



**THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF NIGERIA**

PATHFINDER

**MAY 2018 DIET
PROFESSIONAL LEVEL EXAMINATIONS**

Question Papers

Suggested Solutions

Examiner's Reports

Plus

Marking Guides

FOREWARD

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

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

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

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

NOTES

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

TABLE OF CONTENTS

	PAGE
FOREWARD	1
CORPORATE REPORTING	3 – 37
ADVANCED TAXATION	38 – 67
STRATEGIC FINANCIAL MANAGEMENT	68 – 97
ADVANCED AUDIT AND ASSURANCE	98 – 127
CASE STUDY	128 - 161

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA
PROFESSIONAL LEVEL EXAMINATION - MAY 2018

CORPORATE REPORTING

Time Allowed: 3¼ hours (including 15 minutes reading time)

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Komolafe Group carries on business as a distributor of warehouse equipment and importer of fruit into the country. Komolafe was incorporated in 2008 to distribute warehouse equipment. It diversified its activities during the year 2010 to include the import and distribution of fruit, and expanded its operations by the acquisition of shares in Kelvins in 2012 and Kelly in 2014.

Accounts for all companies are made up to December 31.

The draft statements of profit or loss and other comprehensive income for Komolafe, Kelvins and Kelly for the year ended December 31, 2016 are as follows:

	Komolafe N'000	Kelvins N'000	Kelly N'000
Revenue	91,200	49,400	45,600
Cost of sales	<u>(36,100)</u>	<u>(10,926)</u>	<u>(10,640)</u>
Gross profit	55,100	38,474	34,960
Distribution costs	(6,650)	(4,274)	(3,800)
Administrative expenses	(6,950)	(1,900)	(3,800)
Finance costs	<u>(650)</u>	<u>0</u>	<u>0</u>
Profit before tax	40,850	32,300	27,360
Income tax expense	<u>(16,600)</u>	<u>(10,780)</u>	<u>(8,482)</u>
Profit for the year	24,250	21,520	18,878
Other comprehensive income for the year:			
<i>Items that will not be reclassified to profit or loss in subsequent period</i>			
Revaluation of property	<u>400</u>	<u>200</u>	<u>0</u>
	<u>24,650</u>	<u>21,720</u>	<u>18,878</u>

The draft statement of financial position as at December 31, 2016 are as follows:

	Komolafe N'000	Kelvins N'000	Kelly N'000
Non-current assets			
Property, plant and equipment (carrying amount)	70,966	48,546	26,126
Investments			
Shares in Kelvins	13,300	000	000
Shares in Kelly	<u>0</u>	<u>7,600</u>	<u>0</u>
	84,266	56,146	26,126
Current assets	<u>3,136</u>	<u>18,050</u>	<u>17,766</u>
	<u>87,402</u>	<u>74,196</u>	<u>43,892</u>
Equity			
Ordinary shares	16,000	6,000	4,000
Retained earnings	45,276	48,150	39,796
Current liabilities	<u>26,126</u>	<u>20,046</u>	<u>96</u>
	<u>87,402</u>	<u>74,196</u>	<u>43,892</u>

The following information is available relating to Komolafe, Kelvins and Kelly.

- (i) On January 1, 2012 Komolafe acquired 5,400,000, ₦1 ordinary shares in Kelvins for ₦13,300,000 at which date there was a credit balance on the retained earnings of Kelvins of ₦2,850,000. No shares have been issued by Kelvin since Komolafe acquired its interest
- (ii) At the date of acquisition, the fair value of the identifiable net assets of Kelvins was ₦10m. The excess of the fair value of net assets is due to an increase in the value of non depreciable land.
- (iii) On January 1, 2014 Kelvins acquired 3,200,000, ₦1 ordinary shares in Kelly for ₦7,600,000 at which date there was a credit balance on the retained earnings of Kelly of ₦1,900,000. No shares have been issued by Kelly since Kelvins acquired its interest. The fair value of the identifiable net assets of Kelly at the date of acquisition approximates their book values.
- (iv) During 2016, Kelly had made intra-group sales to Kelvins of ₦960,000 making a profit of 25% on cost and ₦150,000 of these goods were in inventories at December 31, 2016.
- (v) During 2016, Kelvins had made intra-group sales to Komolafe of ₦520,000 making a profit of 25% on sales and ₦120,000 of these goods were in inventories at 31 December 2016
- (vi) An impairment test conducted at the year end did not reveal any impairment losses.
- (vii) It is the group's policy to value the non-controlling interest at fair value at the date of acquisition. The fair value of the non-controlling interests in Kelvins

on January 1, 2012 was ₦1,000,000. The fair value of the 28% non-controlling interest (direct and indirect) in Kelly on January 1, 2014 was ₦1,800,000.

Required:

Prepare for Komolafe Group:

- A consolidated statement of profit or loss and other comprehensive income for the year ended December 31, 2016. (13 Marks)
- A consolidated statement of financial position as at December 31, 2016 (12 Marks)
- In business combination, the consideration given by the acquirer to gain control of the acquiree can be in different forms including deferred and contingent considerations. While deferred and contingent considerations represent amounts of consideration to be transferred in the future, the two differ in nature and form.

Required:

Briefly distinguish between deferred and contingent consideration.

(5 Marks)

(Total 30 Marks)

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

QUESTION 2

Set out below are the draft accounts of Wole-Adura Plc and subsidiaries and of Maseru Associates. Wole-Adura acquired 40% of the equity capital of Maseru Associates three years ago when the latter's retained earnings stood at ₦140m.

Abridged statement of financial position

	Wole-Adura Plc & Subsidiaries	Maseru Associates
	₦ m	₦m
Property, plant and equipment	990	595
Investment in Maseru Associates at cost	290	-
Loan to Maseru Associates	70	-
Current assets	450	175
Loan from Wole-Adura Plc.	-	(70)
	<u>1800</u>	<u>700</u>

FINANCED BY:

Ordinary shares of 50k each	1,125	350
Retained earnings	<u>675</u>	<u>350</u>
	<u>1800</u>	<u>700</u>

Abridged statements of profit or loss

	Wole-Adura Plc & Subsidiaries	Maseru Associates
	₦ m	₦ m
Profit before tax	427.50	280.00
Tax expense	<u>(157.50)</u>	<u>(105.00)</u>
	270.00	175.00

Additional information:

- (i) Wole-Adura proposed a dividend of ₦225m.
- (ii) Total market capitalisation is ₦5,625m.

Required:

- a. Calculate each of these ratios for Wole-Adura Plc. and subsidiaries.
 - i. Earnings per share.
 - ii. Dividend cover.
 - iii. Earnings yield.
 - iv. Dividend yield. (4 Marks)
- b. (i) Using the equity method, compute the earnings of the group incorporating the associates. (4 Marks)
- (ii) Compute the ratios in (a) above for the group. (4 Marks)
- c. Comment on the ratios calculated in (a) and (b) above by pairwise comparison. (3 Marks)
- d. Extracts from the financial statements of Ikoku Plc. recently published are as follows:

Statement of profit or loss for the year ended December 31, 2017

	2017	2016
	₦' m	₦' m
Revenue	360	20
Cost of sales	<u>(150)</u>	<u>(12)</u>
Gross profit	210	8
Operating expenses	<u>(50)</u>	<u>(3)</u>

Operating profit	160	5
Interest expense	(10)	-
Tax expense	<u>(60)</u>	<u>(2)</u>
Profit for the year	<u>90</u>	<u>3</u>

Statement of financial position as at December 31, 2017

	2017	2016
	N'm	N'm
Non-current assets		
Property, plant & equipment	80	20
Current assets		
Inventory	200	40
Trade receivables	70	25
Bank	<u>(50)</u>	<u>30</u>
Total assets	<u>300</u>	<u>115</u>
Equity & liabilities		
Ordinary shares of ₦1 each	60	40
Current liabilities		
Trade payables	190	60
Current tax	<u>50</u>	<u>15</u>
	<u>300</u>	<u>115</u>

Required:

Discuss the liquidity challenges of Ikoku Plc. during the year ended December 31, 2017 from the extracts of the published financial statements.

(5 Marks)

(Total 20 Marks)

QUESTION 3

- a. "IFRS 5 Non-current Asset held for Sale and Discontinued Operations" sets out the principles governing the measurement and presentation of non-current assets that are expected to be realised through sale rather than through continuing use. The standard also deals with reporting the results of operations that qualify as discontinued.

Required:

Discuss the conditions which must be met for a non-current asset to be classified as being "*held for sale*" and explain the accounting treatment that applies when such a classification is deemed appropriate. (7 Marks)

- b. Bamgbose Plc. is a long-established travel agent, operating through a network of retail outlets and online store. In recent years, the business has seen its revenue from the online store grow strongly, and that of retail outlets decline significantly. On July 1, 2017, the board decided to close the retail network at the financial year end of December 31, 2017 and put the buildings up for sale on that date. The directors are seeking advice regarding the treatment of the buildings in the statement of financial position as well as the treatment of the trading results of the retail division for the year. The following figures are available at December 31, 2017.

Carrying amount of buildings	₦30.0 million
Fair value less costs to sell of buildings	₦25.8 million
Other expected costs of closure	₦5.85 million
Trading results:	

	Year ended December 31, 2017		Year ended December 31, 2016	
	Online store ₦m	Retail outlet ₦m	Online store ₦m	Retail outlet ₦m
Revenue	58.5	13.5	48	18
Cost of sales	19.5	10.5	16.5	13.5
Gross profit	39	3	31.5	4.5
Operating costs	(15)	(7.5)	(12)	(7.5)
Profit before tax	24	(4.5)	19.5	(3)

Required:

- Outline the conditions which must be met in order to present the results of an operation as “discontinued” and the accounting treatment that applies when such a classification is deemed appropriate. (5 Marks)
 - Draft the statement of profit or loss for Bamgbose Plc. for year ended December 31, 2017 together with the comparative figures for 2016, taking the above information into account. (8 Marks)
- (Total 20 Marks)**

QUESTION 4

- a. Recording the substance of transactions, rather than their legal form, is an important principle in financial reporting. The use of off-statement of financial position financing arrangement enables companies to obtain financing without showing debts in their books.

Required:

Describe how the use of off-statement of financial position financing can mislead users of financial statements, making specific reference to **THREE** user

groups and giving examples where recording the legal form of transactions may mislead them. (6 Marks)

- b. Waasimi entered into the following transactions during the year ended March 31, 2018:

In March 2018, Waasimi factored some of its trade receivables to Asejere, a finance house. Based on selected account balances, Asejere paid Waasimi 80% of its book value. The agreement was that Asejere would administer the collection of the receivables and remit a residual amount to Waasimi depending upon how quickly individual customers paid. Any balance not collected by Asejere after six months will be refunded to Asejere by Waasimi.

On April 1, 2017, Waasimi's freehold building had a carrying amount of ₦15million and an estimated remaining useful life of 20 years. On this date, Waasimi sold the building to Gbajumose for a price of ₦24million and entered into an agreement with Gbajumose to lease back the building for an annual rental of ₦2.6million for a period of five years.

The auditors of Waasimi have commented that in their opinion the building had a market value of ₦20million at the date of its sale and to rent an equivalent building under similar terms to the agreement between Waasimi and Gbajumose would cost ₦1,600,000 per annum. Assume finance cost of 10% per annum.

Required:

- i. Briefly explain the major accounting issues involved in the above transactions using the principles of substance over form. (5 Marks)
- ii. State the appropriate accounting treatments of the various elements identified. (6 Marks)
- iii. State the classes of charges to be incurred and their appropriate accounting treatments. (3 Marks)

(Total 20 Marks)

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

QUESTION 5

- a. Deferred tax can be determined adopting two perspectives that may result in different numbers in the financial statements and tax computations. These are statement of comprehensive income and statement of financial position, perspectives.

Required:

Distinguish between the **TWO** perspectives of identifying deferred tax balances in the financial statements. (4 Marks)

- b. The following information relates to Tola Plc. as at December 31, 2017:

	Note	Carrying amount	Tax base
Non-current assets		₦	
Plant and equipment		250,000	218,750
Receivables:			
Trade receivables	1	62,500	
Interest receivable		1,250	
Payables			
Fine		12,500	
Interest Payable		2,500	

Note 1

The trade receivables balance in the accounts is made up of the following amounts:

Balances	68,750
Doubtful debt provision (Specific)	<u>(6,250)</u>
	<u>62,500</u>

Further information:

- (i) The deferred tax balance as at January 1, 2017 was ₦1500.
- (ii) Interest is taxed on a cash basis.
- (iii) Allowances for doubtful debts are not deductible for tax purposes. Amounts in respect of receivables are only deductible on application of a court order to a specific amount.
- (iv) Fines are not tax deductible.
- (v) The tax rate is 30% for 2017. The government has not announced the tax rate for 2018 but it is expected to rise to 36%.

Required:

Compute the deferred tax provision which is required as at December 31, 2017 and the charge to profit or loss for the period in accordance with IAS, 12 - Income Taxes. (11 Marks)

(Total 15 Marks)

QUESTION 6

Omotola Nigeria Plc is a conglomerate which operates in different sectors of the economy. The company has many subsidiaries and associates across the six continents of the world and its head office is located in Lagos, Nigeria. The shares of the company are listed on the Nigerian Stock Exchange.

The company is trying to finalise its financial statements for the year ended April 30, 2018 and the following accounting issues are being considered by the chief accountant based on the submission by the assistant accountant who is yet to complete her professional examinations with the Institute of Chartered Accountants of Nigeria. The functional and presentation currency of Omotola Nigeria Plc. is Naira. The following transactions relate to the company:

- (i) On May 1, 2017, Omotola Nigeria Plc. bought an investment property in United States for \$1,000,000. The company uses fair value model of IAS 40 to account for the investment property and the fair value at April 30, 2018 is determined to be \$1,200,000. The assistant accountant is unsure which exchange rate to use in translating the investment property at the year end and how to recognize any exchange difference that may arise.
- (ii) On May 1, 2017, Omotola Nigeria Plc. acquired a wholly owned subsidiary in United States of America. The goodwill that arose on the acquisition of this subsidiary is \$400,000.

In addition, the company invested in an equity instrument on the same date which is measured at fair value through other comprehensive income (OCI) in accordance with the requirements of IFRS 9.

Required:

- a. In accordance with the requirement of IAS 21 - Effect of Changes in Foreign Exchange Rates, discuss the treatment of foreign currency transactions and the gain or loss arising therefrom. (7 Marks)
- b. Discuss how the transaction in (i) will be accounted for in the financial statements of Omotola Nigeria Plc. for the year ended April 30, 2018 in accordance with IAS 21 (4 Marks)
- c. Discuss how the transaction in (ii) will be accounted for in the financial statements of Omotola Nigeria Plc. for the year ended April 30, 2018 in accordance with IAS 21. (4 Marks)

(Total 15 Marks)

QUESTION 7

Some shareholders in Nigeria are becoming increasingly interested in the environmental policies, impacts and practices of business entities given the activities of some oil and gas and telecommunication companies. However financial statements have not traditionally provided this information. As a result, there is early indication that some listed companies in Nigeria are beginning to publish sustainability report complying with the Global Reporting Initiative (“GRI”), an organisation set up in 1997, to develop a sustainability reporting framework for businesses. The GRI Sustainability Reporting Guidelines give guidance to entities on how to measure and report on managements’ approach to the economic, environmental and social aspects that impact on their businesses.

Required:

- a. Identify and explain the principal arguments against voluntary disclosure by business entities of their environmental policies, impacts and practices.
(8 Marks)
 - b. Explain the nature of the information that could be disclosed by entities in their external reports in respect of the economic, environmental and social aspects, in order to comply with the GRI guidelines.
(7 Marks)
- (Total 15 Marks)**

SOLUTION 1

(a) KOMOLAFE GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED DECEMBER 31, 2016

	NOTE	₦'000
Revenue	2	184,720
Cost of sales	3	<u>(56,246)</u>
Gross profit		128,474
Distribution costs	4	(14,724)
Administrative expenses	5	(12,650)
Finance costs		<u>(650)</u>
Profit before tax		100,450
Income tax expense	<u>6</u>	<u>(35,862)</u>
Profit for the year		64,588
Other comprehensive income for the year		
<i>Items that will not be reclassified to profit or loss in subsequent period</i>		
Revaluation of property	7	<u>600</u>
Total comprehensive income for the year		<u>65,188</u>
Profit attributable to:		
Equity holders of the parent	8	57,162
Non-controlling interest	8	7,426
		<u>64,588</u>
Total comprehensive income attributable to:		
Equity holders of the parent	10	57,742
Non-controlling interest	<u>9</u>	<u>7,446</u>
		<u>65,188</u>

(b) KOMOLAFE GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT DECEMBER 31, 2016

	Note	₦'000
Non-current assets		
Property, plant and equipment (carrying amount)	11	146,788
Intangible asset- Goodwill	13	7,040
Current assets	15	<u>38,892</u>
Total assets		<u>192,720</u>
Equity and Liabilities		
Equity		
Ordinary share		16,600
Retained earnings	16	<u>113,283</u>
Equity attributable to owners of parent		129,283

Non-controlling interest	14	<u>17,169</u>
Total equity		146,452
Current liabilities	17	<u>46,268</u>
Total equity and liabilities		<u>192,720</u>

Working notes

1. Group Structure

Komolafe

NCI

10%

90%

01/01/2012

For: ~~₦~~13.3m

Kelvins

NCI

20%

80%

01/01/2014

For: ~~₦~~7.6m

Kelly

Komolafe in Kelly

Indirect holding = 72%

NCI = 28%

2.	REVENUE	₦'000
	KOMOLAFE	91,200
	KELVINS	49,400
	KELLY	45,600
	Less: Inter-group sales - in Kelly	(960)
	- In Kelvins	(520)
		<u>184,720</u>

3.	COST OF SALES	₦'000
	KOMOLAFE	36,100
	KELVINS	10,926
	KELLY	10,640
	Less: Inter-group sales - in Kelly	(960)
	- in Kelvins	(520)
	Unrealised Profit - in Kelly	30
	- in Kelvins	30
		<u>56,246</u>

4.	DISTRIBUTION COSTS				₦'000
	KOMOLAFE				6,650
	KELVINS				4,274
	KELLY				<u>3,800</u>
					<u>14,724</u>
5.	ADMINISTRATIVE EXPENSES				₦'000
	KOMOLAFE				6,950
	KELVINS				1,900
	KELLY				<u>3,800</u>
					<u>12,650</u>
6.	INCOME TAX EXPENSES				N'000
	KOMOLAFE				16,600
	KELVINS				10,780
	KELLY				<u>8,482</u>
					<u>35,862</u>
7.	REVALUATION OF PROPERTY				N'000
	KOMOLAFE				400
	KELVINS				<u>200</u>
					<u>600</u>
8.	Non-controlling Interest	KOMOLAFE	KELVINS	KELLY	NCI
		₦'000	₦'000	₦'000	₦'000
	Profit for the year	24,250	21,520	18,878	
	Less: Unrealised Profit		<u>(30)</u>	<u>(30)</u>	
	Adjusted Profit		21,490	18,848	
	Shares of Profit in Kelly				
	72% : 28%	13,571		(18,848)	5,277
	Shares of Profit in				
	Kelvins 90% : 10%	19,341	(21,490)		2,149
		<u>57,162</u>	<u>—</u>	<u>—</u>	<u>7,426</u>
9.	Total comprehensive				
	Income attributable to NCI				₦'000
	Profit for the year (see 8 above)				7,426
	Other comprehensive income:				
	Revaluation of property (200 x 10%)				<u>20</u>
					<u>7,446</u>

10.	Total Comprehensive Income Attributable to Owners of Parent	₦'000
	Profit for the year (see 8 above)	57,162
	Other comprehensive income:	
	Revaluation of property (400 x 100%)	400
	Revaluation of property (200 x 90%)	<u>180</u>
		<u>57,742</u>
11.	Property, plant and equipment (carrying amount)	₦'000
	KOMOLAFE	70,966
	KELVINS	48,546
	KELLY	26,126
	Fair value adjustment	<u>1,150</u>
		<u>146,788</u>

12(a) Net Assets of the subsidiary - KELVINS

	Reporting Date ₦'000	Acquisition Date ₦'000	Post Acquisition ₦'000
Share capital	6,000	6,000	-
Retained earnings	48,150	2,850	45,300
Fair value adjustment – Land	1,150	1,150	
Unrealised profit – Inventory	<u>(30)</u>		<u>(30)</u>
	<u>55,270</u>	<u>10,000</u>	<u>45,270</u>

12(b) Net Assets of the subsidiary – KELLY

	Reporting Date ₦'000	Acquisition Date ₦'000	Post Acquisition ₦'000
Share capital	4,000	4,000	-
Retained earnings	39,796	1,900	37,896
Unrealised profit – Inventory	<u>(30)</u>		<u>(30)</u>
	<u>43,766</u>	<u>5,900</u>	<u>37,866</u>

13.	Goodwill	KELVINS N'000	KELLY N'000	TOTAL N'000
	Consideration transferred by the parent	13,300	6,840	20,140
	Fair value of NCI at acquisition	<u>1,000</u>	<u>1,800</u>	<u>2,800</u>
		14,300	8,640	22,940
	100% of net assets of subsidiary at acquisition (note 12)	<u>(10,000)</u>	<u>(5,900)</u>	<u>(15,900)</u>
	Goodwill	<u><u>4,300</u></u>	<u><u>2,740</u></u>	<u><u>7,040</u></u>

Note: the consideration transferred for the acquisition of KELLY is N7,600 x 90% i.e N6,84m

GOODWILL – ALTERNATIVE SOLUTIONS

KELVINS N'000	KELLY N'000
Purchase consideration 13,300	Purchase consideration 7,600
NCI 10% 1,000	NCI 28% 1,800
	Indirect Holdings (760)
	<u>8,640</u>
TOTAL CONSIDERATION 14,300	
Fair value of net asset at acquisition <u>(10,000)</u>	Fair Value of net asset at acquisition <u>(5,900)</u>
Goodwill at acquisition 4,300	Goodwill at acquisition 2740
Impairment nil	Impairment nil
Goodwill at reporting date <u><u>4,300</u></u>	Goodwill at reporting date <u><u>2,740</u></u>

14. Non-controlling Interest

	KELVINS N'000	KELLY N'000	TOTAL N'000
NCI fair value at acquisition	1,000	1,800	2,800
Add: Shares of post-acquisition Profit (45,270 x 10%); (37,868 x 28%)	4,527	10,602	15,129
Less: Shares of cost of investment in Kelly (7,600 x 10%)		<u>(760)</u>	<u>(760)</u>
	<u><u>5,527</u></u>	<u><u>11,642</u></u>	<u><u>17,169</u></u>

15.	Current Assets	₦ '000
	KOMOLAFE	3,136
	KELVINS	18,050
	KELLY	17,766
	Less: Unrealised Profit in Kelvins	(30)
	Unrealised Profit in Kelly	(30)
		<u>38,892</u>
16.	Retained Earnings	₦'000
	Komolafe	45,276
	Add: Share of Post-acquisition profit in Kelvins (45,270 x 90%) (Wn 12)	40,743
	in Kelly (37,866 x 72%) (Wn 12b)	<u>27,264</u>
		<u>113,283</u>
17.	Current Liabilities	₦'000
	KOMOLAFE	26,126
	KELVINS	20,046
	KELLY	<u>96</u>
		<u>46,268</u>

(c) **Deferred and contingent considerations**

Deferred consideration arises when all or part of the cost of an acquisition is deferred and does not become payable until a later date. In this case, the amount of any deferred consideration is discounted to its present value at the acquisition date to arrive at fair value as required by IFRS 3. Deferred consideration should be included in the cost of acquisition (i.e. as part of the consideration to acquire the acquiree).

Contingent consideration, on the other hand, arises when the final cost of the consideration is contingent on (dependent on) certain future events. For instance, an acquirer could agree to pay an additional amount if the acquired subsidiary's profits exceed a certain level within a specified period after the date of acquisition. Contingent consideration should be included in the cost of acquisition (discounted to present value if the payment will occur more than 12 months in the future). Contingent consideration must be recognised at acquisition date as long as the fair value can be measured reliably even though it is not probable that amount will be paid.

While both deferred and contingent considerations are measured at acquisition and their fair value recognized as part of cost of acquisition, the two differ as follows:

- While subsequent settlement of contingent consideration is dependent on the occurrence of certain future events, settlement of deferred consideration is not dependent on any future event.
- While subsequent measurement of deferred consideration, that is not equity is easier to determine the value is arrived at by unwinding of discount, (systematic release of discount to finance cost) subsequent measurement of contingent consideration that is not equity is not straight forward as it is based on fair value which is determined in accordance with IFRS 13.
- Whereas deferred consideration will surely be settled in the future, contingent consideration may or may not be paid in the future.
- Contingent consideration is recognised at the date of acquisition as long as the fair value can be measured reliably even though it is not probable that the consideration will be paid (i.e. that the future event will occur). However, there is no such requirement for deferred consideration.

EXAMINER'S REPORT

The question tests the candidates' knowledge of preparation of Consolidated statement of profit or loss and other comprehensive income, Consolidated statement of financial position and the distinction between deferred and contingent considerations.

Being a compulsory question, all the candidates attempted the question and performance was above average.

Commonest pitfalls include:

- Lack of knowledge of how to analyse profit for the year and total comprehensive income between owners of parent and NCI.
- Candidates inability to understand the difference between deferred and contingent consideration.
- Poor calculation of goodwill, NCI, unrealised profit and retained earnings.

Candidates are advised to practice more questions before examination, as this is a regular examinable section of the syllabus. Candidates are also advised to pay more attention to the theoretical aspect of group accounting when preparing for future examinations.

MARKING GUIDE	Marks	Total
1. (a) Revenue	2 ¹ / ₃	
Cost of sales	2 ² / ₃	
Distribution cost	1 ¹ / ₃	
Administrative expenses	1 ¹ / ₃	
Finance costs	1 ¹ / ₃	
Income tax expense	1	
Revaluation of property	1	
Profit attributable to – non-controlling interest	1	
Total comprehensive income		
Attributable to:		
- Equity of parent	1	
- Non-controlling interest	<u>1</u>	13
(b) Goodwill	4	
NCI	2	
Retained earnings	2	
Others	<u>4</u>	12
(c) - Deferred consideration	2	
- Contingent consideration	2	
- Conclusion	<u>1</u>	<u>5</u>
Total Marks		<u>30</u>

SOLUTION 2

(a) Computation of ratios for Wole Adura Plc and subsidiary

(i) Earnings per share:

$$\frac{\text{Earnings/PAT}}{\text{No. of ordinary shares outstanding}} \times \frac{100}{1} = \frac{\text{N270,000,000}}{2,250,000,000} \times \frac{100}{1} = 12\text{kobo}$$

$$\text{No of Ordinary Shares} = \frac{1,125,000,000}{0,5} = 2,250,000,000$$

(ii) Dividend cover:

$$\frac{\text{Earnings/PAT}}{\text{Dividend per share}} \times \frac{100}{1} = \frac{12 \text{ kobo}}{10} = 1.2 \text{ times}$$

OR

Dividend per share

$$= \frac{PAT}{Dividend} = \frac{270m}{2250m} \quad 1.2 \text{ times}$$

$$\text{Note: DPS} = \frac{\text{Dividend}}{\text{No of ord. shares}} = \frac{\text{N}225m}{2,250m} \times \frac{100}{1} = 10\text{kobo}$$

(iii) Earnings yield:

$$\frac{EPS}{MPS} \times \frac{100}{1} = \frac{12 \text{ Kobo}}{250 \text{ Kobo}} \times \frac{100}{1} = 4.8\%$$

$$\text{Note: MPS} = \frac{\text{Market capitalisation}}{\text{No of ord. shares}} = \frac{\text{N}5,625m}{2,250m} = \text{N}2.50$$

(iv) Dividend yield:

$$\frac{DPS}{MPS} \times \frac{100}{1} = \frac{10 \text{ Kobo}}{250 \text{ Kobo}} \times \frac{100}{1} = 4\%$$

Note

PAT = Profit after tax

DPS = Dividend per share

EPS = Earnings per share

MPS = Market Price per share.

(b) Wole Adura Group Plc.

(i) Computation of earnings using equity method

	N'm
Profit before tax: Wole Adura Plc. and Subsidiaries	427.5
Share of profit from Associate (Net of tax)	70
	<hr/> 497.5
Income tax expense	(157.5)
Profit for the year	<hr/> 340

$$\begin{aligned}
 \text{(ii)} \quad \frac{\text{EPS}}{\text{No of ord.shares}} &= \frac{340}{2,250\text{m}} \times \frac{100}{1} &= 15.1\text{kobo} \\
 \text{Dividend Cover} &= \frac{15.11}{10} &= 1.51 \text{ times} \\
 \text{Earnings Yield} &= \frac{15.11}{250} \times \frac{100}{1} &= 6.044\% \\
 \text{Dividend Yield} &= \frac{10}{250} \times \frac{100}{1} &= 4.0\%
 \end{aligned}$$

(c) Comments

- (i) There is an increase of 3.11 kobo in earnings per share of the group. This is in excess of 12kobo EPS of Wole Adura Plc and subsidiaries.
- (ii) There is an increase of 0.31 times in dividend cover of the group. This is in excess of 1.2 times Dividend Cover of Wole Adura Plc and subsidiaries.
- (iii) There is an increase of 1.244% in earnings yield of the group. This is in excess of 4.8% earnings yield of Wole Adura Plc and subsidiaries.
- (iv) The dividend yield for the two entities remains constant.
- (v) The inclusion of the ₦70m share of profit in Maseru Associates impacted positively on all ratios computed.

Pairwise Comparison

	Wole Adura Plc. and Subsidiaries Group		Changes
EPS	12kobo	15.11kobo	3.11k
Dividend Cover	1.2 times	1.51 times	0.31 times
Earnings Yield	4.8%	6.044%	1.244%
Dividend yield	4%	4%	-

- (d) To discuss the liquidity challenges during the year ended December 31, 2017, the following computations are necessary:

	2017	2016	Change
Current Asset Ratio	$\frac{300 - 80}{300 - 60}$	$\frac{115 - 20}{115 - 40}$	
	0.92	1.27	(0.35)
Quick Ratio	$\frac{220 - 200}{300 - 60}$	$\frac{95 - 40}{115 - 40}$	
	0.08	0.73	(0.65)

Both the current ratio and quick ratio reduced drastically in 2017 compared with 2016 by 28% and 89% respective probably due to:

- (i) Bank overdraft of ₦50m compared with positive position of ₦30m in 2016.
- (ii) Higher inventory tied up of ₦200m compared with only ₦40m in 2016.
- (iii) Trade payables increased by 216% in 2017 compared with 2016 from ₦60m to ₦190m.
- (iv) Larger volume of business requires larger working capital which is lacking here. Working capital dipped from ₦20m in 2016 to - ₦20m in 2017.
- (v) Interest expense of ₦10m in 2017 as a result of heavy borrowing.

EXAMINER'S REPORT

The question tests the computation of ratios and the interpretation of same for decision making.

About 81% of the candidates attempted the question and performance was below average.

The commonest pitfall was the inability of the candidates to interpret the computed ratios correctly. Also, some candidates could not correctly applied equity method to calculate the earnings of parent in associate company.

Candidates are advised not to limit their knowledge only to computation of ratios, but also to interpretations of financial information in order to improve their performance in future examinations.

MARKING GUIDE		Marks	Total
(a)	i. EPS	1	
	ii. Dividend cover	1	
	iii. Earnings yield	1	
	iv. Dividend yield	1	4
(b)	i. Computation of earnings		4
	ii. Ratio computation		4
(c)	Comments on ratios		
	Changes in ratio figures	2	
	Comments on changes	<u>1</u>	3
(d)	Liquidity Challenges		
	Current assets ratio and change	1	
	Quick ratio and change	1	
	Discussion	<u>3</u>	<u>5</u>
	Total Marks		<u>20</u>

SOLUTION 3

- (a) The conditions which must be met for a non-current asset to be classified as being “held for sale” are:
- (i) Management is committed to a plan to sell;
 - (ii) The asset is available for immediate sale;
 - (iii) An active programme to locate a buyer has been initiated;
 - (iv) The sale is highly probable;
 - (v) The sale should be completed, or expected to be so, within 12 months from the date of the classification;
 - (vi) The actions required to complete the planned sale would have been made, and it is unlikely that the plan will be significantly changed or withdrawn;
 - (vii) The asset is being actively marketed at a sales price that is reasonable in relation to its fair value.

Accounting treatment

- Assets classified as held for sale must be presented separately on the face of the statement of financial position and included in current assets.
- (b) (i) The condition which must be met in order to present the results of an operation as “discontinued” are that the discontinued operation:
- represents either a separate major line of business or a geographical area of operations;
 - is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or
 - is a subsidiary acquired exclusively with a view to resale.

Accounting treatment

The total (or sum) of:

- the post-tax profit or loss of the discontinued operation, and
- the post-tax gain or loss recognised on the measurement at fair value less costs to sell (or on the disposal) should be presented as a single amount in the statement of profit or loss.

(ii)

Bamgbose Plc

Statement of Profit or loss and other comprehensive income for the year ended December 31, 2017

	2017	2016
	N'm	N'm
Revenue	58.5	66
Cost of sales	<u>(19.5)</u>	<u>(30)</u>
Gross profit	39	36
Operating costs W2	<u>(20.85)</u>	<u>(19.5)</u>
Profit for the year from continuing operations	18.15	16.5
Loss for the year from discontinued operations W1	<u>(8.7)</u>	=
Profit for the year	<u>9.45</u>	<u>16.5</u>

Working W1

	N'M
The post-tax loss of the discontinued operation	4.5
The post-tax impairment loss recognized on the measurement of the buildings at fair value less costs to sell (30 – 25.8)	<u>4.2</u>
Loss for the year from discontinued operations	<u>8.7</u>

Working W2

Operating costs:

As per the accounts	15
Other expected cost of closure	<u>5.85</u>
	<u>20.85</u>

EXAMINER'S REPORT

The question tests the knowledge of the provisions of "IFRS 5" and its application in practical terms.

About 86% of the candidates attempted the question and performance was average.

Candidates' pitfalls was lack of understanding of the provisions of IFRS on discontinued operations aspect of the standard and its practical application.

Candidates are advised to prepare very well for this stage of the examination and completely cover the syllabus by using the ICAN Study Text which covers extensively the required standards, including IFRS 5.

MARKING GUIDE

	Marks	Total
(a) IFRS 5 conditions for an asset to be classified as "held for sale" – any 6 points @ 1 mark each	6	
Accounting treatment – any 2 points @ ½ mark	<u>1</u>	7
(b) i. IFRS 5 conditions for an operation to be reported as "discontinued" – any 2 points @ 1½ marks each	3	
Accounting treatment – any 2 points @ 1 mark each	<u>2</u>	5
ii. Application: Statement of profit or loss and other comprehensive income	6	
Workings	<u>2</u>	<u>8</u>
Total		<u>20</u>

SOLUTION 4

- (a) Substance over form states that economic or commercial substance of a transaction override the legal form. Therefore, organization should always record the economic substance of a transaction rather than their legal form.

The main problem of off-statement of financial position finance is that it results in financial statements that do not faithfully represent the transactions and events that have taken place. This implies that such financial statements cannot be relied upon and as a result, any decision made on the basis of the information contained in the financial statements will be incorrect and misleading.

How the major user groups can be misled

- i. Lenders of capital are especially concerned about the entity's gearing position. When the borrowing is high, it increases risk.
 - ii. Suppliers are concerned with liquidity position of the entity. The existence of consignment inventories may be relevant to trade suppliers. Sometimes, consignment inventories and their related current liabilities are not recorded on the statement of financial position as the wording of the purchase agreement may be such that legal ownership of the goods remains with the supplier until specific event(s) occur.
 - iii. Investors are concerned with the entity's profitability performance. Where borrowing is low, it becomes inexpensive and tax efficient with promising returns to the shareholders.
 - iv. Management may not be able to use the asset to claim capital allowance with the relevant tax authority, if it is off financial statement, thereby understating asset by ignoring substance over form rules.
 - v. Employees are also interested in the financial statements because of their job security. If a facility that is not recorded in the company's book attracts huge finance charges, if this continues for a long period, it can negatively affect the organisation and may lead to staff rationalisation in the future.
- (b) i. Major accounting issues involved in the two transactions using the principles of substance over form:

- **Factoring**

This is a common method of entities releasing the liquidity of their trade receivables. The issue is whether the trade receivables have been sold, or the income, from the finance house for their 'sale' should be treated as a short-term loan. The main "substance issue" with this type of transaction is to identify which party bears the risk relating to the asset. If the risk lies with the finance house (Asejere), the trade receivables should be removed from the statement of financial position. In this case, it is clear that Waasimi still bears the risk relating to slow and non-payment of trade receivables. The residual payment by Asejere depends on how quickly the receivables are collected, the longer it takes, the less the residual payment. Any balance uncollected by Asejere after six months will be refunded by Waasimi, which reflects the non-payment risk.

- **Sales and Leaseback of freehold building**

This is sales and lease back transaction. The substance was that Waasimi needed loan, if not, an asset cannot be sold and leased back immediately. It implies that the excess purchase consideration of ~~₦4million~~ (₦24m – ₦20m) is "in substance" a loan rather than sales proceeds (legal form) which is being repaid through the excess (₦1million per annum) of the rent payments.

It should be indicated that the lease is an "Operating Lease", hence, the property should be treated as sold and derecognised.

ii. **Appropriate accounting treatment**

Factoring

Cash received from Asejere (80% of the selected receivables) should be treated as a current liability (a short-term loan).

The difference between the gross trade receivables and the amount received from Asejere (plus any amount directly from the credit customers) should be recognised in statement of profit or loss.

Sale of freehold property

Sale of the property should be recorded at its fair value (₦20million).

Profit on disposal would be ~~₦5million~~ (₦20million – ₦15million).

The excess of ₦4million (₦24million – ₦20million) should be treated as a loan (Non-current liability).

iii. **Classes of charges to be incurred**

Factoring

Administrative expenses in the form of factoring charges for Asejere collecting receivables.

Finance cost reflecting the time taken to collect the receivables.

Impairment of trade receivables (bad debts).

Sale of freehold property

The total rental payment of ₦2.6 million should be split into three elements as:

Property rental cost	₦1.6m
Finance cost (10% of ₦4m)	₦0.4m
Capital repayment of the loan	₦0.6m
	<u>₦2.6m</u>

EXAMINER'S REPORT

The question tests the principle of substance over legal form and the accounting issues in the principle of substance over form; the relevant accounting treatments; and classes of charges involved in the transactions

About 29% of the candidates attempted the question and performance was below average.

Majority of the candidates were not familiar with the provisions of IFRS as it relates to “factoring”, sales and lease back etc.

Candidates are advised to pay more attention to the provisions of IFRSs as well as their practical applications.

MARKING GUIDE

	Marks	Total
(a) Explanation of substance over form	1½	
How major user groups can be misled with examples	<u>4½</u>	

6

(b)	i.	Major accounting issues	5	
	ii.	Accounting treatments	6	
	iii.	Classes of charges	<u>3</u>	
		Total Marks		<u>14</u> <u>20</u>

SOLUTION 5

(a) The two perspective of identifying deferred tax balances are:

- i. A statement of comprehensive income (income and expenses) perspective:
 - The differences arising in the period are identified by comparing income and expenses recognized under IFRS to the equivalent figures that are taxable or allowable under tax legislation; and
 - The approach identifies the deferred tax expense or credit recognized in the statement of comprehensive income for the period (with the other side of the entry recognised as a liability or asset).
- ii. A statement of financial position (assets and liabilities) perspective:
 - The differences are identified on a cumulative basis by comparing the carrying amount of assets and liabilities under IFRS to the carrying amount of the same assets and liabilities according to the tax rules; and
 - The approach identifies the deferred tax liability (or asset) that should be recognised (with the movement on this amount recognized as a credit or expense in the statement of comprehensive income).

(b)

	Carrying amount	Tax base	Temporary difference
Non-current assets	₦	₦	₦
Plant and equipment	250,000	218,750	31,250
Receivables			
Trade receivables	62,500	68,750	(6,250)
Interest receivable	1,250	-	1,250
Payables			
Fine	12,500	12,500	-
Interest payable	2,500	-	(2,500)
		<i>Temporary Differences</i>	<i>Deferred tax @ 30%</i>
Deferred tax liabilities		32,500	9,750
Deferred tax assets		(8,750)	(2,625)
			<u>7,125</u>
			<i>Deferred tax @ 30%</i>
			₦
Deferred tax as at January 1, 2017			1,500
Profit or loss	balancing figure		<u>5,625</u>
Deferred tax as at December 31, 2017			<u><u>7,125</u></u>

EXAMINER'S REPORT

The question tests candidates' knowledge of computation of deferred tax provision in line with IAS 12.

About 52% of the candidates attempted the question and the performance was below average.

Candidates' lack of adequate knowledge of the concept of deferred taxes lead to the inability to use the data given to accurately compute and present deferred tax provisions.

Candidates are advised to ensure a good coverage of the syllabus at this level of the Institute examination.

MARKING GUIDE

	Marks	Total
(a) i. A statement of comprehensive income (income & expenses) perspective	2	
ii. A statement of financial position (assets and liabilities) perspective	<u>2</u>	4
(b) Calculation of deferred tax as per statement of financial position	9	
Calculation of charges to profit or loss for the period	<u>2</u>	<u>11</u>
		<u>15</u>

SOLUTION 6**(a) Treatment of foreign transactions and gain or loss arising therefrom**

A company can have transactions that are denominated in foreign currency. These must be translated into the company's functional currency for the purpose of recording the transactions in its books of accounts and preparing its financial statements in accordance with guidelines provided in IAS 21.

S/N	Items or period of translation or transaction	Applicable rates	Treatments of gain or loss
1.	On initial recognition	The spot rate on the date of the transaction	No exchange difference will arise, therefore, no gain or profit.
2.	Balances at the beginning of the year in statement of financial position	Opening rate	Any exchange difference should be recognized in profit or loss.
3.	All items for statement of profit or loss and other comprehensive income and where the exchange rate does not fluctuate significantly over the period	Average rate	Any exchange difference should be recognized in profit or loss.
4.	Exchange difference before year end	Rate ruling on the day of exchange	Exchange rate difference to be recognized in profit or loss.
5.	For year end balances the following rules apply:		
i.	Monetary items i.e current assets or current liabilities	Closing rate	Any exchange gain or loss that arises should be recognized in profit or loss.
ii.	non-monetary items such as	Historical rate	Therefore, no exchange

	non-current assets, depreciation non-current liabilities	or rate at acquisition	difference will arise.
iii.	non-monetary items measured at fair value	Date of determining the fair value	Gain or loss should be recognised in profit or loss and Other Comprehensive Income (OCI)

(b) How to account for investment property

- i. Omotola Nigeria Plc. will have to translate the investment property into its functional currency (Naira) on purchase at the end of the year.
- ii. The recording in the books will be as follows:
 - On the initial recognition, the \$1 million should be translated at the spot rate on May 1, 2017.
 - At April 30, 2018, the fair value of \$1.2m should be translated using closing rate at the date of determining the fair value.
 - Any exchange difference arising from this property should be recognized in profit or loss.

(c) Accounting treatment for wholly owned subsidiary and other equity investment

The financial statements of the subsidiary together with the goodwill arising on the acquisition of the subsidiary will be treated as follows:

i. Treatment of acquisition of wholly owned subsidiary

- On acquisition use spot rate or the rate on the date of acquisition.
- At the year-end, on April 30 2018, use closing rate.
- Any exchange difference arising on this exercise will be recognised in other comprehensive income (OCI) and accumulated in equity through other component of equity (OCE).

ii. Treatment of equity investment

- The equity investment at fair value through other

comprehensive income (FVOCI) will be translated at initial recognition using spot rate at the date of initial recognition – May 1, 2017.

- At April 30, 2018, the fair value of this investment will be translated using the exchange rate at the date of determining the fair value.
- Any exchange gain or loss arising from the translation will be recognised in OCI.

EXAMINER'S REPORT

The question tests practical applications of IAS 21 - Effect of Changes in Foreign Exchange Rate; IAS 40 - Investment Property and IFRS 9 – Financial instrument

About 69% of the candidates attempted and the performance was below average.

Commonest pitfalls was the inability of the candidates to discuss the treatment of foreign currency transactions and their inclusion in the financial statements.

Candidates are advised to study all accounting standards and understand their applications.

MARKING GUIDE

	Marks	Total
(a)		
Functional currency	1	
- Foreign currency	1	
- Applicable exchange rates	3½	
- Treatment of exchange difference	<u>1½</u>	7
(b) Translation to functional currency (Naira)	1	
Recognition and presentation	<u>3</u>	4
(c) i. Accounting treatments of wholly owned subsidiary	2	
ii. Accounting treatments of equity investment	<u>2</u>	<u>4</u>
Total Marks		<u>15</u>

SOLUTION 7

- (a) Environmental reports are reports that give details of the entity's activities and its impacts in the environment where they operate and the efforts of the entity to reduce and clean up the impact.

The following are the principal arguments against voluntary disclosures:

- i. Voluntary disclosures are of limited usefulness as they are not readily comparable with other reporting entities;
- ii. Voluntary information may not be audited and therefore the reliability of the information is questionable and makes it less useful to decision makers;
- iii. The lack of comparability may mean that the cost of producing the information outweighs the potential benefits to shareholders;
- iv. Any cost incurred will reduce profit and subsequent potential returns to shareholders;
- v. Voluntary disclosures are part of the annual report which implies that there is a risk of information overload and where this occurs, the relevance and usefulness of the information is reduced;
- vi. The disclosure of wrong environmental report may be used against the entity if contended in a law court;
- vii. Since voluntary disclosures are not regulated by laws, disclosures tend to lack standardization;
- viii. Information overload in voluntary disclosures may lead to window dressing (creative accounting); and
- ix. Voluntary disclosures will state the type of materials the business uses in the course of their production, but will not mention the adverse effect of the chemical components of these materials on the community/environment., for example:
 - In an oil and gas company like in this question, there will be water pollution that will adversely affect the community/environment vis a vis the farming/fishing of the community.
 - Gas emission from power generation constitute health hazard but voluntary disclosure will not mention this.
 - Movement of heavy tractors/vehicles for the purposes of the business will make the road to wear out on time and this will affect the well being of the community which voluntary disclosure will never mention.

- (b) Information that could be disclosed by entities in their external reports in order to comply with the Global Reporting Initiative (GRI) guidelines are as follows:
- i. The economic aspects are likely to contain information about how the entity impacts on the economic conditions of its stakeholders and the area in which it operates globally;
 - ii. An entity may also include its policies regarding local and global economies and disclose targets and its performance to date;
 - iii. The environmental aspect provides information about how an entity impacts on the environment and management's policies on waste, emissions and pollution;
 - iv. Targets on wastage, emission and pollution are likely to be set and strategies for achieving these and performance to date could also be included;
 - v. The social aspect relates to the impact the entity has on the social systems in which it operates in relation to human rights, labour practices including employer/employee relations, occupational health and safety precautions; and
 - vi. There could also be information on research and development in respect of technologies for environmental conservation and environment-conscious products and services.

Global Reporting Initiative (GRI) is a reporting guideline issued by the Sustainability Accounting Standards Board to entities on how to measure and report on management's approach to the economic, environmental and social aspects that impact on their businesses.

EXAMINER'S REPORT

The question tests the candidates' understanding of the principal arguments against voluntary disclosures and information that could be disclosed in external reports in respect of the economic, environment and social aspects.

About 64% of the candidates attempted the question and the performance was below average.

Commonest pitfall was that most of the candidates failed to highlight the principal arguments against voluntary disclosures.

Candidates are advised to cover all sections of the syllabus for better performance in future examinations.

MARKING GUIDE

	Marks	Total
(a) Identification of principal arguments	4	
Explanation of principal arguments	<u>4</u>	8
(b) Information disclosures in external reports:		
- economic	2	
- environmental	2	
- social	2	
Description of GRI	<u>1</u>	<u>7</u>
		<u>15</u>

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2018

ADVANCED TAXATION

Time Allowed: 3¹/₄ hours (including 15 minutes reading time)

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

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

QUESTION 1

You are the tax controller of Rex Pharmaceuticals (Nigeria) Limited, having its head office at Ketu in Epe local government of Lagos State.

In the past three years, the company had been subjected to an array of taxes by different revenue authorities within Lagos State and indeed the entire country.

Apart from the Companies Income Tax, Withholding Tax is another tax that the company's management is concerned about. The Managing Director is very much worried that this multiplicity of taxes is taking its toll on the company's financials.

The company is already facing myriads of problems ranging from high cost of capital which led to increase in cost of production and attendant reduction in profit. The company's goods are becoming uncompetitive compared with imported similar goods. The long term effect is either reduction in work force or relocation to a more favourable economic environment. The Managing Director has invited you to his office to discuss the following issues:

- (i) Whether as a corporate body, the company ought to be subjected to myriads of taxes beyond the corporate tax;
- (ii) The jurisdiction of the tiers of government in the imposition and collection of taxes;
- (iii) Withholding Tax;
- (iv) Pay-As-You-Earn (PAYE) as it affects the staff; and
- (v) Capital Gains Tax

You have also been provided with the following information:

- The company's technical agreement with the foreign head office and the need to remit funds;
- Non-resident directors are to receive ₦2,500,000;
- Staff P.A.Y.E has been centralised;

- Dividend has been paid to shareholders in different parts of the country, and those resident in Kogi State of Nigeria, received ₦375,000;
- Land for a factory in Abuja was purchased from Alhaji Garuba Maito who resides in Kano;
- The company received ₦4,500,000 as net dividend from an associated company, Laiketop Limited, for the year ended September 30, 2014;
- In the audited financial statements of Rex Pharmaceuticals for the year ended December 31, 2015, a dividend of ₦9,500,000 was proposed. Out of this amount, ₦3,500,000 was from dividend received from Laiketop Limited while the balance was from a Total Profit of ₦22,500,000 from other trading activities; and
- Out of the thirty employees in Abuja, five are resident in Suleja, Niger State.

You are required to prepare a memo to the Managing Director explaining the following:

- (a)
 - i. Double/Multiple Taxation.
 - ii. Double Taxation Treaty.
 - iii. Multiple Taxation in Nigeria.
 - iv. Measures put in place to reduce cases of multiple taxation in Nigeria.
 - v. Withholding Tax with respect to (i) to (v).
 - vi. Penalty for non-deduction/remittance of Withholding Tax.

(12 Marks)
- (b) The arms of government empowered to legislate on tax matters by the Constitution. (4 Marks)
- (c) Relevant tax authority and the Withholding Tax due, if any. (4 Marks)
- (d)
 - i. The appropriate description of the income received from Laiketop Limited.
 - ii. The tax due from other trading activities of Rex Pharmaceuticals.
 - iii. Amount to be recouped by Rex Pharmaceuticals, if any.
 - iv. Net amount received by shareholders of Rex Pharmaceuticals.
 - v. Relevant section of the law to buttress your points in (i) and (ii) above.

(10 Marks)

(Total 30 Marks)

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

QUESTION 2

- (a) “Disposal” or “disposed of” are terminologies used frequently in relation to chargeable oil owned by an oil producing company under the provisions of the Petroleum Profits Tax Act Cap P.13 LFN 2004.

Required:

- (i) Differentiate between “disposal” and “disposed of”. (2 Marks)
- (ii) Discuss the following:
- Intangible drilling costs. (2 Marks)
 - Oil mining lease. (1 Mark)
- (b) Ibrahim Oil Nigeria Limited is an oil prospecting company which commenced production in commercial quantity in 2008. Its accounting year end is December 31. The company has provided the following Statement of Profit or Loss for the year ended December 31, 2016:

	₦'000	₦'000
Revenue (value of oil produced and exported)		2,455,200
Cost and expenses incurred:		
Operating costs	952,500	
Non-productive rent	63,200	
Royalty on export sales	14,775	
Depreciation of Property Plant and Equipment	65,400	
Tangible drilling cost	53,800	
Donation	2,500	
Stamp duties	1,250	
Repairs and renewal of machinery	2,000	
Exploration and drilling costs	100,300	
Custom duties on Plant and Machinery	1,130	
Bad and doubtful debts	26,500	
Pension and provident funds contribution	30,600	
Interest paid	26,200	
General expenses	11,050	
Income tax provision	120,000	
		(1,471,205)
Net Profit		983,995

The following additional information is relevant:

- (i) Exploration and drilling costs are in respect of cement and casing of:
- | | |
|--|--------|
| | ₦'000 |
| 1 st Appraisal well (oil field section 1) | 50,300 |

2 nd Appraisal well (oil field section 1)	27,600
3 rd Appraisal well (oil field section 1)	<u>22,400</u>
	<u>100,300</u>

- (ii) Of the ~~₦~~26,500,000 bad and doubtful debts, ~~₦~~16,500,000 relates to specific provision for bad and doubtful debts.
- (iii) Plant and machinery acquired during the year at ~~₦~~30,000,000 was located in territorial waters and continental shelf areas beyond 200 metres of water depth.
- (iv) Pension and provident fund contribution were approved by the Joint Tax Board.
- (v) Donation was made to Boys Scout of Nigeria.
- (vi) Interest paid was attributable to a loan obtained from an affiliated company under terms prevailing in the open market.
- (vii) 160,400 barrels of crude oil was produced and exported at a posted price of \$46 per barrel (exchange rate of ~~₦~~340 to 1 US\$).
- (viii) Capital allowances computed was ~~₦~~88,100,000.

Required:

Determine for management the following:

- (i) Assessable Profit (9 Marks)
 - (ii) Chargeable Profit (3 Marks)
 - (iii) Chargeable Tax (2 Marks)
 - (iv) Total Tax Liability (1 Mark)
- (Total 20 Marks)**

QUESTION 3

- a. Capital gains may be defined as gains arising from increases in the market value of capital assets, to a corporate body or person who does not habitually offer them for sale, and in whose hands they do not constitute inventory-in-trade.

With respect to the Capital Gains Tax Act, you are required to explain:

- (i) When a “disposal” is said to have taken place. (2 Marks)
- (ii) What constitutes “incidental costs”? (2 Marks)
- (iii) Under what circumstances can a “delayed remittance” relief be granted? (2 Marks)
- b. Alero Manufacturing Limited, Abeokuta, Ogun State, purchased a chargeable asset on hire purchase in year 2014. The deposit paid for the purchase was

~~₦~~800,000. The balance was to be paid in forty instalments of ~~₦~~75,000. The cash price of the asset was ~~₦~~2,400,000.

Required:

Calculate the capital gains, assuming the asset was sold as detailed below:

- i. For ~~₦~~4,200,000 after payment of thirty instalments. (7 Marks)
 - ii. For ~~₦~~4,500,000 after payment of all the instalments. (7 Marks)
- (Total 20 Marks)**

QUESTION 4

- a. The tax authorities view any case of tax evasion seriously. They are empowered to set aside tax avoidance schemes that result in artificial or fictitious transactions. Tax evasion is usually more prevalent when the tax system is perceived to be unfair.

You are required to:

Differentiate between **Tax Avoidance** and **Tax Evasion**. (5 Marks)

- b. Engineer Kole Ahmed manages a wholly owned Nigerian engineering outfit – Oduifa Construction Company Limited. The company is based at Ikeja and was incorporated in February 2010.

Given the challenging economic environment in Nigeria and inconsistent government policies, the company's management embarked on foreign diversification of income. They sourced and secured some contracts in the United Kingdom where they have operational activities in London.

Extracts from the Statement of Profit or Loss for the year ended December 31, 2015, for Lagos and London operations, are as follows:

	Lagos	London Branch (Translated in Naira)	Total
	₦	₦	₦
Revenue	68,000,000	70,200,000	138,200,000
Direct expenses	<u>(43,410,000)</u>	<u>(44,050,000)</u>	<u>(87,460,000)</u>
Gross profit	24,590,000	26,150,000	50,740,000
Deduct: administrative expenses:			
Staff salaries	1,200,000	1,440,000	2,640,000
Rent and rates	840,000	960,000	1,800,000
Motor vehicle expenses	136,000	148,000	284,000
Repairs and maintenance	92,000	106,500	198,500
Utilities – electricity, gas, water etc	76,840	81,000	157,840
Business insurances	55,000	60,000	115,000

Miscellaneous expenses	74,000	61,000	135,000
Audit fees	300,000	400,000	700,000
Bank charges and commissions	341,000	425,000	766,000
Foreign taxes suffered	-	4,260,000	4,260,000
Depreciation	860,000	920,000	1,780,000
Net Profit	<u>20,615,160</u>	<u>17,288,500</u>	<u>37,903,660</u>

₦725,000 was agreed with the Revenue as Capital allowances.

You are required to:

Compute the final tax liability of the company for the relevant assessment year.

(15 Marks)

(Total 20 Marks)

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

(30 Marks)

QUESTION 5

- a. Section 5 of the Petroleum Profits Tax Act Cap P.13 LFN 2004, specifies that “every person having possession of or control over any documents, information, returns or assessment, lists or copies of such lists relating to tax or petroleum operations or the amount and value of chargeable oil won by any company who at any time communicates or attempts to communicate such information or anything contained in such documents, returns, lists, or copies to any person, shall be guilty of an offence”.

Required:

Advise on the extent to which the provision of the Act can be relied upon on issues relating to:

- i. Disclosure of information to authorised officers of foreign countries who have double taxation agreement with Nigeria. (2 Marks)
 - ii. The performance of the duties of the Auditor-General for the Federation or any officer authorised by him (2 Marks)
- b. Ayokunle Oil Nigeria Limited engages in petroleum operations. The company was incorporated in 2005 but commenced business in January 2010. It operates in the continental shelf at water depth of 155 metres. The company makes up its accounts to December 31, each year.

The company has presented the following statement of activities for the year ended December 31, 2016:

•	Sales of crude oil:	
	Exported at \$52 per barrel	120,500 barrels
	Domestic at ₦12,250 per barrel	70,000 barrels
•	Chargeable natural gas sold	₦300,800,000
•	Income from other sources	₦ 6,770,000

Expenses incurred:

	₦'000
Operating costs	523,750
Non-productive rent	110,420
Intangible drilling cost	439,000
Custom duty	53,200
Salaries and other personnel costs	280,500
Interest paid	50,410
Royalty on oil exported	110,600
Royalty on local sales	41,200
Stamp duty	1,050
Donations	22,000
Transportation	72,070
Administration and general expenses	340,200
Bad debts	66,000
Pension contribution	21,000
Miscellaneous expenses	32,170

The following information was provided on the above statement:

- Capital allowances were agreed at ₦133,000,000.
- Plant and storage tank acquired and used during the year amounted to ₦80,000,000.
- Depreciation of ₦105,000,000 was included in operating costs.

- Custom duty on plant and storage tank, ₦2,250,000, was included in miscellaneous expenses.
- 70% of custom duty was on essential items.
- The average exchange rate during the period was ₦365 to \$1 (USA).

Required:

Determine for the relevant assessment year, the following:

- a. Assessable Profit (7 Marks)
- b. Chargeable Profit (3 Marks)
- c. Chargeable Tax (1 Mark)

(Total 15 Marks)

QUESTION 6

Chief Bonny Chizaram is the Chairman/CEO of Chizaram group of companies. The conglomerate operates in several states of Nigeria. The group's areas of business interest spans across supply of building materials, transport and banking.

In 2012, at the instance of the Chairman, the group decided to diversify its business into some African Countries by floating Obi Airlines Limited which was incorporated in Ethiopia.

On May 25, 2016, as Chief Chizaram was in the executive lounge of Murtala Mohammed International Airport, Lagos, awaiting departure, he met his long-time friend and business colleague, Chief Roger Menkiti, who is also an entrepreneur.

During their discussion, Chief Menkiti wanted to know how beneficial it would be to him should he decide to invest in Ethiopia. His areas of concern are mainly Companies Income Tax and Tertiary Education Tax payable in Nigeria assuming he decided to start an Airline business in Ethiopia.

Meanwhile, the financial results of Obi Airlines Limited for the year ended December 31, 2015 are as shown below:

	₦	₦
Income from passenger flights on other routes		213,668,750
Income from cargo loaded into aircraft on other routes		218,280,000
Income from passenger flights from Nigeria		54,401,275
Income from cargo loaded into aircraft from Nigeria		<u>49,938,180</u>
		536,288,205
Deduct:		
Depreciation	1,974,125	
Staff salaries	14,373,968	
General provision	215,050	
Other expenses	<u>579,913</u>	
		17,143,056
Net Profit		<u><u>519,145,149</u></u>

Additional information included the following:

- (i) Capital allowances were agreed with the relevant authority at 110% of depreciation charged.
- (ii) Other expenses include disallowable expenses of ~~₦~~425,000.

As the Tax Consultant, **you are required** to prepare computations showing:

- a. Total Profits of Obi Airlines Limited for Nigerian tax purposes. (12 Marks)
 - b. Companies Income Tax Liability for the relevant year of assessment (2 Marks)
 - c. Tertiary Education Tax Liability (1 Mark)
- (Total 15 Marks)**

QUESTION 7

Mr. Nwatakaibeya who studied in Germany and had been working there for over 20 years finally returned to Nigeria in 2015.

He has made some savings to start a new business and incorporated Nwatakaibeya Investments Limited in January 2016. However, since returning to the country, he has been inundated with stories of start-up and existing businesses that closed shop as a result of harsh economic conditions.

Mr. Nwatakaibeya has read in newspapers that as a result of government's determination to facilitate ease of doing business in Nigeria, the Federal Government has periodically been reviewing and improving on the reliefs and incentives available to corporate taxpayers. This has raised a ray of hope in Mr. Nwatakaibeya and he is eager to have more information to avoid pitfalls.

Given his reservation about the current business climate in Nigeria:

- a. Explain briefly **SIX** reliefs and incentives available to corporate taxpayers. (12 Marks)
 - b. Outline **THREE** conditions a company must fulfill to qualify for tax incentives for export oriented business. (3 Marks)
- (Total 15 Marks)**

NIGERIAN TAX RATES

1. CAPITAL ALLOWANCES

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

2. INVESTMENT ALLOWANCE 10%

3. RATES OF PERSONAL INCOME TAX

Consolidated relief allowance is computed at ₦200,000 or 1% of Gross Income whichever is higher + 20% of Gross Income.

After the Consolidated relief allowance and tax exempt items have been granted, the balance of income shall be taxed as specified in the tax table below:

	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

- | | |
|------------------------------|---------------------------|
| 4. COMPANIES INCOME TAX RATE | 30% |
| 5. TERTIARY EDUCATION TAX | (2% of Assessable Profit) |
| 6. CAPITAL GAINS TAX | 10% |
| 7. VALUE ADDED TAX | 5% |

SOLUTION 1

MEMORANDUM

- (a) Date: October 15, 2017
 To: The Managing Director
 From: Tax Controller
 Subject: Re: Tax Matters

With reference to our discussion in your office on October 10, 2017, I wish to comment as follows:

i. **Double/Multiple Taxation**

Double Taxation occurs when a taxpayer is outside his own country and is subject to tax in both his country and country of residence. For instance, income brought into Nigeria would have been subjected to tax in the foreign country in accordance with that country's tax laws. If the same income is further subjected to tax in Nigeria, this will amount to double taxation.

Similarly, income accruing in Nigeria to a non-resident would have been taxed in accordance with the Nigerian tax laws and if also taxed in the foreign country where the taxpayer is domiciled, this amounts to double taxation.

Multiple taxation is a situation in which more than one tier of government charges tax or levies on the same income, assets or financial transactions.

ii. **Double Taxation Treaty**

Where a Nigerian company earns foreign income which is included in its Chargeable Profit for the year of assessment, and is subjected to Nigerian tax, the foreign income received in Nigeria in most cases, would have been taxed in the country where the income is derived from and also in Nigeria where it is received. This results in double taxation as it would appear that the company receiving the income is being penalized for earning foreign income.

In order to minimize the negative effect on international trade, and to attract foreign investment, Nigeria has signed bilateral taxation treaties with many countries. Such treaties provide reliefs to Nigerian companies earning foreign income already taxed.

iii. **Multiple Taxation in Nigeria**

This is a tax regime in which more than one tier of government levies or taxes the same income, assets or financial transactions. An example is a situation in which the Federal Inland Revenue Service assesses and collects Value Added Tax (VAT) on taxpayers and some States Internal Revenue Service also impose Sales Tax on the same taxpayer. Multiplicity of taxes in Nigeria is affecting companies negatively to the extent that a number of companies are either reducing their work force or relocating to a more favourable economic environment.

iv. **Measures put in place to reduce cases of Multiplicity of Taxes**

The Federal Government issued Decree No 21 (Now an Act) under the Laws of the Federation of Nigeria 2004 on Taxes and Levies (Approved list for collection) No 21 September 30, 1998. The schedule listed the taxes and levies to be collected by the Federal Government, State Governments and Local Governments.

The 1999 Constitution also provides in Part II, that no tax should be imposed on the same person by more than one State.

v. **Withholding Tax**

This is an advanced payment of tax which is deducted at source on certain transactions and later applied (where it is not a final tax) as tax credit to settle the income tax liability of the year to which the payment that suffered the deduction relates.

Withholding Tax is deductible at the point of payment or when credit is taken whichever comes earlier. Tax withheld is to be remitted within 21 days or the date the duty to deduct arises, whichever is earlier.

vi. **Penalty for Non-Deduction/Non-Remittance**

For non-deduction or non-remittance within 21 days, the company or individual shall be liable to a penalty of 10% in addition to the amount of tax not deducted/remitted plus interest at the prevailing commercial rate.

(b) **Legislative Powers on Tax Matters**

The power to legislate on taxation rests on the National Assembly (Senate and House of Representatives) and the State Assemblies.

(c) **Deduction of Withholding Tax/ PAYE and Relevant Tax Authority**

- i. Fees on Technical Agreement - Withholding Tax payable to Federal Inland Revenue Service

- ii. Non - executive Directors - Withholding Tax on fees payable to State Internal Revenue where such directors are resident.
 - iii. Non - resident Director - Withholding Tax is the final tax and it is payable to Federal Inland Revenue Service.
 - iv. Dividend payable to - shareholders Withholding Tax to State Internal Revenue Service where such individual shareholders are resident and Federal Inland Revenue Service in case of corporate bodies.
 - v. Dividend payable to - individuals in Kogi State Withholding Tax of ₦37,500 payable to Kogi State Internal Revenue Service (KSIR)
 - vi. Land purchased from Alhaji- Garuba in Abuja Capital Gains Tax to Kano State Internal Revenue Service
 - vii. Five employees in Suleja - PAYE to Niger State Internal Revenue Service.
- (d) (i) Since Rex Pharmaceuticals Limited received ₦4,500,000 from Laiketop Limited net of tax, the amount received is regarded as **Franked Investment Income** and is not assessable to further tax

	₦
Dividend received	4,500,000
Add: Tax at source ($4,500,000 \times \frac{1}{9}$)	500,000
Gross Dividend received	5,000,000
Total Profit from trading activities	<u>22,500,000</u>

27,500,000

- (ii) Profit to be taxed on trading activities

22,500,000
6,750,000

Companies Income Tax @ 30%

Since Rex Pharmaceuticals re-distributed ₦3,500,000, then it has to re-coup 10% of the amount.

	₦
(iii) Franked Investment Income from Laiketop Ltd	4,500,000
Tax recouped (10% of ₦3,500,000)	350,000
	<u>4,850,000</u>

	N
(iv) Distribution from Rex Pharmaceuticals Ltd yet to be taxed (N 9,500,000 – N 3,500,000)	6,000,000
Less: Tax @ source	<u>(600,000)</u>
Net amount due to shareholders of Toyin Pharmaceuticals Ltd.	<u>5,400,000</u>

- (v) Section 80(3) of the Companies Income Tax Act Cap C21 LFN 2004 (as amended) stipulates that dividend received after deduction of tax prescribed, shall be regarded as Franked Investment Income of the company receiving it and shall not be charged to further tax as part of the profits of the recipient company. However, where such income is re-distributed and tax is to be accounted for, on the gross amount of the distribution, the company may set off Withholding Tax which it has itself suffered on the same income.

It is hoped that my above comments will meet your expectation.

Regards,

O. O. Johnson

EXAMINER'S REPORT

The question tests candidates' knowledge of multiple taxation, double taxation treaty, Withholding Tax and resultant penalties for failure to deduct/remit the relevant taxes as they relate to corporate organisations involved in diversified areas of operations.

Candidates' performance was average. The major pitfall was the inability of the candidates to correctly or adequately explain the concepts of double/multiple taxation as well as the incidence of double taxation. They also displayed inadequate knowledge of the resultant penalties for failure to deduct/remit Withholding Tax.

Candidates are advised to be more painstaking in identifying the specific requirements of questions, before proffering solutions. They are also advised to make use of the Institute's Study Texts and Pathfinder.

MARKING GUIDE

Correct address of memo	Marks	Marks
a. Explanation of the following;		
Double/multiple taxation	2	
Double taxation treaty	2	

Multiple taxation in Nigeria	2	
Measures put in place to reduce multiple taxation	2	
Withholding Tax	2	
Penalty for non-deduction	<u>2</u>	12
b. Legislative powers on tax matters		4
c. Withholding tax/relevant authority (one mark each for any four points)		4
d. i. Description of income as Franked Investment Income	2	
ii. Correct computation of tax on trading profit	2	
iii. Correct computation of tax recouped	2	
iv. Net amount received by Rex Pharmaceuticals	2	
v. Mention of re-distribution of income and setting off of Withholding Tax	<u>2</u>	<u>10</u>
		<u>30</u>

SOLUTION 2

- (a) i. In relation to chargeable oil owned by a company, disposal connotes delivery, without sale, of chargeable oil to; while disposed-of means chargeable oil delivered, without sale to a refinery or to an adjacent storage tank for refining by the company.
- **Intangible drilling costs:** These are all expenditure for labour, repairs, maintenance, hauling and supplies and materials (not being supplies and materials for well cement casing or other well fixtures) which are for or incidental to drilling, cleaning, deepening or completing wells or the preparation thereof incurred in respect of:
 - ❖ Determination of well locations, geological studies and topographical and geophysical surveys preparatory to drilling;
 - ❖ Drilling, shooting, testing and cleaning wells;
 - ❖ Cleaning, draining and leveling land, road-building and the laying of foundations; and
 - ❖ Erection of rigs and tankage assembly and installation of pipelines and other plants and equipment required in the preparation of drilling of wells for production of petroleum.
 - **Oil Mining Lease:** A lease granted to a company under the Minerals Act, for the purpose of winning petroleum, or any assignment of such lease.

(b) IBRAHIM Oil Nigeria Limited	
Petroleum Profits Tax For 2016 Assessment Year	
	<div> <div>₦'000</div> <div>₦'000</div> </div>
Export sales (W1)	2,508,656
Less: Allowable expenses	
Operating costs	952,500
Non-productive rent	63,200
Royalty on export sales	14,775
Repairs and renewal of machinery	2,000
Exploration and drilling cost (₦100,300 - ₦22,400)	77,900
Custom duties on Plant and Machinery	1,130
Bad and doubtful debts	16,500
Pension and provident funds	30,600
Interest paid	26,200
General expenses	11,050
Tangible drilling cost	<u>53,800</u>
	<u>1,249,655</u>
	1,259,001
Loss brought forward	-
	<u>1,259,001</u>
Tertiary Education Tax (2/102 x ₦1,259,001)	<u>(24,686)</u>
i. Assessable Profit	1,234,315
Less: Capital allowance:	
Lower of:	
85% of Assessable Profit (.85 x ₦1,234,315)	1,049,168
Less: 170% of PIA (1.7 x ₦6,000)	<u>10,200</u>
	<u>1,038,968</u>
OR	
Capital allowance for the year	88,100
PIA (W2)	<u>6,000</u>
	<u>94,100</u>
	<u>(94,100)</u>
ii. Chargeable Profit	<u>1,140,215</u>
Assessable tax @ 85% of chargeable profit	<u>969,183</u>
iii. Chargeable tax @ 85% of chargeable profit	969,183
Tertiary Education Tax	<u>24,686</u>
iv. Total Tax liability	<u>993,869</u>

Workings

1. Export Sales

N'000

Based on posted price: (160,400 barrels x \$46 x ~~N~~340) = 2,508,655

Based on actual sales: (as per account) = 2,455,200

The practice of the Revenue Service is to pick the higher of the two computations. Hence, export sales = N2,508,656,000.

2. Investment Tax Credit

Plant and machinery: cost (~~N~~30 million); Rate applicable = 20%

ITC (same as PIA) = ~~N~~30 million x 20% = N6 million.

Note: No indication that Ibrahim Oil Nigeria Limited operates in a deep offshore and inland basin production sharing contract, hence, no application of S.20 of PPTA deduction to the company.

EXAMINER'S REPORT

The question tests candidates' knowledge of the provisions of Petroleum Profits Tax Act.

A sizeable number of the candidates attempted the question but performance was below average.

The major pitfall was the inability of some of the candidates to differentiate between "disposal" and "disposed of". A good number of them displayed poor knowledge and understanding of the requirements of intangible drilling costs and oil mining lease.

Candidates are advised to prepare better for future diets of the examination by making use of the Institute's Study Texts.

MARKING GUIDE

SOLUTION 2

	Marks	Marks
a. i. Correct explanation of "disposal" and "disposal of"	2	
ii. Explanation of intangible drilling cost like labour, repairs and maintenance	1	
Mention of any two points in respect of the cost incurred	1	
iii. Explanation of Oil mining lease	<u>1</u>	5
b. Correct heading of the solution	1/4	
Determination of the export sale	2	
Allowable expenses		
(1/4 mark each for 11 items)	2 3/4	

Correct Tertiary Education Tax	1½	
Correct Assessable Profit	<u>2½</u>	9
Correct determination of Capital Allowance	½	
Correct Chargeable Profit	2½	3
Correct Chargeable Tax		2
Total Tax liability		<u>1</u>
		<u>20</u>

SOLUTION 3

- (a) i. **“A disposal”** can be said to have taken place:
- Whenever the ownership of an asset changes or when ownership interest is divested from an asset either by sale, or by gift or by exchange;
 - When part - disposal must have taken place;
 - On receipt of capital sum derived from an asset under the following:
 - compensation money from any kind of damage or injury to an asset, loss, destruction or dissipation of assets;
 - capital sums received under a policy of insurance of the risk of any kind of damage or injury to, or the loss or depreciation of assets;
 - capital sums received in return for forfeiture or surrendering of rights or for refraining from exercising rights; and
 - capital sums received as consideration for use or exploitation of assets (e.g. for copyright use)
 - Loss of an asset through destruction, extinction or dissipation; and
 - Where there is a settled property on the happening of certain events.
- ii. **Incidental Costs**
 These are costs that must be wholly and exclusively incurred for the purposes of acquisition and disposal. They include the following:
- Fees, commission or remuneration for the services of a surveyor; valuer, auctioneer, accountant, agent or legal adviser;
 - Costs of transfer or conveyance, including stamp duty;
 - Costs of advertising to find a buyer or seller; and
 - Costs reasonably incurred in ascertaining market value.
- iii. Delayed Remittance Relief is granted where:
 A person charged or chargeable for any year of assessment in respect of chargeable gains accruing from the disposal of assets situated outside Nigeria, was unable to transfer the gains. The following provisions shall apply for the “relief” on showing that:
- The person was unable to transfer those gains to Nigeria;

- Inability to transfer the gains was due to the laws of the country where the income arose, or to the executive action of the government or to the impossibility of obtaining foreign currency in that territory;
- The inability was not due to any lack of reasonable endeavours on the person's part; and
- Claims to be made in writing to the relevant tax authority within six years after the year of assessment in which the gains accrued.

(b)

**Alero Pharmaceutical Company Limited
Computation of Capital Gains**

		₦'000	₦'000	₦'000
i.	<u>Disposal After 30 instalments</u>			
	Sales Price			4,200
	Less: Cost of the asset:			
	Deposit		800	
	Instalments paid (30 x ₦75,000)	2,250		
	Less: Interest element (30 x ₦35,000)	<u>(1,050)</u>	<u>1,200</u>	
				<u>(2,000)</u>
	Capital Gains			<u>2,200</u>
				₦'000
ii.	<u>Disposal after full payment</u>			
	Sales Price			4,500
	Less: Cost of the assets:			
	Deposit		800	
	Full instalments (40 x ₦75,000)	3,000		
	Less: interest element (40 x ₦35,000)	<u>(1,400)</u>		
			<u>1,600</u>	
				<u>(2,400)</u>
	Capital Gains			<u>2,100</u>

Workings of Interest Element

	₦'000
Deposit	800
Total payments by instalment (40 x ₦75,000)	<u>3,000</u>
Total hire purchase price	3,800
Less: Cash price	<u>(2,400)</u>
Interest element per payment	<u>1,400</u>
Number of instalments	<u>40</u>
Interest per instalment	<u><u>35</u></u>

EXAMINER'S REPORT

The question tests candidates' knowledge of the Capital Gains Tax Act of the syllabus.

Many Candidates attempted this question and performance was good.

The major pitfall of few candidates was lack of understanding of this area of the syllabus which include the inability to explain correctly what constitutes 'incidental cost' as well as the incidence of 'delayed remittance'.

Candidates are advised to make use of the Institute's Study Texts in order to improve on their performance in future diets.

MARKING GUIDE

SOLUTION 3

	Marks	Marks
a. i. Mentioning any two points on disposal	2	
ii. Incidental cost ($\frac{1}{2}$ mark each for 4 points)	2	
iii. Explanation of delayed remittance	1	
Conditions for granting relief		
($\frac{1}{2}$ mark for any two points)	<u>1</u>	6
b. i. Disposal after thirty instalments:		
Sales price	1	
Costing of the asset:		
Deposit	1	
Instalments paid	1	
Interest element	1	
Correct cost value	1	
Capital Gains	<u>2</u>	7
ii. Disposal after full payment		
Sale price	1	
Cost of the asset		
Deposit	1	
Instalment paid	1	
Interest element	1	
Correct cost value	1	
Capital Gains	<u>2</u>	<u>7</u>
		<u>20</u>

SOLUTION 4

(a) Tax Avoidance and Tax Evasion Can be Distinguished as Follows:

	Tax Avoidance		Tax Evasion
i.	This is legal	i.	This is illegal
ii.	Achievable through exploiting loopholes in the tax laws	ii.	Achievable through deliberate action of fraud and deceit or rendering incorrect returns
iii.	Results in taxpayer paying minimum tax possible without breaking the tax law	iii.	Results in wilful default by taxpayer not paying correct tax or paying minimum tax through breaking of the tax laws.
iv.	Supported by the Courts in decided cases	iv.	Not supported by the Courts
v.	No criminal liability, no conviction	v.	Tax evader could be charged to court for criminal offences with the consequent fines, penalties and sometimes, imprisonment
vi.	When stretched to the extreme, the scheme could be disregarded.	vi.	At any level, the revenue will frown at tax evasion
vii.	No investigation by the revenue. Prior years will not be re-opened. Will keep to statute limitation.	vii.	The revenue office will institute an investigation. It has the power to open prior years assessments beyond the statutory six – year limit.

(b) Oduifa Construction Company Limited

	Lagos	London	Global
	Operation	Operation	Operation
	₦	₦	₦
Net Profit per accounts	20,615,160	17,288,500	37,903,660
Disallowable:			
Foreign tax suffered	-	4,260,000	4,260,000
Depreciation	<u>860,000</u>	<u>920,000</u>	<u>1,780,000</u>
Adjusted/Assessable Profit	21,475,160	22,468,500	43,943,660
Capital Allowance (Wk 1)	<u>(350,281)</u>	<u>(374,719)</u>	<u>(725,000)</u>
Total Profit	<u>21,124,879</u>	<u>22,093,781</u>	<u>43,218,660</u>
Companies Income Tax Payable 30%	<u>6,337,464</u>	<u>6,628,134</u>	12,965,598
Less: Double taxation relief (Wk 3)			<u>(3,314,067)</u>
			<u><u>9,651,531</u></u>

Capital Allowances

WK 1

$$\begin{aligned} &\text{Lagos operation} \\ &\text{₦ } \frac{860,000}{1,780,000} \times 725,000 \\ &= \text{₦ } \underline{\underline{350,281}} \end{aligned}$$

$$\begin{aligned} &\text{London operation} \\ &\text{₦ } \frac{920,000}{1,780,000} \times 725,000 \\ &= \text{₦ } \underline{\underline{374,719}} \end{aligned}$$

Note 1 - The Capital Allowances were appropriated based on depreciation available to the operations in both countries.

WK 2 Commonwealth Rate of Tax (CRT)
$$\text{N} \frac{4,260,000}{22,093,781} \times 100 = 19.28\%$$

Nigerian Rate (NR) is 30%
Half of Nigerian Rate is 15%

Since the Commonwealth rate of tax exceeds one half of the Nigerian rate, half of the Nigerian Rate of Tax is applicable for Double Taxation Relief.

Note 11 - Oduifa Construction Limited is a resident company.

WK 3 Double Taxation Relief
= 15% x ~~N~~22,093,781
= ~~N~~3,314,067

Double taxation rate = lower of half Nigerian rate or Commonwealth rate.

Tertiary Education Tax = 2% of the global Assessable Profit
= 2% of ~~N~~43,943,660
= ~~N~~878,873

EXAMINER'S REPORT

The question tests candidates' knowledge of the difference between Tax Avoidance and Tax Evasion as well as the computation of tax liability for a company that diversified into other sources of income outside Nigeria.

A good number of the candidates attempted the question and performance was good in part (a) of the question, whilst it was very poor in part (b).

Candidates' commonest pitfalls include inability to correctly compute the Companies Income Tax payable, Double Taxation Relief claim as well as the Tertiary Education Tax due. About 40% of the candidates that attempted the question could not correctly identify the differences between Tax Evasion and Tax Avoidance. A good number of the candidates that attempted this question had problem in computing correctly the Total Profit from their London operational activities.

Candidates are advised to be more discerning in analysing the requirements of a question, especially where sources of income are diversified especially in terms of location.

MARKING GUIDE**SOLUTION 4**

	Marks	Marks
a. ½ mark each for any five points on tax avoidance	2½	
½ mark each for any five points on tax evasion	<u>2½</u>	5
b. Year of Assessment	1	
Net Profit per Accounts	1½	
Disallowable:		
½ mark each	1½	
Correct adjustment of Profit	1½	
Computation of Total Profit	1½	
Foreign tax suffered	1½	
Computation of Double Taxation Relief	1½	
Final tax liability	1½	
Capital allowance	1½	
Commonwealth rate of tax	1	
Tertiary Education Tax rate	<u>1</u>	<u>15</u>
		<u>20</u>

SOLUTION 5

- (a) i. The obligation as to secrecy shall not prevent the disclosure of necessary information to the authorised officers of the Government of such other country as might be necessary for double taxation relief purposes.
- ii. The Auditor-General for the Federation or any other officer authorised by him, may not be prevented from having access to such records or documents as may be necessary for the performance of his official duties. The Auditor-General or any such official shall be deemed to be a person employed in carrying out the provisions of the Act for the purposes of secrecy.

(b)

AYOKUNLE Oil Nigeria Limited
Petroleum Profits Tax For 2016 Assessment Year

	₦'000	₦'000
Export sales (\$52 x 365 x 120,500 barrels)		2,287,090
Domestic sales (₦ 12,250 x 70,000 barrels)		857,500
Natural gas		300,800
Other income		<u>6,770</u>
		3,452,160
Less: Expenses (Section 10)		
Operating costs (₦ 523,750- ₦ 105,000)	418,750	
Non-productive rent	110,420	

Intangible drilling cost	439,000	
Custom duty on essentials (70% of ₦53,200)	37,240	
Custom duty on non-essentials (30% of ₦53,200)	15,960	
Salaries and other personnel costs	280,500	
Interest paid	50,410	
Royalty on oil exported	110,600	
Royalty on local sales	41,200	
Transportation	72,070	
Administration and general expenses	340,200	
Bad debts	66,000	
Pension contribution	21,000	
Miscellaneous (₦32,170 - ₦2,250)	<u>29,920</u>	
		<u>2,033,270</u>
		1,418,890
Tertiary Education Tax (2/102 x ₦1,418,890)		<u>(27,821)</u>
a. Assessable Profit		1,391,069
Less: Capital Allowance		
Lower of:		
85% of Assessable Profit (0.85 x ₦1,391,069)	1,182,409	
Less: 170% of PIA (1.7 x ₦12,000)	<u>20,400</u>	
	<u>1,162,009</u>	
OR		
Capital Allowance for the year	133,000	
Petroleum Investment Allowance/ITC	<u>12,338</u>	
	<u>145,338</u>	
		<u>(145,338)</u>
b. Chargeable Profit		<u>1,245,731</u>
Assessable Tax @ 85% of Chargeable Profit		<u>1,058,871</u>
c. Chargeable Tax		<u>1,058,871</u>
Workings on Investment Tax Credit (ITC or PIA)		
Plant & storage tank (cost)	₦80,000,000; Rate = 15%	
ITC = 15% of (₦80,000,000 + ₦2,250,000) =	<u>₦12,337,500</u>	

EXAMINER'S REPORT

The question tests' candidates knowledge of the provisions of the Petroleum Profits Tax Act Cap P13 LFN 2004.

A large number of candidates attempted the question. A high proportion of the candidates that attempted this question demonstrated very poor understanding of part (a) of the question relating to the disclosure of information to authorised officers of foreign countries who have "double taxation agreements" with Nigeria

and (ii) the performance of duties by the Auditor-General for the Federation or any officer authorised by him.

Candidates' commonest pitfalls included their inability to correctly compute both the Chargeable Profit, Chargeable Tax as well as the Capital Allowances applicable in Part (b) of the question.

Candidates are advised to improve on their performance in future diets of the examinations by thoroughly and regularly going through past editions of the Institute's pathfinders and Study texts.

MARKING GUIDE

	Marks	Marks
a. i. Correct explanation of disclosure of necessary information	2	
ii. Correct explanation of power of the Auditor-General of the Federation to have access to record The deemed person	1 <u>1</u>	4
b Assessable Profit	1	
Determination of income	$\frac{1}{2}$	
Section 10 expenses: ($\frac{1}{2}$ mark for any ten correct points out of 13 points)	5	
Determination of Tertiary education tax	<u>$\frac{1}{2}$</u>	
		7
Correct determination of Capital Allowance (Distribute marks between the two alternatives)	1	
ii. Chargeable Profit	<u>2</u>	3
iii. Chargeable Tax		<u>1</u>
		<u>15</u>

SOLUTION 6

OBI AIRLINES LIMITED

i. Computation of Total Profits for 2016 Assessment Year

	N	N
Global income		<u>536,288,205</u>
Income from passengers flight from Nigeria		54,401,275
Income from cargo loaded into aircraft from Nigeria		<u>49,938,180</u>
		<u>104,339,455</u>
Global Adjusted Profit:		
Net Profit as per Accounts		519,145,149

Add: disallowable expenses;		
Depreciation	1,974,125	
General provision	215,050	
Other expenses	<u>425,000</u>	
		<u>2,614,175</u>
		<u>521,759,324</u>

Total Profits liable to tax in Nigeria;	
Adjusted/Assessable Profit	
(97.29% x ₦ 104,339,455)	101,511,856
Less: Capital allowances (110% x ₦ 1,974,125)	<u>(2,171,538)</u>
Total Profits	<u>99,340,318</u>

i. Computation of Companies Income Tax liability for 2016 Assessment Year

$$\begin{aligned}
 &\text{i.e. 30\% of Total Profit} \\
 &= 30\% \times \text{₦}99,340,318 \\
 &= \underline{\text{₦}29,802,095.40}
 \end{aligned}$$

$$\begin{aligned}
 &\text{Minimum Tax (2\% x ₦104,339,455)} \\
 &= \underline{\text{₦}2,086,789.10}
 \end{aligned}$$

Therefore, Companies Income Tax payable for 2016 Year of Assessment in Nigeria is ~~₦~~29,802,095.40, since it is higher than the Minimum Tax.

ii. Computation of Tertiary Education Tax for 2016 Assessment Year

$$\text{Tertiary Education tax} = \text{NIL}$$

Workings/ Notes:

$$\begin{aligned}
 \text{a) Adjusted Profit Ratio} &= \frac{\text{Global adjusted profit}}{\text{Global income}} \times 100 \\
 &= \frac{\text{₦}521,759,324}{536,288,205} \times 100 = 97.29\%
 \end{aligned}$$

- b) According to the provisions of Section 1(2) of the Tertiary Education Trust Fund (Establishment, Etc) Act, 2011, the company is not liable to Tertiary Education Tax since it is a non-resident company.

Tertiary Education Tax is payable only by companies registered in Nigeria.

EXAMINER'S REPORT

The question tests' candidates' understanding of the computation of Total Profits, Companies Income Tax Liability as well as the Tertiary Education Tax Liability of a company engaged in diversified areas of business.

Majority of the candidates attempted the question and a good number demonstrated good understanding of the part (a) of the question. A few candidates only displayed clear understanding of the parts (b) and (c) of the question. Performance was above average as only a few candidates displayed clear understanding of computation of the Companies Income Tax Liability and Tertiary Education Tax.

The commonest pitfalls included the inability of a good number of the candidates to correctly compute the Assessable Profits, correct year of assessment as well as failure to realise that a company not duly incorporated in Nigeria is not subject to Tertiary Education Tax as stated in Section 1 (2) of the Tertiary Education Tax Act 2011.

Candidates are advised to make use of the Institute's Study Text.

MARKING GUIDE

	Marks	Marks
Determination of income derived from Nigeria	2	
Determination of income derived from other sources	2	
Net profit per account	1	
The disallowable expenses (1 mark each for the three points)	3	
Total profit liable to tax in Nigeria		
Adjusted profit as determined	1	
Capital allowances as determined	1	
Total Profits	<u>2</u>	12
Companies Income Tax Liability		2
Tertiary Education Tax		<u>1</u>
		<u>15</u>

SOLUTION 7

(1) Reliefs and incentives available to corporate taxpayers:

Reliefs are claims or provisions in tax laws which constitute reduction on the amount of Assessable Profits in the Year of Assessment under consideration.

Incentives, on the other hand, are claims or provisions in tax laws which seek to reduce the amount of income tax payable in the Year of Assessment under consideration.

a. Reliefs available to corporate taxpayers:

- i. **Loss relief** – These are business losses which are only deductible from same business profit indefinitely. The effect of which, is a reduction on the amount of Assessable Profit in the computation of Total Profit.
- ii. **Application of the right of election** – A rational taxpayer only applies for the right of election if the total Assessable Profit for the second and third years of assessment assessed together, on Actual Year Basis is less than what was computed using the normal commencement rule. It is a relief available on commencement of business.
- iii. **Capital Allowance** – This is a relief for a company which has incurred qualifying capital expenditure in any year of assessment, for the purpose of the business. Capital Allowance will be deducted in full, or restricted as the case may be, from the Assessable Profit, in order to arrive at the Total Profit.
- iv. **Carry backward of unclaimed capital allowance on cessation** – This is a relief available to a taxpayer on cessation of business. Any unclaimed Capital Allowance can be carried backward against the remainder of Assessable Profit, that of the immediate preceding 5 years. Thus reducing the amount of Total Profit and the revenue authority makes refund of tax which had been paid by the taxpayer.
- v. **Roll-over relief** – This is where the proceeds on disposal of chargeable assets of a particular class of chargeable asset is re-invested in the acquisition of an asset of the same class. Where roll-over relief is applicable, chargeable gain on the disposal is deferred and the Capital Gains Tax is not computed, depending on the type of roll-over relief whether full, partial or no roll-over.

- vi. **Investment Allowance** – This is an additional allowance to the amount of Capital Allowance already claimed on the qualifying capital allowance. It is also deducted from Assessable Profit like Capital Allowance.

Incentives available to corporate taxpayers:

- i. **Memorandum of Understanding (MOU) Credit** – This is an incentive available to joint venture operators in the petroleum industry. It is normally deducted from the assessable tax in arriving at the chargeable tax of the year of assessment.
 - ii. **Investment tax credit** – This is also available to a production sharing contract operator. It is also used in reducing the assessable tax in order to arrive at the chargeable tax.
 - iii. **Pioneer Status** – Profit of any company conferred with the pioneer status, will be exempted from tax for initial 3 years and for additional 2 years if extension is sought and granted.
 - iv. **Small business rates** – a small business rate of 20% will be applicable instead of the normal 30% for initial 3 years and for another 2 years, if extended. For this to be applicable, turnover must be ₦1,000,000 and below and the company must be among companies that qualify for small business rate.
 - v. **Exemption from Minimum Tax** – As an anti-avoidance legislation, companies will be required to pay minimum tax, if higher than the normal tax effective from the fifth year of assessment. However, certain companies are exempted from the application of minimum tax, thereby paying the normal tax even when lower than the minimum tax.
 - vi. **Double Taxation Relief** – This is to mitigate against the effect of double taxation on foreign income, which is subject to foreign tax and Nigerian tax.
- b. Conditions a company must fulfill to qualify for tax incentives for export - oriented business are as follows:
- i. The company is 100% export oriented;
 - ii. The company produces or manufactures and exports during the relevant year, and the export proceeds during the year is not less than 75% of total turnover for the year; and

- iii. The company repatriates at least 75% of earnings from its exports back to Nigeria, and deposits same in a domiciliary account maintained in a bank in Nigeria.

EXAMINER'S REPORT

This is a question designed to examine candidates' understanding of the nature of reliefs and incentives available to corporate taxpayers and the conditions that need to be fulfilled by companies engaged in export oriented business in order to qualify for tax Incentives.

Few candidates attempted the question and performance was below average as majority of the candidates did not demonstrate a good understanding of the nature of reliefs/incentives available to corporate taxpayers and the conditions to be fulfilled by export-oriented businesses to qualify for tax incentives.

Candidates are advised to make use of the institute's Study Texts.

MARKING GUIDE

	Marks	Marks
1 mark each for any six reliefs	6	
1 mark each for any six incentives	<u>6</u>	12
1 mark for any three conditions		<u>3</u>
		<u>15</u>

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2018

STRATEGIC FINANCIAL MANAGEMENT

Time Allowed: 3¹/₄ hours (including 15 minutes reading time)

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

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

QUESTION 1

Plateau Plc. (PT) is a Nigerian company that manufactures and sells innovative products. Following favourable market research that cost ₦4,000,000, PT has developed a new product. It plans to set up a production facility in Kano, although its board had contemplated setting up the facility in an overseas country. The project will have a life of four years.

The selling price of the new product will be ₦5,900 per unit and sales in the first year to December 31, 2019 are expected to be 120,000 units, increasing by 5% p.a. thereafter. Relevant direct labour and material costs are expected to be ₦3,400 per unit and incremental fixed production costs are expected to be ₦60million p.a. The selling price and costs are stated in December 31, 2018 prices and are expected to increase at the rate of 3% p.a. Research and development costs to December 31, will amount to ₦25 million.

Investment in working capital will be ₦30million on December 31, 2018 and this will increase in line with sales volumes and inflation. Working capital will be fully recoverable on December 31, 2022.

The company will need to rent a factory during the life of the project. Annual rent of ₦20million will be payable in advance on December 31 each year and will not increase over the life of the project.

Plant and machinery will cost ₦1billion on December 31, 2018. The plant and machinery is expected to have a resale value of ₦300million (at December 31, 2022 prices) at the end of the project. The plant and machinery will attract 20% (reducing balance) capital allowances in the year of expenditure and in every subsequent year of ownership by the company, except in the final year when there will be a balancing allowance or charge.

Assume a corporate tax rate of 20% p.a. in the foreseeable future and that tax flows arise in the same year as the cash flows which gave rise to them.

The directors are concerned by rumours in the industry of research by a rival company into a much cheaper alternative product. However, the rumours suggest that this research will take another year to complete and, if it is successful, it will take a further year before the alternative product comes on to the market.

An appropriate weighted average cost of capital for the project is 10% p.a.

Required:

- a. Calculate, using money cash flows, the NPV of the project on December 31, 2018 and advise the company whether to proceed with the project or not. (15 Marks)
 - b. Calculate and interpret the sensitivity of the project to a change in:
 - (i) The annual rent of the factory (2 Marks)
 - (ii) The weighted average cost of capital. (4 Marks)
 - c. If the board of PT decided to set up the manufacturing facility overseas, advise the board on how political risk could change the value of the project and how it might limit its effects. (4 Marks)
 - d. Discuss briefly **FOUR** real options available to PT in relation to the new project. 5 Marks
- (Total 30 Marks)**

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

QUESTION 2

Kazaure Limited has a cash surplus of ₦20m which the financial manager is keen to invest in corporate bonds. He has identified two potential investment opportunities in two different companies which are both rated A by the major credit rating agencies.

Bond A

The issuer plans to raise ₦500m 2-year bond with a coupon rate of 10%. The bond is redeemable at a premium of 8% to nominal value.

Bond B

The issuer plans to raise an ~~₦~~800m 3-year bond with a coupon rate of 12% and redeemable at par.

The annual spot yield curve for government bonds is:

1-Year 9.50%

2-Year 10.40%

3-Year 10.50%

Extract from a major credit rating agency's website:

Table of spreads (in basis points)

Rating	1 -Year	2 -Year	3- Year
AAA	6	16	28
AA	15	25	40
A	20	30	50

Required:

- a. For a nominal value of ~~₦~~1,000, calculate the theoretical issue prices of the two bonds and indicate how many of each of the bonds Kazaure Limited can buy assuming it invests in only one of them. (5 Marks)

Note: Calculate issue prices to the nearest ~~₦~~.

- b. Irrespective of your answer in (a), assume Bond A is issued at ~~₦~~1,054 and Bond B is issued at ~~₦~~1,026, calculate the yield to maturity of each bond at the time of issue. (5 Marks)
- c. Calculate the duration of each bond. What does duration measure? (6 Marks)
- d. If you expect interest rates to increase in the market, which of the two bonds, A or B, would you like to buy and why? (4 Marks)
- (No calculation is required) (Total 20 Marks)

QUESTION 3

Kehinde is a wholesaler who buys and sells a wide range of products, one of which is electrical component TK. Kehinde sells 24,000 units of TK each year at a unit price of ~~₦~~2,000. Sales of TK normally follow an even pattern throughout the year but to protect the business against possible stock-out, Kehinde keeps a minimum inventory of 1,000 units. Further supplies of TK are ordered whenever the inventory falls to this minimum level and the time lag between ordering and delivery is small and can be ignored.

At present, Kehinde buys all his supplies of TK from Ajoke Limited and usually purchases them in batches of 5,000 units. His most recent invoice from Ajoke Limited was as follows:

	N'000
Basic price: 5,000 units of TK at N1,500 per unit	7,500
Delivery charges:	
Transport at N50 per unit	250
Fixed shipment charge per order	<u>100</u>
	<u>7,850</u>

In addition, Kehinde estimates that each order he places costs him N50,000, comprising administrative costs and the cost of sample checks. This cost does not vary with the size of the order.

Kehinde stores TK in a warehouse which he rents on a long lease for N500 per square metre per annum. Warehouse space available exceeds current requirements and, as the lease cannot be cancelled, spare capacity is sublet on annual contracts at N400 per square metre per annum. Each unit of TK in inventory requires 2 square metres of space.

Kehinde estimates that other holding costs amount to N1,000 per TK per annum.

Kehinde has recently learnt that another supplier of TK, Ema Limited offers discounts on large orders. Ema Limited sells TK at the following prices:

Order size	Price per unit
	N
1 – 2,999	1,525
3,000 – 4,999	1,450
5,000 and over	1,425

In other respects, (i.e. delivery charges and the time between ordering and delivery), Ema Limited's terms are identical to those of Ajoke Limited.

Required:

- a. Calculate the relevant
 - i. cost per order
 - ii. holding cost per unit per annum (4 Marks)
- b. Irrespective of your answers in (a) above and assuming cost per order of N150,000 and holding cost per unit per annum of N1,800, calculate the optimal re-order quantity for TK and the associated annual profit Kehinde can expect from their purchase and sale, assuming that he continues to buy from Ajoke Limited. (6 Marks)

- c. Prepare calculations to show whether Kehinde should buy TK from Ema Limited rather than from Ajoke Limited and, if so, in what batch size.

(7 Marks)

- d. Discuss the key limitations of the method of analysis you have used?

(3 Marks)

(Total 20 Marks)

QUESTION 4

Sunmola Funds (SF) Plc. has a portfolio of short-term investments in the shares of four quoted companies.

Company	Holding
Tomiwa (T)	100,000 shares
Pascal (P)	155,000 shares
Binta (B)	260,000 shares
Yetunde (Y)	420,000 shares

You have the following additional information:

Company	Beta	Market Value Per Share (Kobo)	Expected total return on investment p.a (%)
T	1.55	280	21.0
P	0.65	340	12.5
B	1.26	150	18.0
Y	1.14	9.5	18.5

The market risk premium is 10% per year and the risk free rate is 6% per year.

Required:

- a. Estimate the Beta of SF Plc.'s short-term investment portfolio. (4 Marks)
- b. Recommend, giving your reasons, whether the composition of SF Plc.'s short-term investment portfolio should be changed using relevant calculations.

(10 Marks)

(Hint: Consider the alpha values of the shares and the propriety of investing short-term funds in equity).

- c. Explain **THREE** factors that a financial manager should take into account when investing in marketable securities.

(6 Marks)

(Total 20 Marks)

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

QUESTION 5

Katangwa Limited will need to borrow ₦50 million in three months' time for a period of six months. The company is concerned that interest rates are expected to rise over the next few months.

Interest rates and forward rate agreements (FRAs) are currently quoted as follows:

- Spot 5.75 – 5.50
- 3 – 6 FRA 5.82 – 5.59
- 3 – 9 FRA 5.94 – 5.64

Required:

- a. Explain how a forward rate agreement (FRA) may be useful to the company. Illustrate this on the basis that interest rates
 - i. Rise to 6.50%
 - ii. Fall to 4.50% (8 Marks)
 - b. Compare the use of interest rate futures with FRA in this instance (4 Marks)
 - c. Explain how interest rate guarantees or short-term interest rate cap could be used. (3 Marks)
- (Total 15 Marks)**

QUESTION 6

Okpara Plc. is a large publicly quoted company in the eastern part of Nigeria. It operates in the home appliances industry with significant market share. In a recent strategy meeting, the directors decided to pursue aggressive growth through mergers in other parts of the country and along the ECOWAS sub-region.

Required:

Prepare a report to the Board of Directors of Okpara Plc. to address the following matters:

- a. **SIX** factors to be considered when choosing a target for acquisition. (9 Marks)
 - b. **FOUR** factors which a bidding company should take into account in deciding the form of consideration to be offered. (6 Marks)
- (Total 15 Marks)**

QUESTION 7

Nkata Plc. is a large publicly quoted company. The directors are currently debating a number of issues, including the following:

- (i) The role of non-executive directors in corporate governance.
- (ii) Conflict of interest between directors and shareholders.
- (iii) Bond covenants usually imposed by lenders.

Required:

- a. Discuss the role of non-executive directors in the corporate governance of a listed public company. (4 Marks)
 - b. Identify and discuss **THREE** areas where the interests of shareholders and directors may conflict leading the directors to pursue objectives other than maximizing shareholders' wealth. (6 Marks)
 - c. Identify **FIVE** examples of covenant that might be attached to bonds and discuss briefly the advantages and disadvantages of each to companies. (5 Marks)
- (Total 15 Marks)**

Formulae

Modigliani and Miller Proposition 2 (with tax)

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

Asset Beta

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

Equity Beta

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

Growing Annuity

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

Modified Internal Rate of Return

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

The Black-Scholes Option Pricing Model

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

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

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

The Put Call Parity

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

Binomial Option Pricing

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

$$d = 1/u$$

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

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

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

The Miller-Orr Model

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

Annuity Table

Present value of an annuity of 1 i.e.

$$\frac{1 - (1 + r)^{-n}}{r}$$

Where

r = discount rate

n = number of periods

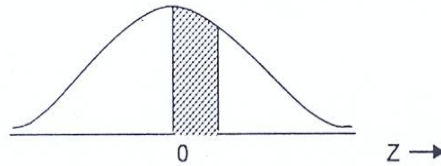
Discount rate (r)

Periods

(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909	1
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736	2
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487	3
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170	4
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791	5
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355	6
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868	7
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335	8
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759	9
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145	10
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495	11
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814	12
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103	13
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367	14
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606	15
(n)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%	
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833	1
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528	2
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106	3
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589	4
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991	5
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326	6
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605	7
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837	8
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031	9
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192	10
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327	11
12	6.492	6.194	5.918	5.660	5.421	5.197	4.988	4.793	4.611	4.439	12
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533	13
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611	14

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	.1481	.1517
0.4	.1554	.1591	.1628	.1664	.1700	.1736	.1772	.1808	.1844	.1879
0.5	.1915	.1950	.1985	.2019	.2054	.2088	.2123	.2157	.2190	.2224
0.6	.2257	.2291	.2324	.2357	.2389	.2422	.2454	.2486	.2518	.2549
0.7	.2580	.2611	.2642	.2673	.2704	.2734	.2764	.2794	.2823	.2852
0.8	.2881	.2910	.2939	.2967	.2995	.3023	.3051	.3078	.3106	.3133
0.9	.3159	.3186	.3212	.3238	.3264	.3289	.3315	.3340	.3365	.3389
1.0	.3413	.3438	.3461	.3485	.3508	.3531	.3554	.3577	.3599	.3621
1.1	.3643	.3665	.3686	.3708	.3729	.3749	.3770	.3790	.3810	.3830
1.2	.3849	.3869	.3888	.3907	.3925	.3944	.3962	.3980	.3997	.4015
1.3	.4032	.4049	.4066	.4082	.4099	.4115	.4131	.4147	.4162	.4177
1.4	.4192	.4207	.4222	.4236	.4251	.4265	.4279	.4292	.4306	.4319
1.5	.4332	.4345	.4357	.4370	.4382	.4394	.4406	.4418	.4430	.4441
1.6	.4452	.4463	.4474	.4485	.4495	.4505	.4515	.4525	.4535	.4545
1.7	.4554	.4564	.4573	.4582	.4591	.4599	.4608	.4616	.4625	.4633
1.8	.4641	.4649	.4656	.4664	.4671	.4678	.4686	.4693	.4699	.4706
1.9	.4713	.4719	.4726	.4732	.4738	.4744	.4750	.4756	.4762	.4767
2.0	.4772	.4778	.4783	.4788	.4793	.4798	.4803	.4808	.4812	.4817
2.1	.4821	.4826	.4830	.4834	.4838	.4842	.4846	.4850	.4854	.4857
2.2	.4861	.4865	.4868	.4871	.4875	.4878	.4881	.4884	.4887	.4890
2.3	.4893	.4896	.4898	.4901	.4904	.4906	.4909	.4911	.4913	.4916
2.4	.4918	.4920	.4922	.4925	.4927	.4929	.4931	.4932	.4934	.4936
2.5	.4938	.4940	.4941	.4943	.4945	.4946	.4948	.4949	.4951	.4952
2.6	.4953	.4955	.4956	.4957	.4959	.4960	.4961	.4962	.4963	.4964
2.7	.4965	.4966	.4967	.4968	.4969	.4970	.4971	.4972	.4973	.4974
2.8	.4974	.4975	.4976	.4977	.4977	.4978	.4979	.4980	.4980	.4981
2.9	.4981	.4982	.4983	.4983	.4984	.4984	.4985	.4985	.4986	.4986
3.0	.49865	.4987	.4987	.4988	.4988	.4989	.4989	.4989	.4990	.4990
3.1	.49903	.4991	.4991	.4991	.4992	.4992	.4992	.4992	.4993	.4993
3.2	.49931	.4993	.4994	.4994	.4994	.4994	.4994	.4995	.4995	.4995
3.3	.49952	.4995	.4995	.4996	.4996	.4996	.4996	.4996	.4996	.4997
3.4	.49966	.4997	.4997	.4997	.4997	.4997	.4997	.4997	.4997	.4998
3.5	.49977									

SOLUTION ONE

(a) Calculation of NPV (N million)

Year	2018	2019	2020	2021	2022
Contribution (W1)	0	309	334	361	391
Fixed costs	0	(62)	(64)	(66)	(68)
Rent	<u>(20)</u>	<u>(20)</u>	<u>(20)</u>	<u>(20)</u>	<u>0</u>
	(20)	227	250	275	323
Tax (Company Tax)	4	(45)	(50)	(55)	(65)
Plant & equipment/Scrap value	(1,000)				38
Tax saved on C.A (W2)	40	32	26	20	22
Working capital (W3)	<u>(30)</u>	<u>(2)</u>	<u>(3)</u>	<u>(3)</u>	<u>300</u>
NCF	(1,006)	212	223	237	618
PVF at 10%	<u>1</u>	<u>0.909</u>	<u>0.826</u>	<u>0.751</u>	<u>0.683</u>
PV	<u>(1,006)</u>	<u>193</u>	<u>184</u>	<u>178</u>	<u>422</u>

NPV = (N29,000,000)

Decision: Negative NPV therefore reject the project.

Workings

(1) Contribution per unit = N5,900 – N3,400 = N2,500

Year		Nmillion
1	$120,000 \times \text{N}2,500 \times (1.03)$	309
2	$120,000 \times (1.05) \times \text{N}2,500 \times (1.03)^2$	334
3	$120,000 \times (1.05)^2 \times \text{N}2,500 \times (1.03)^3$	361
4	$120,000 \times (1.05)^3 \times \text{N}2,500 \times (1.03)^4$	391

(2) Capital allowances (Nmillion)

Year	Cost/WDV	CAs at 20%	Tax at 20%
0	1,000	200	40
1	800	160	32
2	640	128	26
3	512	102	20
4	410		
Sale	(300)	110	22

(3) Working capital (Nmillion)

Year	1	$\text{N}30 \times 1.05 \times 1.03 =$	N32
	2	$\text{N}32 \times 1.05 \times 1.03 =$	N35
	3	$\text{N}35 \times 1.05 \times 1.03 =$	N38

- (b) (i) **The PV of the factory annual rent after tax is (N=million):**

$$\text{N}20 (1 - 0.2) \times 3.487^* = \text{N}56$$

(* = annuity factor at 10% years 0 - 3)

$$\text{Sensitivity margin} = 29/56 = 51.8\%$$

The rent must **fall** by 51.8% to make the project viable.

- (ii) **Need to compute the IRR of the project.**

Try 7%

Year	0	1	2	3	4
NCF	(1,006)	212	223	237	618
PVF at 7%	<u>1</u>	<u>0.935</u>	<u>0.873</u>	<u>0.816</u>	<u>0.763</u>
PV	<u>(1,006)</u>	<u>198</u>	<u>195</u>	<u>193</u>	<u>472</u>

$$\text{NPV} = 52$$

$$\text{IRR} = 7 + \frac{52}{29 + 52} \times (10 - 7) = 8.93 \text{ approx. } 8.9$$

The WACC would have to **fall** by $(10 - 8.9)/10 = 0.11 = 11\%$.

- (b) The risk is that political action will reduce the value of the project.
The measures that a foreign government might use include: Quotas; Tariffs; Non-tariff barriers; Restrictions; Nationalisation; Minimum shareholding; Blocked funds.

Strategies that can be used to limit the effects of political risk include: Negotiations with the host government; Insurance; Production strategies; Management structure.

- (d) NPV only considers the cash flows associated with the new project. It is possible that the project may be worthwhile as a result of the real options associated with it and these include:

- (i) **Follow on options** – PT has the opportunity at the end of four years to continue production of the product. This might be profitable or not. This is a call option.

- (ii) **Abandonment options** – If the product is not popular and is a failures, PT has the right to terminate the project early and sell the equipment. This is a put option.
- (iii) **Timing options** – It may be possible for PT to delay the production of the product and wait until the rumours about the rival company are either dispelled or are based on fact. This is a call option.
- (iv) **Growth options** – The rumours of an alternative product also create growth options. PT could invest and hope that the alternative product does not materialise. Wait and see if the alternative product comes to market but competitors might take a lead and not wait.
- (v) **Flexibility Options** - If the new product is successful and demand is greater than estimated, PT may expand production. This is a call option.

EXAMINER'S REPORT

This is a four-part question which tests the candidates' understanding of investment decisions. The question covers NPV analysis, inflation, relevant and irrelevant cash flows, working capital requirements and taxation.

Part (b) requires candidates to calculate and comment on the sensitivity of the project to two of the inputs in the NPV analysis.

Part (c) requires candidates to consider the political risk of setting up the manufacturing facility overseas and how the company may limit its effects.

About 95% of the candidates attempted the question.

In part (a), most candidates did not pay full attention to the timing of cash flows and when they should be increased for price inflation and growth in quantity sold.

In part (b), most of the candidates had some difficulty, as the project produced a negative NPV.

In part (c), a large number of the candidates could not identify political risks and those who did, could not state how to limit its effects.

In part (d), very few candidates were able to identify the real options available to the company. However, a disappointing number of them did not refer to the scenario of the question.

Candidates should be prepared to apply their knowledge to varying scenarios.

MARKING GUIDE		Marks	Marks
a)	Contribution	4	
	Fixed costs	1	
	Rent	1	
	Tax (Company Tax)	1	
	Plant	1	
	Tax savings on C.A	2	
	Working capital	2	
	Discount factor	1	
	NPV	1	
	Negative NPV and reject	<u>1</u>	15
b) i)	PV of factory rent	1	
	Sensitivity	$\frac{1}{2}$	
	Interpretation	<u>$\frac{1}{2}$</u>	2
ii)	IRR	3	
	Sensitivity	$\frac{1}{2}$	
	Interpretation	<u>$\frac{1}{2}$</u>	4
c)	Possible political measures taken } by government	2	
	Strategies to limit effects	<u>2</u>	4
d)	$\frac{1}{2}$ mark per valid option, max	2	
	$\frac{3}{4}$ mark per explanation of the point	<u>3</u>	<u>5</u>
			<u>30</u>

SOLUTION TWO

- (a) The government bond yield curve needs to be adjusted by the credit spread for an A-rated company.

	1-Year	2-Year	3-Year
Government bond annual spot yield curve	9.5	10.4	10.5
A-rated spread	<u>0.2</u>	<u>0.3</u>	<u>0.5</u>
A-rated yield curve	<u>9.7</u>	<u>10.7</u>	<u>11.0</u>

Calculation of issue price

Bond A

$$P_0 = \cancel{N}100 \left(\frac{1}{1.097} \right) + \cancel{N}1,180 \left(\frac{1}{1.107} \right)^2 = \cancel{N}1,054$$

Bond B

$$P_0 = \cancel{N}120 \left(\frac{1}{1.097} \right) + \cancel{N}120 \left(\frac{1}{1.107} \right)^2 + \cancel{N}1,120 \left(\frac{1}{1.11} \right)^3 = \cancel{N}1,026$$

Number of bonds that can be bought:

Bond A: $\cancel{N}20,000,000 / \cancel{N}1,054 = 18,975$ bonds

Bond B: $\cancel{N}20,000,000 / \cancel{N}1,026 = 19,493$ bonds

(b) Calculation of Yield to Maturity (YTM)

The YTM of each bond is the IRR of the related cash flows.

Bond A

Try 10%: NPV = $\cancel{N}1,054 + \cancel{N}1,00(1.736) + \cancel{N}1,080(0.826) = \cancel{N}11.68$

Try 11%: NPV = $\cancel{N}1,054 + \cancel{N}1,00(1.713) + \cancel{N}1,080(0.812) = \cancel{N}5.74$

$$YTM = 10 + \frac{11.68}{11.68 + 5.74} (11 - 10) = 10.67\%$$

Bond B

Try 11%: NPV = $\cancel{N}1,026 + \cancel{N}120(2.444) + \cancel{N}1,000(0.731) = \cancel{N}1.72$

YTM is approximately 11% (actually about 10.94%).

(c) Calculation of duration of the bonds

Bond A

Year (n)	CF N	PVF at 10.67%	PV at 10.67% N	PV × n N
1	100	0.904	90.40	90.40
2	1,180	0.817	<u>964.06</u>	<u>1,928.12</u>
			<u>1,054.46</u>	<u>2,018.52</u>

$$\text{Duration} = 2,018.52 / 1,054.46 = 1.914$$

Bond B

Year (n)	CF N	PVF at 11%	PV N	PV × n
1	120	0.901	108.12	108.12
2	120	0.812	97.44	194.88
3	1,120	0.731	<u>818.72</u>	<u>2,456.16</u>
			<u>1,024.28</u>	<u>2,759.16</u>

$$\text{Duration} = \cancel{N}2,759.16 / \cancel{N}1,024.28 = 2.69$$

Duration measures the sensitivity of a bond's price to changes in interest rates. It is a measure of interest rate risk associated with a bond. The higher the duration, the higher the sensitivity and the higher the risk. Generally, the **higher** the maturity of the bond, the **lower** the coupon rate and the lower the yield to maturity (YTM), the **higher** the risk.

- (d) If interest rates increase, prices of bonds are expected to **fall**. Bonds with relatively higher durations will experience higher percentage drop in price in response to the same percentage increase in interest rate. Therefore, to minimise the risk of drop in price, Bond A, with lower duration will be selected, holding other factors constant.

EXAMINER'S REPORT

This question tests candidates' knowledge of key bond analysis, that is, pricing, yield and duration.

About 20% of the candidates attempted the question. Only two candidates produced excellent solutions, but the performance of the other candidates was disappointing.

Despite the clear instruction that candidates should work with nominal value of ₦1,000, about 80% of the candidates who attempted the question elected, at their own risk, to work with a nominal value of ₦100.

The key challenges which the candidates faced in the question include the following:

- Inability to deal with the credit spread and thereby incorrectly pricing the bonds;
- Inability to calculate the YTM even when the bond prices were given; and
- Lack of understanding of the concept of duration and its meaning.

Candidates are advised to practise past examination questions as found in the Pathfinders as a question similar to this was in a very recent examination.

MARKING GUIDE

	Marks	Marks
a) A rated yield curve	1	
Issue price of bond A	1½	
Issue price of bond B	1½	
Number of bonds	<u>1</u>	5
b) Calculation of the yield to maturity of		
- Bond A	2½	
- Bond B	<u>2½</u>	5
c) Calculation of duration		
- Bond A	2	
- Bond B	2	
Interpretation of duration	<u>2</u>	6
d) Recommendation with appropriate justification		<u>4</u>
		<u>20</u>

SOLUTION THREE

(a) (i) Cost per order

	₦
Fixed shipment charge	100,000
Administration cost	<u>50,000</u>
Total	<u>150,000</u>

Note: The variable delivery charge of ₦50 per unit is not relevant when computing cost per order because it does not vary with the number of orders made.

(ii) Holding costs per unit per annum.

	₦
Opportunity cost of warehousing space = $2 \times \text{₦}400$	800
Others	<u>1,000</u>
Total	<u>1,800</u>

(b) **Calculation of EOQ**

Annual demand = D	=	24,000 units
Ordering cost = K	=	₦150,000
Holding cost = H	=	₦1,800

$$EOQ = \sqrt{\frac{2DK}{H}} = \sqrt{\frac{2 \times 24,000 \times 150,000}{1,800}} = 2,000 \text{ units}$$

Calculation of total costs

	₦000
Holding Cost = $\frac{2,000}{2} \times \text{₦1,800}$	= 1,800
Ordering Cost = $\frac{24,000}{2,000} \times \text{₦150,000}$	= 1,800
Cost of holding base stock = 1,000 × ₦1,800	= 1,800
Purchase cost = 24,000 units × ₦1,550*	= <u>37,200</u>
Total relevant cost	= 42,600
Total revenue = 24,000 × ₦2,000	= <u>48,000</u>
Profit	= <u>5,400</u>

(* includes variable delivery charge of ₦50 per unit)

(c) **Evaluation of quantity discount**

We need to evaluate the following re-order quantities (ROQ)

ROQ	Purchase price per unit
2,000	₦1,500 + ₦50 = ₦1,550**
3,000	₦1,450 + ₦50 = ₦1,500
5,000	₦1,425 + ₦50 = ₦1,475

(** Assumed bought from Ajoke Ltd)

ROQ	2,000	3,000	5,000
Price (P)	₦1,550	₦1,500	₦1,475
	₦000	₦000	₦000
Holding cost = $\frac{ROQ}{2} \times \text{₦1,800}$	1,800	2,700	4,500
Ordering cost = $\frac{24,000}{ROQ} \times \text{₦150,000}$	1,800	1,200	720
Cost of holding base stock (no change)	1,800	1,800	1,800
Purchase cost = 24,000 × P	<u>37,200</u>	<u>36,000</u>	<u>35,400</u>
Total cost	<u>42,600</u>	<u>41,700</u>	<u>42,420</u>

Recommendation: Based on the above computations, Kehinde should purchase batches of 3,000 from Ema Ltd. in order to minimise costs.

- (d) The limitations of the above analysis are as follows:
- (i) The model assumes that annual demand can be predicted and constant usage applies throughout the year.
 - (ii) The relevant order cost (incremental cost) per unit is extremely difficult to estimate. In practice most of the order costs are likely to be semi-fixed.
 - (iii) The costs of placing an order are assumed to be constant and not to vary with the size of the order.
 - (iv) Some of the holding costs are extremely difficult to estimate. Examples include materials handling and obsolescence.

EXAMINER'S REPORT

This question tests the candidates' knowledge of Economic Order Quantity (EOQ).

Part (a) tests the ability of the candidates to identify the relevant cost per order and the holding cost per unit.

Part (b) tests the calculation of basic EOQ and part (c) tests their ability to evaluate quantity discount.

Though some very few candidates produced very good solutions, large number of them were found wanting.

The key problems include:

- The use of wrong formula;
- Inability to identify the values of the variables in the model (demand etc.); and
- Inability to evaluate the variables needed when evaluating the quantity discounted.

EOQ and discount were also tested in a recent examination. Candidates are advised to make better use of past editions of the Pathfinders in their preparation for the Institute's future examinations.

MARKING GUIDE

	Marks	Marks
a) i) Shipment charge	$\frac{3}{4}$	
Admin cost	$\frac{3}{4}$	
Total	<u>$\frac{1}{2}$</u>	2

ii)	Opportunity cost of warehousing	1	
	Others	$\frac{1}{2}$	
	Total	<u>$\frac{1}{2}$</u>	2
b)	EOQ	2	
	Holding cost	1	
	Ordering cost	1	
	Base stock	1	
	Purchase cost	$\frac{1}{2}$	
	Total revenue	<u>$\frac{1}{2}$</u>	6
c)	Appropriate unit cost	1	
	Alternative ROQs	1	
	Holding costs	1	
	Ordering costs	1	
	Base stock	1	
	Total cost	1	
	Recommendation	<u>1</u>	7
d)	1 mark per valid point, max		<u>3</u>
			<u>20</u>

SOLUTION FOUR

- (a) The risk of Sunmola Funds (SF) plc.'s short-term investment portfolio may be measured by the weighted average beta of the four shares. The weighting is by the market value of the shares.

	Market value		
	N	Beta	N
T	280,000	1.55	434,000
P	527,000	0.65	342,550
B	390,000	1.26	491,400
Y	<u>39,900</u>	1.14	<u>45,486</u>
	<u>1,236,900</u>		<u>1,313,436</u>

$$\text{Portfolio beta} = \frac{1,313,436}{1,236,900} = 1.06$$

SF Plc.'s short-term investment portfolio is slightly riskier than what is obtainable in the capital market.

(b) The composition of the short-term investment may be examined from the following two questions:

- Is the performance of the individual investments within the portfolio satisfactory?
 - Does the portfolio provide the most suitable form of short-term investments for SF Plc.?
- (i) The individual shares may be examined to establish if they are expected to provide satisfactory return for the systematic risk involved.

Using CAPM, the required return of each share is computed as follows:

T	$6 + 1.55(16 - 6)$	=	21.5%
P	$6 + 0.65(16 - 6)$	=	12.5%
B	$6 + 1.26(16 - 6)$	=	18.6%
Y	$6 + 1.14(16 - 6)$	=	17.4%

Next, we compute the expected excess return (i.e. the alpha value = α) and make recommendation.

	Expected return %	Required value %	Alpha value %	Remark/ Recommendation
	(a)	(b)	(a - b)	
T	21.0	21.5	-0.5	Over-valued, sell
P	12.5	12.5	0	Properly valued, hold
B	18.0	18.6	-0.6	Over-valued, sell
Y	18.5	17.4	1.1	Under-valued, buy more

Based on the computations above, the shares in companies T and B are not expected to give a satisfactory return relative to their systematic risk and should be sold. The shares in P should be held, and further shares should be purchased in Y.

However, none of the abnormal returns is large and any decision to buy or sell might be influenced by this, as will the existence of transaction costs. We are also assuming that the capital market is not efficient.

In addition, the analysis considers only systematic risk. If SF Plc. does not have other investment and is not well diversified, systematic risk is likely to under-estimate the risk to SF Plc. of these investments.

- (ii) The portfolio is unusual for short-term investments. Short-term investments are usually made for a specific purpose; for example, to ensure cash is available for purchase of assets, payment of dividends, taxes or creditors where a known amount of funds is required. Most companies are not willing to tolerate much risk of price movement in their short-term investments. This portfolio of investments, in ordinary shares, is exposed to substantial price movements as share prices change and the possibility that one or more of the companies could fail. Although, the expected returns are relatively high, the risk of this portfolio is very high relative to most portfolios of marketable securities. Unless SF Plc. is happy to take such risks, it is recommended that short-term investments should concentrate upon fixed interest marketable securities such as Treasury Bills, Certificates of Deposit and Bills of Exchange. Such investments involve much less risk of price movement and default, and if held short-term, possible inflation may not be a concern.
- (c) The factors that a financial manager should take into account when investing in marketable securities include:
 - i) **Default risk.** The risk that interest and/or principal will not be paid on schedule on fixed interest investments. Most short-term investments in marketable securities are confined to investments with negligible risk of default;
 - ii) **Price risk.** The risk of the value of the investment changing, for example, when interest rates change. Financial managers normally wish to avoid substantial price risk;
 - iii) **Marketability.** Securities should normally be marketable at short notice at close to the quoted market price;
 - iv) **Taxation.** Whether there are any special tax effects on the selected marketable securities;
 - v) **Yield.** Managers will usually try to achieve the maximum yield possible consistent with a satisfactory level of risk and marketability;
 - vi) **Foreign exchange risk.** If marketable securities are not denominated in the domestic currency of the investor, foreign exchange risk must be taken into account;

- vii) **The amount of funds to be invested.** Some types of investment require a minimum size of investment; and
- viii) **The period for which the investment is to be made.** The type of investment should be matched with the timing requirements of future need for funds.

EXAMINER'S REPORT

The question tests some basic concepts of portfolio theory and CAPM.

About 80% of the candidates attempted the question. 40% of the candidates who attempted the question, scored 50% or above of the allocated marks.

Commonest pitfalls include the following:

- In part (a), using nominal value of the shares rather than market values;
- Wrongly calculating alpha value as required return minus expected return rather than expected return minus required return;
- Wrong interpretation of alpha values; and
- Inability of the candidates to apply their knowledge to examination questions. For example, in the final part of question (b), would any of the candidate invest money needed to pay rent in six months time in equity? This is just common sense!

We recommend that students should read widely, making use of the Institute's Study Text, Pathfinder and other examination related text books.

MARKING GUIDE

	Marks	Marks
a) Computing market value	3	
Portfolio beta	<u>1</u>	4
b) Required returns	2	
Alpha values	2	
Buy/hold/sell decision with Reasons	3	
Propriety of the investment	<u>3</u>	10
c) ½ mark each for mentioning, max	1½	
1½ marks each for explanation, max	<u>4½</u>	<u>6</u>
		<u>20</u>

SOLUTION FIVE

(a) Forward Rate Agreement (FRA)

Entering into a FRA will allow the company to effectively lock in an interest rate for a specified future period, here for a six-month period, starting in 3 months' time and ending in 9 months' time. That is, we should use a 3 to 9 FRA which should lock us in to a borrowing rate of 5.94%.

The FRA is independent of the loan itself upon which the prevailing rate must be paid. However, any difference between the actual rate and the FRA rate will result in a cash flow from the FRA that offsets the higher or lower interest cost.

	Fixed Interest Rate	
Net outcome	<u>4.50%</u>	<u>6.50%</u>
Actual rate	4.50%	6.50%
FRA rate	<u>(5.94%)</u>	<u>(5.94%)</u>
Gain/(loss)	<u>(1.44%)</u>	<u>0.56%</u>
FRA Receipt/(Payment)	$\text{₦}50\text{m} \times (1.44\%) \times 6/12$	$\text{₦}50\text{m} \times 0.56\% \times 6/12$
	= (₦360,000)	= ₦140,000
Interest on ₦50m for 6 months	<u>(₦1,125,000)</u>	<u>(₦1,625,000)</u>
Net payment	<u>(₦1,485,000)</u>	<u>(₦1,485,000)</u>

Net payment at 5.94% is $\text{₦}50\text{m} \times 5.94\% \times 6/12 = \text{₦}1,485,000$

Hence, the FRA has locked us in to a rate of 5.94%.

(b) Interest Rate Futures vs FRA

Interest rate futures have the same effect as FRAs, in effect locking in to an interest rate. Unlike FRAs, however, they are standardised in terms of size, duration and term and they are tradable on exchanges.

They are generally closed out prior to maturity with any gain or loss offsetting any higher or lower interest cost when borrowing.

The standardisation in terms of size, duration and term may appear to make them limited compared to FRAs, however, the ability to trade them means that any hedge can be easily released at any time if conditions change which is not the case for FRAs.

Since we, as borrowers, are concerned that rates may rise, we are looking for a profit on these futures to offset the interest cost.

If rates rise, then futures' prices' fall (futures' price = 100 – rate), hence, to gain, we must sell interest rate futures.

- (c) Interest rate guarantees or short-term interest rate caps offer the opportunity to limit the impact of any adverse movement in interest rates whilst still benefiting from any favourable rate movement.

They represent an interest rate option giving the holder the right, but not the obligation, to deal at an agreed interest rate at a future maturity date.

This means that if rates rise, the option would be exercised by Katangwa Ltd. locking the rate. If rates fall, however, Katangwa Ltd. would allow the option to expire without exercising it, and benefit from the lower interest rate in the market.

EXAMINER'S REPORT

The question tests candidates' knowledge of interest rate risk management techniques.

Less than 20% of the candidates attempted it. Candidates demonstrated lack of knowledge of the risk management section of the syllabus.

Commonest pitfalls exhibited by the candidates include:

- Lack of knowledge of the FRA terms;
- Inability to identify the particular term of the FRA to use; and
- Inability to analyse the outcomes of FRA.

Candidates are advised to make better use of the Institute's Study Text, past editions of the Pathfinder and any other relevant text books.

MARKING GUIDE

	Marks	Marks
a) Explanation of the use of FRA in hedging interest rate risk	2	
Calculation of the net outcome of fixed interest rate @:		
4.5%	2½	
6.5%	2½	
Calculation of net payment @ 5.94%	½	
Comment on the result of the calculation of net payment @ 5.94%	<u>½</u>	8

b)	1 mark per valid comparison, max	4
c)	1 mark per valid point given, max	<u>3</u>
		<u>15</u>

SOLUTION SIX

Date: May 16, 2018

To: Board of Directors

From: Finance Controller

Topic: Acquisition targets and mode of financing

(a) Choosing acquisition targets

The criteria that should be used to assess whether a target is appropriate will depend on the motive for the acquisition.

The main criteria that are consistent with the underlying motives include:

i. **Benefit for acquiring undervalued company**

The target firm should trade at a price below the estimated value of the company when acquired. This is true of companies which have assets that are not exploited;

ii. **Diversification**

If the objective is risk reduction, the target firm should be in a business which is different from our own business and the correlation in earnings should be low;

iii. **Operating Synergy**

The target firm should have characteristics that create the operating synergy. Thus, the target firm should be in the same business in order to create cost savings through economies of scale. Alternatively, it should be able to create a higher growth rate through increased monopoly power;

iv. **Tax Savings**

The acquisition of the target firm should provide a tax benefit in the form of unused capital allowances to us;

v. **Increase in debt capacity**

This happens when the target firm is unable to borrow money or is forced to pay high interest rates. The target firm should have capital structure such that its acquisition will reduce bankruptcy risk and will result in increasing its debt capacity;

vi. **Access to cash resources**

A company, with a number of cash intensive projects or products in their pipeline, or heavy investment in Research and Development, might seek a company that has significant cash resources or highly cash generative product lines to support their own needs; and

vii. **Access to technology**

Some companies do not invest significantly in Research and Development but acquire their enabling technologies by acquisition.

b. **Purchase Consideration**

The key factors that determine the form of purchase consideration include:

i. **Liquidity**

Clearly, the use of cash as consideration depends upon having sufficient liquid resources available. Equity or debt securities, if used, will not affect the firm's cash position;

ii. **Control**

The use of cash will not transfer control from the existing shareholders but the use of equity shares and convertible bonds will lead to loss of control;

iii. **Gearing**

The use of debt securities leads to increase in financial gearing and associated financial risk. This may be acceptable if the takeover is small or if there is previously unused debt capacity;

iv. **Uncertainty over the value of the consideration**

Shareholders in the target company are often less willing to accept shares or convertible securities than cash because the value of shares and hence the consideration is liable to fluctuation. With a cash offer and an offer of bonds, the value of the consideration is known; and

v. **Tax consideration**

Cash as consideration will mean shareholders will be subject, if a capital gain has accrued, to an immediate capital gains tax liability on the profit on the sale of their shares in the target company. An offer in the form of securities (equity or bond) will enable shareholders to defer a capital gain tax payment until the gains are realised.

Signed
Name

EXAMINER'S REPORT

The question tests candidates' knowledge of some basic theoretical concepts of mergers and acquisitions.

More than 80% of the candidates attempted the question. About 10% of the candidates that attempted the question scored zero.

Candidates are advised to put in greater effort to ensure their success in the Institute's examinations.

MARKING GUIDE

	Marks	Marks
a) Report format	1	
½ mark per valid factor mentioned, max 3		
1 mark for explanation of the valid points, max	<u>5</u>	9
b) ½ mark per valid factor mentioned	2	
1 mark for explanation of the factors	<u>4</u>	<u>6</u>
Maximum		<u><u>15</u></u>

SOLUTION SEVEN

- (a) The Board of Directors of a listed public company will usually consist of executive directors, who hold specific responsibilities within the business (for example, personnel director and non-executive directors), who do not have specific responsibilities. Non-executive directors are usually employed on a part-time basis and are not involved in day-to-day operational matters. Nevertheless, executive and non-executive directors have the same legal obligations towards the shareholders of the company.

Non-executive directors have a valuable role to play in the development of strategy and in monitoring the actions of the executive directors. In carrying out this role, non-executive directors are expected to challenge the decisions of the executive directors and to highlight bad practices or poor performance.

Non-executive directors should add value to the company in some way and their ability to do so may depend, to a large extent, on the personal qualities that they possess. They should normally bring to the company broad experience of the commercial world as well as considerable expertise in their particular field. These qualities may help to add value through identifying new opportunities and developing new performance measures or improving existing control systems. In addition, non-executive directors may be a valuable source of new contacts for the company.

Non-executive directors can often provide objective and independent advice to the Board of Directors. This should be of particular value during periods of change or crisis, when a detached view can help the executive directors maintain perspective.

(b) Takeovers

Directors often devote large amounts of time and money to defend their companies against takeover. However, research has shown that shareholders in companies that are successfully taken over often earn large financial returns. On the other hand, directors of companies that are taken over frequently lose their jobs. This is a common example of the conflict of interest between the two groups.

Time horizon

Directors know that their performance is usually judged on their short-term achievements; shareholders' wealth, on the other hand, is affected by the long-term performance of the firm. Directors can frequently be observed to be taking a short-term view of the firm which is in their own best interest but not in that of the shareholders.

Risk

Shareholders appraise risks by looking at the overall risk of their investment in a wide range of shares. They do not have 'all their eggs in one basket' unlike directors whose career prospects and short-term financial remuneration depend on the success of their individual firms.

Moral hazard

This deals with manager's interest in receiving all the perquisites of his office like domestic staff, company cars, use of company's airplane; company sponsored holiday trips with family abroad etc. Such moral hazards which increase if the manager has no stake in the company tend to drain the

company's earnings which means reduction in the value of the company. The shareholders wealth and the value of the company will reduce if these incentives and demands of executive management is not kept in checks.

Working hours

Ordinarily, managers prefer to work for less hours than the stipulated working period especially if the reward system does not recognise overtime and hard work. The implication is that the earnings of the company will reduce as well as share price and returns to shareholders. This will be more pronounced with senior management if profit sharing or bonus payment is not attached to profitability.

Dividend policy

Unfortunately, the remuneration of directors and senior managers is often related to the size of the company, rather than its profits. For this reason, executive management may favour a high retention policy which implies growth in asset and size of the company. On the other hand, the shareholders may favour a higher dividend payout which implies more money for them to meet up with their needs

(c) Bond Covenants include:

- i. **Asset Covenant:** This would govern the company's acquisition, use and disposal of assets. This could be for specified types of assets or assets in general;
- ii. **Financing Covenant:** This covenant often defines the type and amount of additional debt that the company can issue, and its ranking and potential claim on assets in case of future defaults;
- iii. **Dividend Covenant:** A dividend covenant restricts the amount of dividend that the company is willing to pay. Such covenants might also be extended to share repurchases;
- iv. **Financial Ratio Covenants:** Fixing the limit of key ratios such as the gearing level, interest cover, net working capital or a minimum ratio of tangible assets to total debt;
- v. **Merger Covenant:** Restricting future merger activity of the company;
- vi. **Investment Covenant:** This concerns company's future investment policy;
- vii. **Sinking Fund Covenant:** This is a situation whereby the company makes payments, typically to the bond trustees, who might gradually repurchase bonds in the open market or build a fund to redeem bonds; and

- viii. **Employees Covenant:** This requires the regulation of the employment and dismissal of key employees.

Advantages of covenants

- i. The main advantage of covenant is that lenders may be prepared to lend more money to the company if it provides the security of a covenant; and
- ii. Covenants may mean that the costs at which the company can borrow money are lower.

Disadvantages of covenants

- i. The main disadvantage of a covenant is that the company's actions may be constrained; it may not be able to raise further funds beyond the covenanted loans or undertake profitable investments; and
- ii. Covenants may require the borrower to bear monitoring costs such as provision of information, auditors' fees or trustee expenses.

EXAMINER'S REPORT

The question tests candidates' knowledge of basic concepts in finance, such as agency problems, conflict of interest etc.

Over 80% of the candidates attempted the question, but performance was very poor.

The major pitfall was lack of basic knowledge and understanding of rudimentary concepts in financial management.

Candidates are advised to pay more attention to basic concepts in Strategic Financial Management.

MARKING GUIDE

	Marks	Marks
a) Reasonable comment on roles of executive directors		4
b) Identification of 3 areas of conflict (1½mark each)	1½	
Discussion on the 3 areas identified (1½mark each)	<u>4½</u>	6
c) Identification of any FIVE covenants mentioned with explanations		<u>5</u>
		<u>15</u>

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION - MAY 2018

ADVANCED AUDIT AND ASSURANCE

Time Allowed: 3¼ hours (including 15 minutes reading time)

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

SECTION A: COMPULSORY (30 MARKS)

QUESTION 1

- a. You are a manager in Puposola & Company (Chartered Accountants) responsible for the audit of the Honey Group (the Group), a quoted company. The Group's main activity is steel manufacturing and it comprises of a parent company and three subsidiaries. Your firm currently audits all components of the Group.

You are working on the audit of the Group's financial statements for the year ended June 30, 2017. This morning, the audit engagement partner left a note for you.

"Hello

I have gone through the draft consolidated financial statements and accompanying notes which summarise the key audit findings and some background information.

Although, at the planning stage, materiality was initially determined to be ₦900,000, and was calculated based on the assumption that Honey Group is a high risk client due to its listing status. However, due to a number of issues that arose during the audit, there is a need to revise the materiality level for the financial statements as a whole. The revised level of materiality should now be ₦700,000.

Thank you.

The Group's draft consolidated financial statements, with notes referenced to key audit findings, are shown below:

Draft Consolidated Statement of Comprehensive Income

	Note	June 30 2017	June 30 2016
		Draft	Actual
		₦'000	₦'000
Revenue	1	98,795	103,100
Cost of sales		<u>(75,250)</u>	<u>(74,560)</u>
Gross profit		23,545	28,540
Operating expenses	2	<u>(14,900)</u>	<u>(17,500)</u>
Operating profit		8,645	11,040
Share of profit of associate		1,010	900
Finance costs		<u>(380)</u>	<u>(340)</u>
Profit before tax		9,275	11,600
Taxation		<u>(3,200)</u>	<u>(3,500)</u>
Profit for the year		<u>6,075</u>	<u>8,100</u>
Other comprehensive income for the year, net of tax:			
Gain on property revaluation	3	800	-----
Actuarial losses on defined benefit plan	4	<u>(1,100)</u>	<u>(200)</u>
Other comprehensive loss		<u>(300)</u>	<u>(200)</u>
Total comprehensive income for the year		<u>5,775</u>	<u>7,900</u>

Notes: Key audit findings on statement of comprehensive income

1. Revenue has been stable for all components of the Group with the exception of one subsidiary, Copesink Company, which witnessed a 25% decrease in revenue.
2. Operating expenses for the year to June 2017 is shown net of profit on a property disposal of ₦2 million. Our evidence includes agreeing the cash receipts to bank statement and sale documentation, and we have confirmed that the property has been removed from the non-current asset register. The audit junior noted when reviewing the sale document, that there is an option to repurchase the property in five years' time, but did not discuss the matter with management.

3. The property revaluation relates to the Group's head office. The audit team has not obtained evidence on the revaluation, as the gain was immaterial based on the initial calculation of materiality.
4. The actuarial loss is 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 at June 30, 2017. No other audit work has been performed other than to agree the amount reported in the financial statements to supporting documentation supplied by Axial Company.

Draft Consolidated Statement of Financial Position

	Note	June 30 2017 Draft ₹'000	June 30 2016 Actual ₹'000
ASSETS			
Non-current assets			
Property, plant and equipment		81,800	76,300
Goodwill	5	5,350	5,350
Investment in associate	6	4,230	4,230
Non-current assets held for sale	7	<u>7,800</u>	<u>-</u>
		99,180	85,880
Current assets			
Inventory		8,600	8,000
Receivables		8,540	7,800
Cash and cash equivalents		<u>2,100</u>	<u>2,420</u>
		<u>19,240</u>	<u>18,220</u>
Total assets		<u>118,420</u>	<u>104,100</u>
EQUITY AND LIABILITIES			
Equity			
Share capital		12,500	12,500
Revaluation reserve		3,300	2,500
Retained earnings		33,600	29,400
Non-controlling interest	8	<u>4,350</u>	<u>4,000</u>
Total equity		<u>53,750</u>	<u>48,400</u>
Non-current liabilities			
Defined benefit pension plan		10,820	9,250
Long-term borrowings	9	43,000	35,000
Deferred tax		<u>1,950</u>	<u>1,350</u>
Total non-current liabilities		<u>55,770</u>	<u>45,600</u>
Current liabilities			
Trade and other payables		6,200	7,300
Provisions		<u>2,700</u>	<u>2,800</u>

Total current liabilities	<u>8,900</u>	<u>10,100</u>
Total liabilities	<u>64,670</u>	<u>55,700</u>
Total equity and liabilities	<u>118,420</u>	<u>104,100</u>

Notes: Key audit findings on statement of financial position

5. The goodwill relates to each of the subsidiaries 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.
6. The associate is a 30% holding in Jamil Company, purchased to provide investment income. The audit team has not obtained evidence regarding the associate as there is no movement in the amount recognised in the statement of financial position.
7. The non-current assets held for sale relate to a trading division of one of the subsidiaries, which represents one third of that subsidiary's net assets. The sale of the division was announced in May 2017, and is expected to be complete by December 31, 2017. Audit evidence obtained includes a review of the sales agreement and confirmation from the buyer obtained in July 2017, that the sale will take place.
8. Two of the Group's subsidiaries are partly owned by shareholders external to the Group.
9. A loan of ~~48~~ million was obtained in October 2016 at an interest rate of 2%, payable annually in arrears. The terms of the loan have been confirmed from the loan agreement provided by the bank. There was no repayment of the loan in the books as at prior year end.

Required:

- a. Explain why auditors may need to reassess materiality as the audit progresses. (4 Marks)
- b. Assess the implications of the key audit findings for the completion of the audit.

Note:

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 audit evidence obtained, but you do not need to recommend further specific procedures.

(18 Marks)

- c. Discuss **TWO** advantages and **TWO** disadvantages of a joint audit being performed on the financial statements. (8 Marks)
(Total 30 Marks)

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

QUESTION 2

Audit firms have been castigated over the years by the public whenever their clients have any financial or operational crises. The potential liability of auditors has also become an important topic in recent years due to the growing complexity of business and legal environment and increase in legal actions against auditors. One reason put forward to explain the high number of legal actions against auditors is the “expectation gap”.

Required:

- a) Explain “expectation gap” and describe its **THREE** main elements. (5 Marks)
b) Discuss the strategies that could assist in closing the expectation gap. (10 Marks)
c) i. Explain briefly the concept of professional skepticism. (2 Marks)
ii. Evaluate the importance of professional skepticism in the audit of financial statements. (3 Marks)
(Total 20 Marks)

QUESTION 3

A new hotel opened for operations on February 1, 2016 in Abuja. The directors at their board meeting of September 2016 selected December as the hotel’s year end. Also, from conception of the hotel, it was decided to fully computerise the hotel and its operations. This will make the hotel stand out and attract clientele in the federal capital territory where there are many other hotels with strong competition.

The room doors are electronically operated and use electronic cards for opening. If a customer did not specify his/her duration and has the lock properly programmed, the door will lock at 12 noon and the customer has to go back to the reception for access. Furthermore, all accounting and other processes are computerised.

The IT company that handled the computerisation agreed to leave a member of staff who will train the staff of the hotel for three months and ensure that the system operates efficiently. Management believes that the staff will familiarise themselves with the system within that period. The server handles all doors, accounting processes including billing and determination of room occupancy rate

on daily basis. Various units of the hotel have desk-top units which key employees use in both ordering and communication between themselves. The server is next to the operations manager's office with the responsibility on him to oversee this in addition to his other duties.

The last quarterly report on the hotel activities was not consistent with expectation, and occupancy rate failed to agree with turnover. The management of the hotel approached your firm of chartered accountants to be engaged as auditors to the hotel. Your review and interactions as the leader of the audit team revealed the information disclosed above.

Required:

Evaluate and apply the relevant general and application controls necessary to be installed in the hotel's information environment. **(Total 20 Marks)**

QUESTION 4

You are the HR partner in Ekemode & Company (Chartered Accountants). As part of continuous training programme of your firm, you are to organise an in-house seminar to educate the staff of your firm on Rules of Professional conduct. You have decided to emphasise the IFAC's Code of Ethics for Professional Accountants published by the International Ethics Standard Board for Accountants (IESBA) recently adopted by ICAN into their localised code called "The Professional Code of Conduct and Guide for Members."

Required:

- a. Explain briefly the **FIVE** fundamental principles of the IFAC's Code of Ethics for Professional Accountants. **(7½ Marks)**
 - b. Explain independence of mind and independence of appearance to the staff. **(5 Marks)**
 - c. Explain briefly **THREE** general sources of threat to the fundamental principles of the IFAC's Code of Ethics for Professional Accountants. **(7½ Marks)**
- (Total 20 Marks)**

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

QUESTION 5

The management of QQ Limited had engaged an expert valuer, Segun & Company in the valuation of its investment property situated at Ojo Oniyun Street, Victoria Island for disclosure in the financial statements as at year end.

Required:

As auditors to QQ Limited;

- a. Discuss the factors to be considered when assessing the objectivity of the expert employed by management (5 Marks)
 - b. Explain the procedures to be performed by the auditor to assess whether the work of the management expert provides sufficient and appropriate evidence for the audit of the financial statements. (10 Marks)
- (Total 15 Marks)**

QUESTION 6

Reliance Ventures Limited has been trading in imported goods for many years. The company's fortune has started to diminish as a result of current economic environment. Your firm has been the auditor of the company in the last three years. You have noticed that the shareholders' equity of the company has been eroded and is currently in deficit. This condition has raised significant doubt on the entity's ability to continue as a going concern.

Required:

Draft a briefing note for the audit team of the company. Your briefing note should:

- (a) Identify and explain **FOUR** audit procedures to be performed by the audit team to determine the going concern status of the company. (10 Marks)
 - (b) Discuss **FOUR** of the steps that the auditor should take if he considers that the going concern assumption is invalid whereas management considers it to be valid. (5 Marks)
- (Total 15 Marks)**

QUESTION 7

- a. You are the accountant to Banana Follow Me Limited and the audit of the financial statements for the year ended December 31, 2016 is currently ongoing. The company is a cocoa processing entity with various factories across the country. During the year end audit, the auditors, Akinfenwa & Company. (Chartered Accountants), observed that the company purchased 200,000 units of XYZ Plc. shares during the year and that the company had not recognised dividends on these shares as at year end.

Upon enquiry, the Managing Director of the company explained that the shares were purchased ex-dividend and had promised to provide suitable representations to confirm this. The auditors have verified this and are

satisfied with the explanation but expect representation letter which includes all other relevant representations from the company.

Required:

As the accountant to the company, prepare the management representation letter to be issued to the company's auditors. (8 Marks)

- b. Management of Banana Follow Me Limited is planning to invest in all its factories in order to attract more customers. The company has sufficient cash to fund all its necessary capital expenditure. Most of the cash will be used to invest in equipment and fittings while the remaining cash will be used for the refurbishment of the factories.

The audit strategy relevant to the audit of the company reveals the existence of a significant risk associated with money laundering, largely due to the high volume of cash-based transactions. The majority of the customers purchase cocoa in cash, and the company transfers its cash to overseas bank accounts on a regular basis.

Required:

- i. Discuss **THREE** requirements of an anti-money laundering programme which the auditor of Banana Follow Me Limited should have in place for detecting and reporting suspicion of money-laundering. (6 Marks)
- ii. State **ONE** example of the criminal offences connected with money laundering. (1 Mark)

(Total 15 Marks)

SOLUTION 1

(a) Materiality

Materiality is a matter of judgment and is commonly determined using a numerical approach based on percentages calculated on revenue, profit before tax and total assets. 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.

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. For example, 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.

Also, a change in the client's circumstances may occur during the audit, such as a decision to dispose a major part of the business. This again may cause the auditor to consider if the previously determined level of materiality is still appropriate.

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.

The initial calculation of materiality for the Honey Group was based on the client's listing status and on an assumption that the group is a high risk client.

It is therefore important that events such as explained above, are taken into account in assessing a new level of materiality for this client to ensure that sufficient appropriate evidence is obtained to support the audit opinion.

b. Puposola & Company
(Chartered Accountants)

From: Audit Manager
To: The Audit Engagement Partner
Subject: **Implications of Key Audit Findings**

I refer to your note this morning regarding key audit findings on the audit of Honey Group financial statements. Please find below, my viewpoint and assessment of the implications of the key audit findings as noted:

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 Copeskin with 25% decrease in revenue.	We need to verify that all revenues of Copeskin has been fully recorded and that understatement of invoices or under-billing did not occur.

- ii. Operating expenses for the year ended June 2017 is shown net of 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 recognized (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
We need to obtain sufficient and appropriate audit evidence on the revaluation. Since the transaction is now considered material being ₦900,000 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 Honey Group.
We shall carry out more audit procedures to verify the loss, which may include obtaining expert opinion such as Actuarial Practitioner or Stocks expert.

Statement of Financial Position

- v. Goodwill relates to each of 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 recognize impairment of goodwill attributable to the subsidiaries where applicable.
- vi. Associate is a 30% holding in Jamil 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.

viii. Two of the Group's subsidiaries are partly owned by shareholders external to the Group.	<p>Additional audit evidence is required especially to determine likelihood of the future sale.</p> <p>We need to ascertain the equity participation of the external shareholders to determine the extent of their interest in the subsidiaries.</p>
	<p>We shall also obtain sufficient and appropriate audit evidence to verify external shareholders investment in the subsidiaries.</p> <p>The financial statements will be materially misstated if the investments are significant and not corrected.</p>
ix. Loan of N8m obtained in October 2016 at an interest rate of 2%.	<p>We shall inquire from management regarding the reason for non-payment of the amount that fell due in December 2016. This may be an indication of going concern issues.</p> <p>We 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.</p>

(signed)

Audit Manager

Puposola & Company

(Chartered Accountants)

(c) Advantages of joint audits

- i. After the acquisition of a large subsidiary, using joint auditors may help the transition process while the group auditors become familiar with the new subsidiary. The 'old' auditors should be familiar with the business of the subsidiary and should pass their knowledge over to the parent company auditors. For the parent company auditors, this should accelerate the process of getting to know the business of the new subsidiary.

- ii. Joint auditors may provide a higher level of technical expertise than either audit firm could provide individually.
- iii. Improved geographical coverage may be obtained for the audit, where each of the joint auditors on its own does not have offices that cover all the geographical locations of the component companies in the group.
- iv. It has been suggested that two medium-sized accountancy firms might 'join forces' and tender for the audit of a company for which the auditors would normally be one of the 'Big 4' accountancy firms. This is possibly a way in which medium-sized firms might try to 'break the monopoly' of the Big 4 on large company audits.

Disadvantages of joint audits

- i. The extra cost to the client. It is likely to cost more to use two accountancy firms than to use one.
- ii. Possible inconsistencies between the two joint auditors in the audit methods that they use. If so, there may be problems in reaching agreement on whose audit method to use.
- iii. The possible difficulty the two firms may have in agreeing the division of work.
- iv. Additional problems that will arise in monitoring and controlling the audit work of two different firms.
- v. The two firms may find it difficult to work well together, and each firm may try to become the leading firm in the joint audit.
- vi. If there is a claim against the auditors for negligence in the conduct of the audit, there may be some difficulty in identifying which of the joint auditors is potentially liable.
- vii. Disagreement on sharing of fees

EXAMINER'S REPORT

The question is in three parts. Part (a) tests candidates' knowledge on materiality; Part (b) tests assessment of key audit findings while Part (c) tests their knowledge on joint audit.

Being a compulsory question, almost all the candidates attempted the question and performance was fair.

Candidates' commonest pitfall is their inability to assess correctly the implications of key audit findings.

Candidates are advised to read the Institute's Study Text in details in preparing for future examinations.

Marking Guide		Marks	Marks
1a.	1 mark each for any 4 points		4
b.	½ mark each for 9 key audit findings	4½	
	1½ marks each for any 9 points on assessment of implication of key audit findings	<u>13½</u>	18
c.	2 marks each for any 2 points on advantages	4	
	2 marks each for any 2 points on disadvantages	<u>4</u>	<u>8</u>
	Total		<u>30</u>

SOLUTION 2

- a. The expectation gap is the difference between what the users of financial statements and other members of the public think that the auditors should do and what the auditors are actually required by law and the profession to do.

There are three main elements in the expectations gap, these are:

- i. **A standard gap:** This occurs because of a perception that auditing standards are more prescriptive than they actually are, and that auditors have wide-ranging rules that they must follow;
 - ii. **A performance gap:** This occurs because of a perception that audit work has fallen below the required standard; and
 - iii. **A liability gap:** This arises from a lack of understanding about the auditor's liability and who the auditor may be liable to.
- b. A number of strategies that could assist in closing the expectation gap are discussed below.
- i. The profession should attempt to improve the general level of knowledge and understanding about the audit process. One of such attempts has been made with the issuance of ISA 700, the auditing standard on auditor's reports. This requires an audit report to include an explanation of the nature of an audit;
 - ii. Controls over the auditing profession are important in enhancing public confidence. For example, the European Union requires the audit of companies whose shares are quoted on a stock market in the European Union (EU) to be conducted in accordance with International Auditing Standards (ISAs).

National oversight bodies such as Public Company Accounting Oversight Board (PCAOB) in USA and Financial Reporting Council (FRC) in the UK and Nigeria monitor the compliance of audit firms in their conduct of audits by performing audit inspections.

- iii. Significant guidance for auditors and management aimed at increasing quality and addressing issues such as going concern has been issued by standard setters, professional bodies and regulators. There has been an increased focus on corporate governance and role that audit committees play in companies, reducing inconsistencies and enhancing quality.
- iv. Open and candid communication between internal and external auditors, finance management and the audit committee is increasingly being seen as critical in helping reduce the expectation gap.

Such communication helps the audit committee to perform their governance role transparently and realistically that will help achieve effective risk management.

- v. Enhanced communication between the parties and confirmation of their respective roles and responsibilities should be presented in the audit committee and directors reports to the shareholders. This will motivate the users to be more aware of the various parties' roles and responsibilities beyond the understanding they gain just from the audit report.
 - vi. The expectation gap will hopefully narrow further as financial reporting participants work together more effectively to improve the deterrence and detection of financial reporting fraud.
- c) i. The ISA 200 defines professional skepticism as "an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud and a critical assessment of audit evidence". They explicitly require the auditor to plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.
 - ii. Professional skepticism plays an important role in auditing and forms an integral part of an auditor's skill. Professional skepticism is closely

interrelated with professional judgment. Both are essential to the proper conduct of the audit and ensure quality audit.

Professional skepticism facilitates the exercise of professional judgment by an auditor, regarding decision in the following areas:

- The nature, timing and extent of audit procedures to be performed;
- Whether or not sufficient and appropriate audit evidence has been obtained or more needs to be done to achieve the objectives of the ISA 200;
- The evaluation of management's judgment in applying an entity's applicable financial reporting framework; and
- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

EXAMINER'S REPORT

The question tests candidates' knowledge on expectation gap.

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

The commonest pitfall was lack of understanding of strategies that could assist in closing expectation gap and the importance of professional skepticism.

Candidates are advised to study the Institute's Study Text very well before entering for future examinations.

Marking Guide		Marks	Marks
2a.	2 marks for explaining the gap	2	
	1 mark each for the 3 elements of the gap	<u>3</u>	5
b.	2 marks each for any 5 points		10
c.	Explanation of professional skepticism	2	
	1 mark each for any 3 illustrative examples	<u>3</u>	<u>5</u>
	Total		<u>20</u>

SOLUTION 3

General Controls

General controls are controls over the environment in which the computer-based information system is designed, developed, operated and maintained.

The main categories of general controls that an auditor would expect to find in a computer-based information system are summarised in the table below.

Control Area

Development of computer-based information systems and applications

Controls

Appropriate standards should be established and enforced for designing, developing, programming and documenting each new system.

Suitable testing procedures should be carried out on each new system.

The design of a new system should be approved formally by the management and the system users.

There should be segregation of duties between system designers and system testers to reduce the risk of error or fraud

There should be suitable staff training in the designing and testing of systems. Formal testing procedures should be applied for any change to an existing programme.

There should be formal authorisation procedures for programme changes.

There should be suitable staff training in making and testing programme changes.

Documentation and testing of programme changes

Prevention or detection of unauthorised programme changes

There should be a segregation of duties between programmers and computer system operators.

All programme changes must be fully documented.

Access to programme files must be restricted.

Programme logs should be used to record access to programme files

There should be anti-virus software to prevent, detect or deal with malicious changes to programme.

	Back-up copies of files and programme should be kept outside the computer environment.
Prevention of the use of incor programmes or data files	Standard operating procedures should be performed by suitably-trained staff. The scheduling of 'jobs' for a computer centre should specify the programme files and data files to be used. There should be effective supervision of computer centre operations.
Prevention of unauthorised amendments to data files	Review of operations should be carried out regularly by management. There must be restricted access to data files that should be limited to authorised personnel
Ensuring continuity of operations	Transaction logs should be kept of all users of data files, and these should be reviewed by management. Secured back-up of programme files and data files should be kept. Measures should be implemented for the protection of equipment against fire, power failure and other hazards. Disaster recovery programmes should be in place so as to restore operation in the event of major disaster that may put the main computer systems out of operation. There should be suitable maintenance and service agreements for all major externally acquired software.

Additional general controls that could be applied to the hotels information environment are as follows:

GENERAL CONTROLS

1. Room door programmed to lock at 12 noon
2. Accounting and other procedures are computerised
3. Post-implementation support arrangement
4. Staff training
5. Server under the watch of the Operation's Manager

EVALUATION OF CONTROLS

This ensures that guests do not extend their stay in the hotel without making further payment.

This control will be adequate if the automatic lock system neither malfunctions nor gets manipulated.

Also, collaboration with guests by IT function will circumvent the control and make it ineffective.

The computerisation of accounting and other procedures will guard against human errors and late recording of transactions.

However, the effectiveness of this control depends on the continuous functioning of the procedures installed.

This arrangement ensures continuity of operations. However, it is for a short period of 3 months.

Adequate arrangement ought to be made to replace the staff of the IT company or to put in place adequate Continuity and Disaster Recovery Plan.

Training of staff ensures that employees understand what to do at any point in time and are not likely to misuse the system or cause it to malfunction.

However, it does not prevent collusion or the tendency of staff to abuse the system or to attempt fraudulent practices.

This is good control to ensure that the Server is not accessed by unauthorised persons to corrupt or steal data.

However, it relies on the Operation's Manager being physically present to monitor the server,

A better control would be putting the server in a secure enclosure where unauthorised persons would not be able to have access to it.

Also a camera could be installed to monitor and record movements around the server area.

Programme applications should be installed on the server such as, Antivirus software, firewall, etc.

Logical access such as password should be implemented on the server to prevent unauthorized access to data files.

A list of application controls that might be found in a computer system is set out below.

Input

Authorisation

- Data for input should be authorised before input.
- Data is input only by authorised personnel.

Completeness

There should be checks to ensure that all data has been processed. Checks might consist of:

- Document counts (for example, counting the number of invoices);
- Control totals;
- Checking output to input; and
- Review of output against expected values (for example, is the total payroll cost broadly in line with expectations).

Accuracy

There should be some checks within the computer software on the validity of input data items (data validation checks). These may include:

- Check digits for key code items, such as supplier codes, customer codes and employee identification numbers;
- Range checks (a check on whether a particular value or figure is feasible and within a realistic range of values);
- Existence checks (a check on whether a

	particular code exists);
	- Review and reconciliation of output and use of control totals.
Processing	There should be checks that all input has been processed and that processing is complete. Checks might include:
	- Control total;
	- Batch totals (where the computer counts the number of transactions in a processed batch, and this is checked against a manual record of the number of items in the batch);
	- Manual review; and
	- On-screen warning that processing is not complete.
Master files and standing data	- Management review of master files and standing data.
	- Regular updates of master files.
	- Record counts.

The auditor should review the application controls for each application to establish whether they are effective 'on paper'. He should then carry out tests of controls to establish whether the application controls are operating effectively in practice.

EXAMINER'S REPORT

The question tests candidates' knowledge in respect of IT controls in a hotel environment.

About 30% of the candidates attempted the question and their performance was poor.

The commonest pitfall of the candidates was lack of technical ability to relate IT controls to an hotel environment.

Candidates are enjoined to acquaint themselves with what operates practically in the global audit environment when preparing for future examinations.

Marking Guide	Marks	Marks
2 marks each for any 3 application controls	6	
2 marks each for any 7 general controls	<u>14</u>	
Total		<u>20</u>

SOLUTION 4

a) The fundamental principles of the code of conduct for Professional Accountants are as follows:

- i. **Integrity:** A professional accountant should be straight forward and honest in all professional and business relationship;
- ii. **Professional competence and due care:** A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services;
- iii. **Objectivity:** A professional accountant should not allow bias, conflict of interest or undue influence of others to override his or her professional or business judgments;
- iv. **Confidentiality:** A professional accountant should respect the confidentiality of information acquired as a result of professional or business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information should not be used for the personal advantage of the professional accountant or third parties; and
- v. **Technical standard:** A professional accountant should comply with relevant laws and regulations and should avoid any action which discredits the profession.

b) Independence of mind and independence of appearance

Independence of mind describes a state of mind that permits the auditor to express a conclusion without being affected by influences or prejudices that compromise within professional judgment. This allows the auditor to act with integrity, exercise objectivity and professional skepticism.

Independence of appearance means the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information (including any safeguards applied) would reasonably conclude that a firm's or a member of the assurance team's, integrity, objectivity or professional skepticism has been compromised.

The presumption is that if an auditor is not independent in appearance then they cannot possibly think with objectivity, that is, be independent in mind. Even if this may not be technically true, it is a presumption that must be held in order to protect the reputation of auditors

- c) Threats to the fundamental principles are matters that could result in the accountant or audit firm acting without integrity, sufficient competence, ensuring confidentiality or in a way that discredits the profession. However, threats to the fundamental principles are largely threats to the independence and objectivity of the accountant or the audit firm.

The code recognizes the following general sources of threat to the fundamental principles:

- i. **Self-interest threat:** This arises when the accountant or the audit firm has a financial interest or other interest in a matter. Typically, this means that the accountant's decisions may be influenced by self-interest and the accountant will therefore not act with objectivity and independence;
- ii. **Self-review threat:** This occurs when an accountant is required to review or re-evaluate (for a different purpose) a previous judgment he has made or action that he has taken. Self-review threats can also apply to audit firm, for example, if an audit firm prepared the financial statements for a client company and then acted as auditor, it would be reviewing its own work and would be reluctant to criticize or question it. This would be a threat to objectivity and independence;
- iii. **Advocacy threat:** This occurs when the accountant is in a position where he is expected to defend or justify the position of the client and act as an advocate for the client's position or point of view. This would be a threat to objectivity and independence;
- iv. **Intimidation threat:** This occurs when the accountant is deterred from acting with objectivity due to threats against him or his firm. The nature of the threat may be a threat by the client that it will take engagement away from the firm unless it agrees with the point of view of the client management; and
- v. **Familiarity threat:** This occurs when the accountant becomes too sympathetic with the client's position due to close relationship. For example, this may occur due to a long association over many years in carrying out the annual audit.

EXAMINER'S REPORT

The question tests candidates' knowledge on IFACs Code of Ethics for Professional Accountants.

About 95% of the candidates attempted the question and performance was very good.

Marking Guide		Marks	Marks
4a.	½ mark for each of the 5 principles	2½	
	1 mark for each of the explanations of the principles	<u>5</u>	7½
b.	2½ marks for independence of mind	2½	
	2½ marks for independence in appearance	<u>2½</u>	5
c.	2½ marks each for any 3 general sources of threats identified		<u>7½</u>
Total			<u>20</u>

SOLUTION 5

- (a) When assessing the objectivity of an expert employed by management, issues for the auditor to consider would include whether:
- (i) the expert has a financial interest in the audit client, for example shareholding;
 - (ii) the expert has a personal relationship with a senior manager in the audit client; and
 - (iii) the fee paid for the expert's services was a fair commercial price.
- (b) When assessing whether the work of management's expert provides sufficient and appropriate evidence for audit purposes.
- i. The auditor should review the terms on which the expert was engaged by the audit client, such as the objective and scope of the expert's work and whether the expert was notified that his work may be relied on by the auditors.
 - ii. The auditor should obviously study the content of the expert's report and the conclusions that the expert reached. Any assumptions used by the expert may be significant (for example in making an asset valuation) and the auditor should compare those assumptions with his own understanding of the audit client's busin
 - iii. The auditor may also need to check the methods used by the expert. For example, for the valuation of Investment Property, the method of valuation used should be consistent with the requirements of IAS 40.
 - iv. If the expert has been used to provide a valuation, the date of the valuation should be close to the end of the financial year of the audit client so that it is current.

There may be additional evidence that the auditor could obtain to confirm the evidence provided by the expert. For example, if a property valuation expert has been used by the audit client to value a number of properties, the auditor may be able to obtain some

additional evidence of the reliability of the valuations in a number of ways:

- By inspecting some of the properties to assess their condition.
 - By checking the cost of similar assets acquired by the audit client during the financial year.
- v. For assets acquired during the year, by comparing their cost with the end-of-year valuation: unless there has been a large rise or fall in property values during the year, current valuation should be fairly close to original cost.
- vi. By checking events after the reporting period: if any of the properties has been sold since the end of the year, their sale value should be compared with their end-of-year valuation. They ought to be similar amounts.
- vii. By obtaining representations from management that the key assumptions used in arriving at estimated values are reasonable.
- viii. Use of fair value accounting may require more frequent use of experts by the auditor.

EXAMINER'S REPORT

The question tests candidates' knowledge on the work of accountants' expert.

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

The commonest pitfall of the candidates was lack of knowledge in the area of the syllabus tested.

Candidates are enjoined to thoroughly read the Institute's Study Text before sitting for future examinations.

Marking Guide

	Marks	Marks
5a. 2½ marks each for any 2 points		5
b. 2 marks each for any 5 points		<u>10</u>
Total		<u>15</u>

SOLUTION 6

(a) Going concern assumptions-audit procedures

Where events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor must obtain sufficient appropriate evidence to determine whether in fact, a material going concern uncertainty does exist. He does this by performing additional audit procedures.

- i. **Discussion with management:** Management should be asked to explain the reasons why they consider the going concern assumptions to be valid. They should also be asked about their future plans for the business. If the entity is expecting to make a loss next year, the possible implications of this for the going concern assumption should be discussed extensively.
- ii. **Obtain a cash flow forecast:** A cash flow forecast should be obtained from the entity and this should also be discussed with management; the assumptions in the forecast should be checked and, if appropriate, challenged. If the forecast shows a cash shortage, the auditor should discuss with management their plans for obtaining the additional financing that will be required.
- iii. **Review the sales order book:** If this indicates a decline in sales orders, the issue should be discussed with management.
- iv. **Review ageing of receivables:** Check a list of ageing receivables and assess the average time to pay. If customers are taking longer to pay, this may have adverse implications for operational cash flow.
- v. Consider whether planned capital expenditure by the entity may be insufficient to support the business as a going concern in the future.
- vi. If a key senior employee has left the business entity recently, the entity may start losing key customers and key employees. This should be discussed with management.
- vii. **Litigation:** If the company is involved in continuing litigation and faces the possibility of having to pay a large amount of money to settle the dispute, the implication should be discussed.
- viii. **Information from the client entity's bank:** If the client entity is expecting to rely on continuing financial support from its bank, for example, a continuation of its bank overdraft facility, the bank should be asked to confirm that the finance will remain available.
- ix. **After discussing the issues with management:** the auditor should obtain a letter of representation from management confirming their opinion that the entity is a going concern.

- (b) The financial statements are the responsibility of management, and if the auditor considers that the going concern assumption is invalid whereas management considers it to be valid, the steps available to the auditor are to:
- i. Discuss the matter with management, having carried out audit procedures to obtain more evidence;
 - ii. Try to persuade management to change their mind and prepare the financial statements on a different basis (a break up basis);
 - iii. If management does not agree to change its view, consider making a qualified audit report; and
 - iv. Unless all those charged with governance are also involved in managing the entity, the auditor must communicate to those charged with governance any events or conditions that may cast significant doubt on the entity's ability to continue as going concern, such communication must include the following:
 - Whether the events or conditions constitute a material uncertainty;
 - Whether the use of the going concern assumption is appropriate; and
 - Whether the related disclosures in the financial statements are adequate.

EXAMINER'S REPORT

The question tests candidates' knowledge of going concern assumption.

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

The commonest pitfall of the candidates was inability to identify sufficient and appropriate evidence to determine whether a material going concern issue exists.

Candidates should read the Institute's Study Text thoroughly before sitting for future examinations.

Marking Guide		Marks
6a.	2½ marks each for any 4 points	10
b.	1¼ marks for each of the 4 points	<u>5</u>
Total		<u>15</u>

SOLUTION 7

a.

Akinfenwa & Co. (Chartered Accountants)
7, Idiogun Street,
Lanfenwa,
Ibadan.

(Date in full and must be after 31 Dec. 2016)

Dear Sir,

Management Representation Letter for the year ended 31 December 2016

This representation letter is provided in connection with your audit of the financial statements of Banana Follow me Limited for the year ended 31 December 2016, for the purpose of expressing an opinion as to whether these financial statements give a true and fair view in accordance with the International Financial Reporting Standards (IFRSs).

We confirm that, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves.

Financial Statements

1. We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated, for the preparation and fair presentation of financial statements in accordance with IFRSs.
2. Measurement methods and significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable (ISA 540).
3. Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with IFRSs (ISA 550).
4. All events subsequent to the date of the financial statements and for which IFRSs require adjustment or disclosure have been adjusted or disclosed (ISA 560).
5. The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of uncorrected misstatements is attached to the representation letter (ISA 450).

Information Provided

6. We have provided you with:
 - Access to all information such as records, documentation and other matters that are relevant to the preparation of the financial statements;

- Additional information that you have requested from us for the purpose of the audit; and
 - Unrestricted access to persons within the company from whom you determined it necessary to obtain audit evidence.
7. We confirm to you that the company does not keep two or more different sets of accounting books and does not have any off balance sheet set-offs as at the end of the period.
 8. All transactions have been recorded in the accounting records and are reflected in the financial statements.
 9. We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the company and involves:
 - Management;
 - Employees who have significant roles in internal control or,
 - Others where the fraud could have a material effect on the financial statements (ISA 240).
 10. We have disclosed to you allegations of fraud, or suspected fraud, affecting the company's financial statements communicated by employees, former employees, analysts, regulators or others. (ISA 240).
 11. We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing the financial statements. (ISA 250).
 12. We have disclosed to you the identity of the company's related parties and all the related party relationships and transactions of which we are aware and all related party relationships and transactions have been appropriately accounted for and disclosed in accordance with IFRSs.
 13. We confirm that the company purchased 200,000 units of XYZ Plc shares during the year and that these shares were bought ex-dividend.
 14. We also have the positive intention and ability to hold the investment securities as 'available for sale', in accordance with IAS 39-Financial Instruments: Recognition and Measurement.

Yours truly,

Signed on behalf of the Board of Directors by:
 Chief Financial Officer
 Managing Director

- b(i) There are many elements which should be in place as part of an anti-money laundering programme.

The audit firm must appoint a Money Laundering Reporting Officer (MLRO), who should have a suitable level of seniority and experience; usually this would be a senior partner in the audit firm. Suspicions of money laundering should be reported to the MLRO, who considers whether the matter should be referred to security agencies, prepares and keeps the appropriate documentation.

There are also firm-wide elements of an anti-money laundering programme. A training programme is essential to ensure that individuals are aware of the relevant legislation and regulations regarding money laundering. Individuals should also be trained in the firms identification, record keeping, reporting policies, money laundering risk factors, identifying such risk factors, appropriate response and tipping off offences.

An important part of anti-money laundering is customer due diligence or know your client procedures. This means that audit firms must establish the identity of clients using documents such as certificates of incorporation and passports, and should obtain information about business activities in order to gain an understanding of matters such as sources of income and the rationale for business transactions.

Finally, the audit firm must ensure that it maintains records of client identification procedures and of all transactions relevant to audit clients, for example, the receipt of cash for services performed. This is important to ensure that the audit firm does not inadvertently become party to a transaction involving money laundering.

- b(ii) The examples of criminal offences connected with money laundering are:
- Failure by a person in the regulated sector to inform the appropriate party of a knowledge or suspicion that another person is engaged in money laundering; and
 - Failure to make a disclosure which is likely to prejudice an investigation into money laundering (tipping off).

EXAMINER'S REPORT

The question tests candidates' understanding of management's representation letter and anti-money laundering matters.

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

The commonest pitfall of the candidates was failure to distinguish between management representation letter and management letter.

Candidates are enjoined to be familiar with the Institute Study Text when preparing for future examinations.

Marking Guide		Marks	Marks
7a.	- Giving name and address of auditor	1	
	- Stating date of report to be after year end	1	
	- Heading of subject matter of the letter	1	
	- Purchase of 200,000 units of XYZ Plc shares	1	
	- Closing remark and show signing of letter by Managing Director or Chief Finance Officer or both	1	
	- Mentioning any other 3 out of the 13 other points in a letter of representation (1 mark each)	<u>3</u>	8
bi.	Mentioning and explaining any 3 of		
	- Money Laundering Reporting Officer – (MLRO)		
	- Training		
	- Record Keeping		
	- Reporting policy		
	- Know your client		
	- Firm not inadvertently become party to the act		
	(2 marks for any 3)	6	
bii.	1 mark for any one point	<u>1</u>	<u>7</u>
	Total		<u>15</u>

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION - MAY 2018

CASE STUDY

Time Allowed: 4 hours (including reading time)

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

DEEDEE 'T' COMMUNICATIONS NIGERIA LIMITED

You are Margaret Dawodu, Consultant in the firm of Top Lev Consulting Services, a firm of financial and tax practitioners. Your Managing Consultant, Daniel Adeolu, has sent you an email (Exhibit 1) requiring you to prepare a report to be submitted to Jake Foster, the Chief Executive Officer (CEO) of Deedee 'T' Communications Nigeria Limited (DCNL), one of your clients.

DCNL has requested your firm to carry out an appraisal of the company's operations and advise on the best way to move forward.

The following time allocation is suggested:

Reading	1hour
Planning and calculation	1hour
Drafting report	<u>2hours</u>
	<u>4hours</u>

LIST OF EXHIBITS

EXHIBIT	DESCRIPTION
1.	Email from Daniel Adeolu to Margaret Dawodu.
2.	Letter from Gbenga Jamiu, the Chief Finance Officer of DCNL.
3.	Summary of 3-year income statements of DCNL.
4.	Summary of 3-year statements of financial position of DCNL.
5.	Financial data of DCNL.
6.	Highlights of loan approval in principle.
7.	The economic environment.
8.	The telecom industry.

Exhibit 1

TOP LEV CONSULTING SERVICES

(Financial and Tax Practitioners)

Email

To: Margaret Dawodu – Consultant
From: Daniel Adeolu – Managing Consultant
Re: Deedee 'T' Communications Nigeria Limited
Date: October 17, 2017

As we discussed this morning during our Monday morning briefings, I would like you to urgently work on the assignment recently given to us by Deedee 'T' Communications Nigeria Limited (DCNL), one of our clients.

DCNL's board is considering how to move the company forward in the face of economic challenges and dwindling disposable income in the country. As I made it clear at our meeting this morning, DCNL wants our advice on their intending plans to restructure their loan portfolio so as to position the company to overcome the current economic challenges. The company would want us to advise them on the best arrangement in respect of the restructuring of their loan commitments. At the same time, DCNL would like to take additional medium term loan facility to finance further expansion of its network. The board of DCNL would also want our opinion on the current position of the company in the industry and to carry out an analysis of the economic environment highlighting the company's strengths and weaknesses as well as potential opportunities and threats in their business environment.

To help us in this assignment, the Chief Finance Officer (CFO) of the company, Gbenga Jamiu, FCA, has sent the following documents to us:

- i. 3 year, 2014 – 2016, summarised financial statements;
- ii. Financial data in respect of the operations of DCNL;
- iii. Highlights of the offer from the consortium of banks in respect of the company's application for \$150m medium term loan;
- iv. Current economic outlook of the country, prepared by an independent consultant; and
- v. Detailed analysis of the telecoms industry in Nigeria, prepared by an independent consultant.

These documents are marked Exhibits 3 to 8.

You are required to work on this assignment, using Exhibits 2 to 8 and draft a report for my consideration. Your report should include:

1. The analysis of DCNL's current financial position, indicating the best way DCNL could restructure its current loan portfolio and obtain further loan to finance its network expansion. You should also carry out an analysis of the viability or otherwise of the proposed network expansion; and
2. Business analysis of DCNL showing the company's strengths and weaknesses and potential opportunities the company can tap and potential threats in the business environment. You are also to suggest strategies the company should follow to build on its core competencies, seize the opportunities and avoid potential threats in the business environment.

Exhibit 2

DEEDEE 'T' COMMUNICATIONS NIGERIA LIMITED

3, Akin Osun Drive
Victoria Island
Lagos

The Managing Consultant
Top Lev Consulting Services
10, Dauda Street
Dolphin Estate
Ikoyi
Lagos.

October 12, 2017

Attention: Daniel Adeolu

Dear Sir,

RESTRUCTURING OF OUR LOAN PORTFOLIO AND BUSINESS ANALYSIS

As we discussed today, during our meeting in my office, and as a follow up to my telephone conversation with you, I write to confirm that our board has agreed that your firm should assist us in the planned restructuring of our loan portfolio and other business analysis. This is to also intimate you with our board's expectations from this current assignment your firm is to handle for us.

As I informed you during our meeting we are considering a strategic move to increase the market share of Deedee 'T' in Nigeria by 12 per cent. This will require restructuring our existing bank facilities and taking additional medium term facility to finance the rehabilitation and expansion of our networks.

The board of Deedee 'T' has therefore chosen your firm to carry out an independent analysis of the issues involved in this strategic move. Your firm is required to carry out:

- An analysis of Deedee 'T' s current financial health, and advise on the best way the company could restructure its current loan facilities and the additional loan required for its networks' rehabilitation and expansion. Your analysis should include the viability or otherwise of this project; and
- A business analysis of Deedee 'T' showing its strengths and weaknesses and indicating the potential opportunities and threats in the company's business

environment. You are also to suggest strategies your firm thinks the board should follow to build on its core competencies, seize opportunities and avoid threats in the business environment.

To assist you in this assignment, I enclose herewith the following documents:

- i. 3 year, 2014 – 2016, summarised financial statements;
- ii. Financial data in respect of the operations of DCNL;
- iii. Highlights of the offer from the consortium of banks in respect of the company's application for \$150m medium term loan;
- iv. Current economic outlook of the country, prepared by an independent consultant; and
- v. Detailed analysis of the telecoms industry in Nigeria, prepared by an independent consultant.

I would like you to treat this assignment with utmost dispatch as the board will be meeting to consider your report in a fortnight. I will therefore look forward to receiving your report next week.

Thanks for your usual assistance.

Yours faithfully,

For: **Deedee 'T' Communications Nigeria Limited**

Gbenga Jamiu
Chief Finance Officer

Exhibit 3

Deedee 'T' Communications Nigeria Limited Summary income statement for the year ended 31 December

	2016 ₦'m	2015 ₦'m	2014 ₦'m
Revenue	14,792	14,706	14,693
Other income	<u>34</u>	<u>841</u>	<u>793</u>
	<u>14,826</u>	<u>15,547</u>	<u>15,486</u>
Operating costs:			
Direct network and technology operating costs	2,352	1,881	1,635
Costs of handsets and other accessories	1,230	1,083	1,031
Interconnect and roaming costs	1,339	1,310	1,365
Staff costs	915	859	884
Selling, distribution and marketing expenses	1,919	1,841	1,717
Government and regulatory costs	519	589	575
Other operating expenses	<u>1,427</u>	<u>1,143</u>	<u>960</u>
	<u>9,701</u>	<u>8,706</u>	<u>8,167</u>
EBITDA	5,125	6,841	7,319
Depreciation of property, plant and equipment	(2,099)	(1,956)	(1,826)
Amortisation of intangible assets	(475)	(374)	(325)
Impairment of goodwill	<u>(87)</u>	<u>(50)</u>	<u>(203)</u>
	<u>(2,661)</u>	<u>(2,380)</u>	<u>(2,354)</u>
Operating profit	2,464	4,461	4,965
Net finance costs	<u>1,050</u>	<u>301</u>	<u>367</u>
	1,414	4,160	4,598
Net monetary gain	174	135	87
Share of results of joint ventures and associates after tax	<u>(13)</u>	<u>123</u>	<u>421</u>
Profit before tax	1,575	4,418	5,106
Income tax expense	<u>835</u>	<u>1,132</u>	<u>1,336</u>
Profit after tax	<u>740</u>	<u>3,286</u>	<u>3,770</u>

Exhibit 4

Deedee 'T' Communications Nigeria Limited Summary statements of financial position as at 31 December

	2016 N'm	2015 N'm	2014 N'm
Non-current assets:			
Property, plant and equipment	20,331	22,904	8,755
Goodwill and intangible assets	10,048	5,589	3,662
Investment in joint ventures and associates	2,667	3,555	2,551
Investments	1,184	997	385
Other non-current assets and deferred tax	<u>847</u>	<u>1,034</u>	<u>1,354</u>
	<u>35,077</u>	<u>34,079</u>	<u>16,707</u>
Current assets:			
Trade and other receivables	1,385	1,593	981
Other current assets	3,736	4,357	3,281
Restricted cash	103	174	89
Cash and cash equivalents	<u>2,738</u>	<u>3,418</u>	<u>4,310</u>
	<u>7,962</u>	<u>9,542</u>	<u>8,661</u>
Total assets	<u>43,039</u>	<u>43,621</u>	<u>25,368</u>
Total equity:			
Share capital	10,000	5,000	5,000
Reserves	<u>5,924</u>	<u>10,184</u>	<u>8,344</u>
	<u>15,924</u>	<u>15,184</u>	<u>13,344</u>
Non-current liabilities:			
Interest-bearing liabilities	17,500	17,500	3,947
Deferred tax and other non-current liabilities	<u>1,842</u>	<u>1,985</u>	<u>1,314</u>
	<u>19,342</u>	<u>19,485</u>	<u>5,261</u>
Current liabilities:			
Interest-bearing liabilities	1,964	2,251	1,381
Trade and other payables	4,514	4,048	3,323
Other current and tax liabilities	<u>1,295</u>	<u>2,653</u>	<u>2,059</u>
	<u>7,773</u>	<u>8,952</u>	<u>6,763</u>
Total equity and liabilities	<u>43,039</u>	<u>43,621</u>	<u>25,368</u>

Note: Assume that any difference in reserves between the years has been capitalised or paid as dividend.

Exhibit 5

DEEDEE 'T' COMMUNICATIONS NIGERIA LIMITED FINANCIAL DATA

1. Analysis of revenue by product 2016:

Product	Value N'm	% of total
Outgoing voice	8,024	54.2
Incoming voice	1,387	9.4
Data	3,955	26.7
SMS	324	2.2
Devices	806	5.5
Others	<u>296</u>	<u>2.0</u>
Total	<u>14,792</u>	<u>100</u>

2. Market research survey

Research conducted by the marketing and research department of the company reveals that after the rehabilitation and expansion of the company's networks, revenue from the above products will increase as follows:

	%
Outgoing voice	30
Incoming voice	25
Data	40
SMS	20
Devices	20
Others	10

The company's previous experience with this type of research shows that it is always 85% accurate.

3. Additional operating costs:

It has been estimated that if the project is carried through, it will increase the company's operating costs as follows:

Cost element	%
Direct network and technology operating costs	20
Costs of handsets and other accessories	25
Interconnect and roaming	25
Staff costs	28
Selling, distribution and marketing expenses	12
Government and regulatory costs	25
Other operating expenses	15

Note:

For now, the company is not interested in the calculation of the net present value of the project but wants to know the viability of the project using simple profit analysis.

Exhibit 6

HIGHLIGHTS OF LOAN APPROVAL IN PRINCIPLE

1. **Facility:**
 - Restructuring of existing loan facilities of \$50m into medium term loan; and
 - Additional medium term loan of \$100m.

2. **Cost:**

Arrangement fee	1% flat
Management fee	1% flat
Prime lending rate	14% p. a.
Spread over prime	2% p. a.
Effective rate	16% p. a.

Note: The prime lending rate is subject to changes as the Central Bank of Nigeria's monetary policy rate changes from time to time.

3. **Security:** Guaranty bond issued by Deedee 'T' of United Arab Emirates.
4. **Repayment:** Repayment will be in twenty (20) quarterly instalments with the first repayment due after six months of drawdown of the additional loan. Repayment and interest will be in United States of America dollar.

Note:

Assume an exchange rate of ₦350 to \$1.0

Exhibit 7

THE ECONOMIC ENVIRONMENT

Nigerian economy experienced one of the most challenging years in recent history in 2016. The economic challenges across the globe, the fall in international price of crude oil, continuous scarcity of foreign exchange due to drop in foreign exchange earnings from crude oil, volatility of exchange rate, absence of clear economic roadmap and delay in the approval of 2016 budget played adverse roles leading to the weak business and economic environment in the country.

The oil price crashed by 74%, from \$115 per barrel in 2013 to average \$39 per barrel in 2016. This affected dollar inflow from \$18 billion in 2015 to about \$8.48 billion in 2016, which translated to a budget funding gap of about ₦2.2trn (1.93% of GDP). Also, inflation reached a seven-year high from 6.8% in December 2015 to 18.3% in October 2016. The Naira exchange rate touches all-time low from ₦220 per dollar at the end of 2015 to ₦490 per dollar at the parallel market and from ₦197 per dollar to ₦368 per dollar in the interbank market in 2016. The country experienced a contraction in its GDP by 0.36, 2.06 and 2.24% in 2016 quarters 1, 2 and 3 respectively.

Consequently, business environment for private sector became more challenging due to uncomplimentary economic policies, worsening infrastructure conditions, higher costs of doing business and weak consumer demand. The year witnessed significant shortfall of government revenue at both the federal and state levels by 40% and 52% respectively over the 2015 figures. This led to extended delays of workers' salaries and non-payment of contractors with attendant adverse effect on the private sector as a result of continuous fall in disposable income. In addition, the year saw higher cases of factory closure, company relocation to nearby countries, cut backs of operational levels with unemployment hitting a record high of 29.8%. These culminated into negative growths of -0.4%, -2.06 and -2.24% in Q1, Q2 and Q3 of 2016 respectively. Painfully, the country is currently "neck deep" in economic recession. As a result of this, the country is standing at the verge of losing its status as the largest economy in Africa to South Africa.

The government's refusal to float the national currency has also given room for round tripping and other harmful practices that stifle and strangle economic growth. Some experts have opined that, there can be no meaningful change until the government relaxes its stranglehold on the Naira and allows it to find its level in the international market under the principles of free market economy.

On the other hand, the federal government is making efforts at revamping the economy through policy intervention such as fiscal prudence, deregulation of the downstream petroleum sector, adoption of flexible exchange rate regime, introduction of Treasury Single Account, renewed interest on addressing the ease of doing business across all sectors, fight against corruption and improvement in security of lives and properties.

Nigeria therefore, remains a country with great potentials for both local and foreign investments. However, this can only be harnessed if friendly business policies, positive information and attitude are canvassed by the government while the government makes effort to completely weaken terrorists' activities in the Northern part of the country, manage appropriately the continuing restiveness in the Niger Delta and douse the ethnic agitation going on at present in the country. But for now, the economy remains in search of that optimal economic road map and policy interventions that can deliver it from the ongoing recession.

Exhibit 8

THE TELECOM INDUSTRY

According to Nigerian Communication Commission (NCC), following the economic recession in the country, average revenue per subscriber has dropped significantly. Also, the subscriber base is shrinking, such that the leading telecoms companies have reportedly lost three million customers in one month. However, this is perceived by many analysts as a temporary situation which will vanish as the country's economy comes out of recession. The telecom industry still promises a lot of untapped opportunities globally, with the continuous development of IT infrastructure in commercial transactions across the globe, expansion of entertainment industry, mobile money transactions, etc.

An independent analyst has provided the following insights of the global telecom industry from the period 2017 to 2020. He opined that the period from 2017 to 2020 will remain important in several ways. The use of mobile devices has risen rapidly and the consumers are gazing at their mobile devices at least 9 billion times a day as per the Global Mobile consumer survey. Smartphone usage across the middle aged people has increased. In Nigeria, about 54 per cent of the population is in the 15 – 64 age brackets, a huge potential for the telecom industry. Growing smartphone usage brings profitable opportunities for all the subsectors in telecom industry.

Political: The political environment is full of risks for the telecom sector. The traditional political risks for telecom are the ones related to regulations, network licensing, national radio spectrums and in case of certain nations, trade barriers. Generally, these issues have affected the network operators and the effect has been felt less by equipment and service providers. Governments across the world have launched measures to monitor and control communications motivated by political and security reasons. These measures are likely to go tougher in the country as result of criminal and terrorist activities and hate messages being peddled on social medias.

Economic: The role of economic factors is just as important as political factors in the context of the telecom industry. The current recession in the country is hurting this sector deeply. People were cutting back on their telecom spending due to continuing drop in disposable income. The truth is that “the happier the economy, the higher will be consumer spending on any product or service”.

Social: Social factors also have a deep influence on the industry and its profitability. Connectivity is central to so many things including work and entertainment. Globally, the use of internet based services has grown. A higher number of people are using the social media for fun and business. From YouTube videos to Netflix, video streaming services all require a very good connectivity. This is the reason that the use of 4G has grown globally and some telecom operators in Nigeria have invested in the 4G technology. Moreover, more and more people like

to remain connected on the go. This is a part of their lifestyle. For some, it is because they are too busy with work and in case of others they cannot remain disconnected with family and friends. Also, the use of mobile computing has grown quite fast and so many features in these smartphones and tablets cannot be used without a very good connection.

Technological: The entire telecom industry is based on technology and therefore technological changes influence it deeply. The use of mobile computing is on the rise. Around the world, IT is changing things like never before. It is central to several things including business and productivity. Computers and cloud computing have become the core of productivity. It is the telecom sector that stands to gain the most from these technological trends. Smartphone and tablet sales have kept growing and none of the two can be used fully without a fast connection.

Environmental: Smartphones are a large part of the e-waste generated every year. In the light of the level of e-waste generated by both service and equipment providers, the industry must focus on waste management and how to minimise its environmental impact. The operators should invest in reducing their carbon intensity.

Legal: Globally legal compliance gives rise to big risks for the telecom providers. Apart from the common labour and employment laws, there are several other laws and licenses that are essential to be complied with. In Nigeria, the NCC is the regulatory authority overseeing the telecom sector. Recently, NCC has slammed a huge fine on one of the operators for not complying with its regulations. There are several laws including those related to telemarketing that the providers must comply with. It is expected that more laws and regulations will be enacted in the recent future that will affect the industry as a result of government's desire to clamp down on unwholesome use of social media.

THE COMPANY

Deedee 'T' Communications Nigeria Limited, trading as Deedee 'T' Nigeria, is a Nigerian company duly registered with the Corporate Affairs Commission (CAC) in partnership with Nubai Development Company and Deedee 'T' of United Arab Emirates (UAE). In January 2007, the company acquired operating licence from the Nigerian Communications Commission (NCC) which granted the company a mobile licence and spectrum in the GSM 1700 and 800 MHz bands.

The company is a joint venture between Teko Investments Nigeria Limited, Nubai Development Company and Deedee 'T' of United Arab Emirates. The company's shares are owned in the proportions of 40%, 20% and 40% respectively. With this arrangement, Deedee 'T', the technical partner, became the operator of the United Access Licence of the company.

Deedee 'T' Nigeria made its first official call on its network on January 15, 2008 in the presence of officials from the NCC and the Senate of the Federal Republic of

Nigeria. In June of the same year, the company kicked off commercial operations with 0808 your choice campaign which enabled subscribers choose special numbers that are significant to them as their mobile numbers.

The company, since then, has grown geometrically, accumulating over 20 million subscribers on its networks and providing employment to over 6,000 with a market share of about 14 per cent. Over the years, Deedee 'T' has made investments in networks' infrastructures, roll out expansion, and development initiatives, including Corporate Social Responsibility in innovation and academic excellence. The company is the fourth largest operator in the telecom industry in Nigeria as at today.

Propelled by its technical partner, Deedee 'T' of UAE, the company has built up state – of – the – art telecom infrastructure and taken a leadership position in innovation and quality service delivery among the telecom operators in the country. The company's internet access is faster and more regular than any of the other operators. Deedee 'T' recently launched a new innovative product called "Franchise Experience Friendly Centres". This is an innovation that affords quality third party retail franchise holders with an opportunity to grow their franchise operations, allowing for the provision of improved offers to end users, even in remote locations.

To further strengthen the company's competitive position, the three investors decided to make a strategic move of making the brand a strong competition to existing operators. The board therefore, decided to carry out rehabilitation and expansion of its network infrastructures, which is targeted at increasing the company's market share by 12 per cent. To finance this, the board has approached a consortium of eleven (11) banks to refinance the company's existing \$50 million loan facilities and take additional medium term loan of \$100 million for rehabilitation and expansion of its networks.

ICAN CASE STUDY 2018

First Marking

DATE		CANDIDATE NO.	
-------------	--	----------------------	--

TIME		MARKER NUMBER	
-------------	--	----------------------	--

	Req 1	Req 2	Overall	TOTAL
SA				
CA				
BC				
NC				
V				
Total	8	8	4	20

SUPERVISOR SIGNATURE		CHECKER SIGNATURE	
---------------------------------	--	------------------------------	--

Changes made? ☐

REQUIREMENTS 1 – DCNL’s Financial Analysis and Shareholders’ Value Added

USES DATA AND INFORMATION APPROPRIATELY

- Uses information provided in Exhibit 3 – summary of income statement.
- Uses information provided in Exhibit 4 – summary of statement of financial position.
- Uses information in Exhibit 5 – operational financial data.
- Uses information provided in Exhibit 6 – Highlights of loan approval in principles.
- Uses information provided in Exhibit 2.

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

USES PROFESSIONAL TOOLS AND KNOWLEDGE

- Calculates profitability ratios.
- Calculate activity ratios.
- Calculates leverage ratios based on the financial statements.
- Prepares trend analysis to determine growth in performance of DCNL.
- Prepares common size analysis to show trends in the components of the financial statements.
- Prepares profitability analysis based on the principle of relevant revenues and costs as given in Exhibit 5.
- Calculate leverage ratios showing the effect of the loan.

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

USES ANALYTICAL SKILLS (material points) written report

- Determines the rate of growth in DCNL’s operating performance.
- Determines how the loan, if taken, will affect the operational performance of DCNL.
- Determines the effect of the loan, if taken, on the financial risk -leverage of DCNL.
- Determines the effect of the loan, if taken, on the cash flow of DCNL.

V	NC	BC	CA	SA
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IDENTIFIES ISSUES AND OPTIONS

- Identifies the risk involved in dollar denominated loan.
- Identifies the risk of volatility in exchange rate.
- Identifies the need for DCNL to explore possibility of agreeing a fixed exchange rate with the consortium of banks.
- Identifies the possibility of currency swap – repayment in Naira and not in dollar.
- Identifies the fact that DCNL earns its revenues in Naira and not in dollars.
- Identifies the fact that the Nigerian economy is neck deep in recession which is already affecting the performance of the telecom operators.

V	NC	BC	CA	SA
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APPLIES PROFESSIONAL SCEPTICISM AND ETHICS

- Recognises that we are not told whether the summarised.
- Recognises the risk involved in dollar dominated loan.
- Recognises that the result of the market research survey was carried out by DCNL’s staff, it could have been padded.
- Recognises that we do not have the industry average figures to determine whether DCNL’s performance is above the industry average or below it.
- Recognises that the six months moratorium may not be enough to complete the project and start to earn additional revenue from the project.

V	NC	BC	CA	SA
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EVALUATE SKILLS AND JUDGEMENT

- Recognises that DCNL’s revenue is increasing yearly however, there was a sharp drop in other income in 2016.
- Recognises that DCNL’s operating cost is increasing more rapidly than the revenue increasing.
- Recognises that there was a sharp drop in DCNL’s operating profit in 2016.
- Recognises that the gearing of DCNL is already very, high and adding more loan to it will put DCNL in a precarious situation.
- Recognises that the loan repayment will affect the cash flow of the company negatively.

V	NC	BC	CA	SA
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CONCLUSIONS

(Draws distinct conclusions under a heading)

- Concludes that the performance of the company has reduced drastically in 2016.
- Concludes that the present debt profile of the company is worrisome,
- Concludes that the loan will result in a negative cash inflow based on the calculation of the project's cash flow.
- Concludes that due to present volatility in exchange rate in the country, it will be too risky to take a dollar denominated loan.
- Conclusion that if the loan is taken, the financial risk of the company will be so high that the company's continuing in business will be impaired.

RECOMMENDATIONS (commercial/relevant)

- Recommends that the company should not take the loan.
- Recommends that the company should explore the possibility of injecting equity capital into the business.
- Recommends that the company should urgently tame its rising operating costs.
- Recommends that the company should explore the possibility of going for long term loan, such as bonds, etc. instead of medium term bank loan.
- Recommends that the company should consider leasing for the equipment required.

V	NC	BC	CA	SA
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SA	
CA	
BC	
NC	
V	

REQUIREMENT 2 Financial Due Diligence of BBNL

USES DATA AND INFORMATION APPROPRIATELY

- Uses information in Exhibit 2.
- Uses additional information on Exhibit 7.
- Uses information on Exhibit 8.
- Uses information on Exhibit 3.
- Uses information Exhibit 4.

V	NC	BC	CA	SA
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USES PROFESSIONAL TOOLS AND KNOWLEDGE (Written into report)

- Prepares PESTEL analysis of DCNL's operating environment.
- Prepares a SWOT analysis for DCNL.
- Identifies DCNL's core competence.
- Identifies DCNL's competitive advantage.

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

- Analyses the economic environment using the industry.
- Analyses the company's current position in the industry.
- Analyses the opportunities in the economic environment.
- Analyses the competitive potentials of DCNL.

V	NC	BC	CA	SA
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IDENTIFIES ISSUES AD OPTIONS

- Identifies that the economy of Nigeria is in recession..
- Identifies the declining disposable income. that is already affecting all the Telecom operators in the country.
- Identifies that spending on communications is one of the areas people can reduce their spending when they experience a drop in their income.
- Identifies that the current recession may however be temporary.
- Identifies that there is a global prospect for the telecom industry.
- Identifies that IT revolution going on will further boost the telecom's operators' 'business across the globe.

V	NC	BC	CA	SA
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APPLYING PROFESSIONAL SCEPTICISM AND ETHICS

- Understands that the influence of terrorist activities in the Northern part of the country may continue to hinder growth in telecom business.
- Understands that the restiveness in the Niger Delta region may also affect the telecom business adversely.
- Understands that there may be increase in government regulations in the telecom industry to climb down on the misuse of social medias.
- Expresses doubt whether this is an opportune time to increase investments in the telecom industry in Nigeria.

V	NC	BC	CA	SA
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EVALUATIVE SKILLS AND JUDGEMENT (Uses analytical heading)

Evaluate each elements of the PESTEL model.

Determines and evaluates the opportunities in the operating environment.

Determines and evaluates the threats in the operating environment.

Determines and evaluates the strengths of DCNL.

Determines and evaluates the weaknesses of DCNL.

V	NC	BC	CA	SA
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CONCLUSIONS**(Draws distinct conclusions under a heading)**

- Comments that DCNL's innovation is a good competitive advantage.
- Comments that DCNL's social responsibility initiatives is a positive for the company's business.
- Comments that the telecom business still has a great potential in Nigeria, giving the country's population.
- Comments that the economic recession in Nigeria may be temporary and the economy will soon pick up giving the current government interventions.
- Comment that the use of Smartphone's will continue to grow in Nigeria since about 54% of the country's population are within 15 to 64 age bracket.

V	NC	BC	CA	SA
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RECOMMENDATIONS (commercial/relevant)

- Recommends that the company should continue to improve and builds on its core competence – internet connectivity.
- Recommends DCNL should continue to expand its franchise operation.
- Recommends that DCNL should use its social responsibility's posture to leverage on its business by introduction specific products for some special festivals across the country.
- Recommends that DNCL should introduce special offer to students in tertiary institutions that enables them have internet connectivity at cheaper rates.

V	NC	BC	CA	SA
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SA	
CA	
BC	
NC	
V	
Total	8

Appendices

Appendices R1: Content and style

Shows DCNL financial ratios.

Shows the DCNL's trend analysis.

Shows DCNL's common size financial statements.

Shows the profitability analysis of the proposed loan.

V	NC	BC	CA	SA
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Appendices R2: Content and style

- Appendices R2: Content and style
- Shows the summary of DCNL's PESTEL.
- Shows the summary of the strengths of DCNL.
- Shows the summary of opportunities in the environment.
- Shows the summary of threats in the environment.

V	NC	BC	CA	SA
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1

Main Report

Report: Structure

Sufficient appropriate headings.

Appropriate use of paragraphs/sentences.

Legible.

Correctly numbered pages.

V	NC	BC	CA	SA
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Report: Style and language

- Relevant disclaimer (external report).
- Suitable language for the board.
- Tactful/ethical comments.
- Acceptable spelling and punctuation.

V	NC	BC	CA	SA
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CC	
SC	
IC	
ID	
NA	
Total	

Deedee T Communications Nigerian Limited
Financial Statements Analysis 2014 - 2016

Income Statement:

	2014		2015		2016		
	N'm	%	N'm		N'm	%	
Revenue	14,693.0	100.0	14,706.0	100.0	14792	100.0	100.0
Other income	<u>793.0</u>	<u>5.4</u>	<u>841.0</u>	5.7	<u>34</u>	<u>0.2</u>	5.4
Gross Profit	<u>15,486.0</u>	<u>105.4</u>	<u>15,547.0</u>	105.7	<u>14,826.0</u>	<u>100.2</u>	105.4
Operating costs:							-
Direct network and technology operating costs	1,635	11.1	1,881	12.8	2,352	15.9	11.1
Costs of handsets and other accessories	1,031	7.0	1,083	7.4	1,230	8.3	7.0
Interconnect and roaming costs	1,365	9.3	1,310	8.9	1,339	9.1	9.3
Staff costs	884	6.0	859	5.8	915	6.2	6.0
Selling, distribution and marketing costs	1,717	11.7	1,841	12.5	1,919	13.0	11.7
Government regulatory costs	575	3.9	589	4.0	519	3.5	3.9
Other operating costs	<u>960</u>	<u>6.5</u>	<u>1,143</u>	7.8	<u>1,427</u>	<u>9.6</u>	6.5
	<u>8,167</u>	<u>55.6</u>	<u>8,706</u>	59.2	<u>9,701</u>	<u>65.6</u>	55.6
EBITDA	<u>7,319</u>	<u>49.8</u>	<u>6,841</u>	46.5	<u>5,125</u>		49.8
Depreciation of properties, plant and equipment	1,826.0	12.4	1,956.0	13.3	2,099	34.6	12.4
Amortisation of intangible assets	325.0	2.2	374.0	2.5	475	14.2	2.2
Impairment of goodwill	<u>203.0</u>	<u>1.4</u>	<u>50.0</u>	0.3	<u>87</u>	<u>3.2</u>	1.4
	<u>2,354</u>	<u>16.0</u>	<u>2,380</u>	16.2	<u>2,661</u>	<u>18.0</u>	16.0

Operating profit	4,965	33.8	4,461	30.3	2,464	16.7	33.8
Net finance costs	<u>367</u>	2.5	<u>301</u>	2.0	<u>1,050</u>	<u>7.0</u>	2.5
	4,598	33.8	4,160	28.3	1,414	9.6	31.3
Net monetary gain	87	0.6	135	0.9	174	1.2	0.6
Share of results of joint venture and associates after tax	<u>421</u>	2.9	<u>123</u>	0.8	<u>-13</u>	<u>0.1</u>	2.9
Profit before tax	5,106	34.8	4,418	30.0	1,575	10.6	34.8
Income tax expense	<u>1,336</u>	9.1	<u>1,132</u>	7.7	<u>835</u>	<u>5.6</u>	9.1
Profit after tax	<u>3,770</u>	25.7	<u>3,286</u>	22.3	<u>740</u>	<u>5.0</u>	25.7

Statement of Financial Position	2014		2015		2016	
	N'm	%	N'm	%	N'm	%
Non-current assets:						
Property, plant and equipment	8,755	34.5	22,904	52.51	20,331	47.2
Goodwill and intangible assets	3,662	14.4	5,589	12.81	10,048	23.3
Investment in joint ventures and associates	2,551	10.1	3,555	8.15	2,667	6.2
Investments	385	1.5	997	2.29	1,184	2.8
other non-current assets and deferred tax	<u>1,354</u>	5.3	<u>1,034</u>	<u>2.37</u>	<u>847</u>	<u>2.0</u>
	<u>16,707</u>	65.9	<u>34,079</u>	<u>78.13</u>	<u>35,077</u>	<u>81.5</u>

Current assets:

Trade and other receivables	981	3.9	1,593	3.65	1,385	3.2
Other current assets	3,281	12.9	4,357	9.99	3,736	8.7
Restricted cash	89	0.4	174	0.40	103	0.2
Cash and cash equivalents	<u>4,310</u>	17.0	<u>3,418</u>	7.84	<u>2,738</u>	<u>6.4</u>
Total current assets	<u>8,661</u>	<u>34.1</u>	<u>9,542</u>	<u>21.87</u>	<u>7962</u>	<u>18.5</u>
Total assets	25,368	100.0	43,621	100.00	43,039	100.0

Equity:

Share capital	5,000	19.7	5,000	11.5	10,000	23.2
Reserves	<u>8,344</u>	32.9	<u>10,184</u>	<u>23.3</u>	<u>5,924</u>	<u>13.8</u>
Total equity	<u>13,344</u>	52.6	<u>15,184</u>	34.8	<u>15,924</u>	<u>37.0</u>

Non-current liabilities

Interest bearing liabilities	3,947	15.6	17,500	40.1	17,500	40.7
Deferred tax and other non- current liabilities	<u>1,314</u>	<u>5.2</u>	<u>1,985</u>	<u>4.6</u>	<u>1,842</u>	<u>4.3</u>
Total non - current liabilities	<u>5,261</u>	<u>20.7</u>	<u>19,485</u>	<u>44.7</u>	<u>19,342</u>	<u>44.9</u>

Current liabilities:

Interest bearing liabilities	1,381	5.4	2,251	5.2	1,964	4.6
Trade and other payables	3,323	13.1	4,048	9.3	4,514	10.5
Other current and tax liabilities	<u>2,059</u>	8.1	<u>2,653</u>	<u>6.1</u>	1,295	<u>3.0</u>
Total current liabilities	<u>6,763</u>	26.7	8,952	20.5	7,773	<u>18.1</u>
Total equity and liabilities	25,368	100.0	43,621	100.0	43,039	100.0

REQUIREMENT 1
APPENDIX 1
Deedee 'T' communications
Trend Analysis - 2014 – 2016
Income Statement

YEARS	2014	2015	CHANGE		2016	CHANGE	
	N'm	N'm	N'm	%	N'm	N'm	%
Revenue	14,693.0	14,706.0	13.0	0.1	14792	86.0	0.6
Other income	793.0	841.0	48.0	6.1	34	(807.0)	-96.0
Gross Profit	15,486.0	15,547.0	61.0	0.4	14,826.0	(721.0)	-4.6
Operating costs:							
Direct network and technology operating costs	1,635	1,881	246.0	15.0	2,352	471.0	25.0
Costs of handsets and other accessories	1,031	1,083	52.0	5.0	1,230	147.0	13.6
Interconnect and roaming costs	1,365	1,310	55.0	4.0	1,339	29.0	2.2
Staff costs	884	859	25.0	2.8	915	56.0	6.5
Sellind, distribution and marketing costs	1,717	1,841	124.0	7.2	1,919	78.0	4.2
Government regulatory costs	575	589	14.0	2.4	519	(70.0)	-11.9
Other operating costs	960	1,143	183.0	19.1	1,427	284.0	24.8
	8,167	8,706	539.0	6.6	9,701	995.0	11.4
EBITDA	7,319	6,841	478.0	6.5	5,125	(1,716.0)	-25.1
Depreciation of properties, plant and equipment	1,826.0	1,956.0	130.0	7.1	2,099	<u>143.0</u>	7.3
Amortisation of intangible assets	325.0	374.0	49.0	15.1	475	<u>101.0</u>	27.0
Impairment of goodwill	203.0	50.0	153.0	75.4	87	<u>37.0</u>	74.0
	2,354	2,380	26.0	1.1	2,661	281.0	11.8
Operating profit	4,965	4,461	504.0	10.2	2,464	(1,997.0)	-44.8
Net finance costs	367	301	66.0	18.0	1,050	749.0	248.8
	4,598	4,160	438.0	9.5	1,414	(2,746.0)	-66.0
Net monetary gain	87	135	48.0	55.2	174	<u>39.0</u>	28.9
Share of results of joint venture and associates after tax	421	123	298.0	70.8	-13	(136.0)	110.6
Profit before tax	5,106	4,418	688.0	13.5	1,575	(2,843.0)	-64.4
Income tax expense	1,336	1,132	204.0	15.3	835	(297.0)	-26.2
Profit after tax	3,770	3,286	484.0	12.8	740	(2,546.0)	-77.5

Statement of Financial Position

	2014	2015	CHANGE		2016	CHANGE	
	N'm	N'm	N'm	%	N'm	N'm	%
Non-current assets:							
Property, plant and equipment	8755	22,904	14,149	161.6	20,331	2,573	11.2
Goodwill and intangible assets	3662	5,589	1,927	52.6	10,048	4,459	79.8
Investment in joint ventures and associates	2551	3,555	1,004	39.4	2,667	888	25.0
Investments	385	997	612	159.0	1,184	187	18.8
other non-current assets and deferred tax	1354	1,034	320	(23.6)	847	187	18.1
	16707	34,079	17,372	104.0	35,077	998	2.9
Current assets:							
Trade and other receivables	981	1593	612	62.4	1385	208	13.1
Other current assets	3281	4357	1,076	32.8	3736	621	14.3
Restricted cash	89	174	85	95.5	103	71	40.8
Cash and cash equivalents	4310	3418	892	(20.7)	2738	680	19.9
Total current assets	8661	9542	881	10.2	7962	1,580	16.6
Total assets	25368	43621	18,253	72.0	43,039	582	1.3
Equity:							
Share capital	5,000	5,000	0	-	10000	5000	100.0
Reserves	8,344	10,184	1840	22.1	5924	-4260	41.8
Total equity	13,344	15,184	1840	13.8	15924	740	4.9
Non-current liabilities							
Interest bearing liabilities	3,947	17,500	13,553	343.4	17,500	0	-
Deferred tax and other non- current liabilities	1,314	1,985	671	51.1	1,842	-143	7.2
Total non - current liabilities	5,261	19,485	14,224	270.4	19,342	-143	0.7
Current liabilities:							
Interest bearing liabilities	1,381	2,251	870	63.0	1,964	-287	12.7
Trade and other payables	3,323	4,048	725	21.8	4,514	466	11.5
Other current and tax liabilities	2,059	2,653	594	28.8	1,295	-1358	51.2
Total current liabilities	6,763	8,952	2,189	32.4	7,773	-1179	13.2
Total equity and liabilities	25,368	43,621	18,253	72.0	43,039	-582	1.3

APPENDIX 2

Deedee 'T' communications

Trend Analysis - 2014 – 2016

Income Statement

YEARS	2014	2015	2016
	%	%	%
Revenue	100.0	100.0	100.0
Other income	5.4	5.7	0.2
Gross Profit	105.4	105.7	100.2
Operating costs:	-		
Direct network and technology operating costs	11.1	12.8	15.9
Costs of handsets and other accessories	7.0	7.4	8.3
Interconnect and roaming costs	9.3	8.9	9.1
Staff costs	6.0	5.8	6.2
Selling, distribution and marketing costs	11.7	12.5	13.0
Government regulatory costs	3.9	4.0	3.5
Other operating costs	6.5	7.8	9.6
	55.6	59.2	65.6
EBITDA	49.8	46.5	34.6
Depreciation of properties, plant and equipment	12.4	13.3	14.2
Amortisation of intangible assets	2.2	2.5	3.2
Impairment of goodwill	1.4	0.3	0.6
	16.0	16.2	18.0
Operating profit	33.8	30.3	16.7
Net finance costs	2.5	2.0	7.1
	31.3	28.3	9.6
Net monetary gain	0.6	0.9	1.2
Share of results of joint venture and associates after tax	2.9	0.8	0.1
Profit before tax	34.8	30.0	10.6
Income tax expense	9.1	7.7	5.6
Profit after tax	25.7	22.3	5.0

Statement of Financial Position

	2014	2015	2016
	%	%	%
Non-current assets:			
Property, plant and equipment	34.5	52.5	47.2
Goodwill and intangible assets	14.4	12.8	23.3
Investment in joint ventures and associates	10.1	8.1	6.2
Investments	1.5	2.3	2.8

other non-current assets and deferred tax	5.3	2.4	2.0
	65.9	78.1	81.5

Current assets:

Trade and other receivables	3.9	3.7	3.2
Other current assets	12.9	10.0	8.7
Restricted cash	0.4	0.4	0.2
Cash and cash equivalents	17.0	7.8	6.4
Total current assets	34.1	21.9	18.5
Total assets	100.0	100.0	100.0

Equity:

Share capital	19.7	11.5	23.2
Reserves	32.9	23.3	13.8
Total equity	52.6	34.8	37.0

Non-current liabilities

Interest bearing liabilities	15.6	40.1	40.7
Deferred tax and other non- current liabilities	5.2	4.6	4.3
Total non - current liabilities	20.7	44.7	44.9

Current liabilities:

Interest bearing liabilities	5.4	5.2	4.6
Trade and other payables	13.1	9.3	10.5
Other current and tax liabilities	8.1	6.1	3.0
Total current liabilities	26.7	20.5	18.1
Total equity and liabilities	100.0	100.0	100.0

APPENDIX 3
RATIOS ANALYSIS
PROFITABILITY

	2014	2015	2016
Operating profit margin	4965/14693% 33.79%	4461/14706% 30.33%	2464/14792% 16.66%
Returns on total assets	5106/25368% 20.13%	4418/43621% 10.13%	1575/43039% 3.66%
Returns on capital employed (ROCE)	5106/18875% 27.05%	4418/18,605% 23.75%	1575/35266% 4.47%
Returns on equity	3770/13344% 28.25%	3286/15184% 21.64%	740/15924% 4.64%
LIQUIDITY			
Current ratio	8661/6763 1.3:1.0	9542/8952 1.1:1.0	7962/7773 1.0:1.0
Quick ratio	8661/6763 1.3:1.0	9542/8952 1.1:1.0	7962/7773 1.0:1.0
cash ratio	4310/6763 0.6:1.0	3418/8952 0.4:1.0	2738/7773 0.4:1.0
ACTIVITY			
Net assets turnover	14693/18875 0.8	14706/34669 0.4	14792/35266 0.4
Non-current assets turnover	14693/16707 0.9	14706/34079 0.4	14792/35077 0.4
Total assets turnover	14693/25368 0.6	14706/43621 0.3	14792/43039 0.3
Average days in receivable	981/14693*365 24days	1593/14706*365 40days	1385/14792*365 34days
SOLVENCY			
Debts to equity	5261/13344% 39.43%	19485/15184% 128.33%	19342/15924% 121.46\$
Debts/equity + debts	5261/18605% 28.30%	19485/34669% 56.20%	19342/35266% 54.85%
Interest cover	4965/367 13.5	4461/301 14.8	2464/1050 2.3

APPENDIX 4
DEEDEE 'T' COMMUNICATIONS NIGERIA
LIMITED

PROJECT VIABILITY

ADDITIONAL REVENUE:	Current value N'000	%Addition	Amount N'000	Probability	Net addition N'000	N'm
Outgoing voice	8,024	30%	2407.2	0.85	2,046	2,046
Incoming voice	1,387	25%	346.75	0.85	295	295
Data	3,955	40%	1582	0.85	1,345	1,345
SMS	324	20%	64.8	0.85	55	55
Devices	806	20%	161.2	0.85	137	137
Others	296	10%	29.6	0.85	<u>25</u>	<u>25</u>
Total additional revenue					<u>3,903</u>	<u>3,903</u>
ADDITIONAL COSTS:						
Direct network and technology operating costs	2,352	20%	470		470	470
Cost of handset and other accessories	1,230	25%	308		308	308
Interconnect and roaming	1,339	25%	335		335	335
Staff costs	915	28%	256		256	256
Selling, distribution and marketing expenses	1,919	12%	230		230	230
Government regulatory costs	519	25%	130		130	130
Other operating costs	1,427	15%	214		<u>214</u>	<u>214</u>
					<u>1,943</u>	<u>1,943</u>
ADDITIONAL FINANCE COSTS:						
Amount of loan		\$150m				
Exchange rate		N350/\$1.0				
Naira amount		<u>N52,500m</u>				
Arrangement fee		1%	N52,500m		525,000	525
Management fee		1%	N52,500m		525,000	525
Interest per annum		16%	N52,500m		<u>8,085,000</u>	<u>8,085</u>
					9,450,000	<u>9,135</u>
Net cash flow					<u>9,135,000</u>	

APPENDIX 1

DEEDEE'T' COMMUNICATIONS NIGERIA LIMITED

PESTLE ANALYSIS

1. POLITICAL

- Terrorist activities in the Northern part of the country.
- Restiveness in the Niger Delta.
- Ethnic agitations.
- Government regulations.
- Government clamp down on users of social media.

2. ECONOMIC

- Scarcity of foreign exchange.
- Volatility of exchange rate.
- Contractions in GDP.
- No economic roadmap.
- High cost of doing business.
- Declining disposable income.
- High unemployment rate – 29.8%.
- Economy in full blown recession.

3. SOCIAL

- Increasing number of people using the social media.
- Increase in the use of mobile computing.
- Increase in the use of smartphones and tablets.
- Increase in the use of internet based payments and money transfers.

4. TECHNOLOGICAL

- Continuing IT technological development is driving the telecom business.
- Smartphones and tablets have potential growth in telecom business.

5. ENVIRONMENT

- Telecom industry generates a lot of e-wastes.
- The rate of carbon intensity is high in the industry.

6. LEGAL

- Need to comply with NCC regulations.
- Need to comply with labour laws.
- Need to comply with the various regulations from all the states where they have their masts.
- NCC's license required.
- Potential new law to clamp down on unwholesome use of social media.

APPENDIX 2

DEEDEE 'T' COMMUNICATIONS NIGERIA LIMITED SWOT ANALYSIS

STRENGTHS:

- Innovative products;
- Initiatives on corporate social responsibility in innovation and academic excellence;
- Fast and reliable internet access;
- Quality service delivery; and
- Built state- of- the- art telecom infrastructure.

WEAKNESSES:

- Declining profitability;
- Lack of fund to rehabilitate and expand networks; and
- High debt profile.

OPPORTUNITIES:

- Increase in development of internet driven IT technology;
- Increasing number of people using smartphones and tablets; and
- Increasing use of internet based payments and money transfers.

THREAT:

- Government's potential clamp down on social media users;
- Terrorist activities in the Northern part of the country; and
- Restiveness in the Niger Delta.

CASE STUDY EXAMINER'S REPORT

The case is based on a telecom company that needs to assess its financial health and requires additional loan facility to finance its planned network rehabilitation and expansion.

Candidates are expected to review Exhibits 2 to 8 and report on:

- a. The company's current financial position, indicating the best way the company could restructure its current loan portfolio and additional loan facility required. The candidates are also to carry out simple profit analysis of the proposed network expansion using the concept of relevant revenues and costs; and
- b. The company's business environments, including the industry and internal environment, to advise the company on how to build on its competencies, ameliorate its weaknesses so as to seize opportunities and avoid threats present in the national and global business environments.

Candidates show partial understanding of the requirements of the case but seem to have forgotten PESTEL as a tool for analysing company's external environment. Therefore, performance was poor as majority of the candidates did not score up to 50%.

The candidates' commonest pitfalls are:

- a. Inability to calculate relevant ratios accurately;
- b. Lack of understanding of how to present trend and common size analyses of the financial statements;
- c. Inability to identify PESTEL and its components from the given scenario;
- d. Inability to apply the principle of relevant revenues and costs in financial decision; and
- e. Inability to write a good report. Most candidates could not distinguish between external and internal reporting.

For future examination, candidates are advised to:

- (a) Familiarise themselves with the principles of report writing;
- (b) Study and review the various strategy and performance management tools;
- (c) Practise with the cases of previous diets before attempting the examinations; and
- (d) Understand that they need the knowledge and the skills they acquired in the other subjects of the examination to succeed in Case Study examination.