THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

MAY 2024 DIET
PROFESSIONAL LEVEL EXAMINATIONS

Question Papers

Suggested Solutions

Examiner's Reports

and

Marking Guides

FOREWARD

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

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

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

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

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

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

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

NOTES

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

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EXAMINATION INSTRUCTIONS

PLEASE READ THESE INSTRUCTIONS BEFORE THE COMMENCEMENT OF THE PAPER

1. Check your pockets, purse, mathematical set, etc. to ensure that you do not have prohibited items such as telephone handset, electronic storage device, programmable devices, wristwatches or any form of written material on you in the examination hall. You will be stopped from continuing with the examination and liable to further disciplinary actions including cancellation of examination result if caught.

2. Write your **EXAMINATION NUMBER** in the space provided above.

3. Do **NOT** write anything on your question paper **EXCEPT** your examination number.

4. Do **NOT** write anything on your docket.

5. Read all instructions in each section of the question paper carefully before answering the questions.

6. Do **NOT** answer more than the number of questions required in each section, otherwise, you will be penalised.

7. All solutions should be written in **BLUE** or **BLACK INK**. Any solution written in **PENCIL** or **RED INK** will not be marked.

TUESDAY, MAY 14, 2024

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2024

CORPORATE REPORTING

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Cabalar Nig. PLC, a company located in Ajao Industrial Estate, Lagos. The company specialises in the production of Adire T-Shirts. The company has a number of subsidiaries located in the South-South and South-West regions of the country and overseas.

On October 1, 2022 Cabalar PLC acquired 100% of the ordinary shares of Mansa-konko Limited, an Adire T-Shirts distribution company based in the Gambia, West Africa. The official national currency of The Gambia is known as Gambia Dalasi (GMD).

The draft statement of financial position of Mansa-Konko Limited prepared under Gambia GAAP as at September 30, 2023 is as follows:

Non-current assets:	**GMD'000**
Property, plant and equipment	308,000
Intangible assets	42,500
Financial investments	38,500
Current assets	118,500
	507,500
Equity and liabilities:	
Equity:	
Share capital at GMD 1 per share	50,000
Retained earnings	213,000
Revaluation surplus	84,000
	347,000
Non-current liabilities:	
Loan notes	50,000
Provisions	75,000
Current liabilities	35,500
Total equity and liabilities	**507,500**

Additional information:
The following are the key transactions of Mansa-Konko Limited under Gambia GAAP. There is no deferred tax under the Gambia GAAP:

(i) **Equipment:**

- On January 1, 2023 Mansa-Konko Limited acquired some specialist equipment from the United States of America (USA) for $150million, payment for the equipment was made on March 31, 2023.

- In accordance with the local Gambia GAAP, the cost of the equipment was recognised on January 1, 2023 at GMD 50million, using the opening rate of exchange at October 1, 2022.

- Full year's depreciation of GMD 5million was charged to cost of sales as Mansa-Konko Limited depreciates the equipment over a ten-year life and it has no residual value, hence the equipment was included in the statement of financial position of Mansa-Konko Limited at GMD 45million.

- The sum of GMD 12.5million has been debited to retained earnings. This is in-respect of the difference between the amount paid to the supplier, of GMD 62.5million on March 31, 2023 and the cost recorded in non-current assets of GMD 50million.

(ii) **Impairments**

- Mansa-Konko Limited bought a warehouse on October 1, 2016 for GMD 180million. The warehouse is being depreciated over 20 years with no residual value. On October 1, 2022, due to a rise in property prices, the warehouse was revalued to GMD 210million and a revaluation surplus of GMD 84million was recognised. No transfer are made between the revaluation surplus and retained earnings under Gambia GAAP in respect of depreciation.

- However, there has been a slump in the local property market in Gambia recently, so an impairment review was undertaken at September 30, 2023; and the warehouse was assessed as being worth GMD 60million. Therefore, a charge of GMD 90million was made to profit or loss to reflect the difference between the carrying amount of the warehouse of GMD 150million before September 30, 2023 and the new value of GMD 60million.

(iii) **Financial Instruments**

On April 1, 2023 Mansa-Konko Limited bought five million shares in a local quoted company for GMD 7.7 per share.

This represents a 3% shareholdings. The intention of the company is to hold the shares until December 31, 2023 and then sell them for a profit. The shares have been recognised at cost in the statement of financial position in accordance with Gambia GAAP. The market value of the shares at September 30, 2023 was GMD 12.5 per share.

Under the Gambia tax rules, income tax is charged at 20% on accounting profit recognised on the sales of the investment.

(iv) **Provisions**

- On October 1, 2022 Mansa-Konko Limited signed an agreement with the Gambian government for exclusive right for the next 20 years to supply Adire- T-shirts for Gambia's national traditional festival (GNTF).

- The cost of buying these rights was GMD 42.5million which had been recognised as intangible assets in Mansa-Konko Limited statement of financial position. Under the terms of the right of agreements, Mansa-Konko Limited has to replace all damaged T-shirts at the end of 20-year period.

  There is 40% probability that the eventual cost of replacement of the damaged T-shirts would be GMD 75million and a 60% probability of the cost of replacement being GMD 50million.

  However, for prudency sake, a provision of GMD 75million was made in the financial statements and debited to the operating costs of the company.

- Mansa-Konko Limited has a pre-tax discount rate of 8%. The replacement cost will be allowed for tax purposes when paid. The relevant income tax rate is expected to remain at 20%.

(v) **Exchange rates:**

	1GMD
October 1, 2022	$3.00
January 1, 2023	$2.50
March 31, 2023	$2.40
September 30, 2023	$2.00

Note: In Gambia the tax treatments of property, plant and equipment and exchange differences is the same as we have under IFRS treatments.

- The following are the exchange rates between Gambia Dalasi (GMD) and Nigerian Naira

October 1, 2022	GMD 4.2	=	₦1
Average for the year	GMD 4.0	=	₦1
September 30, 2023	GMD 5.0	=	₦1

Required:

(a) As the financial controller of Cabalar Nig. PLC, draft a report addressed to the finance director of your company explaining any adjustments which needs to be made to ensure that the subsidiary company's (Mansa-Konko Limited's) financial statements comply with IFRS requirements. (18 Marks)

(b) Prepare a revised statement of financial position for Mansa-Konko Limited that will be suitable for consolidation with the parent's (Cabalar Plc's) financial statements as at September 30, 2023 in accordance with IFRS. (12 Marks)

Note: Show all workings.

(Total 30 Marks)

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

QUESTION 2

Alpha PLC is an entity which has grown in recent years by acquiring established businesses. Alpha PLC is contemplating acquiring Betta Limited and Gamma Limited.

Alpha PLC, Betta Limited and Gamma Limited operate in the same industry. Alpha PLC believes that their company shareholders will be receptive to the takeover. The Management of Alpha PLC has indicated a total (100%) acquisition price of ₦12 million for each of the companies.

The financial statements for Betta Limited and Gamma Limited are as shown below:

Statement of profit or loss for the year ended September 30, 2020

	Betta Ltd	Gamma Ltd
	₦'000	₦'000
Revenue	25,000	40,000
Cost of sales	(19,000)	(32,800)
Gross profit	6,000	7,200
Distribution costs	(800)	(1,400)
Administrative expenses	(450)	(900)
Finance costs	(250)	(900)
Profit before tax	4,500	4,000
Income tax expense	(900)	(1,000)
Profit for the year	3,600	3,000

Statements of financial position as at September 30, 2020

	Betta Ltd	Gamma Ltd
	₦'000	₦'000
Non-current assets		
Property, plant and equipment:		
Property	-	3,000
Owned plant and equipment	4,800	2,000
Leased plant and equipment	-	5,300
	4,800	**10,300**
Current assets:		
Cash at bank and in hand	1,600	200
Trade receivables	1,600	5,100
Inventories	1,600	3,400
	4,800	8,700
Total assets	**9,600**	**19,000**
Equity and liabilities		
Ordinary shares of ₦1.00 each	1,000	2,000
Revaluation surplus on property	-	900
Retained earnings	1,600	2,700
Total equity	**2,600**	**5,600**
Non-current liabilities		
Finance lease obligation	-	4,200
5% loan notes (December 31, 2026)	5,000	-
10% loan notes (December 31, 2026)	-	5,000
	5,000	**9,200**

Current liabilities:		
Trade payables	1,250	2,100
Finance lease obligation	-	1,000
Tax payable	750	1,100
Total current liabilities	2,000	4,200
Total equity and liabilities	**9,600**	**19,000**

Additional information:

(i) The carrying amount of plant:	**Betta**	**Gamma**
	₦'000	**₦'000**
Owned plant – cost	8,000	10,000
Less government grant	(2,000)	-
	6,000	10,000
Accumulated depreciation	(1,200)	(8,000)
Carrying amount	4,800	2,000
Leased plant – original fair value	nil	8,000

(i) **The following ratios have been calculated:**

	Betta	**Gamma**
Gross profit margin	24.0%	18.0%
Profit margin (before interest and tax)	19.0%	12.3%
Return on capital employed (ROCE)	62.5%	31.0%
***Note:** Finance lease obligations are treated as debt		
Current ratio	2.4:1	2.1:1
Acid test ratio	1.6:1	1.26:1
Net assets turnover	3.3 times	2.5 times
***Note:** Taken as same figure as capitals employed		
Closing inventories holding period	31 days	38 days
Trade receivables collection period	31 days	47 days
Trade payables payment period (using cost of sales)	24 days	23 days
Gearing (debt / debt + equity)	65.8%	64.6%

Required:

a. Write a memo to the Director of Alpha PLC advising him on how to make investment decision considering the performance and financial position of Betta Limited and Gamma Limited for the year ended September 30, 2020. (14 Marks)

b. What other qualitative factors should the management of Alpha PLC take into consideration assuming Gamma Limited is a foreign subsidiary? (6 Marks)

(Total 20 Marks)

QUESTION 3

Below is the statement of financial position (extracts) of Bamboo PLC which has a number of subsidiaries in all the geopolitical zones of the country and one foreign subsidiary (Pako Limited) located in the United States of America (USA).

Draft statement of financial position as at October 31, 2023

	₦'m
Deferred tax	77
Other non-current assets	2,329
Inventories and other current assets	1,150
Cash and cash equivalents	422
Total assets	**3,978**
Other non-current liabilities	1,671
Deferred tax liabilities	186
Payables and accruals	1,131
Total liabilities	**2,988**
Share capital	250
Share premium	120
Retained earnings	620
Total equity	**990**
Total liabilities and equities	**3,978**

Mr. Agbaje, the Finance Director of the Bamboo PLC is in the process of preparing the final draft of the financial statements, and the following issues relating to the treatments of deferred tax implication arose:

(i) **Property, plant and equipment**
On November 1, 2022 Bamboo PLC purchased an item of property, plant and equipment for ₦120million which qualified for a government capital grant of ₦20million. The asset has a useful life of 5 years and is depreciated on straight-line basis. Capital allowances are restricted by the amount of grant by Federal Inland Revenue Services (FIRS). The company income tax laws specify a capital allowance rate of 25% per annum.

(ii) **Fair value adjustments**
On November 1, 2022 Bamboo Plc acquired a wholly owned subsidiary, Iroko Limited for ₦100million. On that date, the fair value of Iroko Limited's net assets was ₦80million and carrying amount was ₦70million, which is also the tax base under income tax law. The difference between the fair value and book value of the net assets relates to an item of property, plant and equipment which Iroko Limited currently has no plan to sell.

(iii) **Profit from foreign subsidiary**

Pako Limited, a wholly owned foreign subsidiary of Bamboo PLC, has undistributed post acquisition profit of 5,000 U.S dollars which would give rise to additional tax payable of ₦4million if remitted to Bamboo PLC in Nigeria.

As Pako Limited is relatively new and a rapidly expanding company. Bambo PLCintends to leave the earnings with Pako Limited for re-investment.

Required:

(a) Briefly explain and show necessary calculations, if any, of the deferred tax implications for each of the transactions in (i) to (iii) above. (15 Marks)

(b) Show the deferred tax effects on the draft statement of financial position of Bamboo PLC (if any). (5 Marks)

Note: Relevant tax rate is 30% per annum. **(Total 20 Marks)**

QUESTION 4

(a) Lease gives lessees the right to use assets in return for the lessee accepting an obligation to make series of payments to the owner of the assets; the lessor.

The previous accounting rules set out in IAS 17-Leases focused on identifying leases that were economically similar to purchasing the assets being leased.

However, IFRS 16-Leases was issued subsequently and applies to accounting period beginning on or after January 1, 2019. Nonetheless, earlier application is also permitted.

Therefore, IFRS 16 replaced IAS 17. The introduction of IFRS 16 brought about material changes to the requirements for recognition of rights and obligations under leasing arrangements.

Required:

i. Explain how IFRS 16 requires lessees to recognise and measure rights and obligations under lease arrangements. (4 Marks)

ii. Discuss how a lessee should measure the rights and obligation under a short-term lease arrangements. (4 Marks)

(b) As the financial controller of OdodoeyePLC, an NGX quoted company, you are currently preparing the financial statements of the company for the year ended March 31, 2023. Chief Okechukwu, the finance director has requested for the following information that is not clear to him as regards the treatments of the companies leased assets in view of the adoption of IFRS 16-Leases as against the use of the previous IAS 17-Leases; therefore he states as follows:

- "When I looked at the notes to the financial statements which gave details of our property, plant and equipment, a separate component appeared for the first time this year. This component was described as right-of-use. Upon further investigation, I discovered this relates to a warehouse which we leased with effect from October 1, 2022 to provide for space. The warehouse was leased for a five-year lease contract at an annual lease rental of ₦5,000,000 payable in arrears.

  There is no option to extend the lease at the end of the five-year period. Based on current annual interest of 10%, these rentals have a total present value of ₦18,950,000. We incurred a direct cost of ₦1,050,000 when arranging for the lease with the owner.

  The carrying amount of the right-of-use assets which is shown in our financial statement is ₦18million. I don't understand this at all in particular".

- "As the financial controller, I am sure you are aware that the warehouse cost at least ₦100million to purchase outright and has a useful life of around 25 years. How can this be presented as assets in our company's financial statement in compliance with IFRS 16-leases?

- Also where did the figure of ₦18million stated as right-of-use asset come from?

- Apart from right-of-use assets how else will this transaction affect our financial statements?"

Required:

Write a memo to the finance director, explaining the issues raised above.

(12 Marks)

Note:

The finance director only needs your explanation not detailed workings.

(Total 20 Marks)

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

QUESTION 5

(a) IAS 34 – Interim Financial Reporting does not make preparation of interim financial report mandatory taking the view that this is a matter for government, security regulators, stock exchanges or professional accountancy bodies to decide within each country. The IASB, however, does strongly recommend to government and regulators that interim financial reporting should be a requirement for companies whose equity or debt securities are publicly traded.

Required:

(i) Discuss the conditions under which IAS 34 encourages publicly traded entities to publish their interim reports. (3 Marks)

(ii) Identify and explain the notes that should be included in the interim report of traded entities in accordance with IAS 34. (5 Marks)

(b) Accounting information must be reliable and free from material error, it may be necessary to sacrifice some accuracy and reliability for the sake of timeliness and cost benefits. This is usually the case with interim financial reporting where there will be much less time to produce reports than at the financial year end. IAS 34 therefore recognises that estimates will have to be used to a greater extent in interim reporting, to assess values or even some costs, than in year-end reporting.

Required:

Discuss, giving relevant examples, the financial information that could be included in interim reports, where IAS 34 permits the use of estimates. (7 Marks)

(Total 15 Marks)

QUESTION 6

You are the chief accountant of Japa PLC, that prepares consolidated financial statements. The managing director who is not an accountant, has recently attended a workshop at which key corporate reporting issues were discussed.

The managing director remembers being taught the following at the workshop:

i. Financial statements of an entity should reflect the substance of its transactions.

ii. Revenue from the contracts with customers should only be recognised when certain conditions have been satisfied. Transfer of legal title of the goods is not necessarily sufficient for an entity to recognise revenue from their sales.

The financial year end of Japa PLC is August 31, In the year to August 31, 2021 the company entered into the following transactions:

Transaction 1

On March 1, 2021 Japa PLC sold a property to Kalokalo Bank LTD for ₦50million. The market value of the property at the date of the sale was ₦100million. However, Japa PLC continues to occupy the property rent-free. Japa PLC has the option to buy the property back from Kalokalo Bank LTD. at the end of every month from March 31, 2021 until February 28, 2026. Japa PLC has not yet exercised this option.

The repurchase price will be ₦50million plus ₦500,000 for every complete month that has elapsed from the date of sale to the date of repurchase. Kalokalo Bank LTD did not require Japa PLC to repurchase the property and the facility will lapses after February 28, 2026.

The director of Japa PLC expect property price to rise at around 5% each year for the foreseeable future.

Transaction 2

On September 1, 2020 Japa PLC sold one of its branches to Andrew Tourist Nig. LTD. for ₦80million. The net assets of the branch in the financial statements of Japa PLC immediately before the sale were ₦70million. Andrew Tourist Nig. LTD is a subsidiary of KalokaloBank LTD and was specifically incorporated to carry-out the purchase, it has no other business operations. Andrew Tourist Nig. LTD received the ₦80million to finance this project from its parent (Kalokalo Bank LTD) in the form of a loan.

Japa PLC continues to control the operations of the branch and receives an annual operating fee from Andrew Tourist Nig. LTD. The annual fee is the operating profit of the branch for the 12 months to the previous August 31 less the interest payable on the loan taken out by Andrew Tourist Nig. LTD. for the 12 months to previous August 31, if this amount is negative, then Japa PLC must pay the negative amount to Andrew Tourist Nig. LTD.
Any payments to or by Japa PLC must be made by September 30 following the end of the relevant period.

In the year to August 31, 2021, the branch made an operating profit of ₦20million, interest payable by Andrew Tourist Nig. LTD. on the loan for this period was ₦8million.

Required:

(a) In accordance with IFRS 15 – Revenue from contract with customers. Discuss the conditions that need to be satisfied before revenue can be recognised.
(5 Marks)

(b) Write a memo to the managing director of Japa PLC explaining how the transactions described above will be dealt with in the consolidated financial statements of Japa PLC for the year ended August 31, 2021 in accordance with IFRS 15. (10 Marks)

(Total 15 Marks)

QUESTION 7

Signal PLC purchased land and warehouse for ₦90,000,000. The warehouse is expected to last for 20 years and to have a salvage value equal to 10% of its cost. The Chief Finance Officer (CFO) and the Chief Accountant (CA) discussed the allocation of the purchase price between the land and the warehouse. The CFO believes that the largest amount possible should be assigned to the land because that will improve reported net income in the future. Depreciation expense will be lower because land is not depreciated. He suggested allocation of one third of the cost to the land. The CA argues that the smallest amount possible, about one-fifth of the purchase price, should be allocated to the land, thereby saving income taxes, since the depreciation will be greater if lesser amount is allocated to land.

Required:

a. Evaluate how the different allocations of one-third and one-fifth to land will affect reported earnings and determine how the purchase cost should be allocated. (8 Marks)

b. Identify and discuss inherent ethical issues in the CFO's submission in the above scenario. (7 Marks)

(Total 15 Marks)

SOLUTION 1

(a) Date: May, 2024

From: Financial controller

To: Finance director

Subject: Explanation of adjustments needed to ensure that Mansa-Konko's LTD statement of financial position (subsidiary company) comply with IFRS provisions

The following are the adjustments needed to the financial statements of the subsidiary company, Mansa-Konko LTD based in Gambia, West Africa.

(i) **Equipment**

- The equipment is categorised as a non-monetary asset as per IAS 21, hence, it should be measured at the rate of exchange at the acquisition date of January 1, 2023. Therefore, the equipment should originally have been included at a cost of GMD60million ($150m/2.50) and a liability for that amount recognised;
- Depreciation should be charged over the useful life of the equipment which commences on January 1, 2023 hence only 9 months, depreciation is required to be charged to September 30, 2023. This will give a depreciation charge of GMD4.5million [GMD60m ÷ 10 years x 75%] and a carrying amount of GMD55.5million [GMD60m – GMD4.5m]; and
- Exchange differences arose on January 1, 2023 and payment was made on March 31, 2023. This should be charged to the statement of profit or loss instead of directly to equity. The correct exchange difference is at $2.4 to 1 GMD, i.e. $150m/$2.4 =GMD 62.5m. Therefore, a loss of GMD2.5million [GMD62.5m – GMD 60] arose on settlement.

In view of the above, the subsidiary company will need to raise necessary corrective journals in its ledger as follows:

		DR GMD'000	CR GMD'000
a.	PPE (60m – 50m)	10,000	
	Payables		10,000
	Being correct recording of cost of equipment		
b.	Payables	12,500	
	Retained earnings		12,500
	Being reversal of wrong exchange difference		
c.	Profit or loss	2,500	
	Payables		2,500
	Being recognition of correct exchange loss		
d.	PPE	500	
	Profit or loss		500
	Being reversal of depreciation over charged (GMD5m less GMD4.5m)		

(ii) **Impairments**

Firstly, the initial depreciation (October 1, 2016 - October 1, 2022) and carrying amount at October 1, 2022 of warehouse before revaluation is GMD180m/20years x 6 years = GMD54 million.

Carrying amount at October 1, 2022 is arrived at as follows:
GMD 180m -GMD 54m =GMD 126 m
Revaluation surplus at October 1, 2022 is revalued amount less carrying amount.

Revaluation surplus is GMD 210m -GMD126m =GMD 84million.

Accounting treatment

Dr Warehouse GMD 84m
Cr Revaluation reserves (equity) GMD 84m
In line with IFRS, entity is permitted to make annual transfers of excess depreciation from revaluation surplus to retained earnings.

Excess depreciation = revaluation surplus /remaining useful life
GMD 84m/14 years = GMD 6m

Accounting treatment
Dr Revaluation surplus GMD 6m
Cr Retained earnings GMD6m

(iii) **Financial Instruments**

Under IFRS 9, financial instruments must be classified based on the business model for managing the financial assets and the contractual cash flow characteristics. In this case, the intention is to sell the shares within a year for profit, indicating the business model is to hold the financial asset for trading. Financial assets held for trading are classified as Fair Value Through Profit or Loss (FVTPL).

Initial recognition

Initial Cost: 5million shares×GMD7.7=GMD38.5million

Dr Financial assets (Shares) GMD38.5million

Cr Bank/cash GMD38.5million

Subsequent measurement:

Market Value at September 30, 2023 is:

5million shares×GMD12.5=GMD62.5million

Fair value gain: GMD 62.5million−GMD38.5million=GMD24million

Dr. Financial assets (Shares) GMD 24 million

Cr. Fair Value gain (Profit or Loss) GMD 24 million

Recognition of fair value gain: Under IFRS 9, changes in fair value of financial assets classified as FVTPL are recognised in profit or loss.

(iv) **Provisions**

Intangible asset recognition

In line with International Financial Reporting Standards (IFRS) and in accordance with IAS 38- Intangible Assets, a right is an intangible asset and the costs of acquisition of rights of GMD42.5 million on October 1, 2022 was correct.

Provision for replacement costs

Expected weighted cost should be calculated initially as:

$(40\% \times GMD75million)+(60\% \times GMD50million)$

$=GMD30million+GMD30million=GMD\ 60million.$

Initially, the expected cost of GMD 60m will be considered for the time value of money by calculating the present value using the pre-tax discount rate GMD60m $(1+0.08)^{-20}$= GMD12.87m

At the inception, the present value of GMD 12.87m will be added to cost of rights and credited to the provision for cost of replacement.

Dr Cost of right GMD12.87m

CR Provision for cost of replacement GMD 12.87m

At year-end, September 30, 2023, the unwinding cost will be calculated and treated as a finance cost

8% x GMD12.87m =GMD1.0296m

Dr Profit or loss (finance cost) GMD 1.03m

Cr Provision for the cost of replacement GMD 1.03m

Total intangible asset (right):GMD42.5 +GMD 12.87 = GMD55.37m
The right will be amortised over 20 years (55.37/20 years)
Amortisation =GMD2.77m

The carrying amount is GMD55.37 -GMD 2.77m =GMD 52.6m
Provision for replacement under non-current liability at September 30, 2023 GMD 12.87m +GMD 1.03m =GMD13.9m

The provision for replacement of GMD75m made and included in operating cost was not correct and should be reversed.

Conclusion:

All the treatments given above ensure compliance with IFRS asrelate to the acquisition of the equipment, revaluation and impairment of the warehouse, investment in sharesand financial obligations, and also ensure that the financial statements are not overstated.

Regards,
Financial Controller

(b) Mansa-Konko LTD

Revised statement of financial position suitable for consolidation as at September 30, 2023

Non-current assets:	**₦'000**
Property, plant and equipment	63,700
Intangible assets	10,113
Financial investments	12,500
Deferred tax	463
	86,776
Current assets	23,700
Total assets	**110,476**
Equities and liabilities:	
Equity:	
Share capital	10,000
Retained earnings	80,099
Equity	90,099
Non-current liabilities:	
Loan notes	10,000
Deferred tax	960
	10,960
Current liabilities	7,100
Provision	2,317
	9,417
Total equity and liabilities	**110,476**

Workings:

Mansa-Konko LTD

Revised statement of financial position suitable for consolidation with the parent company

	Initial SFPGMD' 000	Adjustment journals GMD'000 DR/CR	Adjusted SFPGMD' 000	Exchange rate	SFP for consolidation ₦'000
Property, plant and equipment	308,000	10,500DR(i)	318,500	5.0	63,700
Intangible assets	42,500	8,065DR(iv)	50,565	5.0	10,113
Financial investment	38,500	24,000DR(iii)	62,500	5.0	12,500
Current assets	118,500		118,500	5.0	23,700
Deferred tax asset	--	2,315DR(iv)	2,315	5.0	463
Total assets	507,500		552,380		110,476
Share capital	50,000		50,000	5.0	10,000
Retained earnings	213,000	19,200CR(iii) 10,500CR(i) 84,000CR(ii) 73,795CR(iv)	400,495	5.0	80,099
Revaluation surplus	84,000	(84,000)DR(ii)	--	5.0	--
Loan notes	50,000	--	50,000	5.0	10,000
Provisions	75,000	(63,415)DR(iv)	11,585	5.0	2,317
Current liabilities	35,500		35,500	5.0	7,100
Deferred tax liability	--	4,800 CR (iii)	4,800	5.0	960
Total equity and liabilities	507,500	NIL	552,380		110,476

Examiner's report

The question is in two parts, part (a) of the question tests candidates' knowledge of report writing to management on the explanation of adjustments which needs to be made in ensuring that the subsidiary companies comply with IFRS requirements, while part (b) tests candidates' knowledge of how to prepare a revised statement of financial position that will be suitable for consolidation with parents' financial statements.

All the candidates attempted the question but their performance was very poor.

The common pitfalls of the candidates were their inability to present the write up in report format and the inability to prepare correctly the necessary adjustments to explain to the management the adjustments which need to be made to ensure that the subsidiary companies comply with IFRS requirements. Other candidates did not understand how to prepare a revised statement of financial position that will be suitable for consolidation with parents' financial statements.

Candidates are advised to pay more attention tothe principles of various adjustments required for the preparation of consolidated statement of financial position in accordance with IFRS by practicing more questions and making use of ICAN Study Texts for better performance in future examinations.

Marking guide

		Marks	Marks
1(a)	**Adjustment to ensure that a subsidiary comply with IFRS requirements:**		
	Memo format	¼	
	Adjustments made on equipment in the financial statements	2½	
	Corrective journals on cost of PPE	2	
	Adjustments made on impairments in the financial statements	3½	
	Adjustments made on financial instruments in the financial statements:		
	Initial recognition of financial instrument	1¾	
	Subsequent measurement	2¼	
	Adjustments made on provisions in the financial statements	5¼	
	Conclusion	¼	
	Closing remarks	¼	18
(b)	**Revised statement of financial position:**		
	Non-current assets:		
	Property, plant and equipment	1	

Intangible assets	1		
Financial investments	1		
Deferred tax assets	1		
Current assets	1		
Equity:			
Share capital	1		
Retained earnings	1½		
Non-current liabilities:	1		
Loan notes		1	
Deferred tax liabilities		1	
Current liabilities		1	
Provisions		½	12
Total			30

SOLUTION 2

a. To: The Director
From: Finance controller
Date: May, 2024

Assessment of the comparative performance and financial position of Betta limited and Gamma limited for the year ended September 30, 2020.

Introduction

This memo is prepared to advise on how to make investment decision considering the performance and financial position of Betta Limited and Gamma Limited for the year ended September 30, 2020. The financial statements of the two companies must be reviewed and interpreted. The interpretation can be done through ratio analysis. The decision will be based on the outcome of the analysis as follows:

Performance and financial position of the two companies:

The following ratio analysis relates to the level of performance of the companies.

(i) **Gross profit margin:** It measures the proportion of revenue earned as profit after taking into consideration only cost of sales. The higher the gross profit margin, the better the company. Therefore, Betta limited with gross profit margin of 24.0% is better than Gamma limited with 18.6%. This may be attributed partly to marketing policy; Gamma may deliberately be charging lower selling prices in order to generate greater revenue. This may be evidenced by Gamma's turnover of ₦40 million compared to ₦25 million for Betta;

(ii) **Profit margin (before interest and tax):**This measure the proportion of revenue earned as profit after deducting all the expenses except interest and tax. Again, the higher the profit margin the better the company. Betta limited with profit margin of 19.0% is better than Gamma limited with 12.3%;

(iii) **Return on capital employed (ROCE):** This is a vital tool in assessing the performance of any company. The return on capital employed (ROCE) ratio is often described as a measure of management's overall efficiency in the use of assets and other resources at its disposal. It measures the overall performance of an entity by comparing the capital invested with profit. The higher the return on capital employed the better the company. Betta limited has 62.5% ROCE. This is better than Gamma limited with 31.0% ROCE. This superior returns could be analysed into its component part of profit margin and asset turnover and in both of these areas, Betta's performance is better than that of Gamma. Betta is generating ₦3.30 for every naira invested, compared to only ₦2.50 per naira invested in Gamma;

(iv) **Current ratio:** This is used to measure the ability of the entity to meet up with its short term obligation as and when due using current assets. The ideal norm for current ratio is 2:1. The two companies are liquid based on current ratio analysis as both of them has ratio over and above 2:1. Betta limited with 2.4 is better than Gamma of 2.1;

(v) **Acid test ratio:** This ratio measures the ability of the company to meet up with its short term obligation as and when due using liquid assets or quick assets i.e. (Current assets-inventory). The ideal norm for this ratio is 1:1. Although the two companies meet up with the ideal situation but Betta Limited is also better with1.6:1 than Gamma limited with 1.26:1;

(vi) **Net assets turnover:** This ratio measures the efficiency of the company's use of its assets in generating revenue. The ideal norm of net assets turnover is 2.5times. The results of this ratio for the two companies show they are both ideal as Betta Limited has 3.3times while Gamma Limited has 2.5times, therefore, Betta with a ratio of 3.3times is better;

(vii) **Closing inventories holding period:** This measure the average number of days or weeks that an entity's finished product stayed in the warehouse or store before being sold to the customers. The shorter the period, the better it is for the entity. Betta limited has a shorter period of 31days and therefore it is better than Gamma limited with 38 days;

(viii) **Trade receivables collection period:** This ratio measures the average number of days or weeks that it takes an entity to collect money from their customers after selling the goods to them on credit. The shorter the period, the better for the business. Betta limited has a shorter period of 31 days and therefore it is better than Gamma limited with 47days;

(ix) **Trade payables payment period:** This ratio measures the average number of days or weeks that the credit suppliers of the entity remain unsettled. The longer the period, the better for the entity. Betta limited has 24days which is higher than Gamma limited with 23days and therefore, Betta Limited is better among the two;

(x) **Liquidity positions:** Betta's current ratio is slightly higher (perhaps too high) than Gamma's. This seems to be due to holding of more cash (than Gamma) as it has better inventory and receivables control (their payable periods are very similar); though arguably the current finance lease obligation of Gamma should not be included in this ratio for comparative purposes.The individual components of the current ratio could suggest that Gamma holds a greater range of inventory (perhaps this helps it to achieve more sales) and the relatively high receivables collection period could be indicative of an uncollectible customer balance which should have been written off or may just be due to poor credit control;

(xi) **Gearing:** This ratio measures the degree of financial risk a is business exposed to as a result of how the business is financed. It relates debt capital to total capital employed (debt+ equity) of the company. An entity with above 50% gearing is said to be highly geared, less than 50% is said to be lowly geared while exact 50%gearing means the business is neutral. Both companies are highly geared as both of them have gearing of more than 50%. The exposure to financial risk of Gamma limited is lower because of the lower gearing of 64.6% than that of Betta with gearing of 65.8%. The relatively low equity, particularly retained earnings, may be due to the companies having a policy of paying most of their earnings as dividends. Gamma's high gearing is in part due to its policy of using finance leases to acquire its plant; and

(xii) **Other considerations:**

The superior gross margin of Betta continues into the operating profit level indicating that Betta has better control of its overheads. There are, however, a number of areas relating to the capital employed which may bring this superiority into question. Betta has deducted the receipt of a government grant directly from the carrying amount of the related plant (this is allowed but is rather unusual).

Normally, plant is shown gross (less accumulated depreciation) and related government grants are shown as a (separate) deferred credit.
It also appears that Betta rents its property whereas Gamma has purchased its property (and indeed revalued it which has increased its capital employed). Betta also holds proportionately less inventory and receivables than Gamma. Whilst these factors may not necessarily result in a higher profit for Betta (e.g. property rental may be higher than the equivalent depreciation of property), they would give Betta lower net assets (and thus lower capital employed) and, in turn, a higher ROCE than Gamma.

Bearing in mind these differences, it may be more helpful if Alpha were to calculate a return on its potential equity investment (ROE) of ₦12 million as this would be more relevant should it acquire either of the companies. Using profit after tax, Betta's ROE would be 30% (3,600/12,000 x 100) whereas Gamma's ROE would be 25% (3,000/12,000 x 100). This still supports Betta's superior return.

Both companies have ₦5 million in loan notes however, the interest rate on Betta's loan is only 5% compared to 10% for Gamma, presumably this reflects the difference in the credit worthiness of the two companies which is something that Alpha should take note of. There also appears to be a favourable tax discrepancy with Betta paying a nominal rate of tax on its profit of 20% compared with 25% paid by Gamma. This may be due to be adjustments relating to previous years' profits or other tax issues. If Betta had a comparable (to Gamma) finance cost and tax rate, its ROE would be nearer that of Gamma.

Alpha should be aware that, for both companies, the ₦5 million loans are due for repayment in the near future which will represent a substantial further cash outlay on top of the purchase price it may pay.

Summary and conclusion
Although both companies operate in a same industrial sector and have a similar level of after-tax profits and indeed have the same indicative valuation, they would represent very different investments. Gamma's revenue is over 60% (15,000/25,000 x 100) higher than that of Betta, it is financed by high levels of debt (loans and finance leases) and it also owns, rather than rents, its property.
Another point of note is that Gamma's plant is 80% depreciated and will need replacement in the near future (with consequent financing implications). Ultimately, the investment decision may be determined by Alpha's attitude to risk and how well each investment would fit with existing activities and management structure.

In conclusion, by considering the above interpretation of the two companies as carried out in the ratio analysis and as explained in the above ten points. It is clear that the two companies are good to invest in as both of them meet with ideal norms. However, is advisable for Alpha PLC to invest its funds in Betta limited as it is better than Gamma limited based on the above analysis

Thank you.

ABC
Finance controller

b. **Other qualitative factors to consider for investment decision in a foreign subsidiary**

The management of Alpha PLC should take into consideration the following factors:
(i) Currency exchange disparity;
(ii) Interest rate and maturity;
(iii) Other related operating costs;
(iv) Regulatory issues;

(v) Capital markets development;
(vi) Infrastructural development;
(vii) Size and type of the economy, economic policies and growth rate;
(viii) Political stability of the country
(ix) Culture of the people, this may be necessary depending on the nature of the product;
(x) Taxation; and
(xi) Debt-equity ratio.

Examiner's report

The question is in two parts, part (a) tests candidates' knowledge of writing memo to advise on how to make investment decision on the performance and financial position to the directors of company. Part (b) tests candidates' knowledge of other qualitative factors that the management should take into consideration for investment in a foreign subsidiary.

Majority of the candidates attempted the question and their performance was above average.

The common pitfalls of the candidates were their inability to present their report in memo format. While others could not correctly state the reasons why other qualitative factors are taken into consideration by the management for investment in a foreign subsidiary.

Candidates are advised to ensure that they prepare more on interpretation and application of ratio analysis as well as get familiar with other qualitative factors that may be considered in investment decision. They should also get familiar with the presentation of report in memo format.

Marking guide

		Marks	Marks
a.	**Writing of memo to the Director:**		
	Memo format	1	
	Introduction	1	
	Report on profitability	5	
	Report on financial position	5	
	Summary and conclusion	½	
	Closure of the memo	1½	14
b.	Qualitative factors to be considered for a foreign subsidiary		6
	Total		**20**

SOLUTION 3

(i) Property, plant and equipment

a. To address the deferred tax implications of Bamboo PLC's purchase of property, plant and equipment, we need to consider International Accounting Standard IAS 12 - Income Taxes, which outline the accounting treatment for deferred taxes.

IAS 12 requires the recognition of deferred tax liabilities for all taxable temporary differences. Thus, the company must recognise these deferred tax liabilities and assets in its financial statements accordingly

Government grant: Deducted from the cost of the asset for accounting purposes.

Depreciation: Calculated on the net cost (₦100 million) over the asset's useful life (5 years).

Capital allowance: The tax base is reduced by the capital allowance each year, but restricted by the amount of the grant.

Deferred tax liability: Recognised for the temporary differences arising between the carrying amount and the tax base of the asset, multiplied by the applicable tax rate.

Depreciation and carrying amount
Cost of the asset purchased: ₦120 million
Government Grant: ₦20 million
Net Cost (after grant): ₦100 million (this is the amount on which the company will calculate depreciation).

Depreciation:
Useful Life: 5 years
Depreciation on straight-line method
₦100m/5 years =₦20m
Carrying amount of asset = Cost less accumulated deprecation
₦100 - ₦20m =₦80m

Tax implication,tax base and capital allowance
Initial tax base of asset:₦100 million (since capital allowance is restricted by the amount of the grant)

Capital allowance rate: 25% per annum
Capital allowance 25% x₦100m =₦25m
Tax base = cost less capital allowance
₦100m - ₦25m = ₦75m

Deferred tax implication
Temporary difference (Taxable temporary difference)x tax rate
(Carrying amount - Tax base)x30%
₦ (80m -75m)x 30% =₦1.5m
Deferred tax liability =₦1.5m

(ii) **Fair value adjustments**
A taxable temporary difference arise for the group because, on consolidation the carrying amount of property , plant and equipment has increased to fair value but its tax base has not changed. The fair value adjustment is calculated as

Carrying amount of PPE	80
Tax base	(70)
Temporary difference	10

Deferred taxliability (30%x₦10)3m
The deferred tax of ₦3m is debited to goodwill(i.e. increase goodwill), reducing the fair value adjustment (i.e. net asset at acquisition).

(iii) **Profit from foreign subsidiary**
The issue is deferred tax on undistributed profits
According to IAS 12, deferred tax liabilities should be recognised for all taxable temporary differences associated with investments in subsidiaries, branches, associates and joint ventures, except when both of the following conditions are met:

- The parent, investor, or venture is able to control the timing of the reversal of the temporary difference; and
- It is probable that the temporary difference will not reverse in the foreseeable future.

Undistributed profit: $5,000

Additional tax payable if remitted to Bamboo PLC:₦4 million
Current intention: Bamboo PLC intends to leave the earnings with Pako Limited for re-investment.

Deferred Tax Implications:

- Control over timing of reversal:
  Bamboo PLC, as the parent company, has control over whether Pako Limited distributes its profits. This satisfies the first condition for not recognising a deferred tax liability.

- Probability of reversal:

  Bamboo PLC intends to reinvest the earnings in Pako Limited, indicating that it is not probable that these profits will be remitted in the foreseeable future. This satisfies the second condition for not recognising a deferred tax liability.

  Since both conditions are met, Bamboo PLC does not need to recognise a deferred tax liability for the undistributed profits of Pako Limited. However, this situation should be monitored continuously. If circumstances change, such that it becomes probable that the profits will be remitted, Bamboo PLC will need to recognise the deferred tax liability of ₦4m at that point.

a. Draft statement of financial position as at October 31, 2023

	₦'m
Deferred tax	77
Other non- current assets	2,329
Inventories and other current assets	1,150
Cash and cash equivalents	422
Total assets	**3,978**
Other non-current liabilities	1,371
Deferred tax liabilities ₦(186m+3.0m)	189
Payables and accruals	1,131
Total liabilities	**2,991**
Share capital	250
Share premium	120
Retained earnings₦(620m-3.0)	617
Total equity	**987**
Total equity and liabilities	**3,978**

Examiner's report

The question is in two parts, Part (a) tests candidates' knowledge on the computation and implications of deferred tax on property, plant and equipment; fair value adjustments; and profit from foreign subsidiary, while part (b) tests the deferred tax effects on the financial statements and the accounting treatments required under IAS 12.

Few candidates attempted the question and their performance was very poor.

The common pitfalls of the candidates werelack of understanding of the requirements of the question as it relates to practical application of IAS 12- Income Taxes, and deferred tax implications of undistributed profit from foreign subsidiary.

Majority of the candidate were unable to calculate depreciation and carrying amount of the PPE, useful life of the asset, capital allowances, tax base and implications, effect of profit from foreign subsidiary and deferred tax implications

Candidates are advised to have in-depth understanding of accounting standards examinable at this level of the Institute's examinations and the accounting treatment of each of them in the financial statements for better performance in future.

Marking guide

		Marks	Marks
a.	**Explanation on deferred tax implications on the following:**		
(i)	**Property, plant and equipment:**		
	Computation of depreciation and carrying amount	2	
	Tax base and capital allowance implication	1½	
	Deferred tax implication	1½	
(ii)	**Fair value adjustment:**		
	Computation of carrying amount of PPE	1	
	Tax base and temporary difference	2	
	Computation of deferred tax liabilities	1	
	Deferred tax implication	1	
(iii)	**Profit from foreign subsidiary:**		
	Deferred tax on undistributed profits	2	
	Deferred tax implication	3	15
b.	**Deferred tax effects on the draft statement of financial position:**		
	Deferred tax liabilities	3	
	Retained earnings	2	5
	Total		**20**

SOLUTION 4

(i) IFRS 16 requires the lessee to recognise and measure rights and obligations under lease arrangements as follows:

Recognition

- **Identifying a lease:**
  - Definition: A lease is a contract that conveys the right to control the use of an identified asset for a period in exchange for consideration.
  - Control: The lessee must have the right to obtain substantially all the economic benefits from using the asset and the right to direct the use of the asset.

- **Exemptions:**
  - Short-term leases areleases with a lease term of 12 months or less.
  - Low-value assets leases are for assets of low value, such as personal computers or small office equipment. The lessees can choose to recognise these leases as an expense instead of applying IFRS 16's recognition and measurement requirements.

Measurement:

Initial measurement of the lease liability:

- Lease payments: Include fixed payments (less any lease incentives), variable lease payments that depend on an index or rate, amounts expected to be payable under residual value guarantees and the exercise price of a purchase option if the lessee is reasonably certain to exercise that option.
-
- Discount rate: The present value of the lease payments is calculated using the interest rate implicit in the lease if readily determinable; otherwise, the lessee's incremental borrowing rate is used.

Initial measurement of the right-of-use asset:

- Components: The cost of the right-of-use asset includes the initial measurement of the lease liability, any lease payments made at or before the commencement date (less any lease incentives received), any initial direct costs incurred by the lessee, and an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset or restoring the site.

Subsequent measurement

- Lease liability:
  - Accretion: The lease liability is increased by interest on the lease liability and reduced by lease payments made.
  - Re-assessment: If there are changes in lease terms, the lease liability must be re-measured using a revised discount rate.

- Right-of-use asset:
  - Depreciation: The right-of-use asset is depreciated over the shorter of the asset's useful life and the lease term.
  - Impairment: The right-of-use asset is subject to impairment reviews in accordance with IAS 36-Impairment of Assets.
  - Re-assessment: If there are changes in lease payments or the lease term, the right-of-use asset is adjusted to reflect those changes.

Presentation and disclosure

- Statement of financial position:
  - Assets: The right-of-use assets are presented separately from other assets.
  - Liabilities: Lease liabilities are presented separately from other liabilities.

- Statement of profit or loss:
  - Depreciation: Depreciation of the right-of-use asset and interest on the lease liability are presented separately.
  - Interest expense: Interest on the lease liability is presented as an interest expense.

- Disclosure requirements:
  - Qualitative and quantitative Information: The lessee must provide comprehensive disclosures about leasing activities, including information about the nature of the leases, future cash outflows to which the lessee is potentially exposed, and a maturity analysis of lease liabilities.

(ii) A short-term lease is defined as a lease that, at the commencement date, has a lease term of 12 months or less.

Accounting policy choice

Lessees can choose, as an accounting policy, to apply the following simplified approach to short-term leases:

- No recognition of right-of-use asset or lease liability:
  - Under this simplified approach, the lessee does not recognise a right-of-use asset or a lease liability on the statement of financial position for short-term leases;

- Rather the leasee should recognise lease payments as an expense:
  - Lease payments on short-term leases are recognised as an expense during the lease term or another systematic basis if that basis is more representative of the pattern of the lessee's benefit from the use of the underlying asset.

Measurement

- Initial measurement:
  - There is no need to measure a right-of-use asset or a lease liability. Instead, the focus is on recognising lease payments as an expense.
- Subsequent measurement:
  - Lease payments are recognised as an expense in the period in which they are incurred.

Disclosures

Even though short-term leases are not recognised on the statement of financial position, the lessee must still provide certain disclosures in their financial statements:

- Expense information: The total expense related to short-term leases should be disclosed.
- Accounting policy: The accounting policy applied to short-term leases, including the election to use the short-term lease recognition exemption, must be disclosed.
- Nature of leases: Information about the nature of the lessee's leasing activities, including a description of the leases, should be disclosed.

b. **Internal memo**

To: Finance Director
From: Finance Controller
Date: May, 2024

Subject: **Explanation of lease accounting under IFRS 16 for the leased warehouse**

The adoption of IFRS 16 - Leases requires significant changes in how companies recognise and report leases compared to the previous IAS 17 - Leases. This memo outlines the implications for Ododoeye PLC, specifically regarding the lease of a warehouse for five (5) years.

Key changes

- **Right-of-use assets**: Under IFRS 16, leases with terms exceeding 12 months must be recognised as right-of-use assets and lease liabilities on the statement of financial position. This differs from IAS 17, where leases were classified as either operating or finance leases.
- **Lease details**: For Ododoeye PLC, the annual lease rental of ₦5,000,000 is payable in arrears. Interest of 10% will be charged on the total balance of ₦20,000,000 (₦18,950,000 principal + ₦1,050,000 interest) for the year before the installment payment of ₦5,000,000.

Accounting treatment

- A debit of ₦20,000,000 will be made to non-current assets as right-of-use assets, which will be depreciated over five years.
- For March, the depreciation will be calculated as ₦20,000,000 x 20% X 6/12 = ₦2,000,000, resulting in a carrying amount of ₦18,000,000 (₦20,000,000 - ₦2,000,000).
- The Initial carrying amount of the right-of-use asset comprises the present value of the lease payments plus any direct cost incurred in arranging for the lease. In this case therefore, the initial carrying amount at October 1, 2022 will be ₦20million which is ₦ (18,950,000 + 1,050,000).
- The right-of-use asset is included as a separate component of property, plant and equipment and depreciated over the lease terms.
- When the right-of-use asset is recognised, a lease liability is also recognised. It is initially measured at the present value of the lease payment – ₦18, 950,000 in this case.

- The liability will be increased by a finance costs. This cost is based on the carrying amount of the liability and the rate of interest implicit in the lease.
- When lease rental are paid, they will be treated as payment of the lease liability.

- Since a lease rental is due for payment six months after the year end,₦5million of the lease liability will be treated as a current liability. The balance will be classified as non-current liability.

- Under IFRS 16, right-of-use assets are recognised on the statement of financial position rather than as property, plant, and equipment therefore, recognition of a non-current asset will be required in our financial statements.

Financial statement impact

- **Lease liabilities:** Future lease payments will be recognised as lease liabilities on the statement of financial position. This would lead to higher debt and interest payment in view of the fact that operating lease is now capitalised.
- **Interest expense:** Interest expenses related to lease liabilities will be recognised in the statement of financial performance.
- **Statements of cashflows:** Changes in lease liabilities and related interest expenses will be reflected in the statements of cashflows.

Conclusion

Chief Okechukwu's concerns regarding the treatment of leased assets under IFRS 16 are valid. The adoption of IFRS 16 requires Ododoeye PLC to recognise right-of-use assets and lease liabilities for long-term leases like the warehouse. This change significantly impacts both the statement of financial position and the income statement compared to the previous IAS 17 standard.
Hope this information serves your purpose.

Thank you.

Ododoeye
Finance controller

Examiner's report

The question is in two parts, part (a) of the question tests candidates' knowledge of how IFRS 16 – Leases requires lessees to recognise and measure rights and obligations under lease arrangement and discussion on how a lessee should measure the rights and obligations under a short-term lease arrangement. Part (b) tests writing of memo on the adoption of IFRS 16 -leases as against the use of the previous IAS 17 on right-of-use assets in the financial statements.

Few of the candidates attempted the question and their performance was below average.

The common pitfalls of the candidates were their lack of knowledge of the requirements of the question as some were highlighting the provisions of the replaced IAS 17. They did not understand how to write memo to explain the financial statements impacts of the lease liabilities and interest expense arising from the rights-of-use assets.

Candidates are advised to carry out in-depth study and cover all areas of the syllabus, practice more past questions and pay attention to relevant accounting standards that are examinable at this level of the Institute's examination. They should also use ICAN Study Texts for better performance in future examinations.

Marking guide

		Marks	Marks
a. (i)	**Explanation on how IFRS 16 recognised and measure rights and obligations under lease arrangements:**		
	Recognition: Identification and exemptions	1	
	Initial measurement of lease liability and right-of-use assets	1¾	
	Subsequent measurement of lease liability and right-of-use assets	1¼	4
(ii)	**Measurement of the rights and obligations under a short-term lease arrangements:**		
	Identification of short-term lease	1	
	Recognition of short-term lease as an expense	1	
	Initial measurement of short-term lease	1	
	Subsequent measurement and disclosures	1	4
b.	**Internal memo to Finance Director:**		
	Memo format	1	
	Introduction	½	
	Key changes on the right-of-use and lease details	2	
	Accounting treatments of the right-of-use assets	6	
	Financial statement impact of right-of-use assets	1½	
	Conclusion	½	
	Closing remarks	½	12
	Total		20

SOLUTION 5

a. i) **Conditions under which publicly traded entities should publish interim report**

IAS 34 -Interim Financial Reporting does not make preparation of interim report mandatory nor specify the frequency of interim reporting, this is a matter for national regulations which differ from one country to another. However, IAS 34 encourages publicly-traded companies to:

- Prepare interim accounts that conform with recognition, measurement and disclosure principles under IAS 34;
- Prepare interim accounts for at least the first six (6) months of their financial year (i.e. a half year interim report); and
- File their interim reports with the national authority not later than 60 days after the end of the interim period.

Other conditions include the following:

- If a complete set of financial statements are published in the interim reports, they must be in full compliance with IFRSs;
- If the financial statements are condensed, they should include, at a minimum, each of the headings and subtotals included in the most recent financial statements and explanatory notes required by IAS 34;
- If the annual financial statements were consolidated (group), the interim report should be for the group as well; and
- If the company's business is highly seasonal, IAS 34 encourages disclosure of financial information for the latest 12 months and comparative figures for the prior 12 months period in addition to the interim financial period.

(ii) **Notes that should be in the interim report of publicly traded entities**

Explanatory notes required are designed to provide explanations of events and transactions that are significant to the understanding of the changes in the financial position and performance of the entity since the last annual reporting date. It is assumed that users of the interim report have access to the annual report of the company and so repetition of items in the previous annual report is to be avoided. Such notes include:

- Statement that the same accounting policies and methods of valuation have been used for interim and annual reports or otherwise;
- Any significant seasonality or cyclicality in operations;
- Cash flows that are unusual due to their nature, incidence or size;
- The issue of repurchase of equity or debt securities;
- Nature and amount of changes in previous estimates affecting current interim report;
- Dividend paid on all categories of shares;
- Inventories written down;
- Recognition and reversal of an impairment loss;
- Acquisition and disposal of property, plant and equipment;
- Litigation settlements;
- Correction of prior period errors;
- Reversal of provisions for cost of restructuring;
- Commitments for the purchase of property, plant and equipment;
- Un-remedied loan defaults and breaches of loan agreements;
- Segment results if relevant to the entity;
- Any significant event since the end of the interim period;
- Effect of changes in the composition of the entity including acquisition, disposals and long term-investment, restricting and discontinued operations; and

- Any significant change in contingent liabilities or contingent assets since the date of the last statement of financial position.

b. IAS 34 acknowledges the fact that, while reasonable estimates are often used for both annual and interim financial reports, interim reports will require a greater use of estimates than annual financial reports. Therefore, appendix C to IAS 34 provides a number of examples of the use of estimates in interim financial reports.

The areas where estimates are allowed include:

Inventories: Full inventory counts and valuation procedures may not be required for inventories at interim dates, although it may be done at financial year end. It may be sufficient to make estimates at interim dates based on sales margins;

Classifications of current and non-current assets and liabilities: Entities may do a more thorough investigation for classifying assets and liabilities as current or non-current at the end of annual reporting periods than at interim dates;

Provisions: The calculation of some provisions requires the assistance of an expert. IAS 34 recognises that this would be too costly and time-consuming for the interim accounts. IAS 34 therefore states that the figure included in the annual financial statements for the previous year should be updated without reference to an expert;

Pensions: A company is not expected to obtain an actuarial valuation of its pension liabilities at the interim date. The guidance suggests that the most recent valuation should be rolled forward and used in the interim accounts. For interim reporting purposes, reliable measurement is often obtainable by extrapolation of the latest actuarial valuation. Therefore, the requirement in IAS 19 may not be necessary for an interim report;

Income taxes: Entities may calculate income tax expense and deferred income tax liability at annual dates by applying the tax rate for each individual jurisdiction to measures of income for each jurisdiction. IAS 34 acknowledges that while that degree of precision is desirable at the end of interim reporting periods as well, it may not be achievable in all cases and a weighted average of rates across jurisdictions or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates;

Contingencies: The measurement of contingencies may involve the opinions of legal experts or other advisers. Formal reports from independent experts are sometimes obtained with respect to contingencies. Such opinions about litigation, claims, assessments, and other contingencies and uncertainties may or may not also be needed at interim dates;

Revaluations and fair value measurements: An entity may rely on professionally qualified valuers at the end of annual reporting periods, not necessarily at the end of interim reporting periods when usageof estimates may be more realistic;

Intercompany reconciliations: Some intercompany balances that are reconciled on a detailed level in preparing consolidated financial statements at financial year end might be reconciled at a less detailed level in preparing consolidated financial statements at an interim date;and

Specialised industries: Due to complexity, costliness and time, interim period measurements in specialised industries might be less precise than at financial year-end. An example would be calculation of insurance reserves by insurance companies.

Examiner's report

The question is in two parts, part (a) of the question tests candidates' knowledge of the conditions under which IAS 34- Interim Financial Reporting encourages publicly traded entities to publish their interim report and the notes that should be included in the interim report of traded entities in accordance with IAS 34. Part (b) of the question tests candidates' knowledge of the financial information that could be included in interim reports, where IAS 34 permits the use of estimates.

Few of the candidates attempted the question and their performance was below average.

The common pitfalls of the candidates were their inability to interpret the question correctly; they cannot clearly state the conditions under which IAS 34 encourages publicly traded entities to publish their interim report and the notes that should be included in the interim report of traded entities. Majority of the candidates cannot state the areas where the uses of estimates are permitted in the interim financial reports.

Candidates are advised to familiarise themselves with all aspects of the syllabus and pay attention to all accounting standards in the syllabus for better performance in future examinations.

Marking guide

		Marks
a. (i)	Conditions under which publicly traded entities should publish interim report:	
	Identification of six (6) conditions	3
(ii)	Identification and explanation of the notes that should be in the interim report of publicly traded entities:	
	Ten (10) correct points	5
b.	Discussion and examples of financial information that could be included in interim reports where IAS 34 permits the use of estimates:	
	Identification and explanation of seven (7) of such financial information	7
	Total	15

SOLUTION 6

a. In accordance with IFRS 15, revenue is defined as income arising in the course of an entity's ordinary activities. This standard outlines a five step model in accounting for revenue. The five step models are:

(i) Identify the contract with a customer i.e. (The contract has to be approved by the parties);

(ii) Identify each parties performance obligations in the contract i.e. (The parties' right or obligation has to be identified in relation to the goods or services);

(iii) Determine the contract price i.e. (The payment terms must be identified);

(iv) Allocate the transaction price to the performance obligation in the contract; and

(v) Recognise revenue when the entity satisfies a performance obligation.

b. To: **Managing Director**

From: Financial Controller

Date: May, 2024

Subject: **Treatment of transactions for consolidated financial statements asof August 31, 2021 in accordance with IFRS 15**

This write-up is to provide clarity on how the two significant transactions entered into during the financial year will be treated in the consolidated financial statements of Japa PLC for the year ended August 31, 2021, in compliance with IFRS 15 - Revenue from Contracts with Customers.

Transaction 1: Sale and repurchase of property to Kalokalo bank LTD
A repurchase agreement is said to exist where an entity sells an asset, but retains a right to repurchase the asset. According to IFRS 15, this is often not recognised as a sale. Rather, it is referred to as a secured loan against the asset. There are some conditions which indicate that the repurchase agreement is not to be recognised as sales. These include:

(i) When the asset is sold or transferred at an amount which is less than the fair value;
(ii) When there is option to repurchase, the asset is less than or below the expected fair value;
(iii) When the selling entity continues to use the asset;
(iv) When the entity continues to hold the majority of risks and rewards associated with the asset; and
(v) When the sale is made to a bank or other financial institutions.

There are different forms of repurchase agreement. These include:

(i) Forward contract: Where the seller has the obligation to repurchase the asset;
(ii) Call option: Where the seller has the right to repurchase the asset; and
(iii) Put option: Where the seller has the obligation to repurchase the asset at the request of the buyer.

In the case of Japa PLC, the transaction with Kalokalo bank PLC is a call option where the entity that transfers a good does not retain a substantive forward repurchase obligation, that is, a repurchase right. The entity that transfers the good should not recognise revenue when the good was initially transferred because the repurchase right limits the ability to control the good. The repurchase price is not less than the original selling price it should therefore, be accounted for as financing arrangements.

Under call option, if the seller entity expects to repurchase the asset for an amount that is greater than or equal to the original sales price, then the entity will account for the transaction as financing arrangement.
Under financing arrangement, the entity will continue to recognise the asset as part of their non-current asset and recognise any consideration received as liability. This simply means no revenue will be recognised.

Transaction 2: Sale of branch to Andrew Tourist Nig. LTD

Details of the transaction:

- On September 1, 2020, Japa PLC sold a branch to Andrew Tourist Nig. LTD for ₦80 million. The net assets of the branch were ₦70 million.
- Japa PLC controls the operating fee from Andrew Tourist Nig. LTD, which is based on the operating profit of the branch minus interest payable to Kalokalo Bank LTD.

Substance over form:

- The sale appears to lack substance as Japa PLC continues to control the branch's operations through the operating fee arrangement; and
- Despite the transfer of legal ownership, the economic benefits and risks associated with the branch operations remain with Japa PLC.

Accounting treatment:

- Revenue recognition criteria are not met because Japa PLC retains control over the branch operations;
- The ₦80 million received will not be recognised as revenue from the sale. Instead, it should be recorded as a financial liability;
- The branch's assets and liabilities should remain consolidated in Japa PLC's financial statements; and
- The operating fee arrangement indicates ongoing control and benefits retained by Japa PLC, implying the transaction is more similar to a financing arrangement.

Conclusion:

Both transactions should be treated as financing arrangements rather than sales. The properties and branch assets should remain on Japa PLC'sstatement of financial position, with the amounts received recognised as financial liabilities. This approach ensures that the financial statements reflect the substance of these transactions, adhering to the principles of IFRS 15.

Please let me know if you need further clarification on these matters.

Best regards,
Financial Controller

Examiner's report

The question is in two parts, part (a) of the question tests candidates' knowledge of the provisions of IFRS 15- Revenue from Contract with Customers on the conditions that need to be satisfied before revenue can be recognised, while part (b) requires candidates to write a memo to explain the conditions precedent to recognition of repurchase agreement and substance over form will be dealt with in the consolidated financial statements in accordance with IFRS.

Majority of the candidates attempted the question but their performance was below average.

The common pitfalls of the candidates were theirlack of understanding ofthe provisions of IFRS 15 on the conditions that need to be satisfied before revenue can be recognised and they were unable to write memo properly on the treatments of transactions for the consolidated financial statements in accordance with IFRS.

Candidates are advised to pay more attention to all aspects of the syllabus, particularly the areas that relates to accounting standards in corporate financial reporting for better performance in the Institute's future examinations.

Marking guide

		Marks
a.(i)	Conditions under which publicly traded entities should publish interim report: Identification of six (6) conditions	3
(ii)	Identification and explanation of the notes that should be in the interim report of publicly traded entities: Ten (10) correct points	
b.	Discussion and examples of financial information that could be included in interim reports where IAS 34 permits the use of estimates:	5
	Identify and explain seven (7) of such financial information	7
	Total	15

SOLUTION 7

a. **Allocating 1/3 of ₦90,000,000 to land:**

1/3 of ₦90, 000,000 is		₦30, 000,000
Allocation to warehouse will be =		₦60, 000,000
Salvage value of warehouse will be 10% of ₦60, 000,000	=	₦ 6, 000,000
Depreciable amount		₦54, 000,000
Annual depreciation on straight line basis for 20years =		₦2, 700,000

Allocating 1/5 of ₦90, 000,000 to land:

1/5 of ₦90,000,000 is	₦18,000,000
Allocation to warehouse will be =	₦72, 000,000
Salvage value of warehouse will be 10% of ₦72, 000,000	₦ 7, 200,000
Depreciable amount	₦64, 800,000
Annual depreciation on straight line basis for 20years =	₦ 3, 240,000

With annual depreciation of ₦2,700,000, reported earnings will be higher than when annual depreciation is ₦3,240,000. However, the company will be exposed to higher tax.

Income tax savings will be ₦(3,240,000-2,700,000) x tax rate

= (₦540,000) x30%= ₦162,000.

Determining the optimal allocation: In determining the optimal allocation, there is need to consider the economic substance of the assets.
The warehouse has a finite useful life of 20 years and a salvage value equal to 10% of its cost, indicating that it is a depreciable asset.
A more appropriate allocation would involve assigning a higher proportion of the purchase price to the warehouse to reflect its depreciable nature and economic value over time.

A balanced allocation that considers the expected useful life, salvage value, and depreciation of the warehouse would provide a more accurate representation of the company's financial position.

Therefore, while allocating one-third of the cost to the land may temporarily boost reported net income by reducing depreciation expenses, a more appropriate allocation would involve assigning a higher proportion to the warehouse to accurately reflect its depreciable nature and economic value. Balancing the allocation based on the assets' characteristics and expected future benefits would lead to more transparent and reliable financial statements.

b. **Ethical issues**

In the scenario provided, the CFO's suggestion to allocate the largest amount possible to the land in order to improve reported net income raises several ethical issues. Here are the inherent ethical issues in the CFO's submission:

(i) **Manipulation of financial statements**
The CFO's proposal to allocate one-third of the purchase price to the land with the intention of lowering depreciation expenses and boosting reported net income can be seen as an attempt to manipulate the financial statements. This could mislead stakeholders and investors about the true financial performance and position of the company;

(ii) **Lack of transparency**
By selectively allocating a disproportionate amount to the land to achieve a desired financial outcome, the CFO is compromising the transparency and integrity of the financial reporting process. Stakeholders rely on accurate and transparent financial statements to make informed decisions;

(iii) **Conflict of interest**
The CFO's focus on improving reported net income for future periods may indicate a conflict of interest. Prioritising short-term performance metrics over the long-term economic substance of the assets could result in decisions that benefit certain stakeholders at the expense of others;

(iv) **Violation of accounting standards** (Professional competence and due care)
Allocating a significant portion of the purchase price to an asset like land, which is not subject to depreciation, may be in violation of accounting standards and principles. Assets should be valued and allocated based on their economic substance and characteristics, rather than solely for the purpose of enhancing reported metrics; and

(v) **Risk of misrepresentation:**
By advocating for an allocation strategy that distorts the true value and economic attributes of the assets, the CFO increases the risk of misrepresenting the company's financial position. This could have legal and regulatory implications, as well as damage the organisation's reputation.

In summary, the CFO's proposal to allocate a disproportionate amount to the land in order to manipulate financial results raises significant ethical concerns relating to transparency, integrity, compliance with accounting standards and stakeholder trust. It is important for financial professionals to adhere to ethical principles and prioritise accurate and reliable financial reporting to maintain the credibility and sustainability of the organisation.

Examiner's report

The question is in two parts, part (a) of the question tests candidates' practical understanding of the optimal allocation of purchase price to non-current assets comprising of a Land and a warehouse that was purchased together, while part (b) tests candidates' knowledge of the inherent ethical issues in the mis-allocation of a cost or purchase price of an asset.

Majority of the candidates attempted the questionbut their performance was below average.

Common pitfalls of the candidates were inadequate knowledge of how to determine the optimal allocation of purchase price between land and warehouse purchased together. They also displayed poor understanding of the ethical implications of inappropriate allocation of purchase price to assets.

Candidates are advised to ensure they understand the requirements and practical application of make use of all the accounting standards that are examinable at this level of the Institute's examination. They should also make use of ICAN Study Texts for better performance in the Institute's future examinations.

Marking guide

		Marks	Marks
a.			
	Effect of allocation of one-third of cost of purchase of land and warehouse to land on reported earnings	2½	
	Effect of allocation of one-fifth of cost of purchase of land and warehouse to land on reported earnings	2½	
	Discussion of income tax savings on each option	1	
	Determination of the optimal allocation	2	8
b.	**Identification and discussion of ethical issues:**		
	Introduction	½	
	4 correct points identified	2	
	4 correct points explained	4	
	Conclusion	½	7
	Total		**15**

ICAN/241/V/C4 Examination No..........................

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2024

ADVANCED TAXATION

EXAMINATION INSTRUCTIONS

PLEASE READ THESE INSTRUCTIONS BEFORE THE COMMENCEMENT OF THE PAPER

1. Check your pockets, purse, mathematical set, etc. to ensure that you do not have prohibited items such as telephone handset, electronic storage device, programmable devices, wristwatches or any form of written material on you in the examination hall. You will be stopped from continuing with the examination and liable to further disciplinary actions including cancellation of examination result if caught.
2. Write your **EXAMINATION NUMBER** in the space provided above.
3. Do **NOT** write anything on your question paper **EXCEPT** your examination number.
4. Do **NOT** write anything on your docket.
5. Read all instructions in each section of the question paper carefully before answering the questions.
6. Do **NOT** answer more than the number of questions required in each section, otherwise, you will be penalised.
7. All solutions should be written in **BLUE** or **BLACK INK**. Any solution written in **PENCIL** or **RED INK** will not be marked.
8. Tax and Capital Allowances rates are provided with this examination paper

TUESDAY, MAY 14, 2024

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2024

ADVANCED TAXATION

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Soft Farm and Agro-Allied Limited, a subsidiary of Emperor Agro Incorporated, Italy, was incorporated in Nigeria in January 2018. Soft Farm and Agro-Allied Limited produces palm kernel for domestic use and export to the European market.

The Managing Director of the company has just received a letter from the head office (parent company) of an impending visits occasioned by poor business performance (below the group's return on investment benchmark of 25%) since commencement of the business, in spite of financial and technical supports rendered by the parent company. It would be recalled that in January 2022, the parent company granted the loan request of ₦100 million to Soft Farm and Agro-Allied Limited for business expansion.

The Board has scheduled a special meeting for next month for the consideration of the financial report of Soft Farm and Agro-Allied Limited for the year ended December 31, 2022 and review of past financial reports and tax assessments.

As the newly engaged Tax Consultant to the company, you have been invited to be part of the meeting for the purpose of providing professional opinion on tax related issues that may arise. To help you prepare adequately for the meeting, the Financial Accountant has been directed by the Managing Director to make available to you the financial statements for all the periods under review, books of accounts, returns filed with tax authorities and other supporting documents.

You noted from the preliminary review of the financial report for the year ended December 31, 2022, an item that requires further discussions with management of the company. This issue is in respect of interest paid on loan obtained from the parent company.

Extract from the financial statements for the year ended December 31, 2022 reveals:

	₦'000	₦'000
Gross turnover:		
Domestic sales		147,500
Export sales		200,100
Other operating income		3,300
Total gross turnover		350,900
Deduct:		
Staff salary	122,600	
Ground rent paid to the State government	3,200	
Motor running expenses	1,750	
Audit and accountancy fees	1,000	
Repairs and maintenance	5,800	
Depreciation of assets	38,240	
Rent paid	1,850	
Power and lightning	5,400	
Legal cost	5,000	
Rates (water)	2,100	
Allowance for doubtful debts	10,500	
Donations	4,000	
Interest and other finance costs paid	15,600	
Income tax provision	23,400	
General expenses	5,900	246,340
Net profit		104,560

The following additional information is available:

(i) **Export sales**

20% of the export sales was made to the parent company at the prevailing international market price.

(ii) **Other operating income:**

	₦'000
Dividend received (net)	2,700
Profit from disposal of non-current asset	600
	3,300

(iii) **Repairs and maintenance:**

	₦'000
Repairs of plantation equipment	1,200
Repairs to premises (non-industrial building)	900
Expansion to warehouse (industrial building)	3,700
	5,800

(iv) **Rent paid:**

This is in respect of accommodation for the newly employed General Manager, whose basic salary is ₦4,800,000.

(v) **Legal cost:**

	₦'000
Cost of income tax appeal	850
Cost of debt collection	1,300
Cost of acquiring new lease	1,700
Renewal of old lease	1,150
	5,000

(vi) **Allowance for doubtful debts:**

	₦'000
Specific provisions	5,230
General provisions	7,870
Bad debts recovered	(2,600)
	10,500

(vii) **Donations:**

	₦'000
Palm Oil Research Institute	1,400
National Library	600
Cocoa Research Institute of Nigeria	1,000
Women Society of the host community	1,000
	4,000

(viii) **Interest and other finance costs paid**

In January 2022, the company obtained a loan facility of ₦100 million from the parent company forthe purpose of expansion of the business at a competitive interest rate of 12% per annum. The duration of the facility is 10 years.

The company is expected to pay interest due for the first 3 years, while from years 4 to 10, both principal and interest dues are to be paid at the end of each year.

The balance as shown in the financial statements is attributed to other finance cost and bank charges paid to domestic deposit money banks on various accounts operated by the company.

(ix) **General expenses:**

	₦'000
Wedding gift to staff	350
Fine imposed on a company's driver for traffic offense	150
Haulage expenses	3,200
Transport and travelling	2,200
	5,900

(x) **Schedule of prior years' turnover and assessable profits:**

Year ended December 31	Turnover ₦'000	Assessable profit ₦'000
2018	154,400	78,750
2019	198,600	95,120
2020	310,300	142,800
2021	314,900	166,900

(xi) **Schedule of qualifying capital expenditure incurred:**

Date of acquisition	Asset type	Amount ₦'000
August 31, 2017	Plantation equipment	4,600
August 31, 2017	Industrial building	12,000
August 31, 2017	Non-industrial building	9,000
January 1, 2018	Motor vehicles (3)	8,400
January 1, 2018	Furniture and fittings (10)	1,500
February 14, 2021	Motor vehicles (2)	5,600
June 12, 2022	Furniture and fittings (10)	2,000
July 8, 2022	Research and development	7,000

Required:

As the Tax Consultant to the company, you are to draft a report to the Managing Director of Soft Farm and Agro-Allied Limited, in line with the provisions of the Companies Income Tax Act Cap C21 LFN 2004 (as amended). The report should provide professional advice on the:

a. Treatments of excess amount of deductible interest paid (6 Marks)
b. Adjusted profit of the company for the year ended December 31, 2022 (7 Marks)
c. Tax liabilities for all the relevant assessment years (17 Marks)

(Total 30 Marks)

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

QUESTION 2

New Rain Petroleum Company Limited has been operating in the onshore and shallow water areas of the Niger Delta region for over fifteen years. The company was granted a petroleum mining lease licence in January 2021.

In its bid to improve profitability, the company's management intends to apply for licence to operate in the deep sea area as from 2025. The decision of the management is expected to be laid before the members of the company at the 2023 annual general meeting, which comes up in the second half of 2024.

The following was extracted from the book of accounts of the company for the year ended December 31, 2023:

Income:	**₦' million**	**₦' million**
Fiscal value of crude oil sold (note 1)		191,100
Value of condensate from associated gas sold (note 1)		84,474
Value of natural gas liquid from associated gas sold (note 1)		55,328
Other incidental income		151
Realised exchange gain		38
Gross total income		331,091
Expenses/deductions:		
Royalty incurred and paid	86,200	
First exploration wells cost	6,800	
First two appraisal wells costs	18,700	
Joint cost- terminalling	12,000	
Gas reinjection wells cost	3,420	
Salaries and wages	9,300	
Power cost	1,650	
NDDC charge	125	
Concessional rentals	60,430	
Depreciation of assets	13,860	
Allowance for doubtful debts (note 3)	2,400	
Host community trust fund contribution	4,800	
Stamp duty	16	
Staff welfare	350	
Travelling	180	
Donations and subscription (note 4)	6	
Decommissioning and abandonment	1,300	
Environment remediation fund contribution	1,250	
General expenses (note 5)	500	
Finance costs	1,750	225,037
Net profit		106,054

The following additional information was also provided:

(i) Data on crude oil; condensate from associated gas sold; and natural gas liquid from associated gas sold;

Category	Quantity (million barrels)	Actual price USD	Fiscal price USD
Crude oil	5.25	70	72
Condensate from associated gas	3.61	45	44
Natural gas liquid from associated gas	2.80	38	40

(ii) Omitted from the records was a balancing charge of ₦1, 500,000 made from disposal of an old oil equipment platform;

(iii) **Allowance for doubtful debts:**

	₦' million
Specific provisions	900
General provisions	1,500
	2,400

(iv) **Donations and subscription:**

	₦' million
Recognised orphanage homes	3.0
Host community's cultural group	2.0
Subscription to oil and gas association	1.0
	6.0

(v) **General expenses:**

	₦' million
Penalty for gas flare	250
Printing of stationery items	140
State government levy	110
	500

(vi) **Agreed capital allowances:**

	₦' million
Brought forward	167
For the year	2,105
	2,272

(vii) **Production allowance:**

	₦' million
Onshore operations	900
Shallow water operation	1,700
	2,600

(viii) The exchange rate averaged ₦520 to 1 USD during the year; and
(ix) Assume the tax liabilities are to be paid in domestic (Naira) currency.

Required:

As the company's Tax Manager, you are to advise the management, in accordance with the provisions of Petroleum Industry Act 2021, on:

a. Hydrocarbon tax payable in the relevant assessment year (18 Marks)
b. The tax implications, if the company decides to involve or invest in deep offshore areas (2 Marks)

(Total 20 Marks)

QUESTION 3

Lagode Nigeria Limited, a company based in Lagos, Nigeria, commenced operations as a manufacturer of indigenous fabrics/ clothing materials in 2013. The finished products are sold to wholesalers and retailers in Nigeria and Africans in diaspora. There is usually a brisk market during annual holiday periods when Nigerians, in particular, come home for visitations and whilereturning to their foreign destinations purchase some of these finished fabrics for personal use and/or resale purposes.

A market survey conducted by Lagode Nigeria Limited in October 2018 revealed that there was no company in the North American continent that was into the manufacturing of local Nigerian fabrics; hence the opportunity for the company to enter the market.

The resolution of the Board of the company in one of its meetings in 2019 favoured the establishment of a branch of the company in Canada. Kuramo Incorp., Ottawa, was therefore registered and started operations in January 2020. The company has been operating successfully with gross turnover and profits generated from its operations more than that in Lagos (Head office), in each of the last three years.

The business operating results of the two companies for the year ended December 31, 2022 revealed the following:

	Lagos, Nigeria	**Ottawa, Canada**
	₦'000	**₦'000**
Gross turnover	180,200	330,800
Less: Expenses		
Cost of materials	72,100	162,320
Wages and salaries	18,050	42,120
Finance costs	1,400	3,150
Miscellaneous	4,600	5,270
Depreciation of plant and equipment	5,760	8,750

Share of head office expenses	25,600	16,040
Foreign tax paid	-	18,900
Total expenses	127,510	256,550
Net profit	52,690	74,250

Additional information:

(i) The Ottawa branch is a wholly owned Nigerian company.

(ii) All the items classified in miscellaneous expenses are allowable for tax purposes.

(iii) Capital allowances as agreed with the Nigerian tax authorities comprise:

	₦'000
Lagos operations	6,800
Ottawa operations	9,900

(iv) Theexchange rate used in the conversion of the Canadian operation's transactions to Nigerian currency (Naira) is fair and appropriate.

(v) There is no double taxation agreement between Nigeria and Canada.

Required:

In accordance with the provisions of Companies Income Tax Act Cap. C21 LFN 2004 (as amended) you are to:

a. Compute the double taxation relief (if any) available to the Nigerian company (9 Marks)

b. Advise on the tax liabilities of the Nigerian company for the relevant assessment year (9 Marks)

c. Comment on the implications of double taxation agreement on withholding tax deductions by a company resident in a country:
   (i) With no double taxation agreement with Nigeria (1 Mark)
   (ii) With double taxation treaty with Nigeria (1 Mark)

(Total 20 Marks)

QUESTION 4

Professional ethics are essential for building trust and credibility with clients, colleagues and the society at large. The integrity and reputation of the profession are also maintained by members who are required to demonstrate ethical and globally accepted professional behaviours.

It is on this premise that a retreat on "Ethics and professionalism in tax management in Nigeria" is to be organised by a reputable professional accounting firm, for its newly employed audit officers and tax consultants.

Your professional accounting firm has been invited to send a resource person to present a paper at the workshop.

Required:

As the accounting firm's Senior Manager (Audit), you have been mandated by the Senior Partner to prepare and present the paper at the workshop. The contents of the paper should address the following pertinent areas:

a. Categories of threats that may pose a challenge to compliance with fundamental principles of accounting profession. (3 Marks)

b. Safeguards that can be used to eliminate or reduce the identified threats. (4 Marks)

c. Identification of specific legal and ethical issues that could arise from tax engagements. (7 Marks)

d. Powers available to The Institute of Chartered Accountants of Nigeria (ICAN) in enforcing the ethical standards of its members. (6 Marks)

(Total 20 Marks)

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

QUESTION 5

The Nigeria Extractive Industries Transparency Initiative (NEITI) was established through the NEITI Act, 2007. The body has the responsibility for the development of a framework for transparency and accountability in the reporting and disclosure of revenue due to or paid to the Federal Government by companies in the extractive industry.

In the same vein, the National Tax Policy, 2017, expressly stipulates the responsibilities of the various stakeholders towards the achievement of efficient tax administration in Nigeria.

Required:

a. Discuss the vision, mission and **FOUR** primary objectives of NEITI as provided for in the enabling Act. (6 Marks)

b. Explain **THREE** responsibilities of each of the under listed stakeholders as provided for in the National Tax Policy, 2017:

   (i) The government (3 Marks)
   (ii) The taxpayer (3 Marks)
   (iii) Revenue agencies (3 Marks)

(Total 15 Marks)

QUESTION 6

Kanadu Nigeria Limited is a manufacturer of leather shoes, bags and allied accessories since 2017. The recent changes in the taste of customers, particularly the quest for imported, cheaper leather shoes and bags, have had negative impact on the company's profits. The management has decided to re-organise the business in a way to satisfy the customers better.

The following transactions were extracted from the books of the company:

(i) June 2017: Acquisition of an acre of land at the outskirt of the State capital for₦8,500,000. The company spent an additional amount of ₦1,500,000 to sand fill the land;

(ii) August 2017: A factory was built on the acquired land for the purpose of the business at a cost of ₦65,000,000;

(iii) May 2022:Sold part of the factory's land for ₦25,500,000;

(iv) The market value of the remaining property unsold, as valued by a professional valuer, at the time of disposal in May 2022, was ₦99,500,000; and

(v) July 2023: Acquisition of a new acre of land in the town for ₦45,000,000 (utilised all the proceeds from the disposal of the land). This is expected to be used for construction of another factory in the same line of business.

The company's General Manager, who is an engineer, has just engaged your professional accounting firm as its tax consultants.

Required:

As the Principal Partner, you are to prepare a report to the General Manager, stating the:

a. Capital gains tax payable in line with the provisions of Capital Gains Tax Cap C1 LFN 2004 (as amended) (10 Marks)

b. New cost of undisposed property (2 Marks)

c. The roll-over relief (if any) the company is entitled to (2 Marks)

d. Due date(s) for the payment of tax liabilities (1 Mark)

(Total 15 Marks)

QUESTION 7

Abakali Limited is a company engaged in the manufacturing of three variants of beverages. The products of the company are well received by the consumers as the company now controls about 55% of the domestic market. The "chocolate" brand is the top earners for the company. According to a recent newspaper review, "it has the same quality as those imported into the country from the western world".

The Board of the company has at one of its meetings decided to enter the West African market in 2024 and by 2026, the European market, through:

(i) Establishment of depots in major cities of four neighbouring countries (Republic of Benin, Togo, Ghana and Niger) and goods will be transported by road; and

(ii) Incorporation of a branch in a European country; initially serving as a depot, but within the following 2 years, full production will commence.

As stressed by one of the directors at the meeting, the major challenge the company has to sort out before the foray into these new markets, is the strategy to mitigate the negative impact of high tax rates (in Europe and West African countries) on the profits of the company, for better returns on investment to be achieved.

A director, who had earlier worked in an international company, suggested the use of "treaty shopping" as a tax planning strategy in the location of the branch office in Europe.

He equally pointed out that the Economic Community of West African States (ECOWAS) common external tariff framework has provided solution to the issue of different tax regimes in the sub-region.

Most of the members of the Board are not conversant with the concept of "treaty shopping" and ECOWAS common external tariff framework, and has therefore requested for professional advice on these issues.

The Managing Director, on behalf of the Board, has approached your professional accounting firm to provide advice on the salient points raised in the meeting.

Required:

As the officer designated to handle this task, you are to write a report to your Principal Partner for his review, before same is sent to the client. The report should address the following salient concerns of the client:

a. Explanation of the concept and practice of "treaty shopping" (6 Marks)

b. Discussion the strategies employed by various countries in curbing treaty shopping in international transactions (2 Marks)

c. Discussion on the features of ECOWAS common external tariff framework (4 Marks)

d. Comment on the trade defense measures put in place to guide the operations of the common external tariff framework (3 Marks)

(Total 15 Marks)

NIGERIAN TAX RATES

1. **CAPITAL ALLOWANCES**

	Initial %	Annual %
Building Expenditure	15	10
Industrial Building Expenditure	15	10
Mining Expenditure	95	Nil
Plant Expenditure (excluding Furniture & Fittings)	50	25
Manufacturing Industrial Plant Expenditure	50	25
Construction Plant expenditure (excluding Furniture and Fittings)	50	Nil
Public Transportation Motor Vehicle	95	Nil
Ranching and Plantation Expenditure	30	50
Plantation Equipment Expenditure	95	Nil
Research and Development Expenditure	95	Nil
Housing Estate Expenditure	50	25
Motor Vehicle Expenditure	50	25
Agricultural Plant Expenditure	95	Nil
Furniture and Fittings Expenditure	25	20

2. INVESTMENT ALLOWANCE Up to August 31, 2023 (10%); and Finance Act 2023 (NIL)
3. RATES OF PERSONAL INCOME TAX
   Graduated tax rates and consolidated relief allowance of ₦200,000 or 1% of Gross Income, whichever is higher + 20% of Gross Income.

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

   After the relief allowance and exemption had been granted, the balance of income shall be taxed as specified in the tax table above.
4. COMPANIES INCOME TAX RATE: Finance Act 2019 specifies:
   30% (Large Company)
   20% (Medium-Sized Company)
   0% (Small Company)
5. TERTIARY EDUCATION TAX: 2% of assessable profit (up to December 31, 2021)
   2.5% of assessable profit (with effect from January 1, 2022) and 3% of assessable profit, with effect from September 1, 2023 (Finance Act 2023)
6. CAPITAL GAINS TAX 10%
7. VALUE ADDED TAX 7.5%
8. HYDROCARBON TAX 15% (Petroleum prospecting Licence and Marginal Fields Companies)
   30% (Petroleum Mining Lease Companies)

SOLUTION 1

DEBBY TAX CONSULTANTS
BENIN-CITY

Date:

The Managing Director
Soft Farm andAgro-Allied Limited
Benin-City

Dear Sir,

RE: TREATMENT OF EXCESS AMOUNT OF DEDUCTIBLE INTEREST PAID AND COMPUTATIONS OF ADJUSTED PROFIT AND TAX LIABILITIES

We refer to your request on the treatment of amount of deductible interest paid, computations of adjusted profit, and tax liabilities in respect of the company's financial activities for the relevant assessment years. Our comments are as follows:

(a) **Treatment of excess amount of deductible interest paid on foreign loan**

In line with the loan agreement, the company is expected to pay by the end of December 31, 2022, the sum of ₦12million, being the interest due on the ₦100 million facilities obtained from the parent company. The ₦12million loan payment was correctly captured by the Financial Accountant in the financial report.

However, by the provision of paragraph 2 of the 7th Schedule to the Finance Act 2019, there is a limit on allowable deductible interest paid on foreign loan. Any amount beyond the limit is considered to be excess interest and this shall be a disallowable deduction for the purpose of determination of tax liability.

The excess interest, as provided in paragraph 2, means an amount of total interest paid or payable in excess of 30% of earnings before interest, taxes, depreciation and amortisation of the Nigerian company in that accounting period.

As shown in the attached appendix 1, the interest paid on the foreign loan is ₦12million (12% of ₦100million).This is less than the 30% threshold (₦54.54million), hence the interest deductible rule did not affect the company.

(b) **Adjusted profit for the year ended December 31, 2022**

As revealed in the attached appendix 2, the adjusted profit of the company for the year ended December 31, 2022 is ₦178,520,000.

(c) **Tax liabilities for the relevant assessment years**

Appendix 3 presents the report of the companies income tax and tertiary education tax payable for 2018 through 2023 assessment years.

We hope this report adequately represents the mandate given to us. Should you require any further clarification, we will be glad to address it.

Yours faithfully,

For: DEBBY TAX CONSULTANTS

Deborah Oguns
Principal Partner

Appendix 1: Computation of excess deductible interest paid

Loan amount = ₦100 million
Interest rate = 12% per annum
Interest paid = 12% of ₦100 million = ₦12 million

Excess deductible interest = 30% of earnings before interest, taxes, depreciation and amortisation

	₦'000	₦'000
Net profit		104,560
Add:		
Interest	15,600	
Depreciation	38,240	
Income tax	23,400	77,240
EBIT		**181,800**

Maximum allowable interest deduction = 30% of ₦181,800,000
= ₦54,540,000

Since, the interest paid (₦12million) is less than the 30% threshold (₦54,540,000), the company is not affected by the interest deductivity rule.

Appendix 2: Adjusted profit

	₦'000	₦'000
Net profit as per accounts		104,560
Add back:		
Repairs and maintenance:		
Expansion to warehouse	3,700	
Depreciation	38,240	
Legal cost:		
Income tax appeal	850	
Acquisition of new lease	1,700	
Allowance for doubtful debts:		

General provisions	7,870	
Donations (Women society)	1,000	
Income tax provisions	23,400	
General expenses:		
Wedding gift	350	
Fine for traffic offense	150	77,260
		181,820
Less: Non-taxable income		
Dividends received	2,700	
Profit on disposal of non-current asset	600	3,300
Adjusted profit		178,520

Appendix 3: Tax liabilities for the relevant assessment years

2018 assessment year:
(Basis Period: 1/1/18 – 31/12/18)

	₦'000	**₦'000**
Adjusted profit/assessable profit		78,750
Deduct:		
Capital allowances for the year (see note 1)	15,155	
Capital allowances utilised	(15,155)	(15,155)
Unutiised capital allowances c/f	Nil	
Total profit		**63,595**
Companies income tax @ 30% of ₦63,595		19,078.5
Tertiary education tax @ 2% of ₦78,750		1,575

2019 assessment year
Basis Period: 1/1/18 – 31/12/18)

	₦'000	**₦'000**
Adjusted profit/assessable profit		78,750
Capital allowances for the year		Nil
Total profit		**78,750**
Companies income tax @ 30% of ₦78,750		23,625
Tertiary education tax @ 2% of ₦78,750		1,575

2020 assessment year
(Basis Period: 1/1/19 – 31/12/19)

	₦'000	₦'000
Adjusted profit/assessable profit		95,120
Deduct:		
Capital allowances for the year (see note 1)	3,060	
Capital allowances utilised	(3,060)	(3,060)
Unutilised capital allowances c/f	Nil	
Total profit		92,060
Companies income tax @ 30% of ₦92,060		27,618
Tertiary education tax @ 2% of ₦95,120		1,902.4

2021 assessment year
(Basis Period: 1/1/20 – 31/12/20)

	₦'000	₦'000
Adjusted profit/assessable profit		142,800
Deduct:		
Capital allowances for the year (see note 1)	3,060	
Capital allowances utilised	(3,060)	(3,060)
Unutilised capital allowances c/f	Nil	
Total profit		139,740
Companies income tax @ 30% of ₦139,740		41,922
Tertiary education tax @ 2% of ₦142,800		2,856

2022 assessment year
(Basis Period: 1/1/21 – 31/12/21)

	₦'000	₦'000
Adjusted profit/assessable profit		166,900
Deduct:		
Capital allowances for the year (see note 1)	6,559.97	
Capital allowances utilised	(6,559.97)	(6,559.97)
Unutilised capital allowances c/f	Nil	
Total profit		160,340.03
Companies income tax @ 30% of ₦160,340.03		48,102,009
Tertiary education tax @ 2% of ₦166,900		3,338

2023 assessment year
(Basis Period: 1/1/22 – 31/12/22)

	₦'000	₦'000
Adjusted profit/assessable profit		178,520
Deduct:		
Capital allowances for the year (see note 1)	11,029.4	
Capital allowances utilised	(11,029.4)	11,029.4
Unutilised capital allowances c/f	Nil	
Total profit		**167,490.60**
Companies income tax @ 30% of ₦167,490.6		50,247.18
Tertiary education tax @ 2.5% of ₦178,520		4,463

Note 1: Capital allowances

	Plant equipment	Indust. Building	Non-ind Building	Motor Vehicle	Furniture & fittings	Research & dev	C/A
	IA 95%	IA 15%	IA 15%	IA 50%	IA 25%	IA 95%	
	AA Nil	AA 10%	AA 10%	AA 25%	AA 20%	AA Nil	
	₦'000	**₦'000**	**₦'000**	**₦'000**	**₦'000**	**₦'000**	
2018 A/Y							
Cost	4,600	12,000	9,000	8,400	1,500	-	
IA	(4,370)	(1,800)	(1,350)	(4,200)	(375)	-	12,095
AA	-	(1,020) W(i)	(765)	(1,050)	(225)	-	3,060
							15,155
2019 A/Y							
TWDV	230	9,180	6,885	3,150	900	-	
AA	-	-	-	-	-	-	-
2020 A/Y							
TWDV	230	9,180	6,885	3,150	900	-	
AA	-	(1,020)	(765)	(1,050)	(225)	-	3,060
							3,060
2021 A/Y							
TWDV	230	8,160	6,120	2,100	675	-	
AA	-	(1,020)	(765)	(1,050)	(225)	-	3,060
							3,060
2022 A/Y							
TWDV	230	7,140	5,355	1,050	450		
Additions	-	-	-	5,600	-	-	
IA	-	-	-	(2,800)	-		2,800
AA	-	(1,020)	(765)	(1,749.97 W(ii)	(225)	-	3,759.97
							6,559.97

2023 A/Y

TWDV	230	6,120	4,590	2,100.03	225	-	
Additions	-	3,700	-		2,000	7,000	
IA	-	(555)	-		(500)	(6,650)	7,705
AA	-	(1,334.5)	(765)	(700)	(524.9)	-	3,324.4
							11,029.4
TWDV	230	7,936.5	3,825	1,400.03	1,200.1	350	

Workings

i. **2018 A/Y (Industrial building)**

IA = 15% of ₦12,000,000 = ₦1,800,000

AA = (₦12,000,000 – ₦1,800,000)/10 = ₦1,020,000

ii. **2022 A/Y (Motor vehicle)**

AA (old) = ₦1,050,000 – ₦30 (for 3 items disposed)	=	₦1,049,970
AA (new) = (₦5,600,000 – ₦2,800,000)/4	=	700,000
		1,749,970

Examiner's report

The question is divided into three parts. The first part tests the candidates' understanding of the provisions of Companies Income Tax Act (CITA) 2004 (as amended) in respect of treatment of excess amount of deductible interest payable by a company to its foreign (parent) company. The second part tests the candidates' knowledge of computations of adjusted profit. The third part tests candidates' knowledge of computations of tax liabilities, in line with the provisions of CITA 2004 (as amended) and Finance Act 2019.

Being a compulsory question, all the candidates attempted the question. Candidates demonstrated a fair understanding of the question, and performance was average.

The commonest pitfall was the inability of some candidates to identify correctly the basis periods for determination of assessable profits and capital allowances of a company that commenced operations in 2018 in line with the provisions of Finance Act 2019.

Candidates are advised to familiarise themselves with issues concerning computations of companies income tax by reading extensively the Institute's Study Text, other relevant textbooks, the CITA 2004 (as amended), and relevant Finance Acts.

Marking guide		**Marks**	**Marks**
a.	**Treatment of excess deductible interest**		
	Memo (address)	½	
	Memo (heading)	½	
	1 mark for correct discussion of the treatment as presented in the memo, subject to a maximum of 2 points	2	
	Appendix 1:		
	Net profit	½	
	Interest	½	
	Depreciation	½	
	Income tax	½	
	Maximum interest allowed	½	
	Excess interest disallowed	½	6
b.	**Computation of adjusted profit**		
	Appendix 2:		
	Net profit as per accounts	½	
	Expansion to warehouse	½	
	Depreciation	½	
	Legal cost (Income tax appeal)	½	
	Legal cost (Acquisition of new lease)	½	
	Allowance for doubtful debts (general provisions)	½	
	Donations (Women society)	½	
	Income tax provisions	½	
	General expenses (wedding gift)	½	
	General expenses (fine for traffic offense)	½	
	Non-taxable income (dividends received)	½	
	Non-taxable income (profit on disposal of asset)	½	
	Adjusted profit	1	7
c.	**Computation of tax liabilities**		
	Appendix 3:		
	2018 assessment year:		
	Adjusted profit	¼	
	Capital allowances for the year	¼	
	Total profit	¼	
	Companies income tax	¼	
	Tertiary education tax	¼	
	2019 assessment year:		
	Adjusted profit	¼	
	Capital allowances for the year	¼	
	Total profit	¼	

Companies income tax	¼
Tertiary education tax	¼

2020 assessment year:

Adjusted profit	¼
Capital allowances for the year	¼
Unutilised capital allowances c/f	¼
Total profit	¼
Companies income tax	¼
Tertiary education tax	¼

2021 assessment year:

Adjusted profit	¼
Capital allowances for the year	¼
Unutilised capital allowances c/f	¼
Total profit	¼
Companies income tax	¼
Tertiary education tax	¼

2022 assessment year:

Adjusted profit	¼
Capital allowances for the year	¼
Unutilised capital allowances c/f	¼
Total profit	¼
Companies income tax	¼
Tertiary education tax	¼

2023 assessment year:

Adjusted profit	¼
Capital allowances for the year	½
Unutilised capital allowances c/f	¼
Total profit	¼
Companies income tax	¼
Tertiary education tax	¼

Note 1 (Capital allowances):
2018 assessment year:

IA (plantation equipment)	¼
IA (industrial building)	¼
IA (non-industrial building)	¼
IA (motor vehicle)	¼
IA (furniture and fittings)	¼
AA (industrial building)	¼
AA (non-industrial building)	¼
AA (motor vehicle)	¼

AA (furniture and fittings)	¼	
2019 assessment year:		
IA (plantation equipment)	¼	
IA (industrial building)	¼	
IA (non-industrial building)	¼	
IA (motor vehicle)	¼	
IA (furniture and fittings)	¼	
2020 assessment year:		
AA (industrial building)	¼	
AA (non-industrial building)	¼	
AA (motor vehicle)	¼	
AA (furniture and fittings)	¼	
2021 assessment year:		
AA (industrial building)	¼	
AA (non-industrial building)	¼	
AA (motor vehicle)	¼	
AA (furniture and fittings)	¼	
2022 assessment year:		
IA (furniture and fittings)	¼	
AA (industrial building)	¼	
AA (non-industrial building)	¼	
AA (motor vehicle)	¼	
AA (furniture and fittings)	¼	
2023 assessment year:		
IA (industrial building)	¼	
IA (furniture and fittings)	¼	
IA (research and development)	¼	
AA (industrial building)	¼	
AA (non-industrial building)	¼	
AA (motor vehicle)	¼	
AA (furniture and fittings)	¼	17
Total		**30**

SOLUTION 2

a. **New Rain Petroleum Company Limited**
Computation of hydrocarbon tax
For the year ended December 31, 2023

	₦' million	₦' million
Income/Revenue:		
Value of crude oil sold (5.25m barrels x $72 x ₦520)		196,560
Value of condensate from associated gas sold		
(3.61m barrels x $45 x ₦520)		84,474
Value of natural gas liquid from associated gas sold		
(2.8m barrels x $40 x ₦520)		58,240
Gross revenue		339,274
Balancing charge		1.5
Total gross income		339,275.5
Allowable deductions (Section 263):		
Royalty incurred and paid	86,200	
First exploration wells cost	6,800	
First two appraisal wells cost	18,700	
Joint cost-terminalling	12,000	
Gas reinjection wells cost	3,420	
NDDC charge	125	
Concessional rents	60,430	
Host community trust fund contribution	4,800	
Stamp duty	16	
Decommissioning and abandonment	1,300	
Environment remediation fund contribution	1,250	
General expenses- State government levy	110	
Total allowable costs	195,151	
Total costs subject to CPR limit (W1)	(44,618)	(44,618)
Excess allowable cost carried forward	150,533	
Adjusted profit		294,657.5
Less: Loss relief		Nil
Assessable profit		294,657.5
Less: Section 66 and 6th Schedule deduction		
Capital allowances:		
Brought forward	167	
For the year	2,105	2,272
		292,385.5
Less: Production allowances:		
Onshore operations	900	
Shallow water operations	1,700	2,600

Chargeable profit	289,785.5
Hydrocarbon tax @ 30% of ₦289,785.5	**86,935.65**

Workings 1: Cost-profit-ratio (CPR)

		₦' million	₦' million
	Gross revenue		339,274
(i)	Maximum allowable @ 65% of gross revenue		220,528.10
	Total operating cost		195,151
	Capital allowances		2,272
	Total eligible costs		197,423
	Less: Exempted cost incurred (Section 263):		
	Royalty paid	86,200	
	NDDC charge	125	
	Concessional rentals	60,430	
	Host community fund	4,800	
	Environment remediation fund	1,250	152,805
(ii)	Net total costs to be subject to CPR		44,618

Maximum allowable cost is the lower of (i) and (ii), which is ₦44,618 million.

b. **The tax implications on the profit/activities of the company, if it invests in deep offshore areas are:**

(i) Hydrocarbon tax will not apply to companies with investments in the deep offshore areas; and

(ii) The company will need to incorporate a separate company to take care of the deep offshore activities. This means that onshore/shallow water operations cannot be merged with deep offshore activities.

Examiner's report

The question tests candidates' knowledge of computations of hydrocarbon tax of a company that operates in both onshore and shallow water areas in line with the provisions of Petroleum Industry Act 2021.

About 90% of the candidates attempted the question and majority of them showed a good understanding of its requirements, hence their performance was above average.

The major pitfall of the candidates was their inability to identify correctly the allowable and disallowable expenses relevant to the computations of cost-price ratio and hydrocarbon tax.

Candidates are advised to study extensively the template provided by the Federal Inland Revenue Service on computations of hydrocarbon tax and relevant sections of the Petroleum Industry Act 2021 for better performance in future examination.

Marking guide		**Marks**	**Marks**
a.	**Computation of hydrocarbon tax**		
	Value of crude oil sold	½	
	Value of condensate from associated gas sold	½	
	Value of natural gas liquid from associated gas sold	½	
	Gross revenue	½	
	Balancing charge	½	
	Total gross income	½	
	Royalty incurred and paid	½	
	First exploration wells cost	½	
	First two appraisal wells cost	½	
	Joint cost-terminalling	½	
	Gas reinjection wells cost	½	
	NDDC charge	½	
	Concessional rents	½	
	Host community trust fund contribution	½	
	Stamp duty	½	
	Decommissioning and abandonment	½	
	Environment remediation fund contribution	½	
	General expenses- State government levy	½	
	Total allowable costs	½	
	Total costs subject to CPR limit	½	
	Excess allowable cost carried forward	½	
	Adjusted profit	½	
	Assessable profit	½	
	Total capital allowances	½	
	Total production allowances	½	
	Chargeable profit	½	
	Hydrocarbon tax	½	
	Workings on CPR:		
	Maximum allowable @ 65%	½	
	Total operating costs	½	
	Capital allowances	½	
	Royalty paid	½	
	NDDC charge	½	
	Concessional rentals	½	
	Host community fund	½	
	Environment remediation fund	½	
	Net total costs to be subject to CPR	½	18

b,	**Tax implications if the company involves in deep offshore activities** 1 mark for each discussion of the tax implications if the company involves in deep offshore activities, subject to a maximum of 2 points	2
	Total	**20**

SOLUTION 3

a. **Computation of double taxation relief**

Adjusted profit of the foreign company (KuramoIncorp)

	₦'000	₦'000
Net profit as per accounts		74,250
Add back:		
Depreciation	8,750	
Foreign tax paid	18,900	27,650
Adjusted profit		101,900
Deduct: Capital allowances		9,900
Total profit		**92,000**

Commonwealth rate of tax (CR) $= \frac{₦18,900,000}{₦92,000,000} \times 100$

$= \underline{\underline{20.54\%}}$

CR = 20.54%

Nigerian rate of tax (NR) = 30%

½NR = 30%/2 = 15%

Since CR is greater than ½NR, then relief = ½NR

Double taxation relief = 15% of ₦92,000,000 = **₦13,800,000**

b. **Tax liabilities of the Nigerian company**

Lagode Nigeria Limited
Computation of adjusted profit
For the year ended December 31, 2022

	₦'000	₦'000
Net profit as per accounts (₦52,690 + ₦74,250)		126,940
Add back:		
Depreciation (₦5,760 + ₦8,750)	14,510	
Foreign tax paid	18,900	33,410
Adjusted profit/ assessable profit		160,350

Lagode Nigeria Limited
Computation of tax liabilities
For the 2023 assessment year

	₦'000
Adjusted profit/assessable profit	160,350
Less: Capital allowances (₦6,800 + ₦9,900)	16,700
Total profit	**143,650**
Companies income tax @ 30% of ₦143,650	43,095
Less: Double taxation relief (as above)	13,800
Net (final) companies income tax payable	29,295
Tertiary education tax @ 2.5% of ₦160,350	4,008.75

c. **Implications of double taxation agreement on withholding tax deductions by a company resident in a country:**

i) **With no double taxation agreement with Nigeria**
It will suffer withholding tax deduction at the rate of **10%** of the value of the revenue from dividends, interest and royalties.

ii) **With double taxation agreement with Nigeria**
It will suffer withholding tax deduction at the rate of **7.5%** of the value of the revenue from dividends, interest and royalties.

Examiner's report

The question tests candidates' understanding of the provisions of the Companies Income Tax Act 2004 (as amended) on double taxation relief available to a Nigerian company with a branch in a foreign country.

About 80% of the candidates attempted the question. Candidates showed a good understanding of the requirements of the question and their performance was satisfactory.

The major pitfall was the inability of some candidates to correctly state the implications of double taxation agreement on withholding tax deductions by a company resident in a country with, and without taxation treaty with Nigeria.

Candidates are advised to read the Institute's Study Text, Pathfinder, and other relevant textbooks when preparing for future examinations.

Marking guide		**Marks**	**Marks**
a.	**Computation of double taxation relief**		
	Net profit as per accounts	1	
	Depreciation	1	
	Foreign tax paid	1	
	Adjusted profit	1	
	Capital allowances	1	
	Total profit	1	
	Commonwealth rate of tax	1	
	Relief = ½NR	1	
	Double taxation relief	1	9
b.	**Advise on tax liabilities**		
	Net profit as per accounts	1	
	Depreciation	1	
	Foreign tax paid	1	
	Adjusted profit	1	
	Capital allowances	1	
	Total profit	1	
	Companies income tax	1	
	Net (final) companies income tax	1	
	Tertiary education tax	1	9
c. (i)	Implications of double taxation agreement on withholding tax deductions by a company resident in a country with no taxation agreement with Nigeria		
	1 mark for correct discussion on tax implications		1
(ii)	Implications of double taxation agreement on withholding tax deductions by a company resident in a country with taxation agreement with Nigeria		
	1 mark for correct discussion on tax implications		1
	Total		**20**

SOLUTION 4

"Ethics and professionalism in tax management in Nigeria", being a paper presented at a workshop organised for newly employed audit officers and tax consultants

This paper addresses the following thematic areas:

a. **Categories of threats that may pose a challenge to compliance with fundamental principles of accounting profession include:**

(i) **Self-interest:** The threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behaviour. For instance, a firm having undue dependence on total fees from a client;

(iii) **Self-review:** The threat that a professional accountant will not appropriately evaluate the results of a previous judgment made or service performed by the professional accountant, or by another individual within the professional accountant's firm or employing organisation, on which the accountant will rely when forming a judgment as part of providing a current service;

(iv) **Advocacy:** The threat that a professional accountant will promote a client's or employer's position to the point that the professional accountant's objectivity is compromised;

(v) **Familiarity:** The threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or to accepting their work; and

(vi) **Intimidation:** The threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant. For instance, a firm being threatened with dismissal from a client engagement.

b. **Safeguards that can be used to eliminate or reduce the identified threats include:**

(i) Safeguards created by the profession, legislation or regulation, such as:

- Continue professional development requirement;
- Professional standards; and
- Corporate governance regulations; and

(ii) Safeguards in the work environment, such as:
- Leadership and transparency;
- Recruitment procedures for high caliber staff; and
- Continue professional development requirement.

c. **Some specific legal and ethical issues that could arise from tax engagements are:**

(i) **Technical competence:** Failure of tax practitioners to maintain an appropriate level of professional competence due to lack of knowledge and skills in carrying out the engagement;

(ii) **Reasonable enquiry:** Failure to make reasonable enquiries where information or documentation as furnished by a client appears to be inaccurate or incomplete;

(iii) **Continue to act:** Continuing to act for a client in circumstances where incorrect or misleading information is not corrected by the client;

(iv) **Tax avoidance:** Conflicts which arise in distinguishing between legitimate tax planning/tax minimisation arrangements and tax avoidance activities/schemes;

(v) **Supervision of tax audit:** Failure to carefully plan for or otherwise supervise on behalf of the client, audit activities carried out by tax authorities;

(vi) **Tax loopholes:** Loopholes seeking to deliberately test the boundaries of the tax law;

(vii) **Fee setting:** Basing the amount of the fee charged for tax services on the amount of tax saved/liability, contingent fee setting;

(viii) **Aggressive interpretation:** Adoption of overly aggressive interpretations of questionable issues and reporting positions on the basis that detection of the issue by the tax authorities is unlikely;

(ix) **Misleading advice:** Provision of inadequate or misleading advice to clients as to the potential risks and consequences of adopting various reporting positions and tax arrangements;

(x) **Misrepresentation:** Misrepresenting or concealing limitations in a tax practitioner's competence or skills to perform particular tax services;

(xi) **Personal gain:** Conflicts between opportunities for personal financial gain (or other personal benefit) and proper performance of a tax practitioner's responsibilities;

(xii) **Conflict of interest:** Conflicts of interest that providing services to competing clients such that the interests of one client may be prejudiced;

(xiii) **Documentation:** Preparing and signing a tax return without seeing full documentation;

(xiv) **Communication:** Failure to communicate to client's unfavourable as well as favourable information and professional opinions;

(xv) **Tax authority' errors:** Inaction by the tax practitioner in respect of a clear and significant mathematical or clerical mistake by the relevant authorities in favour of a client;

(xvi) **Reporting position:** Determining whether the client or the tax practitioner should make the final reporting decisions for contentious or ambiguous items;

(xvii) **Public responsibility:** Failure to acknowledge a public responsibility to contribute to the improvement of the tax laws and their administration (for example, reporting blatant tax avoidance arrangements;

(xviii) **Professional judgment:** Carrying out a client's instructions which are inconsistent with the professional judgment of the tax practitioner (professional judgment);

(xix) **Poaching client:** Poaching or soliciting potential clients from other practitioners/practices;

(xx) **Authority:** Dealing with a client's funds without client authority;

(xxi) **Tax audit:** Structuring a transaction, or the preparation of a tax return in such a way as to reduce the chances of a tax audit;

(xxii) **Research:** Failure to conduct adequate research on a problem as a reasonable basis for identifying issues and forming carefully considered conclusions and recommendations;

(xxiii) **Prior years errors:** Inaction by the tax practitioner in respect of a clear and significant error detected in a client's prior year return(s);

(xxiv) **Confidentiality:** Failure to ensure confidentiality with regard to privileged

(xxv) **Taxminimisation:** Keeping a client informed of current tax minimisation arrangements which have no real commercial or family purpose.

d. **The powers available to the Institute of Chartered Accountants of Nigeria (ICAN) in enforcing the ethical standards of its members**

(i) The power of the Institute to enforce ethical standards is derived from ICAN Act 1965. The power is conferred on the Accountants Disciplinary Tribunal. The Tribunal in this respect is independent of Council.

(ii) The Investigating Panel considers complaints against the conduct of members, and is empowered to initiate disciplinary action by referring appropriate cases to the Disciplinary Tribunal for adjudication.

(iii) Where a complaint is against the conduct of a firm having more than a partner, the complaint shall be deemed to have been made against each and every member who was partner in the said firm at the material time the engagement was carried out.

(iv) Any failure to follow the guidance in fundamental principles or in the statements shall also be taken into account by the Committee of the Institute responsible for regulating the work of members and member firms.

Examiner's report

The question tests the candidates' knowledge of the rules of the Institute of Chartered Accountants of Nigeria (ICAN) and other professional bodies on ethics and professionalism in tax management.
About 60% of the candidates attempted the question and they exhibited a fair understanding of its requirements. The performance was average.

The commonest pitfall was the inability of some candidates to explain the safeguards that are applicable to mitigate identified threats that could arise from tax engagements.

Candidates are advised to read widely the Institute's Study Text, ICAN Code of Ethics and other relevant textbooks, when preparing for future examinations.

Marking guide		**Marks**	**Marks**
a.	Categories of threats that may pose a challenge to compliance with fundamental principles of accounting profession 1 mark for discussion of the threats that may posea challenge to compliance with fundamental principles of accounting profession, subject to a maximum of 3 points		3
b.	Safeguards that can be used to eliminate or reduce the identified threats		
	1 mark for safeguards created by the profession, legislation or regulation	1	
	1 mark for an example of safeguards created by the profession, legislation or regulation	1	
	1 mark for safeguards in the work environment	1	
	1 mark for an example of safeguards in the work environment	1	4
c.	**Specific legal and ethical issues that could arise from tax engagements** 1 mark for discussion of the specific legal and ethical issues that could arise from tax engagements, subject to a maximum of 7 points		7
d.	**Powers available to ICAN in enforcing the ethical standards of its members** 2 marks for discussion of powers available to ICAN in enforcing the ethical standards of its members, subject to a maximum of 3 points		6
	Total		**20**

SOLUTION 5

a. **The vision, mission and objectives of the Nigeria Extractive Industries Initiative (NEITI)**

Vision

The vision of NEITI is to build a NEITI that is accountable, effective, well-resourced and result oriented.

Mission

The mission is to cultivate a culture of transparency, accountability, due process and zero-tolerance for corruption in Nigeria's extractive industries, for the benefit of the citizenry.

The primary objectives of the NEITI are to:

- Ensure due process and transparency in the payments made by all extractive industry companies to the Federal government and statutory recipients;
- Monitor and ensure accountability in the revenue receipts of the Federal Government from extractive industry companies;
- Eliminate all forms of corrupt practices in the determination, payment, receipts and posting of revenue accruing to the Federal Government from extractive industry companies;
- Ensure transparency and accountability by government in the application of resources from payments received from extractive industry companies; and
- Ensure conformity with the principles of global Extractive Industries Transparency Initiative (EITI).

b. **Responsibilities of the under listed stakeholders**

(i) **The government**

All levels and arms of government; ministries, extra-ministerial departments and agencies where applicable shall:

- Implement and regularly review tax policies and laws;
- Provide information on all revenue collected on a quarterly basis;
- Ensure adequate funding, administrative and operational autonomy of tax authorities; and
- Ensure a reasonable transition period of between three and six months before implementation of a new tax.

(ii) **The taxpayer**

A taxpayer is a person, group of persons or an entity that pays or is liable to tax. The taxpayer is the most critical stakeholder and primary focus of the tax system. The taxpayer shall consider tax responsibilities as a civic obligation and constant duty that must be discharged as and when due.

The taxpayer shall be entitled to:

- Relevant information for the discharge of tax obligations;
- Receive prompt, courteous and professional assistance in dealing with tax authorities;

- Raise objection to decisions and assessments and receive response within a reasonable time;
- A fair and impartial appeal; and
- Self-representation or by any agent of choice, provided an agent acting for financial reward shall be an accredited tax practitioner.

(iii) **Revenue agencies**

Any agencies responsible for the collection and administration of revenue shall:

- Treat the taxpayer as a customer;
- Ensure efficient implementation of tax policies, laws and international treaties;
- Facilitate inter-agency co-operation and exchange of information;
- Undertake timely audits and investigations;
- Undertake tax awareness and taxpayers' education; and
- Establish a robust process to prevent, detect and punish corrupt tax officials.

Examiner's report

The question tests candidates' understanding of the vision, mission, and objectives of the Nigeria Extractive Industries Transparency Initiative (NEITI) and the responsibilities of specified stakeholders as provided for in the National Tax Policy (NTP), 2017.

About 40% of the candidates attempted the question and they showed a poor understanding of the requirements of the question. Therefore, their performance was below average.

The commonest pitfall was the inability of the candidates to explain the vision and mission of NEITI.

Candidates are advised to read the Institute's Study Text and other relevant textbooks on the operations of NEITI and responsibilities of various stakeholders as enshrined in the NTP, 2017 when preparing for future examinations.

Marking guide		**Marks**	**Marks**
a.	**Vision, mission and objectives of NEITI**		
	1 mark for discussion of the vision of NEITI	1	
	1 mark for discussion of the mission of NEITI	1	
	1 mark for discussion of the objectives of NEITI, subject to a maximum of 4 points	4	6
b. i	**Responsibilities of the government as provided for in the National Tax Policy 2017**		
	1 mark for discussion of the responsibilities of the government, subject to a maximum of 3 points		3
ii.	**Responsibilities of the taxpayer as provided for in the National ax Policy 2017**		
	1 mark for discussion of the responsibilities of the taxpayer, subject to a maximum of 3 points		3
iii.	**Responsibilities of the revenue agencies as provided for in the National Tax Policy 2017**		
	1 mark for discussion of the responsibilities of the revenue agencies, subject to a maximum of 3 points		3
	Total		**15**

SOLUTION 6

ECO& Co (Chartered Accountants)
Zaria Road, Kaduna

Date:

The General Manager
Kanadu Nigeria Limited
Kaduna

Dear Sir,

RE: TAX MATTERS

We refer to your request on the computation of capital gains tax payable, cost of undisposed property, roll-over relief and due date(s) for the payment of the tax liabilities in respect of some transactions embarked upon by the company. Our comments are as follows:

a. **Capital gains tax payable**

As shown in the attached appendix 1, the company made a chargeable gain of₦10,200,000 on the disposal of part of its land. In line with the provisions of Capital Gains Tax Cap C1 LFN 2004 (as amended), the company will pay tax at the rate of 10% and this gives ₦1,020,000. This should be paid to the Federal Inland Revenue Service integrated office in Kaduna.

b. **New cost of undisposed property**
This is arrived at by deducting the cost of the part (land) disposed from the total cost of the property. That is, ₦75,000,000 – ₦15,300,000 = ₦59,700,000.

c. **Roll-over relief**
The company utilised the whole proceeds derived from the disposal of land (₦25,500,000) in acquiring another land in the State Capital for the purpose of the business. However, the re-acquisition of the new land took place more than 12 months from the date of the disposal (May 2022 – July 2023).
The Capital Gains Tax Act 2004 (as amended) specifies as part of conditions for grant of roll-over relief, that re-acquisition of a new asset must take place within 12 months of disposal. In view of this provision of the Act, the company does not qualify for any roll-over relief.

d. **Due date(s) for the payment of tax liabilities**
The disposal of the land took place in May 2022. In line with the provisions of Section 2, Finance Act 2020), the due date for the payment of the capital gains tax is June 30, 2022.

We hope this report adequately represents the mandate given to us. Should you require further clarification, we will be glad to address it.

Yours faithfully,
For: ECO & Co (Chartered Accountants)

Tunji Ojo
Principal Partner

Appendix 1: Determination of capital gains tax

	₦'000
Cost of land	8,500
Sand filling	1,500
Factory cost	65,000
Total cost of the factory	75,000
	₦'000
Sales proceeds	25,500
Less: Cost of acquisition (W1)	15,300
Chargeable gain	10,200
Capital gains tax @ 10% of ₦10,200	1,020

Workings 1: Cost of part disposed

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

Where,
A = Sales proceeds = ₦25,500,000
B = Market value of part undisposed = ₦99,500,000
C = Overall cost of the asset = ₦75,000,000

Therefore,

$$\text{Cost} = \frac{₦25{,}500{,}000}{₦25{,}500{,}000 + ₦99{,}500{,}000} x\ ₦75{,}000{,}000$$

$$= \frac{₦25{,}500{,}000}{₦125{,}000{,}000} x\ ₦75{,}000{,}000$$

$$= \underline{\underline{₦15{,}300{,}000}}$$

Examiner's report

The question tests candidates' understanding of the provisions of Capital Gains Tax Act 2004 (as amended) in respect of tax computations and roll-over relief.

About 90% of the candidates attempted the question. Candidates showed a good understanding of the requirements of the question and their performance was satisfactory.

The major pitfall was the inability of some candidates to apply the relevant provisions of the Act in respect of time lag between the date of disposal of old asset and acquisition of new asset in the determination of roll-over relief.

Candidates are advised to read the Institute's Study Text and other relevant textbooks, as this would go a long way in assisting them to perform better in future examinations.

Marking guide		**Marks**	**Marks**
a.	Memo (address)	½	
	Memo (heading)	½	
	Computation of capital gains tax payable		
	Cost of land	1	
	Sand filling	1	
	Factory cost	1	
	Total cost of the property	1	
	Sales proceeds	1	
	Cost of acquisition	1	
	Chargeable gain	1	
	Capital gains tax	1	
	Workings on cost of acquisition	1	10

b.	**New cost of undisposed property**		
	Correct computation (₦59,700,000)		2
c.	**Roll-over relief**		
	1 mark for disclosing the fact that the re-acquisitiontook place after 12 months	1	
	1 mark for the recommendation that the companydoes not qualify for roll-over relief	1	2
d.	**Due date(s) for payment of tax liabilities**		
	June 30, 2022		1
	Total		**15**

SOLUTION 7

ACC& Co (Chartered Accountants)
Lagos

INTERNAL MEMO

Date:

From: Senior Tax Consultant

To: Principal Partner

RE: TREATY SHOPPING AND ECOWAS COMMON EXTERNAL TARIFF

Sequel to your directive in respect of the request of our client for advise on concept and practice of "treaty shopping", strategies being employed to curb treaty shopping; features of ECOWAS common external tariff and the trade defense measures put in place to guide the operations of the common external tariff, my comments are as follows:

a. **Concept and practice of "treaty shopping"**

Concept

(i) Treaty shopping is a situation where a person, who is resident in one country (say the "home" country) and earns income or capital gains from another country (say the "source" country), is able to benefit from a tax treaty between the source country and yet another country (say the "third' country).

(ii) The situation often arises where a person is resident in the home country but the home country does not have a tax treaty with the source country.

(iii) Treaty shopping is an analysis of tax treaty provision by non-treaty party to structure an international transaction or operation so as to gain or take advantage of a particular treaty benefit.

Practice

(i) A resident of a state that is not a party to the double taxation treaty establishes an entity within a state that is party to the treaty in order to take advantage of its provision.

(ii) Consider a situation that there is double taxation treaty between country A and country B. Instead of a company resident in country C (which does not have a tax treaty with country A) investing directly in country A, it establishes a legal entity in country B through which it invests in country A in order to take advantage of country A/country B tax treaty to minimise its tax liability. Meanwhile, since there is no tax treaty between country C and the treaty countries (that is, countries A and B), resident of country A and B will not receive equal tax treatment with respect to income derived from country C. Therefore the principle of reciprocity is breached.

b. **The strategies being employed by various countries in mitigating the menace of treaty shopping in international transactions**

(i) The problem of treaty shopping could be tackled through anti-treaty shopping provisions despite the fact that it is one of the most complex international tax rules.

(ii) Some countries have also tackled the problem of treaty shopping by includingin their tax treaties, specific provision referred to as "limitation on benefit" or "LOB". These provisions limit the benefits under the treaties in certain circumstances.

(iii) Companies which are not bona fide residents of the treaty countries or which are set up for treaty shopping purpose may be denied the treaty benefits.

c. **Features of ECOWAS Common External Tariff (CET)**

(i) The ECOWAS common external tariff is one of the principal instruments for harmonising ECOWAS member states and strengthening its common market.

(ii) To this end, the ECOWAS authority of heads of State and government established an ECOWAS customs necessitating the formulation of a common external tariff with a common nomenclature so that customs procedures are transparent, readily followed and delays at borders decreased, is a key stone in achieving this union.

(iii) In January 2006 in Niamey, the Authority of Heads of State and Government of ECOWAS adopted a decision establishing the ECOWAS-CET which draws on the basic UEMOA CET composed of four tariff bands, or rates of customs duty. Below is a table depicting the four tariff bands:

Category	Percentage of duties	Good description
0	0%	Essential social goods
1	5%	Goods of primary necessity, raw materials and specific inputs
2	10%	Intermediate goods
3	20%	Final consumption goods

(iv) The ECOWAS tariff nomenclature has been migrated from 2007 to the 2012 version (HS2012) introduced by the World Customs Organisation (WCO).

(v) On 25th October 2013, ECOWAS member states adopted the ECOWAS Common External Tariff with the 5-tariff band structure.

Category	Percentage of duties	Good description
0	0%	Essential social goods
1	5%	Goods of primary necessity, raw materials and capital goods
2	10%	Intermediate goods and inputs
3	20%	Final consumption goods or finished goods
4	35%	Specific goods for economic development

(vi) Application of uniform tariff rate - CET is the application of the same customs duties, import quotas and preferences by a group of countries in a custom union.

(vii) The CET is one of the major characteristics of a custom union, which is a type of trade bloc formed through a trade agreement between governments of multiple tax jurisdictions.

d. **The trade defense measures put in place in guiding the operations of the common external tariff include:**

(i) Safeguard measures; especially in the protection of local industries;
(ii) Anti-dumping measures, through prohibition of certain items;
(iii) Anti-subsidy and countervailing measures; and
(viii) Supplementary protection measures.

Thank you.

Owo Ruh
Senior Tax Consultant

Examiner's report

The question tests the candidates' understanding of the concept and practice of treaty shopping and features of Economic Community of West African States (ECOWAS) common external tariff framework.

About 30% of the candidates attempted the question, and they showed a poor understanding of it, resulting in below average performance.

The commonest pitfall was the candidates' inability to identify correctly the trade defense measures put in place to guide the operations of the common external tariff framework.

Candidates are advised to prepare adequately for future examinations by reading the Institute's Study Text, other relevant textbooks, and tax laws in respect of regional integration and trade blocs.

Marking guide		**Marks**	**Marks**
a.	Memo (address)	½	
	Memo (heading)	½	
	Concept of treaty shopping		
	1 mark for discussion of the concept of treaty shopping, subject to a maximum of 2 points	2	
	Practice of treaty shopping		
	1½ marks for discussion of the practice of treaty shopping, subject to a maximum of 2 points	3	6
b.	**Strategies being employed by various countries in curbing treaty shopping in international transactions**		
	1 mark for discussion of the strategies being employed in curbing treaty shopping, subject to a maximum of 2 points		2

c. **Features of ECOWAS common external tariff**
1 mark for discussion of the features of ECOWAS common external tariff, subject to a maximum of 4 points — 4

d. **Trade defense measures put in place to guide The operations of ECOWAS common external Tariff**
1 mark for discussion of the trade defense measures put in place to guide the operations of ECOWAS common external tariff, subject to a maximum of 3 points — 3

Total — **15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2024

STRATEGIC FINANCIAL MANAGEMENT

EXAMINATION INSTRUCTIONS

PLEASE READ THESE INSTRUCTIONS BEFORE THE COMMENCEMENT OF THE PAPER

1. Check your pockets, purse, mathematical set, etc. to ensure that you do not have prohibited items such as telephone handset, electronic storage device, programmable devices, wristwatches or any form of written material on you in the examination hall. You will be stopped from continuing with the examination and liable to further disciplinary actions including cancellation of examination result if caught.

2. Write your **EXAMINATION NUMBER** in the space provided above.

3. Do **NOT** write anything on your question paper **EXCEPT** your examination number.

4. Do **NOT** write anything on your docket.

5. Read all instructions in each section of the question paper carefully before answering the questions.

6. Do **NOT** answer more than the number of questions required in each section, otherwise, you will be penalised.

7. All solutions should be written in **BLUE** or **BLACK INK**. Any solution written in **PENCIL** or **RED INK** will not be marked.

8. A formula sheet and discount tables are provided with this examination paper.

WEDNESDAY, MAY 15, 2024

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2024

STRATEGIC FINANCIAL MANAGEMENT

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

You are employed by Bolade Plc (BP), a very large printing firm with retail outlets across Nigeria. Its board is considering making an offer to buy 100% of the shares of Kenny Ltd (KL), a competitor of Bolade in Aba. KL's financial year end is 28 February and its most recent financial statements are summarised below:

KL Income Statement for the year ended 28 February 2023

	₦m
Revenue	17.3
Profit before interest and tax	5.9
Interest	(0.3)
Profit before taxation	5.6
Tax at 21%	(1.2)
Profit after taxation	4.4
Dividends declared	1.1

KL Statement of financial position at 28 February 2023

	₦m	₦m	₦m
Non-current assets:			
Freehold land and buildings (original cost ₦4.1m)			3.5
Machinery (original cost ₦8.8m)			5.3
			8.8
Current assets:			
Inventories		3.0	
Receivables		0.5	
Cash and bank		2.8	
		6.3	
Current liabilities:			
Trade payables	3.5		
Dividends	1.1		
Taxation	1.2		
		(5.8)	

	0.5
	9.3
Non-current liabilities:	
10% bonds (redeemable 2031)	(3.0)
	6.3
Equity:	
Ordinary shares of ₦1 each	2.1
Retained earnings	4.2
	6.3

Additional Information

KL's management had some of the company's assets independently revalued in January 2023. Those values are shown below:

	₦m
Freehold land and building	8.3
Machinery	4.1
Inventories	3.1

The average price/earnings ratio for listed business in the printing industry is 9 and the average dividend yield is 6% p.a.

The cost of equity of business in the printing industry, taking account of the industry average level of capital gearing, is 14% p.a.

KL's finance department has estimated that the company's pre-tax net cash inflows (after interest) for the next four trading years ending 28 February, before taking account of capital allowances, will be:

	₦m
Year to 2024	4.6
Year to 2025	4.3
Year to 2026	5.2
Year to 2027	5.7

KL's existing equipment has tax written-down value of ₦3.6 million at 28 February 2023. The equipment attracts 18% (reducing balance) tax allowances in every year of ownership by the company, except the final year.

You should assume that KL will not be purchasing or disposing of any machinery in the years 2024-2027 and that it would dispose of the existing equipment on 28 February 2027 at its tax written-down value.

Bolade's board estimates that in four years' time, i.e. 28 February 2027, it could, if necessary, dispose of KL for an amount equal to four times its after-tax cash flow (ignoring the effects of capital allowances and the disposal value of the equipment) for the year to 28 February 2027.

Assume that the company income rate is 21% p.a.

Required:

Using the information provided, prepare a report for Bolade's board by:

a. Calculating the value of one share in KL based on each of the following methods:
   i. Net asset basis (historic cost)
   ii. Net asset basis (revalued)
   iii. Price/earnings ratio
   iv. Dividend yield
   v. Present value of future cash flows (16 Marks)

b. Explain the advantages and disadvantages of using each of the five valuation methods in (a). (8 Marks)

c. What are the possible benefits from the merger between Bolade Plc (BP) and Kenny Limited (KL). (6 Marks)

(Total 30 Marks)

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

QUESTION 2

The following draft appraisal of a proposed investment project has been prepared for the Finance Director of Keke Plc (KP) by a trainee accountant. The project is consistent with the current business operations of KP.

Year	**1**	**2**	**3**	**4**	**5**
Sales (units/yr)	250,000	400,000	500,000	250,000	
	₦000	**₦000**	**₦000**	**₦000**	**₦000**
Contribution	13,300	21,280	26,600	13,300	-
Fixed costs	(5,300)	(5,618)	(5,955)	(6,312)	-
Depreciation	(4,375)	(4,375)	(4,375)	(4,375)	-
Interest payments	(2,000)	(2,000)	(2,000)	(2,000)	-
Taxable profit	1,625	9,287	14,270	613	
Taxation	-	(488)	(2,786)	(4,281)	(184)
Profit after tax	1,625	8,799	11,484	(3,668)	(184)
Scrap value	-	-	-	2,500	-
After-tax cash flows	1,625	8,799	11,484	(1,168)	(184)
Discount at 10%	0.909	0.826	0.751	0.683	0.621
Present values	1,477	7,268	8,624	(798)	(114)

Net present value = (16,457,000 – 20,000,000) = ₦3,543,000 so reject the project.

The following information was included with the draft investment appraisal:

(1) The initial investment is ₦20 million.

(2) Selling price: ₦120/unit (current price terms), selling price inflation is 5% per year.

(3) Variable cost: ₦70/unit (current price terms), variable cost inflation is 4% per year.
(4) Fixed overhead costs: ₦5,000,000/year (current price terms), fixed cost inflation is 6% per year.
(5) ₦2,000,000/year of the fixed costs are development costs that have already been incurred and are being recovered by an annual charges to the project.
(6) Investment financing is by a ₦20 million loan at a fixed interest rate of 10% per year.
(7) Keke Plc can claim 25% reducing balance tax allowable depreciation on this investment and pays taxation one year in arrears at a rate of 30% per year.
(8) The scrap value of machinery at the end of the four-year project is ₦2,500,000.
(9) The real weighted average cost of capital of Keke is 7% per year.
(10) The general rate of inflation is expected to be 4.7% per year.

Required:

a. Identify and comment on any errors in the investment appraisal prepared by the trainee accountant. (4 Marks)

b. Prepare a revised calculation of the net present value of the proposed investment project and comment on the project's acceptability. (12 Marks)

c. Discuss the problems faced when undertaking investment appraisal in the following areas and comment on how these problems can be overcome:
   i. an investment project has several internal rates of return;
   ii. the business risk of an investment project is significantly different from the business risk of current operations. (4 Marks)

(Total 20 Marks)

QUESTION 3

Tope operates a chain of cellular telephone stores in the country. An abbreviated profit or loss account and statement of financial position of the business for the year that has just ended is as follows:

Abbreviated profit or loss account for the year ended 31 May 2023

	₦'000
Sales	6,450
Operating profit for the year	800
Interest payable	(160)
Net profit before taxation	640
Tax (20%)	(128)
Net profit after taxation	512
Dividends proposed	(256)
Retained profit for the year	256

Abbreviated statement of financial position as at 31 May 2023

	₦'000	₦'000
Non-current assets at written down values		3,500
Current assets	1,800	
Less: Current liabilities	(1,100)	
		700
		4,200
Less: long-term liabilities		(2,000)
		2,200
Capital and reserves		
₦0.50 ordinary shares		600
Retained profit		1600
		2,200

The company is expecting a surge in sales following advances in cellular telephone technology that should translate into additional operating profits of ₦180,000 per year for the foreseeable future. However, the company will need to invest ₦1,200,000 immediately in expanding the asset base of the business, if it is to achieve these additional profits.

The business has approached a large supplier that already has an equity investment in the business to see whether it would be prepared to provide further funds for the business. The supplier has indicated it would be willing to provide the necessary funds by either:

(i) An issue of ₦0.50 ordinary shares at a premium of ₦1.50 per share; or
(ii) An issue of ₦1,200,000 10% debt at par.

The Board of Directors of Tope has already announced that it will maintain the same dividend payout ratio in future years as in the past and that this policy will be unaffected by the form of finance raised.

Required:

a. For each of the financing options:
   i. Prepare a forecast profit or loss account for the forthcoming year. (5 Marks)
   ii. Calculate the forecast earnings per share for the forthcoming year. (2 Marks)
   iii. Calculate the projected level of gearing (D/(D+E)) at the end of the forthcoming year. (2 Marks)
b. Calculate the level of operating profit at which the earnings per share will be the same under each financing option. (3 Marks)
c. Evaluate each of the financing options from the view point of an existing shareholder. (2 Marks)

d. Discuss the factors that will influence a company to finance through debt or equity, and whether to opt for long-term or short-term debt. (6 Marks)

(Total 20 Marks)

QUESTION 4

The following information is on 3 default free bonds.

Bonds	Price ₦	Coupon %	Redemption value ₦	Maturity Years
A	105	10	100	1
B	96	4	100	2
C	98	6	100	3

Required:

a. Estimate the two-year forward rate at the end of year 1 and the one-year forward rate at the end of year 2. (5 Marks)

b. You are considering buying a three - year 9% annual-coupon paying bond with face value of ₦1,000. The bond is default free bond.

i. Calculate the price of the bond and its yield to maturity. Clearly explain why you may not realise the calculated yield. (6 Marks)

ii. One-year after purchasing the bond at the price you have calculated and if there are no changes in market interest rates, do you expect the price of the bond to increase, fall or remain constant? Explain. (2 Marks)

iii. Estimate and interpret the modified duration of the bond. Identify the key limitations of modified duration in bond analysis. (7 Marks)

(Total 20 Marks)

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

QUESTION 5

a. Explain the main problems and costs which might arise for a company experiencing a period of severe financial difficulties. (7 Marks)

b. Describe how interested parties, other than bondholders, will be affected by high financial gearing levels, and describe what protective measures they can take. (8 Marks)

(Total 15 Marks)

QUESTION 6

a. With respect to foreign currency risk management, explain economic exposure and discuss generally, how a company can manage economic exposure. (8 Marks)

b. Linko Plc is a Uk-based company. It supplies medical equipment to the USA and Europe. It also buys some basic raw materials from USA.

In a typical financial year Linko has net imports of 8 million dollars from USA. This is expected to continue for the next six years.

The company's cost of capital is 10% per year. Assume that cash flows occur at the year end. Ignore taxation.

Required:

Assuming that there is no change in the physical volume or dollar price of imports, estimate the impact on the expected market value of Linko Plc, if the market expects the dollar to strengthen by 4% per year against the pounds. The current spot rate exchange rate (US$ per £1) is 1.9156 – 1.9210. (7 Marks)

(Total 15 Marks)

QUESTION 7

a. Discuss conflict of interest that may exist between managers and shareholders and give examples. (8 Marks)

b. Explain why synergy might exist when one company merges with or takes over another company. (7 Marks)

(Total 15 Marks)

Formulae

Modigliani and Miller Proposition 2 (with tax)

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

Asset Beta

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

Equity Beta

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

Growing Annuity

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

Modified Internal Rate of Return

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

The Black-Scholes Option Pricing Model

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

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

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

The Put Call Parity

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

Binomial Option Pricing

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

$$d = 1/u$$

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

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

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

Annuity Table

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

Where r = discount rate

n = number of periods

Discount rate (r)

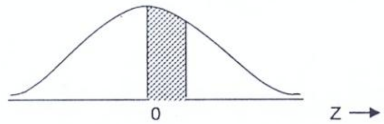
Periods

(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	
1	0·990	0·980	0·971	0·962	0·952	0·943	0·935	0·926	0·917	0·909	1
2	1·970	1·942	1·913	1·886	1·859	1·833	1·808	1·783	1·759	1·736	2
3	2·941	2·884	2·829	2·775	2·723	2·673	2·624	2·577	2·531	2.487	3
4	3·902	3·808	3.717	3·630	3.546	3.465	3·387	3·312	3·240	3·170	4
5	4·853	4·713	4·580	4·452	4·329	4·212	4·100	3·993	3.890	3·791	5
6	5·795	5·601	5·417	5·242	5·076	4·917	4·767	4·623	4.486	4·355	6
7	6·728	6.472	6·230	6·002	5·786	5·582	5·389	5·206	5·033	4·868	7
8	7·652	7·325	7·020	6·733	6·463	6·210	5·971	5·747	5·535	5·335	8
9	8·566	8·162	7·786	7.435	7·108	6·802	6·515	6·247	5·995	5·759	9
10	9·471	8·983	8·530	8·111	7·722	7·360	7·024	6·710	6.418	6·145	10
11	10·368	9·787	9·253	8·760	8·306	7·887	7.499	7·139	6·805	6.495	11
12	11·255	10·575	9·954	9·385	8·863	8·384	7·943	7·536	7'161	6·814	12
13	12·134	11·348	10·635	9·986	9·394	8·853	8·358	7·904	7·487	7·103	13
14	13·004	12·106	11·296	10·563	9·899	9·295	8·745	8·244	7·786	7·367	14
15	13·865	12·849	11·938	11·118	10·380	9·712	9·108	8·559	8·061	7·606	15

(n)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%	
1	0·901	0·893	0·885	0·877	0·870	0·862	0·855	0·847	0·840	0·833	1
2	1·713	1·690	1·668	1·647	1·626	1·605	1·585	1·566	1·547	1·528	2
3	2.444	2.402	2·361	2·322	2·283	2·246	2·210	2·174	2·140	2·106	3
4	3·102	3·037	2·974	2·914	2·855	2·798	2·743	2.690	2·639	2.589	4
5	3·696	3·605	3·517	3·433	3·352	3·274	3·199	3·127	3·058	2·991	5
6	4·231	4·111	3·998	3·889	3·784	3·685	3·589	3.498	3.410	3·326	6
7	4·712	4·564	4.423	4·288	4·160	4·039	3·922	3·812	3·706	3·605	7
8	5·146	4·968	4.799	4·639	4.487	4·344	4·207	4·078	3·954	3·837	8
9	5·537	5·328	5·132	4·946	4·772	4·607	4.451	4·303	4·163	4·031	9
10	5·889	5·650	5.426	5·216	5·019	4·833	4·659	4.494	4·339	4·192	10
11	6·207	5·938	5·687	5.453	5·234	5·029	4·836	4·656	4.486	4·327	11
12	6·492	6·194	5·918	5·660	5·421	5·197	4·988	4·793	4·611	4.439	12
13	6·750	6.424	6·122	5·842	5·583	5·342	5·118	4·910	4·715	4·533	13
14	6·982	6·628	6·302	6·002	5·724	5.468	5·229	5·008	4·802	4·611	14
15	7·191	6·811	6.462	6·142	5·847	5·575	5·324	5·092	4·876	4·675	15

NORMAL DISTRIBUTION

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



$Z=\frac{(x-\mu)}{\sigma}$	0.00	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.08	0.09
0.0	.0000	.0040	.0080	.0120	.0159	.0199	.0239	.0279	.0319	.0359
0.1	.0398	.0438	.0478	.0517	.0557	.0596	.0636	.0675	.0714	.0753
0.2	.0793	.0832	.0871	.0910	.0948	.0987	.1026	.1064	.1103	.1141
0.3	.1179	.1217	.1255	.1293	.1331	.1368	.1406	.1443	.1408	.1517
0.4	.1554	.1591	.1628	.1664	.1700	.1736	.1772	.1808	.1844	.1879
0.5	.1915	.1950	.1985	.2019	.2054	.2088	.2123	.2157	.2190	.2224
0.6	.2257	.2291	.2324	.2357	.2389	.2422	.2454	.2486	.2518	.2549
0.7	.2580	.2611	.2642	.2673	.2704	.2734	.2764	.2794	.2823	.2852
0.8	.2881	.2910	.2939	.2967	.2995	.3023	.3051	.3078	.3106	.3133
0.9	.3159	.3186	.3212	.3238	.3264	.3289	.3315	.3340	.3365	.3389
1.0	.3413	.3438	.3461	.3485	.3508	.3531	.3554	.3577	.3599	.3621
1.1	.3643	.3665	.3686	.3708	.3729	.3749	.3770	.3790	.3810	.3830
1.2	.3849	.3869	.3888	.3907	.3925	.3944	.3962	.3980	.3997	.4015
1.3	.4032	.4049	.4066	.4082	4099	.4115	.4131	.4147	.4162	.4177
1.4	.4192	.4207	.4222	.4236	.4251	.4265	.4279	.4292	.4306	.4319
1.5	.4332	.4345	.4357	.4370	.4382	.4394	.4406	.4418	.4430	.4441
1.6	.4452	.4463	.4474	.4485	.4495	.4505	.4515	.4525	.4535	.4545
1.7	.4554	.4564	.4573	.4582	.4591	.4599	.4608	.4616	.4625	.4633
1.8	.4641	.4649	.4656	.4664	.4671	.4678	.4686	.4693	.4699	.4706
1.9	.4713	.4719	.4726	.4732	.4738	.4744	.4750	.4756	.4762	.4767
2.0	.4772	.4778	.4783	.4788	.4793	.4798	.4803	.4808	.4812	.4817
2.1	.4821	.4826	.4830	.4834	.4838	.4842	.4846	.4850	.4854	.4857
2.2	.4861	.4865	.4868	.4871	.4875	.4878	.4881	.4884	.4887	.4890
2.3	.4893	.4896	.4898	.4901	.4904	.4906	.4909	.4911	.4913	.4916
2.4	.4918	.4920	.4922	.4925	.4927	.4929	.4931	.4932	.4934	.4936
2.5	.4938	.4940	.4941	.4943	.4945	.4946	.4948	.4949	.4951	.4952
2.6	.4953	.4955	.4956	.4957	.4959	.4960	.4961	.4962	4963	.4964
2.7	.4965	.4966	.4967	.4968	.4969	.4970	.4971	.4972	.4973	.4974
2.8	.4974	.4975	.4976	.4977	.4977	.4978	.4979	.4980	.4980	.4981
2.9	.4981	.4982	.4983	.4983	.4984	.4984	.4985	.4985	.4986	.4986
3.0	**.49865**	.4987	.4987	.4988	.4988	.4989	.4989	.4989	.4990	.4990
3.1	**.49903**	.4991	.4991	.4991	.4992	.4992	.4992	.4992	.4993	.4993
3.2	**.49931**	.4993	.4994	.4994	.4994	.4994	.4994	.4995	.4995	.4995
3.3	**.49952**	.4995	.4995	.4996	.4996	.4996	.4996	.4996	.4996	.4997
3.4	**.49966**	.4997	.4997	.4997	.4997	.4997	.4997	.4997	.4997	.4998
3.5	**.49977**									

SOLUTION 1

REPORT

To: The board of directors
From: An Accountant
Date: 28 – 02 – 2023
Subject: Possible offer for KL

Net assets valuation (historic) per share	$\frac{₦\ 6.3m}{2.1\ m}$	₦3.00
Net assets valuation (revalued) per share	$\frac{(₦6.3m + 15.5m - 11.8m)}{2.1\ m}$	₦4.76
Price earnings valuation per share	$\frac{₦4.4m\ x\ 9}{2.1\ m}$	₦18.86

As KL is not a quoted company, and its shares are less marketable, this price should be marked down (by, say, 30%), i.e. (₦18.86 – 30%) ₦13.20

Dividend yield valuation per share	$\frac{₦1.1m/6\%}{2.1\ m}$	₦8.73

As KL is not a quoted company, and its shares are less marketable, this price should be marked down (by, say, 30%), i.e. (₦8.73–30%) ₦6.11

Discounted yield valuation per share	$\frac{₦23.343m}{2.1\ m}$	₦11.12

WORKINGS

(1) DISCOUNTED CASHFLOW

	2024	2025	2026	2027
	₦'m	**₦'m**	**₦'m**	**₦'m**
Pre-tax cash flow (₦m)	4.600	4.300	5.200	5.700
Less income tax at 21%	(0.966)	(0.903)	(1.092)	(1.197)
After-tax cash flows	3.634	3.397	4.108	4.503
tax saving – capital allowance (W2)	0.136	0.112	0.092	0.000
Disposal of equipment				1.985
Total cash flows	3.770	3.509	4.200	6.488
14% discount factor	0.877	0.769	0.675	0.592
present value	3.306	2.698	2.835	3.841

total present values (2024 – 2027)	12.680
plus potential sale in 2027 (4 x 4.503m x 0.592)	10.663
Final present value of future cash flows	23.343

(2) **Capital allowances**

	₦m	₦m	₦m	₦m
WDV b/f	3.600	2.952	2.421	1.985
WDA @ 18%	(0.648)	(0.531)	(0.436)	(0.000)
WDV/disposal	2.952	2.421	1.985	1.985
Tax saving (WDA x 21%)	0.136	0.112	0.092	0.000

b. Explanation of each of the methods (advantages/disadvantages)

Net assets basis (historic) – this is a historic cost and so doesn't have any real merit to it.

Net assets basic (revalued) – as above, but it does take into account the latest asset values.

Intangible assets are not easily included in this calculation, which would mean that an under-valuation would arise.

Price earnings valuation – income based measure, which has advantages over asset-based.
However, is it reasonable to take the industry average P/E ratio? How similar is KL to other printing firms? Also it is based on this year's earnings only.

Dividend yield valuation – income based measure again. Is it reasonable to take the industry average yield? How similar is KL to other printing firms? Also it ignores dividend growth.

Discounted cash flow valuation – this is probably the best methods to adopt, i.e. value a firm by discounting its expected future cash flows. However there are problems with estimating those cash flows - what about synergistic benefits arising from a takeover? Also, what is an acceptable discount rate and for how many years ahead is it reasonable to estimate the cash flows? Finally, the KL sale value in 2027 is based on an estimate which makes up 45.6% (₦10,663/₦23,343) of the total value calculated under this method – how accurate will this be?.

(Note: Reasonable alternative points will be rewarded).

c. Synergy can exist when one company merges with or takes over another company due to several key factors:

i) **Complementary resources**: When two companies combine, they may bring together complementary resources such as technology, distribution networks, or intellectual property. These resources can be used more efficiently and effectively when integrated, leading to cost savings and increased productivity.

ii) **Cost reduction**: Mergers often result in cost synergies, as duplicated functions, departments, and facilities can be streamlined or eliminated. This reduces overhead expenses and improves overall profitability.

iii) **Revenue growth**: The merged entities may have access to a larger customer base or new markets. Cross-selling products or services to the combined customer pool can lead to increased revenues.

iv) **Economies of scale**: Larger organisations can benefit from economies of scale, which means they can produce goods or services at a lower cost per unit when operating at a larger scale. This cost advantage can enhance profitability.

v) **Enhanced innovation**: combining the talent and expertise of two companies can foster innovation and the development of new products or solutions that neither could achieve independently.

vi) **Risk diversification**: By merging, companies can spread risk across a broader portfolio of products, markets, and business segments, reducing their overall exposure to economic downturns or industry-specific challenges.

vii) **Improved access to capital**: A larger, more diversified company may find it easier to secure financing and investment opportunities, providing additional resources for growth and development.

viii) **Competitive advantage**: Synergies can create a stronger competitive position in the market, as the merged entity may have a more comprehensive offering, broader market reach, or better pricing power.

However, it's essential to note that realising these synergies often requires effective integration planning and execution. Cultural clashes, operational challenges, and regulatory hurdles can also hinder synergy realisation. Successful mergers and takeovers depend on thorough due diligence, strategic alignment, and strong leadership to fully unlock the benefits of synergy.
(Note: Reasonable alternative points will be rewarded).

Examiner's report

This is a standard question on valuation of business.

Part (a) tests candidates' knowledge of business valuation, using a number of methods.

Part (b) requires candidates to discuss the advantages and the limitations of the various methods.

Part (c) asks candidates to identify possible benefits that could accrue to the two merging companies.

Being a compulsory questions, almost all the candidates attempted the questions. Part (a) is reasonably straight forward and it is very disappointing that many candidates failed to gain more than average marks. A number of them struggled to identify the net assets figures as required and quite a few were unable to calculate the dividend yield correctly. In the latter case, too many candidates attempted to use a dividend growth figure in their answers, which was incorrect.

Part (b) was generally answered well, but too few candidates produced sufficiently detailed comments on the PV method of valuation.

Part (c) was not done as well as expected and too many candidates failed to answer the question, either basing their answer from Bolade plc's point of view or giving a very general answer and failing to apply their knowledge to the scenario.

It is recommended that students preparing for the institute's examinations should practise with a lot past questions.

Marking guide		**Marks**	**Total**
a.	Compute the share value using net asset basis		
(i)	(historic cost) method.	2	
(ii)	Compute the share value using net asset basis (revealed) method.	2	
(iii)	Calculate the share value using price/earnings ratio method.	2	
(iv)	Calculate the share value using dividend yield method.	2	
(v)	Calculate the value of one share using the present value of future cash flows method.	8	
		16	16
b.	Explain the advantages and disadvantages of using each of the five valuation methods.	8	8
c.	State the possible benefits from the proposed merger.	6	6
	Total		**30**

SOLUTION 2

a. **Errors in the original investment appraisal**

Inflation was incorrectly applied to selling prices and variable costs in calculating contribution, since only one year's inflation was allowed for in each year of operation.

The fixed costs were correctly inflated, but included ₦2,000,000 per year before inflation that was not a relevant cost. Only relevant costs should be included in investment appraisal.

Straight-line accounting depreciation had been used in the calculation, but this depreciation method is not acceptable to the tax authorities. The approved method using 25% reducing balance tax allowable depreciation should be used.

Interest payments have been included in the investment appraisal, but these are allowed for by the discount rate used in calculating the net present value.

The interest rate on the debt finance has been used as the discount rate, when the nominal weighted average cost of capital should have been used to discount the calculated nominal after-tax cash flows.

b. Nominal weighted average cost of capital = $(1.07 \times 1.047)-1$ = 12% per year.

Year	1	2	3	4	5
	₦000	₦000	₦000	₦000	₦000
Contribution	13,300	2,2640	30,100	16,000	
Fixed costs	(3,180)	(3,371)	(3,573)	(3,787)	
Taxable cash flow	10,120	19,269	26,527	12,213	
Taxation		(3,036)	(5,781)	(7,958)	(3,664)
CA tax benefits		1,500	1,125	844	1,781
After-tax cash flow	10,120	17,733	21,871	5,099	(1,883)
Scrap value				2,500	
After-tax cash flow	10,120	17,733	21,871	7,599	(1,883)
Discount at 12%	0.893	0.797	0.712	0.635	0.567
Present value	9,037	14,133	15,572	4,825	(1,068)

	₦000
Present value of future cash flows	42,499
Initial investment	20,000
Net present value	22,499

The net present value is positive and so the investment is financially acceptable.

Alternative NPV calculations using taxable profit calculation

Year	1	2	3	4	5
	₦000	₦000	₦000	₦000	₦000
Contribution	13,300	22,640	30,100	16,000	
Fixed costs	(3,180)	(3,371)	(3,573)	(3,787)	
Taxable cash flow	1,0120	19,269	26,527	12,213	
TA depreciation	(5,000)	(3,750)	(2,813)	(5,938)	
Taxable profit	5,120	15,519	23,714	6,275	
Taxation		(1,536)	(4,655)	(7,114)	(1,883)
Profit after tax	5,120	13,983	19,059	(839)	(1,883)
TA depreciation	5,000	3,750	2,813	(5,934)	
After-tax cash flow	10,120	17,733	21,872	5,095	(1,883)
Scrap value				2,500	
After-tax cash flows	10,120	17,733	21,872	7,595	(1,883)
Discount at 12%	0.893	0.797	0.712	0.635	0.567
Present values	9,037	14,133	15,572	4,822	(1,067)

	₦000
Present of future cash flows	42,497
Initial investment	20,000
Net present value	22,497

Workings

Annual contribution

Year	1	2	3	4
Sales volume (units/yr)	250,000	400,000	500,000	250,000
Selling price (₦/unit)	126.0	132.3	138.9	145.9
Variable cost (₦/unit)	72.8	75.7	78.7	81.9
Contribution (₦/unit)	53.2	56.6	60.2	64
Contribution ((₦/yr)	13,300,000	22,640,000	30,100,000	16,000,000

Tax allowable depreciation tax benefits

Year	TA depreciation (₦)	Tax benefit (₦)
1	5,000,000	1,500,000
2	3,750,000	1,125,000
3	2,812,500	843,750
4	5,937,500	1,781,250
Scrap value	2,500,000	
	20,000,000	

c. (i) **Multiple internal rates of return**

An investment project may have multiple internal rates of return if it has unconventional cash flows, that is, cash flows that change sign over the life of the project. A mining operation, for example, may have initial investment (cash outflow) followed by many years of successful operation (cash inflow) before decommissioning and environmental repair (cash outflow). This technical difficulty makes it difficult to use the internal rate of return (IRR) investment appraisal method to offer investment advice.

One solution is to use the net present value (NPV) investment appraisal method instead of IRR, since the non-conventional cash flows are easily accommodated by NPV. This is one area where NPV is considered to be superior to IRR.

(ii) **Projects with significantly different business risk to current operations**

Where a proposed investment project has business risk that is significantly different from current operations, it is no longer appropriate to use the weighted average cost of capital (WACC) as the discount rate in calculating the net present value of the project. WACC can only be used as a discount rate where business risk and financial risk are not significantly affected by undertaking an investment project.

Where business risk changes significantly, the capital asset pricing model should be used to calculate a project-specific discount rate that takes account of the systematic risk of a proposed investment project.

Examiner's report

This is a 3-part question on capital investment appraisal.

Part (a) requires candidates to identify and comment on any errors in the draft appraisal of the investment.

Part (b) asks candidates to prepare a revised NPV calculations, and correcting the identified errors.

Part (c) asks the candidates to discuss some specific challenges associated with capital investment appraisal.

Large number of the candidates attempted the question.

A good number of the candidates were able to identify the required errors in part (a). In part (b) however, many candidates lost valuable marks due to the following reasons:

- Failure to identify the relevant cash flows to use
- Wrong calculation of capital allowances and related tax savings
- Inappropriate treatment of inflation
- Discounting money cash flows using real cost of capital, etc.

In part (c), most of the candidates demonstrated no idea of multiple internal rate of returns. At the same time, candidates could not provide meaningful discussion on differing project's business risk and company's business risk.

To hedge against failure in future examinations, candidates are advised to read widely and practise past examination questions.

	Marking guide	**Marks**	**Marks**
a.	Identify and comment on any errors in the investment appraisal prepared	4	4
b.	Prepare a revised calculation of the net present value of the proposed investment	12	12
c. (i)	Discuss the problems faced and comment on how to overcome the problems when an investment project has several internal rates of return.	2	2
(ii)	Discuss the problems faced and comment on how to overcome the problems when the business risk of an investment project is significantly different from the business risk of current operations.	2	2
	Total		**20**

SOLUTION 3

(a) i) **Forecast profit or loss account for the year ending 31 May 2024**

	Shares		Debt
	₦'000		**₦'000**
Operating profit (800 + 180)	980		980
Interest	(160)	(160 + 120)	(280)
Profit before tax	820		700
Tax (20%)	(164)		(140)
Profit after taxation (PAT)	656		560
Dividend (PAT × 50%)	328		280
Retained profit for the year	328		280

ii) **Forecast earnings per share**

• Share issue - number of shares currently in issue		1,200,000
- new shares issued (1,200,000/2)		600,000
		1,800,000
Earnings per share = ₦656,000/1,800,000	=	36.4 kobo
• Debt issue		
Earnings per share = ₦560,000/1,200,000	=	46.7 kobo

iii) **Projected level of gearing**

$$\text{Share issue} = \frac{2{,}000}{600 + 1{,}200 + 1{,}600 + 328 + 2{,}000} \times 100\% = 34.9\%$$

$$\text{Debt issue} = \frac{2{,}000 + 1{,}200}{600 + 1{,}600 + 280 + 2{,}000 + 1{,}200} \times 100\% = 56.3\%$$

(b) **Operating profit is profit before interest and tax**. The operating profit level at which earnings per share under each financing option would be equal is calculated at follows:

x = operating profit.

$$\textbf{Shares} \qquad\qquad \textbf{Debt}$$

$$\frac{(x - \text{interest})(1 - \text{tax rate})}{\text{Number of shares}} = \frac{(x - \text{interest})(1 - \text{tax rate})}{\text{Number of shares}}$$

$$\frac{(x - ₦0.16)(1 - 0.2)}{1.8m} = \frac{(x - ₦0.28)(1 - 0.2)}{1.2m}$$

$$\frac{0.8x - 0.128}{1.8m} = \frac{0.8x - ₦0.224}{1.2m}$$

$$0.96x - ₦0.1536 = 1.44mx - ₦0.4032m$$

$$0.48x = ₦0.2496m$$

$$x = ₦0.52m$$

c. **Impact on EPS**: The calculations in part (a) show that for the existing shareholders, the issue of the debt would lead to a significantly higher level of earnings per share than the share issue, and also increases their earnings per share above the current level of 42.7 kobo.

Impact on risk: However, the debt issue would significantly increase the gearing level from the current level of 47.6%. Therefore the debt issue, although increasing earnings per share will increase the level of risk faced by the equity shareholders. The attitude of the existing shareholders to this increase in risk must therefore be considered.

The share issue, although reducing the gearing level, has risks of its own in that the share capital is to increase by 50%, and this one third holding will be held by the supplier who already has an equity investment in the business. This change of ownership power may not be acceptable to the existing shareholders.

d. **Equity and debt**

i) The cost of debt capital. Tax relief is available to companies on interest costs, but not on dividends. Debt capital is therefore cheaper than equity, and is consequently often preferred by management.

ii) The board of directors might try to keep gearing within a target range that shareholders and lenders might regard as ‘normal’ or ‘acceptable’ for the company.

iii) Gearing policy might be affected by board policy on retained profits. When retained profits are fairly high, a company might have little recourse to external financing, and so would have a very low gearing level.

iv) Gearing might be influenced by management's views on interest rates. Borrowing might be avoided when market interest rates are considered high, or in the case of variable rate borrowing, if interest rates are expected to rise.

Long-term and short-term debt

i) The traditional view is that non-current asset should be financed by long-term sources of finance and current assets by a mixture of long-term and short-term sources. If a company finances illiquid assets from short-term debt it faces the risk of insolvency in the event of its being unable to renegotiate the loans when they fall due.

ii) Transaction costs vary according to the type of finance being raised, for example it will be cheaper to arrange a medium-term bank loan than a public issue of dated loan stock. Short-term debt will need to be renegotiated more frequently and this will give rise to recurring transaction costs.

iii) The relative interest rates carried by long-term and short-term debt will vary over time according to supply and demand and to market expectations of interest rate changes. Rates are generally higher on long-term loans than on short-term since the level of risk faced by the lender that interest rates may rise before repayment is due is higher.

iv) The company may find it easier to raise short-term finance with low security than long-term finance.

v) In opting for short-term debt, the company faces the risk that it may not be able to renegotiate the loan on such good terms, or even at all, when the repayment date is reached. Long-term loans are thus less risky.

vi) Long-term debt may carry early repayment penalties if it is found that the loan is no longer needed or a more attractive form of finance becomes available. Short-term debt is more flexible since it allows the firm to react to interest rate changes and to avoid being locked into an expensive long-term fixed rate commitment at a time when rates are falling.

Examiner's report

This is a four-part question that tests the candidates' understanding of several aspects of financing decision. The scenario of the question is that a company wishes to identify the appropriate method of financing a new capital project.

Part (a) of the question requires candidates to prepare a forecast of profit or loss account for each method of financings. They were also to calculate the resulting EPS and the financial leverage.

Part (b) requires candidates to calculate the level of EBIT that will produce the same EPS.

Part (c) requires candidates to evaluate, from shareholders point of view, the two methods of financing.

Part (d) asks the candidates to discuss factors that will influence the choice of equity or debt finance.

More than sixty percent of the candidates attempted the question and performance was just about average.

Many candidates struggled to calculate the appropriate earnings and the number of shares needed to calculate the EPS required in (a) (ii).

Similarly, candidates struggled with the calculation of equity and debt needed to compute the required gearing in (a) (iii).

In parts (b) and (c), candidates had no idea of whatto do and most of them therefore scored no mark.

Part (d) was mostly done fairly well.

Candidates are advised to cover the syllabus comprehensively when preparing for this examination.

Marking guide

		Marks	Marks
a. (i)	Prepare a forecast profit or loss account for the forthcoming year.	5	
(ii)	Calculate the forecast earnings per share for the forthcoming year.	2	
(iii)	Calculate the projected level of gearing at the end of the forthcoming year	2	
			9

b.	Calculate the level of operating profit at which the earnings per share will be same under each financing method	3	3
c.	Evaluate each of the financing options from the view point of an existing shareholder	2	2
d.	Discuss the factors that will influence a company to finance through debt or equity.	6	6
	Total		**20**

SOLUTION 4

a. **Step 1**. Compute the spot rates for 1, 2 and 3 years

1-year spot rate (r_1): This is calculated from bond A.

$$105 = \frac{110}{1 + r_1}$$

r_1 = 4.76% (This is the YTM of bond A)

2-year spot rate (r_2): This is computed from bond B.

$$96 = \frac{4}{1 + r_1} + \frac{104}{(1 + r_2)^2}$$

$$96 = \frac{4}{1.0476} + \frac{104}{(1 + r_2)^2}$$

$$92.18 = \frac{104}{(1 + r_2)^2}$$

$$92.18(1 + r_2)^2 = 104$$

$$r_2 = \left(\frac{104}{92.18}\right)^{\frac{1}{2}} - 1 = 6.22\%$$

3-year spot rate (r_3): This is computed from the information on bond C.

$$98 = \frac{6}{1 + r_1} + \frac{6}{(1 + r_2)^2} + \frac{106}{(1 + r_3)^3}$$

$$98 = \frac{6}{1.0476} + \frac{6}{(1.0622)^2} + \frac{106}{(1 + r_3)^3}$$

$$86.95 = \frac{106}{(1 + r_3)^3}$$

$$86.95(1 + r_3)^3 = 106$$

$$r_3 = \left(\frac{106}{86.95}\right)^{\frac{1}{3}} - 1 = 6.83\%$$

Step 2. Compute the forward rates

$$F_{1,3} = \left(\frac{(1 + r_3)^3}{1 + r_1}\right)^{\frac{1}{3-1}} - 1$$

$$= \left(\frac{(1.0683)^3}{1.0476}\right)^{\frac{1}{3-1}} - 1 = 7.88\%$$

$$F_{2,3} = \left(\frac{(1 + r_3)^3}{(1 + r_2)^2}\right)^{\frac{1}{3-2}} - 1$$

$$= \left(\frac{(1.0683)^3}{(1.0622)^2}\right) - 1 = 8.06\%$$

b. i) The price (P) of the bond is computed. Using the computed spot rates.

$$P = \frac{90}{1.0476} + \frac{90}{(1.0622)^2} + \frac{1090}{(1.0683)^3} = ₦1096.70$$

Calculation of YTM

We try 4% and 6%

Year	Cash Flow	PV at 4%	PV at 6%
	₦	₦	₦
0	-1096.70	-1096.7	-1096.7
1-3	90	249.98	240.57
3	1,000	889.00	839.62
NPV		42.28	-16.51

$$YTM = 4 + \left(\frac{42.28}{42.28 + 16.51}\right) \times (6 - 4)$$

$$= 4 + 1.44\% = 5.44\%$$

The YTM of 5.44% may not be realised for the following reasons:

- **Timely receipt of the associated cash flows.** If the coupons and the redemption value are not received as and when due, the realised yield will be less than 5.44% (because of the time value of money).
- **Reinvestment risk.** If the coupon received at the end of year 1 and at the end of year 2 are reinvested at a rate lower than 5.44%, the realised yield will be less than 5.44% and if they are reinvested at a higher rate, the realised yield will be higher than 5.44%.
- **Price risk.** If the bond is not held to maturity (Year 3 in this case), the investor may realise a capital gain/loss when the bond is sold prior to maturity. This is called price risk.

ii) The bond is a premium bond. Generally, the price of a premium bond falls with passage of time (holding interest rate constant). The reason for this is that at maturity the market value and the face value must be the same – since the face value will be paid at maturity. Thus the market value of the bond at the end of Year 1 will be less than the current market value.

iii) First, we need to compute the duration of the bond.

Year (n)	**CF ₦**	**PV (at 5.44%) ₦**	**PV × n**
1	90	85.36	85.36
2	90	80.95	161.90
3	1090	929.84	2,789.52
		1096.15	3036.78

Duration (D) = 3036.78/1096.15 = 2.77 Years.

Next, we compute the modified duration (MD)

MD = D/1 + YTM =2.77/1.0544 =2.63

Modified duration measures the change in the value of a bond in response to a change in 100-basis point (1%) change in interest rates. In this example, if interest rate increases by 1%, the price of the bond is expected to fall by approximately 5.44%. Alternatively, if interest rate drops by 1%, the price of the bond is expected to increase by approximately 5.44%.

The modified duration is only a **linear approximation** of the full price change due to a change in the interest rates. It doesn't consider the convexity of the bond, that is dependent on the particular features of the specific bond in terms of expiry date, amount of coupons, payment dates of the coupons, redemption price of the bond, amortising of the nominal redemption value if any, call/put options if any.

In addition, the modified duration is a good approximation of bond's price change only if:

- it's assumed that the yield curve is "flat";
- a limited (small) interest rate change is considered;
- a parallel shift of the interest rate curve is considered; and
- an instantaneous interest rate change is considered.

Examiner's report

This question tests candidates' knowledge of the calculation and use of forward rate of interest. It also tests candidates' ability to calculate and interpret both duration and modified duration.

Candidates found this question by far the most challenging in the entire paper. Candidates showed complete lack of knowledge of this area of the syllabus. The question is a clear indication that candidates can expect similar questions from time to time.

Less than twenty percent of the candidates attempted the question and as noted above, performance was extremely poor.

Candidates cannot continue to sample what parts of the syllabus they want to study and expect miracle in the examination.

Marking guide			**Marks**	**Marks**
a.		Estimate the two-year forward rate at the end of year 1 and the one-year forward rate at the end of year 2.	5	5
b.	(i)	Calculate the price of the bond and its yield to maturity.	6	
	(ii)	Do you expect the price of the bond to increase, fall or remain constant? Explain.	2	
	(iii)	Estimate and interpret the modified duration of the bond. Identifying also the key limitations of modified duration in bond analysis.	7	
			15	15
		Total		**20**

SOLUTION 5

a. A company experiencing severe financial difficulties can face a range of problems and costs that can be detrimental to its survival. Some of the main issues and costs that might arise include:

- **Liquidity problems**: Insufficient cash flow can make it challenging to meet short-term obligations like payroll, rent, and suppliers, leading to late payments or default;
- **Increased borrowing costs**: As financial difficulties become evident, lenders may charge higher interest rates or impose stricter terms, increasing the cost of borrowing;
- **Loss of creditworthiness**: A company's credit rating may decline, making it harder to secure loans or trade credit on favorable terms;
- **Reduced employee morale**: Uncertainty about job security can lead to low morale, reduced productivity, and potential talent loss;
- **Supplier issues**: Suppliers may demand faster payments or reduce credit terms, impacting the supply chain and increasing costs;
- **Customer loss**: Customers may lose confidence in the company, leading to reduced sales, canceled contracts, or delayed payments;
- **Legal costs**: Legal actions from creditors, shareholders, or regulatory bodies can result in costly legal fees and potential settlements;
- **Reputation damage**: Negative publicity and a damaged reputation can harm a company's brand, making it difficult to regain trust in the market;
- **Employee layoffs**: Cost-cutting measures may require layoffs, resulting in severance pay and potential legal complications;
- **Restructuring costs**: Implementing a turnaround plan or restructuring the company can be expensive, involving consulting fees, layoffs, and operational changes;
- **Regulatory fines**: Non-compliance with financial regulations or mismanagement can lead to fines and penalties;
- **Decline in share value**: If the company is publicly traded, its stock price may plummet, reducing the wealth of shareholders;
- **Exit costs:** If the financial difficulties are insurmountable, the company may face costs associated with bankruptcy or liquidation; and
- **Lost opportunities**: Financial constraints can prevent the company from pursuing growth opportunities or investing in research and development.

b. High financial gearing levels, also known as high financial leverage, can significantly impact various interested parties beyond bondholders. These parties include:

1. **Shareholders**: High financial gearing can amplify the impact of profits and losses on a company's equity. When a company with high gearing generates profits, shareholders benefit from increased returns on their investment. However, in periods of financial difficulty, the losses can erode shareholder value rapidly.

    i) Accepting that excessively high gearing can damage the interest of equity shareholders, they may seek to limit the damage by the following measures:

    - Placing a limit on the company's borrowing power;
    - Pressure on directors, through members meetings, to follow policies of moderate gearing; and
    - Ultimately, shareholders might consider switching investments to a less geared company.

2. **Customers**: customers of the company will be affected by high gearing to the extent that the resultant financial distress may jeopardise the future of the company. This may affect the quality of customer service in the short term and in the event of bankruptcy will cut off supplies. They can protect themselves by finding alternative supplies and by ensuring that they minimise advance payments. In the event of bankruptcy, these are likely to be lost.

3. **Creditors and suppliers**: Creditors and suppliers will view themselves as adding to what may already be excessive gearing. It is likely that in a situation of resultant financial distress payments will be delayed. Suppliers can protect themselves by tight credit control with strict follow up and, if necessary legal action for recovery: or by withholding suppliers until previous suppliers are paid for. Another approach is to use reservation of title clauses which will enable a supplier recover goods not paid for, either prior or following bankruptcy.

4. **Employees**: Employees of the company are likely to be very concerned about high gearing if it brings financial distress in its wake, as this may ultimately result in the loss of their employment. They must hope to protect their interest through elected representatives or ultimately by "voting with their feet" before being made redundant.

Examiner's report

This question tests candidates' knowledge of the major consequences of severe financial difficulties.

More than eighty percent of the candidates attempted the question with average level of performance. Most well-prepared candidates were able to cope comfortably with part (b) of the question.

Complete coverage of the syllabus is required for success in this examination.

Marking guide		**Marks**	**Marks**
a.	Explain the main problems and costs which might arise for a company experiencing a period of severe financial difficulties.	7	7
b.	Describe how interested parties, other than bondholders, will be affected by high financial gearing, and what protective measures they can take.	8	8
	Total		**15**

SOLUTION 6

a. Economic exposure in currency risk management refers to the impact of exchange rate fluctuations on a company's future cash flows, revenues, and expenses. It reflects the potential changes in the company's competitive position, market share, and profitability due to currency rate changes.

For instance, consider a company based in the United States that exports its products to Europe. If the Euro strengthens against the US Dollar, the company's products become more expensive for European customers. This could lead to a decrease in demand for its products and a potential loss of market share.

On the other hand, if the Euro weakens, the company's products become more affordable for European customers, potentially increasing demand and market share. However, if the company relies on imported materials from Europe, a weaker Euro could increase the cost of those materials, affecting profit margins. In this example, the company's economic exposure is linked to its ability to adapt to currency fluctuations and maintain competitiveness in its target markets.

Companies can employ various strategies to manage economic exposure, which is the risk of currency fluctuations impacting their future cash flows and profitability. Some common methods include:

- **Diversification of markets and suppliers**: Expanding into diverse markets reduces reliance on a single currency and minimises the impact of exchange rate changes. Similarly, sourcing materials from different countries can help mitigate the effects of currency fluctuations on input costs.
- **Currency invoicing**: Using the local currency of the customer or supplier in transactions can help shift the exchange rate risk to the other party.
- **Pricing strategies**: Adjusting prices based on exchange rate fluctuations can help the company maintain competitiveness and protect profit margins. This involves carefully analysing the relationship between price elasticity and currency changes.
- **Natural hedging**: If a company has operations in multiple countries, the revenues and expenses from these operations can naturally offset each other's currency impacts.
- **Operational hedging**: Companies can make operational changes to reduce economic exposure. For instance, setting up production facilities in different countries can help match revenues and expenses in the same currency.
- **Constant monitoring and analysis**: Regularly tracking and analysing currency movements, market trends, and economic indicators can enable companies to make timely and informed decisions to manage economic exposure.

b. If dollar strengthens by 4%, then every one pound of today will worth 100/104 pound in one year's time. Therefore, the relevant exchange rate for the next 6 years are as follows:

Year 1 $1.9156 \times 100/104 = 1.8419$
Year 2 $1.8419 \times 100/104 = 1.7711$
Year 3 $1.7711 \times 100/104 = 1.7030$
Year 4 $1.7030 \times 100/104 = 1.6375$
Year 5 $1.6375 \times 100/104 = 1.5745$
Year 6 $1.5745 \times 100/104 = 1.5139$

(Note: It could also be assumed that if dollar strengthens by 4% then pound will weaken by 4%. In that case, every one pound of today will worth 96% of its value in one year's time. This approach is not precise but it is acceptable in examination. Note further that the exchange rate used is the dollar buying rate i.e. 1.9156).

Estimated effect on value

Year	Exchange Rate $/£	£ equivalent of $8 (m)	£ difference to spot	PVF at 10%	PV £
Spot	1.9156	4,176,237	_	1.000	_
1 year	1.8419	4,343,341	167,104	0.909	151,898
2 years	1.7711	4,516,967	340,730	0.826	281,443
3 years	1.7030	4,697,592	521,355	0.751	391,538
4 years	1.6375	4,885,496	709,259	0.683	484,424
5 years	1.5745	5,080,978	904,741	0.621	561,844
6 years	1.5139	5,284,365	1,108,128	0.565	626,092
					2,497,239

The strengthening of the dollar is expected to reduce the present value of cash flows, and, if the market is efficient, the market value of Linko, by £2,497,239.

Examiner's report

This question deals with foreign currency economic exposure.
Very few candidates attempted the question with below average level of performance.

It is apparent that majority of the candidates were ill-equipped in this important area of finance. They therefore failed to pick up easy marks expected in this type of question.

To increase the chance of success in the examination, students need to practice standard examination questions.

Marking guide		**Marks**	**Marks**
a.	With respect to foreign currency risk management, explain economic exposure and how a company can manage economic exposure.	8	8
b.	Estimate the impact on the expected market value of Linko PLC, if the market expects the dollar to strengthen by 4% per year against the pounds.	7	7
	Total		**15**

SOLUTION 7

a. Certainly, conflict of interest between managers and shareholders can arise in various ways. Here are some examples:

- **Excessive compensation**: Managers might set their own salaries and bonuses, which can lead to overcompensation at the expense of shareholder returns.
- **Risk-taking**: Managers might take on excessive risks to boost short-term profits and the value of their stock options, even if it's detrimental to long-term shareholder value.
- **Mergers and acquisitions (M&A)**: Managers might pursue M&A deals that benefit them personally through golden parachutes or retention bonuses but may not be in the best interest of shareholders.
- **Information asymmetry**: Managers may possess non-public information and use it to their advantage, such as insider trading or disclosing information selectively to certain shareholders.
- **Dividend policies**: Managers may choose to reinvest profits into the company for growth rather than paying dividends to shareholders who rely on income from their investments.
- **Related-party transactions**: Managers might engage in business deals with companies they have personal interests in, potentially overpaying or favoring those companies over better alternatives.
- **Share repurchases**: Managers could use share buyback programs to boost the value of their own stock options while potentially neglecting other opportunities to invest in the business.
- **Inadequate oversight**: Boards of Directors, often comprised of managers, may not provide effective oversight, allowing managers to make decisions that primarily benefit themselves.
- **Long-term vs. short-term focus**: Managers might prioritise short-term gains, such as hitting quarterly targets, over long-term strategic planning, which could harm the company's sustainable growth.
- **Personal agendas**: Managers may pursue personal agendas or pet projects that align with their personal interests but don't necessarily maximise shareholder value.

These conflicts of interest underscore the importance of effective corporate governance, independent boards, and transparency to protect the interests of shareholders.
(Reasonable alternative points will be rewarded)

b. Synergy might exist for several reasons, including:

Economic efficiency gains

Gains might relate to economies of scale or scope. Economies of scale occur through such factors as fixed operating costs being spread over a larger production volume, equipment being used more efficiently with higher volumes of production, or bulk purchasing reducing costs. Economies of scope may arise from reduced advertising and distribution costs when companies have complementary resources. Economies of scale and scope relate mainly to horizontal acquisitions and mergers. Economic efficiency gains may also occur with backward or forward vertical integration that might reduce production costs as the 'middle man' is eliminated, improve control of essential raw materials or other resources that are needed for production, or avoid disputes with what were previously suppliers or customers.

Economic efficiency gains might also result from replacing inefficient management as the result of a merger/take-over.

Financial synergy

Financial synergy might involve a reduction in the cost of capital and risk. The variability (standard deviation) of returns of a combined equity is usually less than the weighted average of the risk of the individual companies. This is a reduction in total risk, but does not affect systematic risk, and hence might not be regarded as a form of synergy by shareholders. However, reduced variability of returns might improve a company's credit rating making it easier and/or cheaper to obtain a loan. Another possible financial synergy exists when one company in an acquisition or merger is able to use tax shields, or accumulated tax losses, which would otherwise have been unavailable to the other company.

Market power

A large organisation, particularly one that has acquired competitors, might have sufficient market power to increase its profits through price leadership or other monopolistic or oligopolistic means.

(Note: Reasonable alternative points will be rewarded)

Marking guide
Part (a) of the question tests candidates' knowledge of agency problems in finance. On the other hand, part (b) deals with theoretical concept of synergy in mergers and mergers.

Almost all the candidates attempted the question with above average performance.

We continue to recommend that students should make effective use of study materials provided by the institute.

	Marking guide	**Marks**	**Marks**
a.	Discuss the conflict of interest that may exist between managers and shareholders.	8	8
b.	Explain why synergy might exist when one company merges with or takes over another company.	7	7
	Total		**15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2024

ADVANCED AUDIT AND ASSURANCE

EXAMINATION INSTRUCTIONS

PLEASE READ THESE INSTRUCTIONS BEFORE THE COMMENCEMENT OF THE PAPER

1. Check your pockets, purse, mathematical set, etc. to ensure that you do not have prohibited items such as telephone handset, electronic storage device, programmable devices, wristwatches or any form of written material on you in the examination hall. You will be stopped from continuing with the examination and liable to further disciplinary actions including cancellation of examination result if caught.

2. Write your **EXAMINATION NUMBER** in the space provided above.

3. Do **NOT** write anything on your question paper **EXCEPT** your examination number.

4. Do **NOT** write anything on your docket.

5. Read all instructions in each section of the question paper carefully before answering the questions.

6. Do **NOT** answer more than the number of questions required in each section, otherwise, you will be penalised.

7. All solutions should be written in **BLUE** or **BLACK INK**. Any solution written in **PENCIL** or **RED INK** will not be marked.

WEDNESDAY, MAY 15, 2024

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2024

ADVANCED AUDIT AND ASSURANCE

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Anything Goes Microfinance Bank Limited was incorporated in 2018 to meet the financial needs of low level customers. The Management Accounts of 2019, revealed that the bank has a shareholders fund of ₦2.1 billion, total assets of over ₦5 billion, and customer deposits of ₦2 billion. It is the largest Microfinance bank in Kito. Today, the bank continues to be the core banker for small and medium scale enterprises and accounts for over 70% of the business turnover in Kito. It is the only indigenous microfinance bank that is fully owned by Kito shareholders. The bank directors are elected by key shareholders and they represent all the shareholders both in the public and private sectors.

The bank currently has a total employee establishment of over 350. With liberalisation of the economy and globalisation of businesses, the bank embraced the new challenges by becoming commercial bank in 2020 and changed its name to Anything Goes Bank Limited. The change of Chief Executive Officer and the management at Anything Goes Bank Limited in early 2020 ushered in a new era where new ideas are adopted and managers reclaiming managerial responsibilities. The main objective then, was to come up with innovative business strategies that would ensure the bank serve its core customers effectively. However, to reposition, the bank embarked on reviewing its corporate strategic plan which builds on the existing strengths specifically addressing growth and development, information technology and business management, enhanced service delivery, profitability and capital growth. The strategic plan for the bank has been drawn up with the theme "Managing for Value". The strategies are based on four perspectives: people, customers, financial performance, and risk and control. The goal of the plan is to ensure that the bank meets the shareholders' expectations, provide the bank with a common language and clearly understood objectives, guarantee satisfaction to its chosen customer segments and business partners. A focus on these four perspectives would result in customer satisfaction, efficient and effective processes, motivated and prepared staff.

The bank in an effort to ensure it continues to be relevant and meet the needs of customers, believes it needs to revisit the operating structure and expand its business. The bank is interested in becoming a globally acclaimed commercial bank in Africa. Management believes a review of approach to strategic change practices and performance must be dynamic, flexible and innovative, particularly when confronted with discontinuities and turbulence in its operating environment. The review of operations shows that the environment in which Anything Goes Bank Limited exists and with which it interacts is increasing in complexity and the rate of change is accelerating. There is increasing pressure to perform from the government, public and other stakeholders. To attract foreign investors, the bank is interested in early reporting but the software in place cannot drive the volume of transactions being processed currently. Most of the staff are not skilled enough in International Financial Reporting Standards, especially in complex accounting issues on financial instruments. The tax audit has just been conducted and it has back duty assessment and other queries to be sorted out. Added to this, the bank is affected by inefficient service delivery, people's distrust for the banking sector, weak corporate governance structure and rising bad loans.

The bank's management has prepared a master plan which contains grand strategies, such as product development, market development, turn-around and joint venture strategies. To facilitate the achievement of these grand strategies, functional strategies, namely marketing, operations, organisational and management, and financial strategies are also detailed in the master plan. It attributes a myriad of stumbling blocks to successful implementation of the strategies including; government policies, poor leadership, limited IT capacity, lack of funds, staff capability and a supporting corporate culture as the main challenges. The bank has an audit committee but has not been performing optimally because the operation is not properly structured. It is also in arrears of some of its reporting requirements at this stage and is paying appropriate fines to regulatory authorities. Although the bank believes it is still a small bank, it still requires an auditor to examine the books of account with a view to expressing an opinion. Management is concerned with the need to change its auditors because of the transition to a commercial bank, hence it has decided to send out a request for proposal for appointment of new auditors. The bank has been facing delay in rendering attestation and assurance reports to regulators for which it has been paying fines.

One of your friends whose father is a management staff of the company and a student of accountancy has intimated you of this development and was asking you to provide some explanations to enlighten management before they send out proposal for audit services.

Required:

a. Discuss the key features needed in an audit report which should be included in the proposal for audit services of Anything Goes Bank Limited. (10 Marks)

b. Explain the type of assurance service that the auditor of the bank should provide. (6 Marks)

c. List the duties the audit committee of the bank ought to be performing. (8 Marks)

d. Distinguish amongst audit, assurance and attestation engagements. (6 Marks)

(Total 30 Marks)

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

QUESTION 2

The statement below is an extract of property, plant and equipment from the "notes to the financial statements" of ABC Plc:

	Land and buildings	**Plant, equipment, fixtures and fittings and motor vehicles**	**Total**
Costs	**₦**	**₦**	**₦**
At January 1, 2020	75,230,481	120,454,850	195,685,331
Additions	12,540,000	16,000,500	28,540,500
Acquisitions through business combinations	24,400,000	35,750,430	60,150,430
Classified as held for sale	(10,200,450)	(15,450,600)	(25,651,050)
Disposals	(5,000,465)	(10,700,250)	(15,700,715)
At December 31, 2020	96,969,566	146,054,930	243,024,496
Accumulated depreciation and impairment losses			
At January 1, 2020	46,660,254	66,675,860	113,336,114
Depreciation charge for the year	5,594,523	17,220,518	22,815,041
Classified as held for sale	(7,650,338)	(9,270,000)	(16,920,338)
Disposals	(3,762,523)	(9,034,069)	(12,796,592)
Impairment losses	5,267,533	6,022,713	11,290,246
Reversal of Impairment losses	(4,515,028)	(4,818,170)	(9,333,198)
At December 31, 2020	41,594,421	66,796,852	108,391,273

Net carrying amount			
At December 31, 2020	55,375,145	79,258,078	134,633,223
At December 31, 2019	28,590,212	53,778,390	82,368,602

The above was the situation of the statement of financial position of the company when it was signed at the board of directors meeting. During further review to sign- off the audit file, it was discovered that the classification of some of the assets as impaired was due to wrong classification and the value had actually increased due to a new road network in the location. This affected the impairment losses for the year. The new value of the buildings affected and shown in the note above as available from market survey had actually grown to ₦8.5million within the period under review.

Required:

a. Evaluate the different types of audit review, the purposes and the scope of the reviews. (10 Marks)

b. Discuss the necessary information to be included in the audit checklist based on the information above in relation to IAS 16 – Property, Plant and Equipment and IAS 36 - Impairment of Assets. (7 Marks)

c. Advise on the treatment of the issue raised with regard to the wrongly classified assets. (3 Marks)

(Total 20 Marks)

QUESTION 3

a. You are the Manager-in-charge of the audit of Moonshine Limited. Your auditor's report for the financial year ended December 31, 2019, was signed without modification in February 2020. The scope of the audit for the year ended December 31, 2020 has been Limited because the company's Chief Executive Officer fled the country in April 2020, taking the accounting records with him.

You have identified a valuable training opportunity for Richard a member of your audit team. As a training exercise, you have asked Richard, to draft the extracts for the basis of opinion and opinion paragraphs that may not be standard wording in an unmodified auditor's report.

Richard's draft extracts were produced as follows:

'Basis of opinion (extract)
However, the evidence available to us was limited because accounting records were missing from early in the year and it was not possible to reconstruct them completely.

Opinion (extract)

Because of the possible effect of the limitations in the information available to us, we do not express an opinion on the financial statements.

Required:

i. Discuss the principal matters relevant to forming of an appropriate opinion on the financial statements of Moonshine for the year ended December 31, 2020. (8 Marks)

ii. Evaluate the suitability of Richard's draft extracts. (2 Marks)

b. A client company has prepared draft financial statements for the year to December 31, 2020. In February 2021, a legal claim was made against the company, claiming substantial damages. The company's lawyers have advised that the claim has less than 50% chance of success. If the claim succeeds, the company would have sufficient cash resources to meet the claim in full.

The matter is disclosed in the draft financial statements in a note, as a material contingent liability.

Required:

i. Advise if the audit opinion should be unmodified, and if so, should the report contain a 'Material Uncertainty Related to Going Concern' paragraph? (3 Marks)

ii. Discuss the form and content of modified auditor's report. (7 Marks)

(Total 20 Marks)

QUESTION 4

Demmy Global Limited was a growth-oriented company that had been controlled by its Managing Director, Mr. Longe. The company sells modern sophisticated mobile smartphones directly to the public. A large number of sales agents were employed on commission basis. The mobile phones were sent to these sales agents who then sold them directly to the public. The mobile phones were supplied to the sales agents on a sale or return basis and Demmy Global Limited recognised the sale of a mobile smart phones when it was received by the sales agents. Any returns of the mobile phones were treated as repurchases in the period concerned. The company enjoyed a tremendous growth record. The main reasons for this apparent expansion were:

(i) Mr. Longe falsified the sales records. He created several fictitious sales agents who were responsible for 25% of the company's revenue;

(ii) At the year end, Mr. Longe dispatched nearly all of his inventories of mobile phones to the sales agents and repurchased those that they wished to return after the year end;

(iii) 20% of the cost of sales were capitalised. This was achieved by the falsification of purchase invoices with the co-operation of its suppliers. The suppliers furnished the company with invoices for non-current assets but supplied mobile smart phones; and

(iv) The directors of the company enjoyed a bonus plan linked to reported profits. Executives could earn bonuses ranging from 50% to 75% of their basic salaries.

The directors did not query the unusually rapid growth of the company, and were unaware of the fraud perpetrated by Mr. Longe.

Mr. Longe spent large sums of money in creating false records and bribing accomplices in order to conceal the fraud from the internal audit department. He made efforts to cover up the illicit activities and precluded the auditor from corroborating sales with independent third parties, and from examining the service contracts of the directors or discussing the affairs of the company with the sales agents.

The external auditor was sued by a bank that had granted loan to Demmy Global Limited on the basis of interim financial statements. These financial statements had been reviewed by the auditor and a review report issued.

Required:

a. Discuss the extent to which an auditor is responsible for detecting fraud and error, and external auditor's procedure where fraud or error is suspected. (7 Marks)

b. Advise the auditor on strategies to close the expectation gap. (5 Marks)

c. Explain how the 'review report' issued by the auditor on the interim financial statements differs in terms of its level of assurance from the auditor's report on the year-end financial statements. (2 Marks)

d. Evaluate the circumstance and nature of the reports that would have been necessary for the auditor based on the activities of the Managing Director. (6 Marks)

(Total 20 Marks)

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

QUESTION 5

Globamedia is a company listed on The Nigerian Exchange (NGX) and is a long-established media company. In the last three years, it made some losses, though it is making investment in digital publishing. This investment and the company's projected sound future prospects have led to a good market rating since it was generally seen that this digital publishing is a leading edge in the media industry. Its investments have been funded through the use of reserves built over many years. However, few weeks ago, Globamedia's shares were suspended having fallen by more than the stipulated threshold by The Nigerian Exchange Group on the rumours that assets values have been significantly over-stated and that the company was no longer financially viable.

Your firm as the auditors has come under significant criticism and is considered as being negligent.

Required:

a. Evaluate the legal position of your firm. (5 Marks)

b. Discuss the requirements for due care. (5 Marks)

c. Highlight the steps and procedures that the firm could have taken to prevent such a situation from occurring. (5 Marks)

(Total 15 Marks)

QUESTION 6

The partners of a number of small firms, some of whom act as alternate firms to each other, were considering the outcome of some reviews by the Financial Reporting Council on some of the financial statements the firms prepared. These reviews showed significant lapses in the works they carried out and compliance failure of some appropriate standards. Some other practitioners amongst them also raised concerns about their failure to meet most of the monitoring guidelines issued by the Professional Practice Monitoring Committee of the Institute. Based on these, it has become imperative that something has to be done urgently to save them from further sanctions and possible litigations.

The partners of these small firms have consulted, sought and obtained approval of your firm to train them on requirements of relevant regulatory bodies as part of your firm's contribution to the accountancy profession in general and in recognition of your firm as one of the reputable big firms. Your partner has directed that you prepare and make a presentation to help improve their service delivery standards.

Required:

Prepare an outline for a paper that will be used to address these practitioners on the following:

a. The consequences and actions that could arise as a result of poor quality professional service delivery. (3 Marks)

b. The responsibilities of "key quality control matters" placed on the engagement partner in accordance with ISA 220-Quality Control for an Audit of Financial Statements. (12 Marks)

(Total 15 Marks)

QUESTION 7

Technology, essentially computerisation has in recent times affected various aspects of life and business activities to varying degrees. For instance, this has led to online purchases, account processing from various other locations than the domiciled bank branches. Though, this electronic business and commerce has made things easy, there are still challenges associated with the process. As an auditor, there is the need to evaluate the audit environment to have proper knowledge of the clients operating environment, whether manual or computerised. This is very essential for your firms newly employed audit staff.

Required:

a. Prepare an advisory guide for these new audit staff, highlighting the application of information technology to audit process. (6 Marks)

b. Discuss the relevant information technology tools that are necessary for effective provision of assurance services. (9 Marks)

(Total 15 Marks)

SOLUTION 1

a. **The key features needed in an audit report which should be included in the proposal for audit services of the bank include:**

(i) The auditors producing the report should be **independent** from the directors of the entity;

(ii) The audit report should give an opinion on whether the financial statements "**give a true and fair view**", or "**present fairly**" the position and results of the entity.; and

(iii) The report should consider that the concept of materiality is applied in reaching an audit opinion.

Independence of the auditor

The external auditor must be **independent** from the directors; otherwise his report will have little value. If he is not independent, his opinion is likely to be influenced by the directors.

True and fair view (fair presentation)

The auditor reports on whether (or not) the financial statements **give a true and fair view,** or **present fairly**, the position of the entity as at the end of the financial period and the performance of the entity during the period. **The auditor does not certify or guarantee that the financial statements are correct**.

This implies that there is no undue bias in the financial statements or the way in which they have been presented.

In preparing the financial statements, a large amount of judgement is exercised by the directors. Similarly, judgement is exercised by the auditor in reaching his opinion. The phrases 'true and fair view' and 'present fairly' indicate that a judgement is being given that the financial statements can be relied upon and have been properly prepared in accordance with an appropriate financial reporting framework.

Materiality concept

The auditor reports in accordance with the concept of **materiality**. He gives an opinion on whether the financial statements, present fairly **in all material respects** the financial position and performance of the entity.

Information is material if, on the basis of the financial statements, it could influence the economic decisions of users should it be omitted or misstated, for example, the shareholders of a company will not be interested if petty cash was misstated by an insignificant amount of money.

The concept of materiality means that the auditor will not focus on examining immaterial but rather concentrate his efforts on the more significant items in the financial statements, either:

i. Because of their (high) value or
ii. Because there is a greater risk that they could be stated incorrectly.

Management responsibilities

This is a description of management's responsibility, which is to prepare the financial statements in such as a manner as to present a true and fair view and to establish and maintain an adequate system of internal control.

Auditor's responsibilities

This is a description of the role of the auditor which is to express an opinion on the financial statements prepared by management and not to detect fraud in order to close the exception gap.

Key Audit Matters

A key audit matters section in compliance with ISA 701; indicating: Areas of higher assessed risk of material misstatement; Significant auditor's judgement; and The effect of significant events.

b. The degree of assurance that should be provided on the reliability of financial statements of a company will depend on:

i. The amount of work performed in carrying out the assurance process; and
ii. The results of that work.

The assurance could be:

i. **Reasonable assurance**

An **audit** provides a **high, but not absolute**, level of assurance that the audited information is free from any material misstatement. The auditor's conclusion in this case is expressed in a **positive form**. e.g. "*In our opinion, the financial statements give a true and fair view*". The objective of a statutory audit is to provide reasonable assurance.

An **external audit** is performed by an appropriately qualified auditor, appointed by the shareholders and independent of the company. An external audit provides **positive assurance** that, in the opinion of the auditors, the financial statements **do** present fairly the financial position and performance of the company.

ii. **Limited assurance**

This is a **moderate** level of assurance provided by the auditor's conclusion expressed in a **negative form**, for example, "*Based on our review, nothing has come to our attention that can make us to believe that the accompanying financial statements do not give a true and fair view*". The objective of a review engagement is often to provide limited assurance.

This applies to a **review** in an investigation or report expected to be sent to regulator. In contrast to 'reasonable' level of assurance provided by an audit, a **review** into an aspect of the financial statements would provide only a **moderate** level of assurance that the information under review is free of material misstatement. The resulting opinion is usually (although not always) expressed in the form of **negative assurance**.

Negative assurance is necessary in situations where the auditor cannot obtain sufficient evidence to provide positive assurance. For example, the management of a client entity may ask the audit firm to carry out a review of a cash flow **forecast**. A forecast relates to the future and is based on many assumptions, and an auditor therefore **cannot provide positive assurance** that the forecast is accurate. However, he **may be able to provide negative assurance** that there is nothing he is aware of to suggest that the forecast contains material errors.

c. **The audit committee duties not performed in the bank include:**

(i) Overseeing the financial reporting and disclosure process;
(ii) Monitoring choice of accounting policies and principles;
(iii) Overseeing hiring, performance and independence of the external auditors;
(iv) Oversight of regulatory compliance, ethics, and whistleblower hotlines;
(v) Monitoring the internal control process;
(vi) Overseeing the performance of the internal audit function;
(vii) Discussing risk management policies and practices with management;
(viii) Ensuring the development of a comprehensive internal control framework for the company, obtaining assurance and presenting annually the financial report on the operating effectiveness of the company's internal control framework;
(ix) Ascertaining that the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices;
(x) Reviewing the scope and planning of audit requirements;
(xi) Reviewing the findings on management matters in conjunction with the external auditor and departmental responses thereon;

(xii) Making recommendations to the Board in regard to the appointment, removal and remuneration of the external auditors of the company;

(xiii) Authorising the internal auditor to carry out investigations into any activities of the company which may be of interest or concern to the committee; and

(xiv) Meeting separately and periodically with management, internal auditors and external auditors.

d. **The distinctive features of audit, assurance and attestation**

Audit is a form of assurance engagement to enhance the degree of confidence of intended users in the financial statements. This is achieved by the auditor expressing an opinion on whether the financial statements of an entity are prepared, in all material respects, in accordance with an applicable financial reporting framework. Audit provides a high level of assurance and an auditor expresses an opinion on the truth and fairness of the financial statements. Audit is governed by specific auditing standards and regulations set by professional bodies and regulators.

An **Assurance engagement** is one in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the subject matter information (that is, the outcome of the measurement or evaluation of an underlying subject matter against criteria).It gives confidence to the party that hired the firm that the information can be relied on.

Assurance engagement is undertaken by a professional accountant in public practice to provide a report for use by user entities (audit client) and their auditors on the controls at a service organization that provides a service to user entities that is likely to be relevant to user entities' internal control as it relates to financial reporting. Level of assurance engagement can be **reasonable** or limited depending on the type of engagement.

Assurance engagement follows specific standards and laws depending on the type of engagement and type of assurance being provided.

In **attestation engagement**, the practitioner is engaged to attest/affirm/vouch to the fact that certain procedures within the entity have been performed in a prescribed way, but will simply attest to the fact that they have been performed. It follows a specific attestation standard that outlines the guidelines for carrying out an attestation engagement.

Examiner's report

The question tests the candidates' knowledge of key features needed in an audit report, the components to be included in a proposal for audit engagements, the functions of Audit Committee, and the distinctive features of audit, assurance and attestation services.

This being a compulsory question, about 100% of the candidates attempted it but their performance was below average.

The common pitfalls of the candidates were their inability to explain the key features of an audit report and the types of assurance services. Additionally, they failed to highlight the functions of the Audit Committee.

Candidates are advised to familiarise themselves with the various reporting requirements of entities and with the roles of the various stakeholders who are involved in the preparation of the financial statements of an entity.

Marking guide		**Marks**	**Marks**
a.	The features of audit report		
	(1 mark each for any 10 points)		10
b.	Mentioning of what degree of assurance depends on:		
	(1 mark each for any 2 points)	2	
	Reasonable assurance		
	(½ mark each for any 4 points)	2	
	Limited assurance		
	(½ mark each for any 4 points)	2	6
c.	Audit Committee duties not performed in the bank		
	(1 mark each for any 8 points)		8
d.	**Explanation of audit:**		
	(1 mark each for any 2 points)	2	
	Explanation of assurance engagement		
	(1 mark each for any 2 points)	2	
	Attestation engagement		
	(1 mark each for any 2 points)	2	6
	Total		**30**

SOLUTION 2

a. The review of audit work is a key aspect of quality control. All audit work should be reviewed by an auditor with a higher level of competence and experience than the members of the audit team who performed the audit work. **The review process may take any of the following forms:**

i) **Peer review:** This is a review carried out by another firm;

ii) **Engagement quality control review (EQCR):** A peer review performed before the audit is signed as required by International Standards on Quality Control 1 (ISQC1) during the audit of a listed or public interest entity. An EQCR forms part of the quality control procedure specific to an individual assignment;

iii) **Hot Review:** Similar in substance to an EQCR except that the hot review is not performed as a direct requirement of ISQC1, for instance, when an engagement partner on a non-listed/public interest entity audit wants a second opinion to monitor the work of a new partner; and

iv) **Monitoring review** (also called a "cold review"): This is a peer review performed after the audit report is signed. A cold review forms part of the monitoring of quality control procedures.

The purpose of audit review is to check whether:

i) Audit work was carried out to proper professional standards;
ii) The objectives of the audit have been achieved; and
iii) The work carried out during audit and the audit evidence are suitably documented, and that the audit evidence supports the conclusions that have been reached.

The review of the audit work should cover:

i) The audit planning process;
ii) Audit procedures, including:
- Documentation (the audit working papers);
- The audit tests performed and the audit evidence gathered;
- Compliance with the audit work programme;
- The resolution of problems encountered on the audit; and

iii) Whether the conclusion reached is consistent with the audit evidence obtained and documented.

b. **The requirements of IAS 16 for the audit checklist include the following:**

i) Has the cost of property, plant and equipment been determined in accordance with IAS 16?
ii) Have costs been correctly allocated to the components of asset in accordance with IAS 16?

iii) Has post acquisition expenditure on property, plant and equipment been properly analysed between capital expenditure and revenue expenditure?
iv) Has depreciation been properly calculated and accounted for?
v) Has asset revaluation been performed in accordance with IAS 16 and accounted for correctly?
vi) Have disposals and resulting gain or loss on disposal been properly calculated and recorded?

Requirements of IAS 36 for the checklist include the following:

i) Have the directors identified events that may indicate that an impairment review is necessary?
ii) Have recoverable amounts been calculated on the basis of IAS 36?
iii) Where appropriate, have cash generating units been identified?
iv) If an impairment loss has been recognised, has the loss been allocated to assets and recorded correctly?

c. An impaired asset is an asset that has a market value less than the value listed in the company's statement of financial position.

The presumed impairment was a wrong classification, hence the correction needed is to identify the wrong account involved and a journal would be raised to correct it by reversing it.

The journal entry: Dr. PPE or building and CR impairment loss, with the amount of ₦5,267,533.

The market value of ₦8.5million is only a guide and, therefore, outside the records.

Examiner's report

The question tests candidates' knowledge of audit review checklist and aspects of IAS 16 - Property, Plant and Equipment, IAS 36 - Impairment of Assets, and classification in accounts.

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

The common pitfalls of the candidates were their inability to explain the types of audit review, the purposes, and the checklists based on IAS 16 and IAS 36.

Candidates are advised to familiarise themselves with the provisions of the relevant auditing and accounting standards.

Marking guide		Marks	Marks
a.	**Definition/objective of audit review**	2	
	Types, purpose and scope of review		
	(1 mark each for any 8 points)	8	10
b.	**Things to be included in PPE checklist**		
	(1 mark each for any 7 points)		7
	Treatment of wrong classification		
	(1 mark each for any 3 points)		3
	Total		20

SOLUTION 3

a. i. **Forming an opinion**

The following matters are relevant to forming an appropriate opinion. This constitutes a limitation on the scope of the audit. The auditors will not be able to obtain sufficient appropriate audit evidence about the relevant period. Therefore, the audit opinion will be modified.

Missing accounting records constitutes a limitation on the scope of the audit, therefore, the auditors will not be able to obtain sufficient appropriate audit evidence about the relevant period, hence, the audit opinion will be modified.

The modification should give details of what records are missing and why, or cross-refer to where this information is given in the financial statements.

The extent of the modification will depend on which records are missing and where the auditors' scope is limited.

It is likely that the information with regard to the income statement/statement of comprehensive income is limited and the statement of financial position.

A modification might be limited to a qualification ('except for') over the statement of comprehensive income of the year, but if in the judgement of the auditor, the matter is considered pervasive, there should be a "disclaimer of opinion".

ii. **Evaluation of the suitability of Richard's draft**

Richard is correct to modify the opinion on the grounds of limitation of scope, however, the draft should refer to the exact nature of the problem, for instance, possible fraud.

He can take account of a possible modification in relation other evidence available.

b. i. The claim was made after the end of the reporting period and is a non-adjusting event. The probability that the claim will be successful is less than 50% (on the assumption that the lawyers have given a reasonable opinion).

It is, therefore, appropriate to disclose the item as a contingent liability (in this case, a material non-adjusting event after the reporting period).

The auditor should therefore give an unmodified opinion.

A 'Material Uncertainty Related to Going Concern' paragraph is normally only used when the matter involves material uncertainty that is adequately disclosed.

Material Uncertainty' usually exists only when there is some concern about the going concern status of the entity or about a matter that could have a major impact on the financial statements.

In this case, we are informed that the company has sufficient cash resources to meet the legal claim in full, in the event that it is successful. It, therefore, appears that material uncertainty does not exist, and a 'Material Uncertainty Related to Going Concern' paragraph would be inappropriate.

ii. An auditor's report is said to be modified where either:

- A matter arises which does not affect the opinion given by the auditor, but which gives rise to an "emphasis of matter paragraph" or an "other matter" paragraph in the auditor's report (covered by ISA 705); and
- A matter arises which does affect the opinion issues on the financial statements. This will give rise to a "qualified opinion, a disclaimer of opinion or an advise opinion" (covered by ISA 705)

A modified report can therefore either have an unmodified audit opinion or a modified audit opinion.

A modified opinion is made up of:

- **Opinion paragraph**
  The opinion paragraph at the start of the auditor's report must be headed '**Qualified opinion', 'Adverse opinion', or 'Disclaimer of**

opinion', as appropriate. Specific wording is prescribed for the different types of modified opinions.

- **Basis for modified opinion paragraph**

  When a modified opinion is issued, ISA 705 **requires** the **'basis for opinion' paragraph** to be amended to **'Basis for qualified opinion', 'Basis for adverse opinion',** or **'Basis for disclaimer of opinion'**, as appropriate.

  This 'basis for opinion' paragraph must include the following:

  - For a material misstatement relating to **specific amounts** – a description and quantification of the impact on the financial statements (or a statement that quantification is not possible);

  - For a material misstatement relating to **narrative disclosures** – an explanation of how the disclosures are misstated;

  - For a material misstatement relating to the **non-disclosure** of information that should have been disclosed – the nature of the omitted information and, unless prohibited by law or regulation, the omitted disclosures; and

  - If the modification results from **an inability to obtain sufficient appropriate audit evidence** – the reasons for that inability. For qualified and adverse opinions, the basis for the qualified/adverse (as appropriate) opinion paragraph will also state: "We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified/adverse (as appropriate) opinion".

Examiner's report

Part (a) of the question tests the candidates' understanding of audit report, audit opinion and relevant matters, whilst part (b) tests their knowledge on modification of audit opinion.

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

The candidates displayed poor knowledge of how to form an audit opinion and modification of audit reports based on circumstances of the client.
Candidates are advised to pay close attention to matters relevant to forming an audit opinion and to read the Institute's Study Text and Pathfinders which are readily available on the Institute's website.

Marking guide			Marks	Marks
a.	(i)	**Forming opinion**		
		(2 marks each for any 4 points)	8	
	(ii)	**Evaluation of Richard's report**		
		(1 mark each for any 2 points)	2	10
b.	(i)	**Advise on report**		3
		(1 mark each for any 3 points)		4
	(iii)	**Discussion on Report**		
		(1 mark each for any 7 points)		7
		Total		**20**

SOLUTION 4

a. **Responsibilities of the auditor**

The auditor has a legal and regulatory responsibility for **reporting** on whether the financial statements show a 'true and fair view' of the financial position and performance of the client. He is therefore only concerned with fraud and error that has a material effect on the true and fair view.

The auditor's responsibility is to obtain **reasonable assurance** that the financial statements, taken as a whole, are **free from material misstatement**, whether caused by fraud or error. It is **not** the primary responsibility of the auditor to prevent or detect fraud or error, although the audit may act as a deterrent to fraud. Auditors may also discover error or fraud during the course of their audit work, but they are by no means certain to do so whenever error or fraud has occurred. It must be recognised that some material misstatements caused by fraud or error may go undetected, because of the inherent limitations in any audit and the fact that deliberate attempts may be made to conceal fraud from the auditor.

ISA 240 states the responsibilities of management and the auditor as follows:

i) The primary responsibility for the prevention and detection of fraud rests with those charged with governance of the entity and management; and

ii) An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.

The auditor should take the following steps when fraud or error is suspected:

i) Identify the extent and possible impact on the financial statements of The fraud or error. Document the facts fully in the audit files. Additional testing may be required to establish the likely extent of any misstatement;

ii) Consider the possible impact on other areas of the audit and on the overall assessment of audit risk. This may result in a revision of the original audit plan;

iii) The findings should be discussed with management, regardless of the extent of the problem, and management should be kept informed of developments;

iv) The auditor should determine the action that management should take. This should include the possibility of seeking legal advice if fraud is suspected;

v) The auditor should normally communicate on a formal basis to management at an appropriate level. In the case of a public interest entities, the auditor communicates formally with the board of directors or the audit committee. However, if management themselves are involved in a suspected fraud, the auditor should consider taking legal advice to decide the best course of action. In extreme cases, the auditor may feel it is appropriate to resign;

vi) The auditor should consider the impact on his audit report to the shareholders, in terms of any impact on the true and fair view presented by the financial statements; and

vii) The auditor should consider whether there is any requirement to report to appropriate authorities. This must be considered in the context of the auditor's duty of confidentiality to his client.

b. To reduce the frequency and cost of legal action, and to maintain the image of the audit profession in the mind of the public, it is in the interests of the profession to take steps to close the expectations gap. A number of strategies exist that could assist in closing the expectation gap include:

i. The audit profession should attempt to improve the general level of knowledge and understanding about the audit process. One such attempt has been made with updates to the auditing standards on auditor's reports published by IFAC in 2015. These updates enhanced the auditor's report to make it more relevant and transparent to users, for example, by introducing a new section on key audit matters, more requirements with regards to reporting going concern and improved descriptions of the responsibilities of the auditor;

ii. Controls over the auditing profession are important in enhancing public confidence;

iii. Significant guidance for auditors and management aimed at increasing quality and addressing issues such as going concern has been issued by standard setters, professional bodies and regulators. There has been an increased focus on corporate governance and the role that audit committees play in companies, reducing inconsistencies and enhancing quality;

iv. Open and candid communication between internal and external auditors, financial management and the audit committee is increasingly being seen as critical in helping reduce the expectation gap. Such communication helps the audit committee to perform their governance role with the necessary transparency and realistic expectations that will help achieve effective risk management;

v. Enhanced communication between the parties and confirmation of their respective roles and responsibilities should be presented in the audit committee and directors' reports to the shareholders. This will ensure that users become much more aware of the various parties' roles and responsibilities beyond the understanding they gain just from the audit report;

vi. The expectation gap will hopefully narrow further as financial reporting participants work together even more effectively to improve the deterrence and detection of financial reporting fraud. The level of success in narrowing the expectation gap is likely to vary considerably between territories depending on factors such as culture, ethics, the level of incidence of governance mechanisms beyond the minimum required by law and regulation and the quality, availability and transparency of corporate reporting;

vii. One thing that is certain is that audit committees are well positioned to play a vital role in reducing the expectation gap given their open and direct relationship with all the parties, including shareholders, board of directors, internal audit and external audit.

c. A review of interim financial statements is very different from an audit of year-end financial statements. In an auditor's report, positive assurance is given on the truth and fairness of the financial statements. The level of audit work will be commensurate with the level of the assurance given that is it will be regorious, testing the systems producing the accounts and the year-end figures themselves using a variety of appropriate procedures.

In the case of a review of interim financial statements, the auditor gives **only negative assurance**, that they have not found any indication that the interim accounts are materially misstated. The level of audit work will be much less penetrating, varied and detailed than in a full audit. The main audit tools used to obtain evidence will be analytical procedures and direct enquiries of the company's directors.

d. **The circumstances presented insufficient evidence of a suspected non-compliance which include:**
   i. Falsification- of sales records;
   ii. Repurchased inventories meant for return after year end;
   iii. Capitalisation of cost of sales;
   iv. Falsification of invoices;
   v. Enjoyment of a bonus on fictitious sales;
   vi. Limitation of scope of the audit by Managing Director as he precluded auditor from corroborating sales with independent third parts; and
   vii. Restraining the auditors from examining service contracts or discussing company affairs with sales agent.

The nature of the report that would have been necessary is for auditor to disclaim opinion due to limitation scope.

Examiner's report
The question tests candidates' knowledge of fraud and error, the expectation gap, the difference between report on interim financial statements and auditors' report, and reporting in a situation of attempted manipulation of accounting records.

The question was attempted by over 60% of the candidates but their performance was just average.

The commonest pitfall of the candidates was their misunderstanding of the responsibilities of various parties to the financial statements.

Candidates are advised to pay close attention to the requirements of the question and to study the Institute's Study Text and Pathfinders when preparing for future examinations.

Marking guide		**Marks**
a.	**Discussion on auditor's responsibilities**	
	(1 mark each for any 7 points)	7
b.	**Methods of closing expectation gaps**	
	(1 mark each for any 5 points)	5
c.	**Explanation of use of hot review**	
	(½ mark each for any 4 points)	2
d.	**Evaluation of nature of report**	
	(1 mark each for any 6 points)	6
	Total	**20**

SOLUTION 5

a. The possible Legal positions of the firm are as follows:

i. The audit firm has statutory responsibilities to report whether financial statements shows a 'true and fair view' or 'present fairly' the financial position. If the firm is shown to be negligent in this process, they could be subject to various types of legal action- civil, criminal;

ii. In the specific case of Globamedia, the problems relate to investment from reserves and the collapse in share price resulting from the 'rumour' of a lack of reserve and lack of financial viability. The suspension of the company's shares allows times to investigate the true position and deal with facts rather than rumour;

iii. During the audit, the firm should have considered the appropriateness of the going concern basis of accounting and should have obtained sufficient and appropriate audit evidence to conclude that assets are not materially overstated. The going concern review should have been carried out with a due level of skill, care and diligence, and with regards to professional standards;

iv. If it can demonstrate that the audit was performed in accordance with professional standards, then it will be difficult to prove negligence. However, if there are doubts in respect of the company as a going concern then it should be fully pursued to establish the facts;

v. The background information does not identify the source of the possible legal action. There is a possibility of 'liability in tort', under which a third party could sue the firm for damages; and

vi. The third party would have to prove that the auditor owes a duty of care to the third party, that appropriate standards of care have been breached, and that the third part has suffered loss as a direct result of this breach of standards.

b. **Requirements for due care include:**

i. When carrying out their duties for a client, the auditors must exercise reasonable care and skill;

ii. IFAC and ICAN's code of ethics require that members should carry out their professional work with **professional competence and due care** and with proper regard for the technical and professional standards expected of them as members;

ii. The degree of skill and care expected of an auditor in a particular situation depends on the circumstances. There is no general standard of skill and care, the auditor is expected to react to the situation and the particular circumstances that he is facing;

iii. A company's auditor shall in the performance of his duties, exercise- all such care, diligence and skill as is reasonably necessary in each particular circumstance;

iv. Where a company suffers loss or damage as a result of the failure of its auditor to discharge the fiduciary duty imposed on him by Section 415 subsection (1) of CAMA 2020, the auditor shall be liable for negligence and the directors may institute an action for negligence against him in the court; and

v. If the directors fail to institute an action against the auditor under subsection (2) of CAMA 2020, any member may do so after the expiration of 30 days' notice to the company of his intention to institute such action.

In general, if the auditor has followed legal and regulatory requirements and can demonstrate this in his working papers, he will not usually be found guilty of negligence. This is why it is so important for the auditor to ensure that he maintains adequate working papers and obtains sufficient, relevant and reliable evidence to support his audit opinion.

c. To avoid successful allegations of negligence, these key steps and procedures that the firm of auditors should have taken include:

i. Ensuring that audit evidence is obtained to demonstrate that best practice procedures are being followed, including effective quality control and supervision of work undertaken on the client;

ii. Effective planning of assignments, including allocation of staff with the appropriate skills and training, as well as effective direction of resources during the audit;

iii. Use of appropriate audit programs and checklists to ensure appropriate focus and effective documentation and capture of evidence;

iv. Reviewing of business and audit risks. This may have indicated a longer-term viability problem, with both the heavy investment in e-commerce and the reliance on reserves to make this investment being important business risks that should have been managed;

v. Regular technical training and updating of all staff, and proper briefing;

vi. Supervising of audit work, including a review of working papers;

vii. Monitoring of quality control procedure;

viii. Final reviewing of the financial statements; and

ix. Taking professional indemnity insurance to provide an insurance protection should the company be faced with successful legal action.

Examiner's report

The question tests the candidates' knowledge of auditor's duty of care and steps to be taken to prevent issues arising from negligence.

The question was attempted by about 70% of the candidates and their performance on the question was above average.

The major pitfall was the candidates' inability to determine the auditor's responsibility of due care and steps to be taken to avoid negligence.

Candidates are advised to familiarise themselves with the Institute's professional ethics and code of conducts for members when preparing for future examination.

Marking guide		**Marks**
a.	**Explanation of the positions of the firm**	
	(1 mark each for any 5 points)	5
b.	**Requirements of due care**	
	(1 mark each for any 5 points)	5
c.	**Procedures to prevent the situation**	
	(1 mark each for any 5 points)	5
	Total	**15**

SOLUTION 6

a. The consequences and actions that would arise as a result of poor quality professional service delivery could be any (or all) of the following:

i. Legal actions and legal costs;

ii. The loss of the client(s);

iii. Adverse publicity and damage to the reputation of the audit firm; and

iv. Disciplinary proceedings by a professional body, such as ICAN.

b. ISA 220 places the responsibility for key quality control matters on the engagement partner. The engagement partner has responsibility for the overall quality of the audit and is required to put procedures in place to ensure that:

   i. Ethical standards are complied with and appropriate action taken if there is evidence for non-compliance;

   ii. Independence requirements are met, including:

      - Identifying circumstances and relationships that might give rise to threats to independence;
      - Assessing the impact of breaches of the firm's independence policies and procedures and whether such breaches create a threat to independence; and
      - Taking suitable action to eliminate identified threats or to withdraw from the engagement if appropriate;

   iii. Procedures are in place to deal with the acceptance of new engagements and the continuance of existing engagements;

   iv. The audit is carried out by an audit team with the appropriate competence and capabilities;

   v. Appropriate management of the engagement is in place, including the direction and supervision of staff and the review of audit work. Before the audit report is issued, the engagement partner must carry out a thorough review of audit the documentation and discussion with the audit team and be satisfied that sufficient, appropriate evidence has been obtained to support the conclusions reached;

   vi. Adequate consultation has taken place on difficult or contentious matters and the conclusions from such consultation implemented;

   vii. An appropriate monitoring system is in place;

   viii. The following matters are documented:

      - Issues in respect of compliance with ethical requirements and how they were resolved;
      - Conclusions on compliance with independence requirements conclusions in respect of new and continuing engagements; and
      - The nature and scope of conclusions from consultations undertaken.

   ix. For audits of listed companies and public interest entities, and any other audits where the firm has determined that an engagement quality control review is required, the engagement partner is also required to appoint an engagement quality control reviewer, who performs an objective evaluation of the significant judgements made by the audit team and the conclusions reached, including:

- Discussion of significant matters with the engagement partner;
- Review of the financial statements and the proposed audit report;
- Review of selected audit documentation relating to significant judgments; and
- An evaluation of the conclusions reached and whether the proposed audit report is appropriate.

x. Due consideration is given to the engagement team's evaluation of the firm's independence in relation to the audit engagement;

xi. Due consideration is made whether appropriate consultation has taken place on difficult or contentious matters; and

xii. Due consideration whether audit documentation selected for review reflects the work performed and the conclusions reached.

Examiner's report
The question tests candidates' knowledge of quality control in audit work and ISA 220 - Quality Control.

About 90% of the candidates attempted the question and the performance was above average as most of them demonstrated good understanding of the question.

The commonest pitfall of the candidates was their inability to explain quality control matters as per ISA 220 for an audit of financial statements.

Candidates are advised to pay close attention to the requirements of the question, to study the Institute's Study Text, and Pathfinders which are readily available on the Institute's website when preparing for future examination.

Marking guide		**Marks**
a.	**Discussion of possible actions**	
	(1 mark each for any 3 points)	3
b.	**Responsibilities of key quality controls**	
	(1 mark each for any 12 points)	<u>12</u>
	Total	**<u>15</u>**

SOLUTION 7

a. **Application of information technology to audit process**

The following indicate how information technology can be applied to the audit process and the areas of audit and assurance likely to be affected by the emerging technologies:

i. **Audit engagement planning** – Audit planning involves identifying the areas to be audited, audit team set up, assigning responsibilities to each audit staff; time allocation, establishing the materiality threshold etc. There are many aspects of these activities that could be automated and made more efficient with the use of technology. Most available off-the-shelve audit software have capabilities and inbuilt tools to enhance audit planning activities;

ii. **Audit risk assessment** - Audit software and advanced data analytic solutions can be used to conduct audit risk assessment – both qualitative and quantitative risk assessment. For instance, in conducting quantitative risk assessment all that is required is to upload the financial information of the client into the audit software and use existing functions to select and compute the relevant ratios, percentages and proportions for the auditor to interpret. In some cases, the results from the computations are given interpretation by the software and made available for the auditor to review and exercise human judgement;

iii. **Evaluation of internal controls** - After planning and risk assessment, the external auditor is expected to evaluate the operating effectiveness of internal controls which would most likely include computer controls. The only viable means to evaluate computer or IT controls is through the use of computer assisted audit techniques (CAATs). Many audit software are built with the capacity to test IT controls to ascertain their level of adequacy and operating effectiveness;

iv. **Audit substantive testing** - Substantive testing involves the use of analytical procedures and test of details to confirm the completeness, accuracy and validity of financial statements' amounts and disclosures. Ratios and trend analysis can easily be carried out by auditors using relevant software. Also automated audit solutions could be used to prepare and serve circularisation letters to obtain third party confirmations; and

v. **Audit reporting** - Auditors normally use word processors and spreadsheets to compile their reports at the end of the exercise. However, modern audit software has embedded reporting modules that could be used by the auditor to put together relevant reports to users. With the help of the reporting modules of these applications, the auditor could convert aspects of his findings into diagrams and pictures which are easier to understand by the executives.

b. **Information technology tools necessary for effective provision of assurance services**

i. Gantt chart software

A Gantt chart is originally a project planning tool which is primarily a bar chart to provide a schedule of tasks involved in a project with timelines. Auditors have found Gantt Chart useful in planning the audit engagement project. With this tool, auditors can view the start and end dates of an audit engagement in one simple chart, with clear list of audit activities. At a glance, the auditors can see:

- The start date of the audit engagement;
- The audit activities;
- The audit team members and tasks assigned to each of them;
- The start and finish date of each audit activity;
- The link and relationship between audit activities;
- Engagement dependencies;
- The end date of the audit engagement; and
- Identify the critical path of an engagement.

With Gantt chart software, auditors can create work breakdown structure; assign activities to team members, track the progress of work and make necessary changes in real time. As the auditor inputs the audit activities, their start dates, end dates and their dependencies, the bars will be populated automatically. Please note that the vertical axis of a Gantt chart shows the activities that need to be completed, while the horizontal axis represents time.

ii. **Risk analysis tool pack**

Managing risk is a necessity of life and should be taken seriously in all human endeavours with predetermined objective. Risk is evidently present in every audit engagement and ISA 315, explains the concept of business and audit risk in detail. The risks (positive and negative) that auditors face in the course of their work must be anticipated, identified, evaluated, prioritised and addressed. To enable auditors manage this process more efficiently and effectively, several automated tools have been developed and made available in the market. The assessment of a risk can either be done qualitatively or quantitatively. The tools which handle these are risk management tools and some of the popular risk management tools and:

- GRC Cloud Resolver;
- Spira Plan;
- Enablon;
- Checkit;
- Analytica;
- Risk Management Studio; and
- A1 Tracker.

It is important to note that most advanced audit software such as audit command language (ACL) and CaseWare IDEA are built with risk management capabilities. In other words, an auditor who purchases topnotch audit software might not need any other independent risk management tool.

Some of the features of these risk management tools include:

- Web-based application and good interface (GUI);
- Scalability and ease of integration with other solutions;
- Risk dashboard(quick snapshot of risk issues in a single view);
- Inbuilt support for risk mitigation activities:
- Risk audit trail (traceability);
- Support for electronic signatures;
- Support for generation of reports in MS Word; MS Excel; PDF; XML; HTML formats;
- Supports printing and emailing the risk reports to various stakeholders;
- Supports import and export functions;
- Supports auto-alert system on risk related updates;
- Support for both qualitative and quantitative risk assessment; and
- Data entry supported by paper, browsers and mobile app.

Examiner's report

The question tests candidates' knowledge of information technology and their relevant tools that are necessary for the provision of assurance services.

About 60% of the candidates attempted the question but the performance was just about average.

The common pitfalls were their lack of knowledge of the application of information technology to the audit process and the I.T. tools relevant for effective provision of assurance services.

Candidates are advised to acquaint themselves with the relevant information technology tools necessary for the provision of assurance services. They are also advised to read the Institute's Study Text and Pathfinders when preparing for subsequent examinations.

Marking guide		Marks	Marks
a.	**Areas of application of information technology to the audit process**		
	(1 mark each for mentioning of any 3 applications)	**3**	
	Explanation of applications mentioned		
	(1 mark each for any 3 explanations)	**3**	**6**
b.	**Software mentioned**		
	(1 mark each for any 2 software mentioned)	**2**	
	Activities of software		
	(1 mark each for any 5 activities of software mentioned)	5	
	(1 mark each of any 2 software tools mentioned)	2	9
	Total		**15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2024

CASE STUDY

EXAMINATION INSTRUCTIONS

PLEASE READ THESE INSTRUCTIONS BEFORE THE COMMENCEMENT OF THE PAPER

1. Check your pockets, purse, mathematical set, etc. to ensure that you do not have prohibited items such as telephone handset, electronic storage device, programmable devices, wristwatches or any form of written material on you in the examination hall. You will be stopped from continuing with the examination and liable to further disciplinary actions including cancellation of examination result, if caught.

2. Write your **EXAMINATION NUMBER** in the space provided above.

3. Do **NOT** write anything on your question paper **EXCEPT** your examination number.

4. Do **NOT** write anything on your docket.

5. Read all instructions in each section of the question paper carefully before answering the questions.

6. All solutions should be written in **BLUE** or **BLACK INK**. Any solution written in **PENCIL** or **RED INK** will not be marked.

THURSDAY, MAY 16, 2024

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2024

CASE STUDY

Time Allowed: 4 hours (including reading time)

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

PRE-SEEN

This material is issued prior to the examination date to enable candidates familiarise themselves with the case scenario so as to undertake any research and analysis they think fit. This pre-seen part of the Case Study examination is also published on the Institute's website: www.ican.org/students.

You **MUST NOT** bring this material with you to the Examination Hall. On receipt of the material, you are to spend the few days to the examination date to familiarise yourself with the information provided, carry out additional research and analysis about the industry and analyse the financials provided in preparation for the examination. Candidates should note that the use of pre-seen part of the Case Study will not significantly help them in their preparation for this examination. It is essential that they carry out sufficient analysis work on their own in order to have a good understanding of the pre-seen part of the case scenario.

At the start of the examination, candidates will receive the complete case scenario which will include both the pre-seen and the unseen, which includes the requirements. You must use the answer booklet provided by The Institute of Chartered Accountants of Nigeria (ICAN) in the Examination Hall. Any solution presented with any other booklet **WILL NOT** be marked.

Assessment of the Case Study

The marks in the Case Study examination are awarded for professional skills and are approximately allocated as follows:

▸ Assimilating and using information	20%
▸ Structuring problems and solutions	20%
▸ Applying judgement	20%
▸ Drawing conclusions and making recommendations	20%
▸ Demonstrating integrative and multidisciplinary skills	10%
▸ Presenting appropriate appendices	10%

Of the total marks available, 20% are awarded for the executive summary and approximately 10% for the relevant discussion of ethical issues within your answer to the requirements. Although ethical issues do not form a specific requirement, as this has been deemed to have been tested in other subjects of the ICAN professional examination, but will be tested within a requirement which may include the following areas:

- Lack of professional independence or objectivity;
- Conflicts of interest among stakeholders;
- Doubtful accounting and/or creative accounting practice;
- Unethical business/commercial practice; and
- Inappropriate pressure to achieve a reported result.

Candidates should note that marks are not awarded for just simply restating facts from the case scenario, but marks are awarded for demonstrating professional skills and technical depth. Therefore, to succeed, candidates are required to:

- Show sufficient evidence of knowledge of the case scenario;
- Be able to carry out appropriate analysis of the issues involved and suggest feasible solutions to the problems identified;
- Demonstrate ability to make informed judgement on the basis of the analysis carried out; and
- Generate reasoned conclusions upon which relevant recommendations are made.

Any candidate that omits any one of these will have a slim chance of success in the examination.

May 2024 Case Study: Spicey Confectioneries Limited

List of exhibits

Exhibit 1: About you (John Adesola) and your employer, Osayemeh, Adelowo, Chukwurah & Co.

Exhibit 2: Spicey Confectioneries Limited: History, Business structure, strategies and model

Exhibit 3: The confectionery market

Exhibit 4: Spicey Confectioneries Limited: Summarised financial statements 2021 – 2022

Exhibit 1

About you (John Adesola) and your employer, Osayemeh Adelowo Chukwurah & Co.

You are **John Adesola**, writing the Professional level of ICAN examination. You are employed as a Trainee in the firm of Osayemeh, Adelowo, Chukwurah & Co. (Chartered Accountants). You are reporting to Julius Idemudea, Partner in charge of the Hospitality group within the firm.

Your responsibilities include:

- Preparing detailed financial analyses and reports on the performance of the firm's hospitality clients;
- Analysing your clients' financial statements to identify areas of weakness and proffering likely solutions to correct any anomalies;
- Assessing operational and strategic business proposals to see how each aligns with the client's objectives and its impact on its business and financial risks;
- Assessing the client's financial and business forecasts together with the assumptions upon which they are based to form judgements, conclusions and recommendations to the client;
- Advising your clients on their strategic tax planning for optimal tax liabilities; and
- Drafting reports for your boss, based on the operational and strategic business analyses you have carried out.

These responsibilities demand that you keep yourself abreast of developments in the accounting and taxation space, and the hospitality industry, both nationally and internationally, to be able to carry out the above tasks effectively.

Exhibit 2

Spicey Confectioneries Limited: History, business structure, strategies and model

Spicey Confectioneries Limited (SCL) was formed in 2010. It manufactures and sells top quality confectionery. For many years, Spicey, as it is widely known, has been recognised as a successful company and has become a household name, particularly in Abuja and Lagos. Its fame is built on the very high-quality confectionery products it sells through its own stores, strategically located in both cities. Some of these stores are operated from buildings owned by Spicey, while the others are operating on leased properties.

Spicey has its factory in Lagos, from where the business originally started. The products are distributed through a multi-channel network, comprising of Spicey's own stores and 'online' business, franchises and retail partners. In addition, Spicey has now started to supply confectionery to large retail stores and supermarkets, on contract basis. These stores sell Spicey's products and also 'own brand label' confectionery that Spicey manufactures for them.

Spicey's product range includes a wide variety of milk, white and plain chocolate products. Previously, Spicey's main sales had been from chocolate products but now the company has expanded into producing other forms of confectionery, which do not contain chocolate in any form, for example, cakes and other sweets (candies). Spicey's customers continue to have strong regard for the quality of its products.

Spicey's customers vary from individuals to corporate clients, which purchase Spicey's products to present to their own clients as corporate gifts. Although individual customers buy from Spicey's stores, franchises or online, corporate clients purchase goods directly from Spicey on contract basis.

Business structure

Spicey has a simple business structure. It has a head office (which includes its management services function) and two divisions: Customer Sales and Distributions, and Manufacturing and Supplies. These divisions operate as follows:

Customer sales and distribution (CSD)

CSD sells and distributes Spicey's products through the following outlets:

- Spicey's own stores;
- Franchises; and
- Online sales.

Manufacturing and supplies (MS)

All purchasing of manufacturing supplies and the actual product manufacturing take place at the Manufacturing and Supplies Division. The division then supplies these products internally and externally as follows:
Internally to:

- CSD for its sales through its own stores; and
  Externally to:
- Corporate clients; and
- External retail stores and supermarkets which sell Spicey's products under Spicey's brand names and also under the stores' own special brand names.

Both divisions are operated as investment centres with limited capital investment authority, for expenditure up to ₦10m per annum. Major capital investments, above ₦10m, have to be authorised by head office.

CSD does not allow any of its outlets to make any capital investment at all without its prior approval. Each of CSD's stores is regarded as a profit centre, including online sales which is a single profit centre in its own right. Brand development is carried out jointly by both divisions. Any brand development costs, such as promotion, above ₦1m, must be approved at head office.

Spicey currently has 30 of its own stores and 20 franchises. It also has developed its own website. This has become very popular and has enabled Spicey's business to grow. In addition, as e-business has become more popular, especially from the time of COVID-19, Spicey has been able to develop its online sales business and has introduced 'click and collect' services using its stores and franchise stores as the collection points.

Business growth strategies

Spicey's current strategies to continue to achieve development and growth of its business are predicated on two strategic objectives, which are to:

- Expand Spicey range of customers through the development of Spicey's markets and products through a wide variety of sales and distribution channels. The focus of this is on the delivery of products the customer demands, where they are required and when they are wanted; and
- Enhance the customer experience through strong and effective customer relationship management. The focus of this is on clear and consistent branding and marketing to encourage customer loyalty and retention, all the year round.

Vision

- Spicey's vision is stated on the company's website as follows: "to be a leading, innovative and customer responsive company that constantly strives to create value which is shared between the shareholders and other stakeholders."

Mission

- Spicey's mission is to be the leading confectioneries manufacturer in the country with a continuous growth in market share, by adding new products to its products portfolio regularly.

Culture

- The company recruits people that are top rated in their various disciplines, that have something to offer the company and the company is willing to pay top of the range salaries to the right persons. The company maintains a culture of openness and freedom, and allows any of its staff to come up with novel ideas that can be translated into value creation.

Technology is at the heart of the company's business process, and it constantly invests in new technology that is seen to further improve the company's value creation process. The company is technology driven and it has deployed technology in virtually all areas of the company's business process.

The company has a research laboratory where food scientists and technologists are constantly working together to create new products and improve existing products and processes. Scientific discoveries are constantly being evaluated in the company's laboratory with the sole aim of converting such discoveries into commercially viable products.

Business model

Spicey recognises that one of its critical success factors is that value created by the company is to be shared among its various stakeholders - shareholders, employees, customers, consumers and the communities. The company therefore incorporates responsibility and sustainability into all aspects of its business management, making corporate social long term investments that are aimed at building value over time.

Sustainability and corporate social responsibility (CSR)

Spicey always strive to carry out its business operations in the most sustainable, environmentally friendly and in a fair manner with regard to all its stakeholders. It makes sure that each of its suppliers adheres to high ethical and sustainability practices with regard to sources of materials and treatment of employees.

Spicey sources cocoa, from the South-Western part of Nigeria. Spicey has initiated schemes to encourage sustainable farming of cocoa and farmers are being trained in effective agricultural methods. The introduction of approved cocoa production certification programme has enabled farmers to achieve higher levels of income from increased production and to access additional training directed at improving their production yields.

Spicey ensures that each of its products' labels contain only the ingredients used in their production. The packaging also shows nutritional content and gives advice on recommended volumes of consumption. Spicey's product packaging are normally recyclable and kept as minimal as possible to protect the environment.

Green energy source has been introduced in Spicey's factory, which has reduced consumption of electricity and greenhouse emissions. Spicey also introduced annual independent health and safety audits in its factory and retail outlets. All factory staff are required to undertake food safety and health safety training in the workplace at the required industry standard level. Workplace benefits, such as pension, medical insurance, and staff discounts are offered to all Spicey's employees.

Exhibit 3

The Confectionery market

Confectionery refers to food items with relatively high sugar and carbohydrate contents. Confectionery has a variety of flavourings, colourings, and other components that give them their distinct taste, texture, and appearance.

The global confectionery market has been put at $210.3billion in 2019 and is projected to increase to $270.5billion in 2027, which represents a compounded annual growth rate of 3.6%. Chocolate segment had the highest confectionery market share in 2019.

According to the confectionery market analysis, the market is segmented on the basis of product type, age group, price point and distribution channel, as follows:

- **Product type**: The market is categorised into chocolate confectionery, ice cream, preserved pastry goods, and cakes and sugar confectionery;
- **Age group:** The market is classified into children, adults, and geriatric;
- **Price point:** The market is distributed into economy, mid-range, and luxury; and
- **Distribution channel:** The market is divided into supermarket/hypermarket, convenience stores, pharmaceutical & drug stores, food services, duty-free outlets, e-commerce, etc.

On the basis of product type, the chocolate category was the dominant segment in 2019 with 35.2% market share. Consumers of all age groups consume chocolate confectionery to satisfy their taste buds. The growth in economic prosperity, especially in emerging economies has driven the demand for the chocolate segment. Furthermore, chocolate is the highest per capita (kg) consumed confectionery product across several countries.

However, it is projected that the medicated confectionery segment will grow at a faster rate during the forecast period, 2021 to 2027. The increase in prevalence of minor ailments and over-the-counter medications or dietary supplements requires active ingredients such as antacids, vitamins, and herbal extracts. These products will propel the growth of the medicated confectionery segment. Also, the rapid growth in geriatric population in the next 10 years is anticipated to be a driver of the market growth for the medicated confectionery segment.

The Nigerian confectionery market has been projected to grow at a compound annual growth rate (CAGR) of 9.8% over the analysis period of 2021 to 2027, in terms of revenue, by Strategy Helix, a data analytic company. The key factors responsible for this market growth are increasing availability of different varieties of candies and chocolates, rise in trend of gifting confectionery, and rising disposable income.

The Nigeria confectionery market is segmented on the basis of product and distribution channel, as follows:

By product: It is categorised into chocolate confectionery, gum, and sugar confectionery; and

By distribution channel: The confectionery market is divided into hypermarkets & supermarkets, convenience stores, specialist retailers, online retailing, etc.

The constantly evolving consumer habits, tastes, and preferences have led to innovation in the confectionery market, which is the driver of its market growth. Manufacturers are increasing their product ranges by including functional ingredients, organic herbal fillings, tropical fruit, and nut-based and exotic flavours in product formulations to meet changing consumer demands. Furthermore, the trend of gifting confectionery products, such as cookies, chocolates, bakery items, and others, has also propelled market growth in recent years. Brands are constantly establishing unique engaging techniques to seek consumer attention as confectionery products are significantly purchased as a result of impulse buying. These factors have cumulatively driven up the market for confectionery products. However, the volatile nature of raw material prices of sugar and cocoa can hamper the growth of the market.

COVID-19 and the subsequent lockdown in 2020 had severe impact on the confectionery market. This impact has been felt from two dimensions, as follows:

- Differential impact on raw material supply (agricultural produce, food ingredients, and intermediate food products), trade & logistics, demand-supply volatility, uncertain consumer demand, also affected the workforce at industrial level; and
- Sales decline as a result of reduced gifting and impulse buying among consumers across the globe.

Exhibit 4

Spicey Confectioneries Limited
Summarised Financial Statements 2021 – 2022

Income Statements

Year	2021	2022
	₦'000	₦'000
Revenue	1,635.0	1,794.6
Cost of sales	(901.0)	(939.2)
Gross profit	734.0	855.4
Marketing & distribution expenses	(216.9)	(254.9)
Administrative expenses	(75.1)	(81.0)
Finance expense	(47.5)	(44.3)
Profit before income tax	394.5	475.2
Income tax expense	(22.1)	(55.9)
Profit after tax expenses	**372.4**	**419.3**

Statements of Financial Position

Year	2021	2022
	₦'000	₦'000
Assets:		
Property, plant and equipment	775.1	791.5
Current assets:		
Inventories	120.6	125.5
Trade receivables	212.3	235.5
Prepayments	10.5	15.3
Cash and cash equivalents	30.5	110.9
Total current assets	373.9	487.2
Total assets	**1,149.0**	**1,278.7**
Equity:		
Share capital	10.0	10.0
Retained earnings	483.8	583.1
Total equity	**493.8**	**593.1**
Liabilities:		
Long term loans	146.0	88.3
Employee benefit	58.3	75.8
Deferred tax liabilities	50.6	50.6
Total non-current liabilities	**254.9**	**214.7**

Year	**2021**	**2022**
	₦'000	**₦'000**
Bank overdraft	15.0	5.0
Current tax liabilities	35.8	60.4
Short term loans	150.0	100.00
Trade and other payables	189.0	289.3
Provisions	10.5	16.2
Total current liabilities	400.3	470.9
Total equity and liabilities	**1,149,0**	**1,278.7**

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May 2024 Case Study: Spicey Confectioneries Limited

List of exhibits

The following exhibits are newly provided and did not form part of the material provided as Pre-seen:

Exhibit 5: Email from Julius Idemudea to John Adesola

Exhibit 6: Email from Dorcas Dahiru to Julius Idemudea

Exhibit 7: Spicey's strategic developments

Exhibit 8: Introduction of Diabetic Chocolate into the market

Exhibit 9: Strategic acquisition

Spicey Confectioneries Limited: Case Study requirements

You are John Adesola, a professional level student of ICAN, working as Trainee in the firm of Osayemeh, Adelowo, Chukwurah & Co. (Chartered Accountants). You report to Julius Idemudea, the Partner in charge of the Hospitality business group.

Requirements

You are required to prepare a draft report, as set out in the email dated 17 October 2023 from Julius Idemudea to you (**Exhibit 5**). Your report should comprise the following:

- An executive summary
- Responses to the two detailed requirements set out in exhibit 5, including appropriate appendices.

State clearly any assumptions you have made. All workings should be attached to your answer.

The following time allocation is suggested:

Reading and planning	1 hour
Performing calculations and financial analyses	1 hour
Drafting report	2 hours

Marks allocation

All of the marks in the Case Study are awarded for demonstration of professional skills and allocated broadly as follows:

Applied to the four elements of your report (as described above)	
Assimilating and using information	20%
Structuring problems and solutions	20%
Applying judgement	20%
Drawing conclusions and making recommendations	20%
	80%
Applied to your report as a whole:	
Demonstrating integrative and multidisciplinary skills	10%
Presenting appropriate appendices	10%
	100%

Of the total marks available, 20% are awarded for the executive summary and approximately 10% for the relevant discussion of ethical issues within your answer to the requirements.

Ensure that you address the two requirements in your report. Failure to address any requirement, including not submitting an executive summary will adversely affect your the chances of success. In addition, as indicated above, all the four skill areas will be assessed under each of the four elements of your report. Accordingly, not demonstrating your judgement or failing to include appropriate conclusions and/or recommendations in your report will adversely affect your chances of success.

Exhibit 5

Email from Julius Idemudea to John Adesola

From: Julius Idemudea
Sent: 17 October 2023
To: John Adesola

Subject: Spicey Confectioneries Limited

As part of Spicey's strategic objectives, it plans to expand its operations to the South-South region part of Nigeria. As a result, the company has identified two companies, Eat Right and Smoothy Chocolatey, in Port Harcourt for possible acquisition. Spicey will want us to evaluate the 2022 financials of the two companies. The company also plans to introduce a new product, Diabetic Chocolate, into the market during the coming year. Dorcas, Spicey's Chief Finance Officer, has provided financial data in respect of this product in Exhibit 8. The board of Spicey, as usual, is asking for our evaluation of the viability, or otherwise, of introducing this product into the market, based on financial numbers. Furthermore, the board of Spicey would want us to evaluate to which extent Spicey's sales development strategies could assist in achieving its two strategic objectives using Ansoff's product/market growth matrix.

Therefore, I will like you to carry out:

i. An evaluation of the 2022 financial statements of Eat Right and Smoothy Chocolatey, using the specified ratios in Exhibit 9 to recommend which of the companies Spicey should acquire;
ii. An evaluation of the viability of the proposed introduction of Diabetic Chocolate into the market, based on its financial details provided in Exhibit 8 and recommend the quantity of the product that should be produced in the first three months, given the constraint during the period; and
iii. Using Ansoff's product/market growth matrix, evaluate the extent to which Spicey's sales development strategies could assist in achieving its two strategic objectives.

I attach herewith Exhibits 9 to 11 to assist you. You can find additional information in the file we maintain for Spicey Confectioneries Limited.

Please draft for my review, a report to be submitted to the board of Spicey confectioneries Limited.

Your report should comprise:

1. An evaluation of the 2022 financial statements of Eat Right and Smoothy Chocolatey, using the specified ratios to recommend which of the companies Spicey should acquire; and
2. An evaluation of the viability of the proposed introduction of Diabetic Chocolate into the market, based on its financial details and recommend the quantity of the product that should be produced and sold in the first 3 months. In addition, using

Ansoff's product/market growth matrix, evaluate the extent to which Spicey's sales development strategies could assist in achieving its two strategic objectives.

I look forward to receiving your draft report.

Julius

Exhibit 6

Email from Dorcas Dahiru to Julius Idemudea

Julius,

Top of the day to you and hope this email meets you well.

In line with our strategic objective of expanding our operations to the South-south region part of Nigeria, we have identified two companies for possible acquisition in Port Harcourt, Eat Right and Smoothy Chocolatey. The board would want you to evaluate the 2022 financial statements of each of the companies, attached to this email, based on the specified ratios, and recommend which one Spicey should acquire. We are also introducing a new product, Diabetic Chocolate, into the market, therefore, the board also wants you to evaluate the viability of this product, based on the attached financial data, and make appropriate recommendations, especially, given the constraints facing the company in the first 3 months.

Furthermore, the board will like you to evaluate, using Ansoff's product/market growth matrix, the extent to which Spicey's sales development strategies could assist in achieving its two strategic objectives.

I would be looking forward to receiving your report on the above in the next one month, bearing in mind that the board would like to review your report at its next meeting, coming up in the third week of November, where the company's 2024 financial plan would be considered and approved.

As usual, I trust you will deliver within the time frame.

Dorcas

Exhibit 7

Spicey's strategic developments

In order to achieve its strategic objectives, Spicey decides to expand its online channel to increase its sales to corporate clients and external retail stores and supermarkets. These sales outlets yield a higher margin than that achieved through sales in Spicey's own stores. The board also intends to acquire a chain store in Port Harcourt, to expand its business into South-South Nigeria.

Spicey will continue to develop through the delivery of its two strategic objectives, as previously stated, to ensure the continued growth of the business. The two strategic objectives are:

- Expand Spicey range of customers through the development of Spicey's markets and products via a wide variety of sales and distribution channels. The focus of this is on the delivery of products the customer demands, where they are required and when they are needed; and
- Enhance the customer experience through strong and effective customer relationship management. The focus of this is on clear and consistent branding and marketing to encourage customer loyalty and retention, all the year round.

Spicey's sales development strategies

Spicey currently operates its own retail stores and a number of franchise outlets in Abuja and Lagos. Spicey believes that its retail stores are a vital sales channel. Therefore, Spicey decided that investment in its retail stores and employees must be made to improve the customer experience and the brand image. This will be achieved through engaging better with customers in the retail stores and providing a wide range of high-quality products.

In the recent time, Spicey has experienced growth in the sales of its own label products to supermarkets. It has been predicted that sales of Spicey's own label products in supermarkets will continue to experience growth, as a result of Spicey increasing its distribution network to a wider range of supermarket chains and through supplying a greater variety of its year-round products. Spicey anticipates further growth through its planned strategic acquisition and product development.

Spicey operates a website, through which it sells a wide range of its products. This has proved to be a very successful sales channel since the emergence of COVID-19. Spicey therefore plans to develop its e-business sales channel and it is considering using the website to sell an even wider product range, including gift hampers.

Spicey's customer relationship management

Customer retention and loyalty are critical to Spicey's achievement of its strategic objectives. The board recognises that one of the most important determinants of its future anticipated growth is encouraging customers to buy more frequently and to buy its products all year round. It believes that the best way to achieve this, is through strong and effective Customer Relationship Management (CRM), as it has set out in its second strategic objective.

Spicey considers that a key factor in building and managing strong customer relationships will be the continued development and use of Spicey's website. Spicey strongly believes that e-business will be a key feature of strengthening and building strong customer relationships, ensuring customer loyalty and retention, and strengthening its reputation as an all-year-round confectionery retailer.

Exhibit 8

Introduction of Diabetic Chocolate into the market

Details of Diabetic Chocolate and two other chocolate products that require similar materials are as follows:

Product	Diabetic Chocolate ₦/box	Low sugar Chocolate ₦/box	Honeybee Chocolate ₦/box
Selling price	37.00	26.00	32.00
Direct labour (₦ 8/hour)	14.00	12.00	14.00
Material A (₦3/kg)	1.50	0.75	0.75
Material B (₦ 6/kg)	3.00	3.00	3.00
Material C (₦ 10/kg)	5.00	1.00	3.00
Variable overhead (₦ 2/hour)	3.50	3.00	3.50
Corporate overhead	1.00	1.00	1.00
	28.00	20.75	25.25
Operating profit	9.00	5.25	6.75

Temporary shortage of Material C

The management of Spicey is aware that there will be a temporary shortage of Material C for the first 3 months in 2024, and that a maximum of 6,500 kgs will be available in each month. Material C is sourced from the South-Western part of the country which has been experiencing insecurity recently and this has limited the amount of Material C available. There are no suitable alternative materials which could replace Material C during these 3 months. Spicey has no inventories of materials A, B or C as well as the final product due to their perishable nature.

Spicey's order book

Currently on Spicey's order book are orders from Spicey's valuable customers, as follows:

City Supermarkets: 10,000 boxes of Low sugar chocolate per month.
Derango Departmental Stores: 10,000 boxes of Honeybee chocolate per month.

Diabetic Chocolate sales projection

A survey conducted by Spicey's marketing department indicates that Diabetic chocolate sales would be in the region of 10,000 to 15,000 boxes per month.

Exhibit 9

Strategic acquisition

The Directors of Spicey Confectioneries Limited have identified two potential target entities, Eat Right Cakes and Smoothy Chocolatey, and obtained copies of their financial statements. Extracts from these financial statements, together with notes providing additional information, are given below:

Income Statements – Year Ended 31 December 2022

	Eat Right ₦000	Smoothy Chocolatey ₦000
Revenue	102,000	85,800
Cost of sales	(63,000)	(59,735)
Gross profit	39,000	26,065
Other operating expenses	(27,000)	(18,200)
Profit from operations	12,000	7,865
Finance cost	(4,500)	(5,200)
Profit before tax	7,500	2,665
Income tax expense	(2,250)	(1,300)
Net profit for the period	5,250	1,365

Statements of Changes in Equity – Year Ended 31 December 2022

	Eat Right ₦000	Smoothy Chocolatey ₦000
Balance at 1 January 2022	33,000	20,800
Surplus on revaluation of properties	-	7,800
Net profit for the period	5,250	1,365
Dividends paid	(3,000)	(1,300)
Balance at 31 December 2022	35,250	28,665

Statement of Financial Position at 31 December 2022

	Eat Right ₦000	Smoothy Chocolatey ₦000
Non-current assets:		
Property, plant and equipment	48,000	45,565
Current assets:		
Inventories	9,000	9,100
Trade receivables	18,000	13,000
	75,000	67,665
Equity:		
Share capital (₦1 shares)	24,000	15,600
Revaluation reserve	-	6,500
Retained earnings	11,250	6,565
	35,250	28,665
Non-current liabilities:		
Long-term borrowings	24,000	23,400
Current liabilities:		
Trade payables	7,500	6,500
Income tax	2,250	1,300
Short-term borrowings	6,000	7,800
	75,000	67,665

Notes to the Financial Statements:

Sale by Eat Right to Sweetie Limited

On 31 December 2022, Eat Right supplied goods, at the normal selling price of ₦3.6 million, to another company, Sweetie Limited. Eat Right's normal selling price is at a markup of 60% on cost. Sweetie paid for the goods in cash on the same day. The terms of the selling agreement were that Eat Right repurchase these goods on 30 June 2023 for ₦3.75 million. Eat Right has accounted for the transaction as a sale.

Revaluation of non-current assets by Smoothy Chocolatey

Smoothy Chocolatey revalued its non-current assets for the first time on 1 January 2022. The non-current assets of Eat Right are very similar in age and type to the non-current assets of Smoothy Chocolatey. However, Eat Right has a policy of maintaining all its non-current assets at depreciated historical cost. Both companies charge depreciation of non-current assets to cost of sales. Smoothy Chocolatey has transferred the excess depreciation for the year of ₦1.3 million on the revalued assets from the revaluation reserve to retained earnings.

Spicey normally use ratio analysis to appraise potential investment opportunities. The company wants to base the appraisal on four key ratios:

- Return on capital employed;
- Gross profit margin;
- Asset utilisation; and
- Gearing (debt / debt + equity).

For the purposes of this ratio analysis, Spicey has decided to use:

- Capital employed as capital and reserves plus borrowings; and
- Borrowings as long-term borrowings plus short-term borrowings.

Exhibit 10

Newspaper article

City People Daily Post
11 Cardoso Street, Kirikiri, Apapa.
Lagos.

September 12, 2023.

Is Spicey really Spicey?

Eating fast food products in Nigeria may actually pose a serious danger to one's health. Most of these food items are being prepared in unhygienic premises that may actually introduce bacteria into the food during processing.

As an undercover reporter, I made a tour of Spicey Confectioneries manufacturing facility. The manufacturing facility that looks almost near perfect outside was another thing inside. There were many garbage cans very close to the mixing room that ooze odours around the factory. Many other decaying unused materials littered the environment where their chocolates are being produced.

I think our food control agencies, including the Sanitation section of the state's Ministry of Health, should make it a duty to visit these fast-food companies, unannounced regularly, to avoid unnecessary outbreak of diseases in the state.

Exhibit 11

Letter From NAFDAC

NATIONAL FOODS AND DRUGS CONTROL AGENCY
5 Adekunle Street, Surulere
Lagos

September 1, 2023

The Managing Director
Spicey Confectioneries Limited
10 Davis Street
Ikeja, Lagos.

Dear sir

Use of Potassium Bromate as Preservative

We write to remind you of our earlier letter to your company, in which we advised that you should stop using bromate in the manufacturing of your food items.

A recent report has indicated your continued use of the item in your manufacturing activities. We need not emphasise to you the health implications of this particular preservative to the health of those who consume these products.

This, therefore, serves as our last warning to your company on this matter. Failure to stop using this preservative will leave us with no other option but to close your factory.

Please accept the assurances of our highest esteem.

Your obedient servants
For: National Foods and Drugs Control Agency

Lere Adekola
Director General

		SPICEY CONFECTIONERIES LIMITED				
	First Marking					
DATE			CANDIDATE NO			
TIME		MARKER NUMBER				
		Exc. Summary	Req. 1	Req. 2	Overall	TOTAL
	SA					
	CA					
	BC					
	NC					
	V					
	Total	5	8	8	4	25

Executive Summary: Spicey Confectioneries Limited

1. General	**4. Requirement 2: Conclusions**
• States the purpose of the report	• Concludes on the viability of Diabetic Chocolate.
• States the summary of the two requirements	• Concludes on the number of boxes of Diabetic Chocolate to be produced per month in the first 3 months due to shortageof Material C.
• States the assumptions	• Concludes on the usefulness of Ansoff Sales/Market growth model to analyse Spicey's sales development strategies.
• States reservations, e. g. scepticism	• Concludes on the need for Spicey to keep its manufacturing environment clean
	• Concludes on the need for Spicey to stop using potassium bromate in the production process
V NC BC CA SA	**V NC BC CA SA**
2. Requirement 1: Conclusions	**5. Requirement 2: Recommendations**
• The acquisition will help Spicey to meet its strategic objectives.	• Spicey should go ahead with the production of Diabetic Chocolate.
• Because of its high operating expenses, Eat Right may not be considered for acquisition, unless it can reduce operating expenses.	• Spicey should produce 5,000 boxes of Diabetic Chocolate per month in the first 3 months because of shortage of Material C.
• Smoothy has a high gearing and may not be considered for acquisition, unless Spicey can introduce funds.	• Ansoff Sales/Market growth model is useful to analyseSpicey's sales development strategies.
• Spicey may need to carry out due diligence on both companies before acquisition.	• Spicey should keep its manufacturing environment clean always.
	• Spicey should stop using potassium bromate in its production process.
V NC BC CA SA	**V NC BC CA SA**
3. Requirement 1: Recommendations	
• Spicey should carry out due diligence on both companies before proceeding with the acquisition.	
• Spicey should take its strategic objectives into consideration before concluding on the acquisition.	
• Eat Right should be considered for acquisition if its operating expenses can be reduced.	
• Smoothy should be acquired if Spicey will introduce additional equity.	
V NC BC CA SA	

Requirement 1: Financial statement analysis

1. USES DATA AND INFORMATION APPROPRIATELY • Uses information on exhibit 2 - Spicey Confectioneries Limited: History, business structure, strategies and model. • Uses information on exhibit 5 - Email from Julius Idemudea • Uses information on exhibit 6 - Email from Dorcas Dahiru. • Uses information on exhibit 9 - Strategic acquisition.	**4. IDENTIFIES ISSUES AND OPTIONS** • Identifies the need to transfer the sale by Eat Right to Sweetie from revenue to loan. • Identifies the needs to only compare financial statements that are prepared using similar accounting policies. • Identifies that Spicey needs to consider its acquisition objectives before deciding on which of the companies to acquire. • Identifies that Spicey need to carry out a due diligence on both companies before taking final decision. • Identifies that Spicey needs to consider the number of stores operated by each of the companies and their locations as part of its due diligence.
2. USES PROFESSIONAL TOOLS AND KNOWLEDGE • Determines the adjustments necessary before carrying out the analysis. • Reprepares the financial statements of the two companies. • Calculates the return on capital employed for the two companies. • Calculates gross profit margin for the two companies. • Calculates the turnover of capital employed for the two companies. • Calculates leverage (gearing) of the two companies.	**5. APPLIES PROFESSIONAL SCEPTICISM AND ETHICS** • Recognises that the financial statements of both companies have not been audited. • Recognises that there may still be more adjustments to be carried out on both financial statements after audit. • Recognises that the inventories being carried by both companies might have become obsolete. • Recognises that both financial statements might have been window dressed, since the two companies are being consideredfor acquisition.
V NC BC CA SA	**V NC BC CA SA**
3. USES ANALYTICAL SKILLS (material points) written report • Determines that the substance of the transaction between Eat Right and Sweetieis not a sale but a loan – IFRS • Determines that there is a need to reprepare the financial statementsof Smoothy to reflect the same accounting policies with Eat Right - reporting non-current assets at historical costs – IAS 16. • Determines that Eat Right has a better gross margin. • Determines that Smoothy is slightly better at generating revenue from capital employed, as reflected by ratio on turnover of capital employed. • Determines that Eat Right has about₦8,000,000 operating expenses more than Smoothy. • Determines that the leverage of Smoothy is higher than that of Eat Right. • Determines that Smoothy has a higher return on capital employed.	**6. EVALUATIVE SKILLS AND JUDGEMENT** • Recognises that Smoothy's return on capital employed is higher. • Recognises that Eat Right's gross margin is better than that of Smoothy. • Recognises that turnover of capital employed by Smoothy is higher than that of Eat Right. • Recognises that Smoothy is high geared than Eat Right. • Recognises that Eat Right's operating expenses is very high.
V NC BC CA SA	**V NC BC CA SA**

7. CONCLUSIONS (Draws distinct conclusions under a heading)	8. RECOMMENDATIONS (commercial / relevant)
• Concludes that the acquisition will help Spicey to meet its strategic objective. • Concludes that because of its high operating expenses, Eat Right may not be considered for acquisition, unless it can reduce operating expenses. • Concludes that Smoothy has a high gearing and may not be considered for acquisition, unless Spicey can introduce funds. • Concludes that Spicey may need to carry out due diligence on both companies before acquisition.	• Recommends that Spicey should carry out due diligence on both companies before proceeding with the acquisition. • Recommends that Spicey should take its strategic objectives into consideration before concluding on the acquisition. • Recommends that Eat Right should be considered for acquisition if its operating expenses can be reduced. • Recommends that Smoothy should be acquired if Spicey will introduce additional equity.
V NC BC CA SA	**V NC BC CA SA**

REQUIREMENT 2 -Evaluation of Introduction of Diabetic Chocolate and usefulness of Ansoff Market Growth model

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1. **USES DATA AND INFORMATION APPROPRIATELY**

- Uses information in exhibit 2 - Spicey Confectioneries: History, Business structure, strategies and model.
- Uses information in exhibit 3- The confectionery market.
- Uses information in exhibit 5 - Email from Julius Idemudea.
- Uses information in exhibit 6 - Email from Dorcas Dahiru.
- Uses information in exhibit 7 -Spicey's strategic developments.
- Uses information in exhibit 8 - Introduction of Diabetic Chocolate into the market.
- Uses information on exhibit 10, Newspaper article.
- Uses information on exhibit 11, Letter from NAFDAC.

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3. **IDENTIFIES ISSUES AND OPTIONS**

- Identifies that the Diabetic Chocolate is a viable product as it will generate additional contribution.
- Identifies that there is a constraint on the number of boxes of Diabetic Chocolate that can be produced in the first three months because of short supply of Material C.
- Identifies that Ansoff Sales/Market Growth model is useful to analyse Spicey's sales and market development strategies.
- Identifies that Spicey needs to strive to improve customers' experience by engaging better with the customers and providing them with wide product range.
- Identifies that Spicey needs to engage more in market research to identify what customers want regularly.
- Identifies that Spicey should introduce more healthy products into the market to meet customers' demand for healthy food.
- Identifies the need for Spicey to stop using potassium bromate in preserving some of its products.
- Identifies the need for Spicey to keep its manufacturing environment clean all the time.

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2. **USES PROFESSIONAL TOOLS AND KNOWLEDGE**

- Calculates the contribution per box for the three products.
- Calculates the quantities of Diabetic Chocolate that should be produced per month in the first three months.
- Calculates each products' contribution per limiting factor.
- Prepares the Ansoff Sales/market growth model.
- Relates the Ansoff model to Spicey's sales development objectives.

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4. **USES ANALYTICAL SKILLS (material points) written report**

- Determines the contribution per box for each of the three products.
- Determines the need to calculate contribution per limiting factor by each of the three products.
- Ranks each of the products by their contributions to the limiting factor.
- Determines the optimal production mix.
- Determines the maximum boxes of Diabetic Chocolate that can be produced per month in the first three months.

  Determines the applicability of Ansoff sales/market growth model to Spicey's sales development strategies.

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5. APPLIES PROFESSIONAL SCEPTICISM AND ETHICS • Discusses the accuracy of the financial data used in calculating the contribution per box of Diabetic Chocolate. • Discusses the accuracy of the sales projection of Diabetic Chocolate and its acceptability in the market. • Discusses the competitors' response to the introduction of Diabetic Chocolate into the market and its effect on its sales forecast. • Discusses the negative effect on the Newspaper article on Spicey's products' performance in the market. • Discuss the ethical implications of Spicey's use of potassium bromate in the preservation of some of its products.	**7. CONCLUSIONS** **(Draws distinct conclusions under a heading)** • Concludes on the viability of Diabetic Chocolate. • Concludes on the number of boxes of Diabetic Chocolate to be produced per month in the first 3 months due to shortage of Material C. • Concludes on the usefulness of Ansoff Sales/Market growth model to analyse Spicey's sales development strategies. • Concludes on the need for Spicey to keep its manufacturing environment tidy all the time. • Concludes on the need for Spicey to stop using potassium bromate in the production of some of its products.
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6. EVALUATIVE SKILLS AND JUDGEMENT • Recognises that Diabetic Chocolate is viable as it will generate additional contribution. • Recognises that because of its contribution per box to the limiting factor Spicey cannot produce more than 5,000 boxes of Diabetic Chocolate per month in the first 3 months. • Recognises that Ansoff Sales/Market growth model is useful to analyse Spicey's sales development strategies. • Recognises that the three products that uses Material C needs to be ranked based on their contribution per box to the limiting factor.	**8. RECOMMENDATIONS (commercial / relevant)** • Recommends that Spicey should go ahead with the production of Diabetic Chocolate. • Recommends that Spicey can only produce 5,000 boxes of Diabetic Chocolate per month in the first 3 months because of shortage of Material C. • Recommends that Ansoff Sales/Market growth model is useful to analyse Spicey's sales development strategies. • Recommends that Spicey should keep its manufacturing environment tidy all the time. • Recommends that Spicey should stop using potassium bromate in the production of some of its products.
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General Appendices	Main Report
1. Appendices R1: Content and style • Shows the adjustments necessary before carrying out the analysis. • Shows the reprepared financial statements of the two companies. • Shows the return on capital employed for the two companies. • Shows gross profit margin for the two companies. • Shows the turnover of capital employed for the two companies. • Shows leverage (gearing) of the two companies.	**3. Report: Structure** • Sufficient appropriate headings • Appropriate use of paragraphs / sentences • Legible/clear hand writing • Correctly numbered pages
V NC BC CA SA	**V NC BC CA SA**
2. Appendices R2: Content and style • Shows the contribution per box for the three products. • Shows the quantities of Diabetic Chocolate that should be produced per month in the first three months. • Shows each products' contribution per limiting factor. • Shows the Ansoff Sales/market growth model. • Relates the Ansoff model to Spicey's sales development objectives.	**4.Report: Style and language** • Relevant disclaimer (external report) • Suitable language for the board • Tactful / ethical comments • Acceptable spelling and punctuation
V NC BC CA SA	**V NC BC CA SA**

Appendix 1
Spicey Confectioneries Limited
Ratio Analyses for Eat Right and Smoothy Chocolatey

Before any meaningful ratio analysis could be carried out, the financial statements of both companies need to be adjusted, based on the further information provided as notes to the financial statements.

Adjustments:

1. Eat Right

The substance of the transaction is not a sale but a loan. Therefore,adjustments need to be made as follows:

Dr. Revenue	₦3,600,000	
Dr. Inventories	₦2,250,000	
Cr. Cost of sales		₦2,250,000
Cr. Loan		₦3,600,000

2. **Smoothy Chocolatey**

To make meaningful comparison between the two companies, both sets of financial statements must be prepared based on the same accounting policies. Therefore, the financial statements of Smoothy need to be restated so that both sets of non-current assets are stated at historical costs as follows:

Dr. Revaluation reserve	₦6,500,000	
Cr. Non current assets		₦6,500,000
Dr. Retained earnings	₦1,300,000	
Cr. Cost of sales		₦1,300,000

The above adjustments will affect the financial statements of both companies as follows:

Eat Right	**Before**	**Adjustment**	**After**
	₦'000	₦'000	₦'000
Revenue	102,000	(3,600)	98,400
Cost of sales	63,000	(2,250)	60,750
Gross profit	39,000	(1,350)	37,650
Operating profit	12,000	(1,350)	10,650
Borrowings (6000+24000)	30,000	3,600	33,600
Capital and reserves	35,250	(1,350)	33.900
Capital employed	65,250	-	67,500
Smoothy Chocolatey			
Revenue	85,800	-	85,800
Cost of sales	59,735	(1,300)	58,435
Gross profit	26,065	1,300	27,365
Operating profit	7,865	1,300	9,165
Borrowings (7,800 + 23,400)	31,200	-	31,200
Capital and reserves	28,665	6,500	22,165
Capital employed	59,865	-	53,365

Ratios

		Eat Right	Smoothy Chocolatey
Return on capital employed	Operating profit/Capital employed%	10,650/67,500% 15.8%	9,165/53,365% 17.2%
Gross profit margin	Gross profit/Revenue%	37,650/98,400% 38.3%	27,365/85,800% 31.9%
Turnover of capital employed	Revenue/Capital employed%	98,400/67,500 1.5	85,800/53,365% 1.6
Leverage (Gearing)	Total borrowing/Capital employed%	33,600/67,500% 49.8%	31,200/53,365% 58.5%

Evaluation

- Eat Right has a better gross margin, while Smoothy has a better return on capital employed.
- Smoothy is better at generating sales revenue from capital employed, as shown by turnover to capital employed.
- Eat Right has about ₦8million operating expenses more than Smoothy.
- Smoothy Chocolatey is a better company to acquire because of higher operating expenses of Eat Right.

Appendix 2

Spicey Confectioneries Limited

Viability of Diabetic Chocolate and Quantity to produce in the first 3 months

1. Calculation of contribution per box

Product	**Diabetic Chocolate**	**Low Sugar Chocolate**	**Honeybee Chocolate**
	₦/Box	**₦/Box**	**₦/Box**
Selling price	37.00	26.00	32.00
Direct labour (₦ 8/hour)	14.00	12.00	14.00
Material A (₦3/kg)	1.50	0.75	0.75
Material B (₦ 6/kg)	3.00	3.00	3.00
Material C (₦10/kg)	5.00	1.00	3.00
Variable overhead (₦2/hour)	3.50	3.00	3.50
Total variable cost	27.00	19.75	24.25
Contribution	10.00	6.25	7.75

Diabetic Chocolate will contribute ₦10 per box, therefore, it is viable.

Determination of Quantity of Diabetic Chocolate to produce.

Limiting factor in the first 3 months is material C with only 6,500kgs available per month.

Calculation of each product's contribution per limiting factor:

	Diabetic Chocolate	**Low Sugar Chocolate**	**Honeybee Chocolate**	**Available Material C**
Contribution per box	₦10	₦6.25	₦7.75	
Material C required per box	0.5kg	0.1kg	0.3kg	
Contribution per kg of Material C	₦20	₦62.5	₦25.83	
Ranking	3rd	1st	2nd	
Current order of existing products		10,000boxes	10,000 boxes	6,500kgs
Material C required per box		0.10kg	0.30kg	
Total material C required		1,000kgs	3,000kgs	(4,000kgs)
Balance available for Diabetic Chocolate				2,500kgs
Material C required per box				0.50kg
Quantity of Diabetic Chocolate to be produced per month for first 3 months				**5,000 boxes**

Appendix 3

Ansoff Product market growth model and Spicey's strategic objectives.

Spicey's two strategic objectives which it plans to achieve, through its sales development strategies, are:

- Expand Spicey range of customers through the development of Spicey's markets and products through a wide variety of sales and distribution channels. The focus of this is on the delivery of products the customer demands, where they are required and when they are wanted; and
- Enhance the customer experience through strong and effective customer relationship management. The focus of this is on clear and consistent branding and marketing to encourage customer loyalty and retention all the year round.

Ansoff product market directional growth model could be used to assess the sales development strategies planned by Spicey.

Market		Products: Existing	Products: New
	Existing	Market penetration/Consolidation	Product Development
	New	Market Development	Diversification Related/Unrelated

Market Penetration/Consolidation (Existing products to Existing customers)
Market penetration is where organisations attempt to increase their market share in the existing market using the existing products. This addresses Spicey's strategic objective 2, which is to "enhance the customer experience" and "to encourage customer retention and loyalty all the year round".

Spicey should make concerted effort to improve the customer experience, through engaging better with customers and providing them with a wide range of high-quality products.

Spicey must focus on customer service and customer relationship management, to make sure customers return frequently throughout the year.

Market penetration and consolidation strategies would help to achieve strategic objective 1, provided Spicey gets the right products in its retail stores and the retail stores are in the optimum location. The retail stores and franchises are also the best places to assist in achieving strategic objective 2, as it is there that its customers will experience the Spicey brand and where effective marketing, and customer relationships must be built.

Product Development (New products to Existing customers)
This is concerned with the development of a wider range of products in order to increase sales. This meets with Spicey's strategic objective 1 to produce "products that the customers demand". This is the reason why Spicey is introducing Diabetic Chocolate into the market and Spicey will need to conduct more market research to identify what its customers want, or what they think they want regularly. It would appear that the website is being considered as a means to achieving product development, through the sale of new products.

Market Development (Existing products in New Markets)
This is about ways to develop and enhance the company's current markets, by selling more of its existing products through new or enhanced sales channels and to new customer segments. This reflects Spicey's strategic objective 1, which states "through the development of Spicey's markets and products". A form of market development is the continued development of sales of Spicey's own label products to new supermarket customers, as it is offering its products to supermarket customers who may not necessarily be customers of Spicey elsewhere.

This will require careful management of relationship with the supermarket customers to ensure Spicey's sales are optimised and that Spicey maintains strong working relationships with the supermarkets, which are likely to be very large organisations. The sale of Spicey's products in supermarkets should encourage a wider range of customers to buy Spicey's products (strategic objective 1) and it should also allow Spicey to promote its brand in more locations and encourage year-round sales (strategic objective 2).

Diversification (New products to New markets)
Diversification deals with expansion into new markets with new products and it is the way companies choose to expand in order to spread the risk of reliance on just one market sector. However, expanding into a new unknown type of market is very risky and many companies often fail due to poor market research or lack of marketing. Another reason for failing in implementing a diversification strategy is that some companies do not have adequate financial resources to bear losses in the early months, or even years, until the new business venture is established.

A company that chooses to diversify needs to have the financial commitment to see the expansion settled, and start to generate profits and cash flows, which takes time. This diversification strategy would help Spicey to achieve strategic objective 1 which is "through the development of Spicey's markets and products through a wide variety of sales channels"

Examiner's report

The case scenario is about Spicey Confectioneries Limited, a company producing and selling chocolate. The Pre-seen case scenario include: Details about the history, business structure, strategies and model; The confectionery market; and 2 years summarised financial statements. While the Un-seen introduces Spicey strategic development; Introduction of Diabetic Chocolate into the market; Strategic acquisition; Newspaper article and a letter from NAFDAC.

The following appendices are required:

As usual, there are two requirements that candidates are to address. These are:

- An evaluation of the 2022 financial statements of Eat Right and Smoothy Chocolatey, using the specified ratios to recommend which of the company Spicey should acquire; and

- An evaluation of the viability of the proposed introduction of Diabetic Chocolate into the market, based on its financial details and recommend the quantity of the product that should be produced and sold in the first 3 months. In addition, using Ansoff's product/market growth matrix, evaluate the extent to which Spicey's sales development strategies could assist in achieving its two strategic objectives.

To perform very well in this Case Study, candidates must prepare the following appendices:

Requirement 1:

Appendix 1: Ratio Analyses for Eat Right and Smoothy Chocolatey, after appropriate adjustments;

Requirement 2:

Appendix 2: Calculations to determine the viability of Diabetic Chocolate and Quantity to produce in the first 3 months; and

Appendix 3: Ansoff Product market growth model and comment whether it is appropriate for Spicey's use to achieve its strategic objectives.

Candidates' performance was very poor, as only very few candidates scored up to 50%.

The common pitfalls of the candidates are:

- Most candidates did not carry out the adjustments necessary on the financial statements of Eat Right and Smoothy Chocolatey before calculating the required ratios;
- Most candidates did not address requirement 2 of the Case Study. The few candidates that attempted the requirement only concentrated on the short term decision part of the requirement, without discussion on the applicability of Ansoff market and product development matrix;

- Lack of understanding of how to write a formal report with appropriate headings and subheadings to address issues required; and
- Inability to write a good executive summary.

Candidates are advised to practise and perfect the art of report writing, learn to address specific requirements of each Case Study and ensure they bring to bear the knowledge they have gained in other subjects of the professional examination when preparing for future examination.