



**THE INSTITUTE OF CHARTERED ACCOUNTANTS
OF NIGERIA**

PATHFINDER

NOVEMBER 2014 PROFESSIONAL EXAMINATION

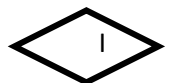
Question Papers

Suggested Solutions

Plus

Examiners' Reports

PROFESSIONAL EXAMINATION – NOVEMBER 2014



FOREWORD

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

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

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

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

NOTES

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

TABLE OF CONTENTS

SUBJECT	PAGES
CORPORATE REPORTING	1 – 34
ADVANCED TAXATION	35 - 66
STRATEGIC FINANCIAL MANAGEMENT	67 – 96
ADVANCED AUDIT AND ASSURANCE	97 – 126
CASE STUDY	127 – 152

Non-current liabilities:			
Long-term loans	2,400	300	100
Deferred tax	<u>500</u>	<u>180</u>	<u>60</u>
Total Non-current liabilities	<u>2,900</u>	<u>480</u>	<u>160</u>
Current liabilities:			
Trade payables	2,300	600	1,200
Current tax payable	1,200	160	480
	<u>3,500</u>	<u>760</u>	<u>1,680</u>
Total equity and liabilities	<u>21,840</u>	<u>8,720</u>	<u>5,580</u>

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

- i. On 1 June, 2012, Bagat acquired 80% of the equity interest of Megat Plc. On the date of acquisition, the retained earnings of Megat was ₦2.72billion and other components of equity were ₦80million. There had been no new issue of capital by Megat since the date of acquisition. The purchase consideration comprised cash of ₦6billion whereas the fair value of the identifiable net assets of Megat on this date was ₦8billion. The excess of the fair value of the net assets is due to an increase in the value of non-depreciable land. An independent valuer has stated that the fair value of the non-controlling interests in Megat was ₦1.72billion on 1 June, 2012. It is the policy of Bagat to measure non-controlling interests on the basis of their proportionate share in the identifiable net assets of the acquired subsidiary and not at fair value (full goodwill method).
- ii. Also on 1 June, 2012, Bagat acquired 70% of the ordinary shares of Mingat. The consideration for the acquisition of these shares was ₦2.56billion. Under the purchase agreement of 1 June, 2012, Bagat is required to pay the former shareholders of Mingat 30% of the profits of Mingat on 31 May, 2014 for each of the financial years to 31 May, 2013 and 31 May, 2014. The fair value of this arrangement was estimated at ₦120million at 1 June, 2012 and this value has not changed. This amount has not been included in the financial statements.

The fair value of the identifiable net assets at 1 June, 2012 of Mingat was ₦3.52billion and the retained earnings and other components of equity were ₦1.1billion and ₦140million respectively. There had been no new

issue of share capital by Mingat since the date of acquisition and the excess of the fair value of the net assets is due to an increase in the value of property, plant and equipment (PPE). The fair value of the non-controlling interests in Mingat was ₦1.06billion on this date. PPE is depreciated on a straight-line basis over seven years.

- iii. Finally, Bagat acquired a 25% interest in Cagat Plc on 1 June, 2012 for ₦400million achieving significant influence over that company in its financial and operating policy decisions. Cagat Plc retained earnings for the year to 31 May, 2013 was ₦200 million.
- iv. Included in trade receivables of Bagat at 31 May, 2013 is a receivable from Megat of ₦30million. Unknown to Bagat, Megat has paid this amount through a bank transfer by the close of work on 31 May, 2013 but it had not yet been reflected in the bank statement of Bagat. Megat has already passed accounting entries to reflect this transaction.
- v. Goodwill arising on the purchase of Mingat was tested for impairment on 31 May, 2013 and this provided evidence of impairment to the tune of ₦36million. No accounting entries have been passed to reflect the impairment.

Required:

Prepare a consolidated statement of financial position as at 31 May, 2013 for the Bagat Group. (30 Marks)

SECTION B: ATTEMPT TWO OUT OF THREE QUESTIONS (40 MARKS)

QUESTION 2

- (a) Labalaba Plc operations involve selling cars to the public through a chain of retail car showrooms. It buys most of its new vehicles directly from the manufacturer on the following terms:
 - (i) Pay the manufacturer for the cars on the date they are sold to customers or six months after they are delivered to its showroom whichever is earlier.
 - (ii) The price paid will be 80% of the retail price as set by the manufacturer at the date that the goods are delivered.

- (iii) Pay the manufacturer 1.5% per month (of the cost to Labalaba) as a 'display charge' until the goods are paid for.
- (iv) May return the cars to the manufacturer at any time up to the date the cars are due to be paid for and incur the freight cost of any such returns. Labalaba Plc has never taken advantage of this right of return.
- (v) The manufacturer can recall the cars or request them to be transferred to another dealer at any time up to the time they are paid for by Labalaba.

Required;

Advise the management of Labalaba Plc as to which party bears the risks and rewards in the above arrangement and show whether there is a sale and how the transactions should be treated by each party. (7 Marks)

- (b) Mr. Ojoowuro, the director of a grocery store, has noticed that the tax charge for his company is ₦15million on profits before tax of ₦105million. This is an effective rate of 14.3%. Another company, Irin Plc has an income tax charge of ₦30million on profit before tax of ₦90million. This is an effective rate of tax of 33.3%, yet both companies state that the rate of income tax applicable to them is 25%. Mr. Ojoowuro has also noticed that in the statements of cash flows each company has paid the same amount of tax of ₦24million.

Required:

Advise Mr. Ojoowuro on the possible reasons why the income tax charge in the financial statements as a percentage of the profit before tax may not be the same as the applicable income tax rate and why the tax paid in the statement of cash flows may not be the same as the tax charge in the statement of profit or loss and other comprehensive income. (7 Marks)

- (c) Maidogo Limited sells NIXAQ, a product manufactured by it, from several retail outlets. In previous years, the company has undertaken responsibility for fitting the product in customers' premises. Customers pay for the product at the time they are ordered. The average length of time it takes from ordering to its fitting is 14 days. In previous years, Maidogo Limited had not recognised a sale in its books until the product had been successfully fitted because the rectification costs of any fitting error would be expensive.

With effect from 1 April, 2013, Maidogo Limited changed its method of trading by sub-contracting the fitting to approved contractors. Under this policy, the sub-contractors are paid by Maidogo Limited and they (the sub-contractors) are liable for any errors made in the fitting. Consequently, Maidogo Limited is proposing to recognise sales when customers order and

pay for the goods rather than when they have been fitted. Details of the relevant sales figures are;

	₦'000
Sales made in retail outlets for the year to 31 March, 2014	69,000
Sales value of NIXAQ fitted in the 14 days to 14 April, 2013	3,600
Sales value of NIXAQ fitted in the 14 days to 14 April, 2014	4,800

Note: The sales value of NIXAQ in the 14 days to 14 April, 2013 are not included in the annual sales figure of ₦69million, but those for the 14 April, 2014 are included.

Required:

Discuss whether or not the above represents a change of accounting policy, and calculate the amount that you would include in the revenue for NIXAQ in the year to 31 March, 2014.

(6 Marks)
(Total 20 Marks)

QUESTION 3

Prochain Plc

The Directors of Prochain Plc have pursued an aggressive policy of expansion in the last two years. They have developed several new products and market share has increased.

The financial statements for the year ended 31 December, 2013 which will be presented to the Board of Directors at its next meeting is being finalised.

The financial statements at the year-end are presented below:

Statement of profit or loss and other comprehensive income for the year ended 31 December

	2013	2012
	(₦'m)	(₦'m)
Revenue	34,200	28,900
Cost of sales	(24,000)	(20,250)
Gross profit	10,200	8,650
Distribution costs & administration expenses	(5,120)	(3,300)
Finance costs	(520)	(450)
Profit before tax	4,560	4,900
Income tax	(1,300)	(1,400)
Profit for the year	3,260	3,500

Other comprehensive income	-	-
Total comprehensive income for the year	<u>3,260</u>	<u>3,500</u>

The results of the company as well as certain key ratios that will form part of the covenants in respect of the loan facilities will be discussed at the Board of Directors meeting.

Statement of Financial Position as at 31 December

		2013		2012	
	Note	N'000	N'000	N'000	N'000
Non-current assets					
Property, plant & equipment		25,930		17,880	
Available for sale investment		<u>6,200</u>	32,130	<u>5,400</u>	23,280
Current assets					
Inventories		4,500		3,600	
Trade receivables		4,300		5,200	
Cash and cash equivalents		-	<u>8,800</u>	<u>120</u>	8,920
Total assets			<u>40,930</u>		<u>32,200</u>
Equity and liabilities					
Equity					
Share capital (N0.50k)		10,000		10,000	
Revaluation reserve	1	4,200		1,100	
Other reserves	2	1,800		1,000	
Retained earnings		<u>7,460</u>	23,460	<u>4,200</u>	16,300
Non-current liabilities:					
Term loan		6,000		6,000	
6% bonus bonds (2015)	3	<u>5,400</u>	11,400	<u>5,200</u>	11,200
Current liabilities:					
Trade and other payables		5,800		4,700	
Short-term borrowings		<u>270</u>	<u>6,070</u>	-	4,700
Total equity & liabilities			<u>40,930</u>		<u>32,200</u>

Notes:

- 1 The movement on the revaluation reserve relates to property, plant and equipment revalued in the year.
- 2 The movement on other reserves relates to the gains on the investments available for sale.
- 3 The bonds are repayable on 1 July, 2015.

The key ratios for the loan covenants include:

		Target
i.	Gearing	50%
ii.	Interest cover	9.5 times
iii.	Current ratio	1.5:1
iv.	Quick ratio	1.1:1

Required:

- (a) Based on the results of Prochain Plc for the year ended 31 December, 2013, calculate the key ratios for the loan. (8 Marks)
- (b) Prepare a report commenting on the financial performance for the year in relation to the key ratios for the loan. (12 Marks)
- (Total 20 Marks)**

QUESTION 4

- (a) The following is the statement of financial position of Lagos Plc as at 31 December, 2013 with its immediate two comparative years.

	2013	2012	2011
	₦'000	₦'000	₦'000
<u>Non-current assets</u>			
Property, plant & equipment	30,600	26,010	22,628
Goodwill on business acquisition	4,300	4,300	-
Investment property	<u>15,400</u>	<u>11,704</u>	<u>10,537</u>
	<u>50,300</u>	<u>42,014</u>	<u>33,165</u>
<u>Current assets</u>			
Inventory	16,900	12,675	11,281
Trade Receivables	21,680	18,862	18,673
Other Receivables	413	560	616
Cash & cash equivalents	<u>5,437</u>	<u>3,821</u>	<u>2,980</u>
	<u>44,430</u>	<u>35,918</u>	<u>33,550</u>
Total Assets	<u>94,730</u>	<u>77,932</u>	<u>66,715</u>
Equity and Liabilities			
Ordinary share capital	20,612	20,612	20,612
Share premium	600	600	600
Retained earnings	<u>30,163</u>	<u>17,164</u>	<u>12,482</u>
	<u>51,375</u>	<u>38,376</u>	<u>33,694</u>
<u>Current liabilities</u>			
Trade payables	24,000	21,120	19,008
Other payables	6,816	7,210	6,273
Bank overdraft	11,223	9,299	6,044
Current tax payable	<u>1,316</u>	<u>1,927</u>	<u>1,696</u>
	<u>43,355</u>	<u>39,556</u>	<u>33,021</u>

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

Required:

- (a) Advise the Board on **FIVE** elements of information which IFRS Practice Statement expects to be included in management commentaries in order to meet its objectives. (5 Marks)
 - (b) Relate the **FIVE** elements of information above to the needs of the various primary users. (7 Marks)
 - (c) Justify why management commentaries should be made compulsory in Nigeria's financial reporting environment. (3 Marks)
- (Total 15 Marks)**

QUESTION 6

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

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

Required:

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

- i. Financial
 - ii. Operations
 - iii. Legal or regulatory (6 Marks)
- (b) Luck & Co. has been making losses over the last few years. Its statement of financial position at 31 December, 2013 showed the following:

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

	₦	₦
Non-current assets:		
Property, plant and equipment		80,000

Current assets:		
Inventory	20,000	
Receivables	<u>40,000</u>	<u>60,000</u>
		<u>140,000</u>
Equity and Liabilities:		
Ordinary capital		100,000
Retained earnings		(140,000)
Secured loan stock		100,000
Payables		<u>80,000</u>
		<u>140,000</u>

On liquidation, the assets would realise the following:

	₦	₦
Property, plant and equipment		30,000
Inventory		12,000
Receivables		<u>36,000</u>
		<u>78,000</u>

If the company continues to trade for the next four years, profit after charging ₦20,000 per annum as depreciation on the property, plant and equipment would be as follows:

	₦
2014	4,000
2015	20,000
2016	26,000
2017	<u>28,000</u>
	<u>78,000</u>

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

Required:

Evaluate the financials and advise the management of Luck and Co on the options available to them and redraft the statement of financial position of Luck and Co after the exercise.

(9 Marks)

(Total 15 Marks)

QUESTION 7

The Chief Financial Officer (CFO) of Niger Breweries Plc, a company listed on the Nigerian Stock Exchange recently attended IFRS certification training of the Corporate Finance Faculty of the Institute of Chartered Accountants of Nigeria (ICAN). He realised that due to the complexity of International Financial Reporting Standards (IFRS), judgments used at the time of transition to IFRS may result in prior year adjustments and changes in estimates disclosed in financial statements.

He also understood from the introductory session on IAS 8 (Accounting Policies, Changes in Accounting Estimates and Errors), that the selection of accounting policy and estimation techniques is intended to aid comparability and consistency in financial statements. Among other things, IFRS also places particular emphasis on the need to take into account qualitative characteristics and the use of professional judgment when preparing financial statements. The IFRS may appear prescriptive and the achievement of all the objectives for a set of financial statements will rely on the skills of the preparers. When selecting or changing accounting policies, changing estimation techniques, and correcting errors, entities should follow the requirements of IAS 8.

However, the application of IAS 8 is usually often dependent upon the application of materiality analysis to identify issues and guide reporting. Entities also consider the acceptability of the use of hindsight in their reporting.

With the above knowledge, the CFO of Niger Breweries is still not clear about the circumstances under which Niger Breweries can change its accounting policies conscious that IAS 8 emphasises consistency in the application of accounting policies once chosen.

Required:

- a. Advise the CFO on the circumstances where an entity may change its accounting policies, setting out how a change in accounting policy is applied and the difficulties faced by entities when a change in accounting policy is made.
(8 Marks)
 - b. Discuss why the current treatment of prior period's errors could lead to earnings management by companies, together with any further arguments against the current treatment.
(7 Marks)
- (Total 15 Marks)**

SOLUTION 1

BAGAT PLC GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MAY 2013

ASSETS	Notes	₹'M	₹'M
Non-current assets			
Property, plant and equipment	1		14,160
Goodwill	2		180
Investment in Associate	3		450
Available for sale financial assets	4		<u>1,240</u>
			<u>16,030</u>
Current Assets			
Inventories	5	5,260	
Trade Receivables	6	3,330	
Cash and cash equivalent	7	<u>4,230</u>	<u>12,820</u>
			<u>28,850</u>
Equity and liabilities			
Equity attributable to owners of the parent			
Share capital			10,400
Retained earnings	8		5,760
Other component of equity			<u>240</u>
			<u>16,400</u>
Non-controlling interest	9		<u>2,850</u>
			<u>19,250</u>
Non-current liabilities			
Long-term liabilities	10	2,800	
Deferred tax	11	<u>740</u>	
		<u>3,540</u>	
Current liabilities			
Trade and other liabilities	12	4,220	
Current tax payable	13	<u>1,840</u>	
		<u>6,060</u>	9,600
			<u>28,850</u>

Notes

	₹/M
1 Property, plant and equipment	
Plant- Bagat	5,300
-Megat	4,600
-Mingat	3,220
Fair Value –Non-depreciable Land (wk1)	800
Fair Value Adjustment (wk2)	280
	<u>14,200</u>
Depreciation Adjustment (wk2)	<u>(40)</u>
	<u>14,160</u>
2 Goodwill	
On acquisition of Mingat	216
Goodwill Impairment (wk5)	<u>(36)</u>
	<u>180</u>
3 Investment in Associate:	
Associate –Cagat	400
Post-acquisition Retained Earning (Wk3)	<u>50</u>
	<u>450</u>
4 Available for Sale Financial Assets	
- Bagat	1,020
- Megat	120
- Mingat	<u>100</u>
	<u>1,240</u>
5 Inventories	
- Bagat	2,700
- Megat	1,100
- Mingat	<u>1,460</u>
	<u>5,260</u>
6 Trade Receivables	
- Bagat	1,820
- Megat	900
- Mingat	640
Receivable from Megat (Intergroup)	<u>(30)</u>
	<u>3,330</u>

7	Cash and Cash equivalent				
	- Bagat	2,040			
	- Megat	2,000			
	- Mingat	160			
	Intergroup receivable from Megat	<u>30</u>			
		<u>4,230</u>			
8	Consolidated retained earnings	Bagat	Megat	Mingat	NCI
	As at 31.05.2013	4,800	3,000	1,600	
	At Acquisition		(2,720)	(1,100)	
	Gain on bargain purchase (wk1)	400.00			
	Share of post acquisition retained Prof Ass (wk3)	50.00			
	Additional dep. PPE Fair value (ek2)	0.00	0	(40)	
	Impairment of goodwill (wk5)	<u>(36.00)</u>			
	Post acquisition retained profit	5,214.00	<u>280</u>	<u>460</u>	
	Bagat share of post prof in megat	224.00			56.00
	Bagat share of post prof in minget	<u>322.00</u>			138.00
		<u>5,760.00</u>			
9	Non-controlling interest	Meya	Minaga	Total	
	At acquisition (wk 1&2)	1,600	1,056		
	Post	<u>56</u>	<u>138</u>		
		<u>1,656</u>	<u>1,194</u>	<u>2,850</u>	
	Alternatively NCI can be determined as follows:				
	At consolidation date				
	20% x 7,480	1,496			
	30% x 3,740		1,122		
	Fair value Adj 800x 20% & 240 x 30% (wk 1&2)	<u>160</u>	<u>72</u>		
	NCI	<u>1,656</u>	<u>1,194</u>	<u>2,850</u>	
		N'M			
10	Long-term liabilities				
	- Bagat	2,400			
	- Megat	500			
	- Mingat	<u>100</u>			
		<u>2,800</u>			
11	Deferred tax				
	- Bagat	500			
	- Megat	180			
	- Mingat	<u>60</u>			
		<u>740</u>			

12	Trade and other liabilities	
-	Bagat	2,300
-	Megat	600
-	Mingat	1,200
-	Contingent consideration	<u>120</u>
		<u>4,220</u>
13	Current tax payable	
-	Bagat	1,200
-	Megat	160
-	Mingat	<u>480</u>
		<u>1,840</u>

Workings

		Bagat	NCI
1	Purchase of Megat		
	Purchase consideration	6,000	
	Fair value of assets acquired		
	Share capital		4,400
	Retained earnings		2,720
	Other components of equity		80
	FV Non-depreciable land (balancing figure)		<u>800</u>
	Total fair value of net assets		<u>8,000</u>
	Bagat/NCI at 80%/20%	<u>6,400</u>	<u>1,600</u>
	Gain on bargain purchase	<u>(400)</u>	
	The land is non depreciable, so no depreciation adjustment.		
	Gain on bargain purchase is taken to earnings going by IFRS 3		
2	Purchase of Mingat		
	Purchase consideration	2,560	
	Contingent consideration	120	
	Total consideration FV	2,680	
	Fair value of assets acquired		
	Share capital		2,000
	Retained earnings		1,100
	Other components of equity		<u>140</u>
			3,240
	FV PPE (balancing figure)		<u>280</u>
	Total fair value of net assets		<u>3,520</u>
	Bagat/NCI at 70%/ 30%	<u>2,464</u>	<u>1,056</u>
		<u>216</u>	

For the fair value adjustment, accounting entry will be

Candidates are advised to study and acquire in-depth understanding of the principles of group accounts.

SOLUTION 2

(a) LABALABA PLC

The issue involved here is an example of a sales or return transaction. From LABALABA'S point of view, the main issue is to determine the point at which purchase has taken place and when recognition of revenue should occur. Usually, in the case of this type of agreement, there is conflicting evidence as to which party bears the risk and rewards relating to the cars.

By virtue of the arrangements in place as regards the substance of the transaction, the manufacturer retains the legal right of ownership until the goods are paid for by LABALABA Plc.

Consistent with this, the manufacturer also has the right to have the goods returned or passed on to another dealer. The fact that LABALABA Plc. can equally return the cars to the manufacturer before the expiration of six months after they are delivered to its show room suggests that the manufacturer is also exposed to the risk of obsolescence or fall in prices or values.

Judging from the above, it appears that the cars have not been sold and should therefore remain in the inventory of the manufacturer and not recognized in the accounting records of LABALABA Plc until they are either paid for or after the expiration of the six months from delivery whichever is earlier.

However, looking at some other factors in the transaction, contrary view may equally be expressed. These factors are:

- The price for the goods is fixed as at the transfer date but not at the date that they are deemed 'sold'. This therefore implies that LABALABA Plc is already protected against possible increase in price.
- The 1.5% paid to the manufacturer appears to be a finance charge even though it is referred to as 'display charge'. A finance charge of this nature indicates that LABALABA Plc. has already incurred a liability on the purchase of such goods from the manufacturer. This liability is the account payable in respect of the cost of the cars.

- Arising from the foregoing, the sales will not be recognized in the books of the manufacture; hence it will be included in its inventory.

Effective tax rate can be obtained by expressing the amount of tax charge as a proportion of profit before tax for the same accounting year. In view of this, effective tax rate may not be the same for any two entities when compared together. The reasons for this difference may be embedded in the different issues that come into play in determining the tax charge for the year. In arriving at tax charge in an income statement in a particular reporting year, the following issues must be borne in mind:

- This represents the amount of income tax payable in respect of the taxable profit for the current year which may differ considerably from the accounting profit. This may not be the same for two entities such as Ojoowuro and Irin even though they posted the same profit for that year because of differences in the two entities allowable and non-allowable expenditure which will invariably affect their taxable profit differently.

- This is the difference between the actual provisions made in respect of chargeable tax in previous years when compared with the actual year tax liability as determined by the relevant authority. The adjustment for under/over provision for tax in previous years in the current year income statement will affect the current year tax charge to profit or loss. While under-provision increases the current year tax charge, over-provision on the other hand will reduce it.

In the case of Ojoowuro, it is possible that it had over-provision in the previous year hence its income tax charge for the current year has a reduction effect. On the other hand, Irin might have under provided for tax last year hence the need to charge more in the current year that has no bearing with its level of profit for the current year.

- Another reason for differences in the amount of income tax charge for different companies is the effect of deferred tax. Deferred tax is the estimated future tax consequences of transactions and events recognized in the financial statements of the current and previous periods. When there is deferred tax adjustment occasioned by either taxable temporary or deductible temporary differences in the current year, the tax charge to income statement in the current year will be affected. While increase in deferred tax liability in the current year will increase income tax chargeable, a decrease will give rise to decrease in income tax charge.

In the case of increase in deferred tax asset, it will have a reduction effect on income tax charge and if otherwise, an increase.

- Other more complex items such as multiple tax reliefs may also be included in issues that affect tax charge.

The combined impact of the above factors will have effect on the effective tax rate of an entity.

However, the effect of taxation, in the statement of cash flow is a different issue entirely. The reason for this is that statement of cash flow only captures cash movement. For instance, an entity may have a tax liability of ₦10million and only able to pay N5million during the year. It is only the amount paid in respect of such taxes that will be captured in the statement of cash flows while the outstanding balance will be reflected in the statement of financial position. It is also possible for an entity to have settled substantially part of its tax liability for the current year through withholding tax payments.

Withholding tax as a tax deducted at source will be available as tax credit against tax liability in the current year thereby reducing the outstanding tax payment that will affect the statement of cash flows. Other differences may

be due to items such as deferred tax movements that do not affect cash flows.

(c) **MAIDOGO LIMITED**

The issue here is one of when revenue should be recognized in the income statements. It involves identification of:

- When the transfer of significant risks takes place;
- Whether the entity retains any continuing managerial involvement to the degree usually associated with ownership;
- If the amount of revenue can be measured reliably;
- Whether it is possible that the economic benefits associated with the transaction will flow to the entity.

Judging from the general guidance in IAS 18- Revenue, the idea of recognising revenue after the NIXAQ is fitted was quite appropriate. At that time, the order can no longer be cancelled, all monies could have been received and the goods delivered. However, given a change in method of trading by sub-contracting the fitting to approved contractors who are liable for any error made in the fitting, the directors want to change the timing of revenue recognition.

Given the change in the circumstances of these transactions as a result of the involvement of the sub-contractors to bear the risk of fitting NIXAQ it may be appropriate for the entity to change the timing of recognition of revenue bearing in mind the conditions precedent for revenue recognition stated above in line with IAS 18.

Notwithstanding, if this change is justified, it cannot be construed to represent a change in accounting policy; hence it will not require retrospective application. It will be treated as an ordinary change in accounting estimate which will require a prospective application.

Arising from the foregoing the amount to be included in sales revenue for NIXAQ in the year to 31 March, 2014 without the change in policy will be as indicated below:

	K'000
Sales in retail outlet for the year	69,000
Sales value of NIXAQ fitted in the 14 days to 14 April 2013	<u>3,600</u>
	72,600
Less sales value of NIXAQ fitted in the 14 days to 14 th April 2014	<u>4,800</u>
Sale	<u>67,800</u>

i.e (sales of ~~₦4.8m~~ from retail premises not fitted will not be recognized).

If there is a change in accounting policy, the new accounting policy should be applied as if it had always been in place and the income recognized in the year to 31 March 2014 would be ~~₦69~~ million.

Conclusively, changes in accounting procedures resulting from circumstances that differ from previous circumstances is not a change of accounting policy. Thus the amount to be recognized in income for the year to 31 March 2014 would be:

	₦'000
Sales in retail outlet	69,000
Sales value of NIXAQ fitted in the 14 days to 14 th April 2013	<u>3,600</u>
Total sales revenue for the year to 31 March 2014	<u>72,600</u>

Given this change in the recognition of revenue, there may be need for the management of MAIDOGO LTD to begin to make provision for warranty obligation which will be based on past experience.

EXAMINER'S REPORT

This three-part question tests candidates understanding of principles and practices involved in the transfer of risks and rewards in a sale or return transaction. Income Tax treatment in financial statements, and revenue recognition in Income Statement.

Most of the candidates attempted the question and performance was fair.

Candidates commonest pitfall was the use of income recognition principles in place of practices for the transfer of risks and rewards in sale or return transactions.

Candidates are advised to understand the requirements of questions being attempted to assure improved performance.

SOLUTION 3

(a) Computation of Key Ratios for the Loan Covenants

	Year 2013	Year 2012	Target
(i) Gearing: $\frac{\text{Fixed Int. Capital} \times 100}{\text{Fixed Int. Capital} + \text{Equity}}$	$\frac{11,400 \times 100}{11,400 + 23,460}$ = 32.7%	$\frac{11,200 \times 100}{11,200 + 16,300}$ 40.73%	50%
(ii) Interest Cover : $\frac{\text{Profit before Int \& Tax}}{\text{Finance Cost}} =$	$\frac{4,560 + 520}{520}$ = 9.8 times	$\frac{4,900 + 450}{450}$ 11.9 times	

9.5 times

(iii)	Current Ratio : $\frac{\text{Current Assets}}{\text{Current Liabilities}} =$	$\frac{8,800}{6,070}$ = 1.45:1	$\frac{8,920}{4,700}$ 1.90:1	1.5:1
(iv)	Quick Ratio: $\frac{\text{Current Assets less Inventory}}{\text{Current Liabilities}} =$	$\frac{8,800 - 4,500}{6,070}$ = 0.71 :1	$\frac{8,920 - 3,600}{4,700}$ 1.13:1	1.1:1

Other ratios Necessary for the performance Review are:

Profitability Ratios

(v) $\text{ROCE} = \frac{\text{Profit before Interest}}{\text{Capital Employed}} = \frac{\text{PBIT}}{\text{Equity+longterm debt}}$

2013	2012
$\frac{4,560+520}{23,460+11,400}$	$\frac{4,900 + 450}{16,300 + 11,200}$
= 14.6%	= 19.5%

(vi) $\text{GROSS PROFIT \%} = \frac{\text{Gross Profit}}{\text{Turnover}} =$

2013	2012
$\frac{10,200}{34,200}$	$\frac{8,650}{28,900}$
= 29.8%	= 29.9%

(vii) $\text{PROFIT MARGIN} = \frac{\text{Profit Before interest \& Tax}}{\text{Turnover}}$

2013	2012
$\frac{4,560+520}{34,200}$	$\frac{4,900 + 450}{28,900}$
= 14.9%	= 18.5%

(b) Report on Prochain Plc.

The comments are based on the financial statements of Prochain Plc and the ratios calculated are based on the annual report as presented in (a) above.

Financial Performance

- (i) Aggressive expansion policy pursued in the last two years helped in increasing revenue by 18% while the company was able to maintain the gross profit margin at 29%.

However, the profit margin dropped by 3.6%, while distribution and administrative expenses as well as finance cost in the period increased substantially by 55%.

- (ii) Return on Capital Employed has fallen from 19.5% to 14.6%. This is because profit is decreasing while capital employed is increasing due to revaluation of assets.

Financial Position: (based on the key ratios for Loan Covenants)

- (iii) **Gearing**

The Company's gearing has improved, decreasing to 32.7% from 40.73% which is within threshold set by the bank (i.e Target of 50%)

This shows that there is a reduction in the level of financial risk bearing faced by Prochain Plc.

Bonds payable are due for repayment in less than 12 months' time-July 2015. The Company needs to secure some longer term funding to trade and expand as well as repay the bonds; hence the application for the bank Loan.

- (iv) **Interest Cover**

The interest cover dropped from 11.9 times in year 2012 to 9.8 times in year 2013. Although, the Company met the target of 9.5times, the bank will be concerned about the falling margin and the effect on the Interest cover.

The interest is 6% on the bond, a funding with a significantly higher associated cost is likely to decrease the interest cover further. The interest cover is already close to the acceptable threshold set by the bank.

- (v) **Current and Quick Ratio**

The Current ratio dropped below the target from 1.9 in 2012 to 1.45 in 2013. The Quick ratio also decreased from 1.13 in 2012 to 0.71 in 2013.

Changes in the two ratios moved against the target of 1.5:1 and 1.1:1 for current ratio and quick ratio in year 2013 respectively.

This working capital problem may be an issue to be given further consideration by the Board.

Cash held decreased from a positive balance of ₦120,000,000 to an overdraft of ₦270,000.

The company should consider the option of selling investments which performed well in the year to inject more working capital.

EXAMINER'S REPORT

The question examines the computation, interpretation and application of ratios.

Majority of the candidates attempted the question. Candidates' performance on ratio computation was fair but most of them were unable to interpret correctly the computed ratios.

Candidates should undertake in-depth study and practice questions covering all areas of the syllabus.

SOLUTION 4

(a) LAGOS PLC

Relevant Asset/Liability	Computation of Deferred Tax Asset/Liability			Tax Rate	Asset/ Liability
	Carrying Amount	Tax Base	Temporary Difference		
	₦'000	₦'000	₦'000	%	₦'000
Property, Plant & Equipment	30,600	40,300	9,700	30%	2,910
Good will	4,300	4,300	—	—	—
Trade Receivables	21,680	29,800	8,120	30%	2,436
Trade Payables	24,000	13,000	11,000	30%	3,300
Total Deferred Tax Assets at 31 December, 2013					<u>₦8,646</u>

Journal Entries:

DR Deferred Tax (in SOFP)
CR Deferred Tax credit (in SCI)
With ₦8,646,000

Advice to Management of Lagos Plc.

- Given the above background information, the temporary differences in Lagos Plc deferred tax computation result in deductible temporary differences thereby resulting into a total deferred tax asset of ₦8.646million at the end of 31 December 2013.
- The required treatment therefore is to debit (DR) deferred tax assets and credit (CR) retained earnings provided it is probable that there shall be available future taxable profit to utilize the deferred tax asset.
- The effects of this deferred tax asset is that it will increase the Non-current assets of Lagos Plc in the Statement of Financial Position at 31 December 2013 by ₦8.646 million and increase the retained earnings by the same amount in the Statement of changes in equity.
- The deferred tax balance is a deferred tax asset which will be classified as a Non-current asset.

(b) **BAM PLC ACQUIRED MENGU LIMITED.**

Calculation of Deferred Tax on Fair Value Adjustment

	₦'M	₦'M
Fair value of net assets		2,550
Less: Book value of net assets:		
Ordinary shares Capital	1,500	
Retained Earnings	825	
Other equity	<u>105</u>	
		<u>(2,430)</u>
Fair value Adjustment (subject to deferred tax)		<u>120</u>
Deferred Tax Liability (30% x 120)		<u>36</u>

Goodwill on initial recognition = purchase consideration – fair value of Net Asset acquired = ₦(3,150 – 2,550)m = ₦600m.

Final Goodwill recognized = ₦(600 – 36)m = ₦564m.

The amounts that arise in deferred tax on business acquisition is adjusted to the amount of goodwill.

EVALUATION COMMENT:

- Based on the above calculation, since the excess of the fair value of identifiable net assets over the book value of same assets on acquisition is mainly attributable to differences in property, plant, and equipment which will later be subjected to depreciation, such difference will give rise to deferred tax liability which should be incorporated into the financial statements as at the date of acquisition.
- Furthermore, the amount that arise in deferred tax on business acquisition is adjusted to the amount of goodwill.

EXAMINER'S REPORT

The question examines the provisions and requirements of IAS 12 (Income Taxes) on Deferred Taxes and their impact on Retained Earnings.

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

Candidates displayed a very poor understanding of the relevant provisions of the standard on Deferred Assets/Liabilities.

There is need for candidates to be more diligent in their study of all the standards.

SOLUTION 5

- (a) Five elements of information which IASB practice statement expects to be included in management commentaries are:
- (i) The nature of the business.
 - (ii) Management objectives and its strategies for meeting those objectives.
 - (iii) The entity's most significant resources, risks and relationships.
 - (iv) The results of operations and prospects.
 - (iv) The critical performance measures and indicators that management was to evaluate the entity's performance against stated objectives.

(b) (i) Nature of business

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

(ii) Objectives & strategies

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

(iii) Resources, risks & relationships

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

(iv) Results and prospect

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

(v) Performance & measures

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

(c) Reasons for Management commentaries

- (i)** Promoting an entity and attraction of investors, lenders, customers and other Stakeholders.
- (ii)** Enables management to communicate its plans and outlook to the users.
- (iii)** Enhanced understanding of financial statements for better decision making.

- (iv) It makes the report more explanatory, transparent and acceptable.
- (v) Without mandatory management commentaries, directors may take a minimalist approach to disclosure which will make financial reports inadequate and less informative.

EXAMINER'S REPORT

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

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

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

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

SOLUTION 6

(a) The Financial factors that indicate an organization may no longer be a going

(i) Financial concern are:

- Default on loan or similar agreements
- Arrears as to payment of dividend
- Denial of usual trade credits from suppliers
- Restructuring of debt
- Recurring operating losses
- Negative workings capital
- Negative cash flow from operating activities
- Adverse key financial ratios
- Non-compliance with statutory capital requirements
- Need to dispose off substantial assets.

(ii) Operations

- Labour difficulties i.e strike, high labour turnover etc.
- Emergence of a highly successful competitor
- Loss of key customers

- Decrease in market share
- Withdrawal of Operating licence where applicable
- Loss of principal suppliers

(iii) Legal or regulatory factors

- Changes in law or regulations that adversely affect the entity
- Pending legal or regulatory proceedings against the entity
- Uninsured or underinsured insurable risks
- Natural disaster such as drought, catastrophe, earthquake or flood.
- Withdrawal of operating licence

(b) Options available to the management of Luck & Co:

Option 1

If liquidation takes place now, the amount that will be available to the loan stock holders is ₦78,000, leaving them with a deficiency of ₦22,000. In this case, there would be nothing for the creditors and shareholders.

Option 2

If trading continues for the next four years and the estimated results are achieved, the available cash would be as follows:

	₦
Profit	78,000
Depreciation	80,000
Inventory	20,000
Receivables	<u>40,000</u>
	<u>218,000</u>

With this option, loan stockholders and creditors would be paid in full ₦100,000 and ₦80,000 respectively, leaving ₦38,000 available for the shareholders.

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

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

Option 3

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

- (i) 75,000 units of ~~£~~1 ordinary shares to the loan stockholders (3 of ~~£~~1 ordinary shares for every ~~£~~4 of loan stock)
- (ii) 40,000 units of ~~£~~1 ordinary shares to the creditors (1 of ~~£~~1 ordinary shares for every ~~£~~2 due)
- (iii) 25,000 units of ~~£~~1 ordinary shareholdings (1 of ~~£~~1 ordinary shares for every 4 of the existing ~~£~~1 ordinary share).

LUCK & CO

Redrafted Statement of Financial position after the exercise.

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

EXAMINER'S REPORT

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

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

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

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

SOLUTION 7

International Accounting Standard 8 (IAS8) *Accounting Policies, Changes in Accounting Estimates and Errors* prescribes the criteria for selecting and changing accounting policies, accounting for changes in estimates and reflecting corrections of prior period errors. Changes in accounting policies and corrections of errors are generally accounted for retrospectively, unless this is impracticable; whereas changes in accounting estimates are generally accounted for prospectively.

(a) Circumstances for Change of accounting Policy

An entity can change an accounting policy only if:

- It is required by a standard e.g. an IFRS or
- The change results in the financial statements providing reliable and more relevant information i.e. voluntary change.

Application or treatment of Change of accounting Policy:

If the change is required by a Standard, an entity shall account for the change in accordance with the specific transitional provisions, (i.e. the standard may specify retrospective application or prospective application), if any.

Where there are no specific transitional provisions in the Standard requiring the change in accounting policy or an entity changes an accounting policy voluntarily, it should apply the change retrospectively.

Where a change in accounting policy is applied retrospectively, an entity should adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts for each prior period presented as if the new accounting policy had always been applied.

Difficulties in treatment of change of accounting policy:

Majority of the difficulties are related to the impracticability of applying the change retrospectively. This makes it difficult to achieve comparability of prior periods with the current period. For instance:

- (i) Data might not have been collected in the prior periods to allow for retrospective application.
- (ii) Restating comparative information for prior periods often requires complex and detailed estimation.

- (iii) When making estimates for prior periods, the basis of estimation should reflect the circumstances which existed at the time and it becomes increasingly difficult to define those circumstances with the passage of time.
- (iv) Estimates and circumstances might be influenced by knowledge of events and circumstances which have arisen since the prior period.
- (v) The effects of the retrospective application or restatement may not be determinable.
- (vi) The retrospective application/restatement requires assumption about what management's intent would have been in that period. IAS 8 does not permit the use of hindsight when applying a new accounting policy, either in making assumptions about what management's intentions would have been in a prior period or in estimating amounts to be recognised, measured or disclosed in a prior period.

The standard permits exemption from this requirement when it is impracticable to determine either the period-specific effects or cumulative effect of the change. When it is impracticable to determine the effect of a change in accounting policy on comparative information, the entity is required to apply the new accounting policy to the carrying amounts of the assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable. This could actually be the current period but the entity should attempt to apply the policy from the earliest date possible.

(b) Prior period errors and earnings management

The term "error" refers to an unintentional misstatement in financial reports, including the omission of an amount or a disclosure. Material prior period errors are corrected retrospectively in the first financial statements issued after their discovery. Correction is made by restating the comparative amounts for the prior period(s) presented in which the error occurred. If the error occurred before the earlier comparative prior period presented, the opening balances of assets, liabilities and equity for the earliest prior period should be restated to reflect correction of the error(s). IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors requires prior period errors to be amended retrospectively by restating the comparatives as if the error had never occurred.

Hence, the impact of any prior period errors is shown through retained earnings rather than being included in the current period's profit or loss. Managers could use this treatment for prior period errors as a method for manipulating current period earnings. Restatements due to errors and irregularities can be

considered to indicate poor earnings quality and to threaten investor confidence, particularly if they occur frequently. Thus, it might appear that the factors associated with earnings corrections could be linked to earnings management.

Earnings Management, specifically Income Smoothing, is a form of creative accounting which involves:

- The use of inappropriate provisions (this reduces profit in good years and increases them in poor years)
- Not providing for liabilities, either at all or not in full, as they arise or
- Restructuring costs not being charged to income

Arguments against the approach in IAS 8 are:

- That the standard allows inappropriate use of hindsight;
- That the treatment renders errors less prominent to users; and
- That it allows amounts to be debited or credited to retained profits without ever being included in a current period profit or loss.

Managers have considerable discretion regarding the degree of attention drawn to such changes. The information content and prominence to users of disclosures regarding prior period errors are issues of significance, with potential economic and earnings quality implications. Expenses could be moved backward into a prior period, with the result that managers are given a possible alternative strategy with which to manage earnings. It is possible to misclassify liabilities, for example, as non-current rather than current, or even simply miscalculate reported earnings per share. Under IAS 8, the prior period error can then be amended the following year, with no lingering effects on the statement of financial position as a result of the manipulation.

EXAMINER'S REPORT

The question tests the provisions and requirements of IAS 8 (Accounting policies, changes in Accounting Estimates and Errors).

About 50% of the candidates attempted the question but they displayed inadequate understanding of its requirements.

Most of the candidates that attempted the question displayed poor understanding of the provisions on treatment of prior period errors.

Candidates are advised to thoroughly study and practice with standard examination questions on all aspects of IFRS.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA
PROFESSIONAL LEVEL EXAMINATION - NOVEMBER 2014
ADVANCED TAXATION

Time Allowed: 3 hours

SECTION A: COMPULSORY QUESTION (30 Marks)

QUESTION 1

The Tax Consultants, ABFR Consult, received an e-mail from Mrs. Deboh Komo, the Managing Director of Deboko Nigeria Limited.

Extracts of her e-mail are as follows:

- i. The company was incorporated on 1 February 2007.
- ii. It commenced business as importers of new engines for tricycles on 1 May 2009
- iii. The Directors chose 30 June as the company's year-end and made the first financial statements up to 30 June 2010.
- iv. The company did not file any Tax Returns to date because of general lull in business activities.
- v. The tax monitoring section of the Federal Inland Revenue Service visited the company's office on 2 September 2014 and found out that the company was not tax compliant. No tax registration was done and no Returns were filed to date in respect of the company.
- vi. The Accounts Officer actually advised that the company should register for all statutory payments including Value Added Tax and Companies Income Tax but the management thought that it could still buy some time.
- vii. The management pleaded with the tax officials to temper justice with mercy but the Tax Authority eventually sent a letter to the company insisting on full compliance with the Tax Laws.
- viii. The company needs to register for tax purposes and file necessary Returns so as to minimise penalties for default.

You are given the following information:

i. Statement of Profit or Loss and other Comprehensive Income

Period/Year Ended:	30/6/13	30/6/12	30/6/11	30/6/10
	₦'000	₦'000	₦'000	₦'000
Operating Profit/(Loss) after charging:	1060	960	720	(504)
Depreciation	380	120	120	153
Staff loans written off	-	-	-	40
Stamp Duties on Incorporation	-	-	-	16
Sales tax	120	80	44	40
Donations to Christian Association	60	-	-	10
Specific bad debts written off	28	-	-	14

ii. Statement of Financial Position

	30/6/13	30/6/12	30/6/11	30/6/10
	₦'000	₦'000	₦'000	₦'000
Paid-Up Capital	30,000	15,000	15,000	15,000
Deposit for Shares	<u>25,000</u>	<u>10,000</u>	<u>5,000</u>	<u>-</u>
	<u>55,000</u>	<u>25,000</u>	<u>20,000</u>	<u>15,000</u>
Net Assets	101,500	84,110	76,700	66,000
Revenue	210,500	180,400	162,000	104,000
Gross Profit	16,400	14,200	12,800	10,200

iii. Capital allowances of the company agreed between the Tax Consultants and the Accounts Officer are as follows:

Year of Assessment:	2014	2013	2012	2011	2010	2009
Amount computed (₦'000)	140	150	150	250	200	300

Deboko Nigeria Limited will no longer be allowed to exercise its right of election for the second and third years of assessment as it failed to do so within the time limits provided by law.

You are required to:

- Explain the penalties in respect of late submission of Annual Returns to the Federal Inland Revenue Service. (4 Marks)
- Compute the Total Profit and Tax Liabilities of the company for the relevant Years of Assessment. (24 Marks)

- c. Explain the conditions that must be met before a company can be exempted from Minimum Tax Liability under the provisions of the Companies Income Tax Act CAP C21 LFN 2004 (as amended). (2 Marks)
- (Total 30 Marks)**

SECTION B: ATTEMPT ANY TWO OUT OF THREE QUESTIONS (40 Marks)

QUESTION 2

Your firm has been commissioned by the Nigerian Business Forum to present a thirty minutes paper at a seminar organised for some German Investors who wish to establish in certain sectors of the Nigerian Economy.

The Nigerian Business Forum made your task very easy by narrowing down your submissions to the available tax incentives which may be enjoyed by business establishments within Nigeria.

Based on the discussions between the Managing Partner and the Chairman of the Nigerian Business Forum, the following areas which should serve as guide for your presentation were highlighted:

- i. Objectives of Tax Incentives
- ii. Available Tax Incentives in the Export Processing Zones in Nigeria

The Managing Partner is currently on six weeks annual leave abroad and has asked you to review the above using the guidelines provided.

You are well trained to use Power Point Microsoft Application to present this kind of report to the select group. This means that the presentation must be outlined in clear terms because of the limited time available.

You are required to prepare your presentation to cover:

- a. Introduction (2 Marks)
- b. Objectives of Tax Incentives (4 Marks)
- c. Tax Incentives for companies operating within the Export Processing Zone. (14 Marks)

(Total 20 Marks)

QUESTION 3

The Independent Auditors to Jisosi Petroleum Limited submitted the draft Audited, Financial Statements for the year ended 31 December 2013 for management's discussion. The executive summary revealed total revenue of ₦286,650,000 and Profit before Taxation of ₦82,642,000.

In order to arrive at the proposed Dividend for the consideration of the Board, there is the need to determine the total tax liabilities for the year. The draft Statement of Profit or Loss has the following items among others:

	₦
Royalty on Crude Oil sold	13,500,000
Cost of Well drilling	25,000,000
Custom duties	500,000
Clearing of oil spillage	7,500,000
Depreciation	32,000,000
Donations	4,500,000
Community relations expenses	10,000,000
Transportation expenses for 2012	8,500,000

The revenue for the Year Ended 31 December 2013, includes:

	₦
Profit on Property, Plant and Equipment sold	48,000
Income from transportation of crude oil for the Year Ended 31 December 2012	16,894,000

The officials of Federal Inland Revenue Service and the Company agreed as follows:

	₦
Annual Allowances on exploration	25,500,000
Balancing Charge on exploration	242,000
Capital Allowances on exploration b/f	11,000,000
Petroleum Investment Allowance	18,500,000
Capitalised Intangible Drilling cost	14,000,000
Losses b/f	10,000,000
Capital Allowances on transportation	750,000

You are required to:

Determine the Total Tax Liabilities of the Company for the consideration of the Directors, with a view to taking a decision on the Proposed Dividend. **(20 Marks)**

QUESTION 4

Broadway Limited was Incorporated on 31 May 2004, as a manufacturer of Plastic products. Four of the Shareholders of the Company who are Lebanese, decided to invest substantially, with the aim of becoming members of the Board of Directors. The promoters decided to apply for a Pioneer Status within the provisions of the

Industrial Development (Income Tax Relief) Act, Cap. 17, LFN 2004. The Company was granted a Pioneer Certificate with a Production Day certified as 1 August 2004.

The following information has been extracted from the Company's records:

	N
Net Profit for the Financial Year Ended 31 July 2008	5,005,000
Depreciation	396,435
The Federal Inland Revenue Service certified the following expenditure up to and including the year ended 31 July 2007:	
Industrial Building	6,142,500
Non-Industrial Building	2,990,000
Plant and Machinery	4,631,250
Motor Vehicles	4,062,500

The Promoters of Broadway Limited have declined to apply for the extension of the Pioneer period.

You are required to:

Advise the Management on the tax implications for the relevant years of assessment.
(20 Marks)

SECTION C: ATTEMPT ANY TWO OUT OF THREE QUESTIONS (30 Marks)

QUESTION 5

You are the Tax Manager of Forum Tax Associates and recently represented your firm at a Workshop organised by the Federal Inland Revenue Service (FIRS), Western Zone, on Transfer Pricing Regulations in Nigeria.

The Workshop was to create awareness on the filing requirements and compliance with the provisions of "The Income Tax (Transfer Pricing) Regulations 2012".

The Workshop which was held on the 20th Floor of the Nigeria Stock Exchange building was fully attended by Company Auditors, Tax Practitioners, Stock Brokers, Bankers and other Stakeholders.

From the notes you took at the Workshop, you presented a report to the Managing Partner, Forum Tax Associates, on Wednesday, 3 September 2014. The Managing Partner thanked you for a good job and highlighted some key areas of the regulations that will serve as a guide to the staff of the firm.

You are required to prepare a technical briefing for the staff explaining the following key areas noted by the Managing Partner:

- (a) Objectives of the application of Transfer Pricing Regulations. (6 Marks)
 - (b) Treatment of Permanent Establishment. (2 Marks)
 - (c) Contents of a Transfer Pricing Disclosure to be submitted by Companies to the FIRS. (7 Marks)
- (Total 15 Marks)**

QUESTION 6

- (a) Sunproof International Inc. has been in tyre manufacturing business in Nigeria and Sierra Leone for over ten years.

The Company's operating results for the year ended 31 December 2012 were as follows:

	₦
Income from Nigeria	75,000,000
Income from Sierra Leone	33,000,000
Overheads	60,000,000
Included in the Overheads are:	₦
Depreciation - Nigeria business	6,750,000
Depreciation - Sierra Leone business	1,125,000
Donations to Island Club in Nigeria	375,000
Foreign tax suffered	6,300,000

Other information:

Net profit attributable to the Company in Sierra Leone was ₦7,725,000

Capital Allowances agreed with Tax Officials for operations in Nigeria and Sierra Leone were ₦5,310,000 and ₦2,175,000 respectively.

Assume the Company is a wholly Nigerian company.

You are required to:

- i. Identify the Double Taxation Relief available to the Company. (4 Marks)
- ii. Compute the tax liability of the Company for the relevant Year of Assessment (6 Marks)

- (b) Rev. (Dr.) Smart is an individual who has worked in many Countries. Many of his disciples regard him as a “Great man of God” because he has won so many souls and performed real miracles. He had worked in Ghana, South Africa, Zimbabwe, United Kingdom, Canada, Germany, Netherlands and United States of America.

His annual income is earned piecemeal from each Country where he ministers. From his itinerary in 2013 as provided by his Personal Assistant, he had visited more than fifteen Countries including Nigeria, and in some cases, stayed for more than two months in few of the countries visited.

He is faced with how to determine his taxable income in each of the countries visited as well as tax payable in Nigeria where he permanently resides.

You have been appointed as the Tax Consultant to Rev. (Dr.) Smart.

You are required to:

Advise on the relevant provisions of the Tax Laws that will mitigate the possible effect of paying tax on the same Income in two or more Countries.

(5 Marks)

(Total 15 Marks)

QUESTION 7

Mr. James Zonto lived in Canada for thirty years and decided to settle down permanently in Nigeria with effect from January, 2007.

Based on the advice he received from his secondary school classmate, to invest his funds in Nigeria, Mr. James Zonto repatriated a huge amount of money to Nigeria.

He took advantage of the probably better investment climate in Nigeria and acquired some properties as follows:

- i. He bought a duplex building in Uyo on 2 March 2008, for the sum of ₦25,320,000. The building was rented out immediately. The rental income from the house is ₦855,000 per annum, net of Withholding tax.
- ii. On 4 January 2008, he invested the sum of ₦14,000,000 in a Fixed Deposit account with DORONINE Bank Plc, from which he derives an interest (net of Withholding tax) of ₦180,000 per month.
- iii. He acquired another building complex of four duplexes, on 6 October 2008, in Onitsha for ₦31,500,000 and incurred incidental expenses of ₦2,400,000. The Onitsha property fetches an annual rent of ₦1,800,000.
- iv. Although his office is based in Owerri, he decided to settle down in Okija and bought a house in the town for the sum of ₦10,000,000. No part of the house was let out to a third party because it serves as his main residence.
- v. On 4 January 2012, Mr. James Zonto decided to resettle in Toronto.

He took the following decisions:

- i. Uyo house was disposed off for ₦47,450,000 after incurring the following expenses:

	₦
• Advertising cost	650,000
• Valuation fees	2,000,000
• Estate Agent's Commission	2,372,500
• Legal fees	1,500,000

- ii. The Fixed Deposit matured on 31 December 2011 and was not rolled over.
- iii. He sold one of the four duplexes of the Onitsha building complex for ₦14,175,000. The rest of the duplexes were valued at ₦40,500,000.
- iv. He also sold the Okija house for ₦36,500,000 after incurring incidental expenses in the sum of ₦3,650,000.

You are required to compute:

- (a) The Total Income for Income Tax purposes for 2011 year of assessment. (5 Marks)
- (b) Capital Gains Tax payable for the relevant year of assessment. (10 Marks)

(Total 15 Marks)

SOLUTION 1

(a)

- i. Failure to register for Value Added Tax within six months after the promulgation of the Act, or six months after commencement of business, whichever is earlier, attracts a penalty of ₦10,000 for the first month in which the failure occurs and ₦5,000 for each subsequent month in which the failure continues.
- ii. Failure to register for Income Tax purposes within eighteen months of incorporation attracts penalty of ₦25,000 for the first month in which the failure occurs and ₦5,000 for each subsequent month in which the failure continues.
- iii. Failure to file with the Federal Inland Revenue Service the company's audited financial statements and tax returns within the stipulated time that is, not later than six months after the close of the company's accounting year or within eighteen months from the date of incorporation attracts penalty of:
 - ₦25,000 in the first month which the failure occurs, and
 - ₦5,000 for each subsequent month in which the failure continues.
- iv. Any Director, Manager, Secretary or Servant of the company who is party to the offence being committed shall pay a fine of ₦100,000. (4 Marks)

(b)

DEBOKO NIGERIA LIMITED

Computation of Income and Education Tax Liabilities for 2009 - 2014 Assessment years Original Assessments (Without election) Basis Period/Workings

Year of Assessment	Assessment
2009 (1/5/2009 – 31/12/2009)	
(w1) Adjusted Loss: $\frac{8}{14} \times (\text{₦}245,000)$	<u>(140)</u>
Capital Allowance c/f	<u>300</u>
Unrecouped loss c/f	<u>(140)</u>
Total Profit	<u>NIL</u>
	<u>NIL</u>
Income Tax liability (30% of Total Profit)	
Tertiary Education Tax (2% of Assessable Profit)	
	<u>NIL</u>

2010 (1/5/2009 – 30/4/2010) First Twelve Months

(W1) Loss ($\frac{12}{14} \times \text{N}245,000$)	(210)	
Unrecouped loss b/fwd	<u>(140)</u>	
	<u>(350)</u>	
Loss restricted c/f		<u>(245)</u>
Capital allowances		
- For the year	200	
- Unutilised b/f	<u>300</u>	
Carried forward		500
Total Profit		<u>NIL</u>
Income Tax liabilities (30% of Total Profit)		<u>NIL</u>
Tertiary Education Tax (2% of Assessable Profit)		<u>NIL</u>

2011 (1/07/2009 – 30/6/2010)

Preceding year		
Loss ($\frac{12}{14} \times \text{N}245,000$)	(210)	
Unrecouped Loss b/f	<u>(245)</u>	
	<u>(455)</u>	
Loss relief restricted c/f		<u>(245)</u>

Capital Allowances		
For the Year	250	
brought Forward	<u>500</u>	
Carried forward		<u>750</u>
Total profit		<u>NIL</u>
Income Tax (30% of Total Profit)		<u>NIL</u>
Tertiary Education Tax liability (2% of Assessable Profit)		NIL
Minimum Tax (W2)		<u><u>N459.375</u></u>

(01/07/2010 – 30/06/2011) Preceding Year

2012

Adjusted/Assessable Profit (w1)		884
Less: Unrecouped Loss b/f		<u>(245)</u>
Less: Capital allowances		639
- For the year	150	
- b/f	<u>750</u>	
	900	
Utilised Restricted to		
($\frac{66}{3} \text{ of } \text{N}884,000$)		<u>(589)</u>
Total profit		<u>50</u>
Income tax @ 30% of Total Profit		<u>15</u>
Tertiary Education Tax @ 2% of N 884,000		<u>17.68</u>
Minimum Tax (w3)	<u><u>585.375</u></u>	

Total Tax liability (= Minimum Tax Plus Education Tax)

= (N585.375 + N17,680) 603.055

(01/07/2012 – 31/06/2013) Preceding Year

2013

Assessable Profit (w1) 1,160

Capital Allowances

- For the year 150

- Unutilised b/f 311

(461)

Total Profit 699

Income Tax at 30% of N699,000 209.7

Tertiary Education Tax @ 2% N1,160 23.2

Minimum Tax (w4) 645.425

Total Tax Liability (Minimum Tax plus Tertiary

Education Tax = (N645,425 + N23,200) 668.625

((1/07/2012 – 30/06/2013) Preceding Year

2014

Assessable Profit (w1)

Capital Allowance: 1,620

- For the year (150)

Total Profit 1,470

Income Tax @ 30% of Total Profit 441

Tertiary Education Tax (2% of N1,620,000)

32.4

Minimum Tax (w5) 770

Total Tax liability (Minimum Tax Plus Tertiary

Education Tax) (N770,000 + N32,400)

802.40

WORKINGS

(W1) DETERMINATION OF ADJUSTED PROFIT/(CAPITAL)

Year Ended	30/6/1 0	30/6/1 1	30/6/1 2	30/6/1 3	30/6/1 4
	N'000	N'000	N'000	N'000	N'000
Operating profit/(Loss)	(504)	720	960	1,060	2,160
Add back:					
Depreciation	153	120	120	380	440
Staff loans w/off	40	-	-	-	80

Stamp duties	16	-	-	-	-
Sales tax	40	44	80	120	166
Donations	<u>10</u>	<u>-</u>	<u>-</u>	<u>60</u>	<u>40</u>
Adjusted profit/(Loss)	<u>(245)</u>	<u>884</u>	<u>1,160</u>	<u>1,620</u>	<u>2,886</u>

(W2) COMPUTATION OF MINIMUM TAX FOR 2011 YEAR OF ASSESSMENT

The highest of A plus B

(A)		₦
(i)	0.5% of Gross profit i.e. 0.5% of ₦10,200,000	51,000
(ii)	0.5% of Net Asset i.e. 0.5% of ₦66,000,000	330,000
(iii)	0.25% of Paid Up Capital i.e. 0.25% of ₦15,000,000	37,500
(iv)	0.25% of Revenue i.e. 0.25% of ₦500,000	<u>1,250</u>
(B)	0.125% of Excess of Revenue over ₦500,000 i.e 0.125% of (₦104,000,000 – ₦500,000)	<u>₦129,3750</u>
Minimum Tax = ₦330,000 + ₦129,375 =		<u>₦459,375</u>

(W3) COMPUTATION OF MINIMUM TAX FOR 2012 ASSESSMENT YEAR

The highest of A plus B

(A)		₦
(i)	0.5% of Gross profit i.e. 0.5% of ₦12,800,000	64,000
(ii)	0.5% of Net Asset i.e. 0.5% of ₦76,700,000	383,500
(iii)	0.25% of Paid up Capital i.e. 0.25% of ₦15,000,000	37,500
(iv)	0.25% of Revenue i.e. 0.25% of ₦500,000	<u>1,250</u>
(B)	0.125% of Excess of Revenue over ₦500,000 i.e 0.125% of (₦162,000,000 – ₦500,000)	<u>₦201,875</u>
Minimum Tax = ₦383,500 + ₦201,875 =		<u>₦585,375</u>

(W4) COMPUTATION OF MINIMUM TAX FOR 2013 ASSESSMENT YEAR

The highest of A plus B

(A)	₦
(i) 0.5% of Gross profit i.e. 0.5% of ₦14,200,000	71,000
(ii) 0.5% of Net Asset i.e. 0.5% of ₦84,110,000	420,550
(iii) 0.25% of Paid up Capital i.e. 0.25% of ₦15,000,000	37,500
(iv) 0.25% of Revenue i.e. 0.25% of ₦500,000	<u>1,250</u>
 (B) 0.125% of Excess of Revenue over ₦500,000 i.e 0.125% of (₦180,400,000 – ₦500,000)	 <u>₦224,875</u>
Minimum Tax = ₦420,550 + ₦224,875 =	<u>₦645,425</u>

(W5) COMPUTATION OF MINIMUM TAX FOR 2014 ASSESSMENT YEAR

The highest of A plus B

(A)	₦
(i) 0.5% of Gross profit i.e. 0.5% of ₦16,400,000	82,000
(ii) 0.5% of Net Asset i.e. 0.5% of ₦101,500,000	507,500
(iii) 0.25% of Paid- up capital i.e. 0.25% of ₦30,000,000	75,000
(iv) 0.25% of Revenue i.e. 0.25% of ₦500,000	<u>1,250</u>
 (B) 0.12% of Excess of Revenue over ₦500,000 i.e 0.125% of (₦210,500,000 – ₦500,000)	 <u>₦262,500</u>
Minimum Tax = ₦507,500 + ₦262,500 =	<u>₦770,000</u>

N.B. In 2011 Assessment Year, there was no Total Profit so the Company pays the Minimum Tax of ₦459,375.

In 2012 Assessment Year, the Total Profit was less than the Minimum Tax, hence the Company pays the Minimum Tax plus the Tertiary Education Tax.

In 2013, Assessment Year, the Total Profit was less than the Minimum Tax, hence the Company pays the Minimum Tax Plus the Tertiary Education Tax.

In 2014, Assessment Year, the Total Profit was less than the Minimum Tax, hence the Company pays the Minimum Tax Plus the Tertiary Education Tax.

(C) CONDITIONS TO BE MET BY COMPANIES FOR EXEMPTIONS FROM MINIMUM TAX

The following are the relevant conditions stated in Section 33 of CITA, 2007

- A company carrying on agricultural trade or business
- A company with at least 25percent imported equity capital
- Any company for the first forty-eight calendar months of its commencement of business

EXAMINER'S REPORT

The question test candidates' knowledge and understanding of the nature of the penalties for late filing of Tax Returns as well as Tax Liability computation and the incidence of Minimum Tax under CITA.

Candidates' performance was poor as they displayed shallow knowledge of the Penalties due for late filing of Returns, as they did also for the conditions for the Grants of exemption from Minimum Tax.

Candidates are advised to be more thorough in their preparations for future examinations especially with understanding basic concepts.

SOLUTION 2

TAX INCENTIVES IN NIGERIA: A PAPER PRESENTED TO THE FORUM OF GERMAN INVESTORS ORGANISED BY THE NIGERIAN BUSINESS FORUM

(a) INTRODUCTION

The Chairman of this session, members of the Nigerian Business Forum and German Investors, Ladies and Gentlemen.

I welcome you all to this seminar on Tax Incentives available to business organisations operating in Nigeria.

At the end of this seminar, participants should be in a position to demonstrate:

- (i) Better understanding of what Tax Incentives mean,
- (ii) State the objectives of Tax Incentives, and
- (iii) Identify key Tax Incentives available to business organizations operating in certain sectors of the Nigerian economy.

TAX INCENTIVES

Tax incentives are those special exclusions, exemptions or deductions from Income or Tax Credits offered to Taxpayers by the Government as an encouragement to engage in specified activities. Examples of tax incentives Available in Nigeria include: Capital allowances, Investment Allowances, Investment Tax Credit, Loss Relief, Tax Holidays, Lower Tax Rate, Tax-Free Dividends, Exemption from tax of interest on certain loans etc.

(b) OBJECTIVES OF TAX INCENTIVES IN NIGERIA

The objectives of Tax Incentives are to:

- (i) Attract foreign investments into Nigeria
- (ii) Encourage businessmen to invest in certain preferred sectors of the economy
- (iii) Encourage investment to develop rural areas and Export Processing Zones
- (iv) Promote Export activities
- (v) Encourage repatriation of Foreign Earnings to Nigeria
- (vi) Encourage voluntary tax compliance
- (vii) Encourage Research and Development activities
- (viii) Encourage and accelerate the growth of Small Scale businesses
- (ix) Encourage businesses to make financial contributions to activities which the Government considers socially desirable.

(c) TAX INCENTIVES AVAILABLE TO COMPANIES LOCATED IN EXPORT PROCESSING ZONES (EPZ)

- (i) Interest on Loans granted by Banks for the purpose of manufacturing goods for Export is exempted from tax as prescribed in the third schedule to CITA.
- (ii) 100% Capital Allowance is granted on Qualified Capital Expenditure on Building, Plants and Equipment in an approved manufacturing activity in an EPZ.
- (iii) All Export Goods and Services are VAT exempt.
- (iv) Dividends received from Investment in a Wholly Export Oriented business, are tax exempt.
- (v) Turnover of not more than ~~N~~1million for a Wholly Export trade is at a lower rate of 20%.
- (vi) Profit of any Nigerian company in respect of Goods Exported from Nigeria are exempted from tax, if the proceeds are repatriated to Nigeria.
- (vii) Profits of an undertaking within and outside EPZ shall be exempted from tax for the first three consecutive years of assessment provided:
 - The undertaking is wholly export oriented.
 - The undertaking is not formed by splitting or reconstructing an existing business.
 - During the relevant year, the undertaking manufactures and exports goods and the export proceeds make up 75% of its turnover.
 - The undertaking repatriates at least 75% of the export earnings to Nigeria and places it in a domiciliary account in any registered and licenced Bank in Nigeria.

EXAMINER'S REPORT

The question tests candidates' knowledge and understanding of the nature and objectives of Tax Incentives available to Companies located in designated Export Processing Zones (EPZ) in Nigeria, under the Nigerian Tax Laws.

Whilst a few candidates displayed good understanding of the requirements of the question, a good number of others mixed-up Tax Incentives generally, as distinct from TAX Incentives available to the Export Processing Zones. This is on key aspects of the Nigerian Tax Laws designed to encourage investments in Nigeria, principally to boost Exports.

Candidates are advised to be more discerning in identifying aspects of Nigerian Tax Laws that are essential in their preparations for future examinations

SOLUTION 3

JISOSI PETROLEUM LIMITED COMPUTATION OF TOTAL TAX LIABILITIES FOR 2013 TAX YEAR

	Notes	₦	₦
Petroleum Profits:			
- Petroleum Profits Tax	(1)	37,775,700	
- Tertiary Education Tax	(3)	<u>1,700,000</u>	
			39,475,700
Companies Tax:			
Companies Income Tax	(2)	2,293,200	
Tertiary Education Tax	(2)	<u>167,880</u>	<u>2,461,080</u>
Total Tax liabilities			<u>41,936,780</u>

Based on the computation of total tax liabilities of ₦41,936,780, the following are relevant for management consideration –

- (i) The available profit for distribution as Dividend is

	₦
Profit before taxation	82,642,000
Less: Income Tax Liabilities	<u>(41,936,780)</u>
	<u>40,705,220</u>

- (ii) The dividend policy of the company regarding what proportion of available profit is to be distributed as Dividend.
- (iii) The effect of Dividend payments on cash flow position of the Company.

JISOSI PETROLEUM LIMITED
COMPUTATION OF PETROLEUM PROFITS TAX FOR 2013 TAX YEAR

	NOTES	₦	₦
Profits before Taxation as per the accounts			82,642,000
<u>Add</u>			
Disallowable expenses:			
Depreciation		32,000,000	
Transportation expenses		8,500,000	
Donations		<u>4,500,000</u>	<u>45,000,000</u>
<u>Less:</u>			
Profit on sale of Property, Plants & Equipments		48,000	
Income from transportation of Crude Oil		16,894,000	
Intangible Drilling Cost capitalized		14,000,000	
Tertiary Education Tax		<u>1,700,000</u>	<u>32,642,000</u>
Adjusted Profit			95,000,000
Less: Loss brought forward			<u>(10,000,000)</u>
Assessable profit			85,000,000
Add: Balancing charge on exploration			<u>242,000</u>
			85,242,000
Less: Capital allowance	(4)		<u>(40,800,000)</u>
Chargeable profit			<u>44,442,000</u>
Chargeable tax @ 85%			<u>37,775,700</u>
 Tertiary Education Tax	 (3)		 <u>1,700,000</u>

2. Computation of Companies Income Tax

	₦
Income from transportation	16,894,000
Less: Transport related expenses	<u>(8,500,000)</u>
	8,394,000
Less: Capital Allowances/Assets	<u>(750,000)</u>
Assessable profit	<u>7,644,000</u>
Companies Income tax @ 30%	<u>2,293,200</u>
Tertiary Education Tax @ 2% of ₦8,394,000	<u>167,880</u>

3. Tertiary Education Tax

$$(\text{Income} - \text{other expenses}) \times \frac{2}{102}$$

$$\begin{aligned}
&= \text{N}127,642,000 - \text{N}40,942,000 \times \frac{2}{102} \\
&= \text{N}86,700,000 \times \frac{2}{102} \\
&= \underline{\text{N}1,700,000}
\end{aligned}$$

4. Capital Allowance

The lower of:	N	N
(i) Capital Allowance b/f	11,000,000	
Annual Allowance for the year	25,500,000	
Petroleum Investment Allowance	<u>18,500,000</u>	
OR		55,000,000
(ii) 85% of Assessable Profit		
i.e. 85% x N 85,000,000	72,250,000	
Less 170% of Petroleum investment		
Allowance (1.7 x N 18,500,000)	(<u>31,450,000</u>)	
Capital allowance utilized		<u>40,800,000</u>)
Capital allowance c/f		<u>4,200,000</u>

EXAMINER'S REPORT

The question tests candidates' ability to compute Tax Liability for a Company that is subject to both Petroleum Profits Tax Act (PITA) as well as the incidence of Tax Liability under the Companies Income Tax Act (CITA).

Candidates displayed poor understanding of the requirements of the question.

Many of the candidates could not compute correctly, both the Adjusted and Assessable Profits under both PITA and CITA, given the incidence of Transportation Income and associated expenses.

Candidates are advised to improve on their preparations for future examinations by practising with worked examples in the Institute's Pathfinder publications.

SOLUTION 4

November 18 2014

The Managing Director
Broad Way Limited - Lagos

Dear Sir

RE: ADVICE ON PIONEER STATUS

We refer to your request on the subject and will like to comment as follows:

- With the certification of August 1 2004 as the Production day and there being no extension, the Pioneer period shall be from August 1 2004 to 31 July 2007.
- Profit made during the Pioneer period is exempted from tax
- Loss made during the Pioneer period can be carried to Post-Pioneer period
- Qualifying Capital Expenditure acquired during Pioneer period are eligible for Capital Allowance after the Pioneer period
- The Post Pioneer business is deemed to have commenced immediately after the Pioneer period. Therefore, commencement rule is applied to determine the Assessable Profit
- As a manufacturing company, there is no restriction of Capital Allowance
- Based on the information provided and applying Commencement Rules, Tertiary Education Tax is payable on the Assessable Profit for the 2007, 2008 and 2009 Tax years
- After absorbing the Capital Allowances, there is an Income Tax liability of ₦711,421 in 2009 Tax Year.

Please note that the Tax authority will carry out a Post-Pioneer audit period of the company. The FIRS is also required to certify the Qualifying Capital Expenditure acquired during the Pioneer period.

Please revert to us for further clarifications as may be required.

Yours faithfully,
Jokotola Albert

FOR: AAA & CO.

Working

BROADWAY LIMITED COMPUTATION OF TAX LIABILITY FOR 2007 to 2009 TAX YEARS

2007 (1/8/07 - 31/12/07)	₦	₦
Assessable Profit (w2)		2,250,598
Capital Allowance	6,956,114	
Capital Allowance Utilised	<u>(2,250,598)</u>	<u>(2,250,598)</u>
Capital Allowance c/f	<u>4,705,516</u>	
Total Profit		-
Company Income Tax at 30%		-
Tertiary Education Tax 2% of ₦2,250,598		<u>45,012</u>

2008 (1/8/07 – 31/7/08)	₦	₦
Adjusted profit (w2)		5,401,435
Capital Allowance b/f	4,705,516	
Capital Allowance for the year	<u>1,862,975</u>	
	6,568,491	
Capital Allowance Utilised	<u>(5,401,435)</u>	<u>(5,401,435)</u>
Capital Allowance c/f	<u>1,428,686</u>	
Total Profit		-
Company Income Tax @ 30%		-
Tertiary Education Tax @ 2% of ₦5,401,435		<u>108,029</u>

2009 (1/8/07 – 31/7/08)		
Adjusted Profit (w2)		5,401,435
Capital Allowance b/f		
	1,167,056	
Capital Allowance for the year	<u>1,862,975</u>	
	3,030,031	
Capital Allowance Utilised	<u>(3,030,031)</u>	<u>(3,030,031)</u>
Total Profit		<u>2,371,404</u>
Company Income Tax @ 30%		<u>711,421</u>
Tertiary Education Tax @2% of ₦5,401,435		<u>108,029</u>

Workings:

(i) Pioneer Period and Basis Period for new trade

Year 1 1/8/04 – 31/7/05

Year 2 1/8/05 – 31/7/06

Year 3 1/8/06 – 31/7/07

New trade commenced 1/8/07

Basis Period

2007 1/8/07 – 31/12/07

2008 1/8/07 – 31/7/08

2009 1/8/07 – 31/7/08

(ii) Computation of Adjusted Profit

	N
Net Profit per Account	5,005,000
Add:	
Depreciation	<u>396,435</u>
Adjusted	<u>5,401,435</u>

2007 Tax Year, $5/12 \times \text{N}5,401,435 = \text{N}2,250,598$

2008 Tax Year $\text{N}5,401,435$

2009 Tax Year $\text{N}5,401,435$

(iii) Computation of Annual Allowance for 2007 Tax Year

Industrial Building $\frac{\text{N}(6,142,500 - 921,375 - 10)}{10} = \text{N}522,122$

Prorated to 5 months = (Aug. – Dec.) = $\text{N}217,546$

Non-industrial building

$\frac{\text{N}(2,990,000 - 448,500 - 10)}{10} = \text{N}254,149$

(Prorated to months) = $\text{N}105,895$

Plant & Machinery

$\frac{\text{N}(4,631,250 - 2,315,625 - 10)}{4} = \text{N}578,904$

Prorated to 5 months $\text{N}241,210$

Motor Vehicle

Plant & Machinery

$\text{N}(4,062,500 - 2,031,250 - 10) = \text{N}507,810$

(iv) Computation of Capital Allowances

Rate %	Industrial – Building	Non- Industrial building	Plant & Machinery	Motor Vehicle	Capital allowance
I.A	15	15	50	50	
A. A	10	10	25	25	
Inv. A	-	-	10	-	
2007 (1/8/07 – 31/12/07)	₦	₦	₦	₦	₦
Cost	6,142,500	2,990,000		4,062,500	
I.A	(921,375)	(448,500)	4,631,250	(2,031,250)	5,716,750
A. A	(217,546)	(105,895)	(2,315,625))	776,239
Inv. A	-		(241,210)	(211,588)	463,125
					<u>6,956,114</u>
Capital Allowance					
2008 (1/8/07 – 31/7/08)					
TWDV	5,003,579	2,435,605	2,074,415	1,819,662	
A. A	(522,112)	(254,149)	(578,904)	(507,810)	1,862,975
Capital Allowance					<u>1,862,975</u>
2009 (1/8/07 – 31/7/08)					
TWDV	4,481,467	2,181,456	1,495,511	1,311,852	
A. A	(522,112)	(254,149)	(578,904)	(507,810)	1,862,975
Capital Allowance					<u>1,862,975</u>
TWDV	<u>3,959,355</u>	<u>1,927,307</u>	<u>916,607</u>	<u>804,042</u>	

EXAMINER'S REPORT

The question tests candidates' knowledge and understanding of the principles guiding the Tax Assessment of Pioneer Companies, as well as good Report presentation format. Answers were expected to address Tax Reliefs for Pioneer businesses, when commencement Rules will apply and the treatments of Pioneer Period Losses – Post the Pioneer Period.

Candidates displayed poor understanding of the requirements of the question, especially with the incidence of Capital Allowances.

Many candidates could not compute the Capital Allowances accurately, neither did they present their answers in the expected REPORT format.

Candidates' are advised to prepare better for future examinations by practising with more computational questions.

SOLUTION 5

(a) Objectives

The objectives of the regulations are to:

- (i) Ensure that Nigeria is able to tax on an appropriate taxable basis corresponding to the economic activities deployed by taxable persons in Nigeria, including on their transactions and dealings with associated enterprises;
- (ii) Provide the Nigerian authorities with the tools to fight tax evasion through over or under pricing of controlled transactions between associated enterprises;
- (iii) Provide a level playing field amongst multinational enterprises and independent enterprises doing business within Nigeria and
- (iv) Provide taxable persons with certainty of transfer pricing treatment in Nigeria.

(b) Treatment of Permanent Establishment

- i. A fixed base through which the business of an enterprise is wholly or partly carried on is treated as a permanent establishment.
- ii. For the purpose of Transfer Pricing, any transaction between a Permanent Establishment and its Head Office or other connected taxable persons shall be considered to be a controlled transaction.
- iii. Such controlled transactions will require the necessary documentation to prove that the transactions have been carried out at arm's length.

(c) Contents of a Transfer Pricing

Disclosure to be submitted to Federal Inland Revenue Service (FIRS)

The Federal Inland Revenue Service Transfer Pricing Disclosure and Declaration form contains the following information:

- i. Particulars of Reporting Company or Entity.
- ii. Particulars of immediate Parent Company
- iii. Particulars of Directors of Reporting Company
- iv. Particulars of major Shareholders of Reporting Companies and related parties

- v. Particulars of Subsidiaries and other concluded persons.
- vi. Ownership structure of Reporting Entity and Related Parties
- vii. Particulars of External Auditors
- viii. Particulars of Tax Consultant of Reporting Entity.
- ix. Particulars of Company Secretary of the Entity.
- x. Particulars of the person making the declaration.

EXAMINER'S REPORT

The question tests candidates' understanding of the concept of Transfer Pricing, the contents, objectives and regulations guiding it, as well as treatment of permanent establishments.

Performance was poor.

Candidates displayed inadequate understanding of the requirements of the question as some mixed-up the objectives of a Transfer Pricing Policy with the Treatments of Permanent Establishments.

Candidates are advised to be more painstaking and analytical in arriving at the requirements of a question.

SOLUTION 6

a. Double Taxation Relief Available:

i. Nigeria (Resident) Company:

- If the commonwealth rate (CWR) of tax does not exceed 50% of the Nigerian Rate (NR), the relief given at the commonwealth rate i.e. if $CWR \leq \frac{1}{2} NR$, Relief = CWR.
- In any other case, the rate at which the relief is given shall be half the Nigerian Rate if the commonwealth rate is greater than 50% of the Nigerian Rate, i.e. if $CWR > \frac{1}{2} NR$, Relief = $< \frac{1}{2} NR$.

ii. **SUNPROOF INTERNATIONAL INC.**
COMPUTATION OF COMPANY TAX LIABILITY FOR 2013 TAX YEAR

	Nigeria ₦	S. Leone ₦	Total ₦
Opening profit before Tax	40,275,000	7,725,000	48,000,000
Add back:			
Depreciation	6,750,000	1,125,000	7,875,000
Donation to Island Club	375,000	-	375,000
Foreign tax suffered	-	6,300,000	6,300,000
Assessable profit	47,400,000	15,150,000	62,550,000
Less: Capital allowance	<u>5,310,000</u>	<u>2,175,000</u>	<u>7,485,000</u>
Total Profit	<u>42,090,000</u>	<u>12,975,000</u>	<u>55,065,000</u>
Income tax @ 30%	12,627,000	3,892,000	16,519,500
Less: Double Tax relief			
Foreign income – S. Leone		12,975,000	
Foreign Tax paid – S. Leone		6,300,000	
Foreign Tax paid			
 CWRT = $\frac{\text{₦6,300,000}}{\text{₦12,975,000}} \times \frac{100}{1}$			 = 48.55%
 Nigerian Rate of Tax (NRT)		30%	
Double Taxation Relief Rate – lower of ½ NRT = 15%			
CWRT = 48.55%			
Double Tax relief 12,975,000 @ 15%	₦1,946,250		(1,946,250)
Net Income Tax liability			14,573,250
			1,251,000
 Tertiary Education Tax @ 2% of ₦62,550,000			

b.

Rev. (Dr.) Smart

- Since Rev. Dr. Smart is permanently resident in Nigeria, he is liable to tax in Nigeria on his global Income
- Where he earns Income outside Nigeria and such income has been subjected to tax outside Nigeria, he can claim relief for the foreign tax already paid.

- iii. The relief or credit claimable in respect of foreign tax suffered depends on whether Nigeria has double taxation agreement. The credit claimable is the lower of the foreign tax paid and the Nigerian tax on the foreign Income.
- iv. Where there is no Double Taxation Agreement, reliefs are claimed under the commonwealth relief

EXAMINER'S REPORT

The question tests candidates' knowledge and understanding of the concepts and principles of Double Taxation Relief, associated Tax Computation as well as the Commonwealth Income Tax Relief.

Candidates were expected to identify correctly, Allowable/Disallowable Expenses under Double Taxation Relief computations, as well as the distinction between and the application of the Commonwealth Rate of Tax (CWRT) and the Nigerian Rate of Tax (NRT).

Performance was poor as candidates displayed inadequate understanding of the requirements of the question. A good number of them subtracted the Adjustment Figures, instead of adding.

Candidates should prepare better for future examinations by using current study materials as well as past editions of the Institute's Pathfinder.

SOLUTION 7

- (a) Mr. James Zonto
Calculation of Total Income for 2011 Year of Assessment

	₦
i. Rent from Uyo House (Gross):	
$\left(\cancel{\text{₦}855,000} \times \frac{100}{90} \right)$	950,000
ii. Interest on Fixed Deposit with Dorunine Bank Plc ($\cancel{\text{₦}180,000} \times 12$) = $\cancel{\text{₦}2,160,000}$	
$\cancel{\text{₦}2,160,000} \times \frac{100}{90}$	2,400,000

iii.	Rental Income from Onitsha House (Gross)	1,800,000
iv.	Okija House	<u>-</u>
		<u>5,150,000</u>

Note: The Interest Income has suffered withholding tax at source and will therefore be treated as Franked Investment Income. This means that Withholding Tax is the final tax on the Interest.

(b) Mr. James Zonto
Computation of Capital Gains Tax for 2012 Year of Assessment

	₦	₦	₦
Uyo House:			
Accruing consideration		47,450,000	
Deduct: Incidental Cost of disposal			
Advertising cost	650,000		
Valuation fees	2,000,000		
Estate agents	2,372,500		
Legal fees	<u>1,500,000</u>	<u>(6,522,500)</u>	
		40,927,500	
		<u>(25,320,000)</u>	
		<u>15,607,500</u>	
		<u>1,560,750</u>	<u>1,560,750</u>
 One (Onitsha) duplex	 ₦	 ₦	
Accruing consideration		14,175,000	
Cost of acquisition:			
Cost of asset	31,500,000		
Incidental expenses	<u>2,400,000</u>		
	33,900,000		

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

$$\frac{\text{N}14,175,000}{\text{N}14,175 + 40,500,000} \text{N}32,900,000$$

N8,788,888

Capital Gains

N5,386,112

Capital Gains Tax @ 10%

N538,611

**SUMMARY OF CAPITAL GAINS
TAX PAYABLE**

	<u>N</u>
Uyo house	1,560,750
Onitsha House	538,611
Okija House	<u>NIL</u>
Total	<u>2,099,361</u>

EXAMINER'S REPORT

The question tests candidates' ability to compute Total Income for an individual, comprising Investments Income and Capital Gains on the Disposal/Part-Disposal of Personal Assets.

Candidates were expected to distinguish Investments Income Tax Computation from Capital Gains Tax Computation on the Disposal/Part-Disposal of Assets.

Candidates displayed good understanding of the question and the performance was good. Nevertheless, few candidates failed to realize that the tax computation for Investment Income is distinct from that of Capital Gains tax computation.

In the first instance, the source (Investment) of the income is not disposed off, whilst in the other case, the source (Assets) is disposed off or partly disposed off.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA
PROFESSIONAL LEVEL EXAMINATION - NOVEMBER 2014
STRATEGIC FINANCIAL MANAGEMENT

Time Allowed: 3 hours

SECTION A

COMPULSORY QUESTION

(30 Marks)

QUESTION 1

AK Plc is a company listed on the Nigerian Stock Exchange. It is involved in property development and sales. The company currently imports more than 60% of its cement requirements. At a recent meeting of the board of directors, a decision was taken to establish a division for the production of cement in Ore, Ondo State. If the division is set up and the cement production goes ahead, output from the division will be sold to AK Plc. and external customers at market price. For planning purposes, it has been decided that the financial viability of the project over the next five years should be determined.

The sum of ₦2 billion will be required. The sum of ₦500 million will be spent to acquire an existing factory considered suitable for the project. The balance of ₦1.5 billion will be applied for the procurement and installation of essential plant and equipment. Tax allowance can be claimed on plant and equipment at a uniform amount over 5 years with NIL scrap value.

A total of ₦20million has been spent on various surveys (market, technical, financial, etc.) to date out of which ₦10million has been paid. The balance of ₦10million is due for payment at the end of year 1.

Production of cement for the next five years is projected as follows:

Year	Bags
1	500,000
2	600,000
3	650,000
4	800,000
5	700,000

A bag of cement sells currently for ₦2,000 in the open market. This price is expected to increase at the rate of 5% per annum. Variable cost is now per bag. This will increase at 4% per annum. Fixed overhead costs will be ₦50 million at current prices but will rise by 8% per annum. Apportioned head office charges of ₦25million at current prices will rise by 10% per annum. Fifty per cent (50%) of the total initial outlay of ₦2billion is to be funded with a loan from a Federal Government

SECTION B: ATTEMPT ANY TWO OUT OF THREE QUESTIONS**(40 Marks)****QUESTION 2**

Chelsy Plc has two manufacturing divisions, Bolts and Nuts. The Bolts division is profitable whereas the Nuts division is not. The company's share price has consequently declined to 50 kobo per share from a price of ₦2.83 per share three years ago.

The board of directors is considering two proposals:

- i. To cease trading and close down the company.
- ii. To close the Nuts division and continue Bolts division through a leveraged management buyout. The new company will continue to manufacture bolts only but will require an additional investment of ₦275million in order to grow the Bolts division's after tax cash flows by 3.5 per cent in perpetuity. The proceeds from the sale of Nuts division will be applied to pay the division's outstanding liabilities. The finance raised from the management buyout will be applied in paying any remaining liabilities, fund additional investment and purchase the current equity shares at a premium of 20 per cent. The Nuts division is twice the size of the Bolts division in terms of the assets attributable to it.

Extracts from the most recent financial statements of Chelsy Plc are as follows:

Statement of Financial Position as at 31 December 2013.

	₦'000
Non-current assets	605,000
Current assets	1,210,000
Share capital (40 kobo per share)	220,000
Reserves	55,000
Liabilities (non-current and current)	1,540,000

Comprehensive Income statement for the year ended 31 December 2013

	₦'000
Sales revenue:	
Bolts division	935,000
Nuts division	1,870,000
Costs prior to depreciation, interest payments and tax:	
Bolts division	(660,000)
Nuts division	(2,035,000)
Depreciation, interest and tax	(187,000)
Loss	(77,000)

If the company's assets are sold, the estimated realisable values are as follows:

	₦'000
Non-current assets	550,000
Current assets	605,000

The following additional information has been provided:

- i. Redundancy and other costs will be approximately ₦297 million if the whole company is closed and pro rata for individual divisions that are closed. These costs have priority for payment before any other liabilities in case of closure. The taxation effects relating to this may be ignored.
- ii. Company income tax on profits is 30% and it can be assumed that tax is payable in the year it is liable.
- iii. Annual depreciation on non-current assets is 10% and this is the amount of investment needed to maintain the current level of activity.
- iv. The new company's cost of capital is expected to be 11%.

Required:

- a. Discuss, briefly, the possible benefits of divesting Bolts division through a management buyout. (4 Marks)
- b. Estimate the return the creditors and the shareholders will receive in the event that Chelsy Plc is closed and all its assets sold. (3 Marks)
- c. Estimate the additional amount of finance needed and the value of the new company, if only the assets of Nuts division are sold and the Bolts division is divested through a management buyout. (8 Marks)

- d. Discuss the issues that should be taken into consideration in relation to:
- i. Seeking potential buyers and negotiating the price
 - ii. Due diligence
(Assume that the Nuts division is to be sold as a going concern)
- (5 Marks)
(Total 20 Marks)

QUESTION 3

Syntax Plc., a fertilizer company, is concerned about fluctuating sales and earnings. This caused the management of the company to consider acquisition of another company in the same line of business.

In order to boost its sales and stabilise its earnings, Syntax Plc's management has identified Synapse Chemical Company Plc. as a possible target. Syntax proposed to acquire Synapse for a consideration of ₦20 million and this was agreed to by the two companies.

Synapse's expected future profits as projected from its past financial records are as follows:

	2015	2016	2017	2018	2019
	<u>₦'m</u>	<u>₦'m</u>	<u>₦'m</u>	<u>₦'m</u>	<u>₦'m</u>
Revenue	<u>60</u>	<u>70</u>	<u>78</u>	<u>86</u>	<u>94</u>
Cost of sales	30	35	39	43	47
Other expenses	15	15	15	15	15
Depreciation	<u>5</u>	<u>4</u>	<u>4</u>	<u>4</u>	<u>4</u>
Total expenses	<u>50</u>	<u>54</u>	<u>58</u>	<u>62</u>	<u>66</u>
Profit before tax	<u>10</u>	<u>16</u>	<u>20</u>	<u>24</u>	<u>28</u>

The following information are relevant:

- i. The forecast profits have been limited to five years.
- ii. All sales are for cash.
- iii. The net book value of Synapse's assets of ₦2 million is intended to be sold for ₦1 million in year 2015. The expected loss from the disposal of these assets has been included in the depreciation for year 2015. These assets currently have a tax written down value of ₦3 million. Capital allowances were claimed as at when due.

- iv. Synapse currently has a tax liability of ~~N~~4.5 million due for payment in 2015.
- v. The interest charges of ~~N~~1 million of Synapse Plc. have been included in other expenses.
- vi. In order to maintain the future earnings' forecast of Synapse Chemical Company, Syntax Plc. needs to invest in capital expenditure as follows:

Years	2015	2016	2017	2018	2019
Amount (N'M)	5	6	8	9	10

- vii. Company income tax is currently at 30 per cent and the tax delay is one year.
- viii. The after tax weighted average cost of capital has been calculated at 22%.

The management of Syntax Plc. has asked you, as a Financial Expert, to appraise the intended acquisition of Synapse Chemical Company Plc. and advise on the reasonableness of the acquisition.

Your advice should be in the form of a report to the Board of Directors of Syntax Plc.
(20 Marks)

QUESTION 4

A Pharmaceutical company wholly owned by the family of Chief Adedutan Jolomi has been in business for many years. The directors have decided to seek quotation on the Alternative Securities Market (ASEM).

A new drug on Ebola Virus Disease (EVD) was developed by the company. The production of the new drug will require more funding since short-term finance will not be sufficient. They believed it was time to introduce the drug into the market.

The directors of the company believed that launching the product would significantly increase the company's share of the market because the country was anxiously looking forward to an effective EVD drug. Production and launch of this product is costly and the company's shareholders may not be able to raise such fund. This informed the directors' decision to seek additional finance to be sourced partly in corporate bond and partly by issue of shares.

They plan to issue the corporate bond in the first quarter of 2015 and the shares through Initial Public Offer (IPO) towards the end of year 2015. To be able to decide

on the appropriate method for the offer, the directors of the company are interested in being educated on the issue.

Required:

- a. Compare and contrast the methods of issuing bonds through private placement and by public offer. State their advantages and advise on which method would be more appropriate in the above situation. (12 Marks)
 - b. Advise the directors on the steps that need to be taken to improve the chances and success of its proposed Initial Public Offer (IPO). (4 Marks)
 - c. Explain the **THREE** forms of Efficient Market Hypothesis (EMH) indicating which of them is most likely to apply in practice. (4 Marks)
- (Total 20 Marks)**

SECTION C: ATTEMPT ANY TWO OUT OF THREE QUESTIONS (30 Marks)

QUESTION 5

- a. Assume that you are a Finance Manager in a state owned enterprise which is about to have its majority ownership transferred to the private sector through listing on the Nigerian Stock Exchange.

You are required to examine the financial objectives and the changes in emphasis that are associated with strategic and operational decisions in the above scenario. (10 Marks)
 - b. What are the associated risks that the company may be exposed to as a result of privatisation? (5 Marks)
- (Total 15 Marks)**

QUESTION 6

- a. Nimega Plc. is a Nigeria based multinational company that has subsidiaries in two foreign countries. Both subsidiaries trade with other group members and with four third party companies.

You are required to present **SIX** arguments for and **FOUR** against centralised treasury management in a multinational organisation. (10 Marks)
 - b. Discuss any **FIVE** reasons why conflict of interest may exist between shareholders and bond holders. (5 Marks)
- (Total 15 Marks)**

QUESTION 7

- a. Build Nigeria Plc. (BNP) is a giant construction company with head office in Kano, Nigeria. It is involved in construction of roads, dams, airfields, etc., in many parts of the country. Recently, the company won construction contracts across a number of African countries. One of the contracts is for the construction of a dam for a country in Central Africa whose currency is Central African dollar (C\$). The dam has now been completed and the retention money of C\$210,000,000 is due for settlement in one year's time.

The current spot exchange rate is C\$40 = ₦1. Risk free rate is 5% in Nigeria and 25% in the foreign country.

The Chief Finance Officer (CFO) of BNP is worried about the above financial statistics and concluded that BNP will lose as much as ₦840,000 due to exchange rate movements between now and the end of the year when the retention money is received.

You are required to explain, showing all relevant calculations, how the CFO arrived at the potential loss of ₦840,000. (4 Marks)

- b. In another contract in a country in the ECOWAS sub-region (with currency of W\$), BNP expects the following payment and receipt in six months time:

	W\$ million
Expected payment	450
Expected receipt	750

You are provided with the following financial data:

Spot exchange rate:

₦ per W\$1 = 1.4735 – 1.4755

Money market rates

	Deposit	Borrowing
	%	%
Nigeria	13.25	16.5
The West African country	6.5	10.5

You are required to show how BNP can make use of money market hedge to mitigate the foreign exchange risk inherent in the above payment and receipt. Show all workings and the necessary steps. (7 Marks)

- c. Discuss **TWO** advantages and **TWO** disadvantages of forward exchange contract. (4 Marks)

SOLUTION 1

- (a) The appropriate cost of capital should reflect the **business risk** of the cement industry and the **financial risk** of AK Plc.

Step 1: Determine the equity beta of the cement division of the given proxy company. The given equity beta of the proxy company is a weighted average of the equity beta of the cement division (which is unknown) and that of the fruit drinks division (which is 0.8). If x is the unknown equity beta, then:

$$0.6x + 0.4 (0.8) = 1.82$$

$$\therefore 0.6x = 1.82 - 0.32$$

$$0.6x = 1.5 \text{ or } x = 2.5$$

This reflects both the business risk of the cement industry and the financial risk of the proxy company.

Step 2: Ungear the equity beta of the cement division to eliminate the financial risk of the proxy company. The following formula is used:

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

Where β_A = asset beta of the proxy company

β_E = equity beta of the proxy company

β_D = beta of debt of the proxy company

V_E = value of equity of the proxy company,

V_D = value of debt.

t = tax rate

Note: We actually do not need to know the absolute value of V_E and V_D . We only need the relative values. With D/E ratio of 40%, we simply maintain the ratio:

D: E = 40: 100 = 4: 10, etc.

$$\beta_A = \frac{2.5 \times 100}{100 + 40(1 - 0.25)} + \frac{0.4 \times 40(1 - 0.25)}{100 + 40(1 - 0.25)} = 2.02 \text{ or say } 2$$

This is the beta that reflects the systematic business risk of the cement industry.

Step 3: Regear the above asset beta using the target D/E ratio of Ak Plc – in order to incorporate the financial risk of Ak Plc. The relevant formula to use is:

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

Note:

V_D = value of debt of Ak Plc

V_E = value of equity of Ak Plc

$$\beta_E = 2 + (2 - 0.4) \left(\frac{30}{100} \right) (1 - 0.25) = 2.36$$

Step 4: Determine cost of equity, using CAPM

$$K_E = R_F + \beta_E (R_M - R_F) = 5 + 2.36 (7) = 21.52\%$$

Step 5: Determine cost of debt, net of tax.

Assumption: In the absence of additional information, we assume that the appropriate cost of debt, before tax, is the concessionary interest rate of 8%.

$$K_D = 8 (1 - 0.25)\% = 6\%$$

Step 6: Compute the WACC

$$\begin{aligned} \text{WACC} &= \left(\frac{100}{130} \times 21.52 \right) + \left(\frac{30}{130} \times 6 \right) \\ &= 16.56 + 1.39 = 17.95 = 18\% \text{ approx} \end{aligned}$$

Why the computed WACC is appropriate

The WACC used to appraise a new project should reflect:

- i. The business risk of the project and
- ii. The financial risk associated with the method of financing the project

The existing WACC of 11% reflects the average business risk of the existing portfolio of projects and the financial risk of the company (i.e. AK Plc).

The index used to measure business risk is asset beta. For the cement project, we need the asset beta of the cement industry which is computed above as 2. This figure is significantly higher than the current asset beta of Ak Plc – indicating that the cement business is inherently riskier than the existing operations of Ak Plc. Consequently, the current WACC of 11%, which is based on asset beta of 1.2 is inappropriate as it will understate the required return on the cement project.

b)i. Computation of NPV

Year	0	1	2	3	4	5
	Nm	Nm	Nm	Nm	Nm	Nm
Sales revenue (W1)	0	1,050	1,323	1,505	1,945	1,787
Variable cost (W2)	0	(416)	(519)	(585)	(749)	(681)
Cash fixed cost (W3)	0	(54)	(58)	(63)	(68)	(73)
Operating profit	0	580	746	857	1,128	1,033
Tax on operating profit	0	(145)	(187)	(214)	(282)	(258)
Tax savings on tax depreciation (W3)	0	75	75	75	75	75
Initial outlay	(2,000)					
Working capital (W4)	(105)	(27)	(19)	(45)	17	179
NCF	(2,105)	483	615	673	938	1,029
PVF at 13%	1	0.885	0.783	0.693	0.613	0.543
PV	(2,105)	427	482	466	575	559
NPV =	N404,000,000					

ii) Computation of MIRR

$$MIRR = \left[\left(\frac{PV_R}{PV_i} \right)^{1/n} \times (1 + r) \right] - 1$$

Where PV_R = PV of return stage, which in this case is the PV of NCF from Years 1 to 5 = N2,509million

PV_i = PV of the investment stage, which in this case is the NCF in Year 0 = N2,105million

r = WACC

n = life of the project

$$\text{MIRR} = \left[\left(\frac{2,509}{2,105} \right)^{1/5} \times (1.13) \right] - 1 = 17\%$$

Alternative method

An alternative is to first compute the terminal value of the return phase:

Year	NCF	Future value factor	Future value
	(a)	(b)	(a x b)
1	483	$(1.13)^4$	788
2	615	$(1.13)^3$	887
3	673	$(1.13)^2$	859
4	938	$(1.13)^1$	1,060
5	1,029	$(1.13)^0$	<u>1,029</u>
			<u>4,623</u>

Next, we compute the MIRR using:

$$\text{MIRR} = \left[\frac{\text{Terminal Value of return phase}}{\text{initial outlay}} \right]^{1/n} - 1 = \left(\frac{4,623}{2,105} \right)^{1/5} - 1 = 17\%$$

- (c) The NPV of the project is positive and the MIRR is higher than the company's WACC. If other factors remain constant the project is viable and should be accepted.

Working Notes

1. Annual sales revenue

Year	1	2	3	4	5
Quantity sold (Q)	500,000	600,000	650,000	800,000	700,000
Selling price (₦)	2,100	2,205	2,315	2,431	2,553
Sales revenue (₦m)	1,050	1,323	1,505	1,945	1,787

2. Annual total variable cost

Year	1	2	3	4	5
Variable Cost/unit (₦) = (V)	832	865	900	936	973

Total Variable Cost (N/m) (V x Q)	416	519	585	749	681
-----------------------------------	-----	-----	-----	-----	-----

3. Incremental fixed cost (cash)

Year	1	2	3	4	5
Total ((N/m)	54	58	63	68	73

4. Incremental working capital

Year	0	1	2	3	4	5
	N	N	N	N	N	N
Total (10% of revenue)	-	105	132	151	196	179
- Incremental (cash flow effect)	-105	-27	-19	-45	+17	+179

5. Other cost items

- i) **Loan repayments:** Loan repayments and interest on loan are irrelevant in DCF calculations. They are financing items.
- ii) **Apportioned overheads:** These are irrelevant because they do not involve incremental cash flows.
- iii) **Cost of surveys:** These are sunk costs and are therefore irrelevant.

6. Tax savings on tax depreciation

Annual tax depreciation = $\text{N}1,500\text{m}/5 = \text{N}300\text{m}$

Tax savings at 25% = $\text{N}75\text{m}$

EXAMINER'S REPORT

The question tests candidates' ability to identify and calculate appropriate cost of capital for a project on diversification into a different industry. It also tests candidates' ability to identify relevant cash flows for a project and their ability to calculate and interpret net present value and modified internal rate of return.

Being a compulsory question, virtually all the candidates attempted it. However, the performance is poor as it appears that the candidates lacked an understanding of these areas of the syllabus.

Candidates' commonest pitfalls were their inability to differentiate between debt/equity ratio and debt/equity plus debt ratio. They were required to carry out the

‘gearing’ and ‘ungearing’ processes. They failed to recognise that financing items are irrelevant in Net Present Value and Modified Internal Rate of Return calculations.

Candidates’ are advised to always cover the syllabus adequately, work on past questions and examination - like questions in textbooks.

SOLUTION 2

(a) Possible benefits of disposing Bolt division through a management buy-out include:

- Management buy out costs may be less compared with other forms of disposal such as selling individual assets of the division or selling it to a third party.
- It may be the quickest method to raise funds compared to other methods.
- There would be less resistance from the managers and employees thereby making the process smoother and easier to accomplish than if both divisions were to be closed down.
- It may offer a better price. The current management and employees possibly have the best knowledge of the division and are able to make it successful. They may therefore be willing to pay for it.
- There will be continuity in management since existing management will become owners and continue to avail the business of their knowledge and expertise.
- There would be improved commitment and achievements by the management since they are now owners.

(b) Close the company:

	₦'000
Sale of all assets	1,155,000
Less: redundancy and other costs	<u>(297,000)</u>
Net proceeds from sale of all assets	<u>858,000</u>
Total liabilities	1,540,000

The creditors will receive 56 kobo per ₦1 owed them $\left(i.e. \frac{858,000,000}{1,540,000,000} \right)$

while equity shareholders will not receive anything.

(c) **Sell Nuts Division:**

	₦'000
Value of selling nuts division ($\frac{2}{3} \times \text{₦1,155million}$)	770,000
Redundancy and other costs ($\frac{2}{3} \times \text{₦297million}$)	(198,000)
Funds available from sale of division	<u>572,000</u>
Amount of current and non-current liabilities	<u>1,540,000</u>
Amount of funds needed to be paid with respect to management buy-out	
Current and non-current liabilities (₦1,540m – ₦572m)	968,000
Amount of management buy-out funds needed to pay shareholders	330,000
Investment needed for new venture	<u>275,000</u>
Total funds needed for management buy-out	<u>1,573,000</u>

Estimating the value of the new company after management buy-out

	₦'000
Sales revenue	935,000
Costs	(660,000)
Profits before depreciation	275,000
Depreciation $\{ (\frac{1}{3} \times \text{₦550m}) + \text{₦275m} \} \times 10\%$	(45,833)
Tax 30% of (₦275,000 – ₦45,833)	(68,750)
Cash flows before interest payment	<u>160,417</u>

Estimate of the value based on perpetuity

$$\frac{\text{₦1660,417,000 (1.035)}}{0.11 - 0.035} = \frac{\text{₦166,031,595}}{0.075}$$

$$= \text{₦2,213.754,600}$$

This is about 41% in excess of the funds invested in the new venture and therefore the buy-out is beneficial. However, the amounts are all estimates and a small change in some variables like the growth rate or the cost of capital can have impact on the value. Besides, the assumption of cash flow growth in perpetuity may not be accurate. It is therefore advisable to undertake sensitivity analysis.

(d)

- (i) Potential buyers will need to be sought through open tender or through an intermediary. Depending upon the nature of the business being sold a single bidder may be sought or arrangements made for an auction of the business. Chelsy Plc's suppliers and distributors may be interested, as competitors in the same industry. High level of discretion is required in the search process to protect the value of the business from adverse competitive action. Otherwise, an interested and dominant competitor may open a price war in order to force down prices and hence the value of Nuts division prior to a bid.
- (ii) Once a potential buyer has been found, access should be given so that they can conduct their own due diligence. Up to date accounts should be made available, Chelsy Plc should undertake its own due diligence to check the ability of the potential purchaser to complete a transaction of this size. It would be necessary to establish how the purchaser intends to finance the purchase, the timescale involved in their raising the necessary finance and any other issues that may impede a clean sale. Chelsy Plc's legal team will need to assess any contractual issues on the sale, the transfer of employment rights, the transfer of intellectual property and any residual rights and responsibilities to Chelsy Plc.

A sale price will be negotiated which is expected to maximise the return. The negotiation process should be conducted by professional negotiators who have been thoroughly briefed on the terms of the sale, the conditions attached and all legal requirements. The consideration for the sale, the deeds for the assignment of assets and terms for the transfer of staff and their accrued pension rights will also be subject to agreement.

EXAMINER'S REPORT

The question tests candidates' ability to analyse business reconstructions and restructuring.

About 75% of the candidates attempted the question. Performance of the candidates was poor.

Candidates' commonest pitfalls were their inability to decode the question and their inadequate business knowledge.

Candidates are advised to practise examination – like questions. They should also read, understand and interpret questions appropriately noting their specific requirements before attempting them.

SOLUTION 3

Arikuyeri & Co.

**Financial Consultants
XYZ Street, Alegongo
Ibadan, Oyo State**

Date

The Board of Directors,
Syntax Fertilizers Plc,
126, Broad Street,
Lagos

Dear Sirs,

RE: ACQUISITION OF SYNAPSE CHEMICAL PLC

The proposed acquisition of Synapse Chemical Plc by your company for ₦25million has been evaluated.

From the financial data made available to us the outcome of our evaluation and appraisal reveals that the proposal is worthwhile.

Our evaluation reveals that the network of your company will increase by about ₦ 2,112,090 being the net present value of the Synapse Chemical Plc.

Analysis of this appraisal is contained in the attached appendices.

If you need further clarification, do not hesitate to contact us.

Yours faithfully,

For: ARIKUYERI & CO.

Computation of Tax Liability

Appendix 1

	2015	2016	2017	2018	2019
	N'M	N'M	N'M	N'M	N'M
Profit before tax	10	16	20	24	28
Add: Depreciation	5	4	4	4	4
Adjusted profit	15	20	24	28	32
Less: Balancing allowances	2				
	13	20	24	28	32
Tax @ 30%	3.90	6.00	7.20	8.40	9.60

Computation of Cash flows

Appendix 2

	2015	2016	2017	2018	2019	2020
	N'M	N'M	N'M	N'M	N'M	N'M
Profit before tax	10.00	16.00	20.00	24.00	28.00	-
Add: Depreciation	5.00	4.00	4.00	4.00	4.00	-
Interest	1.00	1.00	1.00	1.00	1.00	-
Cash profit before tax	16.00	21.00	25.00	29.00	33.00	-
Less tax	4.50	3.90	6.00	7.20	8.40	9.60
Capital	11.50	17.10	19.00	21.80	24.60	(9.60)
Less Capital Investment Required	5.00	6.00	8.00	9.00	10.00	-
Free cash flow	6.50	11.10	11.00	12.80	14.60	(9.60)

Appendix 3

Evaluation of the Acquisition

Years	Net Cash flow	DFat 22%	Present Value
	N'M		N'M
2014	(25.00)	1.0000	(25.00000)
2015	6.50	0.8197	5.32805
2016	11.10	0.6719	7.45809
2017	11.00	0.5507	6.05770
2018	12.80	0.4514	5.77792
2019	14.60	0.3700	5.40200
2020	(9.60)	0.3033	(2.91168)
		NPV	2.11208

EXAMINER'S REPORT

The question tests candidates' ability to determine the value of a business using discounted cash flow method.

About 40% of the candidates attempted the question. Performance of the candidates was poor.

Candidates' commonest pitfall was their inability to correctly interpret the question and note the specific requirements.

Candidates are to note that there is no alternative to adequate preparation, if success in the Institute's examination is desired.

SOLUTION 4

(a)(i) Differences between Private Placement and Public Issue

Features of Private Placement

- Bond units are not offered to the public
- Issuing houses, arrange for the bonds to be placed at an agreed price
- Bonds are placed by the issuing house with institutional clients
- Private placement is faster and cheaper to arrange than an offer for sale
- To some extent, private placing is less risky, since the issuing house will be fairly certain that its client will subscribe to the issue before agreeing to a placement.

Features of Public Issue

- Issuing house acquires the bonds and offer them to the public at a fixed price
- The offer is announced to the public via abridged prospectus in national newspapers
- The main issuing house may involve underwriters if it is unsure of the success of the offer.

Other features of offer for sale/public issue include:

- Oversubscribed offers are scaled down on a pre-determined basis.
- Investors on public issues usually buy to resell later – this is not common with bonds.

Comparison/similarities of the two methods - Private Placement and Public Issue

- They are both means of sourcing for funds
- Cost will be incurred in respect of both
- Both will create new shareholding in the company concerned
- Both will create awareness about the company
- Capital mix (equity/debt) will be created by the two methods

Advantages of Private Placement for this company

- **Marketability:** The company's issues under private placing is limited or restricted than in public issue where the company is not yet well known.
- **Cost:** Cost of issue under private placing will be lower than under public offer.
- **Speed:** The placing may be completed quickly than under a public offer.
- The number of shareholders is low and efforts required to manage them is also reduced.
- Regulatory involvement and control is minimal

Advantages of Public offer

- Publicity preceeding Initial Public Offer (IPO) helps to create awareness in the public, thereby enabling a successful IPO whenever it comes up even if late in the year.
- The advertisement of the issue creates public awareness about the company
- It provides cheap cash or source of financing for the company
- It gives opportunity to a wider range of investors to become bond-holders.

Advice on the method to choose

The directors of the company should use private placement to issue the bonds as this is likely to be more successful for an unlisted company than a public issue. It is also a useful first step in helping to raise the marketing profile of the company in the run up to the planned IPO.

However, where there is firm underwriting of the public issue, a public issue may be preferred.

(b) The success of the IPO can be improved by:

- i. An appropriate choice of issue price. To be attractive, the price should be slightly below the perceived market value, although there is a risk of underpricing the offer as current shareholders would lose out,
- ii. Underwriting the issue (it may be at a significant cost),
- iii. Careful choice of timing in terms of the new product development cycle (i.e. to ensure that the new product is developed sufficiently, patents obtained, market research etc).
- iv. Choice of timing in terms of market conditions,
- v. Careful/planned communication to prospective investors.

(c) Explanation on the three forms of Efficient Market Hypothesis (EMH)

i. Weak form

EMH in its weak form asserts that the current share price reflects all the information that could be gleaned from a study of past share price.

Therefore no investor can earn above average returns by developing trading rules based on historical price or return information.

ii. Semi-strong form of EMH asserts that the current share price will not only reflect all historical information, but will also reflect all other published information.

Therefore no investor can be expected to earn above-average returns from trading rules based on any publicly available information

iii. Strong form of EMH

This form of EMH asserts that the current share price incorporates all information including non-published information. This would include insider information and views held by the Directors of the entity.

Therefore, people with insider knowledge of the company could not make profits by using this information; however, this is insider trading which is illegal.

It is the consensus that weak or semi-strong form is the most likely to occur in practice.

EXAMINER'S REPORT

The question tests candidates' understanding of methods of raising equity and debt finance. It also tests their knowledge of efficient market hypothesis.

More than 80% of the candidates attempted the question but performance was poor.

Candidates showed no understanding of the requirement in parts (a) and (b) of the question. However, part (c) of the question was well attempted.

Candidates are advised to read wide and cover the syllabus adequately for better result.

SOLUTION 5

- (a) The financial objectives of a state owned enterprise are determined by the government of such state and may be strongly influenced by political and social factors. State owned enterprises often exist to provide a service and to satisfy a social need, even though, they may not be operating at a profit.

Finance manager's targets for state enterprises are normally in the form of a percentage on some pre-defined capital employed or turnover. They are not normally profit maximizing, but are often expected to cover their operating costs and to provide from internally generated fund part or all of their funding for capital investment.

Upon privatization, the finance manager will face a new set of objectives:

- Autonomy and freedom of operations
- Maximisation of shareholders' wealth which now becomes a primary objective than when it was state owned.

After privatization, finance manager's focus will be on strategic and tactical decisions which include the following:

- Decision on the company's shares and market valuations

- Investment, finance and dividend decisions which are likely to affect share price
 - Long term plan, opportunities, strength and weaknesses of the organisation
 - Other strategic and tactical decision which include sourcing for materials and components, pricing, marketing, production and staffing.
- (b) The likely risks that the company may be exposed to as a result of privatization include:
- Exposure to future takeover bids
 - If the government still retains majority shareholding, the company's objectives might be subjected to political factors.
 - If the government still retains majority shareholding, the social objectives might still be interfering with private company's profit maximization objective.
 - Exposure to gearing levels which may expose the company to financial risks
 - Government continuous intervention in major decisions even after loss of control.

EXAMINER'S REPORT

The question tests candidates' knowledge of the objectives of state owned enterprises and private enterprises.

Almost all the candidates attempted the question but performance was poor.

Candidates' commonest pitfall was their failure to answer the question set, as irrelevant points were raised by many of them.

Candidates are advised to read, understand and interpret questions appropriately before attempting them.

SOLUTION 6

(a) Advantages of Centralised Treasury Management

- (i) Centralised management avoids having a mix of cash surpluses and overdrafts in different localised bank accounts. It facilitates bulk cash flows, so that lower bank charges can be negotiated and the subsidiaries that need to borrow can borrow from the parent company and hence gain the benefit of lower rates.
- (ii) Larger volumes of cash are available to invest, giving better short-term investment opportunities (for example international money markets, high-interest accounts and Certificate of Deposits).
- (iii) Any borrowing can be arranged in bulk at lower interest rates than for smaller borrowings and on international markets, interest rate hedging will be facilitated.
- (iv) Foreign currency risk management is likely to be improved in a multinational group of companies. A central treasury department can match foreign currency income earned by one subsidiary with expenditure in the same currency by other subsidiaries.
- (v) A specialised treasury department will employ experts with knowledge of dealing in forward contracts, futures, options, euro-currency markets, swaps and so on. Localised departments would not normally have such expertise.
- (vi) The centralised pool of funds required for precautionary purposes will be smaller than the sum of separate precautionary balances that would be held under decentralised treasury arrangements.
- (vii) A centralised function acts as a single focus, ensuring the strategy of the group is fulfilled and group profitability is enhanced by cash funding, investment and foreign currency management.
- (viii) Transfer prices can be set centrally, thus minimising the group's global tax burden.

Disadvantages of Centralised Treasury Management

- (i) Local departments may find it easier to diversify sources of finance and match local assets.

- (ii) Centralised management means that managers in subsidiaries and divisions are not motivated by being given the autonomy to deal with cash management and it may be difficult to assess their performance if the major decisions are being made centrally.
 - (iii) A decentralised treasury function may be more responsive to the needs of individual operating units.
 - (iv) A decentralised operation may find it easier to invest its own balances quickly on a short-term basis than a centralized function would.
 - (v) A centralised function may find it difficult to monitor remote sites; it may therefore be difficult to obtain information from those sites.
- (b) There could be conflict of interest between shareholders and bondholders for the following reasons:
- (i) **Different attitudes to risk and return**

The shareholders may want the company to undertake risky projects with correspondingly high expected levels of returns while the bondholders will want the company to embark on projects that guarantee sufficient returns to pay their interest each year and ultimately to repay their loans.
 - (ii) **Dividends**

Large but legal dividends may be preferred by shareholders, but may affect bondholders as the payments leave low cash balances in the company and hence put at risk the company's ability to meet its commitment to the bondholders.
 - (iii) **Priority in Insolvency**

Bondholders may wish to take the company into liquidation if there are problems paying their interest to guarantee their investment. Shareholders, however, may wish the company to continue trading if they expect to receive nothing should the company go into liquidation.
 - (iv) **Attitude to further finance**

The shareholders may prefer that the company raised additional finance by means of loans in order to avoid having to contribute in a rights issue

or the risk of dilution of their shareholding and hence loss of power, if an open stock market issue is made. Bondholders may not favour the company taking on the burden of additional debt finance because it may increase the risk that the interest that are due will not be paid, or the company will have problems repaying their loans especially if the new loans rank above theirs.

(v) Restrictions imposed by bondholders to protect their loans, such as charges preventing the company from selling assets or covenants may limit the company's ability to maximize returns for shareholders.

(vi) **Bankruptcy costs**

If the costs of bankruptcy, such as receivers and lawyers' fees are likely to be significant, it may cause conflict.

EXAMINER'S REPORT

The question tests candidates' knowledge of the advantages and disadvantages of centralised and decentralised treasury management within multinational companies.

It also tests their understanding of agency theory in finance.

More than 80% of the candidates attempted the question but performance was very poor.

Candidate's commonest pitfall was their lack of indepth knowledge of this area of the syllabus.

Candidates are advised to always give consideration to all sections of the syllabus in their preparations for the Institutes examinations.

SOLUTION 7

(a) Calculation of potential loss of ~~₦~~840,000

Current spot rate is C\$40 = ~~₦~~1

Or ~~₦~~0.025 = C\$1

The depreciation rate of the C\$ against ~~₦~~ is given by

$$\frac{1 + R_D}{1 + R_F} - 1, \text{ where}$$

R_D = domestic interest rate = 0.05

R_F = foreign interest rate = 0.25

Thus:

$$\frac{1.05}{1.25} - 1 = -16\%$$

The expected exchange rate in one year's time will be

$$\text{C\$1} = \text{N0.025} \times 0.84 = \text{N0.021}$$

Value of the retention money

$$* \quad \text{Today} = \text{N}210,000,000 \times \text{N0.025} = \text{N}5,250,000$$

$$* \quad \text{In one year's time} = \text{N}210,000,000 \times \text{N0.21} = \text{N}4,410,000$$

$$\text{Exchange rate loss} \quad \text{N} \quad \underline{840,000}$$

Alternative solution to Q7(a)

Compute the 1 – year forward rate:

$$F = S_0 \times \left(\frac{1 + R_D}{1 + R_F} \right) \text{ where}$$

S_0 = current sport rate in terms of N per C\$

$$= 1/40 = 0.025$$

R_D = domestic risk free = 0.05

R_F = foreign risk free = 0.25

Thus:

$$F = 0.25 \times \left(\frac{1.05}{1.25} \right) = 0.021$$

* Potential loss is:

$$\text{N}210,000,000 \times (0.021 - 0.025) = \text{N}840,000$$

(b) **Money Market Hedge**

Since both payment and receipt occur in the same currency and at the same time, the amount to be hedged is the net (W\$750 – W\$450)m = W\$300m receipt.

The following steps are required to set up the hedge:

- (i) Since a foreign asset (i.e. net receivable) is involved, a corresponding liability should be created in the foreign country to match the maturity of the asset.
- (ii) Determine the amount of W\$ to borrow today at 10.5% p.a. that will grow to become W\$300m after 6 months. This is simply the PV of W\$300m i.e.

$$\text{W\$300m} \times \left(\frac{1}{1 + \frac{0.105}{2}} \right) = \text{W\$285.04m}$$

(Note: $\text{W\$300} \times \left(\frac{1}{1.105} \right)^{1/2} = \text{W\$285.39}$ should be fully rewarded)

The above amount is borrowed today

Convert the borrowed sum into ₦ at the spot rate of 1.4735 – the bank's buying rate to give

$$\text{W\$285.04} \times 1.4735 = \text{₦420.01m}$$

- (iii) Place the ₦420.01m in deposit in Nigeria at 13.25% p.a. for 6 months. This will grow to become:

$$\begin{aligned} & \text{₦420.01} \times \left(1 + \frac{0.1325}{2} \right) \\ &= \text{₦447.84m} \end{aligned}$$

- (iv) In 6 month's time, collect the net receivable of W\$300m and use it to offset the loans plus accumulated interest (totaling W\$300m)

Harvest your ₦ deposit of ₦447.84m

What the money market hedge has done is to convert the foreign asset to domestic asset thereby eliminating the foreign exchange risk.

(c) Advantages of Forward Exchange Contract

- (i) Eliminates currency risk as foreign exchange costs are determined upfront
- (ii) Establishes contracts to match organisations' cash flows
- (iii) Sets up delivery dates to match cash flows
- (iv) Secures a contract in any freely convertible currency
- (v) Ensures market liquidity up to two years into the future in most cases

Disadvantages

- (i) There is no immediate obligation. As time moves forward, the forward price for delivery on the original date of the contract may change
- (ii) Forward contracts can acquire value and become a liability for one party and an asset of another
- (iii) Because no money changes hands at the time of making the contract, the risk of default is even higher, as the seller may not deliver the product at the agreed price or the buyer may not pay the agreed price.
- (iv) Forward contracts involve buying a product, unseen. The problem is that physical characteristics of the product can vary.

EXAMINER'S REPORT

The question tests candidates' knowledge of foreign exchange risk management

Less than 20% of the candidates attempted the question and performance was poor.

Candidates commonest pitfalls were their

- inability to make use of the correct formulae when computing forward rate/rate of depreciation of the foreign currency,
- inability to distinguish between direct quote and indirect quote,
- lack of knowledge of bid-offer rates and
- failure to net expected payment against expected receipt in the same currency and at the same time.

Candidates are advised to cover the syllabus adequately, work on past questions, improve their knowledge of foreign exchange transactions and also endeavour to remember and interpret formulae appropriately for better result in future.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA
PROFESSIONAL LEVEL EXAMINATION - NOVEMBER 2014
ADVANCED AUDIT AND ASSURANCE

Time Allowed: 3 hours

SECTION A: **COMPULSORY QUESTION** **(30 Marks)**
QUESTION 1

Wasp Ltd

You are an audit manager in Ruby & Co, a firm of Chartered Accountants. One of your audit clients Wasp Ltd. provides satellite broadcasting services in a rapidly growing market.

In February 2014 Wasp Ltd purchased Xstatic Ltd, a competitor group of companies. Significant revenue, cost and capital expenditure synergies are expected as the operations of Wasp Ltd and Xstatic Ltd. are being combined into one group of companies.

The following financial and operating information consolidates the results of the enlarged Wasp Ltd. group:

	Year-end 31 December	
	2014	2013
	(Budget) ₦'m	(Actual) ₦'m
Revenue	6,827	4,404
Cost of sales	(3,109)	(1,991)
Distribution costs and administrative expenses	(2,866)	(1,700)
Research and development costs	(25)	(22)
Depreciation and amortization	(927)	(661)
Interest expense	(266)	(202)
Loss before tax	(366)	(172)
Number of subscribers	14.9m	7.6m
Average revenue per subscribers (ARPS)	₦437	₦556

In November 2014 Wasp Ltd. purchased MTbox Ltd. a large cable communications provider in Gambia, where your firm has no representation. The financial statements of MTbox Ltd. for the year ending 31 December 2014 will continue to be audited by a local firm of Chartered Accountants. MTbox Ltd's activities have not been reflected in the above estimated results of the group. Wasp Ltd. is committed to introducing its corporate image into Gambia.

In order to sustain growth, significant costs are expected to be incurred as operations are expanded, networks upgraded and new products and services introduced.

Required:

- a. Identify and describe the principal business risks for the Wasp group.
(9 Marks)
 - b. Explain what effect the acquisitions will have on the planning of Ruby & Co's audit of the budgeted consolidated financial statements of Wasp Ltd. group for the year ending 31 December 2014.
(10 Marks)
 - c. Explain the role of a Letter of Comfort as an evidence in the audit of financial statements.
(6 Marks)
 - d. Discuss how non-consolidated entities under common control affect the scope of an audit and the audit work undertaken.
(5 Marks)
- (Total 30 Marks)**

SECTION B: ATTEMPT ANY TWO OUT OF THREE QUESTIONS (40 Marks)

QUESTION 2

SMP Accountants

You have just joined the partnership of a small firm of Chartered Accountants SMP Accountants & Partners and have been asked to prepare a communication brief for distribution to all staff which will then be followed by a presentation with a question and answer session. The communication brief required is regarding quality control procedures and audit working papers.

ISA 220 requires quality control procedures to be implemented at the engagement level and ISQC 1 requires them to be implemented at the level of the audit firm. The partners are concerned that the firm's quality control procedures may not be

satisfactory as they have never been reviewed since they were first implemented five years ago. In addition, staff are able to read the policies and procedures in the staff manual. There are currently no other ways in which the information is communicated to them.

Required:

- a. Prepare a communication brief for distribution to all staff which sets out:
 - i. why quality control policies and procedures are necessary
 - ii. the areas that should be covered by quality control policies
 - iii. procedures that would be required to ensure that the policies are met.

(12 Marks)
- b. Answer the following queries which were asked at the question and answer session.
 - i. What is the difference between a hot review and a cold review and why are both necessary?
 - ii. Why is it so important that all audit reasons and justifications are documented in the working papers when it should be obvious from test results what the key issues are?
 - iii. Why do audit working papers have to be standardised since this inhibits auditors exercising their skills and experience in the most effective way?

(8 Marks)
(Total 20 Marks)

QUESTION 3

Woes Limited

You are responsible for the audit of Woes Limited for the year-ended 31 December 2013. The principal activity of Woes Ltd is the provision of high quality packaging services for manufacturing companies. The company was established 3 years ago and has significantly exceeded its growth targets in each of those years.

Historically, the packaging process was labour intensive but in September 2013, in an effort to reduce labour costs and increase efficiency, the company invested in an enhanced automated packing system. The investment was funded by a loan repayable in monthly instalments over four years. The loan covenant agreement includes a term specifying that the company's debt: equity ratio should not exceed 1:1.

A comparison of the draft accounts for the year ended 31 December 2013 with the previous year indicates a significant increase in revenue with a small increase in profit. The company is currently trading in excess of its overdraft limit and is negotiating an increase in its facility with the bank. Management has prepared, in support of its negotiations, profit and cash flow forecasts based on the assumptions that the anticipated increase in efficiency including reduction in labour costs will be achieved.

The company struggles to meet the weekly wage bill and has fallen behind in its payments to the tax authorities. It has also failed to comply with the terms of the lease in respect of the factory premises and has not paid the last 3 months' instalments.

Required:

- a. Identify and explain, from the information provided above, factors which indicate that Woes Ltd may not be a going concern. (10 Marks)
 - b. Outline the matters to which you would direct your attention in the period after the reporting date in order to determine whether Woes Ltd can continue as a going concern for the foreseeable future. (10 Marks)
- (Total 20 Marks)**

QUESTION 4

The Cinnamon Group

The Cinnamon Group is an international business, made up of ten subsidiaries and a head office. You are the manager in charge at the firm undertaking the group audit, but there are separate local auditors for the Cayenne subsidiary in the United States, the Habenaro subsidiary in Mexico and the Hybrid subsidiary in Columbia. You are aware of the following information:

- (i) Hybrid is a loss-making subsidiary, with losses at the current year end totalling ₦27 million. There are significant control problems, high level of bad debts and 25% staff turnover. The local auditors have already stated their intention to give a qualified opinion for the year just ended because of the material issues found.
- (ii) Cayenne is operating to a different financial year to that of the group as a whole, being October 2013 rather than December 2013.
- (iii) Shortly after the year end, in January 2014, the Cinnamon Group announced the sale of Habenaro for ₦250 million and this disposal is currently on-going.

- (iv) The Cinnamon Group is guaranteeing loans of approximately ₦100 million for its subsidiaries.

Required:

- a. Set out how you would plan and control the group audit of the Cinnamon Group. (5 Marks)
 - b. Consider the impact of each of the above issues on the group audit. (10 Marks)
 - c. Explain the nature of the relationship between your firm and the auditors of the subsidiaries, making particular reference to the extent to which your firm may rely on the component auditors' work and to the considerations involved where joint audits are conducted. (5 Marks)
- (Total 20 Marks)**

SECTION C: ATTEMPT ANY TWO OUT OF THREE QUESTIONS (30 Marks)

QUESTION 5

Green issues

Oil and Gas Limited is a company involved in the upstream petroleum activities in the Delta Region. The restiveness of the youth in this area of operation was a result of environmental degradation of the region. Your firm has just been appointed as the auditors to the company. During preliminary planning stage of the audit, you realised that the environmental issues could have impact on the financial statements.

Required:

- a. Enumerate **EIGHT** steps you would include in the audit process in order to highlight environmental issues that may be apparent in the client's business. (8 Marks)
 - b. Identify **SEVEN** major social issues that an auditor will be concerned with in a company's social policy report. (7 Marks)
- (Total 15 Marks)**

QUESTION 6

Lagos Leisure Ltd.

You are the senior audit manager for a medium sized firm of accountants. Your firm has just lost two clients which have gone into receivership and has now been invited to tender for the audit of Lagos Leisure Ltd. The audit fees have been initially estimated at ₦200,000.

Lagos Leisure Ltd is a medium sized manufacturing organisation which has existed for 35 years and has generally made consistent profits. However, in the last two years, profits have fallen by approximately 10% in each year, although the market sector in which Lagos Leisure Ltd operates is expanding. The company has also stated that they would like some consultancy support regarding business strategy in order to try and reverse the current profit downturn, and have set aside ₦1m for this.

You have ascertained the following from a brief discussion with the Managing Director:

- (i) There has been no investment in non-current assets in the last 10 years. The company was intending to start a program of investment two years ago but this was cancelled due to the reduced profits, and maintenance and repair costs have increased significantly over the last year.
- (ii) Staff remuneration has been frozen, and there has been some discussion with unions as staff morale is very low and several staff have already left. So far, industrial action has been avoided.
- (iii) The Financial Director was dismissed three months ago, and hasn't been replaced; he is currently suing Lagos Leisure Ltd for unfair dismissal.
- (iv) The Managing Director is due to retire next year; a replacement has not yet been considered.
- (v) There is an outstanding litigation as an employee is suing Lagos Leisure Ltd due to an accident whilst in the workplace, and the authorities have written a detailed report about the case.

Your firm's total fee income last year was ₦7m, including ₦500,000 from the lost clients.

Required:

Prepare a document for discussion with the partners covering the following:

- a. The advantages and disadvantages of tendering for the audit of Lagos Leisure Ltd, highlighting any key risks to your firm. (7 Marks)

- b. Although the initial estimate of the audit fee was ₦200,000, further work needs to be done before a figure could be included in the tender document. List the factors which should be taken into account when calculating this fee. (4 Marks)

- c. An outline of the matters which should be included in the tender document if the firm decides to tender. (4 Marks)

(Total 15 Marks)

QUESTION 7

CAATs

The availability of Computer Assisted Audit Techniques (CAATs) should be considered by auditors when planning the nature, extent and timing of tests in an audit. Auditors must determine their testing strategies which will depend on their choice of either using a manual testing method or computer assisted method.

Required:

- a. Explain **FIVE** factors that will determine auditors' choice of method of testing in the planning of audit in a computer environment. (10 Marks)

- b. Identify **FIVE** solutions to **loss of audit trail**. (5 Marks)

(Total 15 Marks)

SECTION A:

SOLUTION 1

1. Wasp Ltd

(a) Principal business risks

Tutorial note: The requirement to 'identify and describe' suggests that although marks will be awarded for the mere identification of risks from the scenario, those risks must be described (as illustrated below).

i. Development in the industry

- ❑ Possibility of leakages whereby unauthorised users will have access to services.
- ❑ Rapid and new technological developments in the industry, provides faster data transmission. Increasing interactive capabilities will render certain existing products and services obsolete.
- ❑ Wasp Ltd cannot predict how emerging and future technologies (e.g. 'Bluetooth') will affect demand for its services.
- ❑ Billing and collection methods may be cumbersome.

ii. Competition

- ❑ Although Wasp Ltd. may have reduced competition in the short-term by having acquired a competitor, the communications market is still expanding. Increasing competition from other existing and new competitors offering new technologies could:
 - affect Wasp Ltd. ability to attract and retain customers
 - reduce Wasp Ltd. share of new and existing customers
 - force Wasp Ltd. to reduce prices.
- ❑ The cost and revenue-generating capabilities of new technologies tend to fall significantly and relatively quickly (e.g. mobile phone technology is available in disposable form).

iii. Integration

- ❑ Combining two groups which have previously operated independently and competitively against each other, is likely to result in disruption of operations and services.
- ❑ Potential difficulties may be encountered in seeking to retain customers and key personnel.
- ❑ The anticipated 'significant synergies' in revenue, cost and capital expenditure may have been optimistic. If they do not

materialise to the extent predicted, Wasp Ltd. operational activities, financial condition and future prospects are likely to be adversely affected.

- ❑ Wasp Ltd may have difficulty in adapting its corporate image to the culture of the Gambia's network.

iv. Operating losses

- ❑ Loss before tax has more than doubled (increased by 113%). If Xstatic Ltd. was making significant losses before it was acquired by Wasp Ltd. those losses may have been expected to continue in the short-term. Although the group's operations are being combined and synergies are expected, recurring losses will clearly threaten the new group's operational existence as a going concern.

v. Falling Average Revenue Per Subscriber (ARPS)

- ❑ ARPS, a key performance indicator, has fallen by more than 20% $(437-556)/556 = -21.4\%$. This is likely to reflect falling tariffs in a competitive market.
- ❑ Although the number of subscribers has nearly doubled revenue has increased by only 55%. It seems unlikely that such a growth in subscriber base can be maintained, therefore the reduction in tariffs and call rate could result in falling revenues.
- ❑ Part of the growth is due to the acquisition of Xstatic Ltd. The fall in ARPS may indicate that Xstatic Ltd. ARPS is substantially less than that of Wasp Ltd. If Xstatic Ltd. tariffs were lower than Wasp Ltd. because it was offering a lower quality of service, it may be difficult for Wasp Ltd. to increase its tariff.

vi. Sustaining growth

- ❑ Growth may not be sustainable as further expansion will incur significant costs and investment which must be financed.
- ❑ The significant costs expected to be incurred in upgrading networks may not be recouped if additional revenues are insufficient. Failure to maintain existing networks is likely to result in a loss of market share.
- ❑ If Wasp Ltd. financial resources are insufficient to meet the operating losses, it may need to issue equity and/or increase its debt. Possible adverse consequences of increasing indebtedness include:
 - high debt-service costs;

- Tutorial note: Although there are relatively explicit pointers to the above business risks in the scenario, marks will also be awarded for other risks which are perhaps more implicit as illustrated below.*

Operations have been expanded to Gambia. Wasp Ltd. inexperience of economic and legal developments in Gambia may affect the investment in MTbox Ltd.

- Wasp Ltd. transacts business in a foreign country and foreign exchange rate fluctuations could have a material effect on operating results.

- ❑ Network operations could be adversely affected by changes in the laws, regulations or government policies which regulate the industry.
- ❑ Difficulties in obtaining approvals for the erection and operation of transmitters could have an adverse effect on the extent, quality and capacity of Wasp Ltd. network coverage.
- ❑ Allegations of health risks associated with radio waves from transmitter masts and mobile handsets could reduce subscriber demand and increase exposure to potential litigation.

Tutorial note: Candidates are not expected to have knowledge of industry-related complexities (e.g. of licensing, subsidies and network credit recharging - however, appropriate marks would be awarded for comments on such business risks arising.

Tutorial note: Note that the context here is that of the group auditor's planning of a group audit.

The new group structure must be ascertained to identify the entities that should be consolidated into the group budgeted financial statements of Wasp Ltd for the year ending 31 December 2014.

ii. **Materiality assessment**

Preliminary materiality will be much higher, in monetary terms, than in the prior year. For example, if a percentage of revenue is a determinant of preliminary materiality, it will increase by 55% based on estimate.

Tutorial note: 'Profit' is not a suitable criterion as group is loss-making.

The materiality of each subsidiary should be assessed, in terms of the enlarged group as at the planning stage. For example, any subsidiary contributing more than 10% of the group's assets and revenue, is material while less than 5% is not. This will identify, for example:

- ❑ Those entities which will require Ruby & Co. to understand the work of component auditors and possibly have some involvement in their work
- ❑ Those for which analytical procedures may suffice.

If MTbox Ltd is a significant component to the group, Ruby & Co. must, as a minimum:

- ❑ Discuss MTbox Ltd. significant business activities with its management/auditors
- ❑ Confer with MTbox Ltd. auditors the risk of material misstatement of MTbox Ltd financial information;
- ❑ Review MTbox Ltd. auditors' documentation of identified significant risks of material misstatement of the group financial statements; and
- ❑ Evaluate the report of the work performed by MTbox's auditors.

iii. **Goodwill arising**

The audit plan should draw attention to the need to audit the amount of goodwill arising on the acquisitions and management's impairment test at the end of the reporting period.

The assets and liabilities of Xstatic Ltd and MTbox Ltd, at fair value to the group, will be combined on a line-by-line basis and any goodwill arising recognised.

The calculation of the amount attributed to goodwill must be agreed to be the excess of the cost of the acquisition over the fair value of the identifiable assets and liabilities existing at the date of acquisition (Xstatic Ltd - February 2014, MTbox Ltd - November 2014).

Significant non-current assets such as properties are likely to have been independently valued prior to the acquisition. It may be appropriate at the planning stage to identify the need to place reliance on the work of quantity surveyors and other valuers.

iv. **Group transactions and balances**

A list of all the companies in the group should be included in group audit instructions to ensure that intra-group transactions and balances and any unrealised profits and losses on transactions with associated companies are identified for elimination on consolidation.

It should be confirmed at the planning stage that inter-company transactions are identified as such in the accounting systems of all Wasp Ltd group companies and that inter-company balances are regularly reconciled. Problems are likely to arise if new intercompany balances are not identified/reconciled. In particular, exchange differences are to be expected.

v. **Analytical procedures**

Having brought in the operations of a group of companies with similar activities may extend the scope of analytical procedures available. This could have the effect of increasing audit efficiency.

vi. **MTbox Ltd income statement/statement of comprehensive income**

The effective date of the acquisition of MTbox Ltd may be so late in the financial year that it is possible that its post-acquisition results are not material to the consolidated income statement/statement of comprehensive income.

vii. **Component auditors**

Component auditors will include:

- ☐ Any affiliates of Ruby & Co. in any of the countries in which Wasp Ltd operates; and
- ☐ unrelated auditors

Ruby & Co. will plan to use the work of MTbox Ltd auditors who are appropriately recognised. Their competence and independence should be assessed through information obtained from a questionnaire and evidence of their work.

A letter of introduction should be sent to the unrelated auditors, with Wasp Ltd. permission, as soon as possible if not already done requesting their co-operation in providing specified information within a given timescale.

Group instructions will need to be sent to affiliated and unrelated auditors containing:

- ☐ proforma statements;
- ☐ a list of group and associated companies;
- ☐ a statement of group accounting policies
- ☐ the timetable for the preparation of the group accounts

- ❑ a request for copies of management letters;
- ❑ an audit work summary questionnaire or checklist;
- ❑ contact details of senior members of Ruby & Co. audit team.

viii. **Accounting policies (Xstatic Ltd & MTbox Ltd.)**

It is likely that Xstatic Ltd has the same accounting policies as Wasp Ltd. because, as a competitor, it operates in the same jurisdictions MTbox Ltd. may have material accounting policies which do not comply with the rest of the group. Ruby & Co. may request that MTbox Ltd. auditors calculate the effect of any non-compliance with a group accounting policy for adjustment on consolidation.

ix. **Timetable**

The timetable for the preparation of Wasp Ltd group budgeted consolidated financial statements should be agreed with management as soon as possible. Key dates should be planned for:

- ❑ Submission of management financial statements to Ruby & Co.;
- ❑ Agreement of inter-company balances and transactions;
- ❑ Completion of the consolidation package;
- ❑ Tax review of group accounts;
- ❑ Completion of audit fieldwork by other auditors ;
- ❑ Subsequent events review;
2
- ❑ Final clearance on accounts of subsidiaries;
- ❑ Ruby & Co. final clearance of budgeted consolidated financial statements.

Tutorial note: The order of dates is illustrative rather than prescriptive.

(c) **Letter of Comfort**

Consolidated financial statements are prepared on a going concern basis when a group, as a single entity, is considered to be a going concern. However, the going concern basis may only be appropriate for certain separate legal entities (e.g. subsidiaries) because the parent undertaking (or a fellow subsidiary) is able and willing to provide support. Many banks routinely require a letter of reassurance from a parent company stating that the parent would financially or otherwise support a subsidiary with cash flow or other operational problems.

The roles as audit evidence will include:

- ❑ A formal confirmation of the support will be sought in the form of a letter of support or 'comfort letter' confirming the parent company's intention to keep the subsidiary in operational existence or otherwise meet its obligations as they fall due.
- ❑ The Letter of Comfort should normally be approved by a board minute of the parent company or by an individual with authority granted by a board minute.
- ❑ The ability of the parent to support the company should also be confirmed, for example, by examining the group's cash flow forecast.
- ❑ The period of support may be limited to one year from the date of the letter or until the date of disposal of the subsidiary. Sufficient other evidence concerning the appropriateness of the going concern assumption must therefore be obtained where a later repayment of material debts is foreseen.
- ❑ The fact of support and the period to which it is restricted should be noted in the financial statements of the subsidiary.

(d) Non-Consolidated Entities

In general, the scope of a statutory audit should be as necessary to form an audit opinion and the nature, timing and extent of audit procedures should be as necessary to implement the overall audit plan.

Non Consolidated of entities under common control were a significant feature of the Enron and Parmalat business empires. Such business empires increase audit risk as fraud is often disguised through labyrinthine group structures. Hence the auditors need to understand and confirm the economic purpose of entities within business empires as well as special purpose entities (SPEs) and non-trading entities.

Non-Consolidated entities fall outside the requirement for the preparation of group accounts so it is not only finance that is off-statement of financial position when controlled entities are excluded from consolidated financial statements.

In the absence of consolidated financial statements, users of accounts of Non-Consolidated entities have to rely on the disclosure of related party transactions and control relationships for information about transactions and arrangements with other group entities. Difficulties faced by auditors include:

- ❑ Failing to detect related party transactions and control relationships;
- ❑ Not understanding the substance of transactions with entities under common control;
- ❑ Excessive creative tax planning;

- ❑ The implications of transfer pricing e.g. failure to identify profits unrealised at the business empire level;
- ❑ A lack of access to relevant confidential information held by others;
- ❑ Relying on representations made in good faith by those whom the auditors believe manage the company when control rests elsewhere.

Audit work is inevitably increased if an auditor is put on enquiry to investigate dubious transactions and arrangements. However, the complexity of business empires across multiple jurisdictions with different auditors may deter auditors from liaising with other auditors especially where legal or professional confidentiality considerations prevent this.

EXAMINER'S REPORT

The question tests candidates' understanding in identifying business risks in a given scenario and how to plan an audit of consolidated financial statements.

Being a compulsory question, all candidates attempted the question; but performance was very poor.

The commonest pitfall of the candidates was the lack of understanding of the question which led them to proffer irrelevant solutions.

Candidates are enjoined to prepare adequately for future examinations.

SECTION B:
SOLUTION 2

SMP ACCOUNTANTS & PARTNERS

INTERNAL MEMO

To: All employees
From: New partner
Date: 19 November 2014
Subject: Communication brief on quality control

Please find details below regarding the subject of quality control policies and procedures. I will shortly be arranging a time for a presentation to be followed by a staff question and answer session.

(i) Why quality control policies and procedures are necessary

ISA 220 (Quality control for an audit of financial statements) requires that all firms implement quality control policies and procedures at the engagement level. ISQC 1 (Quality control for firms that perform audits and reviews of financial statements and other assurance and related services engagements) requires all firms to implement quality control policies at the firm's level. It is therefore clear that the audit profession as a whole perceives such policies and procedures to be necessary. The key reasons for this are set out below.

Whenever an audit assignment is performed by a firm, there are several risks which it is exposed to such as performing work negligently such that the client or indeed a third party suffers a loss as a result. This could have an adverse effect on the audit firm, its reputation could suffer consequently both the income from that client and potential clients may be lost due to the loss of the client.

Another risk that could arise if there were insufficient/inadequate quality control procedures is that an audit report may be qualified when in fact it should not be.

Such risks should be avoided by any firm and therefore proper management of quality control within our firm is vital.

(ii) Areas that should be covered by quality control policies

- ❑ **Professional requirements for all personnel** - It should be ensured that all staff adhere to ICAN's principles of independence, integrity, confidentiality and professional behaviour.

- ❑ **Skills and competence of all staff** - All staff should be either fully qualified or trained for the work that they are performing, and a system should be in place to ensure that knowledge is kept up to date.
- ❑ **Acceptance and retention of clients** - The firm should ensure that it is able to perform the audit i.e. that it has the necessary capacity and skills, would be able to remain independent, and that the client's directors and management are trustworthy and have integrity.
- ❑ **Assignment of personnel to the audit** - Appropriate staff must be assigned to each audit i.e. they must have the relevant skills and experience to perform the work.
- ❑ **Delegation of work to staff undertaking the audit** - All work that is delegated must be performed to satisfactory standards and meet quality control criteria. Adequate direction, supervision and review should exist throughout all stages of the audit.
- ❑ **Consultation** - There should be consultation within the firm with other audit managers or partners on subjective audit issues; in addition, where necessary, consultation with external bodies/individuals on specialist issues should also be conducted.
- ❑ **Monitoring quality control policies** - An important part of any quality control system is to ensure that such policies stay relevant and are sufficient. An effective and appropriate system should be in place. For audits of listed companies an engagement quality control review must also be carried out by a reviewer independent of that engagement.

(iii) **Procedures required to ensure that quality control policies are met**

An outline of the procedures that would be required within SMP Accountants & Partners to ensure that quality control policies are met is detailed below. These will be expanded and refined following discussions within the firm:

- ❑ **Division of staff** - Current job titles will be reviewed for all staff to ensure that these are still meaningful and accurate, and properly represent the duties undertaken by each individual. The organisation chart will be updated and copies issued to all staff and included within the staff manual. This will ensure that there are no misunderstandings regarding any individual's reporting lines.
- ❑ **Training of staff** - A training course will be devised to ensure that all staff understand and are familiar with the firm's quality control procedures. These procedures will be documented and will form part of the induction process for all new members of

staff. Ongoing training methods will also be devised to ensure that all staff are kept up to date with current issues.

- ❑ **Ethical requirements** - Independence requirements should be communicated to all staff and they should be required to notify the firm of any circumstances or relationships that might cause a breach.
- ❑ **Acceptance and retention of clients** - There should be a system in place which ensures that prior to accepting any new client, and when reviewing all existing clients' circumstances, all such relevant factors are considered.
- ❑ **Working papers** - These will be standardised to ensure that all the work that is required for each part of the audit is complete and documented. It should also ensure that work is properly reviewed at the appropriate level at the required stages in the audit.
- ❑ **Consultation** - Any issues that arise during the course of the audit which are subjective and/or contentious should be discussed with a senior member of staff, or, where necessary, discussed with an approved specialist outside of the firm.
- ❑ **Proper/effective recruitment and retention policies and procedures** - To ensure that the right personnel are selected for the right job, and that such staff are retained within the firm.
- ❑ **Monitoring of quality control policies** - A monitoring process should be established to check that the quality control system is operating effectively. This should include inspecting, on a cyclical basis, at least one completed engagement for each engagement partner.

(b) **Queries from the question and answer session**

(i) **Difference between a hot review and a cold review**

A **hot review** is a review of working papers that is performed by a more senior member of staff during the course of the audit, and is usually performed soon after the work is completed. The reviewer will indicate that he has performed the review by dating and initialling the piece of work. The review should ensure that the work has been performed in line with the audit programme and that the conclusions are consistent with the results obtained.

A **cold review**, on the other hand, is one that is performed at the end of the audit - usually by the audit manager or partner. This will be done before the audit report is signed off and will comprise a review of the whole file together with the financial statements. The purpose of this review is to ensure that the audit work has been fully completed and

that the results and conclusions for the entire audit are consistent.

(ii) Why all audit reasons and justifications need to be documented in the audit working papers

All audit reasons and justifications need to be documented in the audit working papers because those working papers need to be sufficiently detailed and complete to enable an auditor with no previous experience of the audit to establish what work has been completed and how the conclusions were reached. This would become especially important if the auditors had to give evidence in a court of law regarding the audit. It should also be clear from the documentation in the file that the auditors' conclusions are reasonable.

(iii) Reasons for standardised audit working papers

The standardisation of audit working papers ensures that work is performed consistently across audits, and that the evidence that is necessary for each piece of work is always obtained. However, the working papers should not be so rigid that they inhibit the auditors' skills and flair, as these are the factors that make the difference between a good and a bad auditor. Auditors should always be looking for anything unusual when performing their work and if any such issues are identified then they should be put on notice and 'dig deeper'. Any such instances should never be ignored just because such work is not part of the standard programme. Auditors must be flexible in their approach, and use their initiative.

EXAMINER'S REPORT

The question tests candidates' understanding of the need for quality control in an audit firm and the difference between HOT and COLD review. It also tests their knowledge of the need to standardize audit working papers.

About 80% of the candidates attempted the question and performance was poor.

The commonest pitfall was the candidates' mis-interpretation of working papers for audit program.

Candidates should read and interpret questions properly before attempting to answer them.

SOLUTION 3

3. Woes Limited

(a) Factors that indicate that Woes Limited may not be a going concern include:

- ☐ Exceeding growth targets
 - Overtrading may cause cash constraints
 - Working capital may be limited
- ☐ Loan agreement terms
 - May not be able to meet instalments
 - May not comply with terms of covenant
- ☐ Trading in excess of overdraft
 - Increase in facility may not be granted
- ☐ Overdue tax liabilities
 - Tax authorities may call for payments
- ☐ Cash shortage may cause suppliers to press for payment
 - May seek settlement through the courts
- ☐ Overdue rent
 - Risk of eviction by the landlord.
- ☐ Unpaid Salaries
 - May lead to labour unrest
 - Reduced productivity
 - Increase in labour turnover

(b) Matters to direct attention in order to determine whether Woes Ltd can continue as a going concern include:

- ☐ Review profit forecasts
- ☐ Examine cash flow forecasts
 - Inflows for probability of realisation
 - Outflows for reasonableness
- ☐ Consider the quality of the accounting systems for the forecasts
- ☐ Assess the assumptions made in the forecasts
- ☐ Review payback dates for all cash outflows
- ☐ Perform sensitivity analysis on all components

- ❑ Review actual cash flows after the end of the reporting period in order to assess the accuracy of the forecasts
- ❑ Are loan instalments up to date?
- ❑ Review the post year-end trading and its impact on the cash flow
- ❑ Obtain and review management rescue plans and ensure that they are consistent with facts already known to the auditor.
- ❑ Compare clients' position with similar companies in the same business.
- ❑ Where financial assistance is to be given by banks and other sister companies, review the degrees of their commitment.
- ❑ Check correspondence with creditors so as to ensure that pressure is not being mounted by creditors.
- ❑ Ask the directors for their opinion and consider whether their plans are realistic.
- ❑ Obtain a management representation for the going concern basis.
- ❑ Consider factoring of trade receivables.
- ❑ Assess the Net Realisable Value of inventory.
- ❑ Inspect correspondence with tax authorities.
- ❑ Examine the minutes of meeting of the directors and management.

EXAMINER'S REPORT

The question tests candidates' knowledge on issues relating to going concern of a business entity.

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

The commonest pitfalls of candidates were writing solutions relating to part (a) for part (b), and repeating same points over and over again in different words.

Candidates are advised to prepare adequately for future examinations.

SOLUTION 4

4. The Cinnamon Group

(a) Approach to planning and controlling the group audit

Planning the group audit will involve:

- ☐ Obtaining the instructions issued by head office for the preparation of the group's financial statements.
- ☐ Obtaining the timetable for the production of the individual financial statements and the group financial statements.
- ☐ Ensuring that there is a standard format and layout of subsidiary financial statements to facilitate consolidation.
- ☐ Determining audit staffing and skills required.
- ☐ Liaising with component auditors of subsidiaries.
- ☐ Considering potential problems that may arise, for example with Hybrid.
- ☐ Evaluating the risks arising from the group relative to the subsidiaries.
- ☐ Considering any additional procedures that may be required for subsidiaries being audited by component auditors.
- ☐ Assessing whether materiality levels are acceptable.
- ☐ Using questionnaires for the subsidiaries to establish accounting policies, accounting details needed for consolidation but not available from the accounts and information relevant for group accounts but not for subsidiaries' own accounts.

Controlling

The group audit will be subject to the same control and quality checks as any other audit, including maintenance of documented files with auditors' decisions, file review, supervision and discussion with management. Effective planning, allocation of staff and review procedures for group audits are all important elements of control.

(b) Impact of each issue on the group audit

(i) Hybrid

If Hybrid continues to make losses, the directors of Cinnamon may consider it to be an impairment in the value of the holding company's investments. If that is the case, the auditors will need to confirm that any write-down is adequate by examining:

- ☐ The extent of support to Hybrid by Cinnamon - what element of the ₦100 million guarantees relates to Hybrid

- ❑ Hybrid's cash flow projections
- ❑ The extent of disclosure of guarantees in Cinnamon's financial statements.

There are clearly material problems for the subsidiary itself but consideration needs to be made as to whether these issues are also material to the group as a whole and whether the subsidiary control problems are symptomatic of a wider problem.

If the issues are material to the group, then the impact on the audit report will need to be considered.

(ii) Cayenne

Cayenne's year-end precedes that of the group by two months and therefore figures used for this subsidiary will either be estimated or out-of date in the group financial statements.

IAS 27 *Consolidated and separate financial statements* requires the consolidated financial statements to be prepared as at the same reporting date. Therefore, Cayenne should be made to prepare additional financial statements as at the group year-end – unless it is impracticable to do so.

If it is impracticable, provided the difference is no more than three months (as is the case here), the October 2014 financial statements may be used provided adjustments are made for any significant transactions or events occurring in November and December. The auditor will need to consider whether any such adjustments need to be and have been made.

(iii) Habenaro

As the announcement was not made until after the year end, this is a non-adjusting subsequent event that will have a significant impact on the group statement of financial position. The auditor will need to ensure adequate disclosure in the financial statements.

(iv) Guarantees

These loans are an important liability for Cinnamon Group and the auditors will need to ensure that there is appropriate disclosure in the financial statements.

(c) Relationship with component auditors

The group auditors have overall responsibility for expressing an opinion on the group financial statements and therefore need to confirm that they are satisfied with the work undertaken by the subsidiary auditors, referred to by ISA 600 as 'component auditors' where they are not also the group auditors.

In reviewing the work of the component auditors, the group auditors need to confirm the following:

- ❑ That all significant risks of material misstatement of the group financial statements have been addressed in the audit of the components.
- ❑ Whether there are any reasons why they cannot rely on the work of the component auditors for example, a lack of competence, independence, or local regulation of auditors.
- ❑ The materiality of the issues raised in the component financial statements in relation to the group materiality level in particular Hybrid, which seems to be of most significant concern.

If a joint audit is to be undertaken, then it is important that the scope and responsibilities are agreed and documented. This will involve a preliminary meeting to agree approach, timing, staffing, responsibilities and working papers.

EXAMINER'S REPORT

The question tests candidates' knowledge in respect of planning and control of group accounts audits.

Less than 50% of candidates attempted the question and performance was poor.

The commonest pitfall of candidates was lack of understanding of the question.

Planning and control of Audits are important elements of Auditing. Candidates at this level are expected to be well versed with this area of the syllabus.

SECTION C:

SOLUTION 5

Green issues

- (a) Steps in the audit process which will highlight environmental issues are as follows:
 - (i) Review of environmental impact analysis report.
 - (ii) Evaluation of possible risk of misstatements in the financial statements.
 - (iii) Controls which are in place to identify risk should be looked into.
 - (iv) Have an understanding of environment operations and issues.
 - (v) Obtain written representation from management on any environmental matters.
 - (vi) Obtain evidence from environmental experts where necessary.
 - (vii) Seek corroborative evidence of any statements by management.
 - (viii) Consider minutes of directors, board committees or environmental officers' meetings.
 - (ix) Confirm compliance with laws, regulations and standards.
 - (x) Review contingencies and ensure adequate disclosure.
 - (xi) Include environmental issues in the review of the appropriateness of going concern.
 - (xii) Use professional judgment to consider whether the evidence in relation to environmental matters is sufficiently persuasive.
 - (xiii) Prepare a checklist of guidelines and standards to be complied with.
- (b) The auditor will need to know what the company has been doing or intends to do in respect of its social policy. The auditor should consider the following:
 - (i) Confirm that human rights are not violated.
 - (ii) Consider restiveness of stakeholders.
 - (iii) Review the health, safety and environmental policy and procedures.
 - (iv) Evaluate and report on environmental performance of the company.
 - (v) Look into the corporate social responsibility performance of the company.
 - (vi) Look into the economic empowerment of members of host community by the company.

- (vii) Assess the development of host community.
- (viii) Assess charitable donations made by the company.
- (ix) Verify that child labour is not practised by the company.

EXAMINER'S REPORT

The question tests candidates' knowledge on environmental issues in the audit of an entity.

About 60% of candidates attempted the question and performance was poor.

The commonest pitfall exhibited by candidates was their inability to address steps in audit process to highlight environmental issues.

Candidates are enjoined to cover this area of the syllabus adequately since this has become very important in the audit of entities.

SOLUTION 6

6. Lagos Leisure Ltd

(a) Advantages and disadvantages of tendering for the audit

A number of issues require careful consideration before deciding whether or not to tender for the audit.

Advantages

- ❑ Increased fees - this would be especially advantageous as the audit firm has recently lost two clients.
- ❑ There is the possibility of additional work (i.e. management consultancy) as well as the audit which would significantly increase the firm's overall fee income.

Disadvantages and attendant risks)

- ❑ Lagos Leisure Ltd is currently experiencing difficulties in respect of sales.
- ❑ The company has had staff morale problems which could make the audit more difficult as staff may be unwilling to co-operate with the auditors or may present an unbalanced view of circumstances due to their low morale.
- ❑ It has not invested in non-current assets recently. This has only compounded its current financial problems and will not help in

improving the outlook for the future and the company's long term viability, especially taking into account the other mitigating factors such as the retirement of the managing director, staff issues and pending litigation.

- ❑ There is a litigation currently outstanding from an employee regarding an accident in the workplace - the audit firm would have to ensure that this is correctly treated. Furthermore, the finance director is suing the company for unfair dismissal. Both of these litigations should put the audit firm on notice that the situation within the company is one which is far from ideal for taking over an audit.
- ❑ The audit firm should ascertain what has happened to the previous auditors i.e. did they resign, or were they removed from office - reasons for either of these situations should be ascertained. The previous auditors should be contacted for relevant information.
- ❑ The audit fee represents increased total fee income for the firm, this, together with the potential amount for the consultancy support, would mean that the total income from the company represented 18.5% of the firm's total fee income. The audit fees on their own represent 3% so clearly this is well within the recommended limit of 15%. However, because of the potential additional income, the audit firm would have to be aware of any independence issues, and take appropriate action including incorporating relevant safeguards to independence.
- ❑ A company search should be undertaken to confirm who is involved in the running of the company and a copy of the filed financial statements should be obtained.
- ❑ Discussions should be held with management and their lawyers regarding the litigation, as the outcome of the cases could have a significant impact on the profit for the year.
- ❑ If the tender is unsuccessful then all the work involved will have been wasted and this clearly has a cost implication to the audit firm.
- ❑ Background information regarding the industry as a whole and for the company specifically should also be obtained to ascertain whether or not expert assistance would be required and whether the audit firm has the relevant skills and experience to perform the audit.

(b) Factors to be taken into account when calculating the audit fee for inclusion in the tender document

- ❑ What work will be required to be performed for the audit? This depends on how complex the financial affairs are and whether or not the audit firm will be able to rely on the controls in existence. Although the latter will not be known until the audit work is started,

the firm may be able to get a feel for this from the initial information obtained. The tender should state this and make allowance for it.

- ❑ What is the fee for similar companies audited in respect of size, complexity and degree of risk?
- ❑ What the set up costs would be for the audit and then subsequent annual costs? The first audit will obviously take more time due to the systems documentation required.
- ❑ The number and calibre of staff that would be required for the audit.
- ❑ The fee charged must be able to be clearly analysed and explained.
- ❑ Whether or not the fee can be easily renegotiated at a later date?
- ❑ Ensure that the client is clear as to what is included in the audit fee and what would have to be paid for in addition if required.

(c) An outline of what should be included in the tender document if the audit firm decides to tender

- ❑ Details of the firm and its personnel who are likely to be used on the audit and for the management consultancy work.
- ❑ The audit methodology/approach to be used for the audit, together with how the management consultancy work would be approached.
- ❑ The nature, purpose and legal requirements of an audit.
- ❑ An assessment of the company's requirements for the audit and the management consultancy support.
- ❑ Details of how the audit firm will satisfy the requirements in respect of the audit and management consultancy support.
- ❑ Any assumptions made by the audit firm in preparing the tender e.g. work to be done by the company's staff.
- ❑ The fee and how it has been calculated.
- ❑ The other services that the audit firm can offer in addition to management consultancy.

EXAMINER'S REPORT

The question tests candidates understanding of tendering for an audit engagement.

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

The commonest pitfall shown by the candidates was lack of understanding of tendering requirements as they relate to audit engagement.

Candidates are advised to prepare adequately and cover the syllabus in details before registering for examinations.

SOLUTION 7

Computer Assisted Audit Techniques (CAAT)

(a) Auditors' choice of method of testing during the planning of audit in a computer environment will be determined by the following factors:

(i) **Practicability of performing audit tests manually:**

Many computer based accounting systems perform functions for which no visible evidence is available. In this regard, it will not be advisable for the auditor to use manual testing method.

(ii) **Time availability:**

Generally, since the auditor has to report within a short time scale, he may choose to use CAAT as they are quicker to apply, even though manual methods may be more practical and cheaper.

(iii) **Computer facilities availability:**

When using CAAT auditors will need to ensure that the required data, computer files and programs are available;

(iv) **Expertise and experience:**

Auditors will require at least a basic understanding of the fundamentals of computer processes because they are using the computer to assist them in performing the audit tests before contemplating using CAAT.

(v) **Reliance on internal audit functions:**

Where CAAT is used by a suitably trained internal auditor, it may be of significant assistance. The extent to which the external auditors are able to reduce the level of tests by taking account of computer audit techniques performed by the internal auditor will depend on their assessment of the independence and effectiveness of the internal audit function.

(vi) **Volume of clients' business:**

It is not worthwhile to use CAAT where the volume of transactions is small.

(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 report.

- (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.

EXAMINER'S REPORT

The question tests candidates' understanding of audit in a computer environment.

About 60% of candidates attempted the question and performance was poor.

The commonest pitfall by candidates was lack of knowledge in computer audit environment.

Candidates are enjoined to cover the syllabus adequately and read relevant study materials especially because modern day business environment is being computerized.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA
PROFESSIONAL LEVEL EXAMINATION - NOVEMBER 2014

CASE STUDY

Time Allowed: 4 hours

PAGO INVESTMENTS LIMITED

Requirement

You are Maja Opara, a recently qualified Chartered Accountant. You have just been elevated to the post of Qualified Audit Senior with the firm of Dago & Co., Chartered Accountants.

One of the firm's Client Service Partners (Anike Dutti, FCA) has sent you an email (**Exhibit 1**) requesting you to prepare a report to be submitted to Ade Mambuza, Chief Investment Officer (CIO) of Pago Investments Limited. This client requires business advisory services in respect of potential investment in Mago Pharmaceuticals, a publicly listed entity operating in Mulaasia.

The following overall time allocation is suggested:

Reading	1 hour
Planning and calculations	1 hour
Drafting report	<u>2 hours</u>
Total Time	<u>4 hours</u>

LIST OF EXHIBITS

Exhibit	Description
1	Email from Anike Dutti, FCA – a Client Service Partner at Dago & Co. Chartered Accountants, to you, Maja Opara, Qualified Audit Senior.
2	Letter from Ade Mambuza, Chief Investment Officer (CIO) of Pago Investments Ltd, a client company, to Anike Dutti, FCA.
3	3-year Summarised Income Statements of Mago Pharmaceuticals to 30 June 2014.
4.	3-year Summarised Statements of Financial Position of Mago Pharmaceuticals to 30 June 2014.
5.	Additional notes to the Financial Statements.
6.	Management Information on 3 (three) product lines/divisions currently operated by Mago Pharmaceuticals.
7.	Industry information.

**Dago & Co.
Chartered Accountants**

Email

From: Anike Dutti, FCA - Client Service Partner
To: Maja Opara - Qualified Audit Senior
Re: Pago Investments Limited
Date: 20 November 2014

We have just received an email from Ade Mambuza, CIO of Pago Investments Limited, our client, interested in the acquisition of Mago Pharmaceuticals. Please, read through the letter (**Exhibit 2**) which is attached to this email.

I have also attached additional information which includes the following:

- 3-year Summarised Income Statement of Mago Pharmaceuticals to 30 June 2014 (**Exhibit 3**);
- 3-year Summarised Statement of Financial Position of Mago Pharmaceuticals to 30 June 2014 (**Exhibit 4**);
- Additional notes to the Financial Statements (**Exhibit 5**);
- Management Information on 3 (three) product lines/divisions currently operated by Mago Pharmaceuticals (**Exhibit 6**); and
- Industry information (**Exhibit 7**).

Ade Mambuza strongly indicated that Pago Investments Limited is very keen on expanding as well as diversifying its portfolio of investments and has identified Mago Pharmaceuticals as a prime take-over target. He is particularly optimistic about the published information on the recent positive economic outlook in Mulaasia as well as the fall in unemployment rates from 18% to 7% last year. He is, however, concerned

about the upcoming general elections in Mulaasia as it is a country with a history of political instability and uncertainty.

During a brief phone call with Ade Mambuza, he confirmed that Pago Investments Limited would like us to prepare a report analysing the external environment in which Mulaasia operates from a strategic viewpoint. He would also like us to provide financial advice and a fair valuation of Mago Pharmaceuticals. Although its shares are publicly traded on the Mulaasian Stock Exchange (MSE), Ade Mambuza is not confident that the current share price is a reflection of the intrinsic value of a share of Mago Pharmaceuticals.

Required

Using the attached information, prepare a draft report to Ade Mambuza. Your report should include:

1. A financial analysis and business valuation of Mago Pharmaceuticals giving advice on the product lines to discontinue (**using the information provided in Exhibits 2-7**) together with a critical evaluation of the valuation models and analysis of the product lines as proposed by Ade Mambuza. Your report should also discuss the appropriateness or otherwise as well as any shortcomings of the valuation models and analysis method used.
2. A strategic analysis of the current external environment of Mago Pharmaceuticals, using an appropriate business model taking into consideration the scenario in exhibit 2. The business model used should include a clear commentary, together with your judgement, limitations of the model used and overall conclusions.

PAGO INVESTMENTS LIMITED
Email

From: Ade Mambuza, CIO of Pago Investments Limited

To: Anike Dutti, FCA - Client Service Partner Dago & Co., Chartered Accountants

Re: Mago Pharmaceuticals

Date: 20 November 2014

Dear Anike,

Please find attached appendices which include Mago Pharmaceuticals summarised audited Income Statement and summarised Statement of Financial Position together with the Notes to the financial statements. I have also included internal management information on its 3 (three) product lines. I believe that you will find this information quite useful for your report.

Mulaasia - Demographics and Cultural Factors

- | | |
|-------------------------|-----|
| - 55 years and above | 40% |
| - 25 years to 54 years | 35% |
| - Under 25 years of age | 25% |

The population is relatively active but their poor hygiene lifestyles leave them prone to minor infections.

Mago Pharmaceuticals – Product Lines

Three product lines Riagol, Tiagol and Ziagol are medicines for treating minor infections and boosting the immune system for men, women and infants respectively. A substantial part (75.6%) of Mago Pharmaceutical's revenue comes from these three lines.

Mago Pharmaceuticals – Environmental concerns

In recent times, there have been widespread protests by Eco Plus, a Non-Governmental Organisation (NGO), on a “safer and greener” environment. These protests have been

due to Mago Pharmaceutical's waste disposal procedures which are considered harmful to the environment and not in line with best practices.

Pago Investments Limited is unsure how this might affect its decision to proceed with the acquisition.

The Board of Directors of Mago Pharmaceuticals has, however, indicated that there are currently no laws in Mulaasia being breached as a result of their waste disposal processes, and that since they have some influence on the central government of Mulaasia, there was no cause for concern.

Mago Pharmaceuticals – Valuation Strategy

Pago Investments Ltd. is of the view that the Multi-stage Dividend Discount Model is the best way of valuing an ordinary share of Mago Pharmaceuticals, and would like your firm to calculate an appropriate value per share, using this model. We would expect some advice on the appropriate price to pay for an ordinary share in Mago Pharmaceuticals. The applicable discount rate is estimated to be 10%. See **Exhibit 3** for additional information.

Mago Pharmaceuticals – Dividend Policy

Pago Investments Limited intends to purchase a controlling interest in Mago Pharmaceuticals and its Board of Directors intends to maintain the proposed current year dividend pay-out ratio of 50% for the next five years, retaining the excess profits after dividends to invest in expansion projects. Dividend will grow by 10% each year for the next five years, and by 5% from the sixth year indefinitely. The alternative would be to suspend dividend payment and re-invest all the profits in suitable investment projects. See **Exhibits 3 - 5** for additional information.

I would like to thank you as always for your support and look forward to having your report in due course.

Yours Sincerely,

Ade Mambuza

Chief Investment Officer, Pago Investments Limited

EXHIBIT 3**Mago Pharmaceuticals
3-year Summarised Income Statements**

Year ended 30 June	Notes	2014 N'000	2013 N'000	2012 N'000
Revenue	1	985,000	1,105,000	1,228,000
Cost of sales	2	<u>(591,000)</u>	<u>(663,000)</u>	<u>(736,800)</u>
Gross profit		394,000	442,000	491,200
Administrative expenses		(147,750)	(110,500)	(122,800)
Distribution expenses		<u>(78,800)</u>	<u>(55,250)</u>	<u>(73,680)</u>
Operating profit		167,450	276,250	294,720
Finance costs	3	<u>(25,018)</u>	<u>(24,480)</u>	<u>(24,000)</u>
Profit before tax		142,432	251,770	270,720
Income tax expense	4	<u>(49,851)</u>	<u>(88,120)</u>	<u>(94,752)</u>
Profit for the year		<u><u>92,581</u></u>	<u><u>163,650</u></u>	<u><u>175,968</u></u>

EXHIBIT 4**Mago Pharmaceuticals
3-year Summarised Statement of Financial Position**

As at 30 June	Notes	2014 R'000	2013 R'000	2012 R'000
Non- current assets:				
Property, plant and equipment	5	460,000	517,500	575,000
Intangible assets	6	30,000	40,000	-
		<u>490,000</u>	<u>557,500</u>	<u>575,000</u>
Current assets:				
Inventories	7	161,256	98,546	13,000
Accounts receivables		287,626	162,110	68,900
Prepayments		7,632	9,890	5,100
Cash at Bank		<u>18,000</u>	<u>39,010</u>	<u>26,345</u>
		<u>474,514</u>	<u>309,556</u>	<u>113,345</u>
Total assets		<u>964,514</u>	<u>867,056</u>	<u>688,345</u>
Owners' equity:				
Ordinary Share Capital	8	100,000	100,000	100,000
Retained Earnings	9	<u>555,877</u>	<u>463,296</u>	<u>299,645</u>
Total equity		<u>655,877</u>	<u>563,296</u>	<u>399,645</u>
Non- current liabilities:				
Term loan	10	<u>213,497</u>	<u>208,480</u>	<u>204,000</u>
Total non- current liabilities		<u>213,497</u>	<u>208,480</u>	<u>204,000</u>

Current liabilities:

Accounts payable	13,090	12,290	7,600
Taxes due	82,050	79,000	72,300
Accrued expenses	-	3,990	4,800
Total current liabilities	95,140	95,280	84,700
Total equity and liabilities	<u>964,514</u>	<u>867,056</u>	<u>688,345</u>

EXHIBIT 5**Mago Pharmaceuticals****3-year Summarised Financial Statements (to 30 June 2014)****Additional Notes to the Financial Statements****Note 1 Revenue**

Revenue represents the sale of finished goods during the accounting period and are only recognised when the sale satisfies the criteria for recognition in accordance with IAS 18-Revenue.

Note 2 Cost of sales

Cost of sales are direct labour, materials and other directly related costs in producing the finished product.

Note 3 Finance costs

Finance costs represent the charge to the income statement by applying the effective interest rate to the outstanding loan balance at the beginning of the reporting period.

Note 4 Income tax expense

Current tax assets and liabilities are measured at the amount expected to be paid to (recovered from) taxation authorities, using the rates/laws that have been enacted or

substantively enacted at the reporting date. The current tax rate applicable at the reporting date is 35%. This is an increase in tax rates from 30% which was applicable in the year 2013.

Note 5 Property, plant and equipment

Property, plant and equipment represent tangible assets held for production, supply and administrative basis. They were initially recognised at cost. Subsequently, they are measured at cost less accumulated depreciation and impairment losses. The depreciation policy for the company's equipment (5years), furniture and fittings (5 years) and motor vehicles (5 years) is the straight line method of depreciation

Note 6 Intangible assets

Mago Pharmaceuticals secured a patent right to produce an innovative and specialised medication for ₦50million in the year 2013. The company amortises the cost of the patent right over its estimated useful economic life of 5 years.

	2014	2013	2012
	₦'000	₦'000	₦'000
Cost (At 1 July)	50,000	50,000	-
Accumulated Amortisation	<u>(20,000)</u>	<u>(10,000)</u>	-
Carrying amount (At 30 June)	<u>30,000</u>	<u>40,000</u>	-

Note 7 Inventories

Inventories represent unsold stock of goods (finished goods, work in process and raw materials) held for sale or the production process for sale in the ordinary course of business. Inventories held are measured at the lower of cost and net realisable value.

Note 8 Share capital

The authorised and issued share capital consists of 100,000,000 ordinary shares of ₦1.00 each. There were no additional issue of shares during the reporting period. The quoted market price of the company's shares at the reporting date was ₦18 per share.

Note 9 Retained earnings

	2014	2013	2012
	₦'000	₦'000	₦'000
Opening balance (At 1 July)	463,296	299,645	123,677

Profit for the year	<u>92,581</u>	<u>163,651</u>	<u>175,968</u>
Closing balance (At 30 June)	<u>555,877</u>	<u>463,296</u>	<u>299,645</u>

Note 10 Term loan

The term loan represents a ₦200 million 10%, 5 year loan acquired in 2012 to fund the expansion of the business. The effective interest rate of the loan is 12%. The loan is a financial liability measured at amortised cost.

EXHIBIT 6

Mago Pharmaceuticals

Management Information on 3 (three) product lines/divisions

Below is information on 3 (three) product lines Riagol, Tiagol and Ziagol which are considered very effective medicine used by men, women and infants respectively.

	Riagol	Tiagol	Ziagol	Total
Units	5,000	5,000	5,000	
Price per unit (₦)	57	40	52	
	₦'000	₦'000	₦'000	₦'000
Revenue	285,000	200,000	260,000	745,000
Direct materials	145,000	125,000	135,000	405,000
Labour	60,000	60,000	75,000	195,000
Variable overheads	30,000	20,000	25,000	75,000
Fixed costs	22,953	16,107	20,940	60,000

Fixed costs are allocated based on the percentage of total sales generated by each product line. No fixed costs will be eliminated if a product line is discontinued.

EXHIBIT 7

Pharmaceutical Industry – Mulaasia Industry Information

	2014	2013	2012
Return on assets (%)	15.10	27.33	34.62
Return on equity (%)	16.89	35.00	51.96
Net profit margin (%)	16.11	19.65	21.88
Debt/Equity (%)	26.13	29.21	36.12
Accounts receivable days	45	23	11
Total asset turnover (times)	2.15	2.38	3.25
Earnings per share (₦)	1.51	1.99	1.68
Net assets per share (₦)	5.22	6.23	4.52

Note: A 365 day count is used in computing the relevant information above.

End of Question Paper

INTRODUCTION TO THE CASE STUDY MARKING KEY

The marking key is the examiner's guide to the assessors on the expected contents of the candidates' solutions. Candidates are not required to produce a marking key in answering case study papers but to write a report based on the requirements of each case. Candidates should note that the marking key is prepared based on the requirements of each case and will definitely vary from case to case.

Examiner's requirements

There are two requirements in this case:

- A financial analysis and business valuation of Mago Pharmaceuticals including, an advice on the product lines.
- A strategic analysis of the external environment of Mago Pharmaceuticals, using PESTEL and other strategic analysis tools.

Candidates are required to write a report advising the firm's client on the above. The case includes three years' summarized financial statements with notes, a statement on the external environment in which the company operates and industry information on selected ratios.

Candidates are expected to:

- a. Make use of the data presented in the financial statements and notes to the financial statements by calculation of appropriate ratios and analyzing the trend reflected in the operating performance of the company;
- b. Make comments in their reports on the ratios calculated and comparing them with the industry average. The examiner also expects appropriate comments on the trend reflected in the operating performance of the company;
- c. Carry out valuation of the company's shares based on the model specified in the case, with appropriate comments as necessary;
- d. Use professional judgment to highlight areas of concern on the financial statements presented, for example, increasing inventories and debtors despite decreasing performance;
- e. Calculate the contribution of each of the three products, with appropriate comments and recommendations on their profitability;

- f. Identify the external environmental issues facing the company, using PESTEL Analysis;
- g. Make appropriate comments and express professional skepticism as to the information presented and their reliability;
- h. Express professional skepticism on the figures presented and ethical issues reflected in this case; and
- i. Include appropriate disclaimer in their reports.

While the candidates should make use of the various ratios and analysis in their reports, the actual calculations should be in appendices to their reports including detailed strategic external environmental analysis.

Overall, the examiner will also award points for the report in general, looking for correct use of tenses, structures, use of appropriate words and contents in general.

ICAN CASE STUDY EXAMINATION 20 NOVEMBER 2014

MARKING KEY

FINANCIAL ANALYSIS

<div>USES APPROPRIATE DATA AND INFORMATION (follows instruction)</div> <ul style="list-style-type: none">Uses Mago Financial Statements<ul style="list-style-type: none">Income StatementStatement of financial positionUses evaluation criteria<ul style="list-style-type: none">Profitability criteria (3 or 4)Statement of financial position criteriaUses notes re Mago (Exhibit 5)<ul style="list-style-type: none">revenue analysis by streamFollows overall valuation method (divi/growth/dis at CoC)Uses growth ratesUses earnings <div><div>V</div><div>NCBCCA SA</div></div> <div>PERFORMS / CREATES FINANCIAL ANALYSIS (written into / shown in report - 8 items)</div> <ul style="list-style-type: none">Return on assetsReturn on equityNet profit marginDebt /equityAccounts receivable daysTotal assets turnoverEarnings per shareNet assets per share <div><div>V</div><div>NCBCCA SA</div></div> <div>PERFORMS / CREATES VALUATION CALCULATION</div> <ul style="list-style-type: none">2014 earnings 50% payout2 stages recognisedCost of capital/discount rateCumulative pv calculationEstablish share valueEstablish overall value <div><div>V</div><div>NCBCCA SA</div></div>	<div>IDENTIFIES BROADER ACCOUNTING/BUSINESS ISSUES (in context of need to establish valuation)</div> <ul style="list-style-type: none">All figures should be discussed in the context of decreasing revenueAny financial reporting queries (inventory valuation? Amort?)Considers future market for Mago productsIdentifies listed company positive factorsPlans for future/changes in strategyRivalry and competitive reaction (Price/patents run out) <div><div>V</div><div>NCBCCA SA</div></div> <div>COMMENTS ON ANALYTICAL CRITERIA & RELATED FACTORS</div> <ul style="list-style-type: none">Decreasing revenues crucial indicatorCompares RoA and/or RoE with equivalent industry statisticsCompares NP margin with equivalent industry statisticsCompares with industry average (declining)Compares with increasing industry accounts receivable daysCompares with declining industry averageCompares with undulating industry average <div><div>V</div><div>NCBCCA SA</div></div> <div>COMMENTS ON VALUATION & ANALYSIS CRITERIA (uses analytical headings)</div> <ul style="list-style-type: none">constant payout ratioignores marketMaintaining future dividend / growth despite historic declineHigher initial growthStable growth long termAlternatives possible (earnings/cash flow/PE based etc) <div><div>V</div><div>NCBCCA SA</div></div>
--	--

MANAGEMENT AND STRATEGIC ISSUES

<p>USES APPROPRIATE DATA AND INFORMATION</p> <ul style="list-style-type: none"> • Uses product line information (Ex 6) • Uses breakeven / contribution criteria • Uses demographic and cultural factors (Ex 2) • Uses appropriate (undefined) evaluation model (Ex 1 & 2) • Uses wider context information (Ex 1 & 2) • Uses information in accounts (Ex 3 to 5) <div style="border: 1px solid black; padding: 2px; display: flex; justify-content: space-between; width: 100%;"> V NC BC CA SA </div>	<p>IDENTIFYING MARKET / PRODUCTION ISSUES AND OPTIONS</p> <ul style="list-style-type: none"> • Pago to make decision about Mago requires accurate figures • Need to have age: Male/Female/Infant mortality breakdown • Who are the product buying decision makers in the family? • Are products actually gender specific? • Is investment in Mago/Mulaasia only option? • May be a pricing issue with Tiagol? <div style="border: 1px solid black; padding: 2px; display: flex; justify-content: space-between; width: 100%;"> V NC BC CA SA </div>
<p>PERFORMS CALCULATION/RECONCILIATION OF PRODUCTS</p> <ul style="list-style-type: none"> • Performs contribution/profit analysis on Riagol • Performs contribution/profit analysis on Tiagol • Performs contribution/profit analysis on Ziagol • Considers the missing revenue item(s) • Considers overall position / fixed costs • Compares costs/revenue costs/total cost and 3 prices <div style="border: 1px solid black; padding: 2px; display: flex; justify-content: space-between; width: 100%;"> V NC BC CA SA </div>	<p>EVALUATES/COMMENTS ON PRODUCT ANALYSIS</p> <ul style="list-style-type: none"> • Comments on Riagol (positive contribution) • Comments on Tiagol negative contribution (marginal) • Comments on Ziagol (positive contribution) • Comments on profitability of other produces • Comments on inter-connectedness of markets • Comments on the method of allocating fixed costs <div style="border: 1px solid black; padding: 2px; display: flex; justify-content: space-between; width: 100%;"> V NC BC CA SA </div>
<p>PERFORMS PEST(LE) ANALYSIS (uses PEST / SWOT/ other)</p> <ul style="list-style-type: none"> • Political factors <ul style="list-style-type: none"> - instability - imminent election • Economic factors <ul style="list-style-type: none"> - growth eg Mulaasia unemployment rapid decline • Social factors <ul style="list-style-type: none"> - demographic split and activity levels • Technological factors <ul style="list-style-type: none"> - regular re-investment in new non current assets - possibly new technology • Legal <ul style="list-style-type: none"> - breach of environmental laws • Ethical <ul style="list-style-type: none"> - breach of waste disposal rules <div style="border: 1px solid black; padding: 2px; display: flex; justify-content: space-between; width: 100%;"> V NC BC CA SA </div>	<p>EVALUATES PESTLE ANALYSIS WITH RESPECT TO MAGO</p> <ul style="list-style-type: none"> • Political instability / change may mean postponing bid • Increasingly affluent population will buy products <ul style="list-style-type: none"> - main products cover the whole population so always able to sell • Demographic trend indicates on-going & increasing market for products • Minor infections are constant and continue to need treatment • People will increasingly be able to afford products • Identify limitations of pestle • Breaches may lead to legal actions / fines • Can Mago react and change this process legitimately? <ul style="list-style-type: none"> - should not rely on connections <div style="border: 1px solid black; padding: 2px; display: flex; justify-content: space-between; width: 100%;"> V NC BC CA SA </div>

<p>COMMENTS ON RELIABILITY OF INFORMATION (Draws distinct conclusions under a heading)</p> <ul style="list-style-type: none"> • Any comment on provenance (source) of information • Accuracy of product data analysis • Financial information in line with audited Financial Statements • Where did Ade obtain his information from? • Is the information complete? • Is Ade seeking a favourable report? <table border="1" style="width: 100%; text-align: center; margin-top: 10px;"> <tr> <td style="width: 10%;">V</td> <td style="width: 20%;">NC</td> <td style="width: 20%;">BC</td> <td style="width: 20%;">CA</td> <td style="width: 30%;">SA</td> </tr> </table> <p>CONCLUDES ON PRODUCT LINES (Draws distinct conclusions under a heading)</p> <ul style="list-style-type: none"> • Prima facie Tiagol is making a small negative contribution • Abandoning Tiagol may increase overall profitability (by =N=5,000) • May question accuracy of figure attributed to Tiagol • Markets for products may be inter-related • Women tend to buy products for other members of family • Abandon/ Do not abandon Tiagol <table border="1" style="width: 100%; text-align: center; margin-top: 10px;"> <tr> <td style="width: 10%;">V</td> <td style="width: 20%;">NC</td> <td style="width: 20%;">BC</td> <td style="width: 20%;">CA</td> <td style="width: 30%;">SA</td> </tr> </table> <p>CONCLUDES ON PESTLE</p> <ul style="list-style-type: none"> • Election creates uncertainty • Overall significant strength in market • Immediate future looks good • Mulaasia stable and increasingly prosperous • Increasingly affluent population will buy products • Can Mago react / change to this waste disposal criticism? • Will Mago environmental breach affect their image? <table border="1" style="width: 100%; text-align: center; margin-top: 10px;"> <tr> <td style="width: 10%;">V</td> <td style="width: 20%;">NC</td> <td style="width: 20%;">BC</td> <td style="width: 20%;">CA</td> <td style="width: 30%;">SA</td> </tr> </table>	V	NC	BC	CA	SA	V	NC	BC	CA	SA	V	NC	BC	CA	SA	<table border="1" style="width: 100%; height: 600px; margin-top: 100px;"> <tr><td style="width: 10%;">SA</td><td style="width: 90%;"></td></tr> <tr><td>CA</td><td></td></tr> <tr><td>BC</td><td></td></tr> <tr><td>NC</td><td></td></tr> <tr><td>V</td><td></td></tr> <tr><td> </td><td></td></tr> </table>	SA		CA		BC		NC		V			
V	NC	BC	CA	SA																								
V	NC	BC	CA	SA																								
V	NC	BC	CA	SA																								
SA																												
CA																												
BC																												
NC																												
V																												

Appendices / Notes / Workings

Overall Report

R1 Appendices: Content and style

- ♦ Tabulated **and** mix of numbers and percentages
- ♦ Comparative performance analysis and trends for Mago analysis for Mago
- ♦ Comparative position (Statement of Financial position)
- ♦ Little unnecessary (immaterial) detail

V	NC	BC	CA	SA
---	----	----	----	----

Appendices R2: Content and style

- ♦ Logical approach **and** numbers clearly derived (products)
- ♦ Well presented **and** labelled
- ♦ Calculates individual/total product contribution
- ♦ Presents Pestle SWOT table

V	NC	BC	CA	SA
---	----	----	----	----

Report: Structure

- ♦ Sufficient appropriate headings
- ♦ Appropriate use of paragraphs / sentences
- ♦ Legible
- ♦ Correctly numbered pages

V	NC	BC	CA	SA
---	----	----	----	----

Report: Style and language

- ♦ Relevant disclaimer (external report)
- ♦ Suitable language for Pago board
- ♦ Tactful / ethical comments
- ♦ Acceptable spelling and punctuation

V	NC	BC	CA	SA
---	----	----	----	----

CC	
SC	
IC	
ID	
NA	
Total	4

FINANCIAL RATIOS

			2014	2013	2012
1.	Return on assets (%)	<u>PBIT</u> Total Assets	<u>167,450,000</u> 964,514,000	<u>276,250,000</u> 867,058,000	<u>294,720,000</u> 688,345,000
			17.36%	31.86%	42.82%
2.	Return on Equity (%)	<u>PAT</u> Equity	<u>92,561,000</u> 655,877,000	<u>163,650,000</u> 563,296,000	<u>175,968,000</u> 399,645,000
			14.12%	29.05%	44.03%
3.	Net Profit Margin (%)	<u>PAT</u> Revenue	<u>92,581,000</u> 985,000,000	<u>163,650,000</u> 1,105,000,000	<u>175,968,000</u> 1,228,000,000
			9.40%	14.8%	14.33%
4.	Debt/Equity (%)	<u>Debit</u> Equity	<u>213,498,000</u> 655,877,000	<u>208,480,000</u> 563,296,000	<u>204,000,000</u> 399,645,000
			32.55%	37.01%	51.05%
5.	Accounts Receivable Days	<u>AR</u> <u>Revenue</u> *365days	<u>287,626,000</u> 985,000,000 107	<u>162,110,000</u> 1,105,000,000 54	<u>68,900,000</u> 1,228,000,000 20
6.	Total Assets Turnover (times)	<u>Revenue</u> Total Assets	<u>985,000,000</u> 964,514,000	<u>1,105,000,000</u> 867,056,000	<u>1,228,000,000</u> 688,345,000
			1.02	1.27	1.78
7.	Earnings Per share (N)	<u>PAT</u> No. of Shares	<u>92,581,000</u> 100,000,000	<u>163,650,000</u> 100,000,000	<u>175,968,000</u> 100,000,000
			0.93	1.64	1.76
8.	Net Assets Per share (N)	<u>Net Assets</u> No. of Shares	<u>655,877,000</u> 100,000,000	<u>563,296,000</u> 100,000,000	<u>399,645,000</u> 100,000,000
			6.56	5.63	4.00

KEY

PBIT = Profit before interest and taxes

PAT = Profit after tax

AR = Accounts Receivable

EPS	0.92581	1.6365	1.75968
NAPS	6.55877	5.63296	3.99645
GP%	0.4	0.4	0.4
CA/CL	4.987534	3.248908	1.338194
CA-I/CL	3.2926	2.21 4631	1.184711
Stock turnover	59.75476	32.55139	3.864007
NCA change	57,500	57,5000	
Dep rate	0.2	0.2	0.2

					% change	% change
Revenue	1	985,000	1,105,000	1,228,000	-10.86%	-10.02%
Cost of sales	2	<u>(591,000)</u>	<u>(663,000)</u>	<u>(736,800)</u>	-10.86%	-10.02%
Gross profit		394,000	442,000	491,200	-10.86%	-10.02%
Administrative - expenses		(147,750)	(110,500)	(122,800)	33.71%	-10.02%
Distribution expenses		<u>(78,800)</u>	<u>(55,250)</u>	<u>(73,680)</u>	42.62%	-25.01%
Operating profit		167,450	276,250	294,720	-39.38%	-6.27%
Finance costs	3	<u>(25,018)</u>	<u>(24,480)</u>	<u>(24,000)</u>	2.20%	2.00%
Profit before tax		142,432	251,770	270,720	-43.43%	-7.00%
Income tax expense	4	<u>(49,851)</u>	<u>(88,120)</u>	<u>(94,752)</u>	-43.43%	-7.00%
Profit for the year		<u>92,581</u>	<u>163,650</u>	<u>175,968</u>	-43.43%	-7.00%

KEY

EPS	=	Earnings per share
NAPS	=	Net assets per share
GP	=	Gross profit
CL	=	Current liabilities
CA	=	Current assets
NCA	=	Net current assets

Suggested Solution: Multi-stage Dividend Discount Model (DDM)

Dividend per share = (92,561,000 x 100,000,000 shares) x 50% proposed current dividend payout = 0.4629

		Growth rate (10%)		DCF	Present Value
$D_1 =$	0.4629	1.1^1	0.5092	0.9091	0.4629
$D_2 =$	0.4629	1.1^2	0.5601	0.8264	0.4629
$D_3 =$	0.4629	1.1^3	0.6161	0.7513	0.4629
$D_4 =$	0.4629	1.1^4	0.6777	0.6830	0.4629
$D_5 =$	0.4629	1.1^5	0.7455	0.6209	0.4629
V_5					9.7205
					12.035

Value per share of Mago Pharmaceuticals as derived from the Multi-stage DDM model is estimated at ₦12 per share.

Tutorial Note

Candidates' attention is drawn to the Multi-stage DDM model formula below.

Using the Multi-stage DDM, the value of a share is computed as follows:

First stage: The sum of all future dividends discounted at the cost of capital.

Second stage: The value in Year 5 which is calculated as estimated using the formula:

$D_5 (1 + g) \times \text{DCF in final growth period in the first stage}$

$$= \frac{0.7455 (1.05) \times 0.6209}{0.1 - 0.05}$$

$$V_5 = 0.97205$$

D = Dividend

V = Value

Ke = Cost of Capital

g = Growth rate

CONTRIBUTION ANALYSIS

	Ríagol	Tíagol	Zíagol
	₦'000	₦'000	₦'000
Sales	285	200	260
Direct material	(145)	(125)	(135)
Direct labour	(60)	(60)	(75)
Variable overhead	<u>(30)</u>	<u>(20)</u>	<u>(25)</u>
Contribution	<u>50</u>	<u>(5)</u>	<u>25</u>

Decision

- Discontinue Tíagol due to its negative contribution
- Other factors to be considered

PESTLE

Political/legal

General election

History of political instability and uncertainly

Protests by NGO Eco-Plus

Uncertainly for business

Volatile business environment

Safety priority

Greener environment demands

Reputation damage risk

Mago Pharmaceuticals waste disposal process within the law?

Public opinion varies, compliance versus ethical view

Patent in place – 5 years sufficient?

Some, but perhaps limited product/process protection

Socio-cultural

Demographics – relatively old population

Hard to judge without trend including male/female split and longevity data

Active population

Sales opportunities

Poor hygiene – minor infections

Products are needed

Social

None

Technology

Evidence of innovation in specialized drugs

Importance of own Research and Development and buy-in patents, businesses and expertise

Technical

None

Environmental/sustainability

Evidence of best practice standards in waste disposal

Corporate Social Responsibility (CSR) may be seen as important

EXAMINER'S REPORT

The case tests candidates' knowledge and professional skills in financial analysis, business analysis, business valuation and evaluation of the external environment using PESTEL strategic model. Candidates are expected to write a comprehensive report with appropriate appendices, based on a set of financials and other data/information presented in the case, to advise a client.

Majority of the candidates demonstrated good understanding of financial analysis and external environmental analysis. However, candidates understanding of business analysis, business valuation using Multi-stage Dividend Discount Model was shallow.

Nevertheless, candidates' performance was good as over 50% of the candidates scored more than 50% of the allocated marks with some of the candidates scoring as high as 70% of the allocated marks.

The major pitfalls of the candidates were:

- (i) Inadequate understanding of business analysis and Multi-stage Dividend Discount Model for valuation of the shares of Mago Pharmaceuticals;
- (ii) Poor skills in report writing and arrangement of thoughts using lexis and structures appropriate to advise the board of directors;
- (iii) Inability of the candidates to express professional skepticism on the financials with the accompanying notes, presented in the case;
- (iv) Inability to express doubts on the reliability of the information relied upon by Ade Mambuza on Mago Pharmaceuticals; and
- (v) Inability to put an appropriate disclaimer on the report.

Candidates must always have at the back of their minds that case study is to test their knowledge and professional skills, acquired in the Institute's examination curriculum, which enable them to give financial and business advisory services to their clients.

Candidates must therefore sharpen their financial, business and internal and external environmental analysis skills to prepare for future examinations.

Candidates should also improve their report writing skill by practising on various cases in preparation for future examinations