the society and not a restaurant for all commoners. SR, as it is commonly advertised, is a classy restaurant and the environment shows this very clearly.

Operations

SR is equipped with modern catering equipment, starting from the kitchen to the dining area and bar. Giant freezers were installed around the kitchen area for preservation of food items. Sometimes, cooked or per boiled food are also stored in these freezers.

Generally, meals are prepared to order, but some basic food items such as rice, beans, vegetables, fish and meat are cooked and preserved in the freezers to ensure they are made ready for customers immediately orders are placed. Local dishes such as pounded yam, garri, yam flour, etc. are generally prepared to order. Sometimes, some of these food items overstayed in the freezer and the kitchen staff have to add special seasoning flavour to preserve their taste to prevent customers' complaints.

Relationship with industry regulatory agencies

SR ensures it has a cordial relationship with the officials of the regulatory agencies in the industry. Public relation expenses are used to take care of these officials from time to time. Therefore, SR does not need to bother about troubles from these agencies for not complying with rules and regulations. This allows SR to flout some of these regulations sometimes with impunity.

Board and management of SR

SR is run by a board of 4 directors, Dr Jones as the chairman, Mrs. Jones as the managing director and two of their children as non-executive directors. Only Mrs. Jones works as an executive of SR and she is assisted by a General manager who is a seasoned caterer. The management team comprises of:

Mrs Henrietta Jones	Managing director
Mrs. Dupe Thomas	General manager
Mr. Jude Chukwu	Accountant
Hajia Kudrat Sanni	Purchasing manager

Exhibit 6

Spicey Restaurant Limited

Cost/pricing structure

The following cost structure will apply to every contract:

Estimated average cost/pricing per plate – any local dish

	₦'000
Food item	250.00
Protein	500.00
	750.00
Profit	1,750.00
Administrative charges	150.00
Transportation cost	50.00
Facility charges	200.00
Service charges	100.00
Price per plate	3,000.00

Estimated average cost/pricing per plate – Continental

Food item	500.00
Protein	500.00
	1,000.00
Profit	2,500.00

Administrative charges	150.00
Transportation cost	50.00
Facility charges	200.00
Service charges	100.00
Price per plate	**4,000.00**

	₦
Fish Pepper soup	1,500.00 per plate
Goat meat Pepper soup	1,500.00 per plate
Chicken Pepper soup	2,000.00 per plate
'Asun' goat meat	1,500.00 per plate
Sandwich	2,500.00 per portion
Small chops	2,000.00 per plate

Estimated price for drinks

	₦
Bottled water - small 75cl	150.00
big 1.5 liters	300.00
Any soft drink	300.00
Beer/stout - per glass	400.00
Brandy - lower end - per shot	500.00
- medium level - per shot	750.00
- high end - per shot	1,000.00
Champagne - per shot	1,500.00
Chapman - per glass	500.00

Note

1. This price structure could be varied for each contract service, depending on the terms of each contract. However, food and drinks served at the restaurant are at prices quoted per plate.

2. The labour cost per hour included in the above cost structure is ₦200 and ₦300 for staff and supervisor respectively.

3. Administrative, facility and service charge are apportionment of the company's overheads as they are not specifically incurred per plate of food served.

Exhibit 7

Proposed contract terms with SR – draft written commitments received from Thorpe Jones, Medical Director, Lagus Hospitals Limited (LH)

(i) LH would agree to a 3-year rolling contract, renewable annually, for provision of catering services to the patients and staff in all LH five hospitals within Lagos metropolis.

(ii) The contract will commence from 1 July, 2019.

(iii) LH will provide space and equipment for cooking and all other auxiliary equipment.

(iv) Under the proposed contract, SR would be required to subject its staff, who are to work in the hospital restaurant, to annual medical checks, the cost of which would be borne by SR.

(v) SR would be required to provide staff from 6 am to 11pm and at least 15 SR staff would need to be in each hospital at all times, this should include 2 supervisors. The staff are expected to work in two shifts per day, morning and afternoon.

(vi) SR would be required to provide all food stuff and other ingredients

(vii) All invoicing would be done monthly and would be settled by LH within five working days.

(viii) SR would maintain a record for food served in each hospital daily, this should be sent to LH accounts department on a weekly basis. Any bill not supported with a record of food served would not be paid.

(ix) SR would be required to cook three menus, two local and one continental daily. Menu list for each day would be agreed with the Director of Nursing for each day on a weekly basis.

(x) SR would provide breakfast, lunch and dinner for the hospital patients and lunch only for the hospital staff on a daily basis.

(xi) LH would have to specify the type of seasonings for all meals to be served.

(xii) SR would only be allowed to serve water with the food as no soft drink would be allowed in the hospital restaurant.

(xiii) LH proposed to pay only 50% of SR's current price per plate, for both local and continental menu. This price includes one 75cl bottle of water per meal.

(xiv) LH guarantees a minimum of 20 breakfasts, 50 lunches and 20 dinners per day in each hospital.

(xv) LH will charge SR ₦5,000 per staff for annual medical check-up.

Exhibit 8

Press article

Nigerian Business Digest

The food industry in Nigeria and the need for quality control

Nigeria like many other developing countries faces the challenge of providing adequate food supply for its teeming population. Policies and programmes aimed at boosting agricultural and food production are being actively promoted. However, Nigeria needs to take appropriate and pragmatic steps to ensure food safety and quality for domestic consumption and export. An effective national food safety policy is needed to provide assurance that food supplied to the consumers is nutritious, of good quality and wholesome. The government of Nigeria launched the National Policy of Food Hygiene and Safety in 2000 as an integral part of the Nigerian National Health Policy. The overall goal of this policy is the attainment of high level of food hygiene and safety practices which will promote health, control food-borne diseases, minimise and finally eliminate the risk of diseases related to poor food hygiene and safety. The policy seeks to stimulate and promote legislations concerning food in areas of production, storage, handling, processing, preservation, trade, transportation and marketing. It also seeks to improve the quality of healthcare through ensuring that all food consumed in Nigeria, whether imported or locally produced are wholesome, nutritious, free from contaminants and accessible to the consumers at affordable prices. Implementation of the policy is aimed at addressing the unsatisfactory level of food hygiene and safety practices which to a large extent is responsible for the prevalence of food-borne diseases in Nigeria.

Quality control is also the ongoing effort to maintain the integrity of a process in order to maintain the reliability of achieving an outcome. In food processing, controllable factors that either positively or negatively influence the finished products are referred to as the quality control. To be able to achieve product of consistent and high quality, the use of good and sound raw materials is of optimum importance. Maintenance of quality also means there should be set standards which will serve as guidelines in the assurance of consumer protection and safety, as well as being related to improving future processing. Quality standards should ensure that food suitable for consumption is processed in a hygienic manner, is nutritious and safe.

In food processing, the general rule is that effective methods must be carefully applied to conserve the original qualities of the raw materials because processing cannot improve the raw materials. Some of the main objectives of quality control in the food industry are to ensure that food laws are complied with in an effective

manner, to protect consumers from dangers and ensure that they get the proper quality and weight as per payments.

Therefore, a preventive strategy based on thorough analysis of prevailing conditions which ensures that the objectives of the quality assurance programme are met is recommended for the food industry. Producers at all stages of production, processing and distribution must be responsible for safe food and should establish food safety assurance programmes, while the government on the other hand, should play the primary role of providing leadership for the implementation of the food safety assurance system.

A total food chain approach to the production and delivery of safe food to consumers is a responsibility that encompasses all stakeholders throughout the food chain. These include farmers and the suppliers of farm produce, slaughterhouse and packinghouse operators, food manufacturers, transport operators, wholesale and retail traders, caterers and street vendors and the product laboratory certification and enforcement agencies.

Globalisation of food supplies has necessitated attention on how to strengthen measures taken to ensure quality and safety, especially of imported foods. Different countries have specific regulations, legislations, guidelines and Acts which are considered necessary to be complied with by food industry when they process their products. It is the responsibility of the government to ensure that the established standards, legislations and enforcement programmes are kept by the food industry.

In Nigeria, the responsibilities for regulating and monitoring food safety standards and practices devolve on the following government organisations and agencies:

(a) National Agency for Food and Drug Administration and Control (NAFDAC);

(b) Federal Ministry of Health;

(c) Standards Organisation of Nigeria (SON);

(d) National Codex Committee;

(e) Federal Ministry of Agriculture; and

(f) States and Local Governments Ministries and Departments.

The National Agency for Food and Drug Administration and Control (NAFDAC) is the major agency responsible for regulating and controlling the manufacture, importation, exportation, advertisement, distribution, sale and use of food, drugs, cosmetics, medical devices, chemicals and pre-packaged water. However, in line

with the government policy on Food Hygiene and Safety, responsible agencies are mandated to:

- Protect the public against injury to health through the consumption of unwholesome food;
- Restrain the sale of foods which are un-hygienically prepared, adulterated, contaminated, spoilt, and improperly labelled;
- Ensure proper inspection and registration of all food premises;
- Conduct public health surveillance of food premises, food handlers and equipment used for food processing;
- Educate the populace on sound hygiene and safety practices;
- Ensure inter-ministerial and multi-sectional collaborative activities; and
- Collaborate with non-governmental organisations and ensure community participation.

Towards the achievement of the objectives of the policy, the collective activities of the responsible agencies are performed through regulations, regular inspection and surveillance activities and registration of premises. Furthermore, company certification and award procedures for manufacturers who meet the requirements of the relevant standards are in place.

However, it is a common knowledge that some unscrupulous operators in the food chain usually connived with staff of these agencies to issue certification to some operators in the food chain, especially restaurants, without due regard to laid down procedures and quality standard because their palms have been greased.

Also, quality standards play critical role to facilitate goods and services exchanged across borders. In the importation of foods to Nigeria, some major food safety and quality problems encountered are:

- Spoilage and nearness to expiry dates;
- Poor handling and dehydration;
- Substandard/fake products;
- Non-indication of production dates;
- Deceitful labelling;
- Over pricing; and
- Instruction manuals in foreign languages

These food safety and quality problems encountered in the importation of foods can be eliminated if conscientious efforts are made by the regulatory bodies of the individual countries to keep to established international and local standards. If implemented, this will raise the quality, safety and reliability levels of food products and will definitely provide economic benefits.

ICAN CASE STUDY 2019

First Marking

DATE		**CANDIDATE NO.**	

TIME		**MARKER NUMBER**	

	Req 1	Req 2	Overall	TOTAL
SA				
CA				
BC				
NC				
V				
Total	8	8	4	20

SUPERVISOR SIGNATURE		**CHECKER SIGNATURE**	

Changes made? ☐

REQUIREMENTS 1 – Spicey Restaurant's financial statement analysis

USES DATA AND INFORMATION APPROPRIATELY

- Uses information on Exhibit 3 – Income statement to show trend of SR operating performance.
- Uses information provided on Exhibit 3 –statement of financial position to calculate return on capital employed.
- Uses information in Exhibit 3 – notes to management accounts to show trend in performance of each revenue stream.
- Uses information provided in Exhibit 3 to provide cash flow analysis to show the reasons for low or nil cash balance.

V	NC	BC	CA	SA

USES PROFESSIONAL TOOLS AND KNOWLEDGE

- Calculates gross margin ratios.
- Calculate profitability per revenue stream.
- Calculates net profit margin.
- Prepares trend analysis to determine growth in performance of SR.
- Prepares cash flow analysis to show movement in cash balances.

V	NC	BC	CA	SA

USES ANALYTICAL SKILLS (material points) written report

- Determines trend in SR's revenue.
- Determines trend in SR's gross margin.
- Determine trend in SR's expenses to revenue.
- Determines trend in performance of each revenue stream.
- Determines trend in return on capital employed.

V	NC	BC	CA	SA

IDENTIFIES ISSUES AND OPTIONS

- Identifies that the food industry has been growing in Nigeria.
- Identifies the challenges of power supply and security in the industry.
- Identifies that SR does not have a strong board that can drive strategic growth.

V	NC	BC	CA	SA

APPLIES PROFESSIONAL SCEPTICIM AND ETHICS

- Recognises the threat that the continuous drop in revenue pose to SR's future performance and existence.
- Recognises the ethical issues involved in settling the industry regulators unofficially.
- Recognises that cash has been diverted from SR from year to year leaving small or no cash balance.
- Recognises the risks of flouting industry regulations.
- Recognises the ethical issue involved in serving food that has overstayed in the freezer and adding tii much seasoning to them.

V	NC	BC	CA	SA

EVALUATE SKILLS AND JUDGEMENT

- Identifies that SR's revenue have been dropping from year to year.
- Identifies that rate of cost of sales of revenue has been decreasing.
- Identifies that SR's gross margin has been increasing.
- Identifies that SR's rate of expenses to revenue have been increasing.
- Identifies that return on capital employed has been dropping yearly.

V	NC	BC	CA	SA

CONCLUSION
(Draws distinct conclusions under a heading)

- Concludes that SR management should identify reasons for the drop in revenue from year to year.
- Concludes that SR should reconsider serving stale foods to avoid loss or customers.
- Conclude that cash for working capital should be retained in the business for future growth.
- Concludes that restaurant business is a good and growing business in the country and could be a money spinner if the right strategy is put in place.

V	NC	BC	CA	SA

RECOMMENDATIONS (Commercial/relevant)

- Recommends that SR management should take immediate step to arrest the continuous drop in revenue.
- Recommends that SR's management should stop the flouting of industry regulations.
- Recommends that cash for working capital should be left in the business.
- Recommends the SR's management should exercise tighter control over all expenses.
- Recommends that SR should stop serving stale foods to customer.

V	NC	BC	CA	SA

SA	
CA	
BC	
NC	
V	
Total	8

REQUIREMENT 2 Appraisal of LH's contract proposal

USES DATA AND INFORMATION APPROPRIATELY

- Uses information in Exhibit 6 to determine selling price per meal to LH.
- Uses additional information on Exhibit 6 to determine cost of sales on LH contract.
- Uses information on Exhibit 7 to determine no of meals to be sold in LH's hospitals annually.
- Uses information on Exhibit 7 to determine yearly salaries on LH contract.
- Uses information Exhibit 7 to determine cost of annual medial check for staff.
- Uses information in Exhibit 2 to determine contribution of the contract.

V	NC	BC	CA	SA

USES PROFESSIONAL TOOLS AND KNOWLEDGE
(Written into report)

- Determines no of meals to be served yearly on LH contract.
- Determines total cost of sales for LH contract.
- Determines labour cost of LH contract.
- Determines total charges on management time on LH contract.
- Determine LH's charges on staff medical examination yearly.

V	NC	BC	CA	SA

USES ANALYTICAL SKILLS (material points)

- Calculates total yearly revenue from LH contract.
- Calculates the yearly total cost of sales on LH contract.
- Calculates the gross yearly contribution from LH contract.
- Calculates the net yearly contribution from LH contract.

V	NC	BC	CA	SA

IDENTIFIES ISSUES AD OPTIONS

- Identifies that the gross margin on LH contract is lower than the normal margin of SH's normal margin.
- Identifies that the cost of seasonings chosen by LH may be more than what SR provided for in its cost structure.
- Identifies that SR should explore the possibility of reducing the no of staff to be in each hospital per day.
- Identifies that SR should press for settlement of its bill weekly by LH so that much cash will be tied down on the contract.

V	NC	BC	CA	SA

APPLYING PROFESSIONAL SCEPTICISM AND ETHICS

- Queries whether LH would pay for the minimum guaranteed meals per day in case there is a drop any day on no of meals served..
- Queries why SR has to maintain such no of staff in each of LH's hospital per day..
- Expresses the fact that there is no provision for increase in price of menu during the period of the contract, even if the cost of food items go up.
- Expresses treat to staff safety in going back home after closing by 11.oop.m.

V	NC	BC	CA	SA

EVALUATIVE SKILLS AND JUDGEMENT
(Uses analytical heading)

Evaluates the terms of the LH contract.

Evaluates effect of LH contract on SR's overall yearly performance.

Evaluates the yearly net contribution of LH contract and determine whether it is worthwhile for SR to accept the contract.

Evaluate the effect on SR staff closing by 11.00pm on a daily basis.

V	NC	BC	CA	SA

CONCLUSIONS
(Draws distinct conclusions under a heading)

- Commends on the possibility for SR to discuss some terms of the contract to make the contract more favourable..
- Concludes on the acceptability of LH contract by SR.
- Concludes that the contract will results in net positive contribution to SR.
- Concludes that the contract may help SR in overcoming the yearly drop in its revenue.

V	NC	BC	CA	SA

RECOMMENDATIONS (commercial/relevant)

- Recommends that SR's management should try and see whether some unfavourable part of the contract terms could be renegotiated.
- Recommends that SH's management should negotiate for weekly settlement of SR invoice by LH.
- Recommends that SR should accept the contract since it will result in positive contribution.
- Recommends that SR should negotiate to bring closing time to 10pm by SR staff working in LH.

V	NC	BC	CA	SA

SA	
CA	
BC	
NC	
V	
Total	8

Appendices

Appendices R1: Content and style

- Shows trend of SR's operating performance – income statement.
- Shows trend in performance by revenue streams.
- Shows appropriate performance ratios.
- Shows trend in operating expenses to revenue.
- Show return on capital employed.

V	NC	BC	CA	SA

Appendices R2: Content and style

- Shows price per meal LH id prepared to pay.
.
- Shows numbers of meal per annual divided between local and continental dishes.
- Shows annual revenue from contract.
- Shows gross contribution per annum
- Shows net contribution per annum.

V	NC	BC	CA	SA

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Main Report

Report: Structure

- Sufficient appropriate headings.
- Appropriate use of paragraphs/sentences.
- Legible/clear handwriting.
- Correctly numbered pages.

V	NC	BC	CA	SA

Report: Style and language

- Relevant disclaimer (external report).
- Suitable language for the board.
- Tactful/ethical comments.
- Acceptable spelling and punctuation.

V	NC	BC	CA	SA

CC	
SC	
IC	
ID	
NA	
Total	

Appendice 1							
Financial statement analysis							
Spicey Restaurant Limited	**2016**	**2017**	**CHANGE**	**CHANGE %**	**2018**	**CHANGE**	**CHANGE %**
	N'000	**N'000**	**N'000**		**N'000**	**N'000**	
Revenue	254,299	193,739	-60,560	-23.8	170,000	-23,739	-12.3
Cost of sales	-94,667	-60,566	34,101	-36.0	-49,854	10,712	-21.5
Gross profit	159,632	133,173	-26,459	-16.6	120,146	-13,027	-10.8
Admin expenses	-57,048	-41,786	15,262	-26.8	-44,295	-2,509	5.7
Finance cost	-1,185	-891	294	-24.8	0	891	
Depreciation	-6,519	-8,649	-2,130	32.7	-8,255	394	-4.8
Other income	688	540	-148	-21.5	646	106	16.4
Net profit	95,568	82,387	-13,181	-13.8	68,242	-14,145	-20.7
Revenue – Drinks	82,297	77,980	-4,317	-5.2	68,705	-9,275	-13.5
Cost of sales	-24,277	-20,821	3,456	-14.2	-16,720	4,101	-24.5
Gross profit	58020	57159	- 861.0	- 1.5	51985	- 5,174.0	- 10.0
Gross margin	70.5	73.3	2.8	4.0	75.7	2.4	3.1
Revenue – Food	172,002	115,759	-56,243	-32.7	101,295	-14,464	-14.3
Cost of sales	-70,390	-39,745	30,645	-43.5	-33,134	6,611	-16.6
Gross profit	101,612	76,014	- 25,598.0	-25.2	68161	-7853	-10.3
Gross margin	59.1	65.7	6.6	11.2	67.3	1.6	2.4

Ratios	2016	2017	2018
Gross Profit margin	159632/254,299%	133,173/193739%	120,146/170,000%
	62.8%	68.7%	70.7%
Cost of sales to revenue	94,667/254,299%	60,566/193,739%	49,854/170,000%
	37.2%	31.3%	29.3%
Net profit margin	95,568/254,299%	82,387/193,739%	68,242/170,000%
	37.6%	42.5%	40.1%
Total overhead to revenue	64,752/254,299%	51,326/193,739%	52,550/170,000%
	25.5%	26.5%	30.9%
Admin expenses to revenue	57,048/254,299%	41,786/193,739%	44,295/170,000%
	22.4%	21.6%	26.1%
Finance cost to revenue	1,185/254,299%	891/193,739%	
	0.5%	0.5%	
Depreciation to revenue	6,519/254,299%	8,649/193,739%	8,255/170,000%
	2.6%	4.5%	4.9%
Return on capital employed	95,568/106,395%	82,387/111,330%	68,242/108,922%
	89.8%	74.0%	62.7%

Appendices 2				
Spicey Restaurant Limited				
Evaluation of LH contract proposal				
		Local meals	Continental meals	Total(N)
	Price per plate	N1,500	N2000	
	No of meals per annum (20+50+20)365 = 32,850			
	Local meal 2/3x32,850	21,900		
	Continental 1/3x32,850		10,950.0	
		N	N	N
	Revenue	32,850,000	21,900,000.0	54,750,000
	Less costs: Food items (21,900x250; 10,950x500)	5,475,000	5,475,000.0	10,950,000
	Protein (21,900x500; 10,950x500)	10,950,000	5,475,000.0	16,425,000
		16,425,000	10,950,000.0	27,375,000
	Gross contribution	16,425, 000	10,950,000.0	27,375,000
	Less other costs: Water 32,850 x 45			1,478,250
	Labour (2x17x365x300) + (13x17x354x200)			19,856,000
	Transport (32,850 X 50)			1,642,800
	Staff medical examination (15x5000)			75,000
				23,052,050
	Net contribution per hospital			4,322,950
	No of hospitals			5
	Total net contribution			**21,614,750**

EXAMINER'S REPORT

The case is on Spicey Restaurant Limited operating in the hospitality industry. The company has just completed another year of trading and wants its financial consultants, Kilani, Gana, Garuba and Co., to review its financial performance during the year, with emphasis on the operating performance of its two revenue streams. SR also wants the consultants to advise on a new contract proposed from Lagus Hospital (LH.

Candidates were expected to prepare a report covering the two requirements:

- Review of SR's management accounts for 2018 in comparison with 2016 to 2017 performance highlighting key changes in revenue and overheads for the two revenue streams. Candidates were also expected to comment on reason(s) for the little or no cash balance despite huge profits during the years; and

- A critical revenue of the contract terms from Lagos Hospital together with a contribution analysis, so as to advise SR whether to accept or reject the contract.

For candidates to perform well, they must prepare the following appendices:

- Trend Analysis of SR's income statement for 2016 – 2018;
- Profitability ratios for SR as a whole and for each of the revenue streams; and
- Contribution analysis of the LH contract showing net contribution from the contract

Candidate's performance was poor as most of the candidates scored below 50% of the allocated marks.

The commonest pitfalls of the candidates are:

i. Lack of understanding of what to do to appraise the LH contract. Candidates did not know that they have to use relevant costs principle to analyse contribution from the contract;

ii. Candidates were preparing ratios such as leverage, activity and liquidity which were not needed to address the requirement of the case. Candidates only need to prepare profitability ratios for SR and for each of its two revenue streams, together with the ratios of operating expenses to revenue;

iii. Most candidates did not prepare ratios for each of SR's two revenue streams to evaluate their performance;

iv. Most of the candidates could not determine whether it is an external or internal report; and

v. Candidates still demonstrated inability to craft a good report with appropriate headings and sub-headings with relevant appendices.

Candidates are advised to pay proper attention to the requirement of each case study in the future and learn how to write a good report.