THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

NOVEMBER 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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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2024

CORPORATE REPORTING

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 any other **COLOUR OF INK** will not be marked.
8. You are required to attempt **Question ONE (compulsory), any TWO Questions in Section B and any Two questions in Section C**.
9. Check that you have collected the correct question paper for the examination you are writing.

TUESDAY, NOVEMBER 19, 2024

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 2024

CORPORATE REPORTING

Time Allowed: 3¼ 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

Buga Plc operates chains of Bakery in the country which sells various types of bread (whole-wheat bread, cassava bread, cake bread etc.). The company's accounting year-end is September 30.

On October 1, 2022 Buga Plc acquired 80% interest in the ordinary share capital of Kumasi Limited, a company that produce and distributes wheat located in Ghana. Buga Plc has no other subsidiaries.

The draft financial statements of Buga Plc and Kumasi Limited in their local currencies are as follows:

Draft statements of profit or loss and other comprehensive income for the year ended September 30, 2023

	Buga Plc	Kumasi Ltd
	₦'million	GH¢ million
Revenue	3,784	9,892
Cost of sales	(2,480)	(7,084)
Gross profit	1,304	2,808
Other operating income	314	--
Operating expenses	(700)	(3,776)
Profit/(loss) before taxation	918	(968)
Income tax expense	(180)	-
Profit or (loss) for the year	738	(968)
Other comprehensive income or (loss)		(1,132)
Total comprehensive income or (loss)	738	(2,100)

Draft statement of financial position as at September 30, 2023

	Buga Plc ₦'million	Kumasi Ltd. GH¢million
Non-current assets:		
Property, plant and equipment (PPE)	2,546	4,890
Financial assets–Investment in Kumasi Ltd	1,296	-
Amount owed by Kumasi Ltd	728	
Total non current assets	4,570	4,890
Net current assets	616	2,020
Total assets	5,186	6,910
Equity and liabilities		
Equity:		
Share capital	3,000	1,000
Retained earnings Oct 1, 2022	1,056	4,810
Profit or (loss) for the year	738	(968)
Pension reserves		(1,132)
Total equity	4,794	3,710
Non-current liabilities:		
Deferred tax	392	-
Loan notes owed to Buga Plc	-	3,200
Total equity and liabilities	**5,186**	**6,910**

Additional information:

(i) Buga Plc paid GH¢ 7,000 million for its investment in Kumasi Ltd. As Kumasi Ltd is not a listed company, Buga Plc intends to use the proportion of net assets method to value the non-controlling interest.

(ii) Kumasi Ltd. prepares its financial statements using Ghana GAAP. Although there are similarities between Ghana GAAP and IFRS, there are differences in pension accounting and deferred tax, which is not recognised under Ghana GAAP.

(iii) In the year ended September 30, 2020, Buga Plc bought wheat from Kumasi Ltd for GH¢ 5,880 million. Buga Plc paid for the wheat on delivery and there was no debt owing to Kumasi Ltd at the year-end. At September 30, 2023, Buga Plc inventories include ₦360 million of wheat bought from Kumasi Ltd and Kumasi charges mark-up of 30% on cost of sales.

(iv) Buga PLC's other operating income comprise a management charge to Kumasi Ltd of GH¢ 1,506 million for management support given to Kumasi Ltd. This charge was paid by Kumasi Ltd on September 30, 2023 and is included in Kumasi Ltd's operating expenses. In future years, there will be no management charges as it is expected that Kumasi Ltd will not require Buga Plc management support.

(v) Kumasi Ltd has a GH¢ 2,000 million taxable trading loss arising in the year ended September 30, 2023. Ghana tax laws allow tax trading losses to be carried forward only against future taxable trading profit. Kumasi Ltd. is expected to make a taxable trading profit next year. Kumasi Ltd's accountant has suggested that the Ghana tax authorities could investigate the GH¢ 1,506 million

management charge billed by Buga Plc to Kumasi Ltd and challenge the recovery of Kumasi's tax loss. The tax rate for Buga Plc and Kumasi Ltd is 20%.

(vi) In October 2022, Kumasi Ltd set up a defined contribution scheme for its directors and has accrued a contribution of GH¢ 1,132 million for the year ended September 30, 2023. This contribution was paid to the pension fund on October 15, 2023. Under Ghana GAAP, pension contributions are recognised directly in reserves through other comprehensive income. Tax relief for pension contributions is claimed in the accounting year in which the cash is paid to the pension company.

(vii) On April 1, 2023 Buga Plc made an additional investment in Kumasi Ltd when it provided a loan of GH¢ 3,200 million to Kumasi Ltd with interest payable at 5.25% per annum in arrears. Buga Plc does not require repayment of this loan in the near future. No adjustments have been made for this loan, other than to include it in Buga Plc's non-current assets at the rate of exchange at April 1, 2023. Kumasi Ltd has recognised the loan in non-current liabilities. No entries have been made in either company in respect of interest on the loan; interest is taxed on an accrual basis.

(viii) At October 1, 2022, there were no differences between the fair value of Kumasi Ltd's net assets and carrying amounts, except for the valuation of land owned by Kumasi Ltd. PPE included land at cost of GH¢ 3,120 million which had a fair value, at October 1, 2022, of GH¢ 4,640 million. The directors do not intend to sell the land. Ghana GAAP does not allow revaluations.

(ix) The following tax rules apply to property plant and equipment (PPE) in Ghana:
- No tax is charged on disposal of PPE
- Depreciation is an allowable expense for tax purposes.
-

(x) Other information:
₦1/GH¢ exchange rates were as follows:

October 1, 2022	₦1 = GH¢ 5.4
April 1, 2023	₦1 = GH¢ 4.4
September 30, 2023	₦1 = GH¢ 4.2
Average for the year to September 30, 2023	₦1 = GH¢ 4.8

Required:

a. Prepare Buga Plc's consolidated statement of profit or loss and other comprehensive income for the year ended September 30, 2023. (20 Marks)

b. Calculate Buga Plc's consolidated goodwill and consolidated foreign exchange reserves at September 30, 2023. (6 Marks)

NB: show all workings.

c. As the finance director of Buga Plc, you have just been informed by your Accounts Manager at AI-Technologies to whom the company outsourced the operations of Buga Plc's websites and payable ledger functions, that AI-Technologies experienced a significant cyber-attack few days ago which successfully breached the security system. Although you were assured that the situation has been resolved, however, you are not clear what potential consequences this might have on your company and you hope that the Chief Accountant, a newly qualified Chartered Accountant with good knowledge of information technology would be able to advice your company on this.

Although it was AI-Technologies' system that was attacked, can there be any direct consequences for the company? If so, what measures could be taken to eliminate it?

You are required:

As the chief accountant of AI-Technologies, you are to advise the finance director of Buga Plc. (4 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 following is the financial information extracts of Arocome Nig. Limited.

Statement of profit or loss for the year ended June 30,

	2023	2022
	₦'000	₦'000
Revenue	24,000	14,800
Cost of sales	(16,332)	(10,360)
Gross profit	7,668	4,440
Admin expenses	(3,480)	(1,652)
Distribution costs	(1,856)	(1,424)
Finance costs	(172)	(136)
Profit before tax	2,160	1,228
Income tax expense	(540)	(320)
Profit for the year	1,620	908

Statement of financial position as at June 30

	2023	2022
	₦'000	₦'000
Non-current assets:		
Property, plant and equipment	1,520	1,600
Intangible assets (development costs)	80	40
	1,600	1,640
Current assets:		
Inventories	5,040	4,720
Receivables	1,820	1,240
Cash and cash equivalents	-	168
Total assets	8,460	7,768
Equity and liabilities:		
Equity:		
Share capital of ₦1 per share	2,200	2,200
Retained earnings	2,888	2,440
Total equity	5,088	4,640
Non-current liabilities:		
Loan notes	1,648	1,616
Current liabilities:		
Payables	1,452	1,512
Bank overdraft	272	-
	1,724	1,512
Total equity and liabilities	8,460	7,768

The revenue and profits of Arocome Nig. Ltd's three business segments for the year ended June 30, 2023 were:

	Retail operations	Online stores	SOCH contract
	₦'000	₦'000	₦'000
Revenue	16,016	4,384	3,600
Gross profit	4,800	1,320	1,548
Profit before tax	1,280	552	328

Background information:

(i) Arocome Nig. Ltd has been trading for more than 10 years, producing and selling children toys to the public (in its 15 retails shops) and other retailing customers.

(ii) Arocome Nig. Ltd. revenue and profit have been very stable over the last 10 years. However, about one and half years ago, a newly appointed sales director saw an opportunity to sell the products on-line.

(iii) The company, using long-term funding, sets up an on-line shop. The on-line shop has been operating very well for the last 14 months. The sales director also used his personal connections to secure a lucrative deals with Save Our Children Home (SOCH) across the country to supply customised children toys. The contract was signed on January 1, 2023.

(iv) The managing director of Arocome Nig. Ltd is of the opinion that more markets can still be explored with the on-line market and contract with SOCH. However, their bankers are not willing to grant further long-term loans and overdrafts because the company has insufficient assets to offer as security. (The existing funding is secured on Arocome Nig Ltd's property, plant and equipment).

(v) The managing director of Arocome Nig. Ltd has therefore approached a wealthy personal investor, Alhaji Kayari (the Chairman of Jolymarg Investment Co. Ltd), for financial assistance for Arocome Nig. Ltd.

(vi) The business outlook for retail operation for next year is as follows:
   (a) Due to improved patronage, credit sales which is made up of 70% of current sales is expected to increase by 20% and the remaining cash sales by 10%.
   (b) All related cost of sales are expected to increase by 12%.
   (c) Related bad debts written off is expected to be 10% of the credit sales.

As the Accountant/Chief Investment analyst of Jolymarg Investment Co. Ltd.

You are required to:

a. Prepare a report analysing the financial performance of Arocome Nig. Ltd and its financial position for the year ended June 30, 2023. (12 Marks)

b. Advise Alhaji Kayari, the chairman of your company, whether your company should consider this investment. (4 Marks)

c. Forecast year 2024 profit for the retail operations using the business outlook. (4 Marks)

(Total 20 Marks)

QUESTION 3

a. Indomitable Plc is reviewing the fair valuation of certain assets and liabilities in line with IFRS 13-Fair Value Measurement.
It carries an asset that is traded in different markets and is uncertain as to which valuation to adopt. The asset has been measured at fair value under International Financial Reporting Standards. At present, Indomitable Plc only buys and sells the asset in market C. The data relating to the asset are set out below for year to June 30, 2020:

	Market A	Market B	Market C
Volume of market- units	20 million	10 million	5 million
Price	₦95	₦80	₦110
Costs of entering the market	₦10	₦10	₦15
Transaction costs	₦5	₦10	₦10

In addition, Indomitable Plc had acquired an entity on June 30, 2020 and it is required to fair value a decommissioning liability. The entity has to decommission a mine at the end of its useful life, which is in three years' time.

Indomitable Plc has determined that it will use a valuation technique to measure the fair value of the liability. If Indomitable Plc were allowed to transfer the liability to another market participant, then the following data would be used.

Input	**Amount**
Labour and material cost	₦10 million
Overhead	30% of labour and material cost
Third party mark-up (in the industry)	20%
Annual inflation rate	5%
Risk adjustments – uncertainty relating to cash flows	6%
Risk – free rate of government bonds	7%
Entity's non- performance risk	3%

Indomitable Plc needs advice on how to fair value the liability.

Required:
Discuss, with relevant computations, how Indomitable Plc should fair value the above assets and liabilities under IFRS 13-Fair Value Measurement. (12 Marks)

b. On July 1, 2011, Indomitable Plc established a school at a cost of ₦10 million. The estimated useful life of the school was 25 years. On June 30, 2019, the school was closed because of the decline in number of students as a result of population shift. The school is to be converted for use as a library and there is no expectation that the number of students using the school will increase in the future and thus the building will not be reopened for use as a school. The current replacement cost for a library of the same size as the school is ₦4.2 million. The value-in-use and net selling price are unrealistic estimates of the value of the school because of the nature of the non-current assets. The change in use would have no effect on the estimated life of the building.

Required:
Discuss how the above events should be accounted for in the financial statements of Indomitable Plc. (8 Marks)

(Total 20 Marks)

QUESTION 4

a. IAS 26 – Retirement Benefit Plans complement IAS 19-Employee Benefits which is concerned with the determination of the cost of retirement benefits in the financial statement of employers. Also, IAS 26 applies to the report of retirement benefit plans whether they are defined contribution plans or defined benefit plans.

Required:
Differentiate between defined contribution plans and defined benefit plans. (4 Marks)

b. The finance director of Melomelo Holdings Nig. Plc, one of your audit clients, has recently written to you for advice on pension scheme accounting.

The company Melomelo Holdings Nigeria Plc's defined benefit pension scheme has a net assets valued at ₦101 million. The scheme's assets of ₦97 million at the beginning of the year were expected to be enhanced by a cash contribution to the scheme of ₦2 million which is greater than payment to pensioners. An appropriate discount rate of 10% has been identified.

Based on the above information the finance director has prepared the following reconciliation.

Assets as at December 31, 2022

	₦'m
Opening scheme net asset	97
Add:	
Interest on asset at 10%	9.7
	106.7
Net contribution received	2.0
	108.7
Closing scheme net assets	(101
Actuarial deficit	7.7

The actuarial deficit of ₦7.7 million has come as a surprise to the finance director. He is therefore unsure how to treat this deficit in the financial statement and he is concerned about the impact it will have on the company's profit for the year.

Required:

i. Explain the impact of the actuarial valuation of the scheme's assets and the resultant deficit on the financial statements of Melomelo Holding Nig. Plc for the year ended December 31, 2022. (4 Marks)

ii. Identify **TWO** benefits to Melomelo Holdings Nig. Plc of moving from defined benefit scheme to a defined contribution scheme. (2 Marks)

c. Akata Nig. Limited operates a defined benefit pension scheme. Employees are not required to make any contribution into the scheme. Akata Nig. Ltd recognises remeasurement (actuarial) gain and losses immediately through other comprehensive income in accordance with IAS 19-Employee Benefits.

The scheme assets had a fair value of ₦122 million and ₦135 million at May 31, 2021 and May 31, 2022 respectively. The scheme obligations had a present value of ₦180 million and ₦198 million at May 31, 2021 and May 31, 2022 respectively.

At June 1, 2021 the interest rate on high quality corporate bonds was 6%.
In the year ended May 31, 2022, employer's contribution paid to the scheme was ₦9 million and pension paid by the scheme during the year amounted to ₦11 million. These payments took place on May 31, 2022. The service costs for the year ended May 31, 2022 was ₦12 million.

Akata Nig. Ltd. decided to improve the pension benefit at June 1, 2021 for staff who would have worked at least five (5) years for the company at the date the benefit is claimed. The scheme actuarist calculated the additional benefit obligation in present value term to be ₦4 million.

The only entry in the financial statements in respect of the year ended May 31, 2022 was to recognise in profit or loss, the contribution paid to the scheme by Akata Nig. Ltd. with no adjustments to the scheme obligations in the statement of financial position.

Required:
Advice Akata Nig. Ltd, with explanations and relevant calculations, on the appropriate financial reporting treatments of the outstanding matters.

(10 Marks)

(Total 20 Marks)

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

QUESTION 5

a. Zam Ltd is a private table water producing company that meets the definition of an SME under the Companies and Allied Matters Act 2020 (as amended). The Company wishes to comply with the IFRS for small and medium-sized entities for the year ended December 31, 2022 and for the comparative year ended December 31, 2021.

Mr. Ajanlekoko, the managing director of the company is seeking your firm's advice on how the company should address the following accounting issues. He informed you that the company currently prepares its financial statements under full IFRS.

i. Zam Ltd has significant amounts of capitalised development expenditure of ₦16 million at December 31, 2021 (₦14 million at December 31, 2020) in its financial statements which relate to investigation of a table water products. The amount has continued to rise during the current year (December 31, 2022) even after the amortisation commenced. (3 Marks)

ii. On July 1, 2022 Zam Ltd purchased a controlling interest of 60% in equity shares of Aqua Plc, a company in a similar line of business. Zam Ltd paid ₦38.5 million to acquire the investment in Aqua Plc. The fair value of Aqua Plc identifiable assets and liabilities has been calculated as ₦47.5 million at the date of acquisition. The value on the stock market of the non-controlling interest that Zam Ltd did not purchase was ₦24.5 million. The directors of Zam Ltd is not in position to estimate reliably the useful life of the goodwill due to the nature of the business acquired. (6 Marks)

iii. Zam Ltd purchased some properties for ₦8.5 million on January 1, 2022 and designated them as investment properties under cost model. No depreciation was charged as a real estate agent valued the properties at ₦9.5 million at year end. (3 Marks)

Required:
Discuss how the above transactions (i) to (iii) should be dealt with in the financial statements of Zam Ltd for year ended December 31, 2022, in accordance with IFRS for SME(s).

b. You are the head of the team that is assisting Zam Ltd to comply with provisions of IFRS for SME(s). Your assistant team leader, Mr. Adams, has confided in you that in the course of carrying out your assignment he met the daughter of Mr. Ajanlekoko, the managing director of Zam Ltd and he is keen to invite her on a date at the staff canteen before the end of the assignment for personal and corporate gains.

Required:
Discuss the ethical and other professional issues that this might have on the assignment and the firm. (3 Marks)

(Total 15 Marks)

QUESTION 6

Exposure to variety of risks may affect the ability to achieve corporate objectives; thereby making risk management a corporate governance issue. Risk reports enables stakeholders to evaluate the importance attached to risk management and the company's effectiveness in managing identified risks. Therefore, risk reports boost shareholders' confidence that the company has adopted a responsible attitude towards risk.

As part of regulatory framework to manage risk, the Security and Exchange Commission (SEC) provided a number of guidelines for rules and content of effective risk reports.

Required:

a. Analyse the regulatory provisions by SEC in Nigeria (5 Marks)
b. Analyse the components of effective risk reports (10 Marks)

(Total 15 Marks)

QUESTION 7

Sesede Limited is a company incorporated in Nigeria. The company will adopt International Financial Reporting Standards (IFRS) for the first time in the preparation of its financial statements for year ended December 31, 2022.

The directors of the company (Sesede Ltd) are unclear as to the impact of IFRS 1- First Time Adoption of International Reporting Standards.

Required:

Advise the directors of Sesede Ltd on the following:

a. The procedure for preparing IFRS financial statements for the first time as required by IFRS 1. (5 Marks)

b. The practical steps that companies should take in order to ensure an efficient transfer to accounting under IFRS. (5 Marks)

c. In the previous financial statements of the company for December 31, 2020 and December 31, 2021, which were prepared under the old NGAAP, you made a number of routine accounting estimates, including accrued expenses and provisions; and did not recognise a provision for a court case arising from events that occurred in September 2021 even when the case was concluded on June 30, 2022.

   Sesede Ltd. was required to pay ₦20 million and this was paid on July 10, 2022, after the 2021 financial statements were authorised for issue. In the opinion of the director, the company's estimate of accrued expenses and provision under the old NGAAP were made on a basis consistent with IFRS.

Required:

Discuss how the matter above should be dealt with in the financial statements of Sesede Ltd for the year ended December 31, 2022. (5 Marks)

(Total 15 Marks)

SOLUTION 1

a. **Buga group consolidated statement of profit or loss for the year September 30, 2023**

	₦'m	₦'m
Revenue		4,619.83
Cost of sales		(2,813.91)
Gross profit		1,805.92
Operating exp. and finance cost (682.50+1040-314)		(1,408.50)
Profit before tax		397.42
Taxation (-180-67.92+16.61)		(95.64)
Profit for the year		301.78

Other comprehensive income:		
Exchange gain		427.28
Total comprehensive income		729.06
Profit attributable to:	395.85	
Owners of parent company	(94.07)	
NCI	301.78	301.78
Total comprehensive income attributable to:		
Owners of parent company		756.62
NCL (94.07 – 66.51)		27.56
		729.06

b. i. **Consolidated Goodwill**

	GH¢m	₦'m
Consideration transferred	7,000	
Non-controlling interest:		
(GH¢ 7,330 x 20%)	1,466	
	8,466	
Fair value of net asset acquired	7,330	
Goodwill	1,136 at 5.4 (opening rate)	210.37
Exchange gain		60.11
	1,136 at 4.2 (closing rate)	270.48

ii. **Consolidated foreign exchange reserve**

	₦'m
Exchange gain on goodwill (b1)	60.11
Exchange gain on net investment in foreign exchange operations (w3)	34.64
Exchange gain on translation of subsidiary (w6)	332.53
	427.28
NCI share of the gain (w6)	(66.51)
	360.77

WORKINGS:

W(1) Translation of statement of profit or loss at average rate and statement of financial position at closing rate

	GH¢'m	Average Rate	₦'m
Revenue	9,892	4.8	2,060.83
Cost of sales	(7,084)	4.8	(1,475.83)
Gross profit	2,808	4.8	585
Operating exp. And finance costs	(3,776)		
Less: Pension & D/Tax	(1,132)Dr		
Interest	(84)		
	(4,992)	4.8	(1,040)
Profit before tax			(455)
Tax (₦1,626 x 20%)	326	4.8	67.92
Profit for the year	(1,858)		(387.10)
Other comprehensive (loss)	(1,132)		
Pension & D/T	1,132 Cr		--
	Nil		
Total comprehensive income	(1,858)		(387.10)

(W2) Inter group sales and unrealised profit

(i) GH¢ 5,880m/4.8 =₦1,225m

Dr Revenue ₦1,225million

Cr Cost of sales ₦1,225 million

(ii) **Unrealised profit (URP)**

(₦360 million x 30%)/1.30 = ₦83.08 million

Or

₦360 x $^{30}/_{130}$ = ₦83,08 million

(W3) Loan to Kumasi Ltd by Buga Plc net investment in foreign operations

Loan owed to Buga Plc:

	₦'m
GH¢ 3,200m/4.4 (April 1, 2023)	727.27
GH¢ 3,200m @ 4.2 (Sept 30, 2023)	761.91
Exchange gain	34.64

Dr Amount owed by Kumasi 34.64

Cr Profit or loss account (exchange gain) 34.64

(W4) Interest on loan from Buga Plc to Kumasi Ltd

5.25% x GH¢ 3,200 x 6/12 = 84/4.8 = ₦17.5

(W5) Carrying amount of inventory in the consolidated financial statement

		₦'m
₦360m less ₦83.08million		276.92
Tax base		360.00
Temporary difference		83.08
Deferred tax at 20% = [20% x 83.08]		16.61
Accounting treatment	Dr	Cr
	₦'m	₦'m
Dr Cost of sales	83.08	
Cr Inventory		83.08
Dr Deferred tax assets	16.61	
Cr Tax charged (P or L)		16.61

(W6) Exchange difference on retranslating of subsidiary

	₦'m
Opening net assets at Oct 1, 2022 = 7330/5.4	1,357.41
Closing net assets at sept 30,2023= 7,330/4.2	1,745.24
Exchange loss	387.83
Retained loss for the year (1,858) at AV rate [4.8]	(387.08)
Retained loss for the year (1,858) at closing rate 4.2	(442.38)
Exchange loss	(55.30)
Overall gain (387.83 – 55.30)	332.53
Share of NCI in Exchange gain (20%) X 332.53	66.51

(W7) Net assets of Kumasi Ltd at acquisition

	GH¢(m)
Share capital	1,000
Pre-acquisition profit (Oct 1, 2022)	4,810
Fair value Adj. on land (W8)	1,520
	7,330

(W8) Fair value adjustment on land

	GH¢m
Fair value of land (Oct 1, 2022)	4,640
Carrying amount of land	(3,120)
Fair value adjustment on land (w7)	1,520

(W9) Consolidation schedule

	Buga Plc	Kumasi Ltd	Total before consolidation	Adj.		₦'m Consolidated
	₦'m	₦'m	₦'m	Dr	Cr	
Revenue	3,784	2,060.83	5,844.83	1,225 (w2)		4,619.83
Cost of sales	(2,480)	(1,475.83)	(3,955.83)	1,225 (w2ii)	(83.08)	(2,813.91)
Gross profit	1,304	585	1,889		(83.08)	1,805.92
Operating income	314	--	314	(314)		--
Operating exp. and finance cost [700 – 17.5(w4)]	(682.50)	(1,040)	(1,722.5)	314	(83.08)	(1,408.5)
Profit before tax	935.50	(455)	480.5			397.42
Taxation	(180)	67.75	112.08		16.61(w5)	(95.64)
Profit for the year (738 + 17.5)	755.50	(387.25)				301.78
Other comprehensive income:						
Exchange gain						427.28
Total comprehensive income						729.06

(W10) Computation of tax in subsidiaries

	GH¢m
Taxable trading loss	2,000
Management fees disallowed	(1,506)
	494
Pension funds contribution	1,132
	1,626
Tax relief = ₦1,626m x 20%	₦325m

c. **Advise to finance director of Buga Plc on cyber attack of support technology firm (IA-Technology)**

Consequences

i. The consequences depend on the nature and extent of the breach;
ii. It is possible that the hacker may have access to data relating to Buga Plc's customers and suppliers which could be used fraudulently;
iii. It would be advisable to obtain more information about this and assess the need to contact and alert customers and/or suppliers where relevant so that they can take action if necessary;
iv. Buga Plc could suffer reputational damage. For example, customers may be reluctant to use the company's website to make purchases, If they have concern over security of their personal information;
v. There is a possibility that the portal between AI-Technologies and Buga Plc has allowed hackers to access Buga Plc's own system. This should be investigated as a matter of urgency.

Actions to be taken

i. Buga Plc should implement a formal system for managing cyber-security risk within the supply chain.
ii. Buga Plc should define who is responsible for supply chain cyber-security within the organisation e.g. IT department or the operations dept.
iii. Assurance should be obtained from supplies while reviewing tenders for new contracts (possibly through the use of questionnaire) but assurance should also be requested throughout the period of the contract.
iv. Transparency regarding issues or breaches should be encouraged. It appears IA-Technologies has complied with this as they have notified Buga Plc of the breach.

Examiner's report

The question is in three parts, part (a) tests candidates' knowledge of how to prepare group consolidated statement of profit or loss and other comprehensive income for foreign operations and the preparation of adjustments thereon to comply with IFRS requirements. Part (b) tests candidates' knowledge of how to prepare a group consolidated goodwill and consolidated foreign exchange reserves while, part (c) tests candidates' knowledge of the consequences and measures to be taken by an organisation in the event of cyber-attack of support technology firm.

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

The common pitfalls of the candidates were their inability to know the appropriate exchange rate to translate the statement of profit or loss of a foreign subsidiary; the inability to prepare correctly the consolidated schedule, consolidated goodwill and consolidated foreign exchange reserve.

Candidates are advised to pay more attention to the principles of preparing consolidated statement of profit or loss with various adjustments in accordance with IFRS and the appropriate exchange rates to use for translation by practicing more questions and making use of ICAN Study Texts for better performance in future examinations.

Marking guide		**Marks**	**Marks**
(a)	Preparation of group consolidated statement of profit or loss	4¼	
	Translation of statement of profit or loss at average rate	2¾	
	Intergroup sales and unrealised profit	1½	
	Loan and interest on loan	2½	
	Preparation of consolidated schedule	2¼	
	Calculation of carrying amount of inventory	2½	
	Exchange difference on retranslating of the subsidiary	2½	
	Calculation of net asset of the subsidiary	1	
	Fair value adjustment on land	¾	20
(b) i.	Calculation of group consolidated goodwill	3	
ii.	Calculation of group consolidated foreign exchange reserves	3	6
(c)	Advise to finance director on cyber-attack of support technology firm (IS Technology), consequences and actions to be taken		4
	Total		**30**

SOLUTION 2

a. **INTERNAL MEMO**

To: Alhaji Kayari, Chairman of Jolymarg Investment Co. Ltd.

From: Chief Investment Analyst

Subject: Financial analysis of Arocome Nig. Ltd. and Investment advice

Introduction
Arocome Nig. Ltd., a company specialising in children's toys, has experienced significant changes in its operations, including diversification into online sales and securing a lucrative contract with Save Our Children Home (SOCH). This report evaluates the financial performance and position for the year ended June 30, 2023, with a focus on key profitability, liquidity, and efficiency metrics as supported by the attached appendices. The aim is to advise on the viability of investing in the company.

Financial Performance
The revenue of Arocome Nig. Ltd. grew by 62.2%, from ₦14.8 million in 2022 to ₦24.0 million in 2023, driven by retail operations, online sales, and the new SOCH contract. This new contract and the online shop generated 15% of the total revenue for the year ended June 30, 2023 despite the fact that the new contract was only in place for about six (6) months.

This diversification has enhanced the company's growth prospects, with the retail segment contributing the largest share of revenue (67%). However, the cost of sales increased correspondingly by 57.6% (i.e. 5972/10360), reflecting the operational strain of expansion, particularly in inventory management and production costs.

An analysis of the margins of the three segments of the business reveals that the improvement is largely due to the strong margin of 43% on the new SOCH contract. Gross profit margin improved marginally from 30.0% to 31.95%, highlighting better cost control despite the rising cost of sales. However, the increase in administrative expenses to 14.5% of revenue (from 11.16%) constrained profitability. This surge is likely tied to investments and expansion in the online platform and resources allocated to service the SOCH contract. Similarly, distribution costs decreased as a proportion of revenue (from 9.62% to 7.73%), indicating improved efficiency in delivery processes.

Net profit margin has also improved from 8.3% to 9% despite the increase in finance cost due to reliance on an overdraft in the current year and an increase in loan notes.

This is largely due to the on-line shop generating a margin of 12.6%. Also the overheads associated with running the online business are likely to be lower than

those associated with the retail shops. The financial performance of Arocome Nig. Ltd can be further analysed as follows:

- Also set up cost incurred on the online part of the business would have been recognised during the year and written off in profit or loss for the year ended June 30, 2022 causing the year's net profit margin to be low.
- The net profit margin of the SOCH contract, part of the business is 9.1% in the year ended June 30, 2023. This contract is relatively new and the initial legal and other costs will be included in this segments cost. The margin may be expected to improve in future if the contract is renewed regularly.
- The online business and contract with SOCH have successfully initiated terms of growing the revenue and increasing both gross and net profit margins.
- Arocome Nig. Ltd. would need to improve control of its overhead cost as it has increased by 111% in the year. The initial cost of the contract with SOCH might have been responsible for this, hence we may need more information in this area.
- Distribution costs have also increased by 30%. This is proportionately lower than the increase in revenue. This may be because the online customers are required to pay for their own postages and packaging, therefore the increase in revenue associated with this part of the business does not result in a corresponding increase in distribution costs.

Efficiency

Asset turnover

Arocome Nig. Ltd's efficiency in using assets to generate both revenue and profit has improved as illustrated by asset turnover increasing from 1.91 to 2.84. Return on capital employed (ROCE) increased significantly from 21.80% to 34.62%, driven by improved profits and effective utilisation of capital. This indicates a strong ability to generate returns from shareholders and debt investments.

Financial position

Arocome Nig. Ltd's financial position reveals strong liquidity but limited flexibility for further debt financing despite a slight declined from 4.05:1 to 3.98:1 largely due to reliance on an overdraft in the year and the reduced receivables and inventory turnover days. The current ratio remained robust at 3.98:1, showing the company's ability to meet short-term obligations. However, this liquidity is heavily reliant on inventory, which represents a significant portion of current assets. This reliance poses a potential risk if inventory becomes unsalable. The inventory holding period improved markedly from 166 days to 113 days, reflecting faster turnover, likely due to increased sales from the online segment and SOCH contractt or may be due to release of some cash since the overdraft has not been extended.

The receivables collection period improved slightly to 28 days (based on credit

sales), down from 31 days. This indicates better efficiency in collecting outstanding debts, but the expected high reliance on credit sales in retail operations in future (70% of sales) exposes the company to potential bad debts.

Payable payment period fell sharply from 53 days to 32 days, suggesting tighter payment schedules with suppliers. While this reduces supplier-related liabilities, it also puts pressure on cash flow, particularly in light of the company's reliance on a bank overdraft.

Gearing slightly reduced from 25.82% to 24.47%. While this reflects a modest reduction in financial risk, the company's inability to secure further loans due to insufficient collateral is a concern for future expansion.

Solvency

- Though the bank is refusing further funding to Arocome Nig. Ltd., Arocome's gearing despite a small increase in the year, remains at manageable level (38% in the current year).

  Furthermore, Arocome Nig. Ltd can easily afford to pay the interest on its debts as illustrated by interest cover of 13.6 in the current year.

  Segment analysis
  The company's three segments: retail operations, online stores, and the SOCH contract show varied levels of performance and contribution as follows:

i **Retail operations:**
This segment remains the backbone of the business, contributing 67% of total revenue and 59.2% of profit before tax (PBT). However, its future reliance on credit sales poses a significant risk of bad debts, which could erode profitability if not managed effectively.

ii **Online stores:**
The online platform contributed 18.3% of revenue and 25.6% of PBT, demonstrating its potential as a growth driver. The initial investment in this platform appears to be yielding results, positioning it as a key area for future expansion.

iii **SOCH contract:**
Accounting for 15% of revenue and 15.2% of PBT, the SOCH contract is a promising addition. The ability to maintain quality and timely delivery will be crucial for sustaining this lucrative partnership.

Conclusion
Arocome Nig. Ltd. is a company with a strong growth potential, particularly in its online stores and SOCH contract. However, its decision to rely on retail credit sales, rising costs, and limited borrowing capacity poses significant risks.

Please do not hesitate to contract me sir, if you need further classifications on any of the above.

Thank you.

Accountant/Chief investment analyst

b. **Advice to Alh. Kayari chairman of jolymarg investment company on the Investment**

i. On initial analysis, there seems to be a strong case for investing in Arocome Nig. Ltd. This business is growing as a result of innovative ideas initiated by the expertise of the new sales director having just expanded into two new areas, the online business and the new contract with SOCH. The company is also profitable and its profitability is increasing year on year.

ii. However one major concern is reliance on overdraft, but this can be resolved by improving working capital management and ensuring that the full credit period of supplies is taken advantage of. However with further initiative from the sales director such a new contracts and further growth of the online sales, there is potential for even more growth in future.

iii. Mr. Chairman, we need to ascertain the dividend policy of Arocome Nig. Ltd. to be sure that they are not paying themselves high dividends which necessitates reliance on overdraft because no matter how profitable a company is, payment of excessive dividends may affect it adversely. This point needs clarification as to whether or not this is so.

Recommendations:
Jolymarg Investment Co. Ltd. should consider investing, provided the following conditions are met:

i A robust credit policy is implemented to mitigate the risk of bad debts.
ii Administrative costs are controlled to further improve profitability margins.
iii Future expansion should focus on the online store and SOCH contract, leveraging their growth potential.
iv Jolymarg Investment Co. Ltd should provide funding in the form of equity rather than loans, to Jolymarg Investment participate in future after tax profit of the company.

With these measures, Arocome Nig. Ltd. can leverage its current growth trajectory to achieve long-term financial stability and profitability.

Appendix

Financial ratios calculation for Arocome Nig. Ltd.

Ratio	Formula	2023	2022
Gross profit margin:	$\frac{\text{Gross profit}}{\text{Revenue}} \times \frac{100\%}{1}$	$\frac{7,668}{24,000} \times \frac{100\%}{1}$ = 31.95%	$\frac{4,440}{14,800} \times \frac{100\%}{1}$ = 30%
Gross profit margin – retail operations	$\frac{\text{Gross Profit}}{\text{Revenue}}$	30%	--
Gross profit margin-online	$\frac{\text{Gross Profit}}{\text{Revenue}}$	30.1%	--
Gross profit margin – SOCH contract	$\frac{\text{Gross profit}}{\text{Revenue}}$	43%	
Net profit margin:	$\frac{\text{Profit for the year}}{\text{Revenue}} \times \frac{100\%}{1}$	$\frac{1,620}{24,000} \times \frac{100\%}{1}$ = 6.75%	$\frac{908}{14,800} \times \frac{100\%}{1}$ = 6.14%
Net profit margin – Retail operations	$\frac{\text{PBT}}{\text{Revenue}}$	8.0%	--
Net profit margin – Online	$\frac{\text{PBT}}{\text{Revenue}}$	12.6%	--
Net profit margin – SOCH contract	$\frac{\text{PBT}}{\text{Revenue}}$	9.1%	--
Operating profit margin	$\frac{\text{PBT+ Finance cost}}{\text{Revenue}} \times \frac{100\%}{1}$	$\frac{2,160+172}{24,000} \times \frac{100\%}{1}$ =9.72%	$\frac{1,228+136}{14,800} \times \frac{100\%}{1}$ =9.23%
Return on capital employed (ROCE)	$\frac{\text{Profit before interest and Tax}}{\text{Debt + Equity}} \times \frac{100\%}{1}$	$\frac{2,160+172}{5088+1,648} \times \frac{100\%}{1}$ = 34.62%	$\frac{1,228+136}{4640+1616} \times \frac{100\%}{1}$ =21.80%
Admin expense ratio	$\frac{\text{Admin expenses}}{\text{Revenue}} \times \frac{100\%}{1}$	$\frac{3,480}{24,000} \times \frac{100\%}{1}$ =14.5%	$\frac{1,652}{14,800} \times \frac{100\%}{1}$ =11.16%
Distribution expense ratio	$\frac{\text{Distribution Costs}}{\text{Revenue}} \times \frac{100\%}{1}$	$\frac{1,856}{124,000} \times \frac{100\%}{1}$ =7.73%	$\frac{1,424}{14,800} \times \frac{100\%}{1}$ =9.62%

Asset turnover	$\frac{\text{Revenue}}{\text{Total assets}}$	$\frac{24000}{8460}$ = 2.84 times	$\frac{14800}{7768}$ =1.91 times
Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	$\frac{6,860}{1,724}$ 3.98:1	$\frac{6128}{1,512}$ = 4.05
Receivable collection period	$\frac{\text{Trade Receivable}}{\text{Credit sales}} \times \frac{365 \text{ days}}{1}$	$\frac{1,820}{24,000} \times \frac{365 \text{ days}}{1}$ =28 days	$\frac{1,240}{14,800} \times \frac{365 \text{ days}}{1}$ = 31days
Payable payment period	$\frac{\text{Trade Payables}}{\text{Cost of sales}} \times \frac{365 \text{ days}}{1}$	$\frac{1,452}{16,332} \times \frac{365 \text{ days}}{1}$ =32 days	$\frac{1,512}{10,360} \times \frac{365 \text{ days}}{1}$ = 53 days
Inventory holding period	$\frac{\text{Inventory}}{\text{Cost of sales}} \times \frac{365 \text{ days}}{1}$	$\frac{5,040}{16,332} \times \frac{365 \text{ days}}{1}$ = 113 days	$\frac{4,720}{10,360} \times \frac{365 \text{ days}}{1}$ =166days
Gearing ratio	$\frac{\text{Fixed interest capital + overdraft}}{\text{Equity}}$	$\frac{1920}{5088} \times \frac{100\%}{1}$ =37.74%	$\frac{1,616}{4,640} \times \frac{100\%}{1}$ = 34.83%

c. **Forecast for 2024 Profit for retail operations using business outlook**

Assumptions:

i Credit sales (70% of retail sales) will grow by 20%, while cash sales (30%) will increase by 10%.

ii Cost of sales will rise by 12%.

iii Bad debts will equal be 10% of credit sales.

Projections

i. **Revenue projection**:

- Credit sales = ₦16,016×70%×1.2=₦ 13,453.44
- Cash sales = ₦ 16,016×30%×1.1= ₦5,285.28
- Total revenue: ₦ 13,453.44 + ₦ 5,285.28 = ₦18,738.72 2.

ii. **Cost of sales projection**

Existing cost of sales = existing revenue– gross profit

₦16,016 – ₦ 4,800 = ₦11,216

Projected cost of sales: ₦ 11,216×1.12= ₦ 12,561.92

iii. **Bad debts projection**

₦13,453.44×10%= ₦1,345.34

iv. **Gross profit projection**

₦18,738.72– ₦ 12,561.92 = ₦6,176.8

v. **Net profit projection**

- Gross Profit - Bad debts
- ₦6,176.8 – ₦1,345.34 = ₦4,831.46

Conclusion:

The retail segment is projected to make a profit of ₦4,831,460 in 2024 reflecting growth supported by increased sales and controlled cost of sales, without considering related operating expenses. With rising operating costs, the profit may decrease further. Strategic efforts is required to address these other operating costs that are critical to sustaining profitability.

Examiner's report

Part (a) of the question tests candidates' knowledge of report writing to analyse the financial performance and position of a company, while part (b) is on the interpretation for the purpose of granting management investment decisions and part (c) is on profit forecast.

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

The commonest pitfalls of the candidates was their inability to correctly apply the ratios computed for interpretation purpose, while others could not prepare the profit forecast from the ratios computed.

Candidates are advised to ensure that they prepare more on interpretation and application of ratio analysis as well as get familiar with how to interpret the rates for investment decision purposes. They should acquint themselves with this section of the syllabus and practice relevant past questions on ratio analysis and interpretation of financial statements for better performance at this level of the Institute examinations.

Marking guide	**Marks**	**Marks**
Preparation of report analysing the financial performance and financial position:		
Address and subject of the memo	¾	
Introduction	¼	
Report on financial performance	3	
Report on efficiency	2½	
Report on financial position	2½	
Report on solvency	1	
Report on segment analysis	1	
Summary and conclusion	½	
Closure of the memo	½	12

Advise to the chairman on the investment:		
Introduction	½	
Recommendations on the investment		
Closure of the advise	3	
	<u>½</u>	4
Forecast of year 2024 profit for the retail operation:		
Assumptions for the forecast		
Credit sales projection		
Cash sales	½	
Cost of sales projections	½	
Bad debt projections	½	
Gross profit projections	½	
Net profit projections	½	
Conclusion and recommendations	½	
	½	<u>4</u>
	<u>½</u>	<u>**20**</u>
Total		

SOLUTION 3

a. **Fair value of decommissioning liability**

This involves business acquisition, therefore, Indomitable Plc must measure the liability at fair value in accordance with IFRS 13, rather than using the best estimate measurement required by IAS 37-Provisions, contingent liabilities and contingent assets.

Since it is not likely to have an observable market to provide pricing information, Indomitable Plc will use the expected present value technique to measure the fair value of the decommissioning liability.

If Indomitable Plc is committed to transfer its decommissioning liability to a market participant, the company will assume that a market participant would use

Input	**(₦'000)**
Labour and material cost	10,000
Overhead: 30% x 10,000	3,000
Third party mark-up – industry average: 13,000 x 20%	2,600
	15,600
Inflation adjusted (5% compounded over 3 years)	
15,600 x 1.05 x 1.05 x 1.05	**18,059**
Risk adjusted: 18,059 x 6%	1,084
	19,143
Discount rate: risk free + non- performance	**14,382**
(7% + 3% = 10%) 19,143/ 1.1 x 1.1 x1.1	

b. **Impairment of building**

In line with IAS 36, an asset should be carried at no more than its recoverable amount; i.e. the amount to be recovered through use or sale of the asset.

If the value of an asset is greater than its recoverable amount, an impairment loss has occurred. The impairment loss should be written off against profit or loss for the year.

A company must determine at each reporting date whether there is impairment or not. In relation to the above building, impairment is indicated because the use to which the building is to be put has changed from a school to a library and this situation will continue for the foreseeable future.

The recoverable amount is defined as the higher of the asset's fair value less costs to sell and the asset's value-in-use.
The values are not available because of the specialised nature of the asset and the available information are accumulated depreciation and replacement cost. Using a depreciated replacement cost approach, the impairment loss would be

calculated thus:

Assets	Cost/replacement Cost	Accumulated depreciation	Carrying amount
	₦'000	**₦'000**	**₦'000**
School	10,000	(3,200)	6,800
Library	4,200	(1,344)	(2,856)
Impairment loss			3,944

		₦'000
Cost as at 01/07/2011		10
Accumulated depreciation (₦10m/25 X 8)*		(3.2)
Carrying amount 30/06/2019		6.8
Impairment (balancing figure)		(2.6)
Realisable amount (replacement cost)		4.2

Accounting treatment	₦'m	₦'m
Debit profit & loss	2.6	
Credit asset (building)		2.6
Being impairment of building		

* Straight-line method of depreciation assumed and applied.

Examiner's report

Part (a) of the question tests candidates' knowledge on the computation of fair value of decommissioning liabilities under IFRS 13 – Fair Value Measurement, while part (b) tests the accounting treatment of impairment of non – current assets in line with IAS 36 – Impairment of Assets.

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

The commonest pitfalls of the candidates was their lack of understanding of the requirements of the question as it relates to practical application and in-depth knowledge of IFRS 13 and IAS 36.

Candidates are advised to pay more attention to the relevant International Financial Reporting Standards (IFRS). They should focus on the provisions and applications of the accounting standards.

	Marking guide	Marks	Marks
a.	Explanation on fair value of assets liabilities under IFRS 13- Fair Value Measurement:		
	Explanation on the fair value of decomposing liability and computation of:		
	• labour and material cost	2	
	• input on overhead	1½	
	• third party mark-up on industrial average	2	
	• inflation adjustment rate	2	
	• risk adjustment on cash flows	2	
	• risk free rate of government bonds	1½	
	• entity non-performance risk	1	12
b.	Impairment of building	1	
	Calculation of impairment loss	1	
	• Accumulated depreciation on school and library	2	
	• Carrying amount	2	
	Accounting treatment of impairment	2	8
	Total		**20**

SOLUTION 4

Melo Melo Holdings Nigeria Plc

a. **Differences between defined contribution plan and defined benefit plan**

Defined contribution plan

A defined contribution plan is a type of pension arrangement in which both the employer and the employee make fixed contributions to a separate entity, known as the pension fund administrator. The employer's obligation is limited to making the agreed contributions, with no further legal or constructive responsibility to provide additional payments if the fund lacks sufficient assets to cover all employee benefits related to their service. Under this plan, the investment risk and rewards are transferred entirely to the employee, as the retirement benefits depend on the fund's performance and the total contributions made.

Defined benefit plan

A defined benefit plan is a type of pension arrangement where the employer acts as the pension fund administrator and guarantees a specific level of retirement benefits to employees. Under this plan, employees are entitled to receive annual payments upon retirement, typically calculated based on a formula that considers their years of service and final salary.

The employer has a legal obligation to ensure that sufficient funds are available in the pension plan to meet the promised benefit level. This may require the employer to contribute additional funds to address any shortfalls in the plan's assets. The investment risk and funding responsibility rest entirely with the employer, as they bear the obligation to deliver the guaranteed benefits regardless of the plan's investment performance.

Differences between a defined contribution plan and a defined benefit plan:

i **Actuarial assumptions**: In a defined contribution plan, there are no actuarial assumptions involved, whereas a defined benefit plan requires the application of actuarial techniques.

ii **Impact on financial statements**: A defined contribution plan typically does not affect the statement of financial position, while a defined benefit plan impacts both the statement of financial position and the statement of profit or loss and other comprehensive income.

iii **Employer responsibility**: Under a defined contribution plan, the employer's obligation is limited to the annual contributions payable into the fund. In contrast, a defined benefit plan focuses on the benefits employees will receive, making the employer responsible for ensuring the benefits are met.

iv **Determination of obligation**: For a defined contribution plan, the obligation is based on the contributions made in each period. In a defined benefit plan, actuarial techniques are used to estimate the ultimate cost of the benefits earned by employees for their service in the current and prior periods.

v **Amount received by employees**: In a defined contribution plan, the amount an employee receives upon retirement is not pre-determined and depends on investment performance. Conversely, in a defined benefit plan, the benefit amount is pre-determined.

vi **Shortfall responsibility**: Under a defined contribution plan, the employer is not obligated to cover any shortfall if the pension fund lacks sufficient assets. However, in a defined benefit plan, the employer must make up for any shortfall to meet the promised benefits.

vii **Risk-bearing**: In a defined contribution plan, employees bear the investment risk, while in a defined benefit plan, the employer assumes the risk.

b. (i) The actuarial deficit of ₦7.7 million has a significant impact on the financial statements of Melomelo Holdings Nigeria Plc for the year ended December 31, 2022. Here is how the actuarial valuation of the pension scheme's assets and the resultant deficit would affect the company's financial statements:

- **Impact on the statement of financial position:**

  - The **Net asset of the scheme** reported at ₦101 million is below the expected closing asset of 108.7 million. The difference ₦7.7 million, represents an actuarial deficit, which means the scheme's assets have underperformed compared to its obligations and contributions.
  - This actuarial deficit needs to be recorded in the statement of financial position under the pension scheme liability section.
  - Since the company's pension scheme is a defined benefit scheme, any deficit (or surplus) is recorded as either an asset or a liability in the financial statements. In this case, Melomelo Holdings Nigeria Plc will need to recognise a liability of ₦7.7 million on its statement of financial position to reflect the deficit in the pension scheme.

Impact on the statement of profit and loss and other comprehensive income

- Under IAS 19 Employee Benefits, the actuarial gains or losses should be recognised in the Other Comprehensive Income (OCI).
- Therefore, the ₦7.7 million actuarial deficit will not directly impact the company's net profit for the year, but it will affect the overall comprehensive income and debited directly to equity.

(ii) **Two benefits of moving from defined benefits to defined contribution plan**

Defined contribution scheme are easier for a company to administer and manage. A fixed level of contribution is paid on monthly basis for each employee. The risk resulting from the variable returns achieved by the funds' investment is then borne by the employee however this risk is borne by the employer with a defined benefit scheme.

(iv) Defined contribution scheme are easier to account for.
Contributions are charged to profit or loss on a systematic basis.
Provided the company is not in arrears on contribution, the monthly double entry required will be
Dr. Staff cost
Cr. Cash/bank account

c. **Advise to Akata Nig. Ltd**

i. The pension expense and income in the statement of profit or loss and other comprehensive income consist of a number of elements;

- The service costs represent the extra pension liability arising in the year from employee service in the year. It is charged to profit or loss for the year.
- Pension assets are the equities, bonds and other investments in the fund, and the interest income on these are credited to profit or loss.
- The scheme's liabilities are the pension obligations due to current and former employees and these are discounted by the market rate on high quality corporate bonds. The interest charged on the liabilities is expensed to profit or loss.
- The improvement in the pension benefit should be recognised by adding ₦4million and this should be added to the liability immediately.

  Interest on this increased liability should therefore be charged to profit or loss. As the liability increase at June 1, 2021 an interest charge is made in relation to this increase which is ₦240,000 [6% of ₦4million.

ii. Instead of the contribution paid into the scheme, the calculation would be as follows

Defined benefit expenses recognised in profit or loss

	₦'m
Current service cost	12.00
Net interest on net benefit liabilities [7.32 – (10.8 + 0.24)	3.72
Past service cost	4.00
Total expenses	19.72

IAS 19 is silent on how this expense should be charged, however, it is advised that it should be charged to operating costs.

However, some companies usually separate the interest cost and charge this to finance cost.

Operating cost should be increased by the difference of ₦10.72million i.e. [₦19.72million less ₦ 9million] over the contribution paid into the scheme, which was the sum incorrectly charged to the statement of profit or loss and other comprehensive income.

Pension scheme as at May 31, 2022

	FV assets	FV obligations
	₦'m	₦'m
Opening balance	122	(180)
Past service cost	-	(4)
Interest on plan assets	7.32	-
Interest on obligation	-	(10.8)
Interest cost on past service cost	-	(0.24)
Contribution	9	-
Pension paid	11	11
Current service cost	-	12
Expected closing balance	127.32	(196.04)
Actual closing balance	(135.00)	198.00
Difference remeasurement through OCI	7.68	(1.96)

The net actuarial gain of ₦5.72million (₦7.68million less ₦1.96million) should be recognised in other comprehensive income.

The net pension obligation recognised in the statement of financial position is ₦63 million [i.e. ₦198 million less ₦135 million].

Examiner's report

Part (a) of the question tests candidates' knowledge of the differences between defined contribution plans and defined benefit plans under IAS 26- Retirement Benefit Plans. Part (b) tests the impact of the actuarial valuation on pension scheme assets and the resultant deficit on the financial statements and the benefits of moving from defined benefit scheme to a defined contribution scheme, while part (c) tests the computations and explanations of the financial reporting treatments of adjustments to pension scheme future value of the assets and future value of obligations.

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 do not know the differences between defined contribution plans and defined benefit plans under IAS 26- Retirement Benefit Plans. Majority of the candidates do not understand the appropriate actuarial valuation of pension scheme and the accounting treatment of pension scheme.

Candidates are advised to carry out in-depth study to 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 Institutes' examination. They should also make use of ICAN Study Texts for better performance in future examinations.

	Marking guide	Marks	Marks
a.	**Differences between defined contribution plans and defined benefit plans:**		
	Any two (2) differences of defined contribution plans		
	Any two (2) differences of defined benefit plans	2	
		2	4
b i.	**Explanation on the impact of the actuarial valuation of the scheme's asset and the resultant deficit:**		
	• Impact on the statement of financial position		
	• Impact on the statement of profit or loss	2	
		2	4
ii.	**Benefits of moving from defined benefits to defined contribution plan:**		
	• Two benefits of defined contribution plans	1	
	• Two benefits of defined benefit plans	1	2
c.	**Advise with explanation and relevant calculations on:**		
	• Pension expense in the statement of profit or loss	1	
	• Pension assets, equities, bonds and other investments	2	
	• Defined benefit expenses recognised in profit or loss	2	
	• Future value of assets	2½	
	• Future value of obligations	2½	10
	Total		20

SOLUTION 5

a. **IFRS for SMEs - Zam Limited**

(i) **Development expenditure:**

The IFRS for SMEs requires all internally generated research and development expenditure to be expensed through profit or loss. According to IAS 38 Intangible Assets, internally generated assets or development costs are to be capitalised if certain criteria (proving future economic benefits) are met.

- Zam Ltd total expenditure of ₦16,000,000 [including research costs of ₦14,000,000] must be recognised as an expense.
- ₦2 million should be included in the statement of profit or loss for the period ended December 31, 2021.
- The remaining ₦14 million should be used to reduce the opening retaining earnings.

- Accounting entries
  Dr Retained earnings (Retained earnings as at January 1, 2021) ₦14 million
  Dr Retained earnings (Expense for 2021) ₦2 million
  Cr Intangible assets (development expenditure) ₦16 million

(ii) **Acquisition of Aqua Water Plc**
According to IFRS 3-Business combinations, allows an entity to adopt the full or partial goodwill method in its consolidated financial statements. However, under IFRS for SMEs, NCI must always be measured based on their proportionate share of identifiable net assets whether the fair value of NCI was given or not. This is because IFRS for SMEs only allows the partial goodwill method (that is, NCI must be measured based on proportion of identifiable net assets on acquisition date). This avoids the need for SMEs to determine the fair value of the non-controlling interests on acquisition date.

Calculation of goodwill on acquisition of Princess Ltd	**₦**
Cost of investment in subsidiary by the parent (Zam Ltd)	38,500,000
Add Non-controlling interest value at DOA (40% x ₦47,500,000)	19,000,000
Purchase consideration	57,500,000
Less Subsidiary's net assets at DOA [book value of net assets]	(47,500,000)
	10,000,000
Armotisation (₦$10{,}000{,}000/10\ years\ X\ {}^{6}/_{12}$)	500,000
Goodwill on acquisition	9,500,00

OR (Alternative approach)

Calculation of goodwill on acquisition of Princess Ltd	**₦**
Cost of investment in subsidiary by parent company (Zam Ltd)	38,500,000
Less Subsidiary's net assets at DOA acquired (60% x 47,500,000)	(28,500,000)
	10,000,000

Armotisation (₦$10{,}000{,}000/10\ years\ X\ {}^{6}/_{12}$)
500,000
Goodwill on acquisition 9,500,000
DOA is Date of Acquisition

(iii) **Investment property**
SMEs are only permitted to measure investment property at fair value if the fair value is readily available without undue costs and efforts.
Based on the above, Zam Ltd should measure the investment property initially at cost of ₦8.5 million.

After the initial recognition, the investment should be measured using the cost model. Therefore, the investment property should be measured at cost less accumulated depreciation if the property is depreciable in nature.

However, if Zam Ltd can estimate the fair value of the investment property without undue cost, then the investment property should be measured at its fair value of ₦9.5 million as at December 31, 2022 while the fair value increase of ₦1 million (₦9.5 million – ₦8.5 million) should be recognised as income in the statement of profit or loss.

b. **Ethical and professional issues**

Ethical Issues:

i. **Conflict of interest:**
Mr. Adams intention to pursue a personal relationship with the managing director's daughter creates a potential conflict of interest. It may affect his objectivity and impartiality in carrying out his responsibilities.

ii. **Independence threat:**
His actions could impair the perceived independence of the firm. Stakeholders may question whether the assignment's outcome was influenced by personal interests.

iii. **Breach of professional conduct:**
Pursuing such a relationship during an ongoing assignment is unprofessional and violates ethical guidelines under codes like the ICAN Code of Ethics.

iv. **Self-interest threat**
There would be self interest threat as one of the team members of the firm is engaged in personal relationship with a person connected to the subject of the assignment; more so for personal gains.

iv **Familiarity threat**
There could also be this kind of threat in view of the fact that Mr. Adams wants to have a date with the daughter of the MD of Zam Ltd our client.

- Also meeting with the daughter of M. D. during official engagement at canteen of the client may be inappropriate and could have negative effect on the goodwill of the firm and the staff generally.
- This should be done at their private time and not within Zam premises or at official hours.
- The team leads should advise Mr. Adams on this, that is, not mixing business with pleasure and he should make him aware of the ethical and other implications of his actions.

Other professional issues:

vi **Reputational risk:**
If discovered, such conduct could harm the firm's reputation and credibility.

vii **Team dynamics:**
Mr. Adams' actions could create tension or reduce focus within the team, thus impacting productivity.

Action plan:

i **Immediate reporting:**
As the team leader, you should address the issue with Mr. Adams, emphasising the importance of professional boundaries and independence.

ii **Escalation if necessary:**
If Mr. Adams persists, the issue should be reported to higher management to ensure it is dealt with appropriately.

iii **Code of ethics training:**
The firm should conduct regular training sessions on professional ethics to prevent such occurrences in the future.

Examiner's report

Part (a) of the question tests candidates' knowledge of the practical applications of IFRS for SMEs on the accounting treatment of development expenditure; acquisition of business; and measurement of investment property. Part (b) of the question tests candidates' knowledge of ethical and professional issues.

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 could not clearly state the correct accounting treatment for development expenditure; acquisition of business; and measurement of investment property. Majority of the candidates cannot state the various threats related to ethical and professional issues.

Candidates are advised to familiarise themselves with all aspects of the syllabus and pay special attention to all accounting standards in the syllabus as well as the application of ethical and professional code in corporate reporting.

Marking guide

		Marks	Marks
a. (i)	**Accounting for development expenditure under IFRS for SME's:**		
	Definition of development expenditure	1	
	Application of development expenditure on the company	1	
	Accounting treatment of development expenditure	1	3
(ii)	**Accounting for acquisition of controlling interest of shares under IFRS for SME's:**		
	Definition of business combination	1	
	Measurement of NCI under IFRS for SMEs	1	
	Computation of goodwill on acquisition	4	6
(iii)	**Accounting for acquisition of investment property under IFRS for SME's:**		
	Definition of investment property	1	
	Accounting treatment of investment property	2	3
b.	**Discussion on the ethical and other professional issues**	$1\frac{1}{2}$	
	Identify and explain any three (3) ethical issues	$1\frac{1}{2}$	3
	Identify and explain any three (3) professional issues		
	Total		**15**

SOLUTION 6

(a) Security and Exchange Commission (SEC) rules require the following:

i. The board of every public company must establish a risk management committee to assist it in its oversight of risk.

ii. Every public company must include risk management as part of its accounting policies.

iii. Public companies must disclose, by way of notes:

- any material effect of unmitigated risk on corporate profitability; and
- strategies for preventing risks the company is exposed to.

(b) **Components of effective risk reporting**

The required content of effective risk reports can be stated using the following five components that would be expected in an effective risk management system:

i. Risk agenda: This explains the reasons for undertaking risk management activities and expected benefits from doing so. Good risk reports would include the following:
   - a clear statement of the drivers for the company when planning and undertaking risk management activities;
   - a description of the benefits from the risk management processes established; and
     information on resources allocated to risk management activities

ii. Risk assessment: Good risk reports would include the following:
   - a clear description of the procedures in place and information used to identify risks;
   - an explanation of how risk is evaluated; and
   - a list of significant risk.

iii. Risk response: Good risk reports would include the following:
   - description of appropriate responses for each risk;
   - information on how the efficiency and effectiveness of existing controls is assessed; and
   - description of disaster response and business continuity plans.

iv. Risk communication: Good risk reports would include the following:
   - a description of how risk management processes and responsibilities are communicated throughout the company; and
   - information on risk management record keeping and on risk reporting and whistleblowing arrangements in the company.

v. Risk governance: Good risk reports would include the following:
   - a description of risk governance arrangements; and
   - a description of how emerging risks are being managed.

Examiner's report

Part (a) of the question tests candidates' knowledge of the provisions of the Security and Exchange Commission (SEC) on the regulatory rules of risk management, while part (b) tests candidate's knowledge of the guidelines for rules and components of effective risk reports.

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

The common pitfalls of the candidates were their inability to understand the provisions of the Security and Exchange Commission (SEC) on the regulatory rules of risk management and the analysis of the components of effective risk reports.

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

Marking guide

		Marks	Marks
a.	Analysis of the regulatory provisions by SEC in Nigeria		
	Any five (5) SEC rules discussed		5
b.	**Analysis of the components of effective risk reports**		
	Identification and explanation of the following:		
	• Risk agenda	2	
	• Risk assessment	2	
	• Risk response	2	
	• Risk communication	2	
	• Risk governance	2	10
	Total		15

SOLUTION 7

a. **The procedure for preparing IFRS financial statement for the first time**

IFRS 1 requires that at least one year's comparative figures are presented. Sesede Ltd' first IFRS financial statements will be for the year ended December 31, 2022. Therefore, the date of transition to IFRS is the beginning of business on January 1, 2021 (or close of business on December 31, 2020).

The company will be expected to do the following:

i. Identify accounting policies that comply with IFRSs. The company will almost certainly need to change some of its accounting policies and to adjust some of the amount that was reported previously at the same date using previous NGAAP.

ii. Prepare an opening IFRS statement of financial statement by restating the opening statement of financial position at January 1, 2021 (the date of transition).

iii. The company should also explain the effects of the transition from NGAAP to IFRSs by presenting;
   - A reconciliation of equity reported under previous NGAAP to equity under IFRSs at the date of transition and at the latest previous NGAAP reporting date.
   - A reconciliation of the profit or loss reported under previous NGAAP to profit or loss reported under IFRSs for the last period presented under previous NGAAP.
   - Any material adjustments to the statement of cashflows.

iv. Although the general rule is that all IFRSs should be applied retrospectively, a number of exemptions are available. These are intended to cover cases in which the costs of complying fully with a particular requirement would

outweigh the benefits to the users of the financial statements. Sesede Ltd may choose to take advantage of any of the exemptions.

b. **Practical steps to be taken to ensure efficient transition to IFRS adoption**

Changing from previous NGAAP to IFRSs is likely to be a complex process and should be carefully planned. Although previous NGAAP and IFRS may follow broadly the same principles, there are still likely to be many important differences in the detailed requirements of individual standards. Therefore, the company should:

i. Recognise all assets and liabilities whose recognition is required by IFRSs;
ii. Not recognise items of asset or liabilities if IFRSs do not permit such recognition;
iii. Reclassify items that were recognised under previous NGAAP as one type of asset, liability component of equity, are a different type of assets, liabilities or compact of equity under IFRSs;
iv. Measure all recognised assets and liabilities in accordance with IFRSs;
v. Recognise these adjustments directly in retained earnings (i.e. equity); and
vi. If Sesede Ltd has a foreign subsidiary it will need to ensure that they comply with any previous reporting requirements. This may mean that the subsidiary has to prepare two sets of financial statements, one using their previous NGAAP and the other using IFRSs (for consolidation purposes).

The process will be effected by the following;

(i) The company will need to carry out detailed review of current accounting policies, paying particular attention to areas where there are significant differences;
(ii) The level of knowledge of IFRSs of current finance staff (including Internal Auditors). It will probably be necessary to organise training and the company many need to recruit additional staff;
(iii) The group's accounting systems management will need to assess whether computerised accounting system can produce the information required to report under IFRSs. They will also need to produce new consolidation packages and accounting manual; and
(iv) The company should also consider the impact of the change to IFRSs on investors and their advisors. For this reason management should try to quantify the effect of IFRSs on results and other key performance indicators as early as possible.

c. **Accounting estimates and opening IFRS financial statement**

Estimates under IFRS at the date of transition must be consistent with those made at the same date under previous NGAAP (after adjustments to reflect any difference in accounting policies). The only exception to this is if the company has subsequently discovered that these estimates were in error. This is not the

case here and therefore the estimates are not adjusted in the first IFRS financial statements.

Court case

The treatment of this depends on why Sesede Ltd did not recognise a provision under previous NGAAP at December 31, 2021 for the following reasons:

i. If the requirement of previous NGAAP were consistent with IAS 37 – Provision, Contingent Liabilities and contingent Assets; presumably the directors concluded that outflow of economic benefits was not probable and that the recognition criteria were not met;
ii. In this case Sesede's assumptions under IFRS are consistent with its previous assumptions under previous NGAAP. Sesede Ltd does not recognise a provision at December 31, 2021 but account for the payment in the year ended December 31, 2022;
iii. If the requirements of the previous NGAAP were not consistent with IAS 37. Sesede Ltd must determine whether it had a present obligation as at December 31, 2021. Directors should take accounts of all available evidence, including any additional evidence provided by events after the reporting period up to the date the 2021 financial statements were authorised for issue in accordance with IAS 10 – Event after reporting period;
iv. The outcome of the court case confirms that Sesede Ltd had a liability in September 2021, (when the event that resulted in the case occurred) but the event occurred after the 2021 financial statements were authorised for issue. Based on this above, the company would not recognise a provision at December 31, 2021 but the ₦20million cost of court case would be recognised in the 2022 financial statements.
v. If the company's lawyer had advised Sesede Ltd that it was probable that they would be found guilty and suggested the expected settlement amount before the financial statements were authorised for issue, the provision would be recognised in the 2021 financial statements prepared under IFRSs for that amount.

Examiner's report

Part (a) of the question tests candidates' practical understanding of the procedure for preparing IFRS financial statements for the first time as required by IFRS 1. Part (b) tests candidates' knowledge of the practical steps that companies should take in order to ensure an efficient transfer to accounting under IFRS. Part (c) tests candidates' knowledge of preparation of accounting estimates and the opening IFRS financial statements for provisions under the previous NGAAP.

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

Commonest pitfalls of the candidates was their inadequate knowledge of provisions of IFRS 1 – First Time Adoption of International Reporting Standards.

Candidates are advised to understand the requirements and practical application of all the accounting standards that are examinable at this level of the Institute's examination.

Marking guide		**Marks**	**Marks**
a.	**Advise to the directors of the company on the following:**		
	The procedure for preparing IFRS financial statements for the first time (any correct five procedure)		5
b.	Practical steps to be taken to ensure efficient transition to IFRS adoption (any correct five practical steps)		5
c.	**Accounting estimates and opening IFRS financial statements:**		
	Five (5) correct points identified	2½	
	Five (5) correct points explained	2½	5
	Total		15

ICAN/242/V/C4 Examination No..........................

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 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 any other **COLOUR OF INK** will not be marked.
8. Tax and Capital Allowances rates are provided with this examination paper
9. You are required to attempt **Question ONE (Compulsory)**, **TWO Questions in Section B and TWO Questions in Section C.**
10. Check that you have collected the correct question paper for the examination you are writing.

TUESDAY, NOVEMBER 19, 2024

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 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

Colanim Nigeria Limited, a manufacturer of industrial alcohol, was granted a pioneer certificate for an initial period of three years on January 1, 2016. At the expiration of the pioneer period, the company's management did not apply for extension of the certificate but continued in the same line of business.

The company has just received a query letter from the tax authorities in respect of its production and sales of yeast between June and December 2018, which according to them was not part of the approved products as specified in the company's pioneer certificate.

As the consequences of the issues raised in the query letter have some financial implications, you have been engaged by the company as its tax consultant to assist in handling the matter and to also help in the computation of tax liabilities and filing of annual returns for the just concluded financial year.

The following information was extracted from the records of the company for the year ended December 31, 2022:

	₦'000	₦'000
Gross turnover		105,600
Other operating income		2,800
		108,400
Less:		
Salaries – admin staff	35,600	
Repairs and maintenance	5,300	
Ground rent and rates paid	12,000	
Donations and subscription	1,500	
Depreciation	5,900	
Motor running expenses	1,700	
Finance costs	2,250	
Legal expenses	2,100	

Preliminary expenses written off	1,050	
Audit and professional fees	1,800	
Allowance for doubtful debts	1,600	
General expenses	4,100	
Insurance	3,770	78,670
Net profit		**29,730**

Additional information in respect of the records for the year ended December 31, 2022:

(i) **Other income:**
Included in other income was ₦1,440,000 dividends received from investment in a Nigerian listed company.

		₦'000
(ii)	**Donations and subscription:**	**₦'000**
	Subscription to manufacturers' association	500
	Subscription to some employees' professional bodies	300
	Donation to the National Library	700
		1,500
(iii)	**Legal expenses:**	**₦'000**
	Legal: reacquisition of office lease	950
	Legal: debt collection	350
	Retainership (short lease)	800
		2,100
(iv)	**Allowance for doubtful debts:**	**₦'000**
	Specific provision	300
	General provision	400
	Debts written off	900
		1,600
(v)	**General expenses:**	**₦'000**
	Postages and telephone	500
	Transport and traveling	1,700
	Penalty for late filing of returns	25
	Customised (promotional) gifts to customers	1,875
		4,100

Other relevant information:

(vi)	**Adjusted profit/(losses) during the pioneer period:**	**₦'000**
	Year ended December 31	
	2016	(14,700)
	2017	(12,200)
	2018	3,830

(vii) **Summary of turnover and adjusted profits in the new business:**

Year ended December 31	Turnover	Adjusted profit
	₦'000	**₦'000**
2019	90,100	16,250
2020	97,600	18,150
2021	101,900	20,200

(viii) **Schedule of qualifying capital expenditure (QCE) incurred during the pioneer period:**

Date of acquisition	QCE	Amount
		₦'000
November 13, 2015	Non-industrial building	15,000
November 25, 2015	Industrial building	12,000
December 1, 2015	Plant	6,200
January 1, 2016	Furniture and fittings (20)	2,400
January 1, 2016	Motor vehicles (2)	4,800

(ix) **Schedule of qualifying capital expenditure (QCE) incurred in the new business:**

Date of acquisition	QCE	Amount
		₦'000
January 13, 2019	Furniture and fittings	4,000
February 15, 2019	Plant	7,400
July 1, 2019	Motor vehicles (2)	5,600
March 6, 2020	Industrial building	18,000
October 1, 2021	Plant	8,880
December 14, 2021	Motor vehicles (2)	8,400

(x) The furniture and fittings that cost ₦600,000 were disposed of for ₦100,000 on January 1, 2018 and the entire proceeds received were applied to the acquisition of new set of furniture and fittings on January 13, 2019.

(xi) **Dividends (gross) declared:**

Year ended December 31	Amount
	₦'000
2018	900
2019	Nil
2020	Nil
2021	2,160

Required:

As the newly engaged tax consultant, you are to prepare a report, in line with the provisions of Companies Income Tax Act Cap. C21 LFN 2004 (as amended), for the attention of the Managing Director of the company showing explicitly:

a. Adjusted profit for the year ended December 31, 2022 (5 Marks)

b. The tax liabilities of the company for the relevant assessment years (ignore minimum tax provisions) (20 Marks)

c. Comment on the tax implications of gross dividends declared for the financial year ended December 31, 2018, and 2021 (2 Marks)

d. The implications on the company's pioneer status and tax liabilities if the investigation by the tax authorities on the company's activities during the second half of 2018 is validated (3 Marks)

(Total 30 Marks)

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

QUESTION 2

The United Nations (UN) initiated the sustainable development goals (SDGs) in 2015 with the aim of transforming the world and ensuring no one is left behind as it relates to environmental, social, and economic aspects of the sustainable development goals. Of particular interest to the oil producing communities in Nigeria are the SDG numbers 6 (clean water and sanitation); 11 (sustainable cities and communities); and 15 (life on land).

Towards the achievement of the lofty ideals of the SDGs on or before 2030, the relevant Government authority awarded a one-year contract for the sum of two million pound sterling (£2 million) to ECO Group (UK) Limited for cleaning up of the oil polluted communities in September 2021. ECO Group (UK) Limited is an acclaimed international environmental safety organisation with branches and subsidiaries in ten countries across the world. YELE Limited, incorporated in Nigeria in 2016, is one of the branches of the international company.

For effective execution of the terms of the contract, the Nigerian branch was mandated by the parent company to carry out the job while the latter will only provide technical support whenever required. The contract was executed between January 1 and December 31, 2022.

The following is the extract of YELE Limited financial records in respect of the execution of the contract for the year ended December 31, 2022:

Contract sum	**£2 million**
Expenses incurred:	
	₦'000
Cost of direct materials/inputs	815,600
Expatriates (from UK) professional fees (gross)	416,200
Domestic (Nigeria) employees' emoluments	580,300
Depreciation of dredging machine and other equipment	24,100
Administrative	79,700
Income tax provision	90,000
	2,005,900

Other relevant information:

(i) Administrative expenses are made up of:

	₦'000	**₦'000**
Management fees (gross)		35,000
Power cost		4,000
Travelling:		
Local (within Nigeria)	8,300	
Foreign	12,000	20,300
Legal fees (for signing the contract)		20,400
		79,700

(ii) The tax authorities agreed with the company that 70% of the management fees was directly and reasonably related to the contract.

(iii) Capital allowances agreed with the tax authorities amounted to ₦34,250,000.

(iv) Assume that ₦1,200 is equivalent to £1 and taxes are payable in Nigerian currency.

Required:

a. Compute the tax payable (if any) by the company for the relevant assessment year. (12 Marks)

b. Advise on the tax implications if the Nigerian company (YELE Limited):
   - i. Has its "place of management" in the UK company (2 Marks)
   - ii. Is a subsidiary of the UK company (4 Marks)

c. Discuss the provisions of the Finance Act 2019 in respect of taxation of non-resident companies operating in Nigeria. (2 Marks)

(Total 20 Marks)

QUESTION 3

Larrex Petroleum Nigeria Limited has been operating in the Nigerian upstream petroleum sector (onshore and shallow offshore) for over thirty years. At the expiration of its oil mining lease (OML) licence on December 31, 2021, the company was granted a petroleum mining lease (PML) licence on January 1, 2022.

The company has provided the following reports in respect of its operations for the year ended December 31, 2022:

(i)	**Revenue:**	**₦'million**
	Fiscal value of crude oil sold	
	(2,500,000 barrels @ actual price of US $78 per barrel)	99,450
	Value of condensate from associated gas sold	
	(1,600,000 barrels @ actual price of US $65 per barrel)	53,040
	Value of natural gas liquid from associated gas sold	
	(1,200,000 barrels @ actual price of US $50 per barrel)	30,600
	Other operating income	65
(ii)	**Expenditure:**	**₦'million**
	Royalties paid	60,150
	Repairs of plant and machinery	280
	Repairs of fixture	40
	Salaries and other personnel emoluments	3,180
	Depreciation	222.2
	Carriages and freights	175
	Concessional rentals paid	20,900
	First two appraisal wells cost	31,600
	Decommissioning and abandonment fund	11,400
	Other operating cost	23,500
	Levies and fees paid	150
	Finance and bank charges	202
	Interest on loans borrowed	65.3
	Environmental remediation fund	1,255
	Niger Delta Development Commission fund	70
	Gas reinjection wells	1,950
	Bad debts	2,925
	Purchase of information cost	420
	General expenses	220
(iii)	**The fiscal prices of items sold are:**	**US $**
	Crude oil sold	80
	Condensate from associated gas sold	63
	Natural gas liquid from associated gas sold	50

(iv)	**First two appraisal wells cost include:**	**₦'million**
	Productive wells:	
	Tangible cost	10,500
	Intangible cost	5,400
	Unproductive wells:	
	Tangible cost	10,450
	Intangible cost	5,250
		31,600
(v)	**Levies and fees paid comprise:**	**₦'million**
	Stamp duties paid to the Federal Inland Revenue Service	20
	Levies paid to the State Government	85
	Tenement rate paid to the Local Government	45
		150
(vi)	**Purchase of information cost:**	**₦'million**
	This relates to money spent in searching for extent of petroleum deposits and this include:	
	Acquisition of geophysical information	135
	Acquisition of geological data and information	140
	Acquisition of geochemical data	145
		420
(vii)	**General expenses include:**	**₦'million**
	Natural gas flare fees	50
	Head office shared indirect production costs	130
	Fees paid for petroleum mining lease licence	15
	Donation to a public tertiary institution	25
		220
(viii)	**Agreed capital allowances are as follows:**	**₦'million**
	Brought forward	12.9
	For the year	218.6
		231.5

(ix) Production allowance for the year is ₦1,415 million

(x) Balancing charge of ₦580,000 was realised on disposal of an old machinery.

(xi) During the course of the year, some youths of the host community disrupted the activities of the company for its failure to incorporate host communities development trust.

(xii) Assume that ₦510 is equivalent to US $1.

(xiii) Tax liabilities due shall be paid in domestic currency (₦).

Required:
As the newly appointed Tax Manager, you are to submit a report (in line with the provisions of the Petroleum Industry Act 2021), to the Managing Director of the company, for the consideration of the Board, stating the:

a. Hydrocarbon tax payable for the relevant assessment year (17 Marks)
b. Timeframe for incorporation and financing the company's host communities development trust (2 Marks)
c. Penalty for non-incorporation of host communities development trust (1 Mark)

(Total 20 Marks)

QUESTION 4

BFN Limited, a manufacturing company, was incorporated on July 1, 2015, but commenced operations on January 1, 2016. The company is registered with the Federal Inland Revenue Service (FIRS) and the State Internal Revenue Service (SIRS) for tax purposes. XYZ Chartered Accountants was appointed the external auditor and tax consultants to the company barely fifteen months ago.

As a result of misunderstanding between the Managing Director and one of the Senior Partners of the audit firm, which bothered on disclosure of the company's tax related matters by one of the audit staff to a third party, the accounting firm was summarily disengaged via a letter to that effect dated June 20, 2023. This action taken by the company resulted in it having three tax consultants in the last fifteen months.

The Managing Director attended a workshop last month where a tax consultant was a lead paper presenter. Reporting to the Board Chairman after the workshop, he opined that "the manner in which technical tax matters were explained to a 'lay man' like him by the presenter was unimaginable". He therefore recommended your firm as the next external auditor and tax consultants to be appointed. The Board met and approved your firm's engagement and this was communicated to the Principal Partner on July 26, 2023.

The discussion the Principal Partner had with the management of the company was fruitful; the offer was accepted; and a letter of engagement was written by the Principal Partner to the Managing Director of the company, dated August 12, 2023. However, after two months of the appointment as the external auditor and tax consultants, the audit firm was yet to be introduced by the client to the tax authorities.

As the officer designated to handle the new task, your first visit to the company and your interaction with the Accountant revealed the following:

(i) Poor documentation of financial records and other vital information;
(ii) Preparation of two or more different records for the same transaction. The Finance Officer disclosed that one transaction is for the tax authorities and the

other, which is materially different from the first document, is for the company and its shareholders; and

(iii) Suppression of vital transactions in the accounting books with the aim of not paying the appropriate tax liabilities. For instance, non- filing of returns on withholding tax of ₦750,000 deducted at source on professional services rendered to the company four months earlier.

Required:

As the desk officer in charge of the assignment, you are required to draft a report to your Principal Partner for his review. The report should:

a. Explain briefly **FOUR** documents expected to be provided by the new client (5 Marks)

b. List and explain **FIVE** tax related documents that you should maintain in your file for a new client (5 Marks)

c. Explain the circumstances a tax consultant may disclose information on a taxpayer to a third party (5 Marks)

d. Explain the potential risks in handling this engagement and what can be done by the tax consultants to mitigate those risks (5 Marks)

(Total 20 Marks)

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

QUESTION 5

The issue of multiple taxation has once again been brought to the front burner of national discourse. The President in July 2023 signed four Executive Orders to address the menace of multiple taxation in Nigeria. These Orders are:

(i) Finance Act (Effective Date Variation) Order 2023;
(ii) Customs, Excise Tariff (Variation) Amendment Order 2023;
(iii) Order suspending the 5% Excise Tax on telecommunication services as well as the Excise Duties escalation on locally manufactured products; and
(iv) Suspension of Import Tax Adjustment levy on certain vehicles.

Relatedly, the Presidential Tax Reform Committee, which was recently inaugurated by the Federal Government, has as part of its terms of reference, “come up with workable measures to curb the negative impact of multiple taxation on economic activities in Nigeria.”

To achieve a tax revenue to gross domestic product (GDP) ratio of 18% within the next three years, the Federal Government has solicited for international tax cooperation from the global community during the G-20 summit held in India in September 2023.

A number of bilateral tax treaties between Nigeria and some other countries were considered. These treaties have the objectives of reducing the impact of double taxation; and closing loopholes and the ability of the multinational enterprises to avoid payment of taxes.

The Presidential Committee in one of its workshops organised for a selected corporate private sector players, multinational enterprises, accounting professionals, tax practitioners and tax administrators, has called for inputs from various stakeholders on the issue of multiplicity of taxes and global cooperation and assistance on tax matters.

Required:
As a Tax Consultant working in a medium-sized audit firm, you have been mandated by your Senior Partner to prepare a policy paper, which is expected to be submitted to the Committee next week. The contents of the paper are to specifically cover the following pertinent areas:

a. The causes of multiplicity of taxes in Nigeria (5 Marks)
b. The impact of multiplicity of taxes on tax compliance and revenue yield (4 Marks)
c. The roles of international organisations in global cooperation and assistance on tax matters (6 Marks)

(Total 15 Marks)

QUESTION 6

Suruz Limited has been in operation as a manufacturer of liquid soap and allied detergents for more than fifteen years. The appointment of a chartered accountant as its Finance Manager in 2020, has significantly impacted on the investment and financing strategies of the company. Specifically, the investment of surplus funds on "riskless" assets on short and medium-term basis has enabled the company to remain afloat in the ever increasing competitive environment. The company is also considering, in the long run, acquisition of ordinary shares in one of the best market capitalised listed companies in Nigeria.

During the year ended October 31, 2023, the following transactions (as shown in Schedules I and II) took place:

Schedule I (a): Property, plant and equipment and motor vehicle (acquisition and disposal)

Type	Date of acquisition	Cost of acquisition	Date of disposal	Sales proceeds	Incidental cost of disposal
		₦		₦	₦
Land and building (old factory)	November 15, 2015	25,450,000	April 10, 2023	33,000,000	360,000
Machinery	March 6, 2020	8,700,000	July 1, 2023	10,230,000	44,000
Motor vehicle	December 20, 2022	3,210,000	July 8, 2023	3,500,000	10,000

Schedule I (b): Property, plant and equipment and motor vehicle (new acquisition)

Type	Date of new acquisition	Cost of new acquisition
		₦
Land and building (old factory)	June 21, 2023	42,700,000
Machinery	September 11, 2023	9,500,000
Motor vehicle	October 16, 2023	4,600,000

Schedule II: Investment

Type	**Date of acquisition**	**Cost of acquisition**	**Date of disposal**	**Sales proceeds**	**Incidental cost of disposal**
		₦		**₦**	**₦**
Savings certificates	April 22, 2023	1,300,000	July 6, 2023	1,315,000	10,000

Required:

As the company's Tax Consultant, you are to submit a report, in line with the provisions of Capital Gains Tax Act Cap. C1 LFN 2004 (as amended), to the Managing Director of Suruz Manufacturing Company Limited stating the:

a. Relief (if available) on the disposal and re-acquisition of plant, property and equipment and motor vehicle (3 Marks)

b. Capital gains tax payable (if any) on the assets and investment disposed (10 Marks)

c. Provisions of section 2 of Finance Act 2021, in respect of disposal/re-acquisition of ordinary shares in listed Nigerian companies (2 Marks)

(Total 15 Marks)

QUESTION 7

EPS Mining Limited, a private limited liability company, was granted a coal mining and prospecting licence in 2016. The business climate has been favourable to the company as its products are in high demand both in the domestic and international markets. In a bid to secure more mining acreage which will impact on its profitability and market share, the company is planning to approach the Nigerian Exchange Group (NGX) for listing of its shares on the floor of the exchange.

However, in the last three years, the company has been having disputes with the Federal Inland Revenue Service (FIRS) in respect of its tax assessments and compliance. Although appropriate fines and penalty imposed by the regulatory agency were paid by the company, pre-investigation activities/surveillance initiated by the tax authorities revealed the following:

(i) Non-remittance of value added tax collected on behalf of tax authorities as and when due;

(ii) Negative media tax report on the company made recently by one of the disengaged senior staff during a radio phone-in programme;

(iii) Suspicion of tax fraud as annual financial reports in the last three years indicated low adequacy ratios compared with industry average; and

(iv) Carrying out mining operations inconsistent with the provisions of the Nigeria Minerals and Mining Act, 2007 (as amended) and Minerals and Mining Regulations, 2011.

Based on the findings from the pre-investigation activities/surveillance, the FIRS sent a letter dated February 15, 2023 notifying the company that a team of tax investigators will be visiting the company between March 1 and 5, 2023. The purpose was to conduct investigation exercise on its tax related matters for the previous three years.

The list of records/documents to be made available for the investigation was stated. The company was also advised to allow the tax investigators to have free access to records/documents and information necessary for a hitch-free exercise. A pre-investigation meeting has been scheduled for the first day (that is, March 1, 2023) of the exercise.

The Managing Director of the company is of the opinion that the company has nothing to hide and that all their previous tax assessments were prepared and filed in line with the provisions of the Companies Income Tax Act 2004 (as amended). Being the first time the company will have its tax affairs scrutinised, he does not understand the aim of pre-investigation meeting.

Through a letter dated February 17, 2023, your firm has been appointed as the tax consultants to the company. The services to be rendered include, tax computations;

preparation and filing of tax returns with the relevant tax authorities; and related advisory services. The offer has since been accepted by your firm.

The Managing Director has provided your Principal Partner with relevant documents, which showed the operational performance of the company for the year ended December 31, 2022.

	₦'000	**₦'000**
Gross turnover:		
Export sales	223,100	
Domestic sales	132,300	355,400
Dividend received (net)		5,400
		360,800
Less: Expenses		
Mining cost	129,200	
Wages and salaries	64,500	
Depreciation	10,750	
Rent	25,000	
Power and utilities cost	12,890	
Motor vehicle running expenses	1,350	
Donations and subscriptions	1,100	
Repairs and maintenance	3,800	
Audit and other professional fees	2,000	
Bank charges	1,400	
Administrative expenses	12,100	264,090
Net profit		96,710

Additional information:

(i) It has been established that mining cost is a relevant direct cost.

(ii) **Donations and subscriptions:**

	₦'000
Cultural group of host community	350
Nigerian Miners' Association	750
	1,100

(iii) **Repairs and maintenance is made up of:**

	₦'000
Improvement to office building	1,200
Repairs of mining equipment	900
Maintenance of scavenging machine	1,700
	3,800

(iv) **Administrative expenses consist of:**

	₦'000
Transfer to revenue reserve	3,600
Formation expenses written off	2,400
Insurance premium paid	1,000
Fines and penalty paid to the regulatory agency	3,000
Travelling	2,100
	12,100

(v) Capital allowances on qualifying capital expenditure agreed with the Inland Revenue for the assessment year is ₦6,290,000.

Required:

As the desk officer in charge of this assignment, you are to submit a report within a week to the Principal Partner for his review before sending same to the client. The report should:

a. Explain the objectives of a pre-investigation meeting (4 Marks)

b. Discuss the tax implications of lateness in filing returns and remittance of value added tax collected to the relevant tax authorities (3 Marks)

c. Provide the computations of tax liabilities payable for the relevant assessment year (8 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 to August 31, 2023) 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

CODAD Tax Consultants, Abeokuta

February 1, 2023

The Managing Director
Colanim Nigeria Limited
Abeokuta

Dear Sir,

Re: Computation of Adjusted Profit, Tax Liabilities and Other Related Matters

We refer to your request on computation of adjusted profit and tax liabilities for the financial year ended December 31, 2022; professional advice on treatment of donations declared in 2018 and 2021; and the implications on the company's pioneer status and tax liabilities as a result of production and sale of an unapproved product during the pioneer period. We hereby present a report for your review.

a. **Adjusted profit**

As shown in appendix 1, the adjusted profit of the company for the year ended December 31, 2022 was ₦36, 615,000.

b. **Tax liabilities for the relevant assessment years**

Appendix 2 provides the computations of the companies income tax and tertiary education tax payable for 2020, 2021, 2022 and 2023 assessment years.

c. **Status of gross dividends declared for financial years 2018 and 2021**

(i) The Companies Income Tax Act 2004 (as amended) provides that dividends declared and payable out of profits made during the pioneer years do not attract withholding tax. Therefore, the shareholders will not suffer any withholding tax (WHT) on dividends declared and received in the financial year ended December 31, 2018.

(ii) However, a new business was deemed to have commenced with effect from January 1, 2019. Thus, dividends declared and paid to the shareholders will suffer WHT of 10%. For the dividends declared in 2021, 10% (that is, ₦216,000 will be deducted as WHT and remitted to the relevant tax authority. The net balance, ₦1,944,000 (that is, ₦2,160,000 – ₦216,000) will be paid to the shareholders.

d. **The implications on the pioneer status and tax liabilities if the investigation on production and sales of yeast in 2018 is validated include:**

(i) Cancellation of the pioneer certificate;
(ii) The effective date of cancellation is December 31, 2017;
(iii) Commencement rule for new businesses will be used, starting from January 1, 2018; and

(iv) Profit made during the financial year ended December 31, 2018 will be subjected to companies income tax and tertiary education tax.

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

Yours faithfully,

For: CODAD Tax Consultants

Show Wande

Appendix 1: Adjusted profit
For the year ended December 31, 2022
(Year 2023 assessment)

	₦'000	₦'000
Net profit as per accounts		29,730
Add back:		
Depreciation	5,900	
Preliminary expenses written off	1,050	
Legal (reacquisition of office lease)	950	
Allowance for doubtful debts (general prov.)	400	
Penalty for late filing of returns	25	8,325
		38,055
Less: Non- taxable income		
Dividends received (net)		1,440
Adjusted profit		36,615

Appendix 2: Tax liabilities for 2020; 2021; 2022; and 2023 assessment years

2020 assessment year

	₦'000	₦'000
Adjusted/assessable profit		16,250
Less: Losses b/f (see W1)	23,070	
Losses relieved	(16,250)	(16,250)
Unrelieved losses that lapsed	6,820	
Capital allowances for the year	25,025	
Capital allowances utilised	Nil	
Unrecouped capital allowances c/f	25,025	
Total profit		Nil
Companies income tax @ 20%		Nil
Tertiary education tax @ 2% of ₦16,250		325

2021 assessment year

	₦'000	₦'000
Adjusted/assessable profit		18,150
Capital allowances for the year	10,395	
Unrecouped capital allowances b/f	25,025	
Capital allowances available for utilisation	35,420	
Capital allowance utilised	(18,150)	(18,150)
Unrecouped capital allowances c/f	17,270	
Total profit		Nil
Companies income tax @ 20%		Nil
Tertiary education tax @ 2% of ₦18,150		363

2022 assessment year

	₦'000	₦'000
Adjusted/assessable profit		20,200
Capital allowances for the year	19,383	
Unrecouped capital allowances b/f	17,270	
Capital allowances available for utilisation	36,653	
Capital allowance utilised	(20,200)	(20,200)
Unrecouped capital allowances c/f	16,453	
Total profit		Nil
Companies income tax @ 20%		Nil
Tertiary education tax @ 2% of ₦20,200		404

2023 assessment year

	₦'000	₦'000
Adjusted/assessable profit		36,615
Capital allowances for the year	9,854.97	
Unrecouped capital allowances b/f	16,453	
Capital allowances available for utilisation	26,307.97	
Capital allowance utilised	26,307.97	(26,307.97)
Unrecouped capital allowances c/f	Nil	
Total profit		10,307.03
Companies income tax @ 30% of ₦10,307.03		3,092.109
Tertiary education tax @ 2½% of ₦36,615		915.375

Workings

(1) Balance of adjusted profits/ (losses) for the pioneer period

Year ended	Adjusted profit/(losses)
	₦' 000
December 31, 2016	(14,700)
December 31, 2017	(12,200)
December 31, 2018	3,830
Total	**(23,070)**

(2) **Capital allowances**

	Non-ind building	Ind. building	Plant	Furniture & fittings	Motor vehicle	Capital allowance
	IA 15% AA 10%	IA 15% AA 10%	IA 50% AA 25%	IA 25% AA 20%	IA 50% AA 25%	
	₦'000	**₦'000**	**₦'000**	**₦'000**	**₦'000**	**₦'000**
2020 A/Y						
Cost	15,000	12,000	6,200	1,800	4,800	
Additions			7,400	4,000	5,600	
IA	(2,250)	(1,800)	(6,800)	(1,450)	(5200)	17,500
AA	(1,275)	(1,020)	(1,700)	(870)	(1,300)	6,165
Inv. Allow (10%)			(1,360)			1,360
						25,025
2021 A/Y						
TWDV	11,475	9,180	5,100	3,480	3,900	
Additions		18,000				
IA		(2,700)				2,700
AA	(1,275)	(2,550)	(1,700)	(870)	(1,300)	7,695
						10,395
2022 A/Y						
TWDV	10,200	21,930	3,400	2,610	2,600	
Additions			8,880		8,400	
IA			(4,440)		(4,200)	8,640
AA	(1,275)	(2,550)	(2,810)	(870)	(2,350)	9,855
Inv. Allow (10%)			(888)			888
						19383
2023 A/Y						
TWDV	8,925	19,380	5,030	1,740	4,450	
AA	(1,275)	(2,550)	(2,809.99)	(870)	(2,349.98)	**9,854.97**

Working notes:

2020 assessment year
Non-building expenditure
IA = 15% of ₦15,000,000 = ₦2,250,000

$$AA = \frac{cost - IA}{n}$$

where n = 100%/AA%
= 100%/10% = 10

Therefore, $AA = \frac{₦15,000,000 - ₦2,250,000}{10}$ = **₦1,275,000**

Furniture and fittings
The cost = ₦2,400,000 – ₦600,000 (part disposed) =**₦1,800,000**

2021 assessment year
Industrial building expenditure

AA of old asset =		₦1,020,000
AA of new asset = $\frac{₦18,000,000 - ₦2,700,000}{10}$	=	1,530,000
Total AA	=	**2,550,000**

2022 assessment year
Plant expenditure

AA of old asset =		₦1,700,000
AA of new asset = $\frac{₦8,880,000 - ₦4,440,000}{4}$	=	1,110,000
Total AA	=	**2,810,000**

2023 assessment year
Plant
AA = ₦2,810,000 – ₦10 (retained in the books in respect of the item with expired tax life)= **₦2,809,990**

Motor vehicle
AA = ₦2,350,000 - ₦20 (retained in the books in respect of the 2 items with expired tax life)= **₦2,349,980**

Examiner's report

The question is divided into four parts. The first part tests the candidates' understanding of the provisions of Companies Income Tax Act Cap C21 LFN (CITA) 2004 (as amended) in respect of computations of adjusted profit. The second part tests the candidates' knowledge of computations of tax liabilities. The third part tests candidates' understanding of the treatment of gross dividends declared during the pre- and post- pioneer periods. The fourth part tests the candidates' knowledge of the tax implications of companies operating outside of the pioneer status.

Being a compulsory question, all the candidates attempted the question. Candidates demonstrated a fair understanding of the question and performance was average.
The common pitfall was the inability of some candidates to identify correctly the allowable and disallowable expenses in the computations of adjusted profit and tax liabilities of a company.

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)	Memo (address)	1	
	Computation of adjusted profit		
	Net profit as per accounts	½	
	Depreciation	½	
	Preliminary expenses written off	½	
	Legal (reacquisition of office lease)	½	
	Allowance for doubtful debts (general prov.)	½	
	Penalty for late filing of returns	½	
	Dividends received (net)	½	
	Adjusted profit	½	5
b)	**Computation of tax liabilities**		
	2020 Y/A		
	Adjusted profit	½	
	Losses relieved	½	
	Total profit	½	
	Companies income tax	½	
	Tertiary education tax	½	
	2021 Y/A		
	Adjusted profit	½	
	Capital allowances utilised	½	

Total profit	½
Companies income tax	½
Tertiary education tax	½

2022 Y/A

Adjusted profit	½
Capital allowances utilised	½
Total profit	½
Companies income tax	½
Tertiary education tax	½

2023 Y/A

Adjusted profit	½
Capital allowances utilised	½
Unrecouped capital allowance c/f	½
Total profit	½
Companies income tax	½
Tertiary education tax	½
Workings 1 (balance of adjusted profit/(losses)	½

Workings 2 (Capital allowances):

2020 Y/A:

IA (non-industrial building)	¼
IA (industrial building)	¼
IA (plant)	¼
IA (furniture and fittings)	¼
IA (motor vehicle)	¼
AA (non-industrial building)	¼
AA (industrial building)	¼
AA (plant)	¼
AA (furniture and fittings)	¼
AA (motor vehicle)	¼
Investment allowance (plant)	¼
Total capital allowance	¼

2021 Y/A:

IA (industrial building)	¼
AA (non-industrial building)	¼
AA (industrial building)	¼
AA (plant)	¼
AA (furniture and fittings)	¼
AA (motor vehicle)	¼
Total capital allowance	¼

2022 Y/A:

	IA (plant)	¼	
	IA (motor vehicle)	¼	
	AA (non-industrial building)	¼	
	AA (industrial building)	¼	
	AA (plant)	¼	
	AA (furniture and fittings)	¼	
	AA (motor vehicle)	¼	
	Investment allowance (plant)	¼	
	Total capital allowance	¼	
	2023 Y/A:	¼	
	AA (non-industrial building)	¼	
	AA (industrial building)	¼	
	AA (plant)	¼	
	AA (furniture and fittings)	¼	
	AA (motor vehicle	¼	
	Total capital allowance	¼	20
c)	**Comments on gross dividends declared in 2018 and 2021**		
	1 mark for discussion of dividends declared In 2018 (pioneer period)	1	
	1 mark for discussion of dividends declared In 2021 (new business)	1	2
d)	Implications on the pioneer status and tax liabilities if the investigation turned out to be validated		
	1 mark for discussion of the implications on the pioneer status and tax liabilities, subject to a maximum of 3 points		3
	Total		30

SOLUTION 2

a.

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

	₦'000	**₦'000**
Gross turnover (£2 million x ₦1,200)		2,400,000
Less: Expenses		
Cost of direct materials and inputs	815,600	
Expatiates personnel costs	416,200	
Domestic employees' emoluments	580,300	
Administrative:		
Management fees (70% of₦35,000)	24,500	
Power cost	4,000	
Travelling	20,300	1,860,900
Adjusted profit		539,100

YELE Limited
Computation of tax liabilities
For 2023 assessment year

	₦'000
Adjusted profit	539,100
Less: Capital allowances	34,250
Total profit	504,850
Companies income tax @ 30% of ₦504,850	151,455.00
Tertiary education tax @ 2.5% of ₦539,100	13,477.50
Total tax payable	164,932.50

Minimum tax computations

	₦'000
Gross turnover	2,400,000
Add: Other income	Nil
	2,400,000
Less: Franked investment income	Nil
Turnover for minimum tax computation	2,400,000
Minimum tax @ 0.5% of ₦2,400,000	12,000

Since the companies income tax computed above is greater than the minimum tax, the company is expected to pay the companies income tax of ₦151,455,000 as well as the tertiary education tax of ₦13,477,500. This gives total tax liabilities of ₦164,932,500.

b. **(i) Tax implications on the profit of the Nigerian company if it has its "place of management" in the UK company**

- The tax authorities will treat the Nigerian company (YELE Limited) as a resident company on the basis of the place of incorporation, hence, profits made on the basis of its operation in Nigeria will be assessable to tax in Nigeria.
- Relatedly, the tax authority of the other country (Eco Group, UK in this instance) would regard the Nigerian company as resident in UK on the basis of "place of management.
- The Nigerian tax treaties (where applicable) govern the treatment of this case and affected companies can claim tax credit for the Nigerian tax in their home countries (Eco Group, UK in this instance) to avoid double taxation.

(ii) **The tax implications on the profit of the Nigerian company if it is a subsidiary of the UK company include:**

- A subsidiary (YELE Limited) is expected to be incorporated in Nigeria to operate as a separate legal entity from the parent company (Eco Group, UK in this instance). Thus, profits made by YELE Limited is liable for tax assessment in Nigeria;
- Even if the foreign equity-participation is 100%, such equity-ownership or the control will not affect the residence status in Nigeria once it has been incorporated in Nigeria;
- The claim by the parent company (Eco Group, UK in this instance) may raise the issues of dual residence;
- The Nigerian model double taxation agreement (DTA), in Article 4, spells out the mode of resolving the problem of dual residence between Nigeria and a treaty-country; and
- The DTA provides for the criterion of "place of incorporation" as basis of resolving dual residence. Where this fails, the problem is to be resolved by "mutual agreement".

c. **The provisions of the Finance Act 2019 in respect of taxation of non-resident companies in Nigeria are:**

i) Withholding tax shall be the final tax for technical, management, consultancy or professional fees earned by non-resident companies;

ii) A new clause imposing tax on profits of foreign companies for online and/or electronic commercial activities, if they are deemed to have significant economic presence (SEP) in Nigeria. The SEP is to be determined by the Minister of Finance; and

iii) Non-resident companies are to file corporate tax returns with the FIRS.

Examiner's report

The question tests candidates' understanding of the provisions of the Companies Income Tax Act 2004 (as amended) and the Finance Act 2019 in respect of computations of tax liabilities of a Nigerian subsidiary company with a foreign parent company.

About 70% of the candidates attempted the question. Candidates showed a good understanding of the requirements of the question and their performance was above average.

The common pitfall was the inability of some candidates to correctly state the provisions of Finance Act, 2019 in respect of taxation of non-resident companies operating in Nigeria.

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

Marking guide

		Marks	Marks
a)	**Computation of tax payable**		
	Adjusted profit computation:		
	Gross turnover	1	
	Cost of direct materials and inputs	1	
	Expatiates personnel costs	1	
	Domestic employees' emoluments	1	
	Management fees	1	
	Power cost	1	
	Travelling	1	
	Adjusted profit	1	
	Tax liabilities computation:		
	Capital allowances	½	
	Total profit	1	
	Companies income tax	½	
	Tertiary education tax	½	
	Minimum tax computation:		
	Gross income	½	
	Turnover for minimum tax computation	½	
	Minimum tax	½	12
b) i.	**Tax implications if the Nigerian company has its "place of management" in the UK company**		
	1 mark for each discussion on the tax implications, subject to a maximum of 2 points		2
ii.	**Tax implications if the Nigerian company is a subsidiary of the UK company**		
	1 mark for each discussion on the tax implications, subject to a maximum of 4 points		4
c)	**The provisions of the Finance Act 2019 in respect of taxation of non-resident companies in Nigeria**		
	1 mark for discussion of the provisions of the Act In respect of non-resident companies in Nigeria, subject to a maximum of 2 points		2
	Total		**20**

SOLUTION 3

Larrex Petroleum Nigeria Limited
INTERNAL MEMO

Date:

From: Tax Manager
To: Managing Director

Re: Hydrocarbon Tax Computation and Timeframe for Incorporation of Host Communities Development Trust

I refer to your request on computation of hydrocarbon tax payable for the 2022 assessment year and information on timeline for incorporation of host communities development trust in line with the provisions of Petroleum Industry Act 2021. I hereby present a report for your perusal.

a. **Computation of hydrocarbon tax payable**

As revealed in the attached appendix 1, the company made a chargeable profit of ₦114,422.58 million in 2022 assessment year. With hydrocarbon tax rate of 30%, the company is expected to pay hydrocarbon tax of ₦34,326.774 million.

b. **Timeframe for incorporation of the company's host communities development trust and its financing**

This is provided for in section 236 of Petroleum Industry Act 2021 and it states that the settlor or operator on behalf of collective settlors must incorporate and be responsible for a trust overseen by a board of trustees for the benefit of host communities.

The timeframe for incorporation of the trust

(i) The trust should be incorporated with the Corporate Affairs Commission (CAC) within 12 months from the effective date of the Act; or
(ii) Prior to commencement of commercial operations for new licensees.

Mode of financing the trust

(i) This is by an annual contribution of 3% of actual operating expenditure of the preceding financial year of the upstream companies; and
(ii) The fund can also be funded through donations, gifts, grants or honoraria and any profits or interests accruing to the reserve of the fund.

c. **The penalty for not incorporating host communities development trust**

Failure to incorporate a trust will lead to revocation of licence or the lease.

Thank you.

Oye Dele
Tax Manager

Appendix 1: Hydrocarbon tax

	₦' million	₦' million
Revenue:		
Value of crude oil sold (2.5 million barrels x $80 x ₦510)		102,000
Value of condensate from associated gas sold (1.6 million barrels x $65 x ₦510)		53,040
Value of natural gas liquid from associated gas sold (1.2 million barrels x $50 x ₦510)		30,600
Gross revenue		185,640
Balancing charge		0.58
Total revenue		185,640.58
Allowable deductions (Section 263):		
Royalties paid	60,150	
Other operating cost	23,500	
Repairs of plant and machinery	280	
Repairs of fixture	40	
Concessional rentals	20,900	
First two appraisal wells cost	31,600	
Decommissioning and abandonment fund	11,400	
Levies and fees	150	
Environmental remediation fund	1,255	
NDDC fund	70	
Gas re-injection wells	1,950	
Purchase of information	420	
Total allowable cost	151,715	
Total costs subject to CPR limit (W1)	(79,571.5)	(79,571.5)
Excess allowable cost carried forward	72,143.5	
Adjusted profit		106,069.08
Less: Loss relief		Nil
Assessable profit		106,069.08
Less: Section 266 and 6th Schedule deductions:		
Capital allowance (brought forward)	12.9	
Capital allowance (current year)	218.6	231.5
		105,837.58
Less: Production allowances		1,415
Chargeable profit		104,422.58
Hydrocarbon tax @ 30% of chargeable profit		31,326.774

Workings 1: Cost price ratio (CPR) computation

		₦' million	₦' million
	Gross revenue		185,640
(i)	Maximum allowable @ 65%		120,666
	Total operating cost		151,715
	Capital allowances		231.5
	Total eligible costs		151,946.5
	Less: Exempted costs incurred -Section 263(1):		
	Royalty incurred and paid	60,150	
	NDDC fund	70	
	Concessional rentals	10,900	
	Environmental remediation fund	1,255	72,375
(ii)	Net total costs to be subject to CPR		79,571.5

Maximum allowable cost is the lower of (i) and (ii), which is ₦79,571.5 million.

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 common 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.

Marking guide

		Marks	Marks
a.	Memo (address)	½	
	Memo (Heading)	½	
	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 revenue	½	
	Royalties paid	½	
	Other operating cost	½	
	Repairs of plant and machinery	½	
	Repairs of fixture	½	
	Concessional rentals	½	
	First two appraisal wells cost	½	
	Decommissioning and abandonment fund	½	
	Levies and fees	½	
	Environmental remediation fund	½	
	NDDC fund	½	
	Gas re-injection wells	½	
	Purchase of information	½	
	Total allowable cost	½	
	Total costs subject to CPR limit	½	
	Excess allowable cost carried forward	½	
	Adjusted profit	½	
	Assessable profit	½	
	Total capital allowance	½	
	Production allowances	½	
	Chargeable profit	½	
	Hydrocarbon tax	½	
	Workings 1: Cost price ratio:		
	Maximum allowable @ 65%	¼	
	Total operating cost	¼	
	Capital allowances	¼	
	Total eligible costs	¼	
	Royalty paid	¼	
	NDDC fund	¼	
	Concessional rentals	¼	
	Environmental remediation fund	¼	
	Net total costs to be subject to CPR	¼	
	Maximum allowable cost	¼	17

b.	**Timeframe for incorporation and funding of host communities development trust**		
	1 mark for discussion of timeframe for incorporation of host communities development trust, subject to a maximum of 1 point	1	
	1 mark for discussion of timeframe for incorporation of host communities development trust, subject to a maximum of 1 point	1	2
c.	**Penalty for non-incorporation of a trust**		
	1 mark for correct discussion on the penalty for non-Compliance		1
	Total		**20**

SOLUTION 4

AAAA & Co (Chartered Accountants)

INTERNAL MEMO

Date:

From: Senior Tax Consultant

To: Principal Partner

Re: Engagement by BFN Limited

I refer to your request in respect of our new client, BFN Limited, with regard to documentation / information to be maintained / provided by clients; documentation / information to be maintained by tax consultants; circumstances where information of the client may be disclosed to a third party; and potential risks in the new engagement and how they can be mitigated. My opinions are as follows:

a. **Documentation/information to be maintained/provided by clients include:**

(i) Certificate of incorporation;
(ii) Certified true copies (CTC) of memorandum and articles of association;
(iii) CTC of forms on directors; allotment of shares; appointment of secretary; and notice of registration;
(iv) Certificate of increase in share capital including stamp duties, registration fees, board resolution, etc.;
(v) Contracts, rents and its agreements;
(vi) Financial matters, such as:
- * Signed audited financial statements;
- * Books of account, ledgers, trial balance (hard and soft copies);
- * Non-current assets register and the documents;
- * Accounts and procedural manual;
- * Payment vouchers, receipts, etc;

* Banking and cash transaction documents; and
* Monthly payroll and directors' emoluments;

(vii) Correspondence with tax authorities and other third parties; and
(viii) Minutes of board of directors' and annual general meetings.

b. **Documentation/information to be maintained by the tax consultants include:**

(i) Certified true copy (CTC) of incorporation documents (that is, Certificate of incorporation, details of directors, shareholders, secretary, share capital details, etc;
(ii) Engagement letter;
(iii) Company auditors, if different from the tax consultant;
(iv) Audited financial statements, capital allowances, income tax; education tax and other computations;
(v) Trial balance, detailed analysis and schedules on the financial statements;
(vi) Correspondence with the client, tax authorities and third parties;
(vii) Registration documents in respect of income tax, valued added tax, PAYE, withholding tax and other levies;
(viii) Records of billings and outstanding; and
(ix) Other documents, financials and non-financials.

c. **Circumstances where a tax consultant may disclose information on a taxpayer to a third party when:**

(i) Disclosure is permitted by law, such as:
* Production of documents or other provision of evidence in the course of legal proceedings; or
* Disclosure to the appropriate public authorities of infringements of the law that come to light.

(ii) Disclosure is authorised by the client, that is, the taxpayer;

(iii) There is a professional duty or right to disclose, when not prohibited by law, for example:
* To respond to an inquiry or investigation by a member body or regulatory body such as ICAN, CITN, etc,;
* To protect the professional interests of a professional body, that is, ICAN, CITN, etc in legal proceedings; and
* To comply with technical standards and ethics requirements.

d. **Potential risks in handling this engagement and what can be done by the tax consultants to mitigate those risks**

Potential risks in handling this engagement include:

(i) Non-notification of the appointment of tax consultants to the tax authorities: Failure by the client to inform the tax authorities of the appointment of the audit firm as the new tax consultants will hinder the performance of the audit firm;

(i) Communication with former tax consultants and auditors: Non-communication with the former tax consultants since their appointment is considered to be unethical and a threat to the new assignment. The communication with the former will be helpful in determining the course of the assignment; and

(ii) Improper documentations and fraudulent activities of the client: This is perhaps the greatest source of threat the new tax consultants will grapple with during the course of the assignment. If this is not properly handled, the integrity of the tax consultants may be impaired.

What can be done by the tax consultants in mitigating those risks include:

(i) Once the acceptance of offer to act as tax consultants has been concluded and the fees agreed, the next step is for the client to formally introduce the tax consultants to the relevant tax authorities. The audit firm needs to inform the client to do the needful by notifying the relevant tax authorities as failure to do this, will definitely have negative impact on their engagement. If this is not done, then the audit firm should terminate the offer;

(ii) Communication with former tax consultants and auditors
To satisfy professional ethics, a new or an incoming tax consultant is required to liaise with the former consultant and auditors in charge of the client's tax matters. This is particularly important in this engagement as having 3 different tax consultants to the company in fifteen months looks suspicious. The new consultant will also need to:

* Confirm whether or not there exists any professional reason(s) why the engagement should not be accepted;
* Obtain relevant documents, audited accounts, tax computations and background information on the new assignment; and
* Plan the assignment; and

(iii) The attention of the client should be drawn to its improper documentations and unprofessional practice of falsifying or suppressing vital records/information necessary for tax purposes. The implications of this act should be well documented. Also, during the course of the engagement, if the tax consultants come across any of this unprofessional act that resulted in loss of revenue to the government, the

client should be made to pay the difference to the tax authorities, otherwise the engagement should be dropped.

Thank you.

Akin Bode
Senior Tax Consultant

Examiner's report

The question tests the candidates' knowledge of the documents to be provided by new clients and what the tax consultant should maintain in his file; the circumstances in which a tax consultant may disclose information on a taxpayer to a third party; and the potential risks in handling tax engagement of a new client and what can be done to mitigate those risks.

About 70% of the candidates attempted the question and they exhibited a fair understanding of its requirements. The performance was average.
The common pitfall was the inability of some candidates to explain the potential risks in handling tax engagement of a new client.

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

Marking guide

		Marks	Marks
a.	Memo (address)	½	
	Memo (heading)	½	
	Documentation/information to be maintained/ provided by clients		
	1 mark for discussion of documentation/information to be maintained/provided by clients, subject to a maximum of 4 points	4	5
b.	**Documentation/information to be maintained/ by the tax consultants**		
	1 mark for discussion of documentation/information to be maintained by tax consultants, subject to a maximum of 5 points		5
c.	**Conditions when information on taxpayers may be disclosed to a third party**		
	2½ marks for discussion of conditions when information on taxpayers may be disclosed to a third party, subject to a maximum of 2 points		5

d.	**Potential risks in handling this engagement and what can be done by the tax consultants to mitigate those risks**		
	1 mark for discussion of potential risks in handling the engagement, subject to a maximum of 2 points	2	
	1½ marks for discussion of what can be done to mitigate those risks, subject to a maximum of 2 points	3	5
	Total		**20**

SOLUTION 5

Dare & Co (Tax Consultants)
90, Benin-Abuja Road, Benin-City

INTERNAL MEMO

Date:

From: Manager (Tax Compliance)

To: Senior Partner

Re: MULTIPLICITY OF TAXES, CALL FOR GLOBAL COOPERATION, AND ASSISTANCE ON TAX RELATED MATTERS

Sequel to your directive, I hereby present a policy paper which addresses the issues of multiplicity of taxes and the call for global cooperation and assistance on tax related matters.

a. Causes of multiplicity of taxes in Nigeria include:

(i) The listing of 20 items in Taxes and Levies (Approved List for Collection) Act Cap T2 LFN 2004 (as amended) in favour of the local government perhaps may be one of the factors that motivates them into the inordinate drive for revenue through those items;

(ii) Administratively, most of the States Internal Revenue Service are plagued with various problems, including poor funding, lack of infrastructure, poor working condition and lack of highly skilled professionals;

(iii) Some of the State governments deliberately deny their local governments the revenue due to them and in some cases have even usurped the taxes assigned to the local governments. Consequently, the local governments, as a way of survival desperately and aggressively focus on anything that will generate revenue for them;

(iv) All the tiers of government usually fail to adequately fund their departments and agencies. This makes them to embark on aggressive

revenue drive even illegally in the name of increasing their internally generated revenue; and

(v) Lack of tax information and data.

b. Impact of multiplicity of taxes on tax compliance and revenue yield

This is addressed from the angles of the problems arising from multiplicity of taxes and feasible solutions to the menace.

Some of the problems of multiplicity of taxes include:

(i) It comes with a lot of uncertainties in the investment environment. The investors are not sure of the extent to which their incomes would be taxed. This has basically led to large corporate entities moving their operations out of some States or from Nigeria to neighbouring countries on account of multiplicity of taxes and other relevant factors; and

(ii) Tax yield is very low as a result of numerous taxes that bring in little but with high cost of administration.

Some of the feasible solutions that can be applied to address the issue of multiplicity of taxes include:

(i) Streamlining the number of taxes in Nigeria in view of the low yields of many of the taxes. This will involve the review of current tax laws;

(ii) Reviewing and possible acceptance of the recommendations of the 2003 Study Group which state that all the existing taxes in Nigeria should be abolished and replaced by only two taxes imposed at the rate of 10% as follows- income tax (covering both individuals and corporate entities) and expenditure tax (covering all expenditures); and

(iii) Adequate funding of the departments and agencies by the State and Local governments.

c. Roles being performed by international organisations in global cooperation and assistance on tax matters

The United Nations (UN) and the Organisation for Economic Cooperation and Development (OECD) are the two principal venues for the development of international tax norms. Their means include:

(i) The maintenance of model conventions and commentaries;
(ii) Codes of conduct and guidance to countries;
(iii) Organisation of various platforms where tax related matters are discussed. For example, the global forum on transparency and exchange of information for tax purposes was organised by the OECD in conjunction with the G-20 group of countries;

(iv) The OECD also serves as a coordinator and overseer of implementation of its agreements and has designed a number of multilateral conventions and instruments;

(v) The UN and its agencies conduct international policy analysis, just like the OECD, World Bank and the International Monetary Fund (IMF);

(vi) The IMF and the World Bank also work at the national level on policy analysis and recommendations;

(vii) Norm setting include model conventions and multilateral treaties, international policy analysis (such as, research papers, handbooks) and oversight of implementation (such as, peer reviews and the assessment of compliance with international standards);

(viii) National policy analysis and advice such as, surveillance, assessment of tax administrations and policy proposals; and

(ix) Capacity building work such as, the OECD/UNDP tax inspectors without borders initiative, the global tax programme of the World Bank, the OECD global relations programme.

Thank you.
Baba Tolu
Manager (Tax Compliance)

Examiner's report

The question tests candidates' understanding of the causes of multiplicity of taxes in Nigeria; the impact of multiplicity of taxes on tax compliance and revenue yield; and the roles of international organisations in global cooperation and assistance on tax matters.

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 common pitfall was the inability of the candidates to explain the roles of international organisations in global cooperation and assistance on tax matters.

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

Marking guide

		Marks	Marks
a)	Memo (address)	½	
	Memo (introduction)	½	
	Causes of multiplicity of taxes in Nigeria		
	1 mark for discussion of causes of multiplicity of taxes in Nigeria, subject to a maximum of 4 points	4	5

b)	**Impact of multiplicity of taxes on tax compliance and revenue yield**		
	1 mark for discussion of problems of multiplicity of taxes, subject to a maximum of 2 points	2	
	1 mark for discussion of solutions to multiplicity of taxes, subject to a maximum of 2 points	2	4
c)	1½ marks for discussion of roles being performed by international organisations in global cooperation and assistance on tax matters, subject to a maximum of 4 points		6
	Total		15

SOLUTION 6

Blaqqy Tax Consultants
Plot 5, Lagos Road, Kano

Date:

The Managing Director
Suruz Limited
19 Sokoto Way
Kano

Dear Sir,

Re: Computation of Capital Gains Tax on Assets Disposed and Other Related Tax Matters

We refer to your request on determination of relief; capital gains tax payable on assets disposed; and professional advice on the provisions of the Finance Act 2021 in respect of disposal/acquisition of government securities and shares in Nigerian listed companies.

Our comments are as follows:

a. **Relief (if available) on the disposal and re-acquisition of plant, property and equipment and motor vehicle**

The results as presented in Appendix I reveal that the roll-over relief on land and building is ₦7,550,000 and on machinery is ₦800,000. Although, there was an acquisition of a new motor vehicle when the old one was disposed, there is no roll-over relief to be claimed as motor vehicle is not among the classes of assets that are stated in the Capital Gains Tax Act 2004 (as amended).

b. **Determination of capital gains tax liabilities on asset and investment disposed**

Results in appendix 2a suggest that no capital gains tax liability is due on land and building. This is because of the full roll-over relief enjoyed by the company for re- investment of ₦42.7 million on new asset, when ₦33 million was received from the disposal of the old asset. Capital gains tax payable on machinery is ₦68,600 as the company is entitled to a partial roll-over relief. As no roll-over is claimed on motor vehicle, the company is liable to pay a capital gains tax of ₦28,000.

As for disposal of premium bonds and savings certificate at a gain (see Appendix 2b), no capital gains tax is payable on them. This is as a result of the fact that these investments are variants of Federal Government securities.

c. **The provisions of section 2 of Finance Act 2021, in respect of disposal/re acquisition of ordinary shares in Nigerian listed companies**

The gains accruing to a person on disposal of its shares in any Nigerian company registered under the Companies and Allied Matters Act shall be chargeable gains under the Act, except where:

(i) The proceeds from such disposal are reinvested within the same year of assessment in the acquisition of shares in the same or other Nigerian companies, provided that tax shall accrue proportionate on the portion of the proceeds which are not reinvested in the manner stipulated above; or

(ii) The disposal proceeds, in aggregate, is less than N100 million in any 12 consecutive months, provided that the person making the disposals shall render appropriate returns to the Revenue Service on an annual basis; or

(iii) The shares are transferred between an approved borrower and lender in a regulated securities lending transaction as defined under CITA 2004 (as amended).

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

Yours faithfully,
For: Blaqqy Tax Consultants

Ola Niyi
Senior Partner

Appendix 1: Roll-over relief

	Land and building	Machinery
	₦'000	₦'000
Lower of:		
Sales proceeds on disposal of old asset	**33,000**	*10,230*
and		
Amount re-invested in new asset	*42,700*	**9,500**
Less: Cost of old asset	**25,450**	**8,700**
Roll-over relief	**7,550**	**800**

Working note on motor vehicle:
In line with the provisions of Capital Gains Tax Act 2004 (as amended), motor vehicle is not one of the classes of assets that qualify for a roll-over relief.

Appendix 2a: Capital gains tax computation on property, plant and equipment and motor vehicle

	Land and building		Machinery		Motor Vehicle	
	₦'000	₦'000	₦'000	₦'000	₦'000	₦'000
Sales proceeds		33,000		10,230		3,500
Less:						
Cost of acquisition	25,450		8,700		3,210	
Incidental cost of disposal	360	25,810	44	8,744	10	3,220
		7,190		1,486		280
Less: Roll-over relief		7,550		800		Nil
Chargeable gains		Nil		686		280
Capital gains tax @ 10% of chargeable gains		**Nil**		**68.6**		**28**

Appendix 2b: Capital gains tax computation on investment

	Savings certificate	
	₦'000	₦'000
Sales proceeds		1,315
Less:		
Cost of acquisition	1,300	
Incidental cost of disposal	10	1,310
Chargeable gains		5
Capital gains tax @ 10% of chargeable gains		Nil

Examiner's report

The question tests candidates' understanding of the provisions of Capital Gains Tax Act Cap C1 LFN 2004 (as amended) and the Finance Act, 2021 in respect of roll-over relief and tax computations.

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

The common pitfall was the inability of some candidates to explain the provisions of the Finance Act 2021 in respect of disposal and re-acquisition of ordinary shares in listed Nigerian companies.

Candidates are advised to read the Institute's Study Text, Finance Act, 2021 and other relevant textbooks, as this would go a long way in assisting them to pass future examinations.

Marking guide

		Marks	**Marks**
a)	Memo (address)	½	
	Computation of roll-over relief		
	Land and building:		
	Sales proceeds	¼	
	Amount re-invested	¼	
	Cost of old asset	¼	
	Machinery:	¼	
	Sales proceeds	¼	
	Amount reinvested	¼	
	Cost of old asset	¼	
	Roll-over relief	¼	
	Motor vehicle (working note)	½	3
b)	**Computation of capital gains tax**		
	Land and building:		
	Sales proceeds	½	
	Cost of acquisition	½	
	Incidental cost of disposal	½	
	Chargeable gains	½	
	Capital gains tax	½	
	Machinery:		
	Sales proceeds	½	
	Cost of acquisition	½	
	Incidental cost of disposal	½	
	Chargeable gains	½	
	Capital gains tax	½	

Motor vehicle:		
Sales proceeds	½	
Cost of acquisition	½	
Incidental cost of disposal	½	
Chargeable gains	½	
Capital gains tax	½	
Savings certificate:		
Sales proceeds	½	
Cost of acquisition	½	
Incidental cost of disposal	½	
Chargeable gains	½	
Capital gains tax	½	10

c) **The provisions of the Finance Act 2021 in respect of disposal and re-acquisition of ordinary shares in listed Nigerian companies**

1 mark for each discussion of the provisions of the Finance Act 2021 in respect of disposal and Re-acquisition of ordinary shares in listed Nigerian Companies, subject to a maximum of 2 points	2
Total	**15**

SOLUTION 7

Chukwu & Co. (Tax Consultants)
20, Nature Road, Igbogbo, Lagos State

INTERNAL MEMO

Date: ....

From: Senior Tax Consultant

To: Principal Partner

Re: EPS Mining Limited

I refer to your directive on the above-named client's request on the objectives of pre-investigation meeting; tax implications of lateness in filing VAT returns and remittance of money collected; and computation of tax liabilities for 2023 assessment year. My comments on each of the thematic areas are as follows:

a. **Objectives of a pre-investigation meeting**

(i) Informing the taxpayer of the purpose of the investigation.
(ii) Confirming background information of the taxpayer earlier obtained in the surveillance or pre-investigation activities assessment file.
(iii) Familiarisation with the company's accounting and operational systems.
(iv) Giving the taxpayer opportunity to express their views on the investigation.

(v) Seeking the cooperation of the taxpayer in terms of providing books and records and explanation where necessary.

b. **Tax implications of lateness in filing returns and remittance of value added tax collected**

Sections 15 and 16 of Value Added Tax Act 2004 (as amended) specify the need for a taxable person to render returns and remission of tax collected. The effect of failure to render returns and non-remittance of tax collected are captured in the same Act in Sections 18 and 19.

Where a taxable person fails to render returns or renders an incomplete or inaccurate returns, the Revenue Service shall assess, to the best of its judgment, the amount of tax due on the taxable goods and services purchased or supplied by the taxable person (Section 18).

If a taxable person does not remit the tax within the time specified in the Act (section 15), a sum equal to 10% of the tax not remitted and interest at the prevailing CBN minimum re-discount rate, shall be added to the tax not remitted. The provisions of the CITA relating to collection and recovery of unremitted tax, penalty and interest shall apply (Section 40, Finance Act 2019).

c. **Tax payable**

As shown in the attached appendix 1, the company is liable to pay companies income tax of ₦31,896,000 and tertiary education tax of ₦2,815,250. This gives a total tax payable of ₦34,711,250. These tax liabilities are derived from the company's adjusted profit of ₦112,610,000 and total profit of ₦106,320,000.

Should you need further clarifications, please feel free to contact me.

Ola Bisi

Senior Tax Consultant

Appendix 1: Tax payable

EPS Mining Limited
Computation of adjusted profit
For the year ended December 31, 2022

	₦'000	₦'000
Net profit as per accounts		96,710
Add back:		
Depreciation	10,750	
Donation- Cultural group	350	
Improvement to office building	1,200	
Transfer to revenue reserve	3,600	
Formation expenses written off	2,400	

Fines and penalty paid	3,000	21,300
		118,010
Less: Non- taxable income		
Dividends received (net)		5,400
Adjusted profit		112,610

EPS Mining Limited
Computation of tax liabilities
For the 2023 assessment year

	₦'000
Adjusted profit	112,610
Less: Capital allowances	6,290
Total profit	106,320
Companies income tax @ 30% of ₦106,320	31,896.00
Tertiary education tax @ 2.5% of ₦112,610	2,815.25
Total tax payable	34,711.25

Computation of minimum tax

	₦'000
Gross turnover	355,400
Dividend received (gross) ₦5,400/0.9	6,000
	361,400
Less: Franked investment income (Dividend)	6,000
Net turnover for minimum tax computation	355,400
Minimum tax @ 0.5% of ₦355,400	1,777

Examiner's report

The question is divided into three parts. The first part tests the candidates' understanding of the objectives of pre-investigation meeting. The second part tests the candidates' knowledge of tax implications of lateness in filing returns and remittance of value added tax collected to the relevant tax authorities. The third part tests the candidates' knowledge of computations of tax liabilities of a mining company.

About 70% of the candidates attempted the question and they showed a fair understanding of it, resulting in an average performance.

The common pitfalls were the candidates' inability to identify correctly the disallowable expenses in the computations of adjusted profit and tax liabilities of a company.

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

Marking guide

		Marks	Marks
a.	Memo (address)	½	
	Memo (heading)	½	
	Objectives of a pre-investigation meeting		
	1 mark for each discussion of the objectives of a pre-investigation meeting, subject to a maximum of 3 points	3	4
b.	**Tax implications of lateness in filing returns and remittance of value added tax collected**		
	1½ mark for discussion of tax implication of lateness in filing returns		
	1½ mark for discussion of tax implication of lateness in remitting value added tax collected		3
c.	**Computation of tax liabilities**		
	Adjusted profit computation:		
	Net profit as per account	½	
	Depreciation	½	
	Donation- Cultural group	½	
	Improvement to office building	½	
	Transfer to revenue reserve	½	
	Formation expenses written off	½	
	Fines and penalty paid	½	
	Dividends received (net)	½	
	Adjusted profit	½	
	Total tax computation:		
	Capital allowances	½	
	Total profit	½	
	Companies income tax	½	
	Tertiary education tax	½	
	Minimum tax computation:		
	Gross turnover	½	
	Dividends	½	
	Minimum tax	½	8
	Total		**15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 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 any other **COLOUR OF INK** will not be marked.
8. A formula sheet and discount tables are provided with this examination paper.
9. You are required to attempt **Question ONE (Compulsory)**, **TWO Questions in Section B and TWO Questions in Section C.**
10. Check that you have collected the correct question paper for the examination you are writing.

WEDNESDAY, NOVEMBER 20, 2024

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 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

Tolade Plc (Tola) is a listed company which operates in the pharmaceutical sector, manufacturing a broad range of drugs under licence in a number of countries around Africa. In recent years the company has grown organically but a proposal has now been put forward by the company's investment bank that the company might consider the acquisition of Iyadun Plc (Iya), as a route to both further expansion and diversification of the company's activities.

Iya is involved in a different area of the pharmaceutical sector from Tola as it is primarily a research driven company involved in the development of new drugs arising from the latest academic research, often working with research departments of universities to turn research into commercial reality.

The two companies have been trading for over 15 years and have shown strong levels of profitability in most recent years. Tola is financed wholly by equity.

Whereas Tola is fully listed on the main market, Iya is listed on the alternative investment market. However, both companies' shares are thinly traded. It is generally believed that the current book value of equity of Iya represents 75% of its true market value, but it is felt that Tola's shares are not quoted accurately by the market.

The following information is taken from the financial statements of both companies at the start of the current year.

	Tola	Iya
	₦000	₦000
Assets less current liabilities	22,000	21,000
Capital employed:		
Equity	22,000	6,000
5-year floating rate loan at yield rate plus 3%	-	15,000
Total capital employed	22,000	21,000

In the year just ended, Tola recorded operating profit of ₦3.625m. From the statement of cash flow, you extracted the following additional information:

	₦'000
Depreciation Charge	2,500
Profit on disposal of non-current assets	700
Issue of additional shares	2,000
Net reduction in working capital	1,450
Purchase of non-current assets	4,150

The assets of both companies are stated at fair value. There is an agreement that the floating rate loan to Iya can be transferred to the combined business on the same terms.

The current yield rate is 5% and the current equity risk premium is 6%. It can be assumed that the risk free rate of return is equivalent to the yield rate. Tola's asset beta has been estimated to be 1.26.

Tola wants to use the Black-Scholes Option Pricing (BSOP) model to assess the value of the combined business and the maximum premium payable to Iya's shareholders. Tola has conducted a review of the volatility of the operating profit of both companies since both were formed and has estimated that the volatility of the combined business assets, if the acquisition were to go ahead, would be 35%. The exercise price should be calculated as the present value of a discount (zero coupon) bond with an identical yield and term to maturity of the current bond.
Both companies pay tax at 20%.

Required:

a. Prepare calculations to show the current free cash flows to equity (FCFE) of Tola. (5 Marks)

b. Using FCFE model, estimate the current market value of equity for Tola, explaining any assumptions made.
Notes
   i. Irrespective of your answer in (a) above, assume the current FCFE of Tola is ₦2,000,000.
   ii. Assume a growth rate of 3.9% of the company's FCFE. (7 Marks)

c. Explain the circumstances in which the Black-Scholes Option Pricing (BSOP) model could be used to assess the value of a company, including the data required for the variables used in the model. (7 Marks)

d. Using the BSOP method, estimate the maximum price and premium Tola may pay for Iya. (8 Marks)

e. Discuss the appropriateness of the method used in (d) above, by considering whether the BSOP model can provide a meaningful value for a company. (3 Marks)

(Total 30 Marks)

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

QUESTION 2

Leke industries Plc is a listed manufacturer whose principal product is 'Pako'. Pako is widely used in the building trade, particularly in residential properties. The company has several manufacturing plants in the country. Pako manufacture is a highly capital intensive activity. The company's other products, which account for only a small part of turnover are also supplied to the building trade.

Recently, demand for Pako has been very buoyant and the directors have decided to open a new manufacturing plant in Abuja to supply the local market and save on transport costs. A net present value assessment of the projected plant shows a substantial positive outcome. The cost of establishing this plant will be significant for the company, representing about 15% of its current stock market value.

The company is financed by a combination of equity and loan stock. Since the company's funds are all tied up in operations, establishing the new plant will require that the company raises additional finance. The directors generally have open minds on the source or sources of finance.

You are the company's finance director and have had some conversations with your colleagues, when the following points were made:

Director A

"This is not a good time to be issuing equity. I have a small share portfolio of my own and I plot the monthly prices of each share on graphs. I have done this for some years now and I can tell you that the patterns clearly show that we are heading for a major downturn in share prices. If we went for equity finance, by the time that we could get it organised, the bear market would be with us and we would need to issue a large number of shares to raise the necessary cash."

Director B

"We must pay attention to financial gearing. If we get that wrong, the stock market will probably savage our share price. By the way, are we going to make the financing decision without outside advice and how are we going to handle the practicalities? If not, who is going to do it for us?"

Director C

"People only seem to be interested in equities these days and all the evidence show that average returns are higher than you get from lending. We'll struggle to raise loan finance."

Director D

"Everyone seems to be talking about external finance, but I'm not so sure that it's necessary. We make good profits and have done so for some time. Can't we use some of the retained profits for this?"

Required:

Draft notes for the directors to address the whole question of the financing decision using the points raised by the directors. The notes should include explanations for any technical terms to aid the directors understanding.

(Total 20 Marks)

QUESTION 3

Feli Plc operates a low-cost road transport business and is a listed company. By comparison to its major competitors it is relatively small, but it has expanded significantly in recent years. The shares are held mainly by large financial institutions.

The following are extracts from Feli Plc's budgeted statement of financial position at 31 May 2023:

	₦'m
Ordinary Shares of ₦1	100
Reserves	50
9% Bonds 2026 (at nominal value)	200
	350

Dividends have grown in the past at 3% a year, resulting in an expected dividend of ₦1 per share to be declared on 31 May 2023. (Assume for simplicity that the dividend will also be paid on this date). Due to expansion, dividends are expected to grow at 4% a year from 1 June 2023 for the foreseeable future. The price per share is currently ₦10.40 ex div and this is not expected to change before 31 May 2023.

The existing bonds are due to be redeemed at par on 31 May 2026. The market value of these bonds at 1 June 2023 is expected to be ₦100.84 (ex interest) per ₦100 nominal. Interest is payable annually in arrears on 31 May and is allowable for tax purposes. The tax rate for the foreseeable future is 30%. Assume taxation is payable at the end of the year in which the taxable profits arise.

New finance

The company has now decided to purchase three additional vehicles at a cost of ₦10 million each. The Board has decided that the new vehicles will be financed in full by an 8% bank loan on 1 June 2023.

Required:

a. Calculate the expected weighted average cost of capital of Feli Plc at 31 May 2023. (7 Marks)

b. Without further calculations, explain the impact of the new bank loan on Feli Plc's

   i. cost of equity;
   ii. cost of debt; and
   iii. weighted average cost of capital (using the traditional model) (9 Marks)

c. Explain and distinguish between

   i. bonds; and
   ii. a bank loan

   In so doing, explain why, in the circumstances of Feli Plc, the cost of debt may be different for the two types of security. (4 Marks)

(Total 20 Marks)

QUESTION 4

Today's date is 26 May 2024.

WW is a publishing company that is listed in an African country, Country A, which uses the A$ as its currency. WW operates as three separate divisions according to type of publication as follows:

- Public Division - magazines and journals that are widely available in retail stores for purchase by the general public;
- Specialist Division - specialist magazines for particular industry sectors which are only available for delivery by post; and
- In-house Division - company in-house journals for circulation to its own staff members.

WW has been disappointed with the recent performance of the Specialist Division and is considering selling that division. WW manages the company's debt centrally and measures the performance of the divisions on the basis of EBIT (earnings before interest and tax).

XX, a book publishing company, has expressed an interest in purchasing the Specialist Division. XX is also located in Country A and is confident that it has the expertise required to improve the performance of the Specialist Division. XX would purchase the net assets employed in the division (that is, non-current assets plus working capital). All borrowings would remain with WW.

There has been some discussion amongst the Directors of XX as to the most appropriate method to use to value the Specialist Division.

Director A has suggested that an asset-based valuation should be used.

Director B has proposed that the valuation should be based on the future operating cash flows of the division, adjusted for tax and discounted by XX's existing weighted average cost of capital (WACC).

Director C has suggested that the WACC used in the valuation should be derived from a proxy company. He has identified YY as a possible proxy for the Specialist Division. YY's sole activity is publishing specialist magazines in a similar market to the Specialist Division.

Director D has suggested that the earnings valuation model should be used based on an estimated cost of equity for the Specialist Division.

Financial data for WW's Specialist Division

The management of WW have provided XX with the following financial data for the Specialist Division:

- The net assets employed in the division had a book value of A$15.0 million and an estimated replacement value of A$20.0 million on 31 March 2024;
- Operating cash flows adjusted for tax were A$2.5 million in the year ended 31 March 2024; and
- Operating cash flows are forecast to grow by only 1% per annum in perpetuity if the division remains within WW.

Financial data for XX and YY

	XX	**YY**
Equity beta	1.5	0.8
Gearing ratio (debt/debt plus equity)	40%	25%
Pre tax cost of debt	6%	7%
Market capitalization	A$150 million	A$30 million

Additional relevant information for all companies WW, XX and YY:

- Corporate income tax rate is 30%
- Risk free rate is 5%
- The premium over the risk free rate by the market is 6%
- Debt betas are zero

Required:

a. **Calculate:**

i. XX's existing cost of equity. (1 Mark)

ii. XX's existing weighted average cost of capital (WACC). (2 Marks)

iii. A suitable WACC for the Specialist Division based on proxy YY, adjusted for XX's gearing. (4 Marks)

b. i. Calculate a range of values for the Specialist Division based on the different methods suggested by Directors A, B and C (but not Director D) (5 Marks)

ii. Discuss the validity of the methods suggested by each of the four Directors A, B, C and D. (6 Marks)

iii. Advise XX on an appropriate price for the purchase of the Specialist Division. (2 Marks)

(Total 20 Marks)

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

QUESTION 5

Kemi Opeyemi (Kemi) is the finance director of Fola Engineering Plc (FE). Kemi has approached your firm to give a presentation to the board of FE on the characteristics and use of options in the following situation:

FE has been expanding in recent years by acquisition. Kemi would like to know how his company might use traded options to protect itself against a fall in the value of the small shareholdings that it holds in potential acquisitions. One such potential acquisition is Zeco Plc (ZP) in which FE has a holding on 31 December 2024.

The following information is available:
On 31 December 2024 the share price of ZP is 287 kobo (ex div) and traded options on its shares are available as follows (all figures in kobo):

	Calls		Puts	
Exercise price	**January**	**March**	**January**	**March**
280	8.5	16	1.5	10.5
290	2.5	11	5.5	16

Required:
Prepare the briefing notes for the presentation that include:

a. A calculation of the intrinsic value and the time value of each of the options on ZP's shares at 31 December 2024. (5 Marks)

b. A brief explanation of the three factors that affect the time value of the options on ZP's shares. (3 Marks)

c. A brief explanation of the two factors that affect the intrinsic value of the options on ZP's shares. (2 Marks)

d. A demonstration, using options, of how FE can protect itself against a fall in the ZP share price in the period up to 31 March 2025, when it will decide whether to make an offer for the whole of ZP. Assume ZP's share price will be 250 kobo on March 2025. (5 Marks)

(Total 15 Marks)

QUESTION 6

Discuss the main features of the following and include reasons why companies might use them:

a. Corporate share repurchase (buy-backs). (8 Marks)
b. Share (stock) splits. (7 Marks)

Include in your discussion comments on the possible effects on share price of share repurchases and share (stock) splits in comparison to the payment of dividends.

(Total 15 Marks)

QUESTION 7

a. Explain why a publicly quoted company might seek to ascertain the detailed composition of its shareholders and their objectives in investing in the company. Outline the major advantages which may accrue to the financial management function from obtaining this information. (8 Marks)

b. Provide examples of conflicts of interest that may exist between creditors and shareholders. (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)

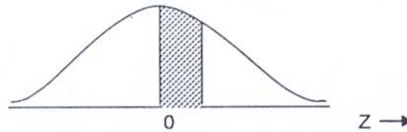
Periods

(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**									

SECTION A

SOLUTION 1

a. **Calculation of FCFE**

	₦'000
EBIT(1 - t) = ₦3,625(1 – 0.20) =	2,900
Depreciation	2,500
Profit on disposal of assets	(700)
Reduction in working capital	1,450
Purchase of assets	(4,150)
$FCFE_0$	2,000

Note: Issue of shares has no effect on free cash flow.

b. **Calculation of current total value of equity of Tola**

First, we determine cost of equity, using CAPM:
$K_E = 5 + (1.26 \times 6) = 12.56\%$

Value of equity can be computed as:

$FCFE_1/(K_E - g) = 2{,}000(1.039)/(0.1256 – 0.039)$ = ₦23,995.4 or (say) ₦24,000,000

This modelling method assumes that the free cash flow model fairly represents the fair value of the business, that the company is a going concern, that the discount rate has a flat term structure, and that future growth is constant. In practice one or more of these assumptions may be violated.

c. Using the BSOP model in company valuation rests upon the idea that equity is a call option, written by the lenders, on the underlying assets of the business. If the value of the company declines substantially then the shareholders can simply walk away, losing the maximum of their investment. On the other hand, the upside potential is unlimited once the interest on debt has been paid.

BSOP model can be helpful in circumstances where the conventional methods of valuation do not reflect the risks fully or where they cannot be used. Given the gearing of the two companies, the low levels of trading in each company's equity, and their future growth potential, including its volatility, it is appropriate to handle the valuation by focusing upon the real option value attributable to the post-acquisition business.

There are five variables which are input into the BSOP model to determine the value of the option. Proxies need to be established for each variable when using the BSOP model to value a company. The five variables are: the value of the underlying asset, the exercise price, the time to expiry, the volatility of the underlying asset value and the risk free rate of return.

For the exercise price, the debt of the company is taken. In its simplest form, the assumption is that the borrowing is in the form of zero coupon debt, i.e., a discount bond. In practice such debt is not used as a primary source of company finance and so we calculate the value of an equivalent bond with the same yield and term to maturity as the company's existing debt. The exercise price in valuing the business as a call option, is the value of the outstanding debt calculated as the present value of a zero coupon bond offering the same yield as the current debt.

The proxy for the value of the underlying asset is the fair value of both the companies' assets less current liabilities on the basis that if the company is broken up and sold, then that is what the assets would be worth to the long-term debt holders and the equity holders.

The time to expiry is the period of time before the debt is due for redemption. The owners of the company have that time before the option needs to be exercised, that is when the debt holders need to be repaid. The proxy for the volatility of the underlying asset is the volatility of the business' assets. The risk-free rate is usually the rate on a riskless investment such as a short-term government bond.

d. The variables required in the valuation are:

Exercise price (E): This is determined by an equivalent zero coupon debt with a term to maturity of five years and yield of 8% (5% + 3%):

$15,000 \times (1.08)^{-5} = ₦10,208.75$

Underlying assets (S) = the value of the underlying assets of the combined company = ₦43,000

Risk-free rate (r) = 5%

Time to expiration (t) = 5 years, volatility (σ) = 0.35

To value the equity of the combined business, we need to value a call option. Applying the BSOP model:'

$$d_1 = \frac{\ln\left(\frac{43,000}{10,208.75}\right) + (0.05 + 0.5(0.35)^2) \times 5}{0.35 \times \sqrt{5}} = 2.548$$

$d_2 = 2.548 - (0.35 \times \sqrt{5}) = 1.765$

$N(d_1) = 0.5 + (0.4945 + 0.8(0.4946 - 0.4945)) = 0.995$

$N(d_2) = 0.5 + (0.4608 + 0.5(0.4616 - 0.4608)) = 0.9612$

Call value (₦000) = $(43,000 \times 0.995) - (10,208.75 \times 0.9612 \times e^{-0.05\times5}) =$ 35,142.90

The value of the call on the combined firm's assets is approximately ₦35,142,900.

Deducting Tola's current equity of ₦24,000,000:
₦35,142,900 - ₦24,000,000 = ₦11,142,900

This suggests that the maximum price which should be paid to the shareholders in Iya is ₦11,142,900.

Market value of Iya = ₦6,000,000/0.75 = ₦8,000,000
Maximum premium payable = ₦11,142,900 - ₦8,000,000 = ₦3,142,000 or 39.3%.

e. Although the BSOP model is very effective in valuing continuously traded securities in active markets, its validity is more questionable where the basic assumptions supporting the model do not hold. It is assumed that the value of the assets of the business change randomly around a rising trend and are thus log-normally distributed. It is also assumed that they are traded in frictionless markets and the holding can be continuously adjusted. Finally, the model is only appropriate for European style options. Given these assumptions, the modelling can only be expected to give an indicative rather than a definitive value, but in the absence of any alternative it is a useful adjunct to commercial judgement.

Examiner's report

This is a five-part question that tests candidates' understanding of various aspects of acquisition and valuation. In part (a), candidates were expected to calculate free cash flows to equity (FCFE). In part (b), they were asked to value Tola, using FCFE. In part (c), candidates were asked to explain the circumstances in which the Black-Scholes Option Pricing (BSOP) Model could be used to assess the value of a company. In part (d) candidates were expected to calculate the maximum price and premium Tola may pay for the acquisition. In part (e), candidates were expected to assess the use of BSOP in equity valuation.

Being a compulsory question, virtually all the candidates attempted the question but performance was extremely disappointing. Candidates lost considerable marks due to the following factors:

- Most of the candidates could not correctly calculate the FCFE. This is because they could not correctly treat items like profit on disposal of assets, issue of additional shares, change in working capital, etc.
- Failure to correctly calculate cost of equity using CAPM
- Complete lack of understanding of the BSOP's variables
- In part (c), almost all the candidates demonstrated total lack of knowledge of the use of the model in valuation.

As this area of the syllabus is likely to be tested more frequently in future examinations, candidates are strongly advised to devote adequate time to studying it.

Marking guide

		Marks	Marks
1 a.	Calculation of FCFE of Tola	5	
b.	Calculation of cost of Equity	2	
	Calculation of value of Equity	3	
	Explanation of assumptions made	2	
c.	Explanation of circumstances in which the Black – Scholes Option Pricing (BSOP) model could be used.	2	
	Stating and explaining the variables used in BSOP model	5	
d.	Computation of Exercise Price (E)	½	
	Computation of underlying assets (S)	½	
	Computation of d_1 applying BSOP model	3	
	Computation of d_2	½	
	Computation of $N(d_1)$	½	
	Computation of $N(d_2)$	½	
	Computation of Call Value	½	
	Deduction of Tola's current equity	½	
	Suggestion of the maximum price	½	
	Computation of marked value of Iya	½	
	Computation of premium payable	½	
	Discussing the appropriateness of the BSOP model used.	3	
		30	**30**

SECTION B

SOLUTION 2

Financing and other issues relating to a major investment

Gearing

Leke Industries Plc (Leke) is operating in a classic cyclical industry, with high capital intensity and, almost certainly, high operating gearing. Operating profits are susceptible to great fluctuations in the face of fluctuations in turnover. History shows this trade to be subject to major fluctuations in turnover.

Financial gearing must therefore be approached with caution. Identifying the optimal level of gearing seems very difficult to achieve. It can only be a matter of judgement, but forming that judgement must take account of Leke's current level of gearing and of levels of gearing in the industry, particularly with market leaders and with companies having high operating gearing, like Leke.

In theory (Modigliani and Miller) gearing makes no difference to the wealth of the shareholders. Cheap loan finance having a positive effect, that is precisely cancelled

out by the higher returns required by shareholders in the face of higher risk. If we take account of the tax deductibility of loan interest, gearing in theory favours shareholders since, in effect, there is a transfer of wealth from the tax authorities to shareholders.

At higher levels of gearing the risk of the company being unable to meet its debt commitments of interest and capital repayment, particularly during a period of low turnover/operating profitability, could force the company to have to liquidate, to the detriment of shareholders wealth (Director B's comment). Gearing policy tends, therefore to be seen as striking a balance between the benefits of tax relief and the potential costs of 'bankruptcy'.

Other factors that could come into play:

Agency
Directors may be unwilling to gear the company up to a level optimum to the shareholders. This is because gearing imposes a set of disciplines on the directors, of having to meet interest payments and arranging continuing finance when the loan is due for redemption.

Signaling
It is believed by some that a company making a loan issue implies confidence in the future and this could have a favourable effect on the share price.

Clientele effect
It is believed that particular shareholders are attracted to particular company's shares, because of the level of gearing. Altering the level of gearing could have a detrimental effect on the share price as investors move away from the company to a 'preferred habitat'. Uncertainty about the company's intentions could also have a detrimental effect.

A large positive NPV project, like the new plant, will affect gearing, since it will add value to the equity of the company.

Equity
This is an obvious source of finance, subject to the gearing level. The most obvious source of equity is a rights issue to existing shareholders. This has the advantage of being relatively cheap to issue and does not face the company with much of a problem regarding the issue price. There is normally a right that existing shareholders are offered new shares before a public issue can be made. Usually the shareholders would need to vote away their 'pre-emption' rights, before the company could go for a public issue.

A public issue is much more expensive than a rights issue to achieve, because there are legally-required, expensive procedures to be complied with. Public issues tend to be more likely to fail. Setting prices for public issues tends to be difficult to judge.

To Leke, equity is rather more expensive than loan finance, investors expect higher returns than they do for loans, but their returns are distinctly more risky. (Director C's comment). Equities seem popular at present.

Loan finance

Whether a loan stock issue to the public or a term loan from a financial institution, loan finance is relatively cheap to raise relative to equity. Lenders typically expect good security, and freehold land tends to offer the best security. So, the ability of Leke is likely to be linked to the extent that it has unused 'debt capacity' in its assets.

Lenders typically expect lower returns than equity holders do, but they have contractual rights to interest and redemption payments on the due dates. This exposes the company to risk and to discipline.

Provided that the company has sufficient taxable profits, loan interest is tax deductible and this makes it still cheaper for the company.

Retained profit

This is an important source of new finance. It would not be suitable in this case, since all of the company's available funds are already committed. There is the option of waiting, perhaps a few years, until retained profits build up before making the investment, but commercially, this may not be a real option.

The revenue reserves are not cash, but part of the owners' claim. Therefore they are not available as investment funds (Director D's comment).

Retaining profit has implications for dividend policy and, possibly, for shareholder wealth.

Market efficiency

The evidence is clear, that in sophisticated stock markets, charted price patterns do not repeat themselves, except by chance. Weak form efficiency is present in such markets.

It is illogical to feel that a time of low share prices is a bad time to issue new shares. Market efficiency theory (and evidence) suggests that whatever the share price is at any point represents the best unbiased estimate of its worth based on available evidence (Director A's comment).

Other sources

Leasing the plant
Sales and leaseback
Working capital efficiencies

Advice

It is possible that Leke has sufficient 'in-house' expertise to enable it to avoid the need for professional advice. Raising the level of finance that we are probably considering

here is not an everyday event for a commercial company, so it is probably better to seek advice from experts.

Merchant banks typically are able to offer advice and may well be able to put the company in touch with potential investors, assuming that the rights-issue route is not taken.

The larger firms of Chartered Accountants, almost certainly Leke's auditors, have close links to corporate finance advisers.

The advice will not typically be cheap (Director B's comment).

Examiner's report

The question tests candidates' knowledge of capital structure. Candidates were expected to make use of their knowledge of capital structure theory to comment on various comments made by the directors.

More than 90% of the candidates attempted the question with below average level of performance. It is a matter of great concern that candidates could perform so poorly on a question intended to be marks booster in the examination.

In preparing for this examinations, candidates are expected to make use of the institute's pathfinder and other relevant examination practice materials.

Marking guide

		Marks	Marks
2.	Draft notes for the directors to address the whole question of financing decision.	<u>20</u>	<u>20</u>

SOLUTION 3

a. i) **Cost of equity(K_E)**

$$K_E = \frac{1 \times 1.04}{10.4} + 0.04 = 14\%$$

Total value of equity = 100m shares × ₦10.40 = ₦1,040m

ii) **Cost of bonds**

The bonds are redeemable and the cost of capital is the IRR of the related after-tax cash flows. Taking face value of ₦100:

Current price (P) = ₦100.84
Annual interest, net of tax (I) = ₦9(1 – 0.30)= ₦6.30
Redemption value (R) = ₦100
Years to redemption (n) = 3

$$\text{Approximate IRR} = \left(\text{I} + \frac{\text{R} - \text{P}}{\text{n}}\right) \div \frac{\text{R} + \text{P}}{2}$$

$$= \left(6.30 + \frac{100 - 100.84}{3}\right) \div \frac{100 + 100.84}{2} = 6\%$$

So, try 6%

NPV = -100.84 + 6.30(2.673*) + 100(0.840) = - ₦0.006

The IRR is approximately 6%

(* Annuity at 6% years 1-3)

(Notes: The approach adopted here is not necessarily prescriptive. However, it is a faster method recommended for use in examination. Candidates are allowed to make use of the usual approach of calculating IRR).

Total value of bonds = ₦200m × 100.84/100 = ₦201.68m

$$\text{WACC} = \frac{1040 \times 14\%}{1040 + 201.68} + \frac{201.64 \times 6\%}{1040 + 201.68} = 12.7\%$$

b. **Impact of new bank loan**

i) **Cost of equity**

The new bank loan will increase the gearing of the company and therefore make the returns to equity more volatile as interest has to be paid before any payment is made to shareholders. In addition, on liquidation the bank loan will be paid in full before any distribution to shareholders. This means that the risk to shareholders increases and therefore the cost of equity will increase to compensate shareholders for this risk.

ii) **Cost of debt**

Gearing is currently fairly low (measured by market value) but the bank loan will increase this. However, the book value of assets less current liabilities would appear to be roughly ₦350 million. This easily covers the ₦232 million of debt, even with the new ₦30 million loan and as long as the book values of the non-current assets do not massively exceed their market values, the increase in debt should not affect the risk perceived by the debt-holders. Therefore, we would not expect the cost of debt to change.

iii) **Weighted average cost of capital (WACC)**

As more debt is introduced, it will tend to reduce the WACC as it is a cheaper form of finance than equity. However, the cost of equity is likely to rise, as noted above. As debt is introduced initially, the overall effect, according to the traditional theory, is to decrease until shareholders perceive the risk to be much greater, at which point the cost of equity rises dramatically and

pulls the WACC up again. Whether the increase in Feli's debt causes the WACC to increase or decrease depends on whether its current gearing structure is below or above this optional point.

c. **Bond or bank loan**

A bond is a written acknowledgment of a company debt, stating the interest coupon and repayment provisions as well as other conditions. These can be offered to the public if a prospectus is prepared and can be held in trust on behalf of many different investors and traded on a secondary market.

A bank loan is not normally traded and is arranged with a single bank or a syndicate of banks.

The cost of debt may be different between the two for Feli as:

- The current interest rates will affect the terms when issued, so the 9% coupon rate on the bonds will have been influenced by the interest rates ruling at the time;
- The covenants to protect the investor may be different; the one with more protection will be less risky and hence carry a lower cost;
- Bonds are marketable, thus reducing the risk to holders and leading to a lower cost;
- The bonds may have been issued at a premium or a discount and the future cash flows increased or decreased to compensate; and
- The cost of debt is not very different between the two. The bank loan is 8% pre tax, whereas the bond is 6% post tax. Pre tax, the cost of the bond (or yield) is 8.7%.

Examiner's report

This question tests candidates' knowledge of various aspects of cost of capital.

Almost all the candidates attempted the question with average level of performance.
In part (a), the calculation of the current WACC was properly handled by majority of the candidates. However, a number of them lost marks because they could not calculate IRR! They could not identify the relevant cash flows associated with the bonds.

In part (b), candidates were asked to assess the impact of new debt on cost of equity, cost of debt and WACC. Only a small proportion of the candidates attempted this part of the question but performance was just average.

It is recommended that candidates should always cover the syllabus comprehensively.

Marking guide

		Marks	Marks
3a.	Computation of cost of equity	1	
	Computation of total value of equity	½	
	Calculation of annual interest	½	
	Computation of the IRR	3	
	Computation of total value of bonds	½	
	Computation of WACC	1½	
b.	Explaining the impact of the new bank loan on cost of equity	3	
	Explaining the impact of the new bank loan on cost of debt	3	
	Explaining the impact of the new bank loan on the weighted average cost of capital	3	
c.	Explain and distinguish between bonds and bank loan	2	
	Reasons why the cost of debt may be different for the two types of security	2	
		20	**20**

SOLUTION 4

a. i) **XX's cost of equity**

$$k_e = R_f + [R_m - R_f]\beta = 5\% + 6\% \times 1.5 = 14.0\%$$

ii) **XX's WACC**

$$\text{WACC} = K_E\left[\frac{V_E}{V_E + V_D}\right] + k_d(1-t)\left[\frac{V_D}{V_E + V_D}\right]$$

$$= 14.0\% \times 60\% + 6\%\,(1 - 0.30) \times 40\% = 10.08\%$$

iii) **WW's specialist division based on proxy YY, adjusted for XX's gearing** For YY:

- Ungear the equity beta of YY, using YY's financial leverage

$$\beta_A = \beta_E\left(\frac{V_E}{V_E + V_D(1-t)}\right) = 0.8 \times \frac{75}{\left(75 + (25 \times 0.7)\right)} = 0.65$$

- Regear the above asset beta, using XX's financial leverage

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

$$= 0.65 + (0.65 - 0)\left(\frac{40}{60}\right)(1 - 0.3) = 0.95$$

- Compute the cost of equity for the Specialist Division

$$K_E = R_f + \beta(R_m - R_f) = 5 + 0.95\ (6) = 10.7\%$$

- Compute the WACC of the Specialist Division

$$WACC = \frac{V_E \times K_E}{V_E + V_D} + \frac{V_D \times K_D(1-t)}{V_E + V_D}$$

$$= (10.7 \times 60\%) + (6)(1 - 0.30)(40\%) = 8.1\%$$

b. i) A range of values for the Specialist division based upon the valuation methods suggested by Directors A, B and C is shown below:

Method	Result	Workings
Director A: net assets	A$15 million book value A$20 million replacement value	Figures given in question
Director B: Cash flow basis using XX's WACC	A$27.8 million	Discount the division's cash flows using XX's WACC of 10.08% and a growth rate of 1%: A$2.5m(1.01)/(0.1008 - 0.01) =A$27.8m
Director C: DCF using a WACC based on proxy YY	A$35.6 million	Discount the division's cash flow using a WACC of 8.1% and a growth rate of 1%: A$2.5m (1.01)/(0.081 – 0.01) =A$35.6m

ii) **Points for discussion**

Director A

- Net assets are not appropriate – these are only used in break-up situations whereas XX is acquiring the business as a going concern.
- Net asset values would be expected to undervalue the division because they do not take intangible assets and goodwill into account

Director B

- Director B has suggested using the operating cash flows of the business (adjusted for tax) discounted at XX's existing WACC.
- As a valuation method, this approach will value the whole of the business before taking into account the way that it is funded. This is an appropriate basis on which to value the Specialist Division as it does not have its own debt, as long as an appropriate WACC is used.

- Although XX's WACC reflects the capital structure of XX, it does not reflect the business risk of the Specialist Division which is not the same as the business risk of XX. A WACC can be obtained that reflects the business risk of the division by using the ungeared beta of the proxy company, YY.

Director C

- Business risk can be taken into account by basing the WACC calculation on YY's beta. This beta can then be ungeared and regeared to take into account the risk profile and capital structure of XX and used to calculate both a cost of equity and a WACC for XX to use in valuing WW's Specialist division. This gives a significantly higher valuation, reflecting the lower risk of YY than XX. The validity of this result is backed up by comparing the likely underlying risk of both businesses. YY has more reliable repeat business from publishing specialist in-house company journals whereas XX is in the more risky book publishing business. This explains the higher beta value for XX.

Director D

- The earnings valuation method requires figures for both earnings and cost of equity.

- However, neither of these figures are available for the Specialist Division as it is not a separate subsidiary company with its own capital structure, share price and dividend history.

- Estimates may be possible if more information were available about the capital structure of WW and an appropriate allocation of capital and interest costs across divisions. It would also be possible to use the capital structure of YY in the evaluation of the interest cost.

- Note that the earnings valuation method only provides the value of equity. So the value of debt would need to be added to the final result to obtain an estimate of the value of the assets being acquired by XX.

iii) **Advice on price**

It could be argued that each of the valuations calculated above has some degree of validity and that XX should start by offering a value near the bottom of the range as an initial bargaining position.

It is likely that XX would regard the proposal put forward by Director C as having the greatest validity in this instance as this is based on pre-debt cash flows and XX is not acquiring any debt attached to the Division. This gives a value of A$35.6 million. Indeed, XX may even be prepared to pay more for the business if it believes that it is possible to achieve growth in excess of the current projected growth rate of 1%. However, this price is at the top of the range of valuations and XX should open negotiations at a lower level, especially as WW may be working

on different figures and may not have uplifted the valuation to reflect the lower perceived riskiness of the Specialist Division when compared with other parts of the business.

In conclusion, I would recommend a starting bid of around A$28 million (which is the valuation of the cash flows discounted at XX's own WACC) and negotiate from that starting point up to a maximum price of A$35 million, a valuation that reflects the lower risk profile of the Specialist Division than that of XX.

Examiner's report

Once again, the question tests some components of cost of capital required for business valuation under different scenarios.

Most of the candidates attempted the (a) part of the question with varying degree of success. Most of the candidates failed to provide any meaningful answers to part (b) thereby losing valuable marks.

Cost of capital links several sections of the syllabus. That underscores the importance of cost of capital in finance.

Candidates presenting themselves for this exam must be well vast in this area.

Marking guide

			Marks	Marks
4.	(i)	Compute XX's existing cost of equity	1	
	(ii)	Calculate XX's existing weighted average cost of capital (WACC)	2	
	(iii)	Ungearing the equity beta of YY	1	
		Regearing the asset beta, using XX's financial leverage	1	
		Computing the cost of equity for the specialist division	1	
		Computing the WACC of the specialist division.	1	
b.	(i)	Calculate the value for the specialist division based on the method suggested by Director A.	1	
		Calculate the value for the specialist division based on the method suggested by Director B.	2	
		Calculate the value for the specialist division based on the method suggested by Director C.	2	
	(ii)	Discussing the validity of the methods suggested by each of the four Directors.	6	
	(iii)	Advise XX on an appropriate price for the purchase of the Specialist Division.	2	
				20

SOLUTION 5

a. **Intrinsic value**

The intrinsic value (i.e. the option payoff) of a call option (C_T) to the option buyer (holder) is given by:

C_T = Max (0, S_T - E), where
S_T = stock price at time T
E = exercise price

i) Call option with E = 280kobo
C_T = Max (0, 287 – 280) = 7kobo

ii) Call option with E = 290kobo
C_T = Max (0, 287 - 290) = 0
(Option value cannot be negative)
For put options, the intrinsic value (P_T) at time T is given by:
P_T = Max (0, E - S_T)

iii) The put option with E = 290
P_T = Max (0, 290 - 287) = 3kobo

iv) The put option with E = 280
P_T = Max (0, 280 – 287) = 0

Time value

The time value is calculated by deducting the intrinsic value from the option premium:

	Calls		Puts	
Exercise price	January	March	January	March
280	1.5	9	1.5	10.5
290	2.5	11	2.5	13

b. The three factors that affect the time value of the options on ZP's shares are:

- The time period to expiry of the option. The longer the time to expiry, the more the option is worth;
- The volatility of the market price of ZP's shares. For example, if ZP's share price becomes more volatile this will increase the probability of the options becoming either in the money or, if they are already in the money, becoming deeper in the money. This would increase the value of the options; and
- The general level of interest rates. The exercising of the option will be at some point in the future, and so the value of the option depends on the

present value of the exercise price. For example, for the call options on ZP's shares if interest rates rise the options will become more valuable.

c. The factors that affect the intrinsic value of the options on ZP's shares are:
The exercise price:

- For a call option: The lower the exercise price in relation to the share price the higher will be the intrinsic value and this will make the option more valuable; and

- For a put option: The higher the exercise price in relation to the share price the higher will be the intrinsic value and this will make the option more valuable.

The share price:

- For a call option: As the share price rises the option becomes deeper in the money and more valuable as the intrinsic value increases. The reverse is the case for a fall in the share price; and

- For a put option: As the share price falls the option becomes deeper in the money and more valuable as the intrinsic value increases. The reverse is the case for a rise in the share price.

d. Kemi can protect itself against a fall in the ZP share price by holding put options that expire on 31 March 2025.

The choice of exercise price will depend on the level of cover required and how much premium Kemi is willing to pay.

If the ZP share price is 250kobo at the end of March, the results of holding put options will be as follows:

With an exercise price of 280kobo

Loss in the value of the shares 287 – 250 = 37kobo
Gain on exercising the put options 280 – 250 = 30kobo
Premium: 10.5kobo

The maximum loss: 37 – 30 + 10.5 = 17.5kobo
Alternative: 287 – 280 + 10.5 = 17.5kobo

With an exercise price of 290kobo
Loss in the value of the shares 287 – 250 = 37kobo
Gain on exercising the options 290 – 250 = 40kobo
Premium: 16kobo
Maximum loss: 37 – 40 + 16 = 13kobo

Alternative: 287 – 290 + 16 = 13kobo

Examiner's report

This is a four-part question that tests candidates' understanding of the risk management section of the syllabus. The scenario is that a company had used derivative instruments to hedge risk that locked the company into one asset price. The finance director of the company wished to know more about the use of financial options in risk management.

Only about 10% of the candidates attempted the question. In all, the level of performance was extremely poor. Most of the candidates that attempted the question appear to be engaging in gambling! For those who made little effort, the basic errors included using calls instead of puts and picking the incorrect month of exercise.

It cannot be overemphasised that success in the examination requires adequate preparation and complete coverage of the syllabus.

Marking guide

		Marks	Marks
5 a.	Compute the intrinsic value of the call options with exercise price 280 kobo.	½	
	Compute the intrinsic value of the call options with exercise price 290 kobo.	½	
	Compute the intrinsic value of the put options with the exercise price 280 kobo.	½	
	Compute the intrinsic value of the put options with the exercise price 290 kobo	½	
	Compute the time value for the call options	1½	
	Compute the time value for the put options	1½	
b.	Explain the three factors that affect the time value of the options on ZP's shares.	3	
c.	Explain the two factors that affect the intrinsic value of the options on ZP's shares.	2	
d.	Stating that put options be used to protect the ZP's share price.	1	
	Compute the loss of value of shares with an exercise price of 280 kobo.	½	
	Compute gain on exercising the put option with an exercise price of 280 kobo.	½	
	Compute premium on exercise price of 280 kobo	½	
	Compute the maximum loss on exercise price of 280 kobo.	½	
	Compute the loss of value of shares with an exercise price of 290 kobo.	½	
	Compute the gain on exercising the put options with an exercise price of 290 kobo.	½	
	Compute premium on exercise price of 290 kobo.	½	
	Compute the maximum loss on exercise price of 290 kobo.	½	
		15	15

SOLUTION 6

a. **Share repurchases**

Purchase of own shares is a alternative means for companies to distribute shares to shareholders other than by a cash dividend. In certain regimes companies can purchase their own shares out of distributable profits, or the proceeds of a new issue of shares, provided certain conditions are fulfilled.

Uses of share repurchase

i) **No available buyer**
For a smaller private company, there may be no immediate willing purchaser at a time when a shareholder wishes to sell shares.

ii) **Going private**
For a listed company, share repurchase can be a means of withdrawing from the stock market and going private.

iii) **Surplus cash**
Share repurchase can be a use for surplus cash, particularly at a time when investment returns are low.

iv) **Increase in share price**
Purchase of own shares can be a means of supporting share price during a period of weakness. A reduction of the number of shares in issue should lead to an increase in earnings per share, and hence an increase in the market price of shares.

v) **Increase in gearing**
Companies whose gearing levels are low can increase gearing by purchasing their own shares. If debt finance is cheaper than equity finance this may lower the company's weighted average cost of capital and hence mean that more potential investments could be undertaken on the grounds that they have a positive NPV.

vi) **Declining business**
If the company's business is in decline, purchase of equity can lower its funding to a more appropriate level for its level of business.

vii) **Thwarting a takeover**
A share repurchase may be used to buy out shareholders who might be favourably disposed towards a takeover bid.

Response of market

i) **Strong-form efficiency**
If the market is strong-form efficient, it may have understood the share repurchase as being the best possible use of funds, and the announcement of the purchase should not influence the share price.

ii) **Signalling effect if markets are not strong-form efficient**
If the markets are not strong-form efficient, a repurchase of shares could be seen as an admission that the company cannot make better use of the funds than the shareholders, and its share price may fall. However the markets may take the contrary view, and see a share repurchase as a sign that the company has more cash and more earnings potential than previously believed.

The price at which shares are repurchased will influence the market response. If shares are repurchased by tender, it will often be at a price in excess of current market price.

iii) **Investor preferences**
Investors may prefer share repurchase to dividend payments because of differences in the tax regime on capital gains and dividend income.

b. **Stock splits**
A stock split occurs when each share is split into shares of smaller nominal values, for example each ₦1 share being split into 10units of 10kobo shares.

Uses of stock splits

i) **Greater marketability**
Evidence suggests that shares of smaller nominal value are more marketable than shares of larger value. Companies whose shares are high valued often split their shares.

ii) **Ownership**
Share splits may be a way of encouraging wider ownership of shares, by making it easier for shareholders to hold small holdings.

Market response

i) **Strong-form efficiency**
If the market is strong-form efficient, the stock split should not make any difference, as it does not make any difference to the company's ability to undertake projects with a positive NPV.

ii) **Signalling effect if markets are not strong-form efficient**
If the market is less than strongly efficient, it may interpret the stock split as new information, as a sign that the company is planning for earnings and

dividend growth in the future. As a result, there may be short-term increases in the share price.

Examiner's report

This is a two-part question testing candidates' understanding of share buy-back and stock splits.

Almost all the candidates attempted the question and performance was about average. There is evidence that some of the candidates have no idea of stock split.

Marking guide

		Marks	Marks
6 a.	Discussing the main features of corporate share repurchase.	1	
	Discuss the reasons why companies might use corporate share repurchase.	5	
	Comment on the possible effects on share price of share repurchase in comparison to the payment of dividends.	2	
b.	Discussing the main features of share (stock) splits.	1	
	Discuss the reasons why companies might use share splits.	3	
	Comment on the possible effects on share price of stock splits in comparison to the payments of dividends.	3	
		15	**15**

SOLUTION 7

a) Shareholders are the legal owners of publicly quoted companies and corporate management should consider the interests of the owners when making financial decisions on their behalf. Shareholders, and other market participants as potential shareholders, are the suppliers of any additional risk capital which may be required and so consideration must be given to the interests of these capital suppliers by any firm which may need to raise further equity. Therefore, ascertaining exactly who owns the firm's shares and what, if any, are their particular preferences and objectives is a basic piece of information needed by management if it is to ensure that, as far as possible, it is acting in the shareholders' interest. The information may also provide information concerning circumstances where different types of shareholder may have conflicting interests – the information will not itself resolve the conflict but will help alert management to it.

If capital markets were perfect and tax systems did not differentiate between dividend income and capital gain then maximising present value would meet the requirements of all shareholders even if their preferences differed. But actual capital markets and tax system imperfections do not allow this to be a valid reason for ignoring shareholder preferences.

The major advantages which may accrue include the effects concerning:

i) Dividend policy. Knowledge of shareholder preferences, and marginal tax rates, will assist in the determination of the firm's optimum dividend policy;

ii) Risky investment. Shareholder preferences may assist corporate management when making decisions concerning risky investments. Shareholders may prefer, or dislike, the opportunity to obtain extra return by undertaking additional risk;

iii) Financing decisions. Knowledge of shareholders' attitudes to risk may assist in determining the company's policy concerning the target level of gearing. Generally the higher the gearing the higher and more risky is the return to equity;

iv) Importance of shareholder attitudes to risk. If shareholders hold highly diversified portfolios then their risk preferences will be less important when considering investment and financing ((ii) and (iii) above) than would be the case if they hold just a few different shareholders in a largely undiversified portfolio;

v) Rebuffing a take-over. A company whose shares are held by a few shareholders may find an unwanted take-over bid less easy to rebuff as the bidder need convince only a few key shareholders for the bid to be successful. However, if shares are held by a few key shareholders it may be easier to provide these shareholders with the type of return they require with a possible reduction in their likely acceptance of any take-over; and

vi) Measurement of performance. Ascertaining how shareholders judge performance, e.g. accounting return on capital, dividend growth, growth in earnings per share etc., may enable management to optimise this measure, or measures, when making decisions.

b. Conflicts of interest between creditors and shareholders can occur when the financial well-being of a company is at stake. Here are some examples of such conflicts:

1. **Dividend payments**: Shareholders may prefer higher dividends to maximise their returns, while creditors might want the company to retain earnings to ensure it has sufficient funds to meet debt obligations; and

2. **Leverage and risk**: Shareholders may encourage the company to take on more debt to finance expansion or increase shareholder returns, while creditors may be concerned about the increased risk of default and the company's ability to service the debt.

3. **Capital structure decisions**: Shareholders might prefer to prioritise equity financing, which dilutes their ownership but does not create additional debt obligations. On the other hand, creditors may prefer debt financing to ensure regular interest payments and a defined repayment schedule;

4. **Asset sales and liquidation**: In the event of financial distress, shareholders might prefer to sell off assets or liquidate the company to salvage some value, while creditors may want to protect their interests by seeking debt repayment or restructuring;

5. **Investment decisions**: Shareholders may push for riskier or aggressive investment strategies to boost share prices, while creditors may prefer conservative investment decisions that safeguard the company's ability to repay debt;

6. **Management compensation**: Shareholders may advocate for generous executive compensation packages to attract top talent, while creditors may view such expenses as detrimental to the company's ability to service debt;

7. **Financial reporting**: Shareholders might want to see positive financial performance even if it means using aggressive accounting practices, while creditors may want accurate and conservative reporting to assess the company's creditworthiness;

8. **Priority in liquidation**: In the case of bankruptcy or liquidation, creditors' claims take precedence over shareholders' claims, creating a direct conflict regarding the distribution of remaining assets;

9. **Restructuring plans**: During financial distress, shareholders may oppose or resist restructuring plans that involve debt renegotiation or equity dilution, as it could lead; and

10. **Covenant compliance**: Creditors may impose certain financial covenants on the company to maintain their loan terms and protect their interests, which could constrain the company's flexibility and affect shareholder value.to loss of ownership and control.
    (Note: Relevant alternative points will be rewarded).

Examiner's report

This is a two-part question. The first part tests candidates' knowledge of why publicly quoted company are interested in knowing who are their major shareholders. The second part of the question on the other hand, tests candidates' knowledge agency problems in finance.

Almost all the candidates attempted the question with above average level of performance.

Marking guide

		Marks	Marks
7a.	Explaining why a publicly quoted company might seek to ascertain detailed composition of its shareholders and their objectives of investing in the company.	3	
	Outlining the major advantages to the financial management function from obtaining detailed composition of a quoted company's shareholders.	5	
	State and explain examples of conflicts of interest that may exist between creditors and shareholders.	7	
		15	**15**

 Examination No..........................

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 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 any other **COLOUR OF INK** will not be marked.

8. You are required to attempt **Question ONE (Compulsory)**, **TWO Questions in Section B and TWO Questions in Section C.**

9. Check that you have collected the correct question paper for the examination you are writing.

WEDNESDAY, NOVEMBER 20, 2024

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 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

You are a manager in Ichadaba & Co. (Chartered Accountants), and responsible for the audit of Prohomey Group of Companies. The group's main activity is engineering, metal fabrication and related businesses. The group comprises the parent company and three subsidiaries. Your firm currently audits all the components of the group.

Work is currently ongoing on the audit of the group's financial statements for the year ended June 30, 2022. When you opened your email box this morning, you saw the following note that was left for you by the Audit Engagement Partner:

"Hello,

The Audit Senior has provided the draft consolidated financial statements with the accompanying notes, which summarise the key audit findings and some background information.

At the planning stage, materiality was initially determined to be ₦950,000 and was calculated based on the assumption that Prohomey Group is a high risk client due to its listing status.

During the audit, a number of issues, including indicators that certain management estimates may not have been properly recorded in terms of the relevant accounting standards, arose. This meant that we needed to revise the materiality level for the financial statements as a whole. The revised materiality level is now determined as ₦650,000.

One of the audit juniors was unsure as to why the materiality level has been revised.

The key audit findings on the group's consolidated financial statements are in the attached notes.

Thank you."

NOTES:

i) Revenue has been stable for all the components of the group with the exception of Copesmink Company Limited, which witnessed a 25% decrease in revenue.

ii) Operating expenses figure for the year ended June 30, 2022 is showing a profit on a property disposal of ₦2million. Our evidence includes agreeing the cash receipts to bank statements and sale documentation, and we have confirmed that the property has been removed from the non-current assets register. The audit junior noted when reviewing the sale documents that there is an option to repurchase the property in five years' time, but did not discuss the matter with management.

iii) The property revaluation gain of ₦800,000 in the income statement relate to the revaluation of a property at the group's head office. The audit team has not obtained evidence on the revaluation, as the gain was immaterial.

iv) Also the actuarial losses on defined benefit plan of ₦1.1million are attributed to an unexpected stock market crash. The group's pension plan is managed by Axial Company, a firm of independent fund managers, who maintain the necessary accounting records relating to the plan. Axial Company has supplied written representation as to the value of the defined benefit plan's assets and liabilities of June 30, 2022. No other audit work has been performed other than agreeing the amount reported in the financial statements to the supporting documentation supplied by Axial Company.

v) The goodwill of ₦5,350,000 relates to the subsidiares in the group. Management has confirmed in writing that goodwill is stated correctly and our other audit procedure was to arithmetically check the impairment review conducted by management.

vi) There is an investment in associated company of ₦4,230,000 which is a 30% holding in Famil Company Limited, purchased to provide investment income. The audit team has not obtained evidence regarding the associate as there is no movement in the account recognised in the statement of financial position as at year end.

vii) The non-current assets held for sale of ₦7.8million in the draft financial statements relate to trading division of one of the subsidiaries, which represents one third of that subsidiaries net assets. The sale of the division was announced in May 2022, and is expected to be completed by December, 2022. Audit evidence obtained includes a review of the sales agreement and confirmation from the buyer, obtained in July 2022, which indicated that the sale will take place.

(viii) Two of the group's subsidiaries are owned partly by shareholders outside of the group.

(ix) A loan of ₦8million was obtained in October, 2021 at an interest rate of 20% payable annually in arrears. The terms of the loan have been confirmed to the documentation provided by the bank. There was no repayment of the loan in the books as at year end.

Required:

a. Discuss the justification for the need for reassessment of materiality as the audit progresses. (6 Marks)

b. Assess and report the implications of the key audit findings for the completion of the audit.
(Your assessment must consider whether the key audit findings indicate a risk of material misstatement. Where the key audit findings refer to audit evidence, you must also consider the adequacy of the evidence obtained, but you do not need to recommend further specific procedures)
Your answers must respond to the notes from the audit engagement partner and the key audit findings. (15 Marks)

c. Justify the reasons for the review of ISA 540: *Auditing accounting estimates including fair value accounting estimates and related disclosures.* Demonstrate how, with its proper application during the audit, the audit team can obtain sufficient appropriate audit evidence on management's processes and accounting for estimates. (9 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 Managing Director (MD) of Zesco Plc has approached his colleague in a social club to recommend a firm of chartered accountants to be appointed as auditor of the company. Zesco Plc is a multi-billion Naira company and newly incorporated but has interest in various sectors of the economy. Your firm was mentioned because of the confidence this social colleague has in your firm. A call was put to your Managing Partner (MP) and the discussions settled on a formal meeting with the MD in your Managing Partner's office. Your MP has directed that you sit in during the discussion and take notes for him.

During the discussion, and as part of gaining an understanding of the business information systems of the company, including its accounting systems, you noted that the company imports breakdown components of a brand of electric generators and assembles the generators locally. The company also operates a warehousing facility for self use and lease to other organisations. It also imports finished milk produce

which are packaged locally. The company is about 10 months old and is planning to prepare a 15 months' accounts to correspond to December 31 which is chosen as its year end. In addition to the financial information provided by the Managing Director, you gathered that presently Zesco Plc may not be:

- Optimising the use of its inputs, such as energy purchase;
- Complying with relevant local government laws, including environmental laws; and
- Applying best practices in recruiting, training and utilising its human resources.

You will be involved in the first audit, which necessitated your involvement in the meeting between the two chief executives. You will also develop the necessary audit programme to suit this new client.

Required:

a. Develop the key controls that are necessary in such a scenario as this, to ascertain the revenue and receivables of the client. (6 Marks)

b. State the components of the information system that the auditor should focus on in identifying and understanding the processing methods, accounting records and processes used in preparing the financial statements in accordance with the terms of ISA 315: *Identifying and assessing the risks of material misstatement through understanding the entity and its environment.* (5 Marks)

c. Discuss the non-financial controls that the internal auditors of this company would be advised to focus on. (3 Marks)

d. Prepare the schedule of duties and responsibilities of the audit committee that would be reviewed during the audit, to ensure compliance with the Code of Corporate Governance. (6 Marks)

(Total 20 Marks)

QUESTION 3

The government parastatal you work for has received a new board of directors including the promotion of the Deputy Managing Director to acting Managing Director following the retirement of the Managing Director.

Prior to this reconstitution of the board, there has been concerns about the performance of the parastatal. The local community where the organisation's main operational activity is situated has threatened a protest against the parastatal before the change in management.

The new management, in consideration of the need to ensure a cordial working environment has held a press conference where the objective was to assuage the concerns of the community. The new management team further started a process of addressing the issues. Part of the steps taken is to initiate a process of finding out the issues with the parastatal and its performance, and you have proposed a value for money review.

Required:

a. Prepare a guide for the evaluation of the performance of the parastatal by looking at the key components of the value for money engagement, giving the objectives, and measures of the components. You should also include a description of the approach expected to be adopted by the practitioner. (12½ Marks)

b. Discuss the distinctive features of the value for money review engagement as contained in the International Framework for Assurance Engagements. (7½ Marks)

(Total 20 Marks)

QUESTION 4

You have just been introduced to the General Manager (GM), Finance and Administration of your firm's new audit client. The client is a newly established company involved in using drones to deliver parcels to various customers in Lagos.

Your Partner and the Managing Director have discussed the details of the respective responsibilities of the two parties at a previous meeting. However, the GM wants to have an insight into the contractual obligations of your firm as the company's auditors and that of the company itself.

To create a mutual confidence at this initial stage, you assured the GM that your firm's engagement letter will address his concerns of this requirement. He has, however, asked for another brief meeting for further interactions before the commencement of the audit. You are, therefore, reviewing and familiarising yourself on the contents of the engagement letter, drone technology and robotic process automation.

Required:

a. Explain the expected contents of the engagement letter in terms of the requirements of the standards and after considering the information provided in the above scenario. Your response should be sufficient to demonstrate your thorough understanding of your responsibility to the client. (8 Marks)

b. i. Discuss Robotic Process Automation (RPA). (5 Marks)

   ii. Highlight some of the manual audit tasks that are prone to error in the audit process and which will therefore benefit from digital technology, including RPA. (7 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

Your team is reviewing the activities of XYZ Plc which has operated for over 20 years and makes effort to comply with appropriate regulatory requirements. However, the results in the recent years of activities present a declining position in various aspects.

The company's operations cut across different sectors of the economy. Recent reviews of operations from economic standpoint show that the vagaries of the economic situations in the country are partly responsible for the factors affecting the company. Management has engaged your firm to carry out a detailed review to ascertain other factors that are responsible for the situation with a view of finding an appropriate solution to bring the company back to its former strong and enviable position.

Required:

a. Evaluate the auditor's risk assessment objective in accordance with ISA 570: *Revised Going Concern.* (3 Marks)

b. Discuss the factors to be interrogated regarding the going concern assumptions from the financial, operational and other perspectives. (12 Marks)

(Total 15 Marks)

QUESTION 6

Mr. Sokenu Talabi operates under the name TST General Importers Limited. Mr. Sokenu Talabi imports and sells anything viable for him in the country. With the connivance of some officials, he gets some foreign exchange and buys others from the bureau de change (BDCs).

Due to the mix of the sources of forex for import, the business of Mr. Sokenu Talabi makes superfluous profits.

The mix of forex sources has also led to the non disclosure of some business activities in the company records.

Mr. Talabi is a popular socialite and a philanthropist with friends in most of the government and regulatory agencies he does business with.

The company's tax is prepared most of the time based on the activities involving the foreign exchange from the official channel. The company's financial statements are audited by a sole practitioner who is Mr. Talabi's club member. Most of the staff of the audit firm are unqualified accountants and documentation is usually minimal. Mr. Talabi uses his influence to negotiate and resolve any issues with regulatory agencies.

Based on the advice of his doctors, Mr. Talabi is slowing down on activities and wants to hand over to the first child of his second wife who appears more focused and organised.

Your firm has been approached to take over the audit due to the need to establish the real state of the business.

Required:

a. Discuss the components of the audit risk model that are likely to be present in the audit of the company. (10 Marks)

b. From the scenario presented, identify and justify the risk areas in the audit of the company (5 Marks)

(Total 15 Marks)

QUESTION 7

You are in charge of the audit of Mallam Musa Olugbenla & Co. Limited for the year. The company is a general trading company with an annual turnover in excess of ₦2billion and the company's business is subject to laws and regulations that have recently attracted public attention. Part of the business process requires selling on credit to some major dealers. These credit facilities are covered by bank guarantees and the individual dealer's personal reputation.

During the current year audit, the team agreed on appropriate materiality level. This became very useful when the attention of the audit manager was drawn to a payment of ₦12.5m to a former landlord in settlement of an old case. Evidence showed that though the company initially lost the case at the High Court and appealed before year end, it lost after year-end and was forced to pay the judgment amount.

Required:

a. Discuss the requirements of the auditor with respect to the audit of the financial statements and the legal environment in accordance with ISA 250: *Consideration of the laws and regulations in an audit of financial statements.* (6 Marks)

b. Evaluate the treatment of the settlement of the judgment amount that was not recorded as at year end in terms of all relevant standards. (9 Marks)

(Total 15 Marks)

SECTION A

SOLUTION 1

a. **Materiality**

i. **ISA 320:** ***Materiality in Planning and Performing an Audit*** requires that the auditor shall revise materiality for the financial statements as a whole in the event of becoming aware of information during the audit that would have caused the auditor to determine a different level of materiality initially.

ISA 320 requires the auditor to apply the concept of materiality:

- When planning and performing an audit; and
- When evaluating the effect of misstatements on the financial statements and therefore on his audit opinion.

The auditor must set what ISA 320 refers to as performance materiality. Performance materiality recoginises the fact that if all areas of the audit are carried out to detect all errors/omissions under the (overall) materiality level, that objective could be achieved, but when all the individual immaterial errors/omissions are added together, overall materiality could in fact be breached. Performance materiality is a way of taking this risk into account and will be set at a lower figure than overall materiality. There may be one or more performance materiality levels, as the level could vary by area.

As the audit progresses, the auditor must revise materiality and, if appropriate, materiality for particular areas and performance materiality, if he becomes aware of information which would have caused him to have initially set different levels, had that information been known to him at the time.

Documentation must include details of all materiality levels set and any revision of these levels as the audit progresses.

ii. During the audit, the auditor becomes aware of a matter which impacts on the auditor's understanding of the client's business and which leads the auditor to believe that the initial assessment of materiality was inappropriate and must be revised.

iii. The actual results of the audit client may turn out to be quite different to the forecast results on which the initial level of materiality was based.

iv. Change in the client's circumstances may occur during the audit, such as a decision to dispose a major part of the business. This may cause the auditor to consider if the previously determined level of materiality is still appropriate.

v. If adjustments are made to the financial statements subsequent to the initial assessment of materiality, then the materiality level may need to be revised accordingly.

vi. The initial calculation of materiality for the Group was based on the client's listing status and on an assumption that the group is a high risk client.

b. Ichadaba & Company
(Chartered Accountants)
From: Audit Manager
To: The Audit Engagement Partner

Subject: Implications of Key Audit Findings

Key audit findings	**Assessment of the implication of the audit findings for the completion of the audit**
Statement of comprehensive income i. Revenue has been stable for all components except for Copesmink with 25% decrease in revenue.	There is the need to verify that all revenues of Copesmink have been fully recorded and that understatement of invoices or under-billing did not occur.
ii. Operating expenses figure for the year ended June 2022 shows profit on a property disposal of ₦2 million.	The option to repurchase the property after 5 years needs to be discussed with management. If the option results in a loan, then the ₦2m should be adjusted and loan recognised (possibly with interest). Inappropriate treatment of the impact of the repurchase option could result in material misstatement of the financial statements given the amount of materiality used for audit.
iii. Property revaluation	There is the need to obtain sufficient and appropriate audit evidence on the revaluation. Since the transaction is now considered material being ₦800,000 and the revised materiality level is ₦700,000, there is a likely risk of material misstatement.
iv. Actuarial loss attributed to unexpected stock market crash	Representation letter would be obtained from the management of Prohomey Group. There is need to carry out more audit procedures to verify the loss, which may

	include obtaining expert opinion such as from Actuarial Practitioner or Stocks market expert.
Statement of financial position v. Goodwill relates to all the subsidiaries in the group	The three subsidiaries are owned and controlled by the group. It is proper to recognise the goodwill of each of the subsidiaries at this time, however, impairment would be assessed. We have to pass adjustment journal to recognise impairment of goodwill attributable to the subsidiaries where applicable.
vi. Associate is by 30% holding in Famil Company	There is need to obtain sufficient and appropriate audit evidence regarding this associate. 30% holding is significant and can result in material misstatement.
vii. The non-current assets held for sale relate to trading division of one of the subsidiaries.	The non-current assets held for sale amounts to 331/3% of the net assets of the subsidiary, which is very significant. Additional audit evidence is required, especially, to determine likelihood of the future sale.
viii. Two of the group's subsidiaries are owned partly by shareholders external to the group.	There is the need to ascertain the equity participation of the external shareholders to determine the extent of their interest in the subsidiaries. We shall also obtain sufficient and appropriate audit evidence to verify external shareholders' investment in the subsidiaries. The financial statements will be materially misstated if the investments are significant and not corrected.
ix. Loan of N8m obtained in October 2021 at an interest rate of 20%.	There is the need to inquire from management regarding the reason for non-payment of the amount that fell due in December 2021. This may be an indication of going concern issues. There is a need to also check that interest expense relating to the un-repaid loan has been fully charged in the statement of profit or loss and other comprehensive income.

c. ISA 540: *Auditing accounting estimates, including fair value accounting etimates, and related disclosures* is concerned with the audit of all accounting estimates, including those involving fair values. It requires auditors to obtain sufficient appropriate audit evidence as to whether:

- Accounting estimates (whether recognised or disclosed in the financial statements) are reasonable; and
- Whether the related disclosures are adequate.

Because of the number of major corporate scandals in recent years about aggressive 'earnings management', ISA 540 (revised and redrafted in accordance with the IAASB's clarity project) introduces requirements for greater rigour and skepticism in the audit of accounting estimates. It encompasses a risk based approach focusing on those estimates that have high estimation uncertainty.

The revised ISA encompasses:

i. Introduction of requirements for greater rigour and skepticism in this area;
ii. Provision of standards and guidance on what constitutes a misstatement and on indications of management bias;
iii. Focusing work on areas of estimation uncertainty and risk; and
iv. Aligning more closely with the audit risk model.

The new requirements include:

i. Obtaining an understanding as to how management identify the need for accounting estimates and how they make those estimates;
ii. Reviewing the outcome of accounting estimates made in prior periods;
iii. Evaluating estimation uncertainty and whether high estimation uncertainty leads to significant risks; and
iv. For identified significant risks:
    - Evaluating how management has considered alternative assumptions or outcomes;
    - Obtaining sufficient appropriate evidence about whether management decisions are in accordance with the applicable financial reporting framework;
    - Evaluating the adequacy of disclosure of the estimation of uncertainty; and
v. Reviewing management's judgement and decisions in order to identify management bias.

Examiner's report

The question tests the candidates' knowledge of materiality assessment in the audit process, the impact of key audit findings in the audit process and the requirements of ISA 540: *Auditing accounting estimates, including fair value accounting and discussion,* and its revision.

This being a compulsory question, all the candidates attempted it. The performance was average.

The common pitfalls of the candidates were the lack of understanding of the process of identification of key audit findings (KAF), the requirements of ISA 540, and materiality assessment in the audit process.

Candidates are advised to familiarise themselves with the practical aspects of engagements and also read the Institute's Study Text and Pathfinders which are freely available on the Institute's website.

Marking guide

		Marks	Marks
a.	**Justification for the need for reassessment of materiality**		
	Definition of materiality		
	(1 mark for definition)	1	
	Discussion on the need for reassessment		
	(1 mark each for any 5 points on need for re-assessment)	<u>5</u>	6
b.	**Implications of the key audit findings**		
	The addressee details	1	
	Subject of the report	½	
	For identifying the key audit findings		
	(½ mark for the 9 headings)	4 ½	
	Discussion of the 9 key audit findings		
	(1 mark for each for any 9 points)	<u>9</u>	15
c.	**Reasons for the review of ISA 540**		
	Identifying the issues before the review		
	(1 mark each for any 3 points)	3	
	Identifying new requirement		
	(1 ½ marks for any 4 points)	<u>6</u>	<u>9</u>
	Total		<u>30</u>

SECTION B

SOLUTION 2

a. Key controls that are necessary to ascertain revenue and receivables of the client include:

   i) Segregation of duties (order acceptance/ despatch/ invoicing);
   ii) Checking that a customer's order is within the customer's credit limit;
   iii) Authorisation of orders;
   iv) Using pre-numbered sales order forms;

v) Pre-numbering of despatch notes and matching with sales orders and invoices;
vi) Authorisation of despatches after checking;
vii) Authorising invoices`for sending to customers, after checking them for accuracy and against sales orders and despatch notes;
viii) Recording invoices promptly in the sales ledger. Batching of invoices for input and batch totals may be used as a control;
ix) Checking and authorising sales returns and allowances (discounts);
x) Recording credit notes accurately;
xi) Reconciliatory the control account for receivables in the main ledger regularly with account balances in the receivables ledger;
xii) Sending statements regularly (monthly) to credit customers;
xiii) Ensuring debt collection procedures are followed systematically, in accordance with debt collection policy;
xiv) Writing off any bad debts must be authorised; and
xv) Ensuring control over cash sales and cash collections.

b. ISA 315: *identifying and ascertaining the risks of material misstatement through understanding the entity and its environment*

This aspect of the auditor's work will involve identifying and understanding the following:

i) The entity's principal business transactions;
ii) How these transactions and other events relevant to the financial reporting process are 'captured' (identified and recorded) by the entity;
iii) The processing methods, both manual and electronic, applied to those transactions;
iv) The accounting records used, both manual and electronic, to support the figures appearing in the financial statements;
v) The processes used in the preparation of the financial statements; and
vi) The Information Technology (IT) risk management processes and how risks to cyber security are managed.

The information system, therefore, consists of:

i) Infrastructure (physical and hardware components)– manual accounting systems may have little infrastructure;
ii) Software (in IT-based accounting systems);
iii) People;
iv) Procedures; and
v) Data.

The existence of an accepted framework such as COBIT used for systems development may provide additional assurance to the auditors in their assessment of the client's information system.

c. The internal audit function often has a much wider role than simply performing financial audits, and in many entities (particularly large entities) the internal auditors are involved in other aspects of auditing, such as:

i) **Energy audits**: these are checks on how the entity is making use of energy and whether its operations are energy-efficient;

ii) **Social audits**: these are checks on the impact of the entity on the society in which it operates;

iii) **Environmental audits**: these are checks on the effect the entity is having on its natural environment, and considers issues such as the use of sustainable materials, re-cycling, reducing pollution; and

iv) **Human resource audits**: these are audits into the work force of an entity, to check whether the entity has adequate systems for the recruitment, training and development of employees to meet its current and future needs.

d. **The following are the schedule of duties and responsibilities of the audit committee that will be reviewed to ensure compliance with the Code of Corporate Governance**

S/N	Areas of focus	Duties and responsibilities
i)	Oversight of the integrity of the company's financial statements	To assist in the oversight of the integrity of the company's financial statements, compliance with legal and other regulatory requirements, assessment of qualifications and independence of external auditor, and performance of the company's internal audit functions as well as that of external auditors.
ii)	Internal audit Function	To establish an internal audit function and ensure that there are other means of obtaining sufficient assurance of regular review or appraisal of the system of internal controls in the company.
iii)	Internal control frame work	To ensure the development of a comprehensive internal control framework for the company, obtain assurance and report annually in the financial report, on the operating effectiveness of the company's internal control framework.
iv)	Fraud and error	To oversee management's process for the identification of significant fraud risks across the company and ensure that adequate prevention, detection and reporting mechanisms are in place.
v)	Internal audit report review	To at least, on an annual basis, obtain and review a report by the internal auditor describing the strength and quality of internal controls including

		any issues or recommendations for improvement, raised by the most recent internal control review of the company.
vi)	Audited financial statements	To discuss the annual audited financial statements and half yearly unaudited statements with management and external auditors.
vii)	Policies and strategies	Discuss policies and strategies with respect to risk assessment and management.
viii)	Whistle blowing procedures	To review and ensure that adequate whistle-blowing procedures are in place and that a summary of issues reported are highlighted to the chairman.
ix)	Independence	Review the independence of the external auditors and ensure that where non-audit services are provided by the external auditors, there is no conflict of interest.
x)	Meeting with auditors	Meet separately and periodically with management, internal auditors and external auditors.
xi)	Auditor's scope and limitations	Review, with the external auditors, any audit scope limitations or problems encountered and management responses to the same.
xii)	Human resources policy	Preserve auditor's independence, by setting clear hiring policies for employees or former employees of independent auditors.
xiii)	Related party	Consider any related party transactions that may arise within the company or group.
ivx)	Report	Report regularly to the board
vx)	Authority to investigate	Invoke its authority to investigate any matter within its terms of reference for which propose the company must make available the resources to the internal auditors with which to carry out this function, including access to external advice where necessary.

Examiner's report

The question tests the candidates' knowledge of the applicable controls in a given scenarios, the information system in accordance with ISA 315: Identifying and assessing the risk of material misstatements and the functions of internal auditors and the audit committee.

The question was attempted by about 80% of the candidates and performance was above average.

Many of the candidates were unable to explain the various aspects of control environments and the different responsibilities with respect to control in an organisation.

Candidates are advised to pay close attention to the requirements of the question and understand responsibilities of various parties in the organisation. They are also advised to study properly the Institute's Study Text and Pathfinders.

Marking guide

		Marks	Marks
a.	**Development of the key controls**		
	Identification of key controls on revenue and receivables		
	(1 mark for any 6 points)		6
b.	**Components of information system for identifying methods**		
	For identifying process methods, accounting methods and processes.		
	(1 mark each for any 3 points)	3	
	For identifying components of the information system		
	(1 mark each for any 2 points)	2	5
c.	**Non-financial controls to focus on**		
	Identify non-financial control		
	(1 mark each for any 3 points)		3
d.	**Preparation of schedule of duties of Audit Committee**		
	Identifying audit committee area of focus, duties and responsibilities		
	(½ mark each for any 6 points on area of focus)	3	
	(½ mark each for explanation of duties and responsibilities)	3	6
	Total		**20**

SOLUTION 3

a. 'Value for money' means using resources in the best way to achieve intended objectives. There are three aspects to achieving value for money, often known as the '3 Es':

   i) **Economy:** This means spending money carefully, and not paying more than necessary for resources - materials, labour, and other expenses;

   ii) **Efficiency**: Efficiency means using resources in such a way that they produce the greatest possible amount of 'output'. It means getting more from the use of available resources. For example, efficiency in the use of an employee means getting a high rate of output for every hour or day worked; and

   iii) **Effectiveness**. Effectiveness means using resources in such a way as to achieve the desired objectives. It is of little value unless the output from the system is what the entity wishes to achieve.

The objective of a value for money (VFM) engagement

The purpose of a VFM engagement is to investigate a particular aspect of an entity's operations and reach a conclusion about whether the entity is obtaining value for money.

	Meaning	**Measurement**
Economy	'Doing it cheaply'	Compare money spent with inputs acquired
Efficiency	'Doing it well'	Compare inputs used with output achieved
Effectiveness	'Doing the right thing'	Compare output achieved with objectives

The approach to performing a VFM engagement is summarised below:

i) For the particular aspect of operations that is the subject of the investigation or 'audit', the practitioner should identify and develop methods of measuring the 3Es – economy, efficiency, and effectiveness;

ii) It is often necessary to assess the 3Es by making comparisons. The practitioner should therefore establish an appropriate basis for making comparisons (such as economy, efficiency, effectiveness and achievements in previous periods, comparisons with other entities, comparisons with targets, and possibly comparisons with national averages);

iii) Having gathered and analysed measurements of the 3Es, the practitioner should conclude whether the 3Es are being achieved for the operations that have been the subject of the investigation; and

iv) If appropriate, the practitioner should identify areas of weakness and make appropriate recommendations to the client about improvements that should be made.

b. The International Framework for Assurance Engagements was revised in 2013 and describes the objectives and elements of an assurance engagement.

The Framework makes a distinction between:
i) Attestation engagements; and
ii) Direct engagements.

The Framework also makes a distinction between:
i) Assurance assignments that give a **reasonable level of assurance**; and
ii) Assurance assignments that give a **limited level of assurance**.

In assurance engagements, it is not possible to give an absolute level of assurance as a result of:

i) The lack of precision often associated with the subject matter;
ii) The nature of the evidence available; and
iii) The time scale involved.

Reasonable level of assurance
Where a reasonable level of assurance is given, the risk attached to the assignment is at a sufficiently low level to enable the practitioner to give **positive assurance**.

Reasonable assurance can only be given in the following circumstances:
- The subject matter of the assurance service engagement is the responsibility of another party; and
- The subject matter is identifiable and can be subjected to evidence-gathering techniques.

In other words, a reasonable level of assurance can be given only if the accountant is carrying out an assignment that looks at information that has not been prepared by the accountant (or relates to some other subject matter that is not the responsibility of the accountant). In addition, the accountant must be able to obtain sufficient evidence for giving a positive opinion.

Limited level of assurance
Where only a limited level of assurance is given:
- The risk is higher than that for an engagement where the accountant is able to give a reasonable assurance, but

- The risk is sufficiently low to allow for a 'negative' expression of the accountant's conclusions (a negative opinion, as in a review report).

Non-assurance engagements
In addition, the framework distinguishes assurance and non-assurance engagements. Examples of a non-assurance engagement are:

- Preparation of tax returns and tax consulting;
- Management consulting; and
- Agreed-upon procedures or compilation engagements.

Examiner's report
The question tests the candidates' knowledge of performance evaluation of parastatals using the value for money concepts, and the features of the International framework for assurance engagements.

The question was attempted by about 60% of the candidates, but performance was poor.

The commonest pitfall was the candidates' inability to apply the link of the requirements of the question to the scenario and poor demonstration of knowledge of the international framework on assurance engagement.

Candidates are advised to pay close attention to the Institute's Study Text and Pathfinders to enhance better performance in future.

Marking guide

		Marks	Marks
a.	**Preparation of guide for evaluation of performance**		
	Definition of value for money	1	
	Identification of the '3Es' (½ mark each for the identification of each of 3Es)	1½	
	Explanation of the 3Es (1 mark for each explanation of the Es	3	
	1 mark for the purpose of VFM	1	
	Explanation on the meaning and measurement of the "3Es" (1 mark each for explanation of each of the three measures)	3	
	Identifying practitioner's approach to value for money engagement (1 mark each for any 3 approaches)	3	12½
b.	**Discussions of distinctive features of value for money review engagements**		
	Identifying features of VFM review engagement in line with International Framework for Assurance Engagement	1	

Introduction (1 mark)		
Identification of the distinctions (1 mark)	1	
Any 2 assurance level identified (1 mark)	2	
Explanation on absolute assurance (½ mark)	½	
Any 2 position level of assurance	2	
Non-assurance engagement (1 mark for any 1 point)	1	7½
Total		**20**

SOLUTION 4

a. The engagement letter must include reference to the following:

i) The objective and scope of the audit;

ii) The responsibilities of the auditor;

iii) The responsibilities of management;

iv) Identification of the underlying financial reporting framework;

v) Reference to the expected form and content of any reports to be issued; and

vi) Because it specifies what the auditor will be doing and what the auditor's exact responsibilities will be, the engagement letter is also seen to be an important way of reducing the 'expectation gap'. This is the difference between:

- the view of the role and responsibilities of the auditors that is held by the users of financial statements, and
- the auditor's actual (statutory) role and responsibilities.

In addition to the above, the auditor may feel that it is appropriate to include additional points in the engagement letter, such as:

i) Legislatory regulations, international standards on auditing (ISAs), and ethical pronouncements;

ii) The fact that because of the inherent limitations of an audit, and the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected even though the audit was properly planned and performed in accordance with ISAs;

iii) Arrangements regarding the planning and performance of the audit, including the composition of the audit team;

iv) The expectation that management will provide written representations;

v) The basis on which fees are computed and any billing arrangements;

vi) A request for management to acknowledge receipt of the engagement letter and to agree to its terms;

vii) Arrangements concerning the involvement of other auditors, experts or internal auditors (or other staff of the entity);

viii) Any restriction of the auditor's liability when such possibility exists; and

ix) Best practice also recommends that the engagement letter should include an explanation of the auditor's responsibility with regard to anti-money laundering checks and procedures.

b. (i) Along the years, auditors have seen a lot of improvements in their work, mainly through the use of spreadsheets, word processors, automated working papers and audit software. Despite these improvements, the audit process is made up of series of repetitive, manual and mundane tasks which are equally labour-intensive for auditors. Auditors are currently leveraging on mainly two newer technologies to assist them automate these tasks with a view to further enhancing the efficiency and effectiveness of audit practice. These two technologies are:

i. Robotic process automation; and
ii. Drone technology.

Robotic process automation (RPA)

- This is a software that is deployed at the user interface level to automate processes that are repetitive, structured and/or rule-based as well as those with machine-readable data.
- RPA can help auditors streamline evidence collection and achieve near end-to-end automation of audit process as it can be used to execute audit tests that have been pre-programmed in other applications such as spreadsheets.
- Once RPA has been implemented to take over the various time-consuming audit tasks, the audit process is bound to become more efficient and the auditor would focus more on resolving complex accounting issues that require professional judgement.
- Implementation of RPA solution should be carefully carried out by auditors and it is recommended for automation of audit activities to be done in phases. It is important to note that the activities identified as being automatable with RPA will need to be subdivided into discrete steps that can be translated into programmable functions, the data to be used must be standardised and in machine-readable format.
- On the other side of the coin, robots are subjected to audit. Sometimes, auditors discover that a client to be audited had implemented the use of robots in one or more areas of their business.
- The use of robots by audit clients brings the benefit of a reliable, standardised process flow as a basis for the audit.
- In addition, relevant data is made available in a reliable and consistent form. This enables the auditors to design an audit approach that focuses on the process and to put an even emphasis on detailed

understanding and analysis of the financial situation, as well as to review in more detail the underlying management decisions.

- The implementation of RPA by a client directly affects the auditor's approach and might lead to modifications in the nature, timing or the extent of the audit procedures to be performed.

c. (ii) Some of the manual tasks which are prone to errors include:

- Data preparation and entry;
- Integration of data from multiple files;
- Manual importation of audit-relevant data into spreadsheets or other software;
- Copying, pasting and sorting data on spreadsheets;
- Performing basic audit tests such as re-computations and analytical procedures; and
- Inventory count.

Examiner's report

The question tests the candidates' knowledge of the contents of the engagement letter and robotic process automation.

The question was well attempted by about 90% of the candidates and performance was good.

The common pitfalls were the candidates' inability to evaluate the contents of the engagement letter, and the identification of errors that may occur in the application of robotic process automation.

Candidates are advised to be familiar with the contents of an engagement process and the evolving technologies applicable in auditing.

Marking guide

		Marks	Marks
a.	**Stating the expected contents of engagement letter**		
	Identifying the content of engagement letter (1 mark each for any 3 points)	3	
	Identifying additional points (1 mark for any 4 points)	4	
	Best practice recommendation on money laundering	1	8
b.	**Discussion of robotic process automation**		
	i) Definition of RPA	1	
	Discussion on RPA (1 mark for any 4 points)	4	5
	Highlight of manual audit task prone to error		
	ii) Identifying manual task prone to error (1½ mark for any 4 points)	6	
	Bonus	1	7
	Total		**20**

SOLUTION 5

a. ISA 570: *Going concern*, requires that the auditor must perform risk assessment procedures to consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

If management has already performed such risk assessment, the auditor must:

i. Discuss this assessment with management;
ii. Determine whether the assessment identified any relevant events or conditions, and if so; and
iii. Determine management's plans to address them.

If management has not yet performed such an assessment, the auditor must prepare the risk assessment procedure and:

iv. Discuss with management the basis for the intended use of the going concern assumption; and
v. Inquire of them whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern.

b. ISA 570 gives a number of examples of events or conditions that individually or collectively, may cast significant doubt about the going concern assumption:

Financial
i. Net liability or net current liability position;
ii. Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets;
iii. Indications of withdrawal of financial support by creditors;
iv. Negative operating cash flows indicated by historical or prospective financial statements;
v. Adverse key financial ratios;
vi. Substantial operating losses or significant deterioration in the value of assets used to generate cash flows;
vii. Arrears or discontinuance of dividends;
viii. Inability to comply with the terms pf loan agreements;
ix. Change from credit to cash-on-delivery transactions with suppliers;
x. Inability to obtain financing for essential new product development or other essential investments;

Operating
i. Management intentions to liquidate the entity or cease operations;
ii. Loss of key management staff without replacement;
iii. Loss of major market, key customer(s), franchise, license, or principal supplier(s);
iv. Labour difficulties (e.g. riot, strike or conflict);

v. Shortages of important supplies;
vi. Emergence of highly successful competitor;
vii. War, strife and other natural disasters;

Others

i. Non-compliance with capital or statutory requirements;
ii. Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy;
iii. Changes in laws or regulations or government policies expected to adversely affect the entity; and
iv. Uninsured or underinsured catastrophe when they occur.

Examiner's report

The question tests the candidates' knowledge of the auditor's risk assessment objectives in accordance with ISA 570: *Revised going concern* and the going concern assumptions.

The question was attempted by about 60% of the candidates and performance was good.

The commonest pitfall was the candidates' inability to evaluate the differences in the ISA 570 before and after revision and the various aspects of issues affecting going concern.

Candidates are advised to be abreast of the developments in the profession and they should ensure that they read the Institute's Study Text and Pathfinders before sitting for the next examination.

Marking guide

		Marks
a.	**Evaluation of auditor's risk assessment objective** Identifying auditor's risk assessment in accordance with ISA 570 (1 mark each for any 3 points)	3
b.	**Discussion of factors for interrogation regarding going concern assumptions** Identifying going concern assumptions (1 mark each for any 12 points with at least 2 points from each section)	12
	Total	**15**

SOLUTION 6

a. **Audit risk** is the risk that the auditor reaches an inappropriate conclusion on the area under audit, especially when the financial statement is misstated. The audit risk model is used to measure the risk attached to any given audit situation. The audit risk model is:

Audit Risk = Inherent Risk X Control Risk X Detection Risk.

TST General Importers Limited (TST) will be exposed to "Inherent Risk", which is the risk that items may be misstated as a result of their inherent characteristics, either because of the nature of the item, the nature of the industry, or the nature of the entity. In this case, the nature of the entity creates an Inherent Risk due to the channels used to source forex for their business and the intentional non-disclosure of some of the business activities.

When inherent risk is high, this means that there is a high risk of misstatement of an item in the financial statements. Inherent risk operates independently of controls and therefore cannot be controlled. The auditor must accept that the risk exists and will not 'go away'.

TST will also be exposed to "Control Risk", which is the risk that misstatements will not be prevented or detected by the internal control system of the company. In this case, there is no evidence that TST has put in place controls to detect misstatements. Also due to the nature of accounting and reporting, the internal controls are likely either weak or non-existent to allow for the Mr. Sokenu's business styles and activities.

In preparing an audit plan, the auditor needs to make an assessment of control risk for different areas of the audit. Evidence about control risk can be obtained through 'tests of control' for each of the major transaction cycles.

The initial assumption should be that control risk is very high, and that existing internal controls are insufficient to prevent the risk of material misstatements. However, tests of control may provide sufficient evidence to justify a reduction in the estimated control risk, for the purpose of audit planning.

It is unlikely that control risk will be zero because of the inherent limitations of any internal control system.

TST will also be exposed to "Detection Risk", which is the risk that the audit testing procedures will fail to detect misstatements in the financial statement. In this case, the audit firm is not considered independent, as the quality of staff is poor, - they are unqualified accountants. This is also obvious from the minimal level of documentation done by the audit team.

In preparing an audit plan, the auditor will usually:

i) **Set** an overall level of audit risk which would be judged to be acceptable for this particular audit;
ii) **Assess** the levels of inherent risk and control risk; and
iii) **Adjust** the level of detection risk in order to achieve the overall required level of risk in the audit.

In other words, the detection risk can be managed by the auditor in order to control the overall audit risk. As noted above, inherent risk cannot be controlled because it operates independently of controls. Control risk can be reduced by improving the quality of internal controls; however, recommendations to the client about improvements in its internal controls can only affect control risk in the future, not control risk for the financial period that is subject to audit. Audit risk can be reduced by increasing testing and reducing detection risk.

b. The risk areas and their justifications are as follows:

i. TST imports and sells in the country: The products could be subject to market fluctuations and remain in the store or warehouse for a long period and lead to reduction in value;

ii. Connivance of officials of appropriate regulatory agencies: this will affect the true amount of activities being handled and lead to understatement of the financial statements;

iii. Non-disclosure of business sourced from bureau de change: the true state of affairs of the business will not be reflected as the full components of the business activities could be difficult to ascertain. There could also be indications of money laundering resulting in both business and financial statement risks;

iv. Lack of reflection of activities in the records: the lack of disclosure of activities could lead to understatement of the financial statements;

v. Friendship with officials of regulatory agencies: using officials to manipulate records could lead to serious issues if those officials are re-assigned and become unable to control and manipulate the systems. It could result in both business and financial statements risks;

vi. Audit of the financial statements by a club member: lack of independence and objectivity from the auditor and non-reflection of the true state of affairs and could result in financial statements risks; and

vii. The use of unqualified accountants and minimal documentation: the use of unqualified accountants to audit financial statements will likely cause non-compliance with appropriate standards and therefore present financial statements risks.

Examiner's report

The question tests the candidates' knowledge of audit risk model and their ability to identify and justify the risks in a given scenario.

The question was attempted by most of the candidates, but performance was average.

The commonest pitfall was the inability of the candidates to decipher and justify the risk elements in the background to the question.

Candidates are advised to read relevant materials on audit risk and the indicators of its various components when preparing for the next examination.

Marking guide

		Marks	Marks
a.	**Discussion of components of audit risk modul**		
	Definition and discussion of audit risk model	2	
	Discussion on inherent risk, control risk, and detection risk		
	(2 marks each for any 4 points)	8	10
b.	**Identification and justification of audit risk areas**		
	Identifying risk areas and their justification		
	(1 mark each for any 5 points)		5
	Total		**15**

SOLUTION 7

a. *ISA 250: Consideration of laws and regulations in an audit of financial statements requires the auditor to:*

i) **Obtain a general understanding** of the applicable legal and regulatory framework and how the entity is complying with that framework. This is part of obtaining an understanding of the entity and its environment – here, the legal environment – as required by ISA 315;

ii) **Obtain sufficient appropriate audit evidence** in respect of compliance with those laws and regulations which might be expected to have a direct effect on material amounts and disclosures in the financial statements;

iii) **Perform the following audit procedures** to help identify such instances of non-compliance:

- Make enquiries of management as to whether or not the entity is complying with the relevant laws and regulations;
- Inspect any correspondence with the relevant authorities;

- During the audit, remain alert to the possibility that other audit procedures might bring instances of non-compliance to the auditor's attention;

iv) Obtain **written representations from management** that all known instances of non-compliance or suspected non-compliance have been disclosed to the auditor;

v) Document all identified or suspected instances of non-compliance and the results of discussions with management and/or other parties;

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

- Obtain an understanding of the nature of the act and the circumstances under which it has occurred;
- Evaluate the possible effect of the non-compliance on the financial statements;
- For suspected non-compliance, discuss the matter with management. If compliance is not demonstrated, take legal advice;
- If there is insufficient evidence of a suspected non-compliance, consider the impact on the audit report. This would constitute a "limitation on scope";
- Consider whether or not the non-compliance impacts on other areas of the audit. For example, on the overall risk assessments; and
- Consider how to report the non-compliance – to those charged with governance and/or to shareholders and/or to the authorities.

b. Treatment of the settlement of the judgment amount of ₦12.5m that was not recorded at year end. The settlement amount was not accrued nor provided for or disclosed as a contingent liability. The treatment was wrong. Relevant Standards are:

i) **IAS 37 - Provisions, Contingent Liabilities and Contingent Assets**

- This Standard outline the accounting for provisions (liabilities of uncertain timing or amount), together with contingent assets (possible assets) and contingent liabilities (possible obligations and present obligations that are not probable or not reliably measurable). Provisions are measured at the best estimate (including risks and uncertainties) of the expenditure required to settle the present obligation, and reflects the present value of expenditures required to settle the obligation where the time value of money is material.

- The objective of IAS 37 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. The key principle established by the Standard is that a provision should be recognised only when there is a liability i.e. a present obligation resulting from past events.

- Since the case was lost and appealed before the end of the reporting period, provision should have been made in the accounts based on the best estimate possible. This would have been a better treatment than not making any provision at all, which has caused a material misstatement in the financial statement. This would be especially important where the misstatement would be higher than the materiality threshold.

ii) **IAS 10 - Events after the Reporting Period**

International Accounting Standard (IAS) 10, *Events after the Reporting Period*, is a financial reporting standard that outlines when and how to adjust financial statements for events that occur after the reporting period. It also specifies the disclosures that should be made about these events and the date when the financial statements were authorised for issue.

- **Adjusting events**
  These events provide evidence of conditions that existed at the end of the reporting period, and require adjustment in the financial statements. For example, a court case settlement that confirms an obligation that existed at the end of the year is an adjusting event.

- **Non-adjusting events**
  These events indicate conditions that arose after the reporting period, and should be disclosed if material. For example, an earthquake that destroys a plant after the reporting period is a non-adjusting event, and should be disclosed in the notes to the financial statements.

- **Material events**
  Some examples of material events after the reporting period include:
  - Dividends declared after the reporting period but before the financial statements are approved;
  - When the going concern assumption no longer applies; and
  - Events that were unknown or unclear at the reporting date.

iii) **ISA 560 – Subsequent events**

Events occurring between the date of the financial statements and the date of the auditor's report

- The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.
- The auditor shall perform the procedures required by paragraph 6 so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following:
- Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified;
    - Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements;
    - Reading minutes, if any, of the meetings of the entity's owners, management and those charged with governance that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available; and
    - Reading the entity's latest subsequent interim financial statements, if any.
- If, as a result the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements in accordance with the applicable financial reporting framework.

Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued

i) The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, if, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the

auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- Discuss the matter with management and, where appropriate, those charged with governance;
- Determine whether the financial statements need amendment and, if so,
- Inquire how management intends to address the matter in the financial statements.

ii) If management amends the financial statements, the auditor shall:

- Carry out the audit procedures necessary in the circumstances on the amendment.
- Unless the circumstances above apply:
    - Extend the audit procedures; and
    - Provide a new auditor's report on the amended financial statements. The new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

Facts which become known to the auditor after the financial statements have been issued

i) After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, if, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- Discuss the matter with management and, where appropriate, those charged with governance;
- Determine whether the financial statements need amendment; and, if so,
- Inquire how management intends to address the matter in the financial statements.

ii) If management amends the financial statements, the auditor shall:

- Carry out the audit procedures necessary in the circumstances on the amendment;
- Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation; and
- Unless the circumstances above applies:
    - Extend the audit procedures to the date of the new auditor's report, and date the new auditor's report no earlier than the date of approval of the amended financial statements; and
    - Provide a new auditor's report on the amended financial statements.

Examiner's report

The question tests the candidates' knowledge of the requirements of the auditor with respect to the audit of the financial statements and the legal environment in accordance with ISA 250: *Consideration of the laws and regulations on audit of financial statements,* and other applications in the treatment of events occurring after year end.

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

The common pitfalls were the candidates' inability to acquaint themselves with such relevant standards and failure to familiarise themselves with treatment of issues as they are encountered in given situations.

The candidates are advised to study relevant materials before sitting for the next examination.

Marking guide

		Marks	Marks
a.	**Discussion of the requirements of the auditor with respect to ISA 250**		
	Identifying requirement of ISA 250 (1 mark each for any 3 requirements)	3	
	Identifying procedure on non-compliance (1 mark each for any 3 procedures by the auditor)	3	6
b.	**Evaluation of the treatment of tax settlement of judgment amount**		
	Identifying relevant standard (1 mark each for 3 correct standard identified)	3	
	Discussion on each standard (1 mark each for any 2 points on each standards)	6	9
	Total		15

ICAN/242/V/C5 **Examination No..........................**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 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 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 **any other COLOUR OF INK** will not be marked.
7. Check that you have collected the correct question paper for the examination you are writing.

THURSDAY, NOVEMBER 21, 2024

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – NOVEMBER 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 you familiarise yourself with the case scenario so that you can undertake any research and analysis that you may deem 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. Upon receipt of this material, you are required to spend a few days to the examination date to familiarise yourself with the information provided, carry out any additional research and or analysis about the industry, together with the relevant developments and analyse the financial results provided in preparation for the examination. You should note that the use of pre-seen part of the Case Study will not significantly help you in answering all the questions during the examination. It is essential that you carry out sufficient analysis on your own so that you can leverage the pre-seen part of the case scenario as appropriate during the examination.

At the start of the examination, you will receive the complete case scenario which will include both the pre-seen and the unseen sections, which include the questions to be answered. You must use the answer paper provided by ICAN in the Examination Hall. Any solution presented with other papers **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% will be assigned to the executive summary section of your response and approximately 10% will be assigned for your proper consideration of ethical issues within your answer to the requirements. Although ethical issues are not a specific requirement of this paper, as they have been tested in other subjects of the ICAN professional examination, it will be tested within a requirement which may include any of the following areas:

- Lack of professional independence or objectivity;
- Conflicts of interests among stakeholders;
- Doubtful accounting and or creative accounting practice;
- Unethical business/commercial practice; and
- Inappropriate pressure to achieve a reported result.

You should note that marks are not awarded for simply restating facts from the case scenario, but marks are awarded for demonstrating professional skills and technical depth. Therefore, to succeed, you 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 analysis carried out; and
- Generate reasoned conclusions upon which relevant recommendations are made.

Omission of any of the above will diminish your chance of success in the examination.

Travex Hotels Limited

List of exhibits:

1. About you (Dan Kabir) and your employer, Techno Consulting Services
2. The Nigerian Economy and the hospitality industry
3. Business environment and challenges facing the hospitality industry
4. Travex Hotels Limited: History, Board, management and competition
5. Travex Hotels Limited: 3-year summary financial statements
6. Hospitality Business: Sustainability and innovation

EXHIBIT 1

ABOUT YOU (DAN KABIR) AND YOUR EMPLOYER, TECHNO CONSULTING SERVICES

You are **Dan Kabir**, writing the Professional level of ICAN examination. You are employed as a Trainee Consultant by Techno Consulting Services and you report to Michael Chukwuma, 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 solutions to management;
- Assessing your clients' operational and strategic business proposals with the view to evaluating their alignment with the clients' objectives and the extent to which relevant business and financial risks have been considered;
- Assessing your client's financial and business forecasts together with the assumptions upon which they are based to suggest recommendations to the clients'; and
- Drafting reports for the Partner, based on the operational and strategic business analyses you have carried out.

These responsibilities demand that you keep yourself abreast of developments in the hospitality industry, both nationally and internationally, so that you can carry out the above tasks effectively.

Techno Consulting Services is a highly reputable consulting firm employing over 1,000 staff and specialising in high growth industries, including the hospitality industry.

EXHIBIT 2

THE NIGERIAN ECONOMY AND THE HOSPITALITY INDUSTRY

Nigeria is one of the biggest market in Africa and has a population of over 200 million people with a youth population that provides Nigeria with an advantage over many countries. In addition, the country is endowed with excellent weather conditions, many tourists' attractions and significant natural resources, including oil and gas.

The economy's heavy dependence on oil and gas has decreased in the last few years, for example, in the third quarter of 2022, activities in the oil and gas sector accounted for about 5.6% of Nigeria's gross domestic product (GDP), down from 7.5% recorded in the third quarter of 2021. However, oil and gas revenue remains a crucial source of government revenue, constituting 29% of total government revenues in the first half of 2022. Though crude oil and gas continue to account for the bulk of Nigeria's export earnings, efforts are in place to diversify the economy, whilst ensuring the country's energy security.

The rate of growth and development has been hindered by a number of issues including poor implementation of government policies, high cost of doing business, the poor state of essential infrastructure, insecurity, corruption, challenges with the judicial system and low levels of transparency and accountability.

On the implementation of government policies, until recently, the Central Bank of Nigeria (CBN) had imposed exchange controls on several product categories and intervened in the market to keep the official naira rate from depreciating. Though steps were taken to harmonise exchange rates in the past, this was not fully addressed until the resumption of the new administration.

This notwithstanding, one of the most daunting challenges for businesses entering the Nigerian market is the limited access to foreign exchange, thus, reducing the ability to import necessary inputs and equipment, and to service external debt. Foreign exchange is tightly managed by the Central Bank of Nigeria and users trade in the alternative markets for their unmet needs.

Despite the challenges, Nigeria presents with significant opportunities for local and international entrepreneurs. The development of the digital economy, ushering the massive use of technology has continued to provide opportunities for the developing population and helping organisations to transform their processes, minimise costs and maximise stakeholders' returns. For instance, by leveraging data, businesses can gain valuable insights into their inventory, receivable and cash flows, enabling them to make more informed operating, investing and financing decisions.

THE HOSPITALITY INDUSTRY IN NIGERIA

At a time, Nigeria had the fastest-growing hospitality market in Africa, with a projected 12 percent compound annual increase from 2019 to 2023 according to an expert projection. In early 2020, however, the COVID-19 pandemic spread globally, and the tourism industry was one of the worst hit. This slowed down the growth in the hospitality industry in Nigeria.

Tourism, a related industry contributes about 10 per cent to the global GDP. This was expected to rise in four years with significant upward movement in some African countries, including Nigeria. In Nigeria, the contribution of travel and tourism to her GDP was 5.1 per cent in 2019. However, in 2020 the upward trajectory slowed down due to the pandemic.

As the world continues to adapt to the changes brought about by Covid-19, the hospitality industry is making a steady, but slow return. Apart from the Covid-19, the green revolution or environmental sustainability is a development impacting the hospitality industry. According to a research by Jenny Southan, it has been projected that "as people think more carefully about the way they travel, they will seek out hotels and travel companies that are doing everything they can to minimise their impact on the planet. We can also expect accreditation to gain prominence, as consumers look for reassurance from legitimate "eco-tourism" certifications and will want to book trips that leave them feeling better than before, when they return home. Wellness tourism will be increasingly popular."

Globally, there is an optimistic projection that the hospitality industry will make a remarkable return. However, only the prepared can make a quick return, and to do so requires an understanding of the uniquely changing needs of customers and clients. Nigeria needs to take a proactive approach in order to be at par with global best practices and not wait for others to take advantage of the relatively small market that is just making a rebound.

According to Deloitte, "the COVID-19 pandemic will eventually fade. The economy will recover, and the hospitality sector, restaurants, hotels, casinos, sports, etc. will regain its footing and look forward with confidence to a successful, thriving future. However, now is the time for companies to act, adapt to the new normal, position themselves for environmentally friendly and sustainable business, and thrive in the years ahead.

EXHIBIT 3

BUSINESS ENVIRONMENT AND CHALLENGES FACING THE HOSPITALITY INDUSTRY

Nigeria is the most populous country in Africa, with a growing middle class and rising international trade and investment. The hospitality industry in Nigeria is on a growth trajectory and has shown significant growth over the years, driven by factors such as increasing business travel, tourism, and the growth of the Nigerian economy. However, Covid 19 pandemic put a temporary halt on the industry's growth as players in the industry grapple with the aftermath of the pandemic.

The business environment of the hospitality industry in Nigeria is characterised, supported or challenged by the following:

a. **Tourism and business travel**: Nigeria is a diverse country with many rich cultural heritages, natural attractions, and historical sites. This has led to growth in domestic and international tourism, boosting the demand for hotels. Additionally, Nigeria is an economic hub in West Africa, attracting business travellers and corporate events.

b. **Economic factors:** Nigeria's economy is one of the largest in Africa. Crude oil and gas exports, telecommunications, finance, agriculture and recently, technological pursuits are significant contributors. Economic growth has a direct impact on the demand for hospitality services, as it leads to increased business activities and disposable income for leisure travel.

c. **Infrastructure:** Adequate infrastructure, including well-maintained roads, airports, and communication networks, are crucial for the growth of the hotel industry. Improved infrastructure makes it easier for both domestic and international travellers to access various parts of the country. At present in Nigeria, some of such infrastructures are in a poor state, mainly due to poor maintenance culture. In addition, challenges presented by unreliable power supply and inadequate waste management systems have adversely impacted the operations of the hospitality industry.

d. **Regulations and government support:** Government policies and regulations play a significant role in shaping the business environment. Supportive policies that promote tourism, investment and ease of doing business can positively impact the hotel sector. The Federal Government has put several policies in place as a form of incentives, including tax incentive, for the industry to thrive.

e. **Security concerns:** Security has been a challenge in Nigeria due to factors such as terrorism, kidnapping, and civil unrest in certain regions. The perception of safety can affect both domestic and international travel decisions, potentially impacting the hotel sector.

f. **Competition:** The hospitality industry in Nigeria is competitive, with both local and international chains vying for market share. Major international hotel brands often enter the market in collaboration with local partners. Yet, they still face stiff competition from smaller, owner-managed hotels and guest houses.

g. **Technology and online booking:** The growth of online booking platforms has changed the way travellers search for and book hotels. Hotels need to have strong online presence and provide seamless booking experience to remain competitive.

h. **Cultural diversity:** Nigeria's diverse culture and languages present challenges in catering to the preferences of various customer segments. Hotels that can accommodate a wide range of cultural preferences and dietary requirements may have a competitive edge.

i. **Continuously changing consumer demands:** According to some CEOs of international hotel chains, "the hotel customer is more culturally oriented now which makes understanding the more difficult". Regardless of the amount spent by the customers, they are more interested in the value obtained for the money spent. Luxury is a term which has many definitions now and changes around customer perception more than ever. Brand or a well-designed hotel is not enough anymore, but the customers' experience matters most.

j. **Competition from hotels' alternatives such as apartment buildings**: The hotel sector performed exceedingly well over the last few years, until Covid-19 pandemic stunted the growth. Although the outlook appear brighter from 2022, the sector still faces serious challenges that could threaten its development. One of the biggest threats to hotels, which emerged at about 2017, is competition from apartment buildings. Boutique firms have also entered this business line, providing in some instances fully equipped accommodation for travellers who love to prepare their own meals, as an alternative to staying in an hotel.

k. **Ineffective marketing due to technological shyness:** As technology continues to impact day-to-day human operations, hotels have been forced to re-evaluate their marketing efforts to capture the ever-growing online market. Unfortunately, although a lot of hotels have embraced the internet and all aspects of digital marketing, many are still relying on old marketing practices.

l. **Difficulties with energy management:** A lot of hotels are going green and smoke-free. This is a great initiative, as the planet fights global warming and other climate-related issues. Moreover, it is also a smart move to get more profits and an edge over the competition.

Hotels must start investing in eco-friendly and renewable energy sources, because customers are on the look out for green and sustainable hotels. People want to contribute positively to climate control initiatives and staying in eco-friendly and green hotels is one such initiatives by a lot of frequent travellers. Establishments that refuse to take issues of sustainability seriously would be impacted negatively, as their overall profit margins will likely suffer.

m. **Poor customer satisfaction as delights become expectations**: With more technological advancements, the entry barriers are lowered, and new competitors and disruptors are appearing on the scene. Poor customer satisfaction has been one of the major hotel sector challenges in the past and continues to be so in 2022. This is set to intensify with growing competition and better customer management tools.

n. **Shortage of trained and specialised personnel within the hotel sector :** The sector had suffered from this shortage but with greater automation, this is set to become more challenging. Hotels that do not prioritise employment of trained and specialised personnel are bound to face more serious challenges in their service delivery. Finding the right people may be more challenging for smaller hotels.

o. **Supply chain management:** The role of supply chain management in the hotel sector is crucial to attaining sustained competitive advantage. A well-managed supply chain can be the key difference between a successful and an unsuccessful hotel operation. Multiple stakeholders are involved in the supply chain of the hotel sector's business and they face many operational risks, which include risks of holding large inventories at high holding costs, risk of preserving perishable goods at high storage costs, etc.

Increasingly, the effective deployment of IT to inventory management has resulted in significant net benefits to the sector.

EXHIBIT 4

TRAVEX HOTELS LIMITED: HISTORY, BOARD, MANAGEMENT AND COMPETITION

History

Travex Hotels was established in Abuja, Nigeria, as a five-star hotel, in year 2001 by a group of investors who specialise in hospitality business. The management of the hotel was given to MTS, one of the top-rated international hotel chains. Travex, Lagos was constructed in Lagos in 2010 and started operations in 2012 in a high brow area of Lagos.

Travex Hotels has become the most patronised hotel in Abuja and Lagos for functions, such as conferences and international meetings and seminars. The hotel is a lodger's delight and has warmed itself into the hearts of tourists and travellers visiting either Abuja or Lagos. The hotel also boasts of high patronage from both State and Federal Governments in Nigeria. Many professional bodies in Nigeria normally host their annual conferences in Travex Hotels. Therefore, the hotel has been improving its bottom-line on a yearly basis.

Board

Travex Hotels' board consists of eight executive and non-executive directors. The current board members are:
Mr. John Dagash - Chairman
Mr. Richard Roy - Managing Director/CEO
Mrs. Felicia Ademiluyi - Non-Executive Director
Mrs. Rebecca Pam - Non-Executive Director
Mrs. Joan Adebayo – Business Development/Innovation Director
Mr. Amos Sawyer - Non-Executive Director
Mr. Tafida Sabir - Non-Executive Director
Ms. Bolu Adelanwa - Independent Non-Executive Director

Management

The management committee of the hotel consists of the following:
Mr. Richard Roy - Managing Director/CEO
Mrs. Joan Adebayo – Business Development/Innovation Director
Mr. Richard Pen – General Manager
Mrs. Deborah Brown – Chief Financial Officer
Mrs. Julianah Foluso – Supply Chain Manager
Mrs. Christie Chukwurah – Human Resources Manager
Mr. George Akpan – Head Chef
Mr. Joseph Ibironke – Facility Manager

Competition
Currently, the hotel is facing stiff competition from new entrants into the industry with highly luxurious rooms and suites. These competitors having penetrated the core customer base of Travex Hotels, constitute a source of significant worry to management and board.

If the management of Travex Hotels does not rethink the hotel's business model, the hotel may soon start to experience declining patronage, which will result in poor financial performance.

EXHIBIT 5

TRAVEX HOTELS LIMITED: 3-YEAR SUMMARY FINANCIAL STATEMENTS

TRAVEX HOTELS LIMITED
SUMMARY FINANCIAL STATEMENTS: 2020 – 2022

Income statement

	2022 ₦'000	2021 ₦'000	2020 ₦'000
Revenue	31,531.1	21,798.6	9,533.4
Cost of sales	(9,702.2)	(6.125.7)	(3,822.3)
Gross profit	21,828.9	15,672.9	5,711.1
Other operating income	2,536.3	1,486.7	1,086.4
Impairment (losses)/gains on financial assets	(64.3)	20.2	53.2
Operating expenses	(14,468.9)	(11,345.0)	(10,302.9)
Operating profit/(loss)	9,832.0	5,834.8	(3,452.2)
Finance costs	(4,132.7)	(4,072.5)	(5,306.3)
Finance income	8.7	4.3	6.2
Profit/ (loss)before tax	5,708.0	1,766.6	(8,752.3)
Income tax	(1,909.1)	(545.3)	2,664,8
Profit/ (loss) for the year	**3,798.9**	**1,221.3**	**(6,087.5)**

Statement of financial position	**₦ '000 2022**	**₦ '000 2021**	**2020 ₦'000**
Assets			
Non-current assets			
Property, plant and equipment	107,971.3	103,979.9	105,707.1
Goodwill	1,974.8	1,974.8	1,974.8
Intangible assets	158.8	158.6	114.8
Investment in financial asset	300.1	132.5	132.7
	110,405.0	106,245.8	107,929.4
Current assets			
Inventories	616.6	619.5	584.5
Trade and other receivables	3,220.5	2,636.6	1,591.0
Prepayments	1,062.2	1,422.3	1,000.1
Cash and bank balances	5,183.1	4,965.5	1,818.3
	10,082.4	9,643.9	4,993.9
Total assets	**120,487.4**	**115,889.7**	**112,923.3**

Equity and Liabilities			
Equity			
Share capital	5,121.3	5,121.3	5,121.3
Premium	12,548.9	12,548.9	12,548.9
Retained earnings	45,207.0	44,577.8	43,433.9
Equity attributable to Owners of the Company	62,877.2	62,248.0	61,104.1
Non-controlling interests	(87.5)	(27.8)	(1.1)
Total equity	62,789.7	62,220.2	61,103.0
Liabilities			
Non-current liabilities			
Borrowings	16,113.2	16,449.0	13,152.3
Deferred income	1,544.3	2,005.9	4,466.1
Contract liabilities	2,139.6	2,333.4	2,445.2
Deposit for shares	2,410.0	2,410.0	2,410.0
Deferred Income	-	-	1,052.6
Defined benefit liability	161.7	-	-
Deferred tax liability	6,023.5	4,841.4	-
	28,392.3	28,039.7	23,526.2
Current liabilities			
Trade and other payables	20,125.6	17,606.9	19,743.7
Current tax liabilities	594.5	166.5	-
Contract liabilities	258.3	152.8	171.0
Borrowings	7,846.4	7,252.9	7,820.5
Deferred income	447.6	450.7	252.8
Dividend payable	-	-	306.1
Defined benefit liability	33.0	-	-
	29,305.4	25,629.8	28,294.1
Total liabilities	**57,697.7**	**53,669.5**	**51,820.3**
Total equity and liabilities	**120,487.4**	**115,889.7**	**112,923.3**

EXHIBIT 6

HOSPITALITY BUSINESS: SUSTAINABILITY AND INNOVATION

Research shows that two major drivers of competition and profitability in the hotel sector today are sustainable business practices and application of technology to innovation in business processes.

In fact, in today's global business environment, companies that fail to take sustainability initiatives seriously run the risk of going out of business because of rising consumer awareness. Corporate behaviour is shifting too, as institutional investors increasingly favour sustainable business practices, and governments offer incentives and tax benefits for going green.

Historically, the hotel sector has had some negative impact on the environment in ways such as impact of water and energy consumption, and heavy use of materials that produce solid and hazardous wastes. Hotels consume a high level of energy for heating, ventilation and air cooling (HVAC) operations, lighting and other power needs.

Therefore, many hotels have taken sustainability issues very seriously and are now going green. Also, hotels are developing strategies to reduce greenhouse gases emission and waste. With development in technology, hotels are using the following innovative strategies in their sustainable business practices:

a. **Automation for conservation of water and energy:** These days many hotels have automatic faucets installed in the public spaces and restrooms. These faucets are equipped with sensors that dispense water only in the presence of a user's hands.

   This is one of the convenient methods to save water, because of regular inflow of guests. In fact, using these motion-sensing faucets at hotels can save water use drastically.

b. **Magnetic keycard facilities:** These keycards act as connectors to complete the circuit and allow the flow of electricity. The moment these cards are taken off from their slots in the rooms, the circuit is broken resulting in power cut-off. It is one of the popular eco-friendly amenities used in hotels to save electricity.

c. **Green energy**: Many hotels have invested in solar heaters, biofuels, CHP (Combined Heating and Power), wind farms, and geothermal energy. Solar power is one of the best ways to harness and store energy for use as an alternative source of electricity.

d. **Implementation of the 3 R's (reduce, recycle and reuse):** One of the important ways to create an eco-friendly environment is by using the 3 R's – reduce, reuse and recycle.

- **Reduce** – This is the reduction of the amount of waste generated in hotels. It is better to avoid using materials that are unfriendly to the environment.
- **Recycle** – This is not limited to plastic or glass. Various things such as fused bulbs, cans, cartons, and cartridges can be recycled. Waste treatment is another alternative for materials that cannot be recycled.
- **Reuse** – Paper, toner cartridges, or linen (if the room has the same guests staying for a couple of days) can be reused.

Apart from these innovative ways being used as sustainable practices, developments in technology have further led to innovative ways of enhancing hotel operations. Innovation in the hotel industry is important because it has the capacity to transform it positively.

Two of these developments as adopted from research works are:

a. **Chatbots – In-person customer service for hospitality industry using AI:** AI Robots adopted by some hotels can provide guests with information that they need when they interact with them.

These robots are designed to learn and adapt to human beings, so the more they interact with people; the more effective they will be in the future.

There are a lot more robots operating in the hotel sector already. They add value to the industry by supporting human interaction, especially for services during odd times and services that require lifting of weights or automation.

Chatbots have been extremely useful when it comes to responding to customer complaints online, as well as chat services that deal with simple customer requests. Chatbots can engage customers at any point of the day and this kind of response time is invaluable to customers.

These would add immense value to customer support in the hotel sector which has quite a few routine queries. Indeed, AI has the potential to redefine the hotel business.

b. **Keyless entries- Smartphone operated room:** With free companion apps in the market, it is now possible to control hotel room remotely through phone or tablet to turn on the TV, browse and order for food, and so on. It is one of the best hospitality technologies that have already been in operation in many hotels now.

UNSEEN

TRAVEX HOTELS LIMITED

List of exhibits:

The following exhibits are newly provided and did not form part of the materials provided as Pre-seen:

S/No

7. Email from Michael Chukwuma to Dan Kabir
8. Email from Deborah Brown to Michael Chukwuma
9. Travex Hotels Limited: Business segments performance
10. Travex Hotels Limited: Project 'Fun Plus'

TRAVEX HOTELS LIMITED: CASE STUDY REQUIREMENT

You are Dan Kabir, writing the professional level ICAN examination and working as a Trainee Consultant with the Techno Consulting Services. You report to Michael Chukwuma, the Partner in charge of the Hospitality business group.

Requirement

You are required to prepare a draft report, as set out in the email dated 15 October 2023 from Michael Chukwuma to you (**exhibit 7**) and the one on 10 October 2023 from Deborah Brown to Michael Chukwuma (**exhibit 8**). Your report should comprise the following:

- An executive summary
- Responses to the three detailed requirements set out in **exhibits 7** and **8,** 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% is assigned to the executive summary section of your response and approximately 10% for consideration of ethical issues within your answers to the requirements as appropriate.

Note:
Ensure you submit an executive summary and address the three requirements in your report. Failure to comply with instructions will adversely affect your chances of success. In addition, as indicated above, note that 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 7

EMAIL FROM MICHAEL CHUKWUMA TO DAN KABIR

From: Michael Chukwuma

Sent: 15 October 2023

To: Dan Kabir

Subject: Travex Hotels Limited

Travex Hotels Limited has contacted us to carry out an evaluation of the performance of their three business segments for the period 2020 to 2022. The purpose is firstly to determine how the Covid-19 pandemic affected the performance of each of the business segments and whether each segment has been able to recover in the years following the pandemic. In addition, the hotel wants us to evaluate the hospitality business environment as affected by sustainability issues and developments in technology. They want us to evaluate their decision to introduce luxury and boutique wings in their Abuja hotel. Furthermore, we are required to evaluate a reoccurring audit observation and recommend corrective steps.

Therefore, I will like you to carry out:

i. A detailed evaluation of the three business segments of the hotel across the two hotel locations - Food and beverages, Rooms and Gaming business segments in each of the hotel locations, using the information in Exhibit 9. Note that Gaming is only available in the Abuja hotel location;
ii. An appraisal of the hospitality business environment in view of developments in the sustainability and innovation areas, noting the opportunities and threats of these developments; and
iii. An evaluation of the proposed project 'Fun Plus' and advise the board on the viability of the project, based on financial records (**exhibit 10**).
iv. An evaluation of the reoccurring observation reported by the hotel's external auditors and recommend process improvements to address the problem.

I attach herewith exhibits 8 to 10 to assist you. You can find additional information in the file we maintain for Travex Hotels Limited.

Please draft for my review, a report to be submitted to the board of Travex Hotels Limited. Your report should comprise:

1. A detailed evaluation of the three business segments of the hotel across the two hotel locations - Food and beverages, Rooms, and Gaming business segments in each of the hotel locations using the information on Exhibit 9. Note that Gaming is only available in the Abuja hotel location.

2. An appraisal of the hospitality business environment in view of developments in sustainability and innovation, noting the opportunities and threats of these developments. Also, an evaluation of the proposed project ‘Fun Plus’, as requested by Travex’s board.

3. An informed report on process improvements, training, etc needed to remediate the reoccurring auditor observations.

I look forward to receiving your draft report.

Michael

EXHIBIT 8

EMAIL FROM DEBORAH BROWN TO MICHAEL CHUKWUMA

From: Deborah Brown – Travex Hotels Limited

To: Michael Chukwuma – Techno Consulting Services

Date: 10 October, 2023

Michael,

Top of the day to you and hope this email meets you well.

Our board has decided that we should evaluate the performance of our hotels and the three most important business segments – Food and Beverages, Rooms, and Gaming, across the two hotels for the last three years, to know the extent the hotel has been able to recover from the effect of Covid-19 pandemic. It will also enable us to evaluate the performance of each of these three business segments in the two hotel locations.

In addition, the board would want you to appraise the business environment of the hospitality industry in relation to global developments in sustainability and innovations. This becomes necessary in view of the decision of the board to introduce luxury and boutique wings in the Abuja hotel, effective from 2024. Therefore, the board will want you to evaluate the viability of this proposed project as well.

Furthermore, included in the management report submitted by our External auditors for the three years under review is an observation that utilisation reports of room cleaning equipments, cooking facilities, laundry equipments, etc show much more activities than related revenues. This is a source of concern to the Board as it would appear that the hotel is not deriving related revenues for the utilisation of its assets. Could it be that some people are colluding to defraud the hotel? You are required to analyse the possibility of this occurring and suggest how, with the use of technology the problem can be addressed.

I would be looking forward to receiving your report on the above evaluation and appraisal in the next one month, bearing in mind that the board would like to review this report before finalising the hotel's 2024 strategic plan.

I attach a summary of the financial data for the three business segments of the two hotel locations and details about the proposed project 'Fun Plus'. As usual, I trust you will deliver within the time frame.

Deborah

EXHIBIT 9

TRAVEX HOTELS LIMITED: BUSINESS SEGMENTS PERFORMANCE

TRAVEX HOTELS LIMITED
BUSINESS SEGMENTS PERFORMANCE – 2020 – 2022

2022
Extract from income statement

Business Segments	Travex Hotels Lagos ₦'m	Travex Hotels Abuja ₦'m	Travex Hotels Games ₦'m	Total ₦'m
Rooms	524.8	19,151.1		19,675.9
Food and beverages	439.9	9,785.3		10,225.2
Shop rental		1,055.7		1,055.7
Service charge	11.8	89.0		100.8
Recreation service		253.9		253.9
Gaming revenue			1,630.0	1630.0
Secretarial services		59.4		59.4
Other operating revenue	26.2	38.3		64.5
Total revenue from contract with customers	1,002.7	30,432.7	1,630.0	33,065.4
Cost of sales				
Rooms	(40.1)	(3,367.1)		(3,407.2)
Food and beverages	(252.7)	(4,851.7)		(5,104.4)
Other operating cost	(57.7)	(482.9)	(650.0)	(1,190.6)
Total cost of sales	(350.5)	(8,701.7)	(650.0)	(9,702.2)
Gross profit	652.2	21,731.0	980.0	23,363.2
Other operating income	7.3	994.7		1,002.0
Operating expenses	(766.7)	(13,766.5)		(14,533.2)
Operating profit/(loss)	(107.2)	8,959.2	980.0	9,832.0
Net finance cost	(24.5)	(4,099.5)		(4,124.0)
Profit/(Loss) before tax	(131.7)	4,859.7	980.0	5,708.0
Income tax	(137.6)	(1,771.5)		(1,909.1)
Profit/(Loss) after tax	(269.3)	3,088.2.	980.0	3,798.9

Extract from statement of financial position

Assets	Travex Hotels Lagos ₦'m	Travex Hotels Abuja ₦'m	Travex Hotels Games ₦'m	Total ₦'m
Property, plant and equipment	2,411.9	93,906.7		96,318.6
Investment property		1,717.8		1,717.8
Long term investments		3,529.8		3,529.8
Other intangible assets	0.8	119.3		120.1
Investment in financial asset		300.1		300.1
Long term receivables		8,418.6		8,418.6
Current assets	329.6	9,752.8		10,082.4
Total assets	2,742.3	117,745.1		120,487.4
Equity and liabilities				
Issued capital	-	5,121.3		5,121.3
Share premium	-	12,548.9		12,548.9
Retained earnings	-	45,207.0		45,207.0
Total equity	-	62,877.2		62,877.2
Total liabilities	2,742.3	54,867.9		57,610.3
Total equity and liabilities	2,742.3	117,745.1		120,487.4

2021

Extract from income statement

Business Segments	Travex Hotels Lagos ₦'000	Travex Hotels Abuja ₦'000	Travex Hotels Games ₦'000	Total ₦'000
Rooms	461.0	13,300.1		13,761.1
Food and beverages	345.6	6,124.3		6,469.9
Shop rental		823.3		823.3
Service charge	9.9	98.3		108.2
Recreation service		142.5		142.5
Gaming revenue			1,567.6	1,567.6
Secretarial services		38.4		38.4
Other operating revenue	41.9	31.9		73.8
Total revenue from contract with customers	858.4	20,558.8	1,567.6	22,984.8

Cost of sales				
Rooms	(36.8)	(1,797.4)		(1,834.2)
Food and beverages	(209.7)	(3,285.6)		(3,495.3)
Other operating cost	(54.0)	(129.3)	(612.9)	(796.2)
Total cost of sales	(300.5)	(5,212.3)	(612.9)	(6,125.7)
Gross profit	557.9	15,346.5	954.7	16,859.1
Other operating income	7.5	313.1		320.6
Operating expenses	(557.6)	(10,787.4)		(11,345.0)
Operating profit/(loss)	7.8	4,872.2	954.7	5,834.7
Net finance cost	(3.3)	(4,064.9)		(4,068.2)
Profit/(Loss) before tax	4.5	807.3	954.7	1,766.5
Income tax	(7.9)	(537.3)		(545.2)
Profit/(Loss) after tax	**(3.4)**	**270.0**	**954.7**	**1,221.3**

Extract from statement of financial position

Assets	**Travex Hotels Lagos ₦'000**	**Travex Hotels Abuja ₦'000**	**Travex Hotels Games ₦'000**	**Total ₦'000**
Property, plant and equipment	153.4	93,843.2	-	93,996.6
Investment property		1,695.0	-	1,695.0
Long term investments		3,529.8	-	3,529.8
Other intangible assets	0.6	137.5	-	138.1
Long term receivables		6,753.7	-	6,753.7
Investment in financial assets	132.6		-	132.6
Current assets	455.2	9,188.8	-	9,644.0
Total assets	**741.8**	**115,148.0**	**-**	**115,889.8**
Equity and liabilities				
Issued capital		5,121.3	-	5,121.3
Share premium		12,548.9	-	12,548.9
Retained earnings		44,577.8	-	44,577.8
Total equity	-	62,248.0	-	62,248.0
Total liabilities	741.8	52,900.0		53,641.8
Total equity and liabilities	**741.8**	**115,148.0**		**115,889.8**

2020

Extract from income statement

Business Segments	**Travex Hotels Lagos ₦'000**	**Travex Hotels Abuja ₦'000**	**Travex Hotels Games ₦'000**	**Total ₦'000**
Rooms	272.2	6,230.3	-	6,502.5
Food and beverages	207.7	2,302.5	-	2,510.2
Shop rental		693.8	-	693.8
Service charge	5.9	77.7	-	83.6
Recreation service	-	-	-	-
Revenue from Games	-	-	520.7	520.7
Secretarial services				
Other operating revenue	19.1	343.1	-	362.2
Total revenue from contract with Customers	**504.9**	**9,647.4**	**520.7**	**10,673.0**
Cost of sales				
Rooms	(120.3)	(1,940.4)		(2,060.7)
Food and beverages	(93.3)	(1,207.6)		(1,300.9)
Other operating cost		(127.9)	(332.8)	(460.7)
Total cost of sales	(213.6)	(3,275.9)	(332.8)	(3,822.3)
Gross profit	291.3	6,371.5	187.9	6,850.7
Other operating income				
Operating expenses	(488.1)	(15,114.9)	-	(15,603.0)
Operating profit/(loss)	(196.8)	(8,743.4)	187.9	(8,752.3)
Net finance cost	-	-	-	-
Profit/(Loss) before tax	(196.8)	(8,743.4)	187.9	(8,752.3)
Income tax	52.8	2,612.0		2,664.8
Profit/(Loss) after tax	**(144.0)**	**(6,131.4)**	**187.9**	**(6,087.5)**

Extract from statement of financial position

Assets	Travex Hotels Lagos ₦'000	Travex Hotels Abuja ₦'000	Travex Hotels Games ₦'000	Total ₦'000
Property, plant and equipment	210.0	94,959.0		95,169.0
Investment property		2,312.0		2,312.0
Other intangible assets		114.6		114.6
Long term investments		3,529.8		3,529.8
Long term receivables		6,671.3		6,671.3
Investment in financial assets	132.7			132.7
Current assets	184.6	4,809.3		4,993.9
Total assets	**527.3**	**112,396.0**		**112,923.3**
Equity and liabilities				
Issued capital	-	5,121.3		5,121.3
Share premium	-	12,548.9		12,548.9
Retained earnings	-	43,433.9		43,433.9
Total equity		61,104.1		61,104.1
Total liabilities	527.3	51,291.9		51,819.2
Total equity and liabilities	**527.3**	**112,396.0**		**112,923.3**

EXHIBIT 10

TRAVEX HOTELS LIMITED: PROJECT 'FUN PLUS'

The board of Travex Hotels has just approved the implementation of Project 'Fun Plus' for management implementation. The project will convert one of the hotel's existing wings, having 100 rooms into luxury apartments wing and one of the existing wings, containing 50 rooms, into a boutique wing. Details are as follows:

a. The luxury wing

A luxury apartment is part of the hotel that provides top of the range luxury rooms and chalets to guests with special taste. Each of the rooms or chalets will be luxuriously furnished with special décor. Fresh plants and flowers would be a part of the lobby décor. Each of the rooms/chalets would have a bathroom that impresses right at the time of entry to the room. Exotic tiles, exquisite bathtub, flower petals, temperature-controlled shower and a lot more would be part of the bathroom experience. It is all about the feel. Anything that contributes to the overall delight of a customer would be taken care of.

Revenue projection: It is projected that each of the rooms in the luxury apartment wing will be charged at a rate 50% higher than the normal rate in the hotel.

Occupancy rate: The occupancy rate in this wing will be as follows:

3 months in the year	90% occupancy rate
6 months in the year	75% occupancy rate
3 months in the year	60% occupancy rate

Cost estimates: It is projected that the operational cost of running the luxury apartments will increase by 25% above the current operational cost per room in the hotel. An additional labour cost of ₦1,000 per room per day is also envisaged, while maintenance cost is projected to increase by 20% above the existing maintenance cost per each of the hotel rooms.

Conversion cost: The cost of converting the existing wing to luxury apartments wing is estimated at ₦2billion while the cost of installation of air conditioners and, other furniture and fittings is put at ₦1billion.

b. Boutique wing

Boutique wing is meant for the class-conscious patrons and not the masses. 'Boutique' describes an upscale wing which has a uniqueness attached to it in terms of art, architecture, design and service. It is almost like a luxury apartments wing but with a touch of art and architectural design. This wing is being created to be a delight to consumers who are able to enjoy themed hotels with art and décor suited to local culture, history or a form of global art and design.

Revenue projection: It is projected that each of the rooms in the apartment wing will be charged at a rate 75% higher than the normal rate in the hotel.

Occupancy rate: The occupancy rate in this wing will be as follows:

3months in the year	70% occupancy rate
6months in the year	60% occupancy rate
3months in the year	50% occupancy rate

Cost estimates: It is projected that the operational cost of running the boutique wing rooms would increase by 25% above the current operational cost per room in the hotel. An additional labour cost of ₦1,000 per room per day is also envisaged, while maintenance cost is projected to increase by 30% above the existing maintenance cost per each of the hotel rooms.

Conversion cost: The cost of converting the existing wing to a boutique wing is estimated at ₦2billion; while the cost of installation of air conditioners and, other furniture and fittings is put at ₦1.5billion.

Project 'Fun Plus' financial data

The following details are relevant to the project:

a. Weighted average cost of capital of Travex Hotels is 15% per annum;
b. Project 'Fun Plus' would be financed using internal sources;
c. Travex plans to breakeven on the project at the end of the seventh year; and
d. Increases in cost due to inflation would be matched with increases in room rates during the period.

Travex Hotels Limited

Financial data

a. Room rate: Currently, the room rate for the equivalent of rooms to be converted into luxury and boutique rooms is ₦120,000 per night.
b. The current operational cost per room is ₦30,000.
c. The daily maintenance cost per room is currently fixed at ₦5,000 per room.

Travex Hotels Limited
Marking Key

	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: Travex Hotels Limited

1. General • States the purpose of the report • States the summary of the two requirements • States the assumptions • States reservations, e. g. scepticism **V NC BC CA SA**	**3. Requirement 1: Recommendations** • The hotel should introduce costs control measures to curtail its operating expenses. • The hotel should develop strategies to improve on its assets utilisation to generate more revenue. • The hotel should expand its operations in Lagos because of availability of large market in the city. • The hotel should improve on its working capital management, so as not to have recourse to borrowing at high interest. **V NC BC CA SA**	**5. Requirement 2: Recommendations** • The hotel should secure regulatory approval for the reconstruction. • From the financial analysis point of view, the project is viable and should be undertake • The management should have a plan for an alternative source of fund, in case internal fund becomes inadequate for the project • The hotel would need to recruit qualified and experienced staff to operate at the two wings. • The management of the hotel should have in place marketing plan, to attract patronage. • Tap opportunities in the business environment • Mitigate against threats in the business environment. • The company should deploy updated technology to prevent the reoccurrence of employee fraud. **V NC BC CA SA**
2. Requirement 1: Conclusion • The hotel's operating expenses is on the high side • There is a need to make more effective use of its assets to generate more revenue. • The hotel's profit after tax to net assets ratio is very low. • The hotel's profit after tax to revenue ratio is very low. • There is a need for the hotel to take advantage of Lagos large market. **NC BC CA SA**	**4. Requirement 2: Conclusions** • Need for regulatory authority's approval for the reconstruction. • A lot of marketing effort will be needed to market the Luxury and Boutique rooms. • Qualified staff would be needed • Management of the hotel need to plan ahead on what to do, in case internal funds is no more sufficient to finish the project. • Opportunities and threats in the business environment affecting the hotel industry. • The investments on the Luxury wing will be recouped at the third year, while that of the Boutique will be in the sixth year. • The project is viable. • There is need for the use of updated technology to reduce employee fraud. **V NC BC CA SA**	

Requirement 1: Travex Hotels Limited's Business Segment Performance

1. USES DATA AND INFORMATION APPROPRIATELY

- Uses information on exhibit 7 - Email from Michael Chukwuma
- Uses information on exhibit 8 - Email from Deborah Brown
- Uses information on exhibit 9 - Business segments' performance
- Uses information on exhibit 5 - 3-year summary financial statements .

V NC BC CA SA

2. USES PROFESSIONAL TOOLS AND KNOWLEDG

- Calculates revenue growth per business location
- Calculates revenue growth for business segments
- Calculates contribution of business segments per location
- Calculates Gross profit ratio per business segment
- Calculates net operating profit to revenue ratio per location
- Calculates operating expenses to revenue ratio per location.
- Calculates profit after tax to revenue ratio per location
- Calculates operating profit to total assets ratio per location.
- Calculates profit after tax to net assets ratio per segment.
- Calculates location segments' contribution to total profit.

V NC BC CA SA

3.USES ANALYTICAL SKILLS (material points) written report

- Determines trend in revenue growth per segment.
- Determines trend in revenue growth for business segment
- Determines trend in gross profit ratio per segment.
- Determines trend in operating costs to revenue ratio per segment.
- Determines trend in operating profit to revenue ratio per segment.
- Determines trend in profit after tax to revenue ratio per segment.
- Determines trend in operating profit to total assets ratio per segment.
- Determines trend in segmental contributions to overall profitability.
- Determines trend in contribution of revenue stream per segment

V NC BC CA SA

4. IDENTIFIES ISSUES AND OPTIONS

- Identifies the need to reduce operating expenses in both Abuja and Lagos hotels.
- Identifies the need to expand the hotel's operation in Lagos to take advantage of opportunities available.
- Identifies that the long-term receivables have been in the financial statements since 2020, when will it crystallise?
- Identifies that the hotel needs to improve on the use of its assets to generate more revenue.

V NC BC CA SA

5. APPLIES PROFESSIONAL SCEPTICISM AND ETHICS

- Recognises that the hotel might not have recovered fully from the effect of Covid.
- Recognises that we are not sure whether the financial statements have been audited or not.
- Recognises the ethics of having gaming machines in a five-star hotel.
- Recognises that the hotel is incurring high finance charges despite the fact that hotel business is more of a cash business.

V NC BC CA SA

6. EVALUATIVE SKILLS AND JUDGEMENT

- Recognises that revenue has been growing steadily for each of the business segment from 2021
- Recognises that Abuja's gross profit ratio is higher than that of Lagos and gaming.
- Recognises that all the business segments made losses in 2020, except gaming.
- Recognises that gaming is the greatest contributor to the hotel's overall profitability.
- Recognises that gamming has the best profit after tax to revenue ratio.
- Recognises that the hotel is not making optimal use of its assets.

V NC BC CA SA

Requirement 1: Travex Hotels Limited's Business Segment Performance – Cont'd

7. CONCLUSION	8. RECOMMENDATIONS (commercial/ relevant)
(Draws distinct conclusions under a heading) • Concludes that the hotel's operating expenses is on the high side. • Concludes that the hotel needs to make more use of its assets to generate more revenue. • Concludes that the hotel's profit after tax to net assets ratio is very low. • Concludes that the hotel's profit after tax to revenue ratio is very low. • Concludes on the need for the hotel to take advantage of Lagos large market. **V NC BC CA SA**	• Recommends that the hotel should introduce costs control measures to curtail its operating expenses. • Recommends that the hotel should develop strategies to improve on its assets utilisation to generate more revenue • Recommends that the hotel should expand its operations in Lagos because of availability of large market in the city. • Recommends that the hotel should improve on its working capital management, so as not to have recourse to borrowing at high interest. **V NC BC CA SA**

REQUIRMENT 2 – Appraisal of the proposed, project “Fun Plus”

<table>
<tr>
<td>1. USES DATA AND INFORMATION APPROPRIATELY
• Uses information in exhibit 3 - Business environment and challenges facing hospitality industry.
• Uses information in exhibit 4, about Travex Hotels' history, board, management and competition
• Uses information in exhibit 6, Sustainability and innovation
• Uses information in exhibit 7, email from Michael Chukwuma.
• Uses information in exhibit 8, email from Deborah Brown.
• Uses information in exhibit 10, Project “Fun Plus”

V NC BC CA SA</td>
<td>3. USES ANALYTICAL SKILLS (material point)
• Determines the annual incremental revenue from Luxury wing
• Determines the annual incremental revenue from Boutique wing
• Determines the annual incremental operational costs for Luxury wing
• Determines the annual incremental operational costs for Boutique wing.
• Determines the total capital cost for converting building to Luxury wing.
• Determines the total capital cost for converting building to Boutique wing.
• Determines the present value payback period for Luxury wing.
• Determines the present value payback period for Boutique wing.

V NC BC CA SA</td>
<td>5. APPLYING PROFESSIONAL SCEPTICISM AND ETHICS
• Discusses that the regulatory authority may not give approval to reconstruct hotel.
• Discusses the possibility of inaccurate estimate of reconstruction costs.
• Discusses the possibility of error in the estimates for additional operational costs.
• Discusses the accuracy of the estimated occupancy rates for both the Luxury and the Boutique wings.
• Discusses the possibility of the hotel not being able to finance the project from Internal sources.
• Discuss the possibility of sub-utilisation of the supplies and consumables

V NC BC CA S</td>
</tr>
<tr>
<td>2. USES PROFESSIONAL TOOLS AND KNOWLEDGE (written into report)
• Calculates the occupancy days for both Luxury and Boutique rooms.
• Calculates the incremental revenues per room for both Luxury and Boutique.
• Calculates the incremental revenue per annum for both Luxury and Boutique rooms.
• Calculates the additional costs per day for both Luxury and Boutique.
• Calculates the capital outlay for both Luxury and Boutique wings.
• Calculates the net present value for both Luxury and Boutique wings
• Determines the opportunities and threats in the business environment affecting the hotel industry.
V NC BC CA SA</td>
<td>4. IDENTIFIES ISSUES AND OPTION
• Identifies the need for special marketing of the Luxury and Boutique rooms to secure the required occupancy.
• Identifies the possibility of the Luxury and Boutique rooms affecting the occupancy rate of the existing rooms.
• Identifies the need for regulatory authority's approval to reconstruct part of the Abuja hotel
• Identifies that the hotel may also need to introduce the Luxury and Boutique rooms in their Lagos outlet as well.
• Identifies opportunities and threats in the economic and business environment affecting the hotel industry.
• Identifies the need to adopt updated technology to reduce employee fraud
V NC BC CA SA</td>
<td>6. EVALUATIVE SKILLS AND JUDGEMENT (uses analytical headings)
• Recognises that it is the incremental revenue that is needed for the required calculations.
• Recognises that it is the incremental costs that is appropriate for the required calculations.
• Recognises that present values must be determined for each of the seven years.
• Recognises that the payback period must be determined using the present values for each year.
• Recognises that there are opportunities and threats in the industry

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REQUIRMENT 2 – Appraisal of the proposed, project “Fun Plus” – Cont’d

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7. CONCLUSIONS
(Draws distinct conclusions under a heading)

- Concludes that regulatory authority approval is needed for the project.
- Concludes that a lot of marketing effort will be needed to market the Luxury and Boutique rooms.
- Concludes that the hotel would need qualified staff to operate the Luxury and Boutique wings.
- Concludes that the management of the hotel need to plan ahead on what to do, in case internal funds is no more sufficient to finish the project.
- Concludes that the investments on the Luxury wing will be recouped at the third year, while that of the Boutique will be in the sixth year.
- Concludes that the project is viable.
- Concludes on the opportunities and threats in the business environment affecting the hotel industry.
- Concludes there is need for the use of updated technology to reduce employee fraud

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8. RECOMMENDATIONS (commercial / relevant)

- Recommends that the hotel should secure regulatory approval for the reconstruction.
- Recommends that from the financial analysis point of view, the project is viable and should be undertaken.
- Recommends that the management should have a plan for an alternative source of fund, in case internal fund becomes inadequate for the project.
- Recommends that the hotel would need to recruit qualified and experienced staff to operate at the two wings.
- Recommends that the management of the hotel should have in place marketing plan, to attract patronage.
- Recommends that the company should evolve strategies to tap the opportunities and reduce impact of threats in the hotel industry business environment identified.
-
- Recommend that the company should leverage on updated technology to prevent the recurrent of employee fraud.

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<tr><th>Appendices</th><th>Main Report</th></tr>
<tr><td>1. R1 Appendices
• Shows revenue growth per business location and business segments
• Shows Gross profit ratio per business location
• Shows net operating profit to revenue ratio per location/segment.
• Shows operating expenses to revenue ratio per location// segment.
• Shows profit after tax to revenue ratio per location/segment.
• Shows operating profit to total assets ratio per location/segment.
• Shows profit after tax to net assets ratio per segment
• Shows segments' contribution to total profit.
• Show contribution of business segments per location.

V NC BC CA SA</td><td>3. Report: Structure

• Sufficient appropriate headings

• Appropriate use of paragraphs / sentences

• Legible/clear handwriting

• Correctly numbered pages

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<tr><td>2. R2 Appendices
• Shows the occupancy days for both Luxury and Boutique rooms
• Shows the incremental revenues per room for both Luxury and Boutique.
• Shows the incremental revenue per annum for both Luxury and Boutique rooms.
• Shows the additional costs per room for both Luxury and Boutique.
• Shows the capital outlay for both Luxury and Boutique wings.
• Shows the net present value for both Luxury and Boutique wings

V NC BC CA SA</td><td>4. Report: Style and language

• Relevant disclaimer (external report)

• Suitable language for the board

• Tactful / ethical comments

• Acceptable spelling and punctuation

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Appendix 1
Travex Hotels Nigeria Limited
Analysis of business segments' performance

	Abuja			**Lagos**			**Gaming**		
	2020	**2021**	**2022**	**2020**	**2021**	**2022**	**2020**	**2021**	**2022**
Revenue growth per location									
Room		113.47%	43.99%	0	69.36%	13.84%			
Food and beverages		165.98%	59.78%	0	66.39%	27.29%			
Others		1.78%	31.90%	0	107.20%	-26.64%		201.06%	3.98%
Gross profit ratio	66.04%	74.65%	71.41%	57.69%	64.99%	65.04%	36.09%	60.90%	60.12%
Operating profit/Revenue ratio	-90.63%	23.70%	29.44%	-38.98%	0.91%	-10.69%	36.09%	60.90%	60.12%
Operating expenses/Revenue ratio	156.67%	52.27%	45.24%	96.67%	64.96%	76.46%	N/A	N/A	N/A
Profit after tax/Revenue ratio	-63.55%	1.31%	10.15%	-28.52%	0.40%	-26.86%	36.09%	60.90%	60.12%
Operating profit/Total assets ratio	-7.89%	4.23%	7.61%	-37.32%	1.05%	-3.91%	N/A	N/A	N/A
Profit after tax/Net assets ratio	-10.03%	0.43%	4.91%	-27.31%	-0.46%	-9.82%	N/A	N/A	N/A
Contribution to overall profitability:	**Abuja**			**Lagos**			**Gaming**		**Total**
2020	100.72%			2.37%			-3.09%		100.00%
2021	22.11%			-0.28%			78.17%		100.00%
2022	81.29%			-7.09%			25.80%		100.00%
	Abuja			**Lagos**			**Gaming**		
Revenue contribution of business segments per locations:(segment revenue/total revenue)									
Room	95.81%	**96.65%**	**97.33%**	4.19%	**3.35%**	**2.67%**	N/A	N/A	N/A
Food and Beverages	91.73%	**94.66%**	**95.70%**	8.27%	**5.34%**	**4.30%**	N/A	N/A	N/A
		Abuja		**Lagos**					
Gross margin of Business segments per location	2020	2021	2022	2020	2021	2022	2020	2021	2022
Rooms	**68.86%**	**86.49%**	82.42%	**55.80%**	92.02%	92.3%	N/A	N/A	N/A
Food & Beverages	47.55%	**46.35%**	**50.42%**	**55.80%**	39.32%	42.56%	N/A	N/A	N/A
Revenue /Total Asset Ratio									
Rooms	5.5%	**11.60%**	**16.35%**	**3.94%**	6.21%	19.10%			
Food and Beverages	2.05%	**5.32%**	**8.31%**	**39.39%**	46.59%	16.04%			

Revenue Growth per Business segment	**2020**	**2021**	**2022**
Room	**-**	**111.62%**	**42.98%**
F&B	**-**	**157.74%**	**58.04%**
Gaming	**-**	**201.06%**	**3.98%**

Appendix 2
Travex Hotels Nigeria Limited

Opportunities and threats

Opportunities
1. Nigeria's population and her growing middle class along with increased international trade and investment
2. Nigeria's tourism potentials
3. Nigeria potential economic growth
4. Tourism incentive introduced by the Federal Government
5. Application of technology in many hotel operations

Threats
1. Infrastructure decay in Nigeria e.g bad roads and poor power supply
2. Insecurity in Nigeria
3. Competition from owner managed hotels
4. Cultural diversity in Nigeria
5. Clamour for hotels to embrace green energy
6. Shortage of trained and experience staff
7. Supply chain problem
8. Clamour for reduction in water consumption
9. Clamour for waste reduction and management

Appendix 3

Travex Hotels Nigeria Limited **(Luxury wing)**

Revenue

First 90days	90 X 90%	81
Next 185 days	185 X 75%	139
Final 90 days	90 X 60%	54
Yearly occupancy		274

Calculation of room rate	₦		Incremental
Normal rate	120,000		
Increase 0f 50%	60,000		60,000
Luxury rate	180,000		
Total incremental revenue per day (a)		274 X 60,000 X 100	1,644,000,000

Cost Estimate

Incremental cost

	Present	Increase	
Operational costs	30,000	25%	7,500
Labour			1,000
Maintenance	5,000	20%	1,000
Total Incremental cost per day			9,500
Total incremental cost per year (b)	74 x 9,500 x 100		260,300,000
Net inflow per year (a - b)			1,383,700,000
Capital costs			
Conversion			2,000,000,000
Furnishing			1,000,000,000
			3,000,000,000

Calculation of NPV	Year	Cash flow	Discount factor	Present value	Cum. PV
Initial cost	0	-3,000,000,000	1	-3,000,000,000.00	-3,000,000,000.00
Net revenue	1	1,383,700,000	0.8697	1,203,403,890.00	(1,796,596,110.00)
Net revenue	2	1,383,700,000	0.7561	1,046,215,570.00	(750,380,540.00)
Net revenue	3	1,383,700,000	0.6572	909,367,640.00	158,987,100.00
Net revenue	4	1,383,700,000	0.5718	791,199,660.00	950,186,760.00
Net revenue	5	1,383,700,000	0.4972	687,975,640.00	1,638,162,400.00
Net revenue	6	1,383,700,000	0.4323	598,173,510.00	2,236,335,910.00
Net revenue	7	1,383,700,000	0.3759	520,132,830.00	2,756,468,740.00
				2,756,468,740.00	

(Boutique wing)

Revenue

First 90days	90 X 70%	63
Next 185 days	185 X 60%	111
Final 90 days	90 X 50%	45
Yearly occupancy		219

Calculation of room rate	₦		Incremental
Normal rate	120,000		
Increase 0f 75%	90,000		90,000
Luxury rate	210,000		
Total incremental revenue per year (a)		219 x 90,000 x 50	985,000,000
Costs estimate			
	Present	Increase	Incremental cost
Operational costs	30,000	25%	7,500
Labour			1,000
Maintenance	5,000	30%	1,500
Total Incremental cost per day			10,000
Total incremental cost per year (b)		219 X 9,500 X 50	109,500,000
Net inflow per year (a - b)			876,000,000
Capital costs			m
Conversion			2,000,000,000
Furnishing			1,500,000,000
			3,500,000,000

Calculation of NPV	Year	Cash flow	Discount factor	Present value	Cum. PV
Initial cost	0	-3,500,000.000	1	- 3,500,000,000	- 3,500,000,000
Net revenue	1	876,000,000.00	0.8697	761,857,200	(2,738,142,800)
Net revenue	2	876,000,000.00	0.7561	662,343,600	(2,075,799,200)
Net revenue	3	876,000,000.00	0.6572	575,707,200	(1500,092,000)
Net revenue	4	876,000,000.00	0.5718	500,896,800	(999,195,200)
Net revenue	5	876,000,000.00	0.4972	435,547,200	(563,648,000)
Net revenue	6	876,000,000.00	0.4323	378,694,800	378,694,800
Net revenue	7	876,000,000.00	0.3759	329,288,400	144,335,200
				144,335,200	

Examiner's report

The case scenario is on Travex Hotels Limited, a company operating in the hospitality industry with hotels in Abuja and Lagos. The Pre-seen case scenario includes: Details about the Nigerian economy and the hospitality industry; Business environment and challenges facing the hospitality industry; Travex Hotels Limited – History, board, management and competition; 3-year summary financial statements; and Hospitality business, sustainability and innovation. While the Un-seen introduces Travex Hotels Limited – Business segments performance; and Travex Hotels – Project 'Fun Plus'.

The following appendices are required:

As usual, there are two requirements that candidates are to address.These are:

- A detailed evaluation of the three business segments of the hotel across the two hotel locations - Food and beverages, Rooms and Gaming business segments in each of the hotel locations.
- An appraisal of the hospitality business environment in view of development in sustainability and innovation, noting the opportunities and threats of these developments. Also, an evaluation of the proposed project 'Fun Plus', as requested by Travex's board. Candidates are also required to advise on process improvements, training, etc., needed to remediate the reoccurring auditor's observations.

To perform very well in this Case Study, candidates must prepare the following appendices:

Requirement 1:

Appendix 1: Ratio Analyses appraising the segmental performance of Travex Hotels Limited business segments;

Requirement 2:

Appendix 2: Opportunities and threats in Travex Hotels Limited's business environment in view of developments in sustainability and innovations in the industry; and

Appendix 3: Calculations to determine the viability of Project 'Fun Plus'.

Candidates' performance was woeful as only a very few of the candidates scored up to 50%.

The common pitfalls of the candidates are:

- Most candidates demonstrated inadequate understanding of how to evaluate segmental performance, using ratio analysis;
- Most candidates did not address requirement 2 of the Case Study. The few candidates that attempted the requirement performed poorly as they could not determine the viability of "Project Fun', using net present value after determining the project's incremental contribution;
- 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, especially Performance Management and Strategic Financial Management, when preparing for future examinations.