



**THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF NIGERIA**

PATHFINDER

**NOVEMBER 2016 DIET
PROFESSIONAL LEVEL EXAMINATIONS**

Question Papers

Suggested Solutions

Marking Guides

Plus

Examiner's Reports

FOREWARD

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

- (i) Candidates preparing to write future examinations of the Institute of Chartered Accountants of Nigeria (ICAN);
- (ii) Unsuccessful candidates in the identification of those areas in which they lost marks and need to improve their knowledge and presentation;
- (iii) Lecturers and students interested in acquisition of knowledge in the relevant subject contained herein; and
- (iv) The professional; in improving pre-examinations and screening processes, and thus the professional performance of candidates.

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

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

NOTES

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

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA
PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2016

CORPORATE REPORTING

Time Allowed: 3 hours

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

SECTION A: COMPULSORY (30 MARKS)

QUESTION 1

- a. Bata Plc, which operates in the manufacturing sector, has been surviving the challenges operating in the Nigeria economic environment. The draft Statements of Financial Position of Bata Plc and its subsidiaries as at October 31, 2016 are as follows:

	Bata ₦'million	Jewe ₦'million	Gaba ₦'million
Non-current assets			
Property, plant and equipment	4,320	360	420
Investments in subsidiaries	1,110	600	-
Financial assets	500	-	-
	<u>5,930</u>	<u>960</u>	<u>420</u>
Current assets	1,050	570	540
Total assets	<u>6,980</u>	<u>1,530</u>	<u>960</u>
Equity			
Share capital - ₦1 ordinary shares	2,400	600	300
Retained earnings	3,410	540	390
Other components of equity	450	-	-
Total equity	<u>6,260</u>	<u>1,140</u>	<u>690</u>
Current liabilities	720	390	270
Total liabilities and equity	<u>6,980</u>	<u>1,530</u>	<u>960</u>

The following information is relevant to the preparation of the group financial statements:

- (i) Bata Plc acquired 60% of the share capital of Jewe Plc. on November 1, 2012 and 10% of Gaba on November 1, 2013. The costs of the combinations were ₦852million and ₦258million respectively. Jewe Plc acquired 70% of the share capital of Gaba Plc on November 1, 2013.
- (ii) The balances on retained earnings were

	November 1, 2012	November 1, 2013
	₦'million	₦'million
Jewe Plc .	270	360
Gaba Plc	180	240

- (iii) At the respective dates of acquisitions, the fair value of the net assets of Jewe Plc was ₦930million and for Gaba Plc ₦660million. The difference in the fair value and book value of the net assets at acquisition dates relates to non-depreciable land. The fair value of the non-controlling interest in Jewe Plc at the date of acquisition was estimated at ₦390million and for Gaba Plc, ₦330million. Bata Plc adopts the full goodwill method under IFRS 3 Business Combinations to account for non-controlling interest.
- (iv) Given the economic environment in the country, impairment test was carried out for the subsidiaries and it was discovered that whereas Gaba Plc suffered no impairment loss due to its line of business, Jewe Plc had suffered an impairment loss of ₦60million.
- (v) During the year ended October 31, 2016, Bata Plc had sold inventory to both Jewe Plc and Gaba Plc. The invoiced prices of the inventories were ₦480million and ₦360million respectively. Bata Plc invoices goods to achieve a mark-up of 25% on cost to all third parties including group companies. At the year-end, half of the inventory sold to Jewe Plc remained unsold but the entire inventory sold to Gaba Plc had been sold to third parties.
- (vi) Bata Plc purchased a deep discount bond, an innovative financial instrument in the Nigerian Capital Market for ₦500million on November 1, 2015 switching from its equity holdings in that market where equities had suffered huge losses. The bonds will be redeemed in 3 years time for ₦740.75million and are carried at amortised cost in line with IAS 39 Financial Instruments – Recognition and Measurement. The Accountant is not clear as to the correct treatment of amortised cost and as such has not passed the correct entry to give effect to amortised cost valuation at year end in the financial statements.
As such the financial asset is shown at ₦500million.

Compound sum of ₦1: $(1+r)^n$ is as follows:

Year	12%	14%
1	1.1200	1.1400
2	1.2544	1.2996
3	1.4049	1.4815
4	1.5735	1.6890

Required:

Prepare a Consolidated Statement of Financial Position for Bata Plc. and its subsidiaries as at October 31, 2016.

(25Marks)

- b. As a result of the challenges in the foreign exchange market since the advent of the current administration which has made it difficult to source foreign exchange to import raw materials, the Directors of Bata Plc are now considering acquiring a foreign subsidiary which may facilitate access to such foreign exchanges that may be needed. They are not fully aware of the requirements of IAS 21 'The Effects of Changes in Foreign Exchange Rates in relation to translating the financial statement of a foreign subsidiary.'

Required:

Briefly explain to the directors of Bata Plc how the assets, liabilities, income and expenses of a foreign subsidiary including the resulting goodwill are translated for consolidation purposes and the treatment of exchange difference arising from the translation.

(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 objective of IAS 33 - Earnings Per Share is to improve the comparability of the performance of different entities in the same period and of the same entity in different accounting periods. This is done by prescribing the methods for determining the numbers of shares to be included in the calculation of earnings per share. The management of Soar Plc had sought for your professional advice on the application of IAS 33.

- a. **You are required to** advise the management of Soar Plc on the:
- Significance of earnings per share. (5 marks)
 - Shortcomings of earnings per share (5 marks)
- b. The directors of Soar Plc have decided to replace most of the existing plant and machinery which are now obsolete during the year ended September 30, 2015 in order to enhance earnings. The costs of removing existing plant and acquiring and installing new plant have been estimated at ₦750,000.

In order to improve liquidity, the directors decided to make a new issue of 800,000 ordinary shares at ₦2 per share fully paid on January 1, 2015 and a further ₦600,000 4% convertible loan notes on June 1, 2015. The terms of issue would provide for conversion into ordinary shares as stated below:

On September 30	Number of shares per ₦100 of loan stock
2015	120
2016	125
2017	118
2018	122

The ordinary shares issued would rank for dividend in the current year. The following relates to the company for the period ended September 30, 2015:

- Profit before interest and tax is ₦850,000.
- Effective rate of company tax on profit is 30% and the basic EPS for the year ended September 30, 2014 was 48kobo.
- The company had issued as at September 30, 2014 the following:
 - 2,000,000 ordinary shares of 50 kobo each fully paid
 - 400,000 12% irredeemable preference shares of ₦1 each fully paid
 - 300,000 10% redeemable preference shares of ₦1 each fully paid.
 - ₦700,000 8% redeemable debenture (non-convertible)

Required:

Calculate for Soar Plc for the year ended September 30, 2015:

- Basic earnings per share (5 marks)
 - Fully diluted earnings per share (5 marks)
- (Total 20 marks)**

QUESTION 3

Nationwide Plc is a conglomerate with subsidiaries in two geographical locations. Each of the subsidiaries has stamped its foot in relevant subsectors and contributes to the group's gross earnings. Segment information are prepared on the basis of geographical areas as well as business lines.

Segment Information By Geographical Areas as at December 31, 2012

	Nigeria N'm	Europe N'm	Total N'm
Subsidiary I			
Derived From External Customers	<u>110,419</u>	<u>2375</u>	<u>112,794</u>
Total Revenue	<u>110,419</u>	<u>2,375</u>	<u>112,794</u>
Interest And Similar Expenses	<u>(25,398)</u>	<u>(271)</u>	<u>(25,669)</u>
Operating Income	85,021	2,104	87,125
Share Of Profit Of Equity Accounted Investee	<u>1,850</u>	<u>-</u>	<u>1,850</u>
	86,871	2,104	88,975
Operating Expenses	(75,507)	(1,530)	(77,037)
Net Impairment Loss On Financial Assets	<u>(2,772)</u>	<u>(106)</u>	<u>(2,878)</u>
Profit Before Taxation	8,592	468	9,060
Income Tax Credit/(Expenses)	<u>(1,572)</u>	<u>(113)</u>	<u>(1,685)</u>
Profit After Taxation	<u><u>7,020</u></u>	<u><u>355</u></u>	<u><u>7,375</u></u>
Assets And Liabilities			
Total Assets	954,165	78,882	1,033,047
Total Liabilities	<u>(781,019)</u>	<u>(57,630)</u>	<u>(838,649)</u>
Net Assets	<u><u>173,146</u></u>	<u><u>21,252</u></u>	<u><u>194,398</u></u>
 Subsidiary II	 Nigeria (N'M)	 Europe (N'M)	 Total (N'M)
Derived From External Customers	<u>82,566</u>	<u>2,535</u>	<u>85,101</u>
Total Revenue	<u>82,566</u>	<u>2,535</u>	<u>85,101</u>
Interest And Similar Expenses	<u>(34,049)</u>	<u>(263)</u>	<u>(34,312)</u>
Operating Income	48,517	2,272	50,789
Share Of Profit Of Equity Accounted Investee	<u>952</u>	<u>-</u>	<u>952</u>
	49,469	2,272	51,741
Operating Expenses	(88,429)	(1,468)	(89,897)
Net Impairment Loss On Financial Assets	<u>(69,525)</u>	<u>(3)</u>	<u>(69,528)</u>
(Loss)/Profit Before Taxation	(108,485)	801	(107,684)
Income Tax Credit/(Expense)	<u>25,346</u>	<u>(213)</u>	<u>25,133</u>
(Loss)/Profit After Taxation	<u><u>(83,139)</u></u>	<u><u>588</u></u>	<u><u>(82,551)</u></u>

Assets And Liabilities

Total Assets	899,434	155,300	1,054,734
Total Liabilities	<u>(711,678)</u>	<u>(143,684)</u>	<u>(855,362)</u>
Net Assets	<u>187,756</u>	<u>11,616</u>	<u>199,372</u>

Required:

You are required to appraise the contributions of each of the geographical locations to the groups performance through a vertical analysis from the segment information.

(Total 20 Marks)

QUESTION 4

- (a) Prior to the advent of IFRS 13, many standards such as IAS 16, IAS 38, IAS 40 and IAS 39 among others require the use of fair value. These various requirements have been harmonised with the introduction of IFRS 13 Fair Value Measurement.

Required:

Define fair value in accordance with IFRS 13

(2 Marks)

- (b) One of the companies formally operating in Nigeria that had recently relocated its operation to Ghana as a result of the challenging business environment in Nigeria has access to both Lagos and Accra market for its product. The product sells at slightly different prices (in naira) in the two active markets. An entity enters into transactions in both markets and can access the price in those markets for the product at the measurement date as follows:

	Lagos	Accra
	Market	Market
	₦'000	₦'000
Sale price	260	250
Transaction cost	(30)	(10)
Transport cost	(20)	(20)
Net price received	210	220

Required

- Briefly explain the principal market of an asset in accordance with IFRS 13 and determine what fair value would be used to measure the sale of the above product if the Lagos market were the principal market?
(4 Marks)
- How is fair value determined in the absence of a principal market and what fair value would be used to measure the sale of the above product if no principal market could be identified?
(4 Marks)

- (c) Megida Plc, a public limited liability company, has just acquired some hectares of land in Abuja earmarked by government for economic empowerment program of citizens given the harsh economic environment in Nigeria and so is only meant for commercial purposes. The fair value of the land if used for commercial purpose is ₦100million. If the land is used for commercial purpose it is expected that it will result in reducing unemployment. This will attract a tax credit annually, which is based upon the lower of 15% of the fair market value of the land or ₦10,000,000 at the current tax rate. The current tax rate as fixed by the government is 20%.

Megida Plc has determined that given the nature of Abuja's land, market participants would consider that it could have an alternative use for residential purposes. The fair value of the land Megida Plc has just acquired for residential purposes before associated costs is estimated to be ₦148 million. In order to transform the land from its commercial purposes to residential use, there is estimated legal costs of ₦4,000,000, a project viability analysis cost of ₦6,000,000 and costs of demolition of the commercial buildings of ₦2,000,000. In addition, permission for residential use has not been formally given by Abuja Municipal Authority. This has created uncertainty in the minds of market participants. Consequently, the market participants have indicated that the fair value of the land, after the above costs, would be discounted by 20% because of the risk of not obtaining the planning permission from Abuja Municipal Authority.

Required:

Discuss the way in which Megida Plc should compute the fair value of the Abuja land with reference to the principles of IFRS 13 Fair Value Measurement.

(10 Marks)

(Total 20 Marks)

SECTION C: YOU ARE REQUIRED TO ANSWER ANY TWO OUT OF THREE QUESTIONS

IN THIS SECTION

(30 MARKS)

QUESTION 5

Manipulation of reporting entities book's and records have been termed in many quarters as "Creative Accounting" and "Window Dressing". The Management of Wastage Plc requires clarification of these two concepts.

You are required to write a report to the management of Wastage Plc.,. Your report should include:

- a. Definitions of the **TWO** concepts (2 Marks)
 - b. **FIVE** examples of each (5 Marks)
 - c. **THREE** possible reasons for Creative Accounting and Window Dressing. (3 Marks)
 - d. Advise to management on **FIVE** possible preventive measures of Creative Accounting (5 Marks)
- (Total 15 Marks)**

QUESTION 6

Maranathan Plc acquired a property for ~~₦~~4million on which annual depreciation is charged on a straight line basis at the rate of 7.5%. An impairment loss of ~~₦~~350,000 was recognised at the end of May 31, 2013 financial year when accumulated depreciation was ~~₦~~1million. Consequently, the property was valued at its estimated value in use. The company planned to move to new premises, before, the property was classified as held for sale on October 1, 2013. By this time, the fair value less costs to sell was ~~₦~~2.4million. Maranathan Plc published interim financial statements on December 1, 2013, by which time the property market had improved and the fair value less costs to sell was reassessed at ~~₦~~ 2.52million. At the year end, on May 31, 2014 it had improved further, so that the fair value less costs to sell was ~~₦~~2.95million. The property was disposed off eventually on June 5, 2014 for ~~₦~~3million.

Required:

- a. Assess the above transactions based on the requirements of IFRS 5, Non-current Assets Held for Sale and Discontinued Operations. (5 marks)
 - b. Evaluate the impact of the events occurring on the property over time and on the reported gain in accordance with IAS 10, Events After the Reporting Period. (10 Marks)
- (Total 15 Marks)**

QUESTION 7

- a. ABC Plc, in accordance with the regulations of the Nigerian Stock Exchange on transition to IFRS, prepared its first IFRS Financial Statement in 2012. The Financial Statement was contained in a voluminous document of 155 pages. Some of the stakeholders found it difficult to understand the essence of the voluminous document.

You are required to prepare a brief report, highlighting the essence and merits of the adoption of IFRS by Nigerian Companies and state some of the challenges that could be encountered. (10 Marks)

- b. Statements of Accounting Standards (SAS) in Nigeria have been replaced by International Financial Reporting Standards (IFRS); however, some of these local standards relating to industry specific rules which are not found in IFRS are expected to be applied by companies in the industries as far as they do not conflict with IFRS.

You are required to examine the above statement and identify those statements of Accounting standards that are still applicable after the adoption of IFRS.

(5 Marks)

(Total 15 Marks)

SOLUTIONS

SOLUTION 1

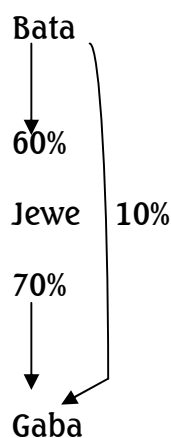
a.

BATA AND ITS SUBSIDIARIES CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT OCTOBER 31, 2016

	₦' m	₦' m
Non-current assets		
Property, plant and equipment (wk2)		5,280.00
Goodwill (wk3)		540.00
Financial Asset (wk5)		570.00
Current Assets (wk4)		<u>2,112.00</u>
Total Assets		<u>8,502.00</u>
<u>Equity and Liabilities</u>		
Equity		
Share capital		<u>2,400.00</u>
Other components of equity		450.00
Retained earnings (wk 6)		<u>3,631.20</u>
Equity attributable to owners of the parent		6,481.20
Non-controlling interest (wk 7)		640.00
Current liabilities		<u>1,380.00</u>
Total Assets		<u>8,502.00</u>

WORKINGS

(1) Group Structure



Bata in Gaba is therefore

Direct	10%
Indirect 60% x 70%	<u>42%</u>
	<u>52%</u>

Working 2

Property, Plant and equipment

	N'm	N'm
Property, plant and equipments:		
- Bata	4,320	
- Jewe	360	
-Garba	<u>420</u>	
		5,100
Fair Value land		
- Jewe	60	
-Garba	120	<u>180</u>
		<u>5,280</u>

The cost of investment paid by Jewe in Gaba belongs to Bata 60% x ~~N~~600 million ie ~~N~~360 million.

(3) GOODWILL

	Jewe N'm	N'm	Gaba N'm	N'm
Purchase Consideration:	Bata	852		258
	Jewe		60% x 600	360
NCI (Note 1) at fair value		<u>390</u>		<u>330</u>
		1,242		948
Net asset at acquisition				
Share capital	600		300	300
Retained earnings	270		240	240
Fair value land	<u>60</u>	<u>930</u>	<u>120</u>	(660)
Goodwill		312		<u>288</u>
Impairment		(60)		<u>-----</u>
Goodwill to SOFP		252		<u>288</u>
Total Goodwill on Consolidation (252 + 288) = 540				

(4) Unrealised profit on inventory

Since Gaba has sold all its inventory to third parties, the entire profit has been realised. Unrealised profit applies to unsold intra-group inventory, hence only sales to Jewe:

$$25/125 \times (\text{N}480\text{m}/2) = \text{N}48 \text{ million}$$

Accounting entry will be Dr Group Retained earnings Cr Inventory.

(5) Deep Discount Bond

The bond has no coupon rate but it will be redeemed at an amount far higher than its purchase price and as such its effective interest is first determined as follows:

$740.75\text{m}/500\text{m} = 1.4815$. As the bond is redeemable in 3 years time, we look at the compound rate that corresponds with this number of years. That rate is 14%.

Since the valuation is just for 1 year, the value of the bond at the end of its first financial year using amortised cost should be Cost + effective interest as there is no coupon rate.

Effective interest is $14\% \times \text{N}500 \text{ million} = \text{N}70 \text{ million}$

Accounting entry will be Dr Financial Asset and Cr Retained Earnings with $\text{N}70 \text{ million}$

(6) Consolidated Retained Earnings

	Bata N'million	Jewe N'million	Gaba N'million
As per question	3,410	540	390
Pre-acquisition retained earnings		<u>(270)</u>	<u>(240)</u>
Bata's share of post acq. Ret. Jewe 60% X 270	162	<u>270</u>	<u>150</u>
Bata's share of post acq. Ret. Gaba 52% X 150	78		
Interest on Bond	70		
Impairment of goodwill	(60)		
Unrealised profit on Inventory(.6 x48)	<u>(28.8)</u>		
	<u>3,631.2</u>		

(7) Non-controlling interest (NCI)

	Jewe N'million	Gaba N'million
NCI (fair value) at acquisition	390	330
Share of post acquisition retained earnings:		
Jewe 40% X 270	108	
Bata's share of post acq. Ret. Earnings: 48% X 150		72
Unrealised profit on Inventory (.4 X 48)	(19.2)	----
NCI Investment in Gaba (40% x 600)	<u>(240)</u>	<u>----</u>
	<u>238.8</u>	<u>402</u>
Total NCI (238.8 + 402) = 640.8		

(b)

From: Financial Controller
To: The Directors,
Bata Plc

Translation of a foreign subsidiary's financial statements

According to IAS 21 "The Effects of Changes in Foreign Exchange Rates" in consolidating the financial statements of a foreign subsidiary, the following items of the foreign subsidiary should be translated as follows:

1. Assets and liabilities are translated at the closing rate at the date of the statement of financial position.
2. Income and expenses are to be translated at the exchange rate at the date of the transaction. Average rates are allowed if there is no great fluctuation in the exchange rates.
3. Goodwill, including any fair value adjustments are treated as assets and liabilities of the foreign subsidiary and are therefore retranslated at each statement of financial position date at the closing spot rate
4. Exchange differences are recognised in other comprehensive income
5. Any exchange that relates to the non-controlling interest is recognised in the statement of financial position.

I. Dee
Financial Controller

MARKING GUIDE

	Marks	Marks
A. i. Statement of Financial position	9	
ii. Goodwill computation	6	
iii. Computation of unrealised profit	1	
iv. Computation of financial assets	1	
v. Computation of Retained earnings	5	
vi. Computation of NCI	<u>3</u>	
		25
B. Asset & Liability translation rate	1	
Income & Expenses translation rate	1	
Goodwill translation rate	1½	
Exchange Difference translation rate	<u>1½</u>	<u>5</u>
Total		<u>30</u>

EXAMINER'S REPORT

The question tests preparation and presentation of consolidated financial statement of a mixed group structure.

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

The commonest pitfall is their inability to calculate the deep discount bond.

This aspect of the syllabus has been examined on regular basis, therefore, candidates are advised to study and understand the principles guiding various aspects of group financial statements.

SOLUTION 2

(a)

The Managing Director/CEO
Soar Plc

Dear Sir,

EARNINGS PER SHARE

In response to our recent discussion on the above subject matter, below is the significance and shortcomings of earnings per share:

Significance of Earnings Per Share (EPS)

- i. EPS (especially growth in EPS) can be used to measure financial performance between entities (or of different periods for the same entity).
- ii. EPS (especially growth in EPS) can be used for investment decisions.
- iii. EPS has a significant impact on the share price of an entity (as it affects the calculation of share price).
- iv. EPS can also serve as a means of assessing the stewardship and management role performed by company directors and managers.
- v. Diluted earnings per share alerts investors of risk attached to their shares as a result of obligations entered into by the entity. That is, the possibility in reduction of their return on investment in future periods.

Shortcomings of Earnings Per Share

- i. Comparison of effective performance between entities may be hindered if the entities operate under different accounting policies.
- ii. Results may be misleading if the impact of inflation is not considered in the preparation of financial statements.
- iii. EPS is not a complete tool for investment analysis as it cannot provide information on liquidity position of the entity.
- iv. It is based on historical information and therefore does not necessarily provide predictive value. High earnings and growth in earnings may be achieved at the expense of investment which may generate increased earnings in the future.
- v. Diluted EPS is only an additional measure of past performance despite looking at future potential shares.

- vi. Linking remuneration package to EPS growth may lead to pressure on management to produce a favourable EPS, thereby distorting it.

Yours faithfully,

Financial Accountant

(b) SOAR PLC
Calculation of weighted average no. of shares

	No. of shares
Existing number of shares (2,000,000 x 12/12)	= 2,000,000
New issue at 1/1/2015 (800,000 x 9/12)	= <u>600,000</u>
BASIC	<u>2,600,000</u>

<u>Calculation of equity earnings</u>	₦'000
Profit before interest and tax	850,000
Less finance costs:	
Non-convertible redeemable debentures (8% x 700,000)	(56,000)
Convertible debentures [4% x 600,000 x (4mths/12mths)]	(8,000)
Redeemable preference dividend (10% x 300,000)	<u>(30,000)</u>
Profit before tax	756,000
Income tax expense @ 30%	<u>(226,800)</u>
Profit after tax	529,200
Less irredeemable preference dividend (12% x 400,000)	<u>(48,000)</u>
BASIC	<u>481,200</u>

$$\text{EPS} = \frac{\text{Equity earnings}}{\text{No. of ordinary shares}}$$

$$\text{Basic EPS} = \frac{481,200}{2,600,000 \text{ shares}} = \underline{\underline{18.51 \text{ kobo}}}$$

Test for dilution

Incremental EPS = Interest savings net of tax on convertible stock

No of ordinary shares that would be exchanged for the convertible stock

$$\frac{4\% \times \#600,000 \times \frac{4}{12} \times 0.7}{[600,000 \times 125/100 \times (4\text{mths} \div 12\text{mths})]} = \frac{\#5,600}{250,000 \text{ shares}} = 2.24 \text{ kobo}$$

Since the incremental EPS is less than the BASIC EPS, the convertible stock should be included in the calculation of DILUTED EPS

$$\text{Diluted EPS for 2015} = \frac{(\#481,200 + \#5,600)}{2,600,000 \text{ shares} + 250,000 \text{ shares}} = \underline{\underline{17.08 \text{ kobo}}}$$

MARKING GUIDE

	Marks
a. i. Significance of Earnings Per Share	5
ii. Shortcomings of Earnings Per Share	5
b. i. Calculation of Basic earnings per share	5
ii. Calculation of diluted earnings per share	<u>5</u>
Total	<u>20</u>

Examiner's Report

The question tests candidates' knowledge of Earnings Per Share.

About 85% of the candidates attempted the question and performance was above average.

Majority of the candidates understood the requirements of part 'a' of the question whilst there was poor understanding of requirements of 'b'. Also some candidates were unable to compute the test for dilution

Earnings Per Share is an important component of Corporate Reporting syllabus, therefore candidates, should pay more attention on the aspect of the syllabus for better performance in future.

SOLUTION 3

VERTICAL ANALYSIS OF STATEMENT OF PROFIT OR LOSS AND NET ASSETS

	Nigerian Region			Europe Region					Regional Contribution	
	Subsidiary I	Subsidiary II	Region Total	Subsidiary I	Subsidiary II	Region Total	Group Total	Vertical Analysis	Nigeria as % of Total	Europe as % of Total
Total Revenues	110,419	82,566	192,985	2,375	2,535	4,910	197,895	100.00	97.52	2.48
Interest And Similar Expenses	-25,398	-34,049	-59,447	-271	-263	-534	-59,981	30.31	99.11	0.89
Operating Income	85,021	48,517	133,538	2,104	2,272	4,376	137,914	69.69	96.83	3.17
Total Income	86,871	49,469	136,340	2,104	2,272	4,376	140,716	71.11	96.89	3.11
Operating Expenses	-75,507	-88,429	-163,936	-1,530	-1,468	-2,998	-166,934	-84.35	98.20	1.80
Net Impairment Loss On Financial Assets	-2772	-69,525	-72,297	-106	-3	-109	-72,406	-36.59	99.85	0.15
(Loss)/ Profit Before Taxation	8,592	-108,485	-99,893	468	801	1,269	-98,624	-49.84	101.29	-1.29
Income Tax Expense	-1,572	25,346	23,774	-113	-213	-326	23,448	11.85	101.39	-1.39
(Loss)/ Profit After Taxation	7,020	-83,139	-76,119	355	588	943	-75,176	-37.99	101.25	-1.25
Total Assets	954,165	899,434	1,853,599	78,882	155,300	234,182	2,087,781	100.00	88.78	11.22
Total Liabilities	781,019	711,678	1,492,697	57,630	143,684	201,314	1,694,011	81.14	88.12	11.83
Net Assets	173,146	187,756	360,902	21,252	11,616	32,868	393,770	18.86	91.65	8.35

Appraisal of Nationwide Plc Operation

The Nigerian region contributed significantly to the performance of the group across the business line.

Income statement

The Nigerian region contributed 97.52% of the entire revenue of the group. With interest and similar expenses being 30.31% of the entire revenue of which Nigeria contributed 99.11% leaving an operating income which is 69.69% of the group revenue.

The operating expenses net impairment was more than the operating income of which the contribution from Nigeria was a major component.

Asset and Liabilities

The liabilities was 81.14% of the group assets. Nigeria contributed 88.78% of the group asset while also having 88.12% of the entire group liabilities.

An overall analysis shows that the major activities of the groups are concentrated in Nigeria.

This is evident in the percentage of the revenue and assets contributed by the Nigerian region to the group.

This may pose a concentration risk to the entire group.

Tutorial Note

Vertical analysis is the proportional analysis of a financial statement, whereby each line item on a financial statement is listed as a percentage of another item within a single period. Vertical analysis between the segments requires a comparison of segment's figure with the group figure i.e. expressing contribution of the segment as a proportion of the group total.

MARKING GUIDE**Marks**

Computation and Analysis Table

14

Discussion of computation and Analysis

620**Examiner's Report**

The question tests performance evaluation of a group of Companies using vertical financial analysis.

About 25% of the candidates attempted the question and the performance was poor.

The pitfall was that candidates could not understand the requirements of the question by confusing financial appraisal with segment information.

Candidates are advised to understand the requirements of the question for better performance in future examination.

SOLUTION 4

- (a) Fair value is “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

According to IFRS 13 the principal market is the market with the greatest volume and level of activity for the asset or liability. The price in the principal market used to measure the fair value of the asset (liability) is not adjusted for transaction costs.

(b)

- i. If Lagos market is the principal market for the product, its fair value would be measured using the price that would be received in that market, after taking into account transport costs at ₦240, 000.

	₦'000
Sale price	260
Transport cost	<u>(20)</u>
Fair value	<u>240</u>

- ii. If no principal market could be identified, the fair value of the product would be measured using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account transaction costs and transport costs (i.e. comparing the net amount that would be received in the respective markets).

This is the Accra market where the net amount that would be received for the product would be ₦220,000, given the fact that transaction costs is not considered in the determination of fair value. The fair value of the asset is determined as:

	₦'000
Sale price	250
Transport cost	<u>(20)</u>
Fair value	<u>230</u>

- (c) IFRS 13 requires the fair value of a non-financial asset to be measured based on its highest and best use from a market participant's perspective. This requirement does not apply to financial instruments, liabilities or equity. The highest and best use takes into account the use of the asset which is physically possible, legally permissible and financially feasible. The highest and best use of a non-financial asset is determined by reference to its use and not its

classification and is determined from the perspective of market participants. It does not matter whether the entity intends to use the asset differently. IFRS 13 allows management to presume that the current use of an asset is the highest and best use unless market or other factors suggest otherwise.

In this case, the economic empowerment land appears to have an alternative use as market participants have considered its alternative use for residential purposes. If the land acquired by Megida is used for economic empowerment purposes, the fair value should reflect the cost structure to continue operating the land for that purpose, including any tax credits which could be realised by market participants. Thus the fair value of the land if used for commercial economic empowerment purposes would be:

	N'000
Fair Value	100
Tax credit	<u>2</u>
	<u>102</u>

If used for residential purposes, the value should include all costs associated with changing the land to the market participant's intended use. In addition, demolition and other costs associated with preparing the land for a different use should be included in the valuation. These costs would include the uncertainty related to whether the approval needed for changing the usage would be obtained, because market participants would take that into account when pricing value of the land if it had a different use. Thus the fair value of the land if used for residential purposes would be:

	N'000
Fair Value	148
Legal cost	(4)
Viability Analysis Cost	(6)
Cost of demolition	<u>(2)</u>
	<u>136</u>
Discounted at 80%(80% of 136)	<u>108.8</u>

In this situation, the presumption that the current use is the highest and best use of the land has been overridden by the market factors which indicate that residential development is the highest and best use.

A use of an asset need not be legal at the measurement date, but it must not be legally prohibited in the jurisdiction.

MARKING GUIDE

		Marks	Marks
	Details of Question		
a.	Definition of Fair Value in accordance with IFRS 13		2
b. i	Brief explanation of principal market	2	
	Determination of Fair Value if principal market is identified	<u>2</u>	4
ii.	Explanation for determination of fair value in the absence of principal market	2	
	Computation of fair Value if principal market is not identified	<u>2</u>	4
c.	Discussion of the way fair value of Abuja land can be determined in accordance with the principles of IFRS 13, fair value measurement	4	
	Computation fair value of Abuja land based on commercial and residential purposes in accordance with the principles of IFRS 13	<u>6</u>	<u>10</u>
	Total Marks		<u><u>20</u></u>

EXAMINER'S REPORT

The question tests the provisions and application of IFRS 13, Fair Value measurement.

More than 50% of the candidates attempted the question and some of them do not have clear understanding of the requirement.

The commonest pitfall was the inability of the candidates to understand IFRS 13 requirements, that the highest and best use of a non-financial asset is determined from the prospective of market participant. As such they were unable to distinguish fair value of land if used for commercial and residential purposes.

Candidates should endeavour to cover all relevant IFRS and IAS in the professional level of the examination of the Institute.

SOLUTION 5

a.

To: The Board of Directors, WASTAGE Plc.

From: The Consultant

Date: November, 15 2016

Subject: Concept of Creative Accounting and Window Dressing

Creative Accounting

Creative accounting can be defined as the presentation of information in a manner that is inconsistent with the underlying facts. It can also be the application of accounting policies to structure particular transactions in such a way that the financial statements will portray a picture of financial health that is in line with what the directors would like users to see rather than the true financial performance and position of the business. The main purpose of creative accounting is to inflate profit figure though some companies may also reduce report profits in good years either to smooth results or depending on what the directors want to achieve. Assets and Liabilities may also be manipulated either to remain within limit such as debt covenants or to hide problems.

Window dressing

The term, “window dressing” is strategy used to create a superficial or misleading presentation of financial performance in an illegal and unethical manner. The manipulation of investment portfolio performance numbers is window dressing and creative accounting.

In a nutshell, the objective of window dressing and creative accounting are the same, but the ways of achieving their results differs in the sense that creative accounting involves taking the advantage of the loopholes in the accounting laws and standards but window dressing does not necessarily take advantage of the loopholes but sometimes intentionally go against the provision of the accounting laws and standards.

(b) Common examples of Creative Accounting

(i) Examples of creative accounting

There are many types of creative accounting practices. Some of these are discussed below.

Earnings management

The earnings management literature outlines how management may engage in income smoothing practices so as to reduce the risk perceptions of their firms:

- Smoothing through allocation over time. Management can manipulate the periods in which expenses are recognized. For example, the useful life of assets can be adjusted, thereby affecting the amount of depreciation charged as an expense.
- Use of discretionary accruals. Income can also be smoothed by the use of discretionary accruals. For example, management can determine the amount to be provided as a provision for bad debts, or the amount of a provision in respect of a warranty on a company's products or services.

Off-balance-sheet financing

This involves a firm's debt being omitted from its statement of financial position. This was the main creative accounting technique employed by Enron, prior to its bankruptcy in 2001.

Revenue recognition

This is a technique to recognize revenue before it is earned. One of such practice, known as 'channel stuffing', involves a distributor supplying more goods to retail outlets than can be sold to customers.

Overstating assets

This involves the failure by a firm to record impairments relating to the value of assets such as machinery, property, inventory, investments and receivables.

Aggressive capitalization of costs

Some firms may decide to capitalize costs (e.g. research & development) which others write off routinely.

Capitalisation of expenses that are meant to be expensed in order to reduce operating costs and improve profit and total assets. e.g. Capitalization of research costs and training cost that are meant to be expensed in the profit or loss.

Engaging in accounting measures that encourages profit smoothing.

Inappropriate and constant changes in accounting policies with the main aim of improving profitability performance.

Inappropriate classification of some statement of financial position items as set off statement of financial position by complying with legal form rather than substance. For example where the lease deliberate classifies a finance lease transaction as an operating lease so as to avoid the recognition of lease obligation (lease liability) in the statement of financial position.

b(ii) Examples of window dressing

- Non-recognition of irrecoverable debts (i.e. bad debts)
- Understatement of provisions for doubtful debts (i.e. allowance for receivables).
- Non provision for damaged and obsolete inventories and assets.
- Deliberate overstatement of closing inventories.
- Deliberate recognition of unrealized income and profit arising from inter-company transactions as if they were realized in the consolidated financial statements.
- Deliberate revaluation of non-current asset downward at the beginning of the period so as to charge lower depreciation and subsequently revaluing the same non-current asset upward at the end of the period in order to increase total assets and improve gearing.
- Arrangement with customers to make sales towards the end of an accounting period while the goods sold can be returned at the beginning of the next period.
- Deliberate understatement of expenses.
- Deliberate overstatement of income.
- Deliberate recognition of income in advance in the current period profit or loss while accrued expenses are not recognized so as to improve performance.
- The use of special purpose entity: To improve the returns on capital employed and gearing of the sponsor.
- Inadequate disclosure of items in the financial statement as required by the applicable accounting standards. e.g service concessions arrangement.

c. Common reasons for creative accounting and window dressing

- i. To incur a lower tax liability.
- ii. To improve remuneration packages of management
- iii. To improve the quality and value of assets
- iv. To improve the gearing position of the reporting entity
- v. To reduce costs and improve profitability and performance

- vi. To improve the market value or worth of the company's shares so as to attract investors.
- vii. To attract further credit facilities from loan providers at favorable terms.
- viii. To achieve competitive advantage in the industry.
- ix. To meet an expected target or performance in order to enjoy an expected reward.
- x. To avoid certain sanctions by any regulatory authority or body.
- xi. To control dividend payment
- xii. Big bath theory which maintains that new management will maximise losses and blame them on their predecessors. This should result in the new management taking credit for improved results going forward

d. Preventive measures for creative accounting

It is unlikely that creative accounting can never be eliminated entirely. A number of approaches can, however, be effective in reducing its incidence.

i. Financial regulation

Legislation provides the basic weaponry in the war against creative accounting. In prescribing the statutory regulations that must be complied with the relevant statutory and regulatory requirements which establish a solid platform for the prevention of creative accounting.

ii. Monitoring, enforcement and penalties

An external audit of a company's financial statements plays a crucial role in the prevention of creative accounting. This involves an independent assessment to determine whether the financial statements give a true and fair view of a company's performance and position.

iii. Corporate governance

Adherence to a Corporate Governance Code can enable a company to establish appropriate structures to prevent the use of creative accounting policies. For example, the appointment of a majority of non-executive independent directors on a company's board acts as a control against abuses by management.

iv. Focus on ethics

An emphasis on ethics in education can also play a significant role in helping to reduce the use of creative accounting practices by management.

- v. **Creating a culture of whistle-blowing in organisations**
Insiders are often aware of creative accounting practices long before they become known to the outsider. Management can help to eradicate creative accounting practices by providing support for a culture of whistle-blowing in their organisation. This can assist in bringing accounting irregularities to light at an early stage.
- vi. **Culture of good Citizen**
Creating a culture of good citizenship in an organisation helps to extend management's focus beyond the needs of the shareholder/investor group. Thus, a commitment to corporate social reporting makes management accountable to a broader range of stakeholders, thus reducing the motivation to engage in creative accounting.
- vii. Ensuring that adequate controls are in place to checkmate non-compliance with relevant accounting standards.
- viii. Ensuring that the substance of transactions as against its legal form is reflected in the financial statements.
- ix. Ensuring that adequate disclosures of items in the financial statements are made to improve transparency, completeness, neutrality and reliability.

Yours faithfully

Financial Controller

MARKING GUIDE

	Marks
Definition of Creative Accounting and window dressing	2
Five (5) examples of window dressing and Creative Accounting at 1 mark each	5
Five(5) preventive measures for creative accounting at 1 mark each	5
Three (3) reasons for Creative Accounting at 1 mark each	<u>3</u>
Total	<u>15</u>

Examiner's Report

The question tests the knowledge and understanding of the creative accounting and window dressing.

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

The commonest pitfall is the inability of the candidate to clearly distinguish between Window dressing and Creative accounting.

Candidates are required to understand every aspect of the syllabus for better performance in future.

SOLUTION 6

- (a) In accordance with the requirement of IFRS 5- Non-current assets held for sale and Discontinued Operations, Maranathan Plc transactions would be treated as follows:
- i. The property would be classified as held for sale from 1st Oct, 2013
It is assumed that the directors have made a decision to sell the property from 1st Oct, 2013 and that active steps to locate a buyer and the property is being marketed at a reasonable price.
 - ii. The property would be removed from Non-current assets and presented separately under current assets in the statement of financial position.
 - iii. The property will no longer be depreciated from the date of classification (i.e from 1st Oct 2013) as held for sale, hence, it will only be depreciated for the first four months before classification as held for sale (i.e from 1/6/2013 – 1/10/2013).
 - iv. The property would be measured at the lower of carrying amount and fair value less costs to sell.
 - v. Impairment must be considered both at the time of classification as held for sale and subsequently as follows:
 - Any impairment loss is recognized on profit or loss unless the assets had been revalued before in which case the impairment is treated as a revaluation decrease.
 - A gain from any subsequent increase in fair value less costs to sell of an asset is recognized in the profit or loss to the extent that it is not in excess of the cumulative impairment loss already recognized in line with IFRS 5.
- (b)
- i. At the time of classification as held for sale, depreciation needs to be charged for the four months to 1 October 2013. This will be based upon the year end value at 31 May 2013 of ₦2.65 million. The property has 10 years life remaining based upon the depreciation to date and assuming a zero residual value, the depreciation for the four months will be approximately ₦0.883 million. Thus, at the time of classification as held for sale, after charging depreciation for the four months of ₦0.883million, the carrying amount is ₦2.561 million (₦4m – ₦1 – ₦0.883 m – ₦0.35m) and fair value less costs to sell is assessed at ₦2.4 million. Thus, the initial write-down on classification as held for sale is ₦161,667 and the property is carried at ₦2.4 million.

- ii. On 1 December 2013 in the interim financial statements, the property market has improved and fair value less costs to sell is reassessed at ~~₦2~~52 million. The gain of ~~₦120,000~~ (i.e ~~₦2~~52 million - ~~₦2~~4 million) is less than the cumulative impairment losses recognised to date(~~₦350,000~~ plus ~~₦161,667~~, i.e. ~~₦511,667~~). Therefore, it is credited in profit or loss and the property is carried at ~~₦2~~52 million.
- iii. On 31 May 2014, the property market has continued to improve, and fair value less costs to sell is now assessed at ~~₦2~~95 million. The further gain of ~~₦430,000~~ is, however, in excess of the cumulative impairment losses recognised to date (~~₦350,000~~ plus ~~₦161,667~~ – ~~₦120,000~~ – ~~₦430,000~~, i.e. ~~₦38,333~~). Accordingly, a restricted gain of ~~₦391,667~~ is credited in profit or loss and the property is carried at ~~₦2,911,667~~ which is (~~₦2.9m~~ minus ~~₦38,333~~).
- iv. Subsequently, the property is sold for ~~₦3~~million at which point a gain of ~~₦88,333~~ is recognised. This sale would be a non-adjusting event under IAS 10 Events after the Reporting Period if deemed to be material.

MARKING GUIDE

	Marks	Marks
a. Criteria for classifying Non-current asset as held		
- For sale & Discontinued Operation	3	
- Treatment of asset so classified	<u>2</u>	5
b. Evaluation of Impact of given transaction over time	8	
Identification of Reported Gain Treatment	<u>2</u>	<u>10</u>
		<u>15</u>

EXAMINER'S REPORT

The question tests candidates ability to apply the provisions and the requirements of IFRS 5 – Criteria to classify a non-current assets as held for sale and discontinued operations and IAS 10 – Events after the reporting date.

The percentage attempt was about 40% and most candidates that attempted the question demonstrated very poor understanding and performance was below average.

The commonest pitfall was that there were poor evaluation/ presentation of solution by majority of the Candidates.

Professional level candidates are required to understand the provisions and applications of IFRS at this level of the Institute's examination.

SOLUTION 7

a.

To: The Managing Director
ABC Plc
Lagos – Nigeria

Report of the Adoption of International Financial Reporting Standards (IFRS) by Nigeria Companies

Introduction:

International Financial Reporting Standards (IFRS) are a set of accounting standards developed by the International Accounting Standards Board (IASB) that is becoming the global standard for the preparation of public company financial statements.

Convergence of accounting standards refers to the goal of establishing a single set of accounting standards that will be used internationally. This is also described as the international harmonisation of accounting standards.

Highlighting the essence and merit of the adoption of ifrs

There are some strong arguments in favour of the harmonisation of accounting standards in all countries of the world.

- i. Investors and analysts of financial statements can make **better comparisons** between the financial position, financial performance and financial prospects of entities in **different countries**. This is very important, in view of the rapid growth in international investment by institutional investors.
- ii. For international groups, harmonisation will **simplify the preparation of group accounts**. If all entities in the group share the same accounting framework, there should be no need to make adjustments for consolidation purposes.
- iii. If all entities are using the same framework for financial reporting, management should find it **easier to monitor performance** within their group.
- iv. Global harmonisation of accounting framework may **encourage growth in cross-border trading**, because entities will find it easier to assess the financial position of customers and suppliers in other countries.
- v. **Access to international finance should be easier**, because banks and investors in the international financial markets will find it easier to understand the financial information presented to them by entities wishing to raise finance.

- vi. Harmonisation could also lead to **reduction in cost of capital** as a result of 4 and 5 above.
- vii. Reduction in audit costs
- viii. It makes the transfer of Accounting staff easier
- ix. It enables relevant Tax Authority to have appropriate understanding of the accounting information.

Challenges of Harmonization Of Accounting Standards

- i. National legal requirements may conflict with the requirements of IFRSs. Some countries may have strict legal rules about preparing financial statements, as the statements are prepared mainly for tax purposes. Consequently, laws may need re-writing to permit the accounting policies required by IFRS.
- ii. Some countries may believe that their framework is satisfactory or even superior to IFRS.
- iii. Cultural differences across the world may mean that one set of accounting standards will not be flexible enough to meet the needs of all users.
- iv. Different User Groups
- v. Lack of strong accounting regulatory bodies
- vi. High cost of adopting IFRS to Nigerian Companies

Yours faithfully

Financial Controller

b. SAS STILL IN USE IN NIGERIA

In Nigeria, the date of transition from local standard to IFRS was established by the provisions in the National Road Map on adoption of IFRS. The opening IFRS Statement of financial position is prepared by full retrospective application of all IFRS extant at the first IFRS reporting date with the provision that:

- Some standards relating to industry specific rules not found in IFRS should be applied by companies in the industries concerned as far as they do not conflict with the provisions of IFRS. Such standards include:
 - i. SAS 14: Accounting in the petroleum industry: Down-stream activities
 - ii. SAS 17: Accounting in the petroleum industry: Up-stream activities
 - iii. SAS 25: Telecommunications activities.

MARKING GUIDE

		Marks	Marks
a.	2 points of Essence of IFRS	2	
	5 merits of IFRS	5	
	3 Challenges of IFRS	<u>3</u>	10
b.	SAS still in force after IFRS adoption	<u>5</u>	<u>5</u>
	Total		<u>15</u>

EXAMINER'S REPORT

The question tests the essence, merits and challenges of IFRS adoption in Nigeria.

The candidates demonstrated a fairly satisfactory understanding of the question. About 50% of the Candidates attempted the question but did not perform well in Part b.

Commonest pitfall was the inability of the candidate to recognise the statements of Accounting Standards still solely applicable to Nigerian environment after the adoption of IFRS.

Candidates should endeavour to familiarise themselves with ICAN Study Texts for Institute's future examinations.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2016

ADVANCED TAXATION

Time Allowed: 3 hours

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Zeze Nigeria Limited was incorporated on September 7, 2012, but it did not commence business until July 1, 2013. Based on the Memorandum and Articles of Association, the company was incorporated to carry on the business of distributorship and general contracting.

Extracts of the Company's Statements of Profit or Loss and Other Comprehensive Income are as given below:

	6 Months ended December 31, 2013	Year Ended December 31, 2014	Year ended December 31, 2015
	N	N	N
Revenue	5,430,000	12,600,000	18,400,000
Direct Cost	<u>(890,000)</u>	<u>(1,345,000)</u>	<u>(1,910,000)</u>
Gross Profit	4,540,000	11,255,000	16,490,000
Other Income	45,000	458,150	201,000
Distribution cost	(386,000)	(820,000)	(1,060,500)
Administrative expenses	(4,810,550)	(6,510,440)	(8,240,600)
Other expenses	<u>(41,000)</u>	<u>(113,240)</u>	<u>(145,100)</u>
Net (Loss)/Profit	<u>(652,550)</u>	<u>4,269,470</u>	<u>7,244,800</u>

Additional information:

(i) Other Income comprises:

	6 Months ended December 31, 2013 N	Year Ended December 31, 2014 N	Year ended December 31, 2015 N
Sale of scraps	-	57,000	-
Interest received on Treasury Bills	-	325,000	120,000
Interest on Domiciliary Account	<u>45,000</u>	<u>76,150</u>	<u>81,000</u>
	<u>45,000</u>	<u>458,150</u>	<u>201,000</u>

(ii) Administrative expenses include:

	N	N	N
Depreciation	160,000	320,000	440,000
Preliminary and formation expenses	216,000	-	-
Penalties and fines	-	-	65,000
General provision for bad debts	110,000	180,000	240,000
Staff salaries	2,060,000	4,230,000	4,230,000
Office rent	600,000	1,200,000	1,800,000

(iii) Details of Property, Plant and Equipment are as follows:

	Date of Purchase	Cost N
Furniture and Fittings	June 7, 2013	980,000
Motor vehicles	June 30, 2013	2,400,000
Office equipment	July 1, 2013	1,200,000

(iv) On January 2, 2015, the company bought another Motor vehicle for

N1,800,000

(v) Extracts of the Statements of Financial Position are given below:

	6 Months ended December 31, 2013 ₦	Year Ended December 31, 2014 ₦	Year ended December 31, 2015 ₦
Net Assets	1,360,000	2,870,500	3,260,700
Paid – up Share Capital	5,000,000	5,000,000	5,000,000

You were recently appointed the Tax Consultant to the company. The directors sought your advice on whether or not to exercise the company's right of election for the relevant years of assessment.

For all the relevant years of assessment, **you are required to:**

- Compute the Adjusted Profit/Loss. (9 Marks)
 - Determine the Assessable Profit/Loss and **advise** the Company on whether or not to exercise its right of election. (6 Marks)
 - Compute the capital allowances. (4½ Marks)
 - Compute the tax liabilities. (10½ Marks)
- (Total 30 Marks)**

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

QUESTION 2

Nigerian National Petroleum Corporation (NNPC) is one of the regulatory agencies in the Oil and Gas sector of the Nigerian economy. NNPC through its subsidiaries, carries out various regulatory functions.

You are required to:

- State any **FIVE** activities of the Nigerian Petroleum Development Company (NPDC), a subsidiary of NNPC. (5 Marks)
- State the importance of an **Oil Mining Lease** and an **Oil Prospecting Lease**. (2 Marks)

- c. Mr. Gillani Azurhi intimated you about his desire to invest in any company engaged in petroleum operations. One of his friends advised him against the petroleum sector in view of the current low price of crude oil in the international market and the high cost of domestic operations. He declined the advice, arguing that the price will not remain at its current low level as Nigeria will not be in recession forever.

On his own, he carried out some research using the internet. He presented you with the following financial extracts of Joji Petroleum Company Limited, which he obtained from the internet:

	₦'000
Current year capital allowances	6,080
Previous years' capital allowances b/f	8,901
Custom duty	125
Royalties not included in the accounts	1,638
Loss brought forward	6,250
Petroleum Profits Tax payable	1,336

Assume a tax rate of 85%.

You are required to:

Compute and explain the significance of each of the following:

- i. Adjusted profit (9 Marks)
- ii. Chargeable profit (2 Marks)
- iii. Chargeable tax (2 Marks)

(Total 20 Marks)

QUESTION 3

Obioma and Sons Limited, a company based in Emene – Enugu, has been producing vegetable oil since 2015. It has been a leading name in the production of a popular brand of household vegetable oil known as “*Abop*” which is in high demand.

Given the fact that the company is doing very well, it secured funds from its bankers and bought additional Plant and Machinery in excess of its immediate needs on June 1, 2013 for ₦24,600,000.

The Finance Director convinced the Board to dispose part of the plant and machinery to boost the company's working capital. Consequently, on December 31, 2015, the company sold part of the Plant and Machinery for ₦37,925,000 spent ₦5,125,000 as expenses incidental to the sale. The market value of the remaining Plant and Machinery was ₦15,375,000 as at December 31, 2015.

However, the issue of the tax implications of these transactions is worrisome to the Managing Director, who is visibly disturbed that the Federal Inland Revenue Service (FIRS) might come after the company.

As the tax consultant to the company, **you are required to:**

- a. State any **FOUR** Chargeable Assets. (2 Marks)
- b. State any **FOUR** conditions for granting Roll-Over Relief. (8 Marks)
- c. Compute the Chargeable Gains on the asset sold. (4 Marks)
- d. Compute the Capital Gains Tax. (2 Marks)
- e. Compute the new cost of the remaining asset. (4 Marks)

(Total 20 Marks)

QUESTION 4

Tax Planning is anticipatory and requires an understanding of tax laws. A Tax Consultant should be versed in these two areas in order to be able to render excellent advisory services to clients, government and other institutions.

You are required to:

- a. State any **FIVE** matters that should be considered in **Tax Planning**, using a standard **Tax Planning Checklist**. (5 Marks)
- b. Gringrin Nigeria Limited is proposing to embark on two courses of action:
 - (i) Change its accounting date from March 31 to June 30; or
 - (ii) Change its accounting date from March 31 to December 31.

The Adjusted profits where the change is to June 30, each year, are as follows:

	₦'000
Year ended March 31, 2011	30,000
Year ended March 31, 2012	33,000
Period ended June 30, 2013 (15 months)	78,000
Year ended June 30, 2014	34,000

The Adjusted profits where the change is to December 31, each year, are as follows:

	₦'000
Year ended March 31, 2011	50,000
Year ended March 31, 2012	60,000
Period ended December 31, 2013 (21 months)	180,000
Year ended December 31, 2014	70,000

As the Tax Consultant, **you are required to:**

Compute the relevant tax liabilities.

(15 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. One of the incentives available to industries in Nigeria is contained in the Industrial Development (Income Tax Relief), Act 1971, which grants tax holidays to companies in the industries that meet the conditions for being designated "Pioneer Industries".

Under the Industrial Development (Income Tax Relief) Act 1971, state any **FOUR** industries that qualify to be regarded as Pioneer Industries.

(4 Marks)

- b. Ajanaku Nigeria Limited was incorporated as a pioneer company on March 15, 2011, with focus on the manufacture of aluminum roofing sheets. It was granted a Pioneer Certificate with Production Day given as July 1, 2011. Extracts of Audited Financial Statements are as shown below:-

	6 Months to 31/12/11 N '000	Year to 31/12/12 N '000	Year to 31/12/13 N '000	Six Months to 30/6/14 N '000
(Loss) / Profit	(3,750)	(4,800)	2,250	4,500
After Charging:				
Depreciation	2,800	2,500	1,700	1,000
Withholding tax on rent included in expenses	500	250	-	-
Donations to:				
Epe Traditional Dance Troupe	10	-	-	-
Nigerian Red Cross	-	100	-	-
Borno State General Hospital	-	-	120	-

Ajanaku Nigeria Limited declared gross dividends of ₦600,000 and ₦1,500,000 for 2013 and 2014 years respectively.

Withholding tax rates on dividends for the relevant years is 10%. Ignore Minimum tax provisions. The company's initial tax relief period was not extended.

You are required to:-

Compute the tax liabilities for the relevant years of assessment relating to Pioneer Status only, and state the amount of Withholding Tax due from the shareholders.

(11 Marks)

(Total 15 Marks)

QUESTION 6

- a. The administration of the Petroleum Profits Tax Act is under the charge and management of the Federal Inland Revenue Service with respect to Petroleum Profits Tax Act Cap P13 LFN 2004.

You are required to explain:

- i. Associated Gas (2 Marks)
- ii. Downstream Activities (2 Marks)

- b. Bivenette Petroleum Company Limited has been in the oil prospecting business for some years. Extracts from the financial statements for the year ended December 31 2013 shows the following information:

	₦'000	₦'000
Value of oil exported		1,030,000
Domestic sales		842,000
Chargeable gas sales		603,000
Other income		425,000
Operating costs	1,385,000	
Intangible costs	142,800	
Royalty on export sales	125,000	
Royalty on local sales	96,500	
Non-productive rent	102,000	
Exploration incentives	313,500	
Rental	101,200	
Interest paid	98,000	
Administrative expenses	265,000	

You are also given the following information:

- (i) The Petroleum Profits Tax rate is 85%.
- (ii) Interest paid included ₦12,000,000 paid to an affiliated company.
- (iii) Capital allowances were agreed at ₦253,750,000.
- (iv) Included in the operating cost is ₦302,000,000 paid to a company for information on oil prospect in Adamawa State.
- (v) The company is entitled to Investment Allowance of ₦173,000,000.

You are required to:

Determine the Assessable Profit, Chargeable Profit, Assessable Tax and Chargeable Tax of the company for the relevant Year of Assessment.

(11 Marks)

(Total 15 Marks)

QUESTION 7

You were invited as the Chairman of a Tax Summit at Ikeja, Lagos State. The topics for discussion were as follows:

- (i) Tax Planning, an Effective Method of Tax Avoidance;
- (ii) Tax Evasion in a Growing Economy;
- (iii) Double Taxation – The Provisions and the Impact; and
- (iv) Jurisdiction for Investment – Non-Tax Factors.

As the Chairman, you had the opportunity to summarise the papers presented by the four paper presenters in just ten minutes.

You are required to:

- a. Explain briefly, Tax Planning and Anti-Avoidance Legislations put in place by the Government (3 Marks)
 - b. Summarise situations that may involve Tax Evasion (4 Marks)
 - c. Explain Double Taxation Agreement – Provisions and the Main Objectives (4 Marks)
 - d. Summarise Non-tax factors that attract investors in choosing a business jurisdiction (4 Marks)
- (Total 15 Marks)**

NIGERIAN TAX RATES

1. CAPITAL ALLOWANCES

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

2. INVESTMENT ALLOWANCE 10%

3. RATES OF PERSONAL INCOME TAX

Graduated tax rates with consolidated relief allowance of ₦200,000 or 1% of 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% |

SOLUTIONS

SOLUTION 1

(a)

ZEZEE NIGERIA LIMITED COMPUTATION OF ADJUSTED PROFIT OR LOSS

	6 Months ended December 31, 2013	Year Ended December 31, 2014	Year ended December 31, 2015
	₦	₦	₦
Net (Loss) /Profit per accounts	(652,550)	4,269,470	7,244,800
Add disallowable expenses:			
Depreciation	160,000	320,000	440,000
Preliminary and formation expenses	216,000	0	0
Penalties and fines	0	0	65,000
General provision for bad debts	<u>110,000</u>	<u>180,000</u>	<u>240,000</u>
	(166,550)	4,769,470	7,989,800
Interest received on Treasury Bills	0	(325,000)	(120,000)
Interest on foreign Domiciliary Account	<u>(45,000)</u>	<u>(76,150)</u>	<u>(81,000)</u>
Adjusted (loss)/profit	<u>(211,550)</u>	<u>4,368,320</u>	<u>7,788,800</u>

b)

ZEZEE NIGERIA LIMITED COMPUTATION OF ASSESSABLE PROFITS

Assessment Year	Normal Basis Period	Basis Assessable Profit/(Loss)	Actual Basis (Option) Basis Period	Assessable Profit/(Loss)
		₦		₦
2013	1/7/13 – 31/12/13	(211,550)	1/7/13 – 31/12/13	(211,550)
2014	1/7/13 – 30/6/14 (12 months)			
	1/7/13 – 31/12/13	(211,550)		
	1/1/14 – 30/6/14	<u>2,184,160</u>	1/1/14 – 31/12/14	4,368,320
2015	1/1/14 – 31/12/14 (Preceding Year)	<u>4,368,320</u>	1/1/15 – 31/12/15	<u>7,788,800</u>
	Total Assessable profit 2 nd & 3 rd Years of Assessment	<u>6,340,930</u>		<u>12,157,120</u>
2016	1/1/15 – 31/12/15 (Preceding Year)	7,788,800	1/1/15 – 31/12/15	7,788,800

It is better for the company not to exercise its right of election to be assessed on actual basis for the second and third years of assessment.

Tax will be saved on Assessable Profit of ~~₦~~5,816,190 (~~₦~~12,157,120 – ~~₦~~6,340,930) by not exercising the option.

c)

ZEZEE NIGERIA LIMITED COMPUTATION OF CAPITAL ALLOWANCES FOR ASSESSMENT YEARS 2013 TO 2016				
	Furniture and Fittings	Motor vehicles	Office equipment	Total
Initial allowance (%)	25	50	50	
Annual allowance (%)	<u>20</u>	<u>25</u>	<u>25</u>	
<u>Assessment Year 2013</u> <u>(6 Months)</u>	<u>₦</u>	<u>₦</u>	<u>₦</u>	<u>₦</u>
Cost	980,000	2,400,000	1,200,000	<u>4,580,000</u>
Initial allowance	(245,000)	(1,200,000)	(600,000)	(2,045,000)
Annual allowance	<u>(73,500)</u>	<u>(150,000)</u>	<u>(75,000)</u>	<u>(298,500)</u>
W.D.V c/f to A.Y. 2014	661,500	1,050,000	525,000	<u>2,236,500</u>
<u>Assessment Year 2014</u> <u>(12 Months)</u>				
Annual allowance	<u>(165,375)</u>	<u>(350,000)</u>	<u>(175,000)</u>	<u>(690,375)</u>
W.D.V. c/f to A.Y. 2015	496,125	700,000	350,000	1,546,125
<u>Assessment Year 2015</u> <u>(12 Months)</u>				
Annual allowance	<u>(165,375)</u>	<u>(350,000)</u>	<u>(175,000)</u>	<u>(690,375)</u>
W.D.V c/f to A.Y. 2016	330,750	350,000	175,000	855,750
<u>Assessment Year 2016</u>				
Additions	<u>0</u>	<u>1,800,000</u>	<u>0</u>	<u>1,800,000</u>
	330,750	2,150,000	175,000	2,655,750
Initial allowance	(0)	(900,000)	(0)	(900,000)
Annual allowance:				
On new assets	(0)	(225,000)	(0)	(225,000)
On old assets	<u>(165,375)</u>	<u>(334,990)</u>	<u>174,990</u>	<u>(509,980)</u>
W.D.V. c/f to A.Y. 2017	<u>165,375</u>	<u>690,010</u>	(10)	<u>1,020,770</u>

(d)

ZEZEE NIGERIA LIMITED
COMPUTATION OF TAX LIABILITIES (WITHOUT ELECTION)

Assessment Year 2013	₦	₦
Assessable (Loss)		(211,550)
Capital Allowance		<u>2,343,500</u>
Loss carried forward		<u>(211,550)</u>
Unutilized capital allowance carried forward	<u>2,343,500</u>	
Total profit		<u>NIL</u>
Companies Income Tax @ 30%		<u>NIL</u>
Tertiary Education Tax @ 2% of Assessable Profit		<u>NIL</u>
<u>Assessment Year 2014</u>		
Assessable Profit		1,972,610
Loss brought forward		<u>(211,550)</u>
		1,761,060
Less:		
Capital allowance:		
Brought forward	2,343,500	
For the year	<u>690,375</u>	
	3,033,875	
Restricted to $\frac{2}{3}$ of Assessable profit		
$\frac{2}{3}$ of ₦1,761,060	<u>1,174,040</u>	<u>(1,174,040)</u>
Unutilised capital allowance c/f	<u>1,859,835</u>	
Total profit		<u>587,020</u>
Companies Income Tax @ 30%		176,106
Tertiary Education Tax (2% of ₦1,761,060)		<u>35,221</u>
Total tax liability		<u>211,327</u>
<u>Assessment Year 2015</u>		
Assessable profit		4,386,320
Less		
Capital allowances:		
Brought forward	1,859,835	
For the year	<u>690,375</u>	
Capital allowance utilized in the year	<u>2,550,210</u>	<u>(2,550,210)</u>
Total profit		<u>1,836,110</u>
Companies Income tax @ 30%		550,833
Tertiary Education Tax @ 2% of ₦4,368,320		<u>87,726</u>
Total tax liability		<u>638,559</u>

Assessment Year 2016

Assessable profit	7,788,800
Capital Allowance for the Year	<u>(1,634,980)</u>
Total Profit	<u>6,153,820</u>
Companies Income Tax @ 30%	1,846,146
Tertiary Education Tax @ 2% of ₦7,788,800	<u>155,776</u>
Total tax liability	<u>2,001,922</u>

Note:

Minimum Tax computation does not apply as the company is not up to 48 calendar months in business.

MARKING GUIDE

	Marks	Marks
(a) Heading	1	
Net (Loss) / Profit per accounts – ½ mark for each year (3)	1½	
Depreciation – ½ mark for each year (3)	1½	
Preliminary and formation expenses	½	
Penalties and fines	½	
General provision for bad debts - ½ mark for each year (3)	1½	
Interest received on Treasury Bills - ½ mark for each year (2)	1	
Interest on foreign Domiciliary Account - ½ mark for each year (3)	<u>1½</u>	9
b) Heading	½	
A.Y. 2013 Assessable Loss – ½ mark for each basis (2)	1	
A.Y. 2014 Assessable Profit – ½ mark for each point (3)	1½	
A.Y. 2015 Assessable Profit – ½ mark for each basis (2)	1	
A.Y. 2016 Assessable Profit – ½ mark for each basis (2)	1	
Comments	<u>1</u>	6
c) Heading	¼	
A.Y. 2013:		
Initial allowance	¾	
Annual allowance	¾	
A.Y.2014 – Annual allowance	¾	
A.Y. 2015 – Annual allowance	¾	
A.Y. 2016:		
Initial allowance	¼	
Annual allowance	<u>1</u>	4½

d) Heading	1/2	
A.Y. 2013 – Companies Income Tax Computations	2	
A.Y. 2014 – Companies Income Tax Computations	3	
A.Y. 2015 – Companies Income Tax Computations	2	
A.Y. 2016 – Companies Income Tax Computations	2	
Comment	<u>1</u>	<u>10½</u>
		<u>30</u>

EXAMINER'S REPORT

The question tests candidates' knowledge and understanding of allowable and disallowable expenses, the determination of assessable profits or losses and capital allowances in the computation of tax liabilities.

It was attempted by all the candidates. Candidates' performance was poor. The commonest pitfalls was the candidates inability to distinguish between allowable and disallowable expenses, incorrect basis period and incorrect years of assessment for calculating capital allowances.

Candidates are advised to prepare better for future examinations using the ICAN Study Texts and other suitable materials in order to improve performance.

SOLUTION 2

- (a) The Nigerian National Petroleum Corporation (NNPC) through one of its subsidiaries - The Nigerian Petroleum Development Company (NPDC) carries out the following activities:
- i. Exploration-seismic acquisition/processing activities which involve analyzing, exploratory, drilling and testing activities;
 - ii. Appraisal- drilling of appraisal wells, re-evaluation survey testing;
 - iii. Development- drilling/development of wells, production, optimization, well engineering and field survey;
 - iv. Production- intervention and stimulation of production optimization; and
 - v. Abandonment – environmental impact assessment (EIA) effluent monitoring, testing/facilities, demobilization, remediation and decommissioning.
 - vi. NPDC has joint partners e.g. Shell Petroleum Development Company and Chevron Nigeria Limited (SPDC and CNL) and Service Contract Partners.
- (b) **An Oil Mining Lease** is the lease granted to a company under the Minerals Act for the purpose of winning petroleum or any assignment of such a lease. Its importance rests on the fact that it is the legal approval to commence mining operations.
- Oil Prospecting Licence**
A licence granted to a company under the Minerals Act for the purpose of winning petroleum or any assignment of such a licence. Its importance is the fact that it is the legal approval to commence prospecting for petroleum.

2c

JOJI PETROLEUM COMPANY LIMITED
COMPUTATION OF PETROLEUM PROFITS TAX

	₦	₦
Petroleum profit tax payable		<u>1,336,000.00</u>
Chargeable profit $\left\{ \text{₦}1,336,000 \times \frac{100}{85} \right\}$		1,571,765.70
Add: deductions		
Loss b/f	6,250,000.00	
Royalties paid but unexpensed	1,638,000.00	
Custom duty	125,000.00	
Capital allowances:		
- brought forward	8,901,000.00	
- for the year	<u>6,080,000.00</u>	
		<u>22,994,000.00</u>
Adjusted profit		24,565,765.70
Less: loss brought forward		<u>(6,250,000.00)</u>
		18,315,765.70
Tertiary Education Tax		
$(\frac{2}{102} \times \text{₦}24,565,765.70)$		<u>481,681.68</u>
Assessable Profit		17,834,084.02
Lower of		
Capital allowance for the year	6,080,000.00	
Brought forward	<u>8,901,000.00</u>	
	<u>14,981,000.00</u>	
OR		
85% of assessable profit		
$(0.85 \times \text{₦}17,834,084.02)$	15,158,971.41	
Less: 170% of tax offset		
$(1.70 \times \text{₦}(1,638,000 + 125,000))$	<u>(2,997,100.00)</u>	
	<u>12,161,871.41</u>	<u>(12,161,871.41)</u>
Chargeable profit		<u>5,672,212.61</u>
Assessable Tax @ 85% of ₦5,672,212.61		<u>4,821,380.72</u>
Chargeable Tax		<u>4,821,380.72</u>
Tertiary Education Tax		<u>481,681.68</u>
		<u>5,303,062.40</u>

- (c)
- i. The significance of Adjusted Profit for tax purpose is that it incorporates adjustments for disallowable expenses distinct from the computation of Net Profit or Surplus for the year for accounting purposes.
 - ii. The significance of Chargeable profit is that it incorporates adjustments for losses brought forward (if any), Tertiary Education Tax and Capital Allowance. It is the amount on which Petroleum Profits Tax is charged.
 - iii. The significance of Chargeable Tax is that it is the tax that will be paid for the year of assessment to which it relates.

MARKING GUIDE

	Marks
(a) Identify activities of NPDC (1 mark each for any correct one)	5
(b) Identifying what Oil Prospecting Licence/Oil Mining Lease are ($\frac{1}{2}$ mark for each correct one)	1
Stressing their significance ($\frac{1}{2}$ mark for each correct one)	1
(c) Identifying the disallowable deductions	4
Identifying parameters to determine capital allowance to use	1½
Identifying Tax offsets	2
Calculation of Assessable tax	2
Calculation of chargeable tax	2
Significance of each of the computations ($\frac{1}{2}$ Mark each for 3 points)	1½
	<u>20</u>

EXAMINER'S REPORT

The question tests the candidates' knowledge of the regulatory role of the NNPC in the Oil and Gas Sector of the Nigerian economy and the significance of the Oil Mining Lease and Oil Prospecting Lease. Candidates are also expected to compute chargeable profits, Adjusted Profit, Chargeable Tax and explain their significance under Petroleum Profits Taxation.

Over 60% of the candidates attempted the question.

Major pitfall is the poor understanding of the question.

Candidates are advised to use ICAN Study Texts and other suitable reading materials in their preparation for the examination.

SOLUTION 3

OBIOMA AND SONS LIMITED

a) Chargeable assets include:

- i. Options and debts;
- ii. Incorporeal properties (goodwill, patents, trademarks and copyrights);
- iii. Any currency other than Nigerian currency;
- iv. Land and buildings, plant and machinery, motor vehicles, etc; and
- v. Any other form of property created by the person disposing of it or otherwise coming to be owned without being acquired.

b) Conditions for Granting Roll-Over Relief are:

- i) The consideration from the disposal of the old asset must be re-invested wholly or partly in the acquisition of the new asset;
- ii) The old assets disposed of and the new assets acquired must be within one, and the same one, of the following classes of assets;
Class 1- Land, buildings, fixed plant and machinery
Class 2- Ships
Class 3- Aircraft
Class 4- Goodwill;
- iii) The acquisition of the new assets was made for the purpose of their use in the trade not wholly or partly for the purpose of realising a gain from the disposal of the new assets;
- iv) The new assets must be acquired or an unconditional contract for the acquisition entered into within the period beginning 12 months before and ending 12 months after the date of disposal of the old assets or at such earlier or later time as the relevant tax authority may, by a written notice allow;
- v) The person carrying on the trade must make a claim for the Roll-Over relief.

c) Computation Of Capital Gains

	₦
Sale proceeds of Plant and Machinery	37,925,000
Incidental expenses of disposal	<u>(5,125,000)</u>
Net sale proceeds	32,800,000
Cost attributable to part disposed of (see workings)	<u>(17,503,846)</u>
Chargeable gain	<u>15,296,154</u>

d)	Computation of Capital Gains Tax For 2015 Assessment Year	₦
	Chargeable gains	<u>15,296,154.00</u>
	Capital gains tax payable (10% x ₦15,296,154)	<u>1,529,615.40</u>
e)	Cost of part of Plant and Machinery not disposed of	₦
	Cost of Plant and Machinery	24,600,000
	Cost attributable to part of Plant and Machinery disposed of	<u>(17,503,846)</u>
	Cost of part of Plant and Machinery not disposed of	<u>7,096,154</u>

Workings:

Cost attributable to part of plant and machinery disposed of:

$$\frac{A}{A+B} \times C$$

Where;

A = Value of part of Plant and Machinery disposed of

B = Value of part of Plant and Machinery not disposed of

C = Total cost of the asset

$$= \frac{₦37,925,000}{₦37,925,000 + ₦15,375,000} \times ₦24,600,000$$

$$= ₦17,503,846$$

MARKING GUIDE

	Marks
Chargeable assets ($\frac{1}{2}$ mark each for any four points)	2
Conditions for grant of Roll-over relief (2 marks each for 4 correct answers)	8
Sale proceeds of plant & machinery	$\frac{1}{2}$
Incidental expenses	$\frac{1}{2}$
Net sale proceeds	$\frac{1}{2}$
Cost attributable to part disposed of	2
Chargeable Gains	4
Capital gains tax payable	<u>1</u>
	<u>15</u>

EXAMINER'S REPORT

The question tests candidates' understanding of various aspects of Capital Gains Tax covering identification of chargeable assets; conditions governing the grant of Roll-Over Relief; computation of chargeable gains and Capital Gains Tax.

Most all the candidates attempted the question. Majority of them displayed a good understanding of the question and performance was above average.

The commonest pitfalls were the inability of some candidates to state the conditions for the grant of Roll-Over Relief and calculate correctly the cost of the remaining asset.

Candidates are advised to use ICAN Study Texts and other suitable reading materials for future examinations. This will enhance their performance in future examinations.

SOLUTION 4

- (a) Tax planning involves making conscious efforts to consider the tax that will be payable by a taxpayer at a future date and how such tax can be minimized. This is the element of the anticipatory nature of tax planning.

The ability to minimize the tax payable presupposes a deep knowledge of tax laws. You are as good as your knowledge of tax laws in planning future tax liability if you have some knowledge about dates and timing of such tax payments on due dates. It is to this extent that both skills are critical in tax planning.

Tax planning requires a well thought out methodology in achieving set objectives. The use of a Tax Planning Checklist is a sine qua non for adoption of methodologies that will aid tax planning. These include:

- i. List of approved taxes and levies;
- ii. Timing of fixed assets or non-current assets acquisition;
- iii. Timing of fixed assets or non-current assets disposals in view of balancing allowance adjustments;
- iv. Timing of capital allowances claim and amount to claim;
- v. Where to invest;
- vi. Making specific instead of general provisions;
- vii. Properly deducting PAYE;
- viii. Withholding tax properly deducted;
- ix. Consider Roll-Over Relief under the Capital Gains Tax Act;
- x. Consider existing tax incentives available;
- xi. Hire of assets as alternative to outright purchase which is not tax deductible;
- xii. Consider exempt income and profits (Sec 19 CITA Cap C21 LFN 2004);
- xiii. Investment options – low or no tax investment opportunities;
- xiv. Dividend distribution out of Franked Investment Income; and
- xv. Consider the effects of benefits-in-kind on taxable remuneration.

(b)

**GRINGRIN NIGERIA LIMITED
COMPUTATION OF TAX LIABILITIES
ASSESSMENT YEARS 2013, 2014 and 2015**

Year of Assessment		Scenario 1	
	(Based on June 30)		
2013	1/7/2011 – 30/6/2012 $\frac{9}{12} \times \text{N}33,000 + \frac{3}{15} \times \text{N}78,000$ $\text{N}24,750 + \text{N}15,600$	40,350	<u>12.105</u>
2014	1/7/2012 – 30/6/2013 $\frac{12}{15} \times \text{N}78,000$	62,400	<u>18.720</u>
2015	1/7/2013 – 30/6/2014	34,000	<u>10.200</u>
		Scenario 2	
	(Based on December 31)		
2013	1/1/2011 – 31/12/2012 $\frac{3}{12} \times \text{N}33,000 + \frac{9}{21} \times \text{N}180,000$ $\text{N}8,200 + 77,142.85$	85,392.85	<u>25,618.85</u>
2014	1/1/2013 – 31/12/2013 $\frac{12}{21} \times \text{N}180,000$	102,857.17	<u>30,857.15</u>
2015	1/1/2014 – 31/12/2014	70,000.00	<u>21,000.00</u>

MARKING GUIDE

	Marks
Five matters for Tax Planning	5
Correct identification of basis period Scenario I & II	
1 mark each for each 6 points	6
Correct Assessment Year (Scenario I & II)	
¼ mark each for the six points	1½
Correct Assessment profit (Scenario I & II)	
1 mark each for the six points	6
Correct Tax Liability (Scenario I & II)	
¼ mark each for the six points	1½
	<u>15</u>
	<u>20</u>

EXAMINER'S REPORT

The question tests candidates' understanding of the content of a Standard Tax Planning Checklist and a change of accounting date scenario.

Over 50% of the candidates attempted the question. They displayed poor understanding of the question.

The commonest pitfall was that many of the candidates did not go beyond computing the Assessable Profits. Marks were lost by many candidates who did not proceed to compute the tax liabilities for each year.

Candidates should ensure they grasp the requirements of questions as it is an important element of success in examinations.

Candidates are advised to use the ICAN Study texts.

SOLUTION 5

- (a) Industries that qualify for the grant of pioneer status:
- i. Vehicle manufacturing;
 - ii. Integrated dairy production;
 - iii. Manufacture of Iron and Sheet from Iron Ore;
 - iv. Manufacture of lime and local lime stone;
 - v. Quarrying and processing of marbles;
 - vi. Manufacture of fertilizer;
 - vii. Cultivation and processing of food crops, vegetables and fruits;
 - viii. Manufacture of salt;
 - ix. Manufacture of pharmaceutical products;
 - x. Manufacture of Ceramic products;
 - xi. Manufacture of cement;
 - xii. Manufacture of glass and glasswares;
 - xiii. Manufacture of animal foodstuffs;
 - xiv. Manufacture of starch and plantation crops;
 - xv. Manufacture of paper – pulp, paper and paperboard;
 - x. Bone crushing operations; and
 - xi. Oil palm plantation and processing etc.

(b)

AJANAKU NIGERIA LIMITED
COMPUTAION OF ADJUSTED PROFITS/(LOSSES)

	6 Months	Year to	Year to	Six Months
	31/12/11	31/12/12	31/12/13	30/6/14
	₦'000	₦'000	₦'000	₦'000
(Loss)/Profits	(3,750)	(4,800)	2,250	4,500
Add Back				
Depreciation	2,800	2,500	1,700	1,000
Withholding tax on rent	500	250	-	-
Traditional Dance Troupe	<u>100</u>	<u>-</u>	<u>-</u>	<u>-</u>
Adjusted profits	<u>(350)</u>	<u>(2,050)</u>	<u>3,950</u>	<u>5,500</u>

COMPANIES INCOME TAX COMPUTATION

	1 st Year 1/7/11 – 30/6/12 N'000	2 nd Year 1/7/12 – 30/6/13 N'000	3 rd Year 1/7/13 – 30/6/14 N'000
Profit/(loss) for the period (N350,000) + ½ (N2,050,000)	(1,375)	-	-
Profit/(loss) for period ½ (N2,050,000) + ½ (N3,950,000)	-	950	-
½ (N3,950,000) + (N4,500,000)	-	-	6,475
	<u>(1,375)</u>	<u>950</u>	<u>6,475</u>
Tax payable	NIL	NIL	NIL

AJANAKU NIGERIA LIMITED will not pay any tax for the 2012, 2013 and 2014 Years of Assessment – as a result of its Pioneer status. Tax holiday covers the years in question.

Dividends declared and payable out of Profits made during the Pioneer years do not attract Withholding Tax, thus the shareholders will not suffer Withholding tax on the dividends declared.

MARKING GUIDE

	Marks
Heading	1
Identification of each of four products (½ mark each for any 4)	2
Correct identification of period (½ mark each for each basis period)	2
Correct computation of Adjusted Profit (1 mark each for each basis period)	4
Correct computation of Income Tax payable(1 mark for each basis period)	3
Summary of tax due for Ajanaku Nigeria Ltd.	1½
Remarks on Withholding Tax	1½
	<u>15</u>

EXAMINER'S REPORT

The question tests candidates' understanding of industries that qualify for the grant of "Pioneer Status" under the Industrial Development (Income Tax Relief) Act 1971 and ability to compute the tax liabilities relating to the Pioneer period of a company. They were also required to deal with issues relating to withholding tax on dividends.

About 50% of the candidates' attempted the question and performance was below average.

The commonest pitfalls include candidates' inability to identify industries that qualify as "pioneer industries" reliefs available to pioneer industries and determination of the relevant basis periods.

Candidates are advised to use ICAN Study texts and other suitable materials in their preparation for future.

SOLUTION 6

(a)

i. **Associated Gas**

Associated Gas is a form of natural gas which is found in deposits of Petroleum either dissolved in the oil or as a free 'gas cap' above the oil in the reservoir. This may be a stranded gas reservoir due to the remote location of the oil field. It is produced in the course of Crude oil production and is flared by most of the Oil producing companies in Nigeria.

ii. **Downstream Activities**

They are those activities that take place from receipt of crude oil into crude oil tanks or gas into petrol-chemical tanks to the transportation of refined products to the final user of processed products to secondary Industries.

These activities encompass transporting, refining, liquefaction of natural gas, distribution and marketing of refined petroleum products, gas and derivatives.

Companies engaged in downstream activities are subject to tax under the Companies Income Tax Act Cap C21 LFN 2004. They include marketing companies, independent marketers, and oil servicing companies.

(b)

**Bivenette Petroleum Company Limited
Computation of Petroleum Profits Tax
Assessment Year 2013**

	N	N
Value of Oil exported		1,030,000,000
Domestic Sales		842,000,000
Chargeable Gas Sales		603,000,000
Other Income		<u>425,000,000</u>
		2,900,000,000
Operating Cost N (1,385,000,000 – 302,000,000)	1,083,000,000	
Intangible Cost	142,800,000	
Royalty on Export Sales	125,000,000	
Royalty on Local Sales	96,500,000	
Non-productive Rent	102,000,000	
Rentals	101,200,000	
Administrative expenses	265,000,000	
Interest paid N (98,000,000 – 12,000,000)	<u>86,000,000</u>	
		<u>(2,001,500,000)</u>
Net Profit		898,500,000
Tertiary Education Tax N (898,500,000 x $\frac{2}{102}$)		<u>(17,617,647)</u>
Assessable Profit		880,882,353
Capital Allowances:		
The lower of		
(a) Capital Allowance for the year plus	253,750,000	
Petroleum Investment Allowance	<u>173,000,000</u>	
	<u>426,750,000</u>	
OR		
(b) 85% of Assessable Profit (85% of N 880,882,353)	748,750,000	
Less: 170% of Petroleum Investment Allowance:		
(170% of N 173,000,000)	<u>(294,100,000)</u>	
	<u>454,650,000</u>	
		<u>(426,750,000)</u>
Chargeable Profit		<u>454,132,353</u>
Assessable Tax @ 85%		<u>386,012,500</u>
Chargeable Tax		<u>386,012,500</u>

In calculating the Net Profit, a candidate may include the Exploration Incentive as part of the Operating Cost. The same amount must be added back in computing the Net profit.

MARKING GUIDE

		Total	Marks
a.	i.	Description as by - product of Crude Oil Production	2
	ii.	Definition of the term downstream	1
		Assessment under CITA	1
			<hr/>
			4
b.		Correct Heading showing year 2013	1
		Total Income	1
		All operating cost ($\frac{1}{4}$ mark for each)	2
		Correct determination of Tertiary Education Tax	2
		Capital allowance claimable	
	-	Determination of "a"	
	-	Determination of "b"	
	-	Determination of alternative to use	
			<hr/>
			8
		Chargeable Profit	1
		Assessable Tax	1
		Chargeable Tax	1
			<hr/>
			15

EXAMINER'S REPORT

The question tests candidates understanding of technical terms relevant to the Petroleum Industry such as Associated gas downstream activities and how to determine Assessable Profit, Assessable Tax and Chargeable Tax.

The question was generally well understood by the candidates. About 90% of them attempted it and Performance was fair, notwithstanding that they could have done better.

The commonest pitfalls include incorrect computation of capital allowances, tertiary education tax, assessable tax, chargeable tax as well as the mix-up of downstream activities with upstream activities.

Candidates are advised to prepare better, by using ICAN Study Texts along with other relevant study materials. Working through computational examples will also enhance confidence in attempting questions since the subject involves some calculations.

SOLUTION 7

(a) Tax Planning

This entails an analysis of an individual's or corporate organisation's financial situation in a most efficient and optimum manner so as to minimize tax liability.

The taxpayer makes the best use of or takes advantage of the various tax deductions, exclusions, exemptions, incentives, concessions, benefits and allowances permitted by the tax laws in order to minimize tax liability.

This comes in a way that the taxpayer within his business activities and the tax legislation, arranges his/her financials in such a way as to equally place his/her earnings outside his/her tax returns. In this way, little or no tax is paid for a particular financial year and beyond.

Tax planning in most cases is synonymous with Tax avoidance which must be done within the letters and the spirit of the law.

Some of the Anti-avoidance measures put in place by Government include:

- i. Treating undistributed profit of a Closed Company and distributed where it appears that a Nigerian Company controlled by not more than five persons, with a view to reducing the aggregate of the tax chargeable in Nigeria on the profits or income of the company it has not distributed to its shareholders as dividend from profits, which if distributed would not have been detrimental to the company's business. Such profits distributed to individuals will be deemed to be profits or income from a dividend accruing to those persons in proportion to their shares in the capital of the company.
- ii. **Dividend payment**
Where dividend paid is more than total profit or dividend is paid where there is no total profit by a Nigerian Company to another Nigerian Company or companies, the dividend paid shall be treated as total profit and charged to tax at the rate of 30% for that year of assessment.
- iii. **Arm's length**
Where the board is of the opinion that any disposition is not in fact given effect to or that any transaction which reduces or would reduce the amount of any tax payable is fictitious or artificial, it would disregard the disposition and assess it at the market value of the transaction.

iv. **Turnover Assessment**

Where the Revenue Board feels that a trade or business produces either no assessable profit or assessable profit that is less than expected of the trade or business, assessment may be raised on the basis of a reasonable percentage of turnover or that part of the turnover attributable to the fixed base of the business (if its a Non- Nigerian Company)

v. **Minimum Tax provision**

vi. **Trade or business sold or transferred**

The Board may decide not to grant the company applicable sections of commencement and cessation clauses and initial allowance where the sale or transfer is between connected persons.

vii. **Transfer Pricing**

It is based on arm's length price to ensure that prices charged by associated enterprises for transfer of goods and services and intangible property are done at arm's length.

(b) **Tax Evasion**

This is also called Tax Fraud in some countries. The situation may involve one of the following:

- i. Failure to furnish a return or information;
- ii. Failure to keep records as may be required by the Tax Authority;
- iii. Failure to comply with the requirements of a notice;
- iv. Making incorrect returns or information;
- v. Understating income liable to Tax;
- vi. Inflation of claims;
- vii. Refusing to pay Tax;
- viii. Forgery, fraud or willful default or neglect.

It should be noted that tax evasion is a criminal offence which can lead to imprisonment if convicted.

(c) **The provision of the Double Taxation Agreement**

Where there exists double taxation agreement between one country and Nigeria, the amount of relief available will be computed on the basis of the provisions of the agreement and the relevant sections of the Act.

The main objectives of Double Taxation Treaty are:

- i. Avoidance of Double Taxation;
- ii. Lower compliance cost;

- iii. Exchange of information;
- iv. Mutual agreement procedure;
- v. Prevention of fiscal evasion and avoidance;
- vi. Encouragement of Economic Cooperation within States; and
- vii. Clarification of taxing rights of each State.

(d) **Non-Tax factors that influence investors choosing/preferring a Jurisdiction for business**

- i. Economic and Political Stability.
- ii. Adequate physical business, accounting and legal infrastructures.
- iii. The absence (or limited presence) of bureaucratic obstacles.
- iv. Adequate Communication Channels.
- v. Ability to negotiate profit freely.
- vi. Effective banking system.
- vii. Availability of an adequate dispute resolution mechanism.

MARKING GUIDE

	Total	Marks
(a) Explanation of Tax Planning	1	
Advantages of deductions, exemptions, incentives, concessions, benefits and allowances	1	
Definition of Tax Avoidance $\frac{1}{2}$ mark		
Anti-avoidance measures put in place (any two) $\frac{1}{4}$ each	<u>1</u>	3
(b) Actions leading to Tax Evasion (1 mark each for any 4)		4
(c) The definition of Double Taxation Treaty	1	
Objectives of Double Taxation (Any three)	<u>3</u>	4
(d) Tax-factors that affect investors (Any four factors)		<u>4</u>
		<u>15</u>

EXAMINER'S REPORT

The question tests candidates' understanding of the concepts of tax planning, anti-avoidance legislations, Double Taxation Agreements and Non-tax factors that influence Investors' choices.

About 75% of the candidates attempted the question and performance was poor.

The pitfalls observed were instances when some candidates treated tax planning from the point of view of government instead of from that of the taxpayer. Some did not understand the non-tax factors that influence investor's choice of business justification. Some displayed a lack of understanding of objectives of Double Taxation Agreements and the provisions.

Candidates should prepare better for future examinations using the ICAN Study text and learn how to apply the knowledge acquired in answering questions.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2016

STRATEGIC FINANCIAL MANAGEMENT

Time Allowed: 3 hours

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

SECTION A:

COMPULSORY QUESTION

(30 MARKS)

QUESTION 1

Tinko Plc (TP) repairs and maintains heavy duty trucks, with workshops all over Nigeria and a number of countries in Africa.

Below are extracts from the most recent Statement of Financial Position of TP:

	₦'million
Share capital (50kobo/share)	200
Reserves	320
Non-current liabilities	760
Current liabilities	60
	<u>1,340</u>

TP's Free Cash Flows to Equity (FCFE) is currently estimated at ₦153million and this is expected to grow at 2.5% per annum to infinity. The equity shareholders require a return of 11%.

The company's non-current liabilities consist entirely of ₦1,000 nominal value of bonds which are redeemable in four years at par, with a coupon rate of interest of 5.4%. The debt is rated BB and the credit spread on BB rated debt is 80 basis points above the risk-free rate of return.

The government recently launched its "Graduates Back To Land (GBTL)" programme in which graduates are being encouraged to take on highly mechanised farming. The programme will involve massive importation of heavy duty agricultural machines like tractors, harvesters, driers, etc. for distribution to "Graduate Agric Clubs" all over the country. However, there is a growing concern, within the country about the possibility of effective maintenance of these machines. TP is therefore considering entering this market through a four-year project. The project will cease after four years because of increasing competition.

The initial cost of the project is expected to be ₦84million and it is expected to generate the following after-tax cash flows over its four-year life:

Year	1	2	3	4
Cash flows (₦'000)	5,555.20	32,268.60	73,009.40	71,367.20

The above figures are based on the GBTL programme growing as expected. However, it is estimated that there is 25% probability that the GBTL programme will not grow as expected in the first year. If this happens, then the present value of the project's cash flows will be 50% of the original estimates over its four-year life.

It is also estimated that if the GBTL programme grows as expected in the first year, there is still a 20% probability that the expected rate of growth will slow down in the second and subsequent years, and the present value of the project's cash flows would then be 40% of the original estimates in each of these years.

Feedwell Limited (FL) has offered ₦100million to buy the project from TP at the start of the second year. TP is considering whether having this choice would add to the value of the project.

Although, there is no beta for companies offering maintenance services for only agricultural machines and equipment in the country, Abako Plc (AP), a listed company, offers maintenance and related services for construction, minning, and agricultural equipment. About 15% of its business is in the equipment maintenance services in the agricultural sector. AP has an equity beta of 1.6. It is estimated that the asset beta of non-agricultural maintenance sectors is 0.80. AP's shares are currently trading at ₦4.50 per share and its debt is currently trading at ₦1,050 per ₦1,000. It has 80 million shares in issue and the book value of its debt is ₦340million. The debt beta is estimated to be zero.

The income tax rate applicable to all companies is 20%. The risk-free rate is estimated to be 4% and the market risk premium is estimated to be 6%.

Required:

- a. Calculate the current total market value of TP's:
 - i. Equity (3 Marks)
 - ii. Bonds (4 Marks)
 - b. Calculate the risk-adjusted cost of capital required for the new project. (Round your final answer to the nearest %). (10 Marks)
 - c. Estimate the value of the project **with and without** the offer from FL (10 Marks)
 - d. State the assumptions made in your calculations. (3 Marks)
- (Total 30 Marks)**

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

QUESTION 2

Honey Comb Plc, has issued 10% convertible loan stock which is due for redemption in 10 years' time i.e. December 31, 2025. The option to convert is open only for another two years. If conversion does not take place by December 31, 2017, the option will lapse. The issue was sold to the public at a price of ₦920 for ₦1000 of convertible loan stock. The conversion rate at January 1, 2016 was 250 equity shares for ₦1000 of stock. Non-convertible loan stock in a similar risk class is presently yielding 12%. The market price of Honey Comb Plc. equity shares has been increasing steadily over time reflecting the performance of the company. The shares currently pay a dividend of ₦0.30 per share. The current price of the convertible security is ₦960 and each share is currently valued at ₦3.00. A holder of the convertible loan stock is considering whether to sell his holdings or continue to hold the stock. Ignore taxation, while answering the questions.

Required:

- a. What is the value of the security as simple unconvertible loan stock? (5 Marks)
 - b. What is the expected minimum annual rate of growth in the equity share price that is required to justify the holder of convertible loan stock holding on to the security before the option expires? (12 Marks)
 - c. What recommendation would you make to the holder of the security and why? (3 Marks)
- (Total 20 Marks)**

QUESTION 3

Jack Limited is a family-owned business which has grown strongly in the last 50 years. The key objective of the company is to maximise the family's wealth through their shareholdings.

Recently, the directors introduced value-based management, using Economic Value Added (EVA) as the index for measuring performance.

You are provided with the following financial information.

Statement of Profit or Loss and Other Comprehensive Income for the year ended December 31, 2015.

	₦'million
Operating profit	340.0
Finance charges	<u>(115.0)</u>
Profit before tax	225.0
Tax at 25%	<u>(56.3)</u>
Profit after tax	<u>168.7</u>

Notes	2015 (₦'m)	2014 (₦'m)
(i) Capital employed – from the Statement of Financial Position	6,285	6,185
(ii) Operating costs:		
Depreciation	295	285
Provision for doubtful debts	10	2.5
Research and development	60	–
Other non-cash expenses	35	30
Marketing expenses	50	45
(iii) Economic depreciation is assessed to be ₦415 in 2015. Economic depreciation includes any appropriate amortisation adjustments. In previous years, it can be assumed that economic and accounting depreciation were the same.		
(iv) Tax is the cash paid in the current year (₦45million) and an adjustment of ₦2.5million for deferred tax provisions. There was no deferred tax balance prior to 2015.		
(v) The provision for doubtful debts was ₦22.5million on the 2015 Statement of Financial Position.		
(vi) Research and development cost is not capitalised in the accounts. It relates to a new project that will be developed over five years and is expected to be of long-term benefit to the company. The first year of this project is 2015.		
(vii) The company has been spending heavily on marketing each year to build its brand long term.		
(viii) Estimated cost of capital of the company:		
Equity	16%	
Debt (pre-tax)	5%	
(ix) Gearing (Debt/Equity) Ratio	1.5: 1	

Required:

- a. Calculate, showing all relevant workings, the Economic Value Added (EVA) for year ended December 31, 2015. Make use of the adjusted opening capital employed. Comment on your result and make appropriate recommendations. (15 Marks)
- b. Irrespective of your answer in (a) above, assume the company's current EVA is ₦120million and that this will decline annually by 2% for the next ten years and then increase by 4% per annum in perpetuity. Assume the following for this part only:
- Cost of equity 14%
 - WACC 10%
- Calculate the market value added (MVA) by the company.
Show all workings (5 Marks)
- (Total 20 Marks)**

QUESTION 4

Gugi Plc. is a highly successful manufacturing company operating in Nigeria. In addition to sales within Nigeria, the company also exports to a foreign country (with currency F\$) along the ECOWAS sub-region. The export sales generate annual net cash inflow of ₦50,000,000.

Gugi Plc. is now considering whether to establish a factory in the foreign country and stop export from Nigeria to the country. The project is expected to cost F\$1 billion, including F\$200million for working capital.

A suitable existing factory has been located and production could commence immediately. A payment of F\$950million would be required immediately with the remainder payable at the end of year one. The following additional information is available:

- | | |
|--|--------------|
| • Annual production and sales in units | 110,000 |
| • Unit selling price | F\$5,000 |
| • Unit variable cost | F\$2,000 |
| • Unit royalty payable to Gugi Plc | ₦300 |
| • Incremental annual cash fixed costs | F\$50million |

Assume that the above cash items will remain constant throughout the expected life of the project of 4 years. At the end of year 4, it is estimated that the net realisable value of the non-current assets will be F\$1.40billion.

It is the policy of the company to remit the maximum funds possible to the parent (i.e. Gugi Plc.) at the end of each year. Assume that there are no legal complications to prevent this.

If the new factory is set up and export to the foreign country is stopped, it is expected that new export markets of a similar worth in North Africa could replace the existing exports.

Production in Nigeria is at full capacity and there are no plans for further capacity expansion.

Tax on the company's profits is at a rate of 40% in both countries, payable one year in arrears. A double taxation agreement exists between Nigeria and the foreign country and no double taxation is expected to arise. No withholding tax is levied on royalties payable from the foreign country to Nigeria.

Tax allowable "depreciation" is at a rate of 25% on a straight line basis on all non-current assets.

The Directors of Gugi Plc. believe that the appropriate risk-adjusted cost of capital of the project is 13%.

Annual inflation rates in Nigeria and the foreign country are currently 5.6% and 10% respectively. These rates are expected to remain constant in the foreseeable future. The current spot exchange rate is F\$1.60 = ₦1. You may assume that exchange rate reflects the purchasing power parity theorem.

Required:

- a. Evaluate the proposed investment from the view point of Gugi Plc.

Notes

- i. Show all workings and all calculations to the nearest million.
ii. State all reasonable assumptions. (18 Marks)
- b. State **TWO** further information and analysis that might be useful in the evaluation of this project? (2 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. Capital Asset Pricing Model (CAPM) is an equilibrium model of the trade-off between expected portfolio return and unavoidable risk.
What are the basic assumptions on which this model is based? (6 Marks)

- b. Currently, the rate of return on the Federal Government Bond redeemable at par in the year 2018 is 5%. The securities of four companies, Akira Plc., Bombadia Plc., Courage Plc. and Divine Plc. have expected returns of 12%, 9.5%, 10.5% and 13% respectively. The average expected return on market portfolio is 10% subject to a 6% risk (standard deviation). Other relevant information relating to the four securities of the companies is as stated below:

	Standard Deviation	Correlation Coefficient
Akira Plc	0.080	0.975
Bombadia Plc	0.075	0.640
Courage Plc	0.090	0.740
Divine Plc	0.150	0.680

You are required to show which of the companies is/are overvalued. (9 Marks)
(Total 15 Marks)

QUESTION 6

Osamco Limited, manufacturer of wire and cables, was bought from its conglomerate parent company in a management buyout deal in August, 2010. Six years after, the managers are considering the possibility of listing the company's shares on the Nigerian Stock Exchange.

The following information is made available:

OSAMCO LIMITED	
INCOME STATEMENT FOR THE YEAR ENDED JUNE 30, 2016	
	₦'million
Turnover	91.25
Cost of sales	<u>(79.00)</u>
Profit before interest and taxation	12.25
Interest	<u>(3.25)</u>
Profit before taxation	9.00
Taxation	<u>(1.25)</u>
Profit attributable to ordinary shareholders	7.75
Dividend	<u>(0.75)</u>
Retained profit	<u>7.00</u>

STATEMENT OF FINANCIAL POSITION AS AT JUNE 30, 2016

	₦'million	₦'million
Non-current assets (at cost less accumulated depreciation)		
Land and buildings		9.00
Plant and machinery		<u>24.75</u>
		33.75
Current assets		
Inventories	11.00	
Accounts receivable	11.75	
Cash at bank	<u>2.50</u>	
		<u>25.25</u>
		<u>59.00</u>
Ordinary shares of ₦1 each		6.75
Reserves		<u>24.25</u>
		31.00
Accounts payable due after more than one year:		
12% Debenture 2018		5.50
Current Liabilities		
Trade accounts payable	17.5	
Bank overdraft	<u>5.0</u>	
		<u>22.50</u>
		<u>59.00</u>

Average performance ratios for the industry sector in which Osamco Limited. operates are as stated below:

Industry sector ratios

Return before interest and tax on long term capital employed	24%
Return after tax on equity	16%
Operating profit as percentage of sales	11%
Current ratio	1.6:1
Quick (acid test) ratio	1.0:1
Total debt: equity (gearing)	24%
Dividend cover	4.0
Interest cover	4.5

Required:

- Evaluate the financial state and performance of Osamco Limited by comparing it with that of its industry sector. (10 Marks)
 - Discuss **FOUR** probable reasons why the management of Osamco Limited. is considering Stock Exchange listing (5 Marks)
- (Total 15 Marks)**

QUESTION 7

One of the means by which companies expand is through mergers and acquisition. However, there are other means of expansion aside these methods.

Inkline Plc. is one of your client companies intending to expand its business by means of merger or acquisition.

Your firm of management consultants has been asked to advise the management of the company on what steps to take, while considering the merger and acquisition methods, and whether it should go ahead with the expansion programme or otherwise.

Required:

Advise your client on:

- a. (i) **FOUR** benefits derivable from its proposed means of expansion. (4 Marks)
 - (ii). **THREE** probable demerits of employing its proposed method of expansion. (3 Marks)
 - b. State **TWO** alternatives to merger and acquisition in your report. (2 Marks)
 - c. Where the company decides to go ahead with either of these methods, indicate **THREE** criteria the company may consider in choosing its target company. (6 Marks)
- (Total 15 Marks)**

Formulae

Modigliani and Miller Proposition 2 (with tax)

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

Asset Beta

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

Equity Beta

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

Growing Annuity

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

Modified Internal Rate of Return

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

The Black-Scholes Option Pricing Model

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

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

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

The Put Call Parity

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

Binomial Option Pricing

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

$$d = 1/u$$

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

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

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

The Miller-Orr Model

$$\text{Return Point} = \text{Lower Limit} + \left(\frac{1}{3} \times \text{spread} \right)$$

$$\text{Spread} = 3 \times \left[\frac{\frac{3}{4} \times \text{Transaction Cost} \times \text{Variance of Cash flows}}{\text{Interest rate}} \right]^{\frac{1}{3}}$$

Annuity Table

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

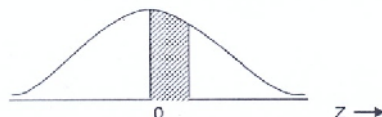
Where r = discount rate
 n = number of periods

		Discount rate (r)									
Periods		1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
(n)											
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)											
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

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

NORMAL DISTRIBUTION

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



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

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

SOLUTIONS

SOLUTION 1

a) i) Current value of equity

Using FCFE model, the current value of equity

$$= \frac{FCFE_0(1+g)}{K_E - g} = \frac{153(1.025)}{0.11 - 0.025} = \frac{156.825}{0.085} = \text{₦1,845million}$$

ii) • Cost of the bond = Risk-free rate of return plus the credit spread

$$= 4\% + 0.80\% = 4.80\%$$

• Current market value of bond with ₦1,000 face value

$$= 54\left(\frac{1}{1.048}\right) + 54\left(\frac{1}{1.048}\right)^2 + 54\left(\frac{1}{1.048}\right)^3 + 1054\left(\frac{1}{1.048}\right)^4 = \text{₦1,021.37}$$

∴ Total market value:

$$= \text{₦760m} \times 1,021.37/1,000 = \text{₦776.24million}$$

b) Calculation of project's risk-adjusted cost of capital:

The cost of capital should reflect the systematic business risk of the project. This should be calculated from the information given about AP.

• Abako Plc. (AP) asset beta

$$\text{AP's equity value} = \text{₦4.50} \times 80\text{m} = \text{₦360m}$$

$$\text{AP's debt value} = 1.05 \times \text{₦340m} = \text{₦357m}$$

$$\beta_A = \frac{\beta_E \cdot V_E}{V_E + V_D(1-t)} \quad (\text{Beta of debt} = 0)$$

$$= \frac{1.6 \times 360}{360 + (357 \times 0.8)} = 0.89$$

• Project's asset beta (x)

$$0.89 = 0.15x + (0.80 \times 0.85)$$

$$x = 1.4$$

TP

- **Project's risk adjusted equity beta**

$$\beta_E = \beta_A + (\beta_A - \beta_D) \left(\frac{V_D}{V_E} \right) (1 - t) = 1.4 + (1.4 - 0) \left(\frac{776.24}{1,845} \right) (0.8) = 1.87$$

- **Project's risk adjusted cost of equity**

Using CAPM: $R_s = R_f + \beta (R_m - R_f)$

NB: $R_m - R_f = \text{Market Risk Premium} = C$

$$\therefore R_s = 4 + 1.87 (6) = 15.22\%$$

- **Project's risk adjusted cost of capital**

$$\text{WACC} = \frac{15.22 \times 1,845}{1,845 + 776.24} + \frac{4.8 \times 0.8 \times 776.24}{1,845 + 776.24} = 11.85 \quad \text{or} \quad 12\%$$

c) Where WACC = Weighted Average Cost of Capital

i) **Value of the project without the offer from Feedwell Limited (FL)**

Year	1	2	3	4
Cash flow (₦'000)	6,555.20	32,268.6	73,009.4	71,367.20
Present value at 12%	5,852.90	25,724.3	51,966.6	45,355.10
Total PV years 1 – 4	= ₦128,898,900			Possibility A
50% of PV of years 1 – 4	= ₦64,449,450			Possibility B
Total PV years 2 – 4	= ₦123,046,000			
40% PV years 2 – 4	= ₦49,218,400			
Add PV of year 1	= ₦ 5,852,900			
	<u>55,071,300</u>			Possibility C

Summary

Possibility	Cash Flow ₦	Probability		Expected value ₦
A	128,898,900	0.60	*	77,339,340
B	64,449,450	0.25		16,112,363
C	55,071,300	0.15	**	<u>8,260,695</u>
Total PV of inflows				101,712,398
Initial outlay				<u>(84,000,000)</u>
Expected NPV (ENPV)				<u>17,712,398</u>

$$\begin{aligned}
 * \quad & 0.75 \times 0.80 = 0.60 \\
 ** \quad & 0.75 \times 0.20 = \underline{0.15} \\
 & \quad \quad \quad \underline{0.75}
 \end{aligned}$$

ii) Expected value of the project with the offer from Feedwell Limited (FL)

$$\text{PV of ₦100m} = 100,000,000/1.12 = \text{₦89,286,000}$$

If the Graduate Back To Land (GBTL) does not grow as expected in the first year, then it is more beneficial for Tinko Plc. to exercise the offer made by FL, given that FL's offer of ₦89.27 million (PV of ₦100 million) is greater than the PV of years two to four cash flows, that is, $50\% \times \text{₦}(25.72\text{m} + 51.97\text{m} + 45.36\text{m}) = \text{₦61.53m}$ for that possible outcome.

This figure is then incorporated into the expected net present value calculations. Thus, for possible outcome B:

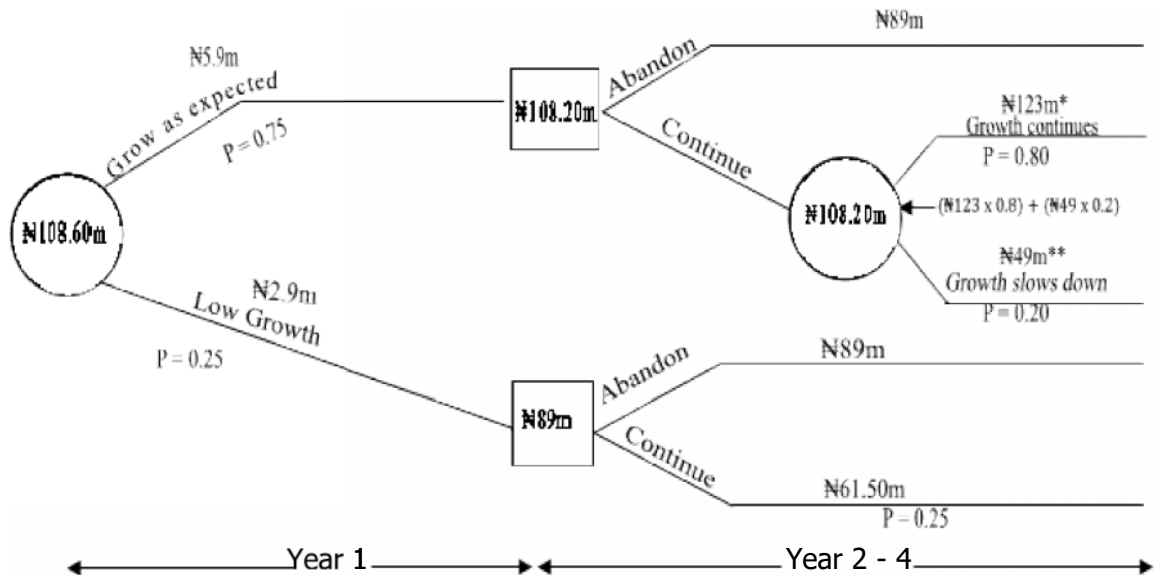
		₦
Year 1:	$50\% \times \text{₦}5,852,900$	2,926,000
2:	PV of ₦100million	<u>89,286,000</u>
		<u>92,212,000</u>

The revised NPV is as follows:

Possibility	CF ₦	Probability	Expected value ₦
A	128,898,900	0.60	77,339,000
B	92,212,000	0.25	23,053,000
C	55,071,300	0.15	<u>8,260,695</u>
PV of inflows			108,652,695
Initial outlay			<u>84,000,000</u>
ENPV			<u>24,652,695</u>

Note

The analysis above is the intended solution. Another method is to make use of decision tree. Although, a longer process, it is included here for educational purposes.



(All cash flows are in present value terms in ₦m)

* PV of cash flows in years 2 – 4

** 40% of PV of cash flows in years 2 – 4

The final value of ₦108.60million is derived as follows:

$$\text{₦}[(5.9 + 108.2) \times 0.75] + [(2.9 + 89) \times 0.25] \text{million} = \text{₦}108.60 \text{million.}$$

Removing the initial outlay of ₦84million produces ENPV of ₦24.60million.

d) Key assumptions

- It is assumed that the capital structure of the company will not change substantially when the new project is taken on. Since the initial cost of the project is significantly smaller than the value of TP itself, it is not an unreasonable assumption.
- There may be more possible outcomes in practice than the ones given and financial impact of the outcomes may not be known with such certainty. The Black-Scholes Option Pricing Model may provide an alternative and more accurate way of assessing the value of the project.
- It is assumed that TP can rely on FL paying the ₦100m at the beginning of year two with certainty.
- It is assumed that all the figures relating to the beta, growth rates, risk adjusted cost of capital and probabilities are accurate.

MARKING GUIDE

		MARKS	MARKS
(a)i	Current value of equity	3	
ii.	Current value of bond	<u>4</u>	7
(b)i	AP's asset beta	3½	
ii.	Project's asset beta	1½	
iii.	TP's equity beta	2½	
iv.	Project's cost of equity	½	
v.	Project's cost of capital (WACC)	<u>2</u>	10
(c)i.	Identification of all possible outcomes and related cash flows	3	
ii.	Present value calculations	2	
iii.	Relevant cash flows with abandonment option	3	
iv.	Calculation of present value	<u>2</u>	10
(d)	½ mark for each well-discussed point: max		<u>3</u>
	TOTAL		<u>30</u>

EXAMINER'S REPORT

The question tests candidates' knowledge of valuation of equity and bond, calculation of risk-adjusted cost of capital and evaluation of capital project involving risk and uncertainty.

Being a compulsory question, almost all the candidates attempted the question. However, it is highly disappointing that most of them did not understand the concepts being tested as they could not generate the required solutions to parts 'b' and 'c' of the question, hence performance was poor.

Candidates' commonest pitfalls were their inability to calculate the equity beta needed for the project and their failure to sort out its cash flows.

Candidates are advised to cover the syllabus adequately, work on past questions in the Institute's Study Texts, Pathfinders and other relevant text books for better results in future examination.

SOLUTION 2

- (a) The value of the security as a simple unconvertible loan stock is the present value of the future interest (years 1 – 10) and the present value of the face value due in year 10.

Item	Year	CF ₦	PVF at 12%	PV ₦
Interest	1 – 10	100	5.650	565
Face Value	10	1,000	0.322	<u>322</u>
				<u>887</u>

- (b) For the holder to convert, the current market value of the convertible must at least equal the present value of interest for the next two years and the present value of the conversion value. The conversion value:

$$= P_0 (1 + g)^n \times R,$$

Where:

P_0 = current VPS = ₦3

g = growth rate in share price to be determined

n = years to expiration of the option to convert = 2 years

R = conversion ratio = 250 shares

Thus:

Correct Market Value = The Present Value Interest for the next two years + Present Value of the conversion value.

$$\text{i.e. } 960 = \left(\frac{100}{(1.12)} + \frac{100}{(1.12)^2} \right) + \frac{3(1+g)^2 \times 250}{(1.12)^2}$$

$$960 = 169 + \frac{750(1+g)^2}{(1.12)^2}$$

$$791 = 597.90 (1 + g)^2$$

$$\frac{791}{597.90} = (1 + g)^2$$

$$g = \left(\frac{791}{597.90} \right)^{1/2} - 1 = 15\%$$

- (c) The key to hold or sell, lies in the expected growth in the value of the equity. If growth of 15% cannot be achieved, he should sell the convertible loan stock now because the failure to achieve the growth implies that the present value of interest and equity is below ~~₦~~960.00. This will not be a problem if the market is not paying a premium on the basis of expected growth. However, the value of the convertible loan stock is around ~~₦~~890 and a ~~₦~~70 premium is paid on the value basis of growth in the value of shares. The share price must increase beyond ~~₦~~890/~~₦~~250 i.e ~~₦~~3.56 to make conversion a possibility. This is because it is only at prices in excess of ~~₦~~3.56 that the convertible is worth more as shares than as a debenture.

MARKING GUIDE

	MARKS	MARKS
(a) Calculation of value as an unconvertible bond		5
(b)i. Setting out the conversion price equation	2	
ii. Substituting the relevant values	2	
iii. Computing the growth rate	<u>8</u>	
(c) Comments and recommendations		12
TOTAL		<u>3</u> <u>20</u>

EXAMINER'S REPORT

The question tests candidates' knowledge of convertible bonds, Part 'a' of the question tests candidates' knowledge of bond valuation, while part 'b' tests analysis of convertibles.

About 40 percent of the candidates attempted the question and performance was generally poor. A few of the candidates that attempted the question displayed good understanding while some had problems in providing appropriate solutions hence poor performance.

Candidates' commonest pitfalls were their inability to recognize the requirements of the question in part 'a' which was simply the valuation of bonds and their failure to work out the growth rate in part 'b'.

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

SOLUTION 3

a)

- **Calculation of Net Operating Profit After Tax (NOPAT)**

	₦m	₦m
Operating profit		340.00
Add back:		
Non-cash items	35.00	
Accounting depreciation	295.00	
Doubtful debts	10.00	
Research and development	60.00	
Marketing expenses	<u>50.00</u>	450.00
Less		
Economic depreciation	415.00	
Tax cash paid (45 – 2.5)	42.50	
Loss tax relief on interest (25% of ₦115m)	<u>28.75</u>	<u>(486.25)</u>
NOPAT		<u>303.75</u>

Adjusted opening capital employed (AOCE)

	₦m	₦m
Per 2014 Statement of Financial Position		6,185.00
Add back:		
Provision for doubtful debt at the end of 2014 (22.50 – 10)	12.50	
Other non-cash expenses (2014)	30.00	
Marketing expenses (2014)	<u>45.00</u>	<u>87.50</u>
Adjusted opening capital employed (AOCE)		<u>6,272.50</u>

- **Weighted Average Cost of Capital (WACC)**

$$WACC = (16 \times \frac{2}{5}) + (5 \times \frac{3}{5} \times 0.75) = 8.65\%$$

- **EVA (Economic Value Added)**

$$\begin{aligned} EVA &= NOPAT - (AOCE \times WACC) \\ &= 303.75 - (6,272.50 \times 0.0865) = -238.82 \text{ million} \end{aligned}$$

Comments and recommendations

The company is currently destroying value as it is failing to meet the economic cost of its own capital. This is an unsustainable position in the long term and will lead to shareholders' dissatisfaction.

To improve EVA, the following are recommended:

- Dispose assets in excess of requirement to minimize capital cost.
- Exercise tighter expenditure control to reduce expenses.
- Adopt a more aggressive sales drive to improve revenue.
- Market Value Added (MVA) is the present value (using WACC) of future EVA.
- First 10 years when $g = -2\%$. It is faster to work with growing annuity in this case.

$$\begin{aligned} PV &= \frac{EVA_1}{r-g} \left[1 - \left(\frac{1+g}{1+r} \right)^n \right] \\ &= \frac{120(1-0.02) \left[1 - \left(\frac{1-0.02}{1.10} \right)^{10} \right]}{0.10 - -0.02} = \text{N}671.28\text{m} \end{aligned}$$

- **Years 11 to infinity**

$$EVA_{11} = 120 (1 - 0.02)^{10} \times 1.04 = 101.97\text{m}$$

$$PV = \frac{101.97}{0.10 - 0.04} \times (1.10)^{-10} = \text{N}655.23\text{m}$$

$$\text{Total MVA} = \text{N}671.28\text{m} + \text{N}655.23\text{m} = \text{N}1,326.51\text{million}$$

MARKING GUIDE

	MARKS	MARKS
(a)i. Adjusted NOPAT	5	
ii. Adjusted opening capital employed	5	
iii. Calculation of WACC	1	
iv. Calculation of EVA	1	
v. Comments and recommendations	<u>3</u>	
		15
(b) Calculation of MVA		<u>5</u>
TOTAL		<u>20</u>

EXAMINER'S REPORT

The question tests candidates' knowledge of value-based management. It requires candidates to calculate Economic Value Added (EVA).

About 50% of the candidates attempted the question but most of them did not have a clear and accurate understanding of both parts of the question hence their performance was poor.

Candidates' commonest pitfalls were their inability to carry out the accounting adjustments required to determine the Net Operating Profit After Tax (NOPAT) and the Opening Capital Employed (OCE).

Candidates are advised to make use of the Institute's Study Texts in their preparation for the Institute's examinations.

SOLUTION 4

a) Calculation of (NPV) (₦million)

Year	0	1	2	3	4	5
Receipts from foreign project (W4)	(594)	99	118	112	957	(289)
Royalty received in Nigeria	-	33	33	33	33	-
Related tax in Nigeria (at 40%)	-		(13)	(13)	(13)	(13)
Net cash flow	(594)	132	138	132	977	(302)
PVF at 13%	1	0.885	0.783	0.693	0.613	0.543
PV	(594)	117	108	91	599	(164)

$$\therefore \text{NPV} = -594 + 117 + 108 + 91 + 599 - 154 = \text{₦}157,000$$

Based on the above calculation, the project is viable with a positive net present value of ₦157,000,000.

Note: The loss of exports to the foreign country is not a relevant cash flow since it will be replaced by equivalent exports to North Africa.

Working Notes

1. Exchange rate

The rate of change of the value of the foreign currency is given as:

$$\frac{1+i_D}{1+i_f} - 1, \text{ where}$$

i_D = domestic inflation rate

i_f = foreign inflation rate

In this case, we expect the foreign currency to depreciate by 4% p.a., i.e.

$$\frac{1.056}{1.10} - 1 = -4\%$$

The current value of F\$1 = $1/1.60 = \text{₦}0.625$. This is expected to depreciate by 4% p.a.

Year		₦per F\$1
0		0.625
1	0.625×0.96	0.600
2	0.600×0.96	0.576
3	0.576×0.96	0.5530
4	0.5530×0.96	0.5309
5	0.5309×0.96	0.5097

2. Royalty payable to Gugi Plc. converted to F\$

		F\$ million
Year 1	$110,000 \times 300/0.6$	55
2	$110,000 \times 300/0.576$	57
3	$110,000 \times 300/0.553$	60
4	$110,000 \times 300/0.5309$	62

3. Profit after tax (F\$ million)

Year	1	2	3	4
Contribution ($110,000 \times (5,000 - 2,000)$)	330	330	330	330
Cash fixed costs	(50)	(50)	(50)	(50)
Royalty (W2)	(55)	(57)	(60)	(62)
Tax depreciation	(200)	(200)	(200)	(200)
Taxable profit	25	23	20	18
Tax at 40%	(10)	(9)	(8)	(7)
Profit after tax	15	14	12	11

4. Project Cash Flows (F\$ million)

Year	0	1	2	3	4	5
Profit after tax		15	14	12	11	
Add depreciation		200	200	200	200	
Initial investment	(950)	(50)				
Tax			(10)	(9)	(8)	(7)
Realisable value of non-current assets					1,400	
Related tax at 40%						(560)
Working capital recovery					200	
NCF available to Gugi Plc.	(950)	165	204	203	1,803	(567)
Exchange rate	0.625	0.600	0.576	0.553	0.5309	0.5097
Available CF (₦million)	(594)	99	118	112	957	(289)

b) Further information and analysis might include:

- Information on political and economic factors of both countries; for example, how stable is the foreign government policy, the exchange rate, taxation, exchange control, attitudes towards foreign investment etc.

- ii) How accurate are the cash flow forecasts? How have they been established?
- iii) Risk: Risk is taken into account by using a Capital Assets Pricing Model (CAPM) derived discount rate. For an international project, risk is best handled using the international version of CAPM. It might also be helpful to consider the use of sensitivity analysis or simulation.
- iv) Why has a 4-year planning horizon been chosen? The valuation of non-current assets at Year 4 is highly significant to the NPV solution. How has this valuation been established? Is this valuation based upon future earnings as a going concern? It would be more desirable to evaluate the project over the whole of its projected life.
- v) Legal requirements of the foreign country.

MARKING GUIDE

	HEADING	MARKS	MARKS
(a)i	Calculation of exchange rates	3	
ii.	Conversion of royalty to F\$	1	
iii.	Computation of profit after tax F\$	4	
iv.	Projects' cash flows in ₦	5	
v.	Computation of NPV and conclusion	<u>5</u>	
			<u>18</u>
(b)	1 mark per point, max	2	<u>2</u>
	TOTAL		<u>20</u>

EXAMINER'S REPORT

The question tests candidates' knowledge of the analysis of foreign projects under International Investment decisions aspect of the syllabus.

About 80 percent of the candidates attempted the question. They however demonstrated insufficient knowledge of this area of the syllabus hence performance was very poor.

Candidates' commonest pitfalls include their inability to:

- (a) calculate the appropriate exchange rates to use;
- (b) sort out the appropriate cash flows;
- (c) remove working capital from the initial investment before computing tax depreciation;
- (d) convert the royalty paid in Naira to the F\$ for the purpose of computing the foreign tax;
- (e) account for tax on the resale value of the investment even when the asset has been fully depreciated for tax purposes;
- (f) account for Nigerian tax on royalty collected in Nigeria.

Candidates are advised to always cover the syllabus adequately and make use of the Institute's Pathfinders, Study Texts and other relevant text books in their preparations for the Institute's future examinations. They should also endeavour to pay attention to and improve their knowledge on International Investment decisions aspect of the syllabus. However, it is extremely important for candidates to note that future examination questions will continue to be set to cover all areas of the syllabus.

SOLUTION 5

(a). Assumptions of Capital Asset Pricing Model (CAPM) include the following:

- i. Investors only need to know the expected returns, the variances, and the co-variances of returns to determine which portfolios are optimal for them;
- ii. Investors have identical views about risky assets' mean returns, variances of returns, and correlations;
- iii. Investors can buy and sell assets in any quantity without affecting price; all assets are marketable (can be traded);
- iv. Investors can borrow and lend at the risk-free rate without limit, and they can sell short any asset in any quantity;
- v. Investors pay no taxes on return;
- vi. Investors pay no transaction costs on trades;
- vii. All investors' decisions are based on a single time period.

(b) Computation of the beta of each security:

$$\beta_i = \frac{(\text{Correlation with market})(\text{Standard deviation of the project})}{\text{Standard deviation of the market}}$$

$$\text{Akira (A)} \beta = \frac{(0.975)(8)}{6} = 1.30$$

$$\text{Bombadía (B)} \beta = \frac{(0.64)(7.5)}{6} = 0.80$$

$$\text{Courage (C)} \beta = \frac{(0.74)(9)}{6} = 1.11$$

$$\text{Divine (D)} \beta = \frac{0.68 \times 15}{6} = 1.70$$

- Computation of the required returns:

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

$$\text{A: } R_A = 5 + 1.30 (10 - 5) = 11.50\%$$

$$\text{B: } R_B = 5 + 0.80 (10 - 5) = 9\%$$

$$\text{C: } R_C = 5 + 1.11 (10 - 5) = 10.55\%$$

$$\text{D: } R_D = 5 + 1.70 (10 - 5) = 13.5\%$$

- Calculation of the alpha of each security and make conclusion

C1	C2	C3	C4	C5
Security	Expected return	Required return	Alpha C2 – C3	Remarks
A	12%	11.5%	0.5%	Undervalued
B	9.5%	9%	0.5%	Undervalued
C	10.5%	10.55%	-0.05%	Overvalued
D	13%	13.5%	-0.5%	Overvalued

- Conclusion

Securities with **positive** alpha are undervalued and securities with **negative** alpha are overvalued and should be sold.

MARKING GUIDE

	MARKS	MARKS
(a) Any 6 points at 1 mark each		6
(b)i. Calculation of alpha	3	
ii. Calculation of required return	2	
iii. Calculation of alpha value and its interpretation	4	
TOTAL		<u>9</u> 15

EXAMINER'S REPORT

The question tests candidates' knowledge on Capital Asset Pricing Model (CAPM).

About 25 percent of the candidates attempted the question. The few that attempted it showed a good understanding of 'part b' of the question but others had problems in providing appropriate solutions hence performance was average.

Candidates' commonest pitfalls were their mix up of the assumptions of Capital Asset Pricing Model (CAPM) with those of capital market generally in part 'a' of the question and their failure to apply the appropriate formula to calculate beta factor in part 'b'.

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

SOLUTION 6

- (a). The performance and financial health of Osamco Limited in relation to that of the industry sector as a whole can be evaluated by comparing its financial ratios with the industry averages, as follows:

Osamco Ltd.	Company's Average	Industry Average
Returns on (long-term) Capital Employed. Operating profit (PBIT):Equity + long term debt ₦12.25 : (₦31m + ₦5.5m)	33.6%	24%
Returns On Equity Profit attributable to ordinary shareholders: Equity ₦7.75m : ₦31m	25%	16%
Operating Profit Margin Operating profit : Sales ₦12.25m : ₦91.25m	13.4%	11%
Current Ratio Current assets : Current Liabilities ₦25.25m : ₦22.5m	1.12:1	1.6:1
Acid Test Ratio Current assets excluding inventory: Current liabilities ₦14.25m : ₦22.5m	0.63:1	1.01:1
Gearing Ratio Debt : Equity (₦5m + ₦5.5): ₦31m	33.9%	24%
Dividend Cover Profit attributable to equity: Dividend ₦7.75m : ₦0.75	10.3 times	4.0 times
Interest Cover Profit before interest and tax (PBIT): Interest ₦12.25m : ₦3.25	3.77 times	4.5 times

These ratios can be used to evaluate performance in terms of profitability, liquidity and financial stability.

Profitability

Osamco Limited's return on capital employed, return on equity and operating profit margin are all significantly above the industry averages. Although, the first two measures could be inflated due to asset being shown at book values, the profit margin indicates that OSAMCO LTD is managing to make good profit which could be due to successful marketing, a low cost base or to its occupation of a particularly profitable niche in the market.

Liquidity

Both the current and the quick (acid test) ratios are well below the industry averages. This suggests that Osamco Limited is either short of liquid resources or is managing its working capital poorly.

However, the three key working capital ratios modify this impression as follows:

$$\text{Receivable days :} \quad \frac{11.75}{91.25} \times \frac{365}{1} = 47 \text{ days}$$

$$\text{Inventory Turnover days:} \quad \frac{11.00}{79.00} \times \frac{365}{1} = 51 \text{ days}$$

$$\text{Payment Period days} \quad \frac{17.5}{79.00} \times \frac{365}{1} = 81 \text{ days}$$

Although, the industry averages are not given, these ratios appear to be good by general standards.

Financial Stability

Gearing ratio is high in comparison with the rest of the industry and 48% of the debt is in the form of overdraft which is generally repayable on demand. This is therefore a risky form of debt to use in large amounts. The debenture is repayable in two years and will need to be refinanced since Osamco Limited cannot redeem it out of existing resources. Interest cover is also poor, and this together with the poor liquidity probably account for the low payment ratio (the inverse of the dividend cover).

In summary, profit performance is strong, but there are significant weaknesses in both the liquidity and financial stability. These problems need to be addressed if Osamco Limited is to be able to maintain its record of strong and consistent growth.

- b) A company such as Osamco Limited may seek a stock market listing for the following reasons:
- i. **To allow access to a wider pool of finance:** Companies that are growing fast may need to raise large sums than is possible privately. Obtaining a listing widens the potential number of equity investors and may also result in an improved credit rating thus reducing the cost of additional debt finance.
 - ii. **To improve marketability of the shares:** Shares that are traded on the stock market can be bought and sold in relatively small quantities at any time. This means that it is easier for existing investors to realise a part of their holding.
 - iii. **To allow capital to be transferred to other ventures:** Founder owners may wish to liquidate the major part of their holdings either for personal reasons or for investment in other new business opportunities.
 - iv. **To improve the company's image:** Quoted companies are commonly believed to be more financially stable, and this may improve their image with their customers and suppliers, allowing them to gain additional business and improve their buying power.
 - v. **Growth by acquisition is easier:** A listed company is in a better position to make an offer for a target company than an unlisted one.

MARKING GUIDE

	MARKS	MARKS
(a)i. Calculation of the given ratios	6	
ii. Interpretation	<u>4</u>	
		10
(b) 1¼ per point (for any four points)		<u>5</u>
TOTAL		<u>15</u>

EXAMINER'S REPORT

The question tests candidates' ability to calculate and interpret basic financial ratios.

About 90% of the candidates attempted the question and performance was average. Some of the candidates displayed good understanding of the question while some had problems in providing appropriate solutions.

Candidates' commonest pitfalls were their failure to calculate some of the ratios correctly and their inability to provide appropriate interpretations of the computed ratios.

Candidates are advised to ensure adequate coverage of all sections of the syllabus.

SOLUTION 7

ABC Management Consultants

6, Ajase Street, Yaba, Lagos
Abcmanagmentconsultants.com

Date: November 16, 2016

The Directors
Inkline Plc
34, Ojodu Street
Ikeja, Lagos

Dear Sirs,

RE: PROPOSED EXPANSION VIA MERGER AND ACQUISITION

We have gone through your request asking us to offer advice on your proposed expansion via merger and acquisition, we advise as follows:

- a. (i) The benefits derivable from the proposed method of expansion include:
- Your company will experience faster growth than when the internal development is pursued.
 - If your company's expansion is made through acquisition of another company, there is greater likelihood that your company may inherit new products, new markets and new/additional customers from the acquired company which may be difficult to obtain through internal development.
 - Your mode of expansion will enable your company enter a new market and set up a new business which would have been difficult because of high entry barriers.
 - Your acquisition of a competitor will prevent it from acquiring yours.
 - Your company may save cost and earn higher profits from synergy effects
- (ii) The probable demerits of employing your proposed method of expansion include:
- It might be very expensive since bid price should be high enough to make the target company sell their shares. This may as well result in low return on your investment.
 - A proportional loss of ownership may result from acquisition of another company.
 - Merger of two organisations having different structures, management styles, cultures, etc may be difficult and might result in loss of employees. Employees may feel threatened by possible redundancies which may

bring about downsizing. Resolution of likely disruption might take considerable time.

- Convergence of different individuals may result in 'clash of culture' since they are from differing backgrounds. This will make working together difficult.

b. Alternatives to merger and acquisition:

From the foregoing, a comparison of the merits and demerits of your expansion proposal might result in searching for alternatives. The following are alternative expansion programmes which your company may pursue:

- i. Growth through internal development of the business; (organic growth)
- ii. Growth by means of a joint venture;
- iii. Licensing;
- iv. Franchising; and
- v. Strategic alliance.

c. Criteria for choosing an acquisition target include:

- i) **Strategic aims and objectives:** Target company should be one that will help to grow the acquiring company in terms of existing market expansion, increase in new products and entry into new geographical area;
- ii) **Cost and relative size:** Although there are occasional examples of small companies acquiring much larger ones in a reverse take over, target companies are usually selected because they are affordable;
- iii) **Opportunity and availability:** In many cases, targets for acquisition are selected because of circumstances. An opportunity to acquire a particular company might arise, and the acquiring company might decide to take the opportunity whilst it is available;
- iv) **Potential synergy:** Targets for acquisition might possibly be selected because they provide an opportunity to increase total profits through improvements in efficiency.

We hope this will meet your quest for advice for your proposed expansion bid. If you need further clarification, do not hesitate to contact us.

Yours faithfully,

Signed:

Name

For: ABC Management Consultants

MARKING GUIDE

		MARKS	MARKS
	Report format		3
(a)	1 mark per point	4	
(b)	1 mark per point	<u>3</u>	
			7
(c)	1 mark each		2
(d)	1 mark each		<u>3</u>
	TOTAL		<u>15</u>

EXAMINER'S REPORT

The question tests candidates' knowledge of Mergers and Acquisitions with specific emphasis on candidates' ability to identify advantages and disadvantages of growth by mergers and acquisition and its alternative means of growth.

About 90% of the candidates attempted the question and performance was good. However, some of the candidates lost some marks for their failure to present their solution in a report format.

Candidates are advised to always ensure that they read, understand, interpret questions correctly and note their specific requirements before attempting them to avoid loss of marks.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2016

ADVANCED AUDIT AND ASSURANCE

Time Allowed: 3 hours

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

SECTION A: COMPULSORY (30 MARKS)

QUESTION 1

Havana Bank Plc was listed on the Nigerian Stock Exchange in February 2015. There was an initial public offer in the same period with proceeds of ₦5billion. Part of the proceeds was expected to be utilised to strengthen the bank's internet banking facility. In November of the same year the Managing Director/Chief Executive Officer (MD/CEO) proceeded on a three-week vacation to the United Kingdom but did not return at the time of concluding the audit of the 2015 financial statements early in 2016. It was observed that the MD/CEO had absconded with documents relating to the public offer. It was also noted that he kept drawing cash whilst in the United Kingdom amounting to ₦922 million.

The Bank closed its Gambian operations in June 2015 because it had made losses for two consecutive years. Prior to the 2 years before the closure, the operations in Gambia had grown into a network of five branches, contributing 15 percent of the gross income and 9.5 percent of the net profits of the group. The closure was not disclosed in the financial statements but reference was made to the closure in the directors' report.

As the Audit Manager in the firm of Chartered Accountants that audits Havana Bank Plc, you are required to:

- a. Identify and explain the significant audit matters you will consider in forming an opinion in relation to the missing documents and the cash drawings by the absconded MD/CEO. (10 Marks)
 - b. Analyse and evaluate your views on the non-inclusion of the discontinued Gambian operations in the financial statements. (10 Marks)
 - c. Explain **FIVE** duties, as an auditor in relation to the bank's internet banking. (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

As an Audit Manager in a big audit firm in Nigeria, you were opportuned to attend a conference on Professional Ethics and Anti-Money Laundering in New York. On your return, one of the audit seniors went through the presentations and asked questions on some of the statements she noted in the presentations.

You are required to explain the following statements to her:

- a. A good Auditor is an independent auditor. (5 Marks)
 - b. The Accountant's normal professional duty of confidentiality to clients is not an adequate defence where money laundering is involved. (5 Marks)
 - c. Specific obligations for detecting and reporting suspicions of money laundering are placed on professional firms. (5 Marks)
 - d. A firm might act for two clients that are in direct competition with each other where there are acceptable safeguards. (5 Marks)
- (Total 20 Marks)**

QUESTION 3

You are the Audit Manager in charge of the audit of Mix Biz, a company which runs a chain of snack bars operating in a number of strategic locations in Lagos. Your firm has been the auditor for a number of years and has always had to substantively test cash sales because of lack of control over the recording of takings. The audit reports to date have been unmodified.

You have recently been informed that the company has employed a newly qualified Chartered Accountant as Chief Internal Auditor and a partly qualified Assistant Internal Auditor. Since their appointment half way through the year ended December 31, 2015, they have spent most of their time carrying out substantive tests on cash sales.

The Directors are hopeful that your audit fee this year will decrease because you will be able to rely on the work carried out by the Internal Auditors.

Required

- a. Explain the issues that will be relevant to your firm in deciding:
 - i. whether you can rely on the work performed by the Internal Auditors (8 Marks)

- ii. how much reliance to place on that work (7 Marks)
- b. In connection with Accountancy and Audit, an Expert or Specialist is a firm or person that possesses special skills in a profession other than Accountancy.
Required
 - i. What is the significance of evidence from Experts to an auditor? (2 Marks)
 - ii. Identify **THREE** factors to be considered before placing reliance on the report of a Specialist. (3 Marks)

(Total 20 Marks)

QUESTION 4

- a. You have been appointed as the Auditor of a company whose accounting transactions are processed using computer. You have decided to use Computer-Assisted Audit Techniques (CAAT) to generate evidence for the audit assignment.
Required
 - i. State **FOUR** advantages and **THREE** disadvantages of using test data in compliance testing of application controls. (7 Marks)
 - ii. List **FOUR** activities for which audit software may be used to perform substantive tests by the auditor. (4 Marks)
 - iii. List **TWO** advantages and **TWO** disadvantages of the use of audit software. (4 Marks)
- b. The availability of Computer-Assisted Audit Techniques should be considered by the Auditor when planning the nature, extent and timing of tests in an audit.

The Auditor must determine his testing strategies which will depend on his choice of either using a Manual Testing Method or Computer-Assisted Method.

Required

Identify **FIVE** solutions to loss of audit trail. (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

In compliance with ISA 250 “Consideration of Laws and Regulations in an Audit of Financial Statements”, the auditor shall conduct the audit in a manner that gives him confidence that the client has met all legal requirements of the country in which it operates.

As the Audit Partner in charge of APB Manufacturing Plc, you are required to:

- a. Identify and clarify **SIX** steps that ISA 250 requires of you in ascertaining that the company complies with all applicable laws and regulations.
(9 Marks)
- b. State and explain **FOUR** procedural actions you will take in the event that the company failed to comply, in material areas, with applicable laws and regulations.
(6 Marks)

(Total 15 Marks)

QUESTION 6

Allhope Publications Limited is an old established publishing company owned by two brothers. Over the years, the company had made consistent progress both in sales and profitability.

Due to the quality of their work, the patronage of the company has grown to the extent that its working capital cannot accommodate the work on hand.

The Directors have approached their bankers, Owopo Bank Plc for a facility of ₦500m to procure essentially modern machineries and printing materials and also for running expenses, particularly salaries.

In support of its application for the bank facility, the company has prepared a profit forecast which is being presented to your firm for review.

Required:

As contained in ISAE 3400: “The Examination of Prospective Financial Information (PFI)”.

- a. What will you take into consideration before accepting this assurance engagement?
(5 Marks)

b. Enumerate the procedures to be adopted after you have agreed to take up the engagement:

- i. As regards PFI assurance engagements generally
- ii. On the Profit forecast.

(10 Marks)

(Total 15 Marks)

QUESTION 7

Iyanuoluwa Pharmaceutical Industries Limited has been in existence for some years and it has been audited by a firm of Chartered Accountants up to December 31, 2014. Your firm, Blueberry & Co. (Chartered Accountants) has just been appointed to act as auditors for the financial year January 1, 2015 to December 31, 2015 which has been accepted.

Required:

In line with ISA 510: "Initial Audit Engagements".

- a. What are the objectives of the Auditor when considering such an initial audit engagement in respect of opening balances? (6 Marks)
- b. Provide audit procedures that are required to be followed in respect of opening balances. (9 Marks)

(Total 15 Marks)

SOLUTIONS

SOLUTION 1

- (a) The significant audit matters relevant to the formation of opinion in relation to the missing documents and the cash drawings by the absconded MD/CEO include:
- i. The accounting records for the sale of shares are missing.
 - ii. The accounting records are missing because the MD/CEO absconded with them. There must be reasons why he took the accounting records: fraud is a possible reason especially as he kept withdrawing cash while in United Kingdom and also for failing to return at the end of his vacation.
 - iii. There is an indication in the manner the MD/CEO has taken the accounting records and withdrawn cash that there may have been a fraud. It is therefore probable that the auditors will have to modify the opinion even if they are able to reconstruct the financial records, while it will not be possible to gain sufficient appropriate evidence about the possible fraud.
 - iv. The Bank may have been concealing ailing financial position by manipulation for some years, and probably to make up for this, it went public to raise cash.
 - v. There is constraint in obtaining sufficient appropriate audit evidence (limitation on scope) for the year ended 31 December, 2015. The audit opinion should be modified.
 - vi. The effectiveness of the internal control relating to the custody of documents and cash withdrawal needs to be evaluated.
 - vii. Consider the utilization of the funds and cash realised from the public offer.
 - viii. The possible impact of the cash withdrawal in other areas of the audit and the overall assessment of audit risk.
- (b) Views on the non-inclusion of the discontinued Gambian operations in the financial statements.

The Gambian operations appear to have been a subsidiary of the bank's business, incorporated in The Gambia, which contributed materially to total revenue. The closure represents a discontinued operation, and failure to disclose the details is a failure to comply with IFRS 5 "Non-current Assets Held for Sale and Discontinued Operations". It is also in breach of the requirements of IAS 7 "Statements of Cash Flows" and IFRS 8 "Operating Segments" which also require disclosures relating to discontinued operations. The matter is material, but is not pervasive. If management does not amend the financial

statements to provide the required disclosures, a qualified audit opinion (for a misstatement) would be appropriate.

(c) Duties of the auditor in relation to the Bank's internet banking.

The auditor's duties in an internet banking environment should include the following elements:

- i. The audit firm should decide whether the engagement should be accepted (as in any professional engagement).
- ii. The firm should then plan the engagement: an important aspect of planning may be to make available audit staff with appropriate expertise in internet banking operations.
- iii. The firm should obtain a detailed knowledge of the bank's business.
- iv. It should consider liaison with the internal auditors of the bank, if there have been internal audit investigations into the bank's internet banking transactions or systems.
- v. The firm should identify and evaluate the risks in the internet banking operations.
- vi. It should ascertain and evaluate the control environment and the specific internal controls that are in operation in tracking transactions and alerting customers instantly, without errors.
- vii. It may also be appropriate to perform a going concern review, particularly in the case of the bank relying heavily on internet banking activities for efficiency.

MARKING GUIDE

	Marks	Marks
(a) Identifying and explaining the following <ul style="list-style-type: none">- Significant audit matters- Records for sale of shares- MD/CEO absconding with accounting records- Possibility of fraud- Modification of audit opinion- Concealment of ailing financial position- Inability to obtain audit evidence- Effectiveness of internal control- Impact of cash withdrawal on operations 2 Marks each for any five points	10	
(b) Views of non-inclusion of the closed Gambian branch on financial statements: <ul style="list-style-type: none">- Gambian operation is a subsidiary- Closure represents discontinued operations- Failure to disclose is a failure to comply with IFRS 5- Breach of requirements of IAS 7- Requirements of IFRS 8- Material but not pervasive- Qualified audit opinion 2 Marks each for any five points	10	
(c) Auditor's duties shall include: <ul style="list-style-type: none">- Decide whether engagement should be accepted- Plan the engagement- Obtain detailed knowledge of the business- Liaison with internal auditor- Identify and evaluate risks in the internet banking- Evaluating the control environment- Carry out going concern review 2 Marks each for any 5 points	10	<u>30</u>

EXAMINERS' REPORT

The question tests candidates understanding of (a) significant audit matters to be considered in forming an opinion, (b) the requirements of IFRS 5, 8 and IAS 7; and (c) auditors' duties in relation to internet banking.

Being a compulsory question, almost all the candidates attempted it, but performance was poor.

The commonest pitfall of the candidates was their inability to interpret the question properly.

Candidates are enjoined to read the ICAN Study Text thoroughly.

SOLUTION 2

- (a) The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the auditor expressing an opinion on whether the financial statements of an entity are prepared in all material respects in accordance with applicable financial reporting framework..... ISA 200.

For an audit report to be of value, the auditor must not only be independent, but must also be seen to be independent. The auditor must have independence of mind and be seen to be independent in appearance.

‘Independence of mind’ is a psychological state that permits the auditor to express a conclusion without being affected by influences or prejudices that compromise his professional judgment.

Independence in appearance means the avoidance of facts and circumstances that a reasonable and informed third party would conclude that a firm or a member of the assurance team’s integrity, objectivity or professional scepticism has been compromised.

Auditors’ independence can be compromised by any of the following factors called threats: self-interest, self-review, familiarity, advocacy and intimidation, although safeguards are available to mitigate some of these threats.

Therefore, a good auditor is the one whose objectivity is not in doubt i.e. an auditor who is independent in mind and appearance and who reduces the risk to his independence to an acceptable low level by applying appropriate safeguards.

- (b) Money laundering is the process by which criminals attempt to conceal the true origin and ownership of the proceeds from their criminal activities (e.g. drug trafficking, terrorism, theft, tax evasion and other types of fraud), allowing them to maintain control over the proceeds and, ultimately, providing a legitimate cover for their sources of income. The term is widely defined to include possessing, in any way dealing with, or concealing the proceeds of any crime.

Professionals, including accountants, have professional duty of confidentiality to their clients, in which case they are not allowed to disclose their clients’ information to others unless where they have legal or professional duty or right to disclose. However, the accountant’s professional duty of confidentiality is not an adequate defence where money laundering is involved. The accountant has a legal duty to report suspicions of money laundering to the appropriate authorities as required by law, i.e. National Financial Intelligence Unit (NFIU) or Economic and Financial Crimes Commission (EFCC). Under the Money

Laundrying (Prohibitions) Act 2011, professionals, including accountants, enjoy statutory protection against breach of confidentiality if they report their suspicion of money laundering activities of their client in good faith and to the appropriate authority. Auditor's duty of confidentiality will therefore not be breached if they report, in good faith, any money laundering knowledge or suspicions to the appropriate authority.

However, disclosure in bad faith or without reasonable grounds would possibly lead to the accountant being sued for breach of confidentiality.

The following may be an acceptable defence to the accountant on money laundering issues:

- A report had been made to the appropriate party, or
- There was an intention to make a report but there was a reasonable excuse for not having done so.

(c) Obligations placed on professional firms

Money laundering may be of particular relevance to accountants, and in particular auditors, in cases where criminals establish companies and use transactions among their companies to 'launder' their dirty money. Specific obligations for detecting and reporting suspicions of money laundering are placed on professional firms (for example, lawyers and accountants) and financial institutions. These requirements include the following:

- i. Putting into place systems, controls and procedures to ensure that the firm is not used for money laundering purposes.
- ii. Appointing a Money Laundering Reporting Officer (MLRO), whose responsibility is to receive reports on suspected money laundering activities from other employees and report them to the appropriate authorities.
- iii. Establishing and enhancing the record-keeping systems (a) for all transactions, which must be kept for at least five years, with controls to ensure that they are not inadvertently destroyed and (b) for verifying the identity of clients by obtaining official documents, such as – for an individual – passport or driving license, supported by recent utilities bills, and – for a company – certificate of incorporation.
- iv. Establishing procedures within the firm for reporting any suspicion of money laundering by client companies.

- iv. Training and educating staff in procedures for detecting and reporting suspicions of money laundering activities.

These obligations are wide-ranging and auditors and other professionals need to be fully aware of the extent of their responsibilities in taking care of them.

(d) Safeguards in Acting for Two Competing Clients

A firm might act for two clients that are in direct competition with each other. The firm has a professional duty of confidentiality, and so will not disclose confidential information about one client company to its competitor. Again, the test is whether a “reasonable and informed third party” would consider the conflict of interest as likely to affect the judgement of the firm. The approach that the accounting firm should take will be a matter of judgement and should reflect the circumstances of the case. Where the acceptance or continuance of an engagement would materially prejudice the interests of any client, the appointment should not be accepted or continued.

In such cases, acceptable safeguards should be put in place. These include the following:

- i. Giving careful consideration to whether or not it is appropriate to accept an assurance engagement from a new client that is in direct competition with an existing client. It may be appropriate to decline the offer from the potential client.
- ii. Careful management of the clients: For example by ensuring that different members of staff are used on the two engagements.
- iii. Full and frank disclosure to the clients of the potential conflict, together with suitable steps by the firm to manage the potential conflict of interest.
- iv. Procedures to prevent access to information (such as physical separation of the teams and confidential and secure data filing). Such an approach is known as creating “Chinese walls”.
- v. Establishing clear guidelines on security and confidentiality and the use of confidentiality agreements.
- vi. Regular review of safeguards in place.
- vii. Advising one or both clients to seek additional independent advice.

MARKING GUIDE

	Marks	Marks
(a) Independence of the Auditor <ul style="list-style-type: none">- Expression of opinion- Enhancement of degree of confidence- Agreeing with financial reporting framework – ISA 200- Explaining of independence of mind and appearance- Causes of compromise of independence- Objectivity not in doubt 1 Mark each for any five points	5	
(b) Duty of confidentiality <ul style="list-style-type: none">- Identifying money laundering- Professional duty of confidentiality to client- Report suspicious acts to appropriate authority- Protection against breach of confidentiality- Not disclosing in bad faith- Acceptable defence 1 Mark each for any five points	5	
(c) Obligations placed on professional accountants <ul style="list-style-type: none">- Putting controls in place to ensure that the firm is not used for money laundering purpose- Money Laundering Reporting Officer- Enhance record keeping system- Reporting procedure- Staff training 1 Mark each	5	
(d) Safeguards where acting for two competing clients: <ul style="list-style-type: none">- Considering whether or not to accept engagement- Client management- Confidentiality and separation of audit teams- Clear guidance on security- Regular review of safeguards 1 Mark each	5	<u>20</u>

EXAMINERS' REPORT

The question tests candidates understanding of Professional Ethics and Anti-Money Laundering activities.

About 85% of the candidates attempted the question, but performance was poor.

The commonest pitfall of the candidates was poor application of theoretical knowledge and misinterpretation of the question.

Candidates are advised to cover the syllabus properly and learn to apply their knowledge in practical ways.

SOLUTION 3

(a) Placing Reliance on the Work of Internal Auditor

Where the activities of external auditors overlap with the work of internal auditors, the external auditors may be able to reduce the amount of testing and checking they perform in their work by relying on the work that has already been carried out by the internal auditors. Reliance should lead to a more efficient and cost-effective audit, which may translate to reduction in audit fee.

Since the external auditors are responsible for their opinion even if they have relied on the work of the internal auditors, they must be satisfied that they can rely on the work of the internal auditors to support their audit opinion.

In taking this decision, ISA 610 “Using the Work of Internal Auditors” requires the external auditors to assess whether or not reliance can be placed on the work performed by the internal auditors and how much reliance can be placed on that work.

To assess whether or not the external auditors can rely on the work of internal auditors of Mix Biz, the external auditors must consider the following issues.

a)

- i. Sufficiency of organizational status of the internal audit, its objectivity and operational independence of management structure. In particular, whether or not the chief internal auditor reports to an ‘independent’ senior person or body within the entity, such as the audit committee rather than the finance director.
- ii. The scope of the internal audit work and any restrictions placed by the senior management on the scope of their work and whether or not management acts on the internal audit recommendations or undermines them. External auditor will have less confidence on the internal audit work if their recommendations are not acted upon by management.
- iii. The technical competence and due professional care of the internal auditors. The external auditors will assess the qualifications, technical training and experience of the internal auditors. For Mix Biz, the chief internal auditor is newly qualified and the second staff is partly qualified, which suggests inadequate experience. The external auditor will also assess to what extent the internal auditors take professional approach towards their work.

- iv. The extent of application of systematic and disciplined approach including quality control by the internal auditors.
- v. Appropriateness and adequacy of resources of internal audit function given the company's size and the nature of its operations.
- vi. Existence of established policies for hiring, training and assigning internal auditors to internal audit engagements.
- vii. Required level of knowledge of the entity's financial reporting and applicable reporting framework.
- viii. Level of skills or industry-specific knowledge to perform work related to entity's financial statements.
- xi. Existence of quality control procedures in the internal audit function.
If the internal audit function is not reliable based on the above general assessments, then external auditors need not assess the specific internal audit work, as it will not be reliable enough for external audit purpose.

aii. How much reliance to place on the work of internal auditors

If internal audit function is reliable, then the external auditor should evaluate the specific work performed during the year to ascertain their adequacy for external audit purposes. In doing this evaluation, the external auditor will consider the nature and scope of the specific work performed by the internal audit, the assessed risk of material misstatement at the account balance or transaction level, and the degree of subjectivity involved in the evaluation of the evidence gathered by the internal audit to see if these will be relevant to the specific areas of the audit. The amount of reliance to be placed on the specific work will depend on the consideration of the following issues whether or not:

- i. The work was properly performed, supervised, reviewed and documented;
- ii. The staff doing the work were adequately qualified/experienced/trained;
- iii. Sufficient and appropriate audit evidence was obtained;
- iv. The conclusions drawn were appropriate in the circumstances given the result of the work performed;
- v. The reports prepared were consistent with the work performed;
- vi. Management acted on the specific recommendations made or ignored them;
- vii. Any exceptions or unusual matters were properly resolved.

So, if both internal audit function and the specific work performed are reliable, then external auditor may rely on the internal audit work in order to reduce the level of substantive testing to be performed.

b. Evidence from Experts

- i. An Auditor is an expert only in accountancy and not in other fields. ISA 620 “Using the Work of an Auditor’s Expert” therefore allows auditors to use the work of an expert to provide knowledge relevant to audit, which the audit firm does not possess such as in the areas of legal opinions, valuation of properties, other assets and pension liabilities. Relying on the work of an auditor’s expert is inevitable in the following circumstances:
 - As a safeguard necessary to eliminate the identified significant threats or to reduce those threats to an acceptable level;
 - As an efficient and effective way of obtaining appropriate audit evidence required to form an opinion;
 - Where auditor is unable to form an opinion without expert’s help.
- ii. Factors to consider before relying on the report of an expert ISA 620 “Using the Work of an Auditor’s Expert” requires auditors to decide whether or not to use the work of an expert, and assess whether or not that work is adequate. Before relying on the work of an expert, the auditor needs to consider the following factors:
 - (a) Independence and objectivity of the expert, e.g.
 - The expert’s relationship with management and those charged with governance. The expert must be sufficiently independent.
 - The degree of reliability of the expert’s reports. Professional competence of the expert in terms of his qualifications and experience.
 - (b) Reputation, expertise, resources available and applicable professional/ethical standards.
 - (c) Before any work is performed by the expert, the auditor should agree in writing:
 - Nature, scope and objectives of the expert’s work;
 - Respective roles and responsibilities of both parties;
 - Nature, timing and extent of communication between both parties;
 - Confidentiality or non-disclosure agreement.

- (d) Upon completion, the auditor must assess the work completed to ensure appropriateness for audit purposes. The auditor must consider the:
- Consistency of findings with the other evidence that the auditor has obtained;
 - Significant assumptions made;
 - Use and accuracy of source data.

MARKING GUIDE

		Marks	Marks
ai	Placing reliance on the work of the internal auditor		
	- Explanation of the relevance of ISA 610 – “Using the Work of an Internal Auditor”	2	
	Other considerations		
	- Status of the internal audit unit in the organisation		
	- Scope of its work		
	- Technical competence		
	- Quality control by the internal auditor		
	- Adequacy of resources		
	- Line of reporting		
	- Documented procedural guide		
	1 Mark each for any 6 points	6	8
ii.	How much reliance can be placed on the internal auditor’s work		
	Evaluating the internal audit work performed to determine reliability, risk assessment, transaction level	2	
	Other areas to consider include:		
	- Whether or not the work was properly performed		
	- Qualification of internal audit team		
	- Experience of team		
	- Whether or not sufficient and appropriate audit evidence was obtained		
	- Whether or not reports prepared were consistent with the work performed		
	- Whether or not management acted on recommendations and findings of audit		
	- How exception matters were resolved		
	1 Mark each for any 5 points	5	7

bi	Significance of evidence from experts		
	- Definition of an expert	1	
	- Inevitability of relying on the work of an expert		
	- Where auditor is unable to form an opinion without an expert's help		
	- As an efficient and effective way of obtaining audit evidence		
	- As a safeguard to eliminate significant threats or reduce the threats		
	$\frac{1}{2}$ Mark each for any two points	1	
			2
ii.	Factors to consider before placing reliance on the work of a specialist:		
	- Independence of the expert		
	- Reputation, expertise and resources available		
	Auditor to agree in writing		
	- Nature, scope and objectives of the expert's work		
	- Role and responsibility of both parties		
	- Nature, timing and extent of communication between both parties		
	- Confidentiality of Non-disclosure agreement		
	(1 Mark each for any three points)		3
			<u>20</u>

EXAMINERS' REPORT

The question tests candidates' knowledge of External Auditor's reliance on the work of Internal Auditors and other specialists or experts.

About 85% of the candidates attempted the question, but performance was poor.

The commonest pitfall of the candidates was that, they were focusing on the newly appointed officers rather than the technicalities involved and also repetition of answers.

Candidates should endeavour to read and understand the question properly before attempting it.

SOLUTION 4

(a)

(i) **Advantages of test data include:**

- helps to confirm that exception reports are correctly produced
- provides a positive assurance of the correct functioning of the program controls actually tested;
- can be used on a continuing basis until the programs are changed;
- Once set up, running costs from year to year are low;
- requires less detailed knowledge of data processing; and
- are cheap to install and easy to implement as their contents are variable at will.
- Can be used to verify effectiveness

Disadvantages

- The problem of data files corruption where 'live' test data is used
- It is time consuming
- Where 'dead' test data is used, the auditor requires a reasonable assurance that the programs being used are those in normal processing
- It cannot provide assurance that the system and its controls operate effectively at any other time.

(ii) **Activities for which audit software may be used during substantive tests by the auditor include:**

- (i) Re-performing calculations;
- (ii) Selecting individual transactions for subsequent manual substantive tests;
- (iii) Extracting list of exceptional items;
- (iv) Obtaining information relevant to analytical review;
- (v) Used to scrutinize large volume of data.
- (vi) Matching the contents of two or more computer files and selecting any unmatched items for further audit work.

(iii) **Advantages of the use of Audit Software**

- (i) It can be used to analyse voluminous data.
- (ii) The search is much more accurate and faster than when software is not applied.
- (iii) The running costs are usually low.
- (iv) It can be used for other transactions

Disadvantages

- (i) Has a high set up cost.
- (ii) Usually not available for small companies.
- (iii) Requires considerable level of knowledge in data processing.
- (iv) Consumes a lot of computer time which may not be acceptable to clients.

(b) Solutions to loss of audit trail include the following:

- i. Use of computer assisted audit techniques to assess reliability.
- ii. Testing on a total basis and ignoring individual items to access data output.
- iii. Closer co-ordination between internal and external auditors to bridge gaps in compliance tests.
- iv. Arranging for special print-outs of individual information for the auditors to attempt to re-create transaction trail.
- v. Clerical re-creation of individual items of data for comparison with computer generated totals.
- vi. Programmed interrogation facilities whereby records held on magnetic files are printed on a selective basis by means of direct request to those files.
- vii. Involvement of the auditor during the system development stage when a client is computerizing its accounting system. This will enable the auditor advise management on the controls that should be incorporated within the system and those reports, which he will require from the system for audit processes.
- viii. Where reports that have audit relevance are routinely produced by the client's system, the auditor should inform management, at an early date during the financial year, to retain such computer generated reports for the purposes of the audit.
- ix. The auditor may place greater emphasis on alternative audit procedures as a means of obtaining audit evidence. Such alternative audit procedures may include third party confirmation and physical verification of computer generated balances.
- x. Where it becomes impracticable to vouch individual transactions, the auditor may be able to achieve his audit objective by performing reasonableness tests on the total balances using analytical review procedures.

- xi. The auditor may increase the frequency of his audit visits in order to ensure that audit tests are performed close to when transactions are processed.

MARKING GUIDE

	Marks	Marks
ai Advantages of using test data in compliance testing of application controls:		
<ul style="list-style-type: none"> - Helps to confirm that exception reports are correctly produced - They provide positive assurance of the correct functioning of the program control - Can be used on continuing basis - Running cost low once it is set up - Requires less detailed knowledge of data processing - Can be used to verify effectiveness - Cheap to install 		
1 Mark each for any four points	4	
Disadvantages:		
<ul style="list-style-type: none"> - Problem of data file corruption - Time consuming - It cannot provide assurance that the system and its controls operate effectively at any other time - Where dead test data is used, the auditor requires a reasonable assurance that the programs being used are those in normal process 		
1 Mark each for any three points	3	
ii. Activities for which audit software may be used to:		
<ul style="list-style-type: none"> - Re-perform calculations - Select individual transactions for subsequent manual substantive tests - Extract list of exceptional items - Obtain information relevant to analytical review - Scrutinize large volume of data 		
1 Mark each for any four points	4	
iii. Advantages of the use of Audit Software:		
<ul style="list-style-type: none"> - Analyses voluminous data - Searches much more accurate and faster - Reduces running cost - Can be used for other transactions 		
1 Mark each for any two points	2	

Disadvantages

- High set up cost
- Not available for small companies
- Requires knowledge of data processing
- Consumes lot of computer time

1 Mark each for any two points

2

(b) Solution to loss of audit trail:

- Use of CAAT to assess reliability
- Testing on a total basis and ignoring individual items
- Closer co-ordination between internal and external auditors
- Arranging for special printout of individual information
- Clerical re-creation of individual items of data
- Programmed interrogation facilities whereby records held on magnetic files are printed on a selective basis
- Frequent audit visits to perform tests on transactions close to when they are processed

1 Mark each for any 5 points

5

20

EXAMINERS' REPORT

The question tests candidates' knowledge of Computer-Assisted Audit Techniques.

About 25% of the candidates attempted the question and performance was poor.

Candidates' commonest pitfalls were lack of knowledge in this area. Candidates should learn to cover the syllabus adequately.

SOLUTION 5

(a) ISA 250- “Consideration of laws and regulations in an audit of Financial Statements” requires the auditor to:

- i. Obtain a general understanding of the applicable legal and regulatory framework and how the entity is complying with that framework. This is part of obtaining an understanding of the entity and its environment – here, the legal environment – as required by ISA 315.
- ii. Obtain sufficient appropriate audit evidence in respect of compliance with those laws and regulations which might be expected to have a direct effect on material amounts and disclosures in the financial statements.
- iii. Make enquiries of management as to whether or not the entity is complying with the relevant laws and regulations.
- iv. Inspect any correspondence with the relevant authorities.
- v. During the audit, remain alert to the possibility that other audit procedures might bring instances of non-compliance to the auditor’s attention.
- vi. Obtain written representations from management that all known instances of non-compliance or suspected non-compliance have been disclosed to the auditor.
- vii. Document all identified or suspected instances of non-compliance and the results of discussions with management and/or other parties.

(b) Action by the auditor in the event of non-compliance or suspected non-compliance by a client company.

If the auditor identifies or suspects material areas of non-compliance by the company, the following procedures are required:

- i. Obtain an understanding of the nature of the act and the circumstances under which it has occurred.
- ii. Evaluate the possible effect of the non-compliance on the financial statements.
- iii. For suspected non-compliance, discuss the matter with management. If compliance is not demonstrated, take legal advice.
- iv. If there is insufficient evidence of a suspected non-compliance, consider the impact on the audit report. This would constitute a “limitation on scope”.

- v. Consider whether or not the non-compliance impacts on other areas of the audit, for example, on the overall risk assessments.
- vi. Consider how to report the non-compliance to those charged with governance, shareholders and/or to the authorities.

MARKING GUIDE

	Marks	Marks
(a) ISA 250 requirements include:		
<ul style="list-style-type: none"> - Obtaining general understanding of applicable legal and regulatory framework and how entity is complying - Getting appropriate audit evidence in respect of compliance - Enquiring of management as regards compliance - Inspecting correspondence - Obtaining written representation - Documenting all identified or suspected instances of non-compliance - Being alert during audit for instances that may bring about non-compliance 		
1½ Marks each for any six points	9	
(b) Actions to be taken in the event of non-compliance		
<ul style="list-style-type: none"> - Obtain an understanding of the nature of the act - Evaluate effect on financial statements - Discuss with management - Seek legal advice - Consider impact of non-compliance to other areas - Consider how to report non-compliance 		
1½ Marks for any four points	6	15

EXAMINERS' REPORT

The question tests candidates' knowledge of the requirements of ISA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements".

About 70% of the candidates attempted the question and performance was poor. It was apparent that candidates did not cover this area of the syllabus. Candidates are advised to cover all aspects of the syllabus before embarking on registering for the examination.

SOLUTION 6

Allhope Publications Limited

- (a) Areas to consider before accepting this type of assurance engagement include-
- The availability of resources and staff with the necessary expertise
 - Determining the timescale for the completion of the engagement
 - Agreeing a fee for the work with the client
 - Establishing with the client the form that the assurance report will take
 - An engagement letter should be agreed and signed by both parties before the work is actually started.
 - It is particularly important that the client should understand that in a review of forward – looking information, only negative assurance can be provided
 - The client should also be informed that the audit firm will comply with the requirements of ISAE 3400 “When Reviewing the Prospective Financial Information”.
- (b)
- (i) Procedures in a PFI assurance engagement include-
- Understanding the nature of the information to be examined
 - Establishing the intended use of the information and the intended recipients of the final report.
 - Establishing whether the information will be for general distribution or limited distribution to a small number of users.
 - The nature of the assumptions that have been made by management. Whether or not they are best estimate assumptions for a forecast, or hypothetical assumptions for the purpose of making projections.
 - The time period covered by the information
 - Obtain sufficient knowledge of the entity and its environment
 - Seek evidence to support estimates/assumptions
 - Assess whether or not hypothetical assumptions are realistic and sensible
 - Assess whether or not the prospective financial information contains all the relevant material items and that nothing of significance has been omitted.
 - If part of the future period in the forecast or projection has already passed, the auditor should review the actual results for that part of the period, and compare actual results with the forecast or projection. The differences will help the auditor to assess the reliability of the forecast or accuracy of the projection.
 - The auditor should check the arithmetical accuracy and consistency of the projected financial information that has been prepared.
 - The auditor should obtain representations from management on

- Management's acceptance of responsibility for the information
- The intended use of the information
- The completeness of the assumptions that were made to prepare the PFI.

(ii) Procedures to be adopted on a profit forecast should include the following:

- Understand the basis of the forecast by asking the person who prepared it.
- Test the calculations of the forecast according to its method for example, if it has been extrapolated from previous results, re-perform the arithmetic of the extrapolation.
- Consider whether or not the assumptions in the forecast are consistent with each other e.g., will sales grow at that rate without additional marketing costs?
- Consider whether or not the forecast is reasonable in the light of known facts such as current economic circumstances and past trading history.
- Discuss the key variables and sensitivities with management. Often, key assumptions will be estimates of sales demand and sales prices, and the gross profit ratio. The auditor should establish the basis on which these estimates have been made.
- Review internal consistency of forecast, for example, has the same interest rate been used throughout the forecast, has the same growth rate been applied to sales and purchases?
- Compare assumptions and bases for forecasting with information used internally e.g., by the marketing department
- Compare figures with other forecasts to ensure consistency.
- Compare figures with any available evidence.
- Consider whether or not all items of cost have been included.
- Consider whether or not the forecast of the amount of finance required allows for working capital.
- Check that the forecast of profit and cash flows includes the cost of borrowed finance.
- Check that forecast of costs and revenues allow for estimated inflation.
- Carry out some sensitivity analysis of the forecasts of revenues, costs and profits to establish the extent to which estimates in the forecast would need to differ before the forecast profit turns into a forecast loss.
- Where the audit firm has no previous knowledge of the entity, it should obtain sufficient knowledge of the entity and its environment.

MARKING GUIDE

	Marks	Marks
(a) What to consider before accepting PFI assurance engagement		
<ul style="list-style-type: none"> - Availability of resources and staff - Time frame for completion - Agree fee - Form of reporting - Engagement letter - Review of forward-looking information will give negative assurance 		
1 Mark each for any 5 points	5	
(b) Procedural steps to adopt on		
i. PFI assurance engagement:		
<ul style="list-style-type: none"> - Obtain letter of engagement - Understand nature of information - Establish intended use of the information - Confirm if it is for general distribution or limited distribution - Nature of assumptions made by management - Time period covered - Obtain knowledge of entity - Assess whether or not hypothetical assumptions are realistic - Check arithmetic accuracy - Obtain management representation - Review projections 		
1 Mark each for any five points	5	
ii. Profit forecast		
<ul style="list-style-type: none"> - Understand basis of the forecast - Test calculations - Consider consistency of assumptions - Reasonableness of forecast - Compare figures with available evidences - Check items of costs - Carry out sensitivity analysis - Discuss key variables - Review internal consistency of forecast - Check that forecast includes cost of borrowed finance 		
$\frac{1}{2}$ Marks each for any ten points	5	15

EXAMINERS' REPORT

The question tests candidates understanding of the requirements of ISAE 3400 "The Examination of Prospective Financial Information".

About 70% of the candidates attempted the question and performance was poor. It appears that candidates did not cover this area of the syllabus.

Candidates are advised to cover all aspects of the syllabus before registering for examinations.

SOLUTION 7

Iyanuoluwa Pharmaceutical Industries Limited

- a. The objectives of the auditor when considering an initial audit engagement in respect of opening balances is to obtain sufficient appropriate audit evidence about whether or not:
- The opening balances contain misstatements that materially affect the current period's financial statements, and
 - Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period, or a change of accounting policy has been properly accounted for and disclosed.
- b. The following audit procedures are required in respect of opening balances:
- Read the most recent financial statements and audit report, if any, for information relevant to opening balances.
 - Check that the prior period's closing balances have been correctly brought forward.
 - Check that opening balances reflect appropriate accounting policies
 - Where possible, if the prior period financial statements were audited, review the predecessor auditor's working papers to obtain evidence in respect of opening balances
 - Consider whether or not audit procedures carried out in the current period provide evidence on some of the opening balances. For example, cash received from customers in the current period gives evidence of the existence of a receivable at the opening date.
 - Carry out specific audit tests to obtain evidence for opening balances
 - If evidence is found that opening balances could contain material misstatements affecting the current period's financial statements, perform appropriate additional tests to assess the effect.
 - If such misstatements do exist, communicate this to those charged with governance in accordance with ISA 450.
 - Check that the accounting policies reflected in the opening balances have been consistently applied in the current period or a change of accounting policy has been properly accounted for and disclosed.

MARKING GUIDE

	Mark	Mark
In line with ISA 510		
(a) Auditor's objectives when considering an initial audit engagement in respect of opening balances		
- Whether or not balances contain misstatements		
- Appropriate accounting policies reflected have been consistently applied		
3 Marks for each of the two points	6	
(b) Audit Procedures:		
- Read the most recent financial statements and audit report, if any, for relevant information		
- Check prior period balances		
- Check reflection of appropriate accounting policies		
- Review predecessor auditor's working paper where possible		
- Carry out specific audit test		
- If misstatement exists, communicate to those charged with governance in accordance with ISA 450		
- Check consistency of accounting policies applied		
1½ Marks for any 6 points	9	<u>15</u>

EXAMINERS' REPORT

The question tests candidates understanding of the requirements of ISA 510 "Initial Audit Engagements".

About 90% of the candidates attempted the question but performance was poor.

The commonest pitfall of the candidates was their misinterpretation of the question by taking it to mean new audit engagement.

Candidates are advised to read and understand the requirements of a question before attempting to answer it.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2016

CASE STUDY

Time Allowed: 4 hours (including reading time)

INSTRUCTION: YOU ARE TO USE THE CASE STUDY ANSWER BOOKLET FOR THIS PAPER

Requirement:

You are Marian Garuba, a recently qualified Chartered Accountant. You are employed by Tees Financial Services, a consulting firm specialising in corporate restructuring, financial and accounting services, as a Trainee Consultant.

Your managing partner, Fidelis Aihomu, has requested that you draft a report to be submitted to Jide Adeolu, the Chief Executive Officer (CEO) of Jullys Engineering Company Plc., one of your firm's major clients, as set out in his email to you. (Exhibit 1)

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 Fidelis Aihomu, Managing Partner, Tees Financial Services to you, Marian Garuba
2	Letter from Dr. Jide Adeolu, the CEO of Jullys Engineering Company Plc to Fidelis Aihomu.
3	Summarised statement of financial position of Jullys Engineering Company Plc as at December 31, 2015.
4	Notes to the summarised statement of financial position of Jullys Engineering Company Plc as at December 31, 2015.
5	Preliminary findings on proposed capital reconstruction by the directors of Jullys Engineering Company Plc.

Exhibit 1

TEES FINANCIAL SERVICES

EMAIL

Date: September 27, 2016
From: Fidelis Aihomu
To: Marian Garuba (Mrs.)
Re: Jullys Engineering Company Plc.

Following our discussion on the above subject at the Monday Review meeting, I will like you to peruse the attached documents (Exhibits 2 – 5) from Jullys Engineering Company Plc., one of our major clients and let me have your recommendations in the form of a report for my review before sending to our client next week.

Jullys Engineering is one of the oldest engineering companies in the country and has grown from sole proprietorship to a limited liability company. It was quoted on the Nigerian Stock Exchange (NSE) five years ago. The company has been performing well until last two years when it started accumulating losses as a result of stiff competition from new companies that have encroached into its core business with better technology, manufacturing and management processes.

The board of the company has recently agreed with the shareholders to carry out a major restructuring of the company's business operational processes and this will include capital reconstruction and reduction, if necessary. The board is optimistic that it will obtain the cooperation of the company's secured and unsecured creditors, including the preferential shareholders.

The board is also of the opinion that the company will return to profitability after this restructuring and will be able to pay handsome dividends to its shareholders and adequately compensate the creditors.

During my recent telephone conversation with Dr. Jide Adeolu, the CEO of the company, he informed me that although the board is not envisaging any loss of jobs to its employees, but where this occurs, the board and management of the company have good rapport with the house unions and it is not likely that they will pose any major threat to the restructuring exercise.

To further strengthen the company's ability to deliver after the restructuring, the board also decided to benchmark three key areas of its operational processes with the best in the industry and possibly with the best global practice. These areas are:

- technology;
- manufacturing; and
- management.

I will therefore, like you to cover the following areas in your report:

- Suggestions on a capital reconstruction scheme that will be equitable and fair to the company's shareholders and creditors. Your report should include the necessary steps the company will need to take to carry through the exercise; and
- The major steps the company should take in benchmarking the areas identified by the board, the type of benchmarking that would be required, possible advantages of the exercise to the company and any limitations you may envisage.

We have to finalise this report by early next week, so I would like you to deal with it with utmost dispatch, but without compromising the needed attention to details. Once again, I must reiterate that your recommendations for capital reconstruction and reduction should be fair to all the stakeholders of the company. I hope I can get this draft report before close of work on Tuesday next week.

Regards

Fidelis Aihomu
Managing Partner
Tees Financial Services.

Required:

Use the attached information to draft a report to Dr. Jide Adeolu, the CEO of Jullys Engineering Company Plc.

Your report should comprise of:

1. Recommendations on how to reconstruct the company's capital, including capital reduction, if necessary, so as to bring the company's capital in line with the fair value of the company's assets. You should also outline the steps the board would take to successfully carry out the exercise;
2. A brief discussion on benchmarking as a strategic tool to improve corporate performance, types of benchmarking and which type the company should adopt, the steps necessary to carry out a successful benchmarking, the benefits the company is likely to derive from the exercise and the possible limitations.

JULLYS ENGINEERING COMPANY PLC

September 20, 2016

The Managing Partner
Tees Financial Services
10 Denton Road
Victoria Island
Lagos.

Dear Mr. Fidelis Aihomu

RE: RESTRUCTURING OF JULLYS ENGINEERING COMPANY PLC.

Further to our telephone conversations this morning on our desire to carry out a restructuring of the company, we shall be grateful if your firm can give us professional advice on two key areas of this exercise, that is:

- Capital reconstruction and reduction; and
- Benchmarking of three key areas of our operational processes.

As you are well aware, Jullys Engineering Company Plc. has operated successfully over the years and has metamorphosed from a one man business to what it is today. The success story of the company is well known to you since your firm has been rendering professional services to our company from inception. However, since the past two years the story has changed for the worse as a result of incursion of two new engineering companies into the core areas of our business as well as the present economic recession in the country. The company has accumulated losses that are now threatening its corporate existence.

From the summarised financial position of the company attached herewith, you will notice that the company's retained earnings is now a negative of ₦4.6million while the net assets is ₦3.9million out of which we have obligations of ₦3.0million to our debenture holders. Despite a bank overdraft of ₦6.0million, the company currently has a negative working capital of ₦4.7million.

In our last annual general meeting, the company's shareholders gave approval to the board and mandated it to do everything possible to restructure the company, including capital reduction, if necessary, to bring the company back into profitability. They also expressed their preparedness to subscribe to new shares if called upon.

As a result of this, the board has reached out to the preference shareholders and the creditors of the company. Both have also expressed their willingness to support the company in its effort to come back to profitability. Therefore, at our last board meeting, the board resolved to carry out a restructuring of the company. The two major areas the board is looking at are:

- Capital restructuring and reduction to bring the company's capital in line with the fair values of the assets;
- Benchmarking of three key areas of the company's operational processes with the best in the industry and global best practices.

The company will also need to invest in new technology to be able to compete effectively with our new competitors. We are of the opinion that after this capital reconstruction, we shall be able to raise additional funds from our shareholders and creditors to finance the new machinery.

To assist you on this exercise, I attached herewith the following documents:

- (i) A summarised financial position of the company as at December 31, 2015;
- (ii) Notes to the summarised financial position; and
- (iii) Our preliminary findings based on our meeting with our shareholders and creditors.

I need not to reiterate the urgency of this assignment, but I shall be grateful if I can have your recommendations in form of a report latest by Friday next week.

Thank you for your usual cooperation.

Yours faithfully,

For: **Jullys Engineering Company Plc.**

Dr. Jide Adeolu
Chief Executive Officer

JULLYS ENGINEERING COMPANY PLC

SUMMARY OF STATEMENT OF FINANCIAL POSITION AS AT DECEMBER 31, 2015

	Notes	₦'000	₦'000
Non-Current Assets:			
Properties, plant and equipment	1		8,600
Current Assets:			
Inventories	2	2,500	
Receivables	3	<u>1,800</u>	<u>4,300</u>
			12,900
Less Current Liabilities:			
Bank Overdraft		6,000	
Payables		2,500	
Arrears of debenture interest		<u>500</u>	
			<u>(9,000)</u>
Net Assets			<u>3,900</u>
Long-term Liabilities:			
10% Secured debenture	4		2,500
Equity:			
5% Cumulative preference shares	5		2,000
Ordinary shares	6	4,000	
Retained earnings		<u>(4,600)</u>	<u>(600)</u>
			<u>3,900</u>

**NOTES TO THE SUMMARISED STATEMENT OF FINANCIAL POSITION
AS AT DECEMBER 31, 2015**

1. Properties, plant and equipment:

The properties, plant and equipment comprise:

	N'000
Land and buildings	5,600
Plant and machinery	<u>3,000</u>
	<u>8,600</u>

The debentures are secured on the office premises, the fair value of which is estimated to be ~~N~~1.8million. The other land and building are estimated to have a fair value of ~~N~~4.5million.

The fair value of the plant and machinery is estimated to be ~~N~~1.5million.

2. Inventories:

The net realisable value of the inventories is estimated to be ~~N~~1.875million.

3. Receivables:

The amount recoverable from the receivables is estimated to be ~~N~~1.7million.

4. 10% Debenture:

The debenture is secured on the office premises. Two years interest is however outstanding on the debenture.

5. 5% preference shares:

Two million authorised, issued and fully paid at ~~N~~1.00 per share. The preference shareholders have not been paid any dividend in the past two years.

6. Ordinary shares:

Four million authorised, issued and fully paid ordinary shares of ~~N~~1.00 per share.

JULLYS ENGINEERING COMPANY PLC**PRELIMINARY AGREEMENT WITH STAKEHOLDERS**

From the preliminary meetings of the company's directors with shareholders and creditors, the following additional information has been provided:

1. The debenture holders are prepared to agree to a reconstruction scheme, provided the rate of interest is increased from 10 to 15 per cent per annum. Also, they want a fixed security on the total land and buildings, rather than just the office premises. They are ready to accept ordinary shares in exchange for their interest in arrears;
2. The bank is prepared to accept a reconstruction scheme provided the existing overdraft is converted to a term loan and secured by a floating charge over the company's assets, thus improving its position vis-a-vis any other creditors of the reconstructed company. The bank is also willing to give further medium term loan to the company to acquire its proposed new machinery;
3. The trade creditors are not willing to accept any reduction in their claims but are ready to supply the reconstructed company and grant credit based on the existing terms;
4. The preference shareholders are ready to forfeit their outstanding dividends and are willing to accept ordinary shares instead of preference shares ;
5. The directors are of the opinion that if the company is able to raise at least an additional ~~₦~~2.0million in cash by a rights issue and acquire new plant and machinery, the company will return to profitability. Expected annual earnings before debenture interest and dividends is projected to be at least ~~₦~~5.0million and, due to accumulated tax losses, no company tax will be payable in the next three years;
6. The debenture holders, preference shareholders and ordinary shareholders are prepared to subscribe for new ordinary share capital in the company;
7. The costs of the reconstruction scheme are estimated to be ~~₦~~805,000; and
8. If this reconstruction scheme is not accepted, the company will go into liquidation and this will cost ~~₦~~2.0million.

SOLUTIONS

ICAN CASE STUDY NOVEMBER 2016

First Marking

DATE		CANDIDATE NO.	
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TIME		MARKER NUMBER	
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	Req 1	Req 2	Overall	TOTAL
SA				
CA				
BC				
NC				
V				
Total	8	8	4	20

SUPERVISOR SIGNATURE		CHECKER SIGNATURE	
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Changes made? ☐

REQUIREMENT 1 - CAPITAL RECONSTRUCTION AND REDUCTION

<p>USES DATA AND INFORMATION APPROPRIATELY</p> <ul style="list-style-type: none"> • Uses information provided in Exhibit 1 • Uses information provided in Exhibit 2 • Uses information in summarised financial position (exhibit 3) • Uses information provided in the notes to the summarised financial position (exhibit 4). • Uses information provided in the preliminary findings of the directors (Exhibit 5) • Recognises other issues (provisions of the debenture deed, etc) <div> <div>V</div> <div>NC BC CA SA</div> </div> <p>USES PROFESSIONAL TOOLS AND KNOWLEDGE</p> <ul style="list-style-type: none"> • Recognises the position of the law, provisions of CAMA, in respect of capital reconstruction and reduction. • Recognises need to secure approval from regulatory agencies such as Nigerian Stock Exchange, Corporate Affairs Commission, Securities and Exchange Commission, etc. • Recognises need to secure approval from the court. 	<p>IDENTIFIES ISSUES AND OPTIONS</p> <ul style="list-style-type: none"> • Considers the need to get the scheme approved by the shareholders of the company through a special resolution. • Considers the need to get the scheme approved by 75% of the secured creditors • Considers the need to get the scheme approved by 75% of the unsecured creditors. • Considers the company's ability to return to profitability after the scheme is completed. • Considers need to get a firm commitment from the bank that it will support the company with funds to acquire the needed plant and machinery. <div> <div>V</div> <div>NC BC CA SA</div> </div> <p>APPLIES PROFESSIONAL SCEPTICISM AND ETHICS</p> <ul style="list-style-type: none"> • Considers whether the summarised financial position is from the audited financial statement of the company. • Considers why the complete financial statement for 2015 was not sent. Can this be requested for? • Considers need to get a firm commitment from the company's banker to partly finance the purchase of new plant and machinery.
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• Recognises need to call a meeting of	• Considers availability of working capital
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<p>shareholders and creditors for formal approval of the scheme.</p> <ul style="list-style-type: none"> • Considers whether the Articles of the company allows for capital reconstruction and reduction. 	<p>after the reconstruction.</p> <ul style="list-style-type: none"> • Evaluates the basis of the profit projection by the company's board after restructuring. • Considers the fairness of the proposed scheme to all stakeholders. • Considers whether there are preferential creditors - no indication of this in the summarised financial position and the accompany notes. • Considers how the fair values of the assets was determined. Was it through a professional valuation?
<div>V</div> <div>NC BC CA SA</div>	<div>V</div> <div>NC BC CA SA</div>
<p>USES ANALYTICAL SKILLS (material points) written report</p> <ul style="list-style-type: none"> • Determines what will be the positions of the shareholders and the creditors if the company has to go into liquidation. • Determines an equitable and fair reconstruction scheme that will be acceptable to all stakeholders. • Determines the total amount to be written off from the assets of the company. • Determines the position of the shareholders and creditors after reconstruction. 	<p>EVALUATIVE SKILLS AND JUDGEMENT</p> <ul style="list-style-type: none"> • Recognises the need to appoint professionals to midwife the scheme. • Recognises the need to prepare a detail timetable for the exercise. • Evaluates the possibility of the company to be able to raise funds to meet the costs of reconstruction. • Considers whether the supplier and the cost of the proposed new plant and machinery have been determined.
<div>V</div> <div>NC BC CA SA</div>	<div>V</div> <div>NC BC CA SA</div>

CONCLUSIONS

(Draws distinct conclusions under a heading)

- Concludes on the amount to be written off to bring the assets to their fair values.
- Concludes on the amount to be borne by the shareholders and the debenture holders as a reduction on their capital.
- Concludes on the steps to be followed by the company to carry out the exercise successfully.
- Concludes on documents to be filled with all the regulatory agencies before and after the exercise.

V

NC	BC	CA	SA
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RECOMMENDATIONS (commercial / relevant)

- Jullys Engineering company should call a formal meeting of the shareholders and get their approval through a special resolution
- Jullys Engineering company should call a formal meeting of the creditors and secure their approval.
- Jullys Engineering company should secure the approval of the regulatory agencies for the scheme.
- Jullys Engineering should secure a court approval for the scheme.
- Jullys Engineering should make sure the scheme proposed is fair to all the stakeholders.

V

NC	BC	CA	SA
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SA	
CA	
BC	
NC	
V	

REQUIREMENT 2 – Benchmarking

USES DATA AND INFORMATION APPROPRIATELY

- Uses information in exhibit 1
- Uses information from the letter of Jullys' CEO (exhibit 2)
- Uses information from the summarised statement of financial position (exhibit 3)
- Identifies wider issues

V

NC	BC	CA	SA
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USES PROFESSIONAL TOOLS AND KNOWLEDGE

(written into report)

- Identifies the various types of benchmarking
- Identifies the type of benchmarking suitable for Jullys Engineering Company Plc.
- Identifies the steps necessary for a successful benchmarking.
- Identifies the likely constraints the company may have in carrying out the proposed benchmarking
- Determines benefits of benchmarking

IDENTIFIES ISSUES AND OPTIONS

- Identifies the need to put in place method of selecting the companies to benchmark with.
- Considers the possibility of the company to benchmark's willingness to make available useful data
- Considers other methods of repositioning the company, e.g, developing the company's core competence to gain competitive advantage.
- Identifies the need to carry along the company's management and staff in the exercise.

V

NC	BC	CA	SA
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APPLYING PROFESSIONAL SCEPTICISM AND ETHICS

- Considers the capability of the present management of Jullys' Engineering Company Plc to carry out an effective and successful benchmarking
- Considers need to bring in an external consultant for the benchmarking exercise.
- Considers availability of data that are needed for the exercise.
- Considers availability of funds needed to carry out the exercise.
- Considers the response of the competitors.
- Identifies need to consider the response of the staff union to the outcome of the exercise, especially if it involves lost of job.

V	NC	BC	CA	SA
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USESG ANALYTICAL SKILLS (material points)

- Identifies need to determine the best organisation in the industry. and global best practices.
- Identifies need to consider what makes the organisation the best.
- Identifies need to compare key performance indicators (KPI) of the company identified with that of Jullys Engineering company Plc.
- Identifies the need to close the gap discovered in the KPIs

V	NC	BC	CA	SA
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CONCLUSIONS

(Draws distinct conclusions under a heading)

- Concludes on the type of benchmarking appropriate for the company.
- Concludes on the need to secure the commitment of the company's management and staff.
- Concludes on the need to secure the support of the senior management of the company.
- Concludes on the need to select appropriate companies to benchmark with

V	NC	BC	CA	SA
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EVALUATIVE SKILLS AND JUDGEMENT

- Identifies pitfalls associated with benchmarking.
- Identifies need to break down the three areas to be benchmarked into specifics.
- Identifies limitations of using benchmarking as a performance improvement strategy.
- Identifies actions that are necessary after benchmarking to integrate the findings into the company's operational processes.

V	NC	BC	CA	SA
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- Concludes on the need for a definite timetable for the exercise.
- Concludes on the need to consider constraints and limitation of benchmarking as a performance improvement strategic tool.

V	NC	BC	CA	SA
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RECOMMENDATIONS (commercial/relevant)

- Jullys to consider professionals to help carry out the benchmarking exercise.
- Jullys to select companies to benchmark with carefully.
- Jullys should consider the various companies' willingness to provide unbiased data.
- Jullys should select appropriate data analysis tools for analysing data collected.
- Jullys should appoint a good team to carry out the benchmarking exercise.
- Jullys should prepare a definite timetable for the exercise.

V	NC	BC	CA	SA
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SA	
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Appendices	Main Report
<p>Appendices R1: Content and style</p> <ul style="list-style-type: none"> Shows the position of the shareholders and creditors of the company if it goes into liquidation. Shows the total amount to be written off the assets of the Company Shows the proposed scheme of reconstruction and the position of the shareholders and creditors after the scheme. Shows the steps to be followed by the company to carry out the scheme. <div data-bbox="152 1019 743 1059"> <div>V</div> <div>NC BC CA SA</div> </div>	<p>Report: Structure</p> <ul style="list-style-type: none"> Sufficient appropriate headings Appropriate use of paragraphs/sentences Legible Correctly numbered pages <div data-bbox="864 1019 1378 1059"> <div>V</div> <div>NC BC CA SA</div> </div>
<p>Appendices R2: Content and style</p> <ul style="list-style-type: none"> Shows the steps to be followed in carrying the proposed benchmarking. Shows the benefits the company is likely to derive from the proposed benchmarking. Shows the limitations of benchmarking. Shows a tentative timetable for the benchmarking exercise. <div data-bbox="152 1648 743 1692"> <div>V</div> <div>NC BC CA SA</div> </div>	<p>Report: Style and language</p> <ul style="list-style-type: none"> Relevant disclaimer (external report) Suitable language for the board Tactful / ethical comments Acceptable spelling and punctuation <div data-bbox="864 1648 1378 1692"> <div>V</div> <div>NC BC CA SA</div> </div>

APPENDIX 1
JULLYS ENGINEERING COMPANY PLC
CAPITAL REDUCTION REQUIRED

	₦'000
a. To correct the value of plant and machinery	1,500
b. To correct the value of inventories	625
c. To correct the value of receivables	100
d. To eliminate the negative balance on retained earnings	4,600
e. Cost of the scheme	<u>805</u>
	7,630
f. Less surplus on fair value of land and buildings	<u>700</u>
	<u>6,930</u>

DISTRIBUTION OF REALISABLE VALUES OF THE ASSETS ON LIQUIDATION

	N'000	N'000
Office building		
	1,800	
Less payable to debenture holders	<u>1,800</u>	-
Other land and buildings		4,500
Plant and machinery		1,500
Inventories		1,875
Receivables		<u>1,700</u>
		9,575
Less cost of liquidation		<u>2,000</u>
Available for unsecured creditors		<u><u>7,575</u></u>
UNSECURED CREDITORS:		
Bank overdraft		
		6,000
Debenture holders: capital	2,500	
Interest	<u>500</u>	
	3,000	
Less paid out to secured debenture holders as above	<u>1,800</u>	1,200
Payable to trade creditors		<u>2,500</u>
		<u><u>9,700</u></u>

Note:

There is no indication of any preferential creditors in the summarised statement of financial position and the accompany notes.

Since there is only N7.575m to meet the claim of unsecured creditors of N9.7m, including the debenture holders to the extent that they are unsecured, each would therefore receive N0.7809 in N1.00.

The various parties would therefore receive the following amounts on liquidation of the company:

	N'000
Bank (6,000 x 0.7809)	4,686
Debenture holders (1,800 + {1,200 x 0.7809})	2,737
Trade Creditors (2,500 x .7809)	
	1,952
Preference shareholders	0
Ordinary shareholders	<u>0</u>
	<u>9,375</u>

The above shows that all parties would lose on liquidation and there is incentive to agree to a suitable reconstruction scheme. However, the greatest burden of the loss will be borne by the shareholders.

JULLYS ENGINEERING COMPANY PLC
PROPOSED RECONSTRUCTION SCHEME

		REDUCTION
		₦'000
a.	4 million ₦1.00 ordinary shares each to be reduced to 1 kobo ordinary shares.	3,960
b.	2 million preference shares to be cancelled in exchange for 2 million 1 kobo Ordinary shares	1,980
c.	Granting of an increased rate of interest of 15% per annum and a fixed charge on all land and buildings to the debenture holders; cancellation of ₦500,000 debenture in exchange for 500,000 ordinary shares of 1 kobo each (₦5,000) and waiving of outstanding interest of ₦500,000 in exchange for 500,000 ordinary share of 1 kobo each (₦5,000)	990
d.	Granting of floating charge on the bank overdraft	-
e.	Consolidation of the 7 million ordinary shares into 70,000 ordinary shares of ₦1.00 each	-
f.	Making of rights issue of 30 ₦1.00 ordinary shares for each ₦1.00 ordinary share held, to raise additional ₦2.1m, thus finance will come from old ordinary shareholders (₦1.2m), old preference shareholders (₦600,000) and old debenture holders (₦300,000)	-
		<u>6,930</u>

**JULLYS ENGINEERING COMPANY PLC
STATEMENT OF FINANCIAL POSITION
AFTER CAPITAL RECONSTRUCTION**

	₦'000	₦'000
Non current assets:		
Properties, plant and equipment		7,800
Current Assets:		
Inventories	1,875	
Receivables	1,700	
Cash	<u>1,295</u>	
	<u>4,870</u>	
Current Liabilities:		
Bank overdraft (secured)	6,000	
Payables		
	<u>2,500</u>	
	<u>8,500</u>	
Net Current assets		
	<u>(3,630)</u>	
Net Assets		<u>4,170</u>
Long term liabilities:		
15% Debenture		2,000
Shareholders' Equity:		
2,170,000 ordinary shares of ₦1.00 each		<u>2,170</u>
		<u>4,170</u>

Note:

The negative working capital is caused by inclusion of bank overdraft in current liabilities, but this is technically a medium term loan. The statement of financial position will reflect this when the new agreement is signed with the bank.

PROCEDURES FOR CAPITAL RECONSTRUCTION

The following are the essential steps in capital reconstruction:

- a. Meeting of shareholders where the scheme will be approved by a special resolution of members;
- b. Meeting of all classes of creditors where the scheme will be approved by at least $\frac{3}{4}$ of the various classes of creditors;
- c. Filing of the proposed scheme in the court for court's approval;
- d. Filing of the following documents with the Securities and Exchange Commission:
 - Extract of the Shareholders' Resolution at the Annual General Meeting authorizing the share capital reconstruction.
 - Extract of Board Resolution authorizing the share capital reconstruction
 - Memorandum and Articles of Association (including amendment thereto) of the Company recently certified by the CAC
 - Form CAC 2 – (Statement of Share Capital and Return of Allotment) certified by the CAC
 - Form SEC 6 (duly completed)
 - Form CAC 7 (Particulars of Directors) certified by the CAC
 - Audited Accounts for the preceding five years or such number of years the company has been in operation if less than 5 years
 - A copy of Certificate of Incorporation of the Company certified by the CAC or Company Secretary
 - The most recent copy of Certificate of Increase in Share Capital certified by the Company Secretary (where applicable).
 - Copy of the Court Order where the reconstruction entails a reduction of share capital
 - Explanatory memorandum on the factors necessitating the reconstruction
 - Evidence of payment of filing fees
- e. Filing with the Corporate Affairs Commission; and
- f. Filing with the Nigerian Stock Exchange.

APPENDIX II

APPENDIX TO REQUIREMENT 2

STEPS TO BENCHMARKING/ PROCESSES FOR BENCHMARKING

OPTION 1



Steps of the Benchmarking process by *Larisa Dragolea and Denisa Cofirlea*

OPTION 2

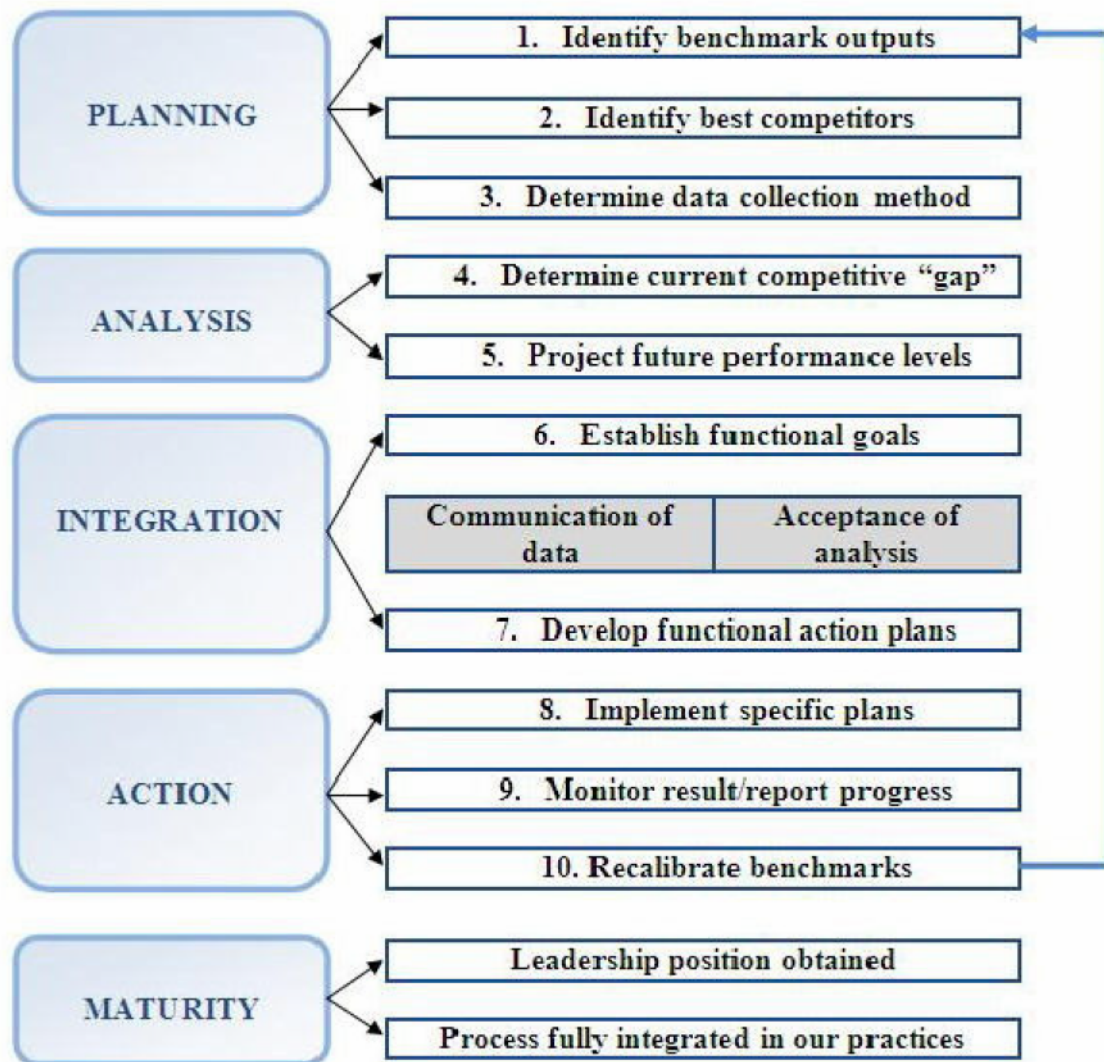


Fig. no. 5 - Xerox benchmarking model

Note:

Candidates can use any other method to explain the steps but such methods must contain the essential steps as shown above.

BENEFITS OF BENCHMARKING

Benchmarking offers the following benefits to companies and organizations:

- Highlights areas of practice and performance requiring attention and improvement;
- Identifies strengths and weaknesses to other respondents;
- Establishes company's true position versus the rest, making it easier for the company to raise the organizational energy for change and develop plans for action;
- Helps measure current company performance;
- Prevents reinventing the wheel (Why invest the time and costs when someone else; may have done it already -and often better, cheaper, and faster?);
- Accelerates change and restructuring by:
 - using tested and proven practices,
 - convincing sceptics who can see that it works, and
 - overcoming inertia and complacency and creating a sense of urgency when gaps are revealed;
- Leads to "outside the box" ideas by looking for ways to improve outside of the Industry;
- Forces organizations to examine present processes, which often leads to improvement in and of itself;
- Makes implementation more likely because of involvement of process owners; and
- Enables the identification of other companies and/or organizations with processes resulting in superior performance, with a view to their adoption.

PITFALLS OR LIMITATIONS OF BENCHMARKING

Following is a list of common pitfalls associated with benchmarking:

- **INSUFFICIENT COMMITMENT** - No sufficient 'high level' or 'sincere' commitment from the management;
- **NOT PLANNING AHEAD** - Insufficient planning; 'this is easy, let's just do it' attitude;
- **MISUNDERSTANDING** of iterative, continuous nature of benchmarking or conducting intellectual (cf. practical) benchmarking
- **NOT LINKING BENCHMARKING TO PROCESS** - Failure to 'go behind' measures and understand the 'how';
- **APPLES vs ORANGES** Comparison with insufficient process analysis or partner 'fit';

- **WHAT GETS MEASURED** - Measuring 'easy' factors, not those that will make a difference;
- **NOT TEACHING PEOPLE TO FISH** - Lack of education and awareness- building in those responsible or, or involved in, benchmarking;
- **LACK OF COMMUNICATION** or unclear communication. Benchmarking not linked to other corporate activity / goals so communication and relevance blurred; and
- **FAILING TO PRIORITISE** - Trying to "change the world" at once and not identifying subjects which are linked to key business processes.
(From Benchmarking by DrVassilisKelessidis)

PROPOSED BENCHMARKING TIMETABLE

	Activity	Expected Days
1	Identify what is to be benchmarked	5days
2	Create the benchmarking team in the organization 2 – 10 Executives & team	2days
3	Identify the organization(s) you want to benchmark against	5days
4	Determine the indicators and the data collection method	5days
5	Collect data	10days
6	Determine current performance levels and identify gaps	3days
7	Determine future performance levels; forecast the expected improvements	3days
8	Communicate the benchmark findings	2days
9	Develop an action / improvement plan based on the strategy developed	<u>5days</u>
	TOTAL	<u>40days</u>

EXAMINER'S REPORT

The case is on capital reconstruction and benchmarking as a strategic tool for performance improvement.

Candidates were required to write a report advising the company on:

- a. A capital reduction scheme based on the summarized financial position given in the case and steps to be followed to carry through the scheme; and
- b. The types of benchmarking and the most appropriate type to meet the company's situation, steps to be taken to carry out the exercise as well as benefits the company can derive from benchmarking and possible limitations. Candidates were also required to suggest a timetable for carrying out the exercise.

Candidates were expected to prepare the following data in order to properly address requirement 1 in the report:

- a. Total amount of capital reduction required, based on the fair values of the assets and to write off the negative balance on retained earnings;
- b. Distribution of realizable values of the assets of the company, if liquidated, i.e if the capital reconstruction is not carried out;
- c. The proposed reconstruction scheme based on the information supplied on exhibit 5, preliminary agreement with stakeholders; and
- d. The expected statement of financial position after the capital reconstruction exercise.

All these will form the appendices for requirement 1 together with the procedures the Company should follow in effecting the capital reconstruction scheme.

Also, for requirement 2, candidates were not expected to carry out a benchmarking but to discuss the types of benchmarking and recommend the one that will be suitable for the company, based on the scenario.

Candidates were also expected to show in the appendice to requirement 2 the following:

- a. Steps to be followed for the benchmarking exercise;
- b. Benefits the company could derive from benchmarking;
- c. Limitations or pitfalls to beware of in benchmarking; and
- d. Proposed timetable for the benchmarking

The performance of the candidates was poor. Major problems of the candidates are:

- a. Lack of understanding of a capital reduction scheme and procedures to be followed to effect capital reduction;**
- b. Limited understanding of benchmarking as a strategic tool and steps necessary to carry out benchmarking;**
- c. Inability to write a good report with appropriate headings, sub-headings and appendices;**
- d. Most of the candidates failed to put appropriate disclaimer on their report, being an external report.**

Candidates need to remember that case study examination is a test of professional competence and it involves the ability of the candidates to make use of the knowledge and technical skills they have acquired in all the other papers of the Institute's examination. They are also expected to bring to bear the experience they have gained in practical terms. Therefore, to succeed in case study examination, candidates must refresh their knowledge of other papers in the Institute's examination, develop their analytical and report writing skills. They must familiarise themselves with current situations in the economy as most case study papers considers the economic situation to build a scenario to be examined.

In approaching any Case Study paper in the future, candidates should take note of the following steps:

- a. Read and understand the case in the light of the requirements of the examiner, stated in the case;**
- b. Determine and carry out detail financial and data analysis that will help candidates give a sound advice in their report: All these will form the appendices.**
- c. Determine the appropriate strategic model that is appropriate for the type of business analysis required in the case, where the examiner do not ask candidates to use a particular model;**
- d. Carry out the detail business analysis and put this as an appendice to their report;**
- e. Understand the elements of a good report with appropriate headings, sub-headings and disclaimer where it is required;**
- f. Practice with the cases examined in previous examinations in their preparation.**